THE STATE OF NEW HAMPSHIRE

HILLSBOROUGH, SS. SUPERIOR COURT
NORTHERN DISTRICT

No. 08-E-484

TRG Holdings Corp. and Affiliates

v.

New Hampshire Department of Revenue Administration

ORDER

TRG Holdings Corp. petitions the court to set aside a determination of the New Hampshire Department of Revenue Administration that TRG is liable for business profits taxes and accompanying interest charges for 2002. By agreement of the parties, the court enters judgment on the basis of stipulated facts.[1] After carefully reviewing the parties' submissions, I affirm the Department's finding.

Background

The parties agree to the following facts. TRG is a Delaware corporation with a place of business in Lewisville, Texas. It filed a New Hampshire 1120 Water's Edge Combined Business Profits tax return for 2002. The water's edge combined group consisted of nine entities, including International Insurance Company (IIC) and RiverStone Resources, LLC (RiverStone).

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[1] The parties initially filed cross-motions for summary judgment. An earlier order (document no. 19) explains the transition from a summary judgment proceeding to one in which the parties authorized the court to enter judgment on the merits. (See also document nos. 21, 22).

IIC was an Illinois corporation in 2002. It discontinued its business as an insurance company in 1987, and began operation as a so-called "run-off" company.

> A run-off is the management of claims disconnected from new policies. These claims are mostly commitments that correspond to old policies written by ceding companies . . . that arise out of inactive or discontinued books of business or operations, or where the reinsured is insolvent.

Larry P. Schiffer, "Insurance Runoff is Big Business," PLI Newsletter, All-Star Briefing, March 24, 2004. [Attached as Exhibit A-1 to Dept's Motion for Summ. J.]. As a run-off, IIC collected premiums on existing policies, but did not issue policies. Its income for 2002 came principally from its investments, which themselves were IIC's reserves against the liabilities of outstanding policies.

In conjunction with oversight by its board of directors, IIC arranged for the management of its investments under separate Investment Management Agreements with two Canadian concerns, Hamblett-Watsa Investment Counsel, Ltd. and Fairfax Financial Holdings Limited. See TRG Memo. on Summ. J., Exhibits B and C to Exhibit 1 (Affidavit of William J. Gillett, 10/26/09) ["Gillett Affid."]. IIC also entered into a Services Agreement with RiverStone Resources, LLC, under which RiverStone conducted IIC's run-off business.

IIC's 2002 interest income and capital gains income on investments was $39,656,541 and $45,476,195 respectively. TRG apportioned none of this income to New Hampshire or any other state. Though IIC filed a tax return in Illinois, the investment income was not taxed there. Illinois apportions investment income of an insurance company on the basis of direct premiums related to Illinois-based property or risk. IIC was not taxed in Illinois because its direct premiums were not from insurance related to property or risk in Illinois. TRG Memo. on Summ. J. at 7.

In 2005, the audit division of the New Hampshire Department of Revenue Administration reviewed TRG's 2002 business profits tax return. It concluded that TRG's unitary group New Hampshire sales apportionment numerator should have included IIC's interest and capital gains income, and issued a Notice of Assessment for additional business tax and interest in the amount of $610,891.71. A department hearings officer rejected TRG's appeal from the auditors' determination, and TRG filed the present petition.

Standard of Review

TRG's appeal is considered *de novo*. RSA 21-J:28-b, IV (2009 supp.). TRG bears the burden of proving what it alleges in its petition – that the Department should not have ascribed interest income and capital gains income of one of its unitary group members to the group's sales apportionment numerator. See Appeal of Steele Hill Development, Inc., 121 N.H. 881, 884 (1981).

Discussion

The case arises in the context of New Hampshire's business profits tax, which is levied at a rate of 8.5% on the taxable business profits of business organizations. Members of a unitary group conducting business activity both in and out of New Hampshire, apportion income between New Hampshire and the other state or states if the activity outside New Hampshire was sufficient for another state to impose a tax. N.H. Admin. Rules, Rev. 304.01(a). See Opinion of the Justices, 128 N.H. 1, 5 (1986). "[A]pportionment of income for tax purposes is not necessary unless a business conducts sufficient business activity in another state to entitle that state to tax a portion of its income." Scott & Williams, Inc. v. Board of Taxation, 117 N.H. 189, 194-95 (1977). See N.H. Admin. Rules, Rev. 304.01 (c); RSA 77-A:3.

The taxpayer calculates the apportionment by identifying (a) activities that generate the income, (b) which of those activities are "income producing," and (c) the costs of performance that relate to each of the income producing activities and where they are performed. By statute, "sales other than sales of tangible personal property are in this state if the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance." RSA 77-A, I (c). An administrative rule defines income-producing activity as "[t]ransactions and activities directly engaged in by the business organization for the ultimate purpose of obtaining gain or profit . . . ." N.H. Admin. Rules, Rev. 301.16 (a). Income-producing activity does not include "[t]ransactions and activities performed for the business organization by independent contractors or other similar persons or entities; . . ." Id., Rev. 301.16(b)(1).

TRG contends the department's assessment is inapt for three reasons. It argues first that even though Illinois did not impose a tax on its investment income, it was subject to tax in Illinois so New Hampshire cannot claim all the income for itself. Second, it says the income-producing activity that produced the investment income did not occur in New Hampshire, but rather in Illinois. Its third argument is that to the extent "income-producing activity" is attributed to RiverStone, the income is not chargeable to IIC because RiverStone is an independent contractor. See N.H. Admin Rules, Rev. 301.16 (b)(1).

A. Whether IIC is Subject to Tax in Illinois

Both sides agree that investment activity generated the income the department seeks to tax. They disagree on whether Illinois has a sufficient connection to the investment income-producing activity such that it would be permissible under the United States Constitution for Illinois to tax the investment income. The department argues that without such a connection, the income is apportioned entirely to New Hampshire.

Whether Illinois may tax IIC "depends on whether or not [IIC] has sufficient contact with the state . . . to bring it within the taxing jurisdiction of that state." Scott & Williams, Inc., 117 N.H. at 195. The requirement of sufficient contact, referred to as a "nexus," is required under both the Due Process and Commerce clauses of the United States Constitution. The Commerce Clause requires a "substantial nexus" with the taxing State, Caterpillar, Inc. v. N.H. Department of Revenue Administration, 144 N.H. 253, 257 (1999), but both sides agree the Commerce Clause analysis does not apply to this case. See TRG Memo at 16-17; Dept. Reply Memo at 2. Therefore, nexus is evaluated under the Due Process Clause alone.

Analysis under the due process clause focuses on "the fundamental fairness of governmental activity" and "whether an individual's connections with the state are substantial enough to legitimate the State's exercise of power over him." Quill Corp. v. North Dakota, 504 U.S. 298, 312 (1992). In order to tax an interstate business, "'due process requires some definite link, some minimum connection, between a state and the person, property, or transaction sought to be taxed.'" Opinion of the Justices, 117 N.H. 749, 757-58 (1977) (quoting Miller Bros. v. Maryland, 347 U.S. 340, 344-45 (1954)). The nexus requirement under the due process clause "is not difficult to satisfy." Opinion of the Justices, 117 N.H. at 758.

"The Due Process Clause places two restrictions on a State's power to tax income generated by the activities of interstate business. First, no tax may be imposed unless there is some minimal connection between those activities and the taxing state. . . . Second, the income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'" Moorman Mfg. Co. v. Bair, 437 U.S. 267, 272-73 (1978), quoting Norfolk & Western R. Co. v. State Tax Commissioner, 390 U.S. 312, 325 (1968). The inquiry "is whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state – that is, whether the state has given anything for which it can ask return." MeadWestvaco Corp. v. Illinois Dept. of Revenue, 553 U.S. 16, 24 (2008). Accord Scott & Williams, Inc., 117 N.H. at 195. See Edward G. Zelinsky, *Rethinking Tax Nexus and Apportionment's Voice, Exit and the Dormant Commerce Clause*, 28 Va. Tax. Rev. 1, 23 (Summer 2008) ("For tax purposes, Due Process is understood in economic terms with no requirement that the taxpayer be physically present in the taxing state, as long as the taxpayer has deliberately utilized the taxing state's market and is thus unsurprised to be taxed there.").

This case presents the unusual circumstance of a business arguing it has a sufficient connection with a state such that it may be taxed by that state. TRG cites several facts that support a nexus with Illinois. It was an "Illinois domiciled insurer" in 2002 and made a number of required filings with the Illinois Department of Insurance. TRG Memo. on Summ. J., Exhibit 1, Gillett Affid., ¶ 1. On December 13, 2002, the Director of the Illinois Department of Insurance certified the merger of IIC (which the certificate describes as "a company organized and existing under and by virtue of the laws of the State of Illinois"), with a California insurer.

Two Canadian entities provided investment services to IIC under investment guidelines imposed by Illinois statute. Id., ¶ 5. In 2002, IIC's Board of Directors met in Chicago three times to review and approve investment transactions. Id. IIC also had approximately $80 million in reserves for runoff policies with insured risks located in Illinois, TRG Memo. on Summ. J. at 20, and it filed a 2002 Illinois Corporation Income and Replacement tax return. Id., Exhibit 3-A.

The court finds that IIC has the necessary minimum contact with Illinois to provide a nexus for tax purposes. Its directors meetings in Chicago in aid of investment decisions, as well as IIC's other involvement with the state show that Illinois was not completely disconnected from IIC's generation of investment income. IIC's contacts with Illinois are more than *de minimis*, and considerations of due process would not bar Illinois from taxing IIC's investment income.

B. Whether IIC's Business Profits Should Be Apportioned to New Hampshire

Even though Illinois has enough of a connection with IIC to tax its investment income, RSA 77-A:3, I(c) provides that the income may still be taxed in New Hampshire if the income-producing activity was performed in a "greater proportion . . . in this state than in any other state, based on costs of performance." "Costs of performance" are the "direct costs of providing the service or activity determined in a manner consistent with generally accepted accounting principles and in accordance with practices prevalent in the trade or business of the organization." N.H. Admin Rules, Rev. 301.09. Therefore, New Hampshire may tax IIC's investment income if a greater proportion of the direct activities and direct costs relating to IIC's income-producing activity occurred here.

The income-producing activity at issue is that which yielded IIC's investment income. TRG asserts that IIC is not subject to tax in New Hampshire for two reasons. First, the income-producing activity relied upon by the department was that of an independent contractor – RiverStone – which the administrative rule places outside the scope of "income-producing activity" by IIC. Second, TRG says that to the extent there was income-producing investment activity, it occurred primarily in Illinois and not in New Hampshire.

1. TRG asserts that if the conduct of RiverStone was "income-producing," it falls outside the definition because RiverStone was an independent contractor. At the time TRG filed its 2002 tax return, the Department's administrative rules defined an independent contractor as

> a person who:
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> (a) Exercises an independent employment;
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> (b) Contracts to do work for multiple business organizations according to his own judgment and methods and without being subject to any employer except as to the results of the work; and
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> (c) Has the right to employ and direct the action of other workmen independently of such employer and freed from any superior authority to say how the specified work will be done; or
>
> (d) Has been granted independent contractor status by the Internal Revenue Service for federal income tax purposes.

N.H. Admin. Rules, Rev. 301.17 (2002). See Vector Marketing v. N.H. Dept. of Revenue Administration, 156 N.H. 781, 784 (2007).

The rule's definition of independent contractor changed in 2006 to require that other business organizations with which the entity had contracts be unrelated parties. Vector Marketing, 156 N.H. at 785; N.H. Admin. Rules, Rev.

301.17 (b) (2006). A preliminary issue is whether administrative rule 301.17 should be applied as it existed in 2002 or as it is written now. Which version applies is significant, because TRG argues that RiverStone contracts to do work for other organizations. As these other organizations appear to be "related parties," this fact would nullify the significance of those other contracts in evaluating whether RiverStone is an independent contractor under the present rule.

The State Supreme Court found the rule's revision to be a "clarification" of the prior rule rather than a substantive change. Vector Marketing, 156 N.H. at 789. "Generally, substantive changes to statutes or rules are applied prospectively," In re Appeal of Morrill, 145 N.H. 692, 705 (2001), but "[a] rule clarifying an unsettled or confusing area of the law 'does not change the law, but restates what the law according to the agency is and always has been.'" Orr v. Hawk, 156 F.3d 651, 654 (6th Cir. 1998) (quotation omitted). TRG argues that the Supreme Court did not purport to consider the amended rule as it pertained to related or unrelated parties, but only whether the prior rule required a party claiming independent contractor status to prove the entity worked for more than one principal. See Vector Marketing, 156 N.H. at 784. I agree it overstates Vector Marketing's analysis to say that the rule has always said other principals with which the entity contracts must be unrelated in order for the entity to meet the definition of "independent contractor." Accordingly, the issue is reviewed under the rule as it was in 2002.

TRG concedes RiverStone has not been "granted independent contractor status by the Internal Revenue Service for federal income tax purposes." TRG Memo at 24. Therefore, TRG must prove that RiverStone meets paragraphs (a), (b) and (c) of the rule in order to establish that RiverStone was an independent contractor such that its income-producing activity is not attributable to IIC. Vector Marketing, 156 N.H. at 789.

TRG argues for application of the "totality of the circumstances" test employed by courts in this state to determine independent contractor versus employee status. See Boissonnault v. Bristol Federated Church, 138 N.H. 476, 478 (1994) (noting adoption of test and that it includes consideration of factors in *Restatement (Second) of Agency* § 220 (1958)). TRG contends such an analysis is consistent with the test devised by the Internal Revenue Service to assess whether an entity is an independent contractor under 15 U.S.C. § 381 (d)(1), which itself provides guidance in interpreting Rev. 301.17. See Vector Marketing, 156 N.H. at 789; TRG Memo. at 24. Accord, Herff Jones Company v. State Tax Commissioner, 430 P.2d 998, 1000 (Or. 1967) (looking to state case law to define "independent contractor."). I accept that this analysis may be employed, but find under the totality of the circumstances that RiverStone's relationship with IIC is not that of an independent contractor.

The Department argues that RiverStone is not an independent contractor for two reasons that I consider here. First, it points out that IIC and RiverStone are part of the same unitary business. An independent contracting relationship in that setting is "counterintuitive," it says. Second, it notes the substantial overlap in the management and property of IIC and RiverStone, as well as in the services each offers. As to the Department's first argument, TRG counters that other courts faced with similar assertions of independent contractor status in the context of a unitary business have not found the unitary business relationship disqualifying *per se*. See e.g., Reader's Digest Association, Inc. v. Franchise Tax Board, 115 Cal. Rptr. 2d 53, 94 Cal. App. 4th 1240 (Cal. App. 2001). The Department's "counterintuitive" argument is not implausible, but its stronger evidence in opposition to RiverStone's status as an independent contractor is the close connection between IIC and RiverStone.

There is little that separates IIC from RiverStone. IIC acknowledged in its Illinois tax return that its principal place of business is in New Hampshire and that it keeps its books and records in Manchester. Its letterhead uses the same Manchester address as RiverStone and RiverStone operates from property leased in the name of IIC. Gillett Affid., ¶ 8. Either IIC uses RiverStone's offices as its principal place of business, or RiverStone uses IIC's offices for its work. While it is not entirely clear which is the case, either scenario militates against independent contractor status. See *Restatement*, supra, § 202 (2) (e); Tonka Corporation v. Commissioner of Taxation, 169 N.W. 2d 589, 594 (Minn. 1969) (principal's use of agent's office a factor in finding agent was not independent contractor).

Other factors working against TRG include the Service Agreement, which directs that IIC and RiverStone may provide essentially the same services to each other. This suggests that RiverStone is not in a business distinct from that of IIC. See *Restatement*, supra, § 202 (2)(b)). Moreover, the work RiverStone performs for IIC is, for all practical purposes, the run-off business of IIC. Id. § 202 (2) (h), (j). Given the nature of the relationship, TRG has not established RiverStone is an independent contractor.

2. TRG's second argument is that even if RiverStone is not an independent contractor, the activity resulting in the investment income and the corresponding costs of performance occurred primarily in Illinois where the board of directors met three times in 2002 to discuss investment issues, or even in Canada where Hamblett-Watsa and Fairfax managed the investments. It argues that these were the primary costs of performance and as they occurred outside New Hampshire, the income generated should be apportioned elsewhere.

I agree with the Department that TRG did not prove IIC's investment income was due primarily to its activity in Chicago, as opposed to the regular activity of its officers and RiverStone employees in New Hampshire. TRG concedes some direct activity by RiverStone relating to the generation of investment income when RiverStone communicated between IIC's board and the investment managers. Gillett Affid. ¶¶ 3, 6. It describes this work as "ministerial" and "*de minimis*." Id., ¶ 3. However, IIC's investment portfolio was the reserves it held against risks from runoff policies managed in New

Hampshire. IIC's directors were also RiverStone employees working in New Hampshire. It is fair to infer that their risk protection strategies affected investment decisions.

While IIC's directors met in Illinois, they also discussed investment matters in Manchester. See Dept. Memo., Exhibit M, Audit Committee Minutes, 10/28/02. As noted earlier, IIC acknowledged on its Illinois tax return that its business was directed and managed principally in New Hampshire and that it kept its books and records here. In view of the foregoing, TRG has not established that the direct costs of its income-producing activity were incurred primarily outside New Hampshire.

Conclusion

For the reasons given, the decision of the Department is affirmed and the petition dismissed.

SO ORDERED.

Date: August 2, 2010

Brian T. Tucker
Presiding Justice