Ruling 92-12

Vermont Department of Taxes

Date: October 7, 1992

Written By: Mary L. Bachman, Attorney for the Department

Approved By: Joyce H. Errecart, Commissioner of Taxes

You have requested a formal ruling on the application of Vermont's investment and holding company law which is found at 32 V.S.A. § 5837. This ruling relies on representations contained in your letter of August 10, 1990, as well as subsequent conversations you have had with Tax Department personnel.

The facts are as follows. [(Company)] proposes to locate a company in Vermont [Corporation], the activities of which will be confined to the maintenance and management of the following assets which it will hold: (1) asset-backed securities, which could take the form of Federal Home Loan Mortgage Association (FNMA) pass-through certificates, Government National Mortgage Association (GNMA) pass-through certificates, Federal Home Loan Mortgage Corporation (FHLMC) pass-through certificates, collateralized mortgage obligations (CMO), and asset-backed securities guaranteed by other government agencies or private institutions; (2) mortgage-servicing rights; and (3) rights to trust fees. With respect to mortgage-servicing rights and rights to trust fees, the servicing activities and the trust activities will be subcontracted to and performed by third parties, not by [Corporation]. [Corporation's] maintenance and management of its assets will include the collection and distribution of income thereon and the sale and reinvestment of the proceeds in similar assets.

You have requested a ruling on whether [Corporation's] activities with respect to each of the above-described assets qualify as protected activity within the provisions of 32 V.S.A. § 5837.

32 V.S.A. § 5837 limits the corporate income tax paid by qualifying investment and holding companies to $150. A qualifying company is one "whose activities are confined to the maintenance and management of their intangible investments and the collection and distribution of the income from such investments or from tangible property physically located outside this state." Thus, the statute imposes two limitations. The activities of the company must not exceed those specified by the statute, and the assets held by the company must qualify as well, that is, the assets must be intangibles or tangible property physically located outside of the state.

The asset-backed securities described above conform to the traditional notion of intangible property; the certificates have no intrinsic value but are merely the evidence of value. Such assets are widely traded so that the asset holder is frequently unrelated

to the transaction which gave rise to the asset. Such disassociation does not diminish the value of the asset. A company whose activities are limited to management and maintenance of the kind of asset-backed securities described above is a holding company within the purview of section 5837.

Mortgage-servicing rights and rights to trust fees are simply the entitlement to receive compensation for the performance of services. With respect to the former, such services include the billing and collection of loans and processing of payments. Trust fees are generated through management of investment portfolios. In this case, it is proposed that [Corporation] will subcontract the obligation to perform such services to third parties, retaining only the right to the income generated by those services. This arrangement does not alter the essential fact that the income received by [Corporation] is generated by services. The disassociation of the right to income under a contract and the obligation to perform the services under that contract could not occur in an arm's length transaction because the "right" to income is contingent upon future services. No unrelated party would purchase the right to uncollected income where it acquired no control over the collection of that income. Nor would an unrelated party undertake the obligations of a mortgage servicing contract or contract for trust fees without receiving fair market value for such services. Where entitlement to income is contingent upon future services, that entitlement is not an intangible investment, but is active income. Subcontracting the obligation to perform the services does not alter the nature of the income.

If active income were convertible into intangible investments by the device proposed here, virtually any corporation could become a "holding company" by creating a related corporation, dropping its service obligations into it, and retaining only the right to income generated by such services. Thus income, actively generated, would be sheltered from tax. This would all but abolish the corporate income tax. Had the Legislature intended this result, it is reasonable to believe it would have clearly expressed that intent.

The Vermont statute was modeled on Delaware's holding company statute and Delaware has not found mortgage servicing rights to be a source of passive income. Vermont could certainly adopt a broader view of "intangibles" than Delaware, but in the absence of any indication that the Legislature intended the broad reading urged here, the Department declines to adopt that position.

This ruling is issued solely to your firm and is limited to the facts presented as affected by current statutes and regulations. Other taxpayers may refer to this ruling to determine the Department's general approach, but the Department will not be bound by this ruling in the case of any other taxpayer or in the case of any change in the relevant statute or regulations.