Corporate Excise Tax

Legislative Developments

Market sourcing and throwout enacted, effective January 1, 2014:

On July 24, Massachusetts enacted legislation replacing Massachusetts' current cost-of-performance sourcing regime for receipts from sales, other than sales of tangible personal property. The new law implements a market-sourcing and a throwout rule for sales, other than sales of tangible personal property, for tax years beginning on or after January 1, 2014.

Under the new market-sourcing rule, receipts for the following classes of sales are included in a taxpayer's sales factor numerator as follows:

- Sales, rentals, leases or licenses of real property are sourced to Massachusetts if the property is located in the Commonwealth
- Rentals, leases or licenses of tangible personal property are sourced to Massachusetts if and to the extent that the tangible personal property is located in the Commonwealth
- Sales of services are sourced to Massachusetts if the service is delivered to a location in the Commonwealth
- Leases or licenses (including sales) of most types of intangible property are sourced to Massachusetts if the intangible property is used in the Commonwealth
- Sales of intangible property, where the property sold is a contract right, government license or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area, are sourced to Massachusetts if the intangible property is used in or otherwise associated with the Commonwealth
- Any receipts from intangible property not falling under (iv) or (v) above are excluded from the sales factor
- The July 24 legislation also institutes a throwout rule for certain sales. Under this rule, sales are excluded from the sales factor completely if the taxpayer is not taxable in a state to which a sale is assigned under the new market-sourcing rules, or if the state to which such sales should be assigned cannot be determined or reasonably approximated. Ch. 46, Acts of 2013, amending G.L. c. 63, section 38(f).

Utility excise tax repealed, losses do not carry forward:

The Transportation Finance Act repeals G.L. c. 63, section 52A. For taxable years beginning before January 1, 2014, G.L. c. 63, section 52A imposes a public utilities excise of 6.5 percent of net income. For tax years beginning on or after January 1, 2014, utility companies formerly

subject to the public utilities excise tax will be taxed as business corporations for corporate excise tax purposes. Public utilities will be subject to tax on the sum of (1) 8 percent of net income; plus (2) $2.60 per $1,000 of value of taxable tangible property located in Massachusetts. Utility companies formerly subject to the public utilities excise tax will also be able to carry forward losses generated in taxable years beginning on or after 2014. Under G.L. c. 63, section 52A, utility companies could not carry losses forward. However, any losses incurred for years prior to 2014 will not be available to be carried forward. Ch. 46, Acts of 2013.

FAS 109 deduction postponed again:

When Massachusetts adopted combined reporting for tax years beginning on or after January 1, 2009, unitary businesses that experienced a resulting increase in deferred tax liability were to be allowed an “FAS 109” deduction. The “FAS 109” deduction was to be taken over seven years, beginning in taxable year 2014; however, under the Fiscal Year 2014 Budget, the “FAS 109” deduction cannot be claimed until taxable year 2015. Ch. 38, Acts of 2013.

Community investment tax credit established:

A Community Investment Credit may be claimed by individuals or corporations that make qualified investments in community developments. The credit is equal to 50 percent of the qualified investment. If any credit balance remains, the taxpayer may choose to have it refunded or to carry it forward five years. G. L. c. 62, section 6M; G. L. c. 63, section 38EE.

Extension of brownfields credit:

The Fiscal Year 2014 Budget extends the Brownfields Credit through 2018. (It was originally set to expire in August 2013.) The credit is available to individuals, corporations, and tax-exempt organizations that incur eligible costs to remediate a hazardous waste site on property used for business purposes and located within an economically distressed area. The credit is equal to 50 percent or 25 percent of costs associated with the project, and is also transferrable. Ch. 38, Acts of 2013.

Judicial Developments

Add-back and cash management company interest payments:

The Massachusetts Appeals Court upheld a decision of the Appellate Tax Board (“ATB”) denying Kimberly-Clark interest deductions for interest payments attributable to a cash-management system. The appeal involved interest deductions for a three-year period, including a tax year (2001) before the adoption of the statutory add-back for related-party interest, and two tax years (2002-2003) after the adoption of the statutory interest add-back.

Prior to the enactment of the statutory interest add-back, taxpayers had to establish by the preponderance of the evidence that their interest payments were for obligations deemed to be "true debt." Kimberly-Clark provided a sample executed loan agreement with one of its subsidiaries, sample promissory notes, and proof that the interest rate paid was considered "arm's length" for purposes of I.R.C. section 1274(d). The court, however, found that the evidence did not support Kimberly-Clark's contention because: (1) the loan agreement and promissory notes did not require security or collateral, and did not address the possibility of default by one of the parties; (2) Kimberly-Clark never repaid the principal on the loans, despite the fact that the due date had passed for the promissory notes provided as evidence; and (3) Kimberly-Clark used the same interest rate for all subsidiaries. Accordingly, the court disallowed Kimberly-Clark's interest deductions attributable to its cash-management system for the 2001 tax year.

For the 2002-2003 tax years, Massachusetts' related party interest add-back statute was in effect. For those years, the court held that there was no change in Kimberly-Clark's facts, and that the "true debt" standard still applied. The only difference was that under the add-back statute, Kimberly-Clark had an even *greater* evidentiary burden: it was required to establish that the obligations under its cash-management system were true debt through "clear and convincing evidence,"—*instead of the former* "preponderance of the evidence" standard.[1] Since Kimberly-Clark did not meet the lower standard in effect for the years before the statutory add-back went into effect, it could not meet the higher standard for the add-back years.

On January 31, Kimberly-Clark filed an application for further appellate review with the Supreme Judicial Court, which was denied March 1, so the decision is now final. *Kimberly-Clark v. Commissioner*, 2013 WL 119778 (Mass. App. Ct. 2013); application for further appellate review denied 464 Mass. 1107 (2013).

[1] G. L. c. 63, section 31J(a)(1).

Royalty add-back under sham transaction doctrine:

The Appeals Court also upheld the ATB's add-back of deductions claimed by Kimberly-Clark for royalty payments made to affiliates on the basis that the payments were the result of sham transactions. As part of a 1996 reorganization, Kimberly-Clark transferred all patents to a newly created affiliate, Worldwide. Under the licensing agreement, Worldwide gave Kimberly-Clark a license to use the trademarks in exchange for a royalty of 3 percent of sales. Worldwide, in turn, swept the cash back up to Kimberly-Clark under the cash-management system discussed above. The ATB found that the commissioner was justified in adding back the royalty payments to Worldwide, because Kimberly-Clark could not show that tax was not a principal purpose of the 1996 restructuring. The ATB based its decision on the dominant role played by tax personnel in the reorganization, and on the fact that Worldwide did not enter into any third-party licensing agreements.

The Appeals Court affirmed the ATB's decision, holding that Kimberly-Clark failed to meet the burden of showing that tax was not a principal purpose of the transfer of the patents to Worldwide and the resulting royalty payments to Worldwide. Although the court noted that there may have been other reasons to justify the restructuring, the court viewed the royalty transactions separately for purposes of applying the sham-transaction doctrine. The sham-transaction doctrine gives the commissioner the power to disregard transactions that have no economic substance of business purpose other than tax avoidance. *See Sherwin-Williams Co. v. Commissioner*, 438 Mass. 71 (2002). According to the court, the royalty payment transactions lacked economic substance because the royalty payments were ultimately returned to Kimberly-Clark under the cash-management scheme, and because Worldwide did not license the intangible property to any third parties. These findings were sufficient for the court to distinguish Kimberly-Clark's facts from those underlying the taxpayer's victory in *Sherwin-Williams*. Additionally, the Department provided statements that a purpose of the 1996 reorganization was to produce significant tax savings. Based on these factors, the court determined that Kimberly-Clark did not meet its burden of proving the economic substance of the transfer of the patents to Worldwide, and affirmed the ATB decision.

On January 31, Kimberly-Clark filed an application for further appellate review with the Supreme Judicial Court, which was denied March 1, so the decision is now final. *Kimberly-Clark v. Commissioner*, 2013 WL 119778 (Mass. App. Ct. 2013); application for further appellate review denied 464 Mass. 1107 (2013).

Interest deductions on intercompany debt:

The ATB issued another decision denying true debt treatment for an intercompany obligation. The ATB upheld assessments denying National Grid's interest deductions for payments under deferred subscription arrangements ("DSAs") on the basis that the DSAs did not qualify as true

debt.[2] The ATB also upheld the Department's decision to add back the DSAs in computing National Grid's net worth, which resulted in additional tax under the net worth component of Massachusetts' corporate excise tax.

The DSAs were refinancing instruments used by National Grid as part of its purchase of several U.S. energy companies. When National Grid purchased a U.S. energy company, it would initially finance the purchase with a loan from the global parent of the affiliated group, a UK entity ("UK Parent").

After a corporate reorganization to integrate a newly acquired company, National Grid would become the obligor under the loan from UK Parent. National Grid would then enter into a DSA with an affiliated special purpose entity ("SPE"), whereby it agreed to purchase shares in the SPE. The DSA would require National Grid to make a small initial payment, and then agree to make "call payments" to the SPE equal to the amount of the initial loan from the UK Parent, plus additional amounts. National Grid characterized these additional amounts as interest payments, and characterized the DSAs as debt.

National Grid would then sell its shares in the SPE to a different affiliate for an amount that permitted repayment of the loan to UK Parent, but National Grid would retain its obligation to make the call payments pursuant to the DSAs.

National Grid treated the DSAs as debt when computing its net worth, and deducted payments under the DSAs as interest in computing its federal taxable income. This treatment was consistent with the characterization of the DSAs as debt in National Grid's financial statements and filings with the U.S. Securities and Exchange Commission. While the DSAs were not in the form of traditional loan documents, National Grid argued that, in substance, they operated as debt because: (1) they had a fixed maturity date; (2) the SPE had a legally enforceable right to the call payments; and (3) there were penalty interest and other enforcement mechanisms that the SPE could employ if National Grid did not make the call payments. Furthermore, National Grid did

[2] The appeals involved three affiliated entities; for purposes of this outline, we are referring to the three entities collectively as "National Grid."

ultimately make call payments equal to the initial loan amount from UK Parent, plus additional amounts that it argued were "interest" payments that reflected interest it would have been charged if it had financed the transaction through a third-party loan.

The Department, however, issued assessments characterizing the DSAs as equity, rather than debt. This resulted in a significant increase in the taxpayer's net income, by disallowing the interest deduction for DSAs claimed on the taxpayer's federal and Massachusetts returns, as well as a significant increase in the taxpayer's tax base for the net worth portion of its tax.

The ATB ultimately rejected the taxpayer's argument that the DSAs should be treated as debt and found in favor of the Commonwealth.[3]

The ATB has indicated that it will be issuing Findings of Fact and Report, at which point the taxpayer can appeal. Given the weeks of trial testimony and voluminous exhibits, we expect that it will take the ATB some time before it is able to publish its written determination. *National Grid Holdings, Inc., et. al. v. Commissioner*, Appellate Tax Board, Docket No. C292287-9 (Findings of Fact and Report pending).

Appeals Court also denies interest deductions on intercompany transfers:

The Appeals Court upheld the ATB's decision denying interest deductions on loans resulting from intercompany transfers. The court held that payments transferred between Sysco and its wholly owned subsidiaries under a cash-management system were not the result of true debt. For an intercompany transfer to be considered a loan instead of a dividend, at the time of making the transfer, the recipient must intend to repay the "loan." In this case, the Appeals Court held that there was insufficient proof that Sysco intended to repay the advances from its subsidiaries and, as a result, the transfers were dividends—not loans. Accordingly, the interest deductions claimed by Sysco were denied. *Sysco Corp. v. Commissioner, Massachusetts Appeals Court*, Docket No. 11-P-2108, April 30, 2013, application for further appellate review denied 465 Mass. 1109 (2013).

---

[3] The ATB did rule for the taxpayer regarding the treatment of an intercompany loan (separate from the DSA) as debt. The Department had conceded this issue in its brief.

Taxpayer cannot escape manufacturing classification by outsourcing manufacturing process to third party:

Massachusetts requires corporations classified as manufacturing corporations to use a single-sales-factor apportionment formula, rather than the standard three-factor apportionment formula applied to most other business corporations. The ATB confirmed that a taxpayer can be a manufacturer, even if a third party actually produces the product that it sells to customers. Random House, a book publisher, worked closely with independent authors to create a final draft of a book to be published, and then worked with a third party to design and format the book layout. The design and format were completed electronically and then transmitted to a third-party printer. While the tangible books had to be printed to Random House's specifications, the actual printing of the tangible books was done by the third-party printer.

Following the reasoning in the prior decision in *Commissioner v. Houghton Mifflin Co*., 423 Mass. 42 (1996), the ATB held that Random House was a manufacturer—even though the third-party printer produced the physical books. While the statutory definition of "manufacturing corporation" requires that a taxpayer be engaged in transforming *physical* materials into a new product, the ATB, relying on its prior decisions, determined that the manufacturing company itself need not actually transform the physical materials. Designing a product and setting the specifications for it to be produced, and then directing a third party to transform materials into the specified product, is sufficient for a corporation to be classified as a manufacturer. *Random House, Inc. v. Commissioner*, Mass. Appellate Tax Board, Docket No. C303502 (October 2, 2012).

Tax credits for Massachusetts property investments:

The Commonwealth offers manufacturing corporations an investment tax credit equal to three percent of the cost or other basis of eligible property situated in and used in Massachusetts. Random House argued that basing the investment tax credit solely on the cost of eligible property located in Massachusetts results in an unfair competitive advantage for Massachusetts' businesses, thereby violating the Commerce and Due Process clauses of the United States Constitution.

The ATB dismissed this argument, finding that the credit was available to both domestic and foreign corporations, and thus did not discriminate based on domicile. *Random House, Inc. v. Commissioner*, Mass. Appellate Tax Board, Docket No. C303502 (October 2, 2012).

Securitization entity qualifies as financial institution:

The ATB issued a decision that provides insight into the treatment of bankruptcy remote entities that are necessary for securitization transactions. The appeal involved Gate Holdings, a wholly owned subsidiary of First Marblehead Corporation. Gate Holdings held beneficial interests in trusts holding securitized student loans initially issued by third parties. The Department

contended that Gate Holdings did not qualify as a "financial institution" for corporate tax purposes. The ATB held:

- *Purchasing loans is a "lending activity."* A taxpayer qualifies as a financial institution for corporate excise tax purposes if, among other activities, it is engaged in a "lending activity" that is in "substantial competition" with other financial institutions. While Gate Holdings and its trusts did not issue loans to the public, the ATB found that Gate Holdings was engaged in a lending activity because the trusts it owned purchased and held student loans.

- *Expansive definition of "substantial competition."* In interpreting the "substantial competition" requirement, the ATB found that banks also engaged in similar transactions involving the securitization of loans, and that such transactions facilitated lending by the banks. The ATB further noted that the purchase and securitization of loans by Gate Holdings and its affiliates reduced the investment opportunities available to other banks and financial institutions. Thus, the ATB determined that Gate Holdings and its affiliates were in substantial competition with other financial institutions. The ATB rejected the Department's argument that the "substantial competition" prong was satisfied only if the taxpayer directly competed with other financial institutions to purchase the specific loans in its portfolio.

The taxpayer has appealed the ATB's decision to the Appeals Court. The Appellant filed its opening brief on July 22. The next brief is due November 22. *First Marblehead Corp. & Gate Holdings, Inc. v. Commissioner,* Mass. Appellate Tax Board, Docket Nos. C293487, C305217, C305240, C305241 (April 17, 2013).

ATB applies economic nexus analysis in determining whether taxpayer is eligible for apportionment, but does not take into account activities of third-party contractors:

The *First Marblehead/Gate Holdings* decision, see I.B.7 above, also provided guidance regarding a financial institution's eligibility for apportionment and the sourcing of the institution's loan portfolio for property factor purposes. Significantly, the ATB held:

- *Economic nexus standard applied to determine whether taxpayer is "taxable" in another jurisdiction*: Gate Holdings had no payroll or receipts, and no property other than the student loans it purchased. Nonetheless, the ATB held that Gate Holdings was entitled to apportion its income because it held loans made to borrowers in all 50 states, and the presence of those borrowers would permit those other states to impose tax on Gate Holdings—presumably under Massachusetts' economic nexus

standard.

- *Third-party activities are not considered in sourcing loans for property factor purposes*: For financial institutions, a loan is included in the property factor and sourced to the regular place of business where the preponderance of the "SINAA" activities occur with respect to the loan.[4] Gate Holdings argued that in determining where the SINAA activities occurred with respect to its loans, it should be permitted to take into account the location of activities conducted by the third-party loan servicers under contract with Gate Holdings. The ATB rejected this argument because it did not consider the loan servicers to be agents of Gate Holdings. Instead, the ATB concluded that Gate Holdings did not have a regular place of business, either inside or outside Massachusetts, and sourced the loans to Gate Holding's commercial domicile in Massachusetts.

- *Third-party activity insufficient to establish nexus*: The taxpayer argued that activities of its third-party loan servicers were sufficient to cause Gate Holdings to be subject to tax in states other than Massachusetts. The ATB rejected this argument on the basis that no agency or other relationship existed between Gate Holdings and the third parties sufficient to attribute the activities of the servicers to Gate Holdings. If the ATB had not rejected this argument, the Department could have used the same theory to assert that out-of-state taxpayers were similarly "taxable" in Massachusetts based on the Massachusetts activities of unrelated third parties, based merely on the fact that those third parties were paid by the taxpayers.

First Marblehead Corp. & Gate Holdings, Inc. v. Commissioner, Mass. Appellate Tax Board, Docket Nos. C293487, C305217, C305240, C305241 (April 17, 2013).

---

[4] The SINAA activities with respect to a loan are solicitation, investigation, negotiation, approval, and administration. *See* G.L. c. 63, section 2A(e)(vi)(3)(C).

Sham transaction doctrine and nexus:

The ATB applied the sham transaction doctrine to determine that an affiliate with substantial losses lacked nexus with Massachusetts. Prior to the tax years at issue, the taxpayer, Allied Domecq Spirits and Wines, was the principal reporting corporation in a combined group filing Massachusetts corporate excise tax returns. The taxpayer reported net income apportioned to Massachusetts on these returns. The taxpayer was a subsidiary of another corporation ("Parent"). Parent did not have sufficient nexus with Massachusetts to be included in the Massachusetts combined group with the taxpayer. Parent generated substantial losses each year. In order to make Parent's losses available to offset the income of the Massachusetts combined group, the taxpayer caused certain Massachusetts employees to be transferred to Parent, and subleased, through a subsidiary, Massachusetts office space to Parent. As a result of these arrangements, the taxpayer treated Parent as having nexus with Massachusetts, and included Parent in the Massachusetts combined group. This maneuver allowed the taxpayer to offset its taxable income with the losses generated by Parent.

In a further expansion of the sham-transaction doctrine in Massachusetts, the ATB agreed with the Department's determination that both the employee transfer and the sublease arrangement were shams, and thus upheld Parent's exclusion from the Massachusetts combined group.

The ATB determined that the employee transfer was a sham, in part, because the employee transfer had no valid, non-tax business purpose. In reaching this conclusion, the ATB focused on a damning internal memorandum indicating: (1) that state tax savings was the purpose of the transfer; and (2) that the employee transfer could be accomplished with no effect on the business.

The taxpayer has appealed this decision to the Massachusetts Appeals Court. The Appellant filed its opening brief on September 4. The next brief is due November 1. *Allied Domecq Spirits and Wines USA, Inc.*, Mass. Appellate Tax Board, Docket Nos. C282807, C293684, and C297779 (May 27, 2013).

Administrative Developments

The Department formalizes its policy on the operational approach to cost of performance:

On August 20, the Department issued a *Technical Information Release* ("TIR") announcing that AT&T,[5] which applied an operational approach to cost of performance sourcing, was not broadly applicable. In other words, the Department will continue to challenge taxpayer attempts to apply an operational approach to source receipts outside Massachusetts on an "all or nothing basis."

With this TIR, the Department has formalized its policy of applying different standards depending on each taxpayer's unique facts. Taxpayers are left on their own to determine whether the transactional approach is "arduous" or "impossible"—the only guidance provided for when the operational approach is necessary. *Technical Information Release 13-12*: *Commissioner of Revenue v. AT&T Corporation* (August 20, 2013).

Combined reporting: Department defines "voting control":

In a Letter Ruling, the Department concluded that the term "voting control," as used in 830 CMR 63.32B.2(2), means control over the elections of a majority of a corporation's board of directors. The Department ruled that if a shareholder has voting control over two corporations, those two corporations are under common ownership, and must therefore be combined for purposes of the corporate excise tax under G.L. c. 63, section 32B.

In the ruling, the corporate taxpayer and a separate corporate entity ("Corp. Y") had identical corporate structures. Each had two classes of stock: common stock and Class B stock. One share of common stock entitled the holder to one vote; one share of Class B stock entitled the holder to 10 votes. Each corporation's board comprised ten directors: three were elected solely by common stock holders; the other seven were elected by all stock holders. Voting was noncumulative. A shareholder held substantial stakes in both corporations. The shareholder

---

[5] *AT&T Corp. v. Commissioner*, Mass. Appellate Tax Board, Docket No. C293831 (June 8, 2011) *aff'd* Mass. App. Ct., Docket No. 11-P-1462 (July 13, 2012).

owned 22 percent of taxpayer's common stock and 57 percent of its total number of votes. The shareholder also owned 22 percent of Corp. Y's stock and 64 percent of its total votes.

Distinguishing the term "voting control" from the term "voting power" as used under I.R.C. section 1504(a)(2), the Department concluded that "voting control" means control over a board of directors. Under the facts presented by the taxpayer, the shareholder—with a majority of votes in a noncumulative voting format—controlled seven of ten board seats for each corporation. The shareholder thus had 70 percent voting control of both corporations. Accordingly, the Department concluded that the two corporations must be combined for purposes of the corporate excise tax. Letter Ruling 13-7: Combined Reporting—Corporations Under Common Ownership (September 20, 2013).

New pass-through withholding regulations adopted:

The Department adopted new regulations regarding pass-through entity withholding. The new regulations replace the existing regulations. Among the notable changes are:

- **New Exempt Entities:** Publicly traded partnerships and entities prohibited from withholding tax on member distributions under federal or state law are exempt from pass-through entity withholding
- **New rules for Exempt Members:** A member's exemption certificate remains in effect until revoked by the member. If the member's status changes during the tax year, a new exemption certificate must be obtained within 30 days.
- **Qualified Securities Partnerships:** The regulations add the definition of Qualified Securities Partnership, and exempt withholding on behalf of nonresident limited partners in Qualified Securities Partnerships to the extent the partner's distributive share is not subject to tax in Massachusetts
- **Good faith exception to joint and several liability:** A pass-through entity that reasonably relies, in good faith, on an exemption certificate provided by a member shall not be liable for failure to withhold. However, joint liability exists in any instance where the member holds more than a 50 percent interest in the pass-through entity.
- **Penalties for failing to properly allocate distributive share:** The regulations allow for additional penalties if a pass-through entity fails to properly allocate distributive shares to each members as required

830 CMR 62B.2.2, amended effective August 2, 2013.

Life science company credits:

The Department has issued a *Technical Information Release* to provide rules explaining the requirement to recapture two tax incentives received by a certified life sciences company whose

certification is subsequently revoked by the Massachusetts Life Sciences Center ("Center"): the refundable research credit[6] and the refundable life sciences investment tax credit.[7]

In general, certification granted by the Center is valid for five years starting with the tax year in which the certification was granted. However, the certification may be revoked if it is determined that representations made by a certified company in its certificate proposal materially differ from the actions of the company following certification. When the certification is revoked, the company must recapture any credits, exemptions, deductions, or other benefits allowed under the original certificate.[8] *Technical Information Release 13-6:* Calculation and Recapture of Certain Tax Incentives from Decertified Life Sciences Companies (April 9, 2013).

Charitable Contributions do not endanger "security corporation" classification:

In a Letter Ruling, Massachusetts concluded that a "security corporation" can make charitable donations of securities while maintaining its "security corporation" designation. This ruling does not allow a security corporation to receive any tax benefit from the donation, but merely treats the donation as a permissible business activity for purposes of determining the corporation's status as a security corporation. Letter Ruling 13-1: Permissibility of Charitable Contribution by a Security Corporation (February 4, 2013).

Hot Issues for 2013 and Beyond

Cost of performance litigation continues:

Consistent with the Department's pronouncement in TIR 13-12 that the AT&T decision is limited in its applicability, the Department continues to assert this position in pending cases. Examples

[6] G.L. c. 63, section 38M(j)

[7] G.L. c. 62, section 6(m)(2); G.L. c. 63, § 38U

[8] G.L. c. 23I, section 5(e)(3)

of the types of receipts for which the Department has objected to sourcing using an "operational approach" include:

- Franchise fees
- Broker/dealer receipts (several cases)
- Consulting services
- Money transfer services
- Wholesaler credits

New sourcing regulations expected:

The Department has announced that it expects to release draft regulations on the new market sourcing rules in the upcoming months.

Special-industry apportionment still valid?

Taxpayers that currently apportion their income under one of the Department's industry-specific apportionment regulations will want to keep a close eye on the Department's application of the new market legislation, as the change in the statutory apportionment rules arguably rescinds these regulations effective January 1, 2014. The authority of the Department to promulgate alternative apportionment rules for specific industries is triggered only if the statutory apportionment rules "are not reasonably adapted to approximate the net income" of a particular industry in Massachusetts. The current industry-specific regulations were arguably permissible because the Department determined that the statutory apportionment rules, including the cost of performance sourcing rule, did not meet the "reasonable approximation" standard. However, now that the statutory rules adopt market-based sourcing, the Department's prior determination is irrelevant. For example, in 1989, the Department promulgated regulations for the delivery and courier industry that apportioned income for sales factor purposes based upon non-delivery revenue and revenue derived from business in Massachusetts, measured by the percentage of Massachusetts pickups and deliveries. With the new sourcing rules, the Department should be required to make new findings that excluding pickup/delivery rates from the sales factor of a delivery company does not reasonably approximate the net income of the industry in Massachusetts. If the Department does not, such companies should arguably be able to exclude the pickup/delivery rate in calculating their sales factor starting in the January 1, 2014 tax year.

Software licenses sourced to server location:

The new statutory market sourcing rules provide that receipts from licenses to use tangible personal property are sourced to the location of the tangible personal property. In addition, the Department has already issued regulations indicating that pre-written software is tangible personal property for corporate excise tax purposes. See 830 CMR 63.38.1(9)(e). As a consequence, receipts from licenses to use pre-written software should be sourced to where the

actual software is located. This sourcing rule could have interesting repercussions for taxpayers. For instance, in some cases, it could result in receipts from a license to use pre-written software being sourced to the location of the server on which the software is loaded, instead of being sourced to the customer address.

Sales and Use Tax

Legislative Developments

Software services tax enacted, then retroactively repealed:

On July 24, the legislature enacted the Transportation Finance Bill, which, as part of the method for funding transportation, expanded the sales tax base to include computer system design and software modification, configuration, and installation services (referred to here as the "software services tax"). The software services tax took effect July 31, only one week after its enactment, leaving technology services companies scrambling to determine whether they needed to start collecting tax from their customers.

Opposition to the tax grew quickly and, in an abrupt about face, Governor Patrick and other Democrats who had pushed for the bill's passage announced their support for a repeal of the software services tax. On September 27, Governor Patrick signed that repeal into law. The repeal was given full retroactive effect back to July 31. *See* H. 3662.

The repeal occurred before any vendor had been required to remit the tax to the Commonwealth. However, many vendors attempting to comply with the law since its passage had collected the tax from their customers. Those vendors are now required to refund collected tax to their customer. *See* H. 3662, section 5.

If a vendor has collected and remitted tax on software services, they have until December 31, 2013, to file an application for abatement with the Department of Revenue. If the application is approved, the vendor is then required to return the tax to its customers. Ch. 46, Acts of 2013; *repealed by* H. 3662.

Judicial Developments

Bad-debt refunds denied:

A vendor was denied a refund for sales tax remitted on amounts that were later written off as bad debts. The vendor argued that it was entitled to a bad-debt deduction for financed transactions where the customer ultimately did not pay the full sales price for a purchased item. The ATB, however, held that when the taxpayer made sales at retail to customers, received full payment for those sales from a finance company, and remitted sales tax to the Commonwealth for those

transactions, it was not eligible to take a bad-debt deduction when the customer ultimately did not pay the financing company. In this situation, the ATB found that the financing company recorded the bad debts on its books and it, rather than the taxpayer, ultimately wrote them off. The ATB thus concluded that the vendor was not entitled to claim a bad-debt deduction for sales tax purposes. *Sears, Roebuck & Co. v. Commissioner*, Mass. Appellate Tax Board, Docket Nos. C293755, C294129, C299055, C305010 (January 11, 2012).

As a result of this holding, under current Massachusetts case law, in the typical retail sale involving third-party financing, neither the vendor nor the financing company would be eligible to claim a bad-debt deduction for sales tax purposes. *See Household Retail Services v. Commissioner*, 859 N.E.2d 837 (Mass. 2007). The Massachusetts Appeals Court upheld the ATB's decision, and the taxpayer's application for further appellate review was denied by the Supreme Judicial Court. *Sears, Roebuck & Co. v. Commissioner*, Mass. App. Ct., Docket No. 12-P-547 (June 19, 2013), application for further appellate review denied, 466 Mass. 1106 (2013).

Class action waivers valid against claims for improper sales tax collection:

The Supreme Judicial Court held that class action suits alleging improper collection of sales taxes are barred if the plaintiffs previously signed a class action waiver. Before reaching its most recent holding, the court previously decided in *Feeney v. Dell* ("*Feeney II*"), that waivers that compel individual arbitration claims for improper sales tax collection by vendors, rather than pursuit of such claims through class actions, may be invalid.

Feeney II involved optional service contracts that Dell sold to purchasers of its hardware. Dell collected sales tax on the purchase price paid for these optional service contracts. Customers brought suit against Dell, alleging that Dell made them pay for a tax that was not authorized by any Massachusetts taxing authority, and sought relief through a class action under a consumer protection law. Dell moved to compel individual arbitration based on the class action waiver included in the standard Terms and Conditions that accompanied each sale.

In *Feeney II*, decided June 12, the court revisited its 2009 decision in *Feeney I*[9] in which it found in favor of the class in light of a United States Supreme Court decision that held that class action waivers are presumptively valid under freedom of contract and the Federal Arbitration Act's ("FAA") policy of promoting arbitration.[10]

The Supreme Judicial Court's holding in *Feeney II* was based on different grounds than its decision in *Feeney I*. Instead of relying on the consumer protection law, the court held that the class action waiver was invalid where a plaintiff can show that the enforcement of the waiver would effectively bar the plaintiff from pursuing a claim against a defendant, making the claim nonremediable.

The court held that the plaintiffs had sufficiently showed that their sales tax claims would be nonremediable if the class action waiver were enforced. The court determined that each individual customer's claim against Dell was so small that no individual customer could efficiently enforce his or her rights in arbitration. Thus, the court noted that enforcing the class action waiver would effectively immunize Dell from civil liability for the alleged injuries resulting from its sales tax collection practices. Therefore, the court invalidated the waiver.

A mere eight days after the court decided *Feeney II*, the U.S. Supreme Court issued *American Express Co. v. Italian Colors Restaurant*.[11] In *American Express*, the court held that, under the FAA, class action waivers are enforceable even if the plaintiffs demonstrate that they will be left without an effective remedy. Because the SJC's decision in *Feeney II* contradicted the Supreme Court's interpretation of the FAA, on rehearing in *Feeney III*. the SJC reversed its decision in *Feeney II* and held that class action waivers are enforceable against customers claiming improper collection of sales tax. *Feeney v. Dell, Inc.*, 465 Mass. 470 (2013) ("*Feeney II*") reversed on rehearing, *Feeney v. Dell, Inc.*, 466 Mass. 1001 (2013) ("*Feeney III*").

---

[9] *Feeney v. Dell, Inc.,* 908 N.E.2d 753 (2009) *("Feeney I").*

[10] *AT&T Mobility LLC v. Concepcion*, 131 S.Ct. 1740 (2011).

[11] 133 S.Ct. 2304 (2013).

Administrative Developments

Draft directive issued to provide guidance on the 'object of the transaction' test for mixed software/services products:

After issuing more than a dozen letter rulings on the application of sales tax to a variety of transactions involving the purchase of software and services, the Department issued a draft directive attempting to summarize the analysis and rules scattered throughout its ad hoc guidance to taxpayers.

As outlined in the Draft Directive, when non-taxable services and access to pre-written software are sold for a single bundled price, Massachusetts looks to the object of the transaction to determine whether the transaction is a taxable sale of pre-written software, or a non-taxable service. The Draft Directive lays out eight criteria that may indicate that the object of a transaction was the purchase of taxable software—including the vendor branding itself as a provider of ASP, software as a service ("SaaS"), or cloud-computing services—and ten criteria that may indicate that the object of a transaction was the purchase of a non-taxable service.

In general, under the Draft Directive, a bundled transaction is more likely to be treated as a taxable purchase of software:

- The more the purchaser is able to manipulate or control the software
- The fewer services the vendor provides to the purchaser beyond maintaining and repairing the software and the network

The Draft Directive is subject to change before the Department issues its final guidance. Our understanding is that the Department still intends to issue a final version of the directive, although the timeline for issuing this guidance has been pushed back by the need to provide guidance regarding the application the software services tax. *Working Draft Directive 13-XX*, "Criteria for Determining Whether a Transaction is a Taxable Sale of Pre-Written Software or a Non-taxable Service," (February 7, 2013).

Amazon to start collecting sales tax:

On December 11, 2012, Massachusetts Gov. Deval Patrick and Amazon.com announced that Amazon will collect and remit sales tax in Massachusetts starting November 1, 2013.

Massachusetts school district required to collect and remit sales tax:

The Department has ruled that a public school district, a political subdivision of the Commonwealth, must collect sales tax from students leasing laptops from the district. The ruling concluded that the school district was a vendor because the lease arrangements were sales of

property typically engaged in by private persons. Although there is a specific sales tax exemption for sales made to a government entity, there is no exemption for sales made by a government entity. Letter Ruling 13-6 (June 19, 2013).

Hot Issues for 2013 and Beyond

Legislature may have repealed 'Software Services Tax,' but software services are still being taxed:

The "object of the transaction" test outlined in the Department's Draft Directive tilts heavily in the favor of taxing purchases that combine both software and services, on the basis that the object of the customer's purchase was taxable software. For example, the directive indicates that merely branding a sale as a SaaS transaction is—while not determinative of taxation—an indication that the object of the purchase is software, not related services. Several taxpayers have brought appeals to the ATB challenging the Department's application of the object of the transaction test. Currently, there are pending appeals filed by both SaaS and ASP vendors contending that their sales are not subject to sales tax in Massachusetts.

Can Massachusetts tax remotely accessed software?

In addition to appeals challenging the Department's application of the "object of the transaction" test, there are also pending appeals at the ATB that raise the issue of whether Massachusetts can tax remotely accessed software at all. Vendors that provide their customers with a free applet in order to allow the customers to access software hosted by the vendor on a server outside Massachusetts via the Internet, and vendors whose customers access the vendors' software exclusively through web browser, are challenging the Department's regulation treating such sales as subject to sales tax to the extent the purchaser accesses the software in Massachusetts. The vendors are arguing that there is no taxable "transfer" of software and ,therefore, the sales are not subject to Massachusetts sales tax. If these cases are ultimately decided in the taxpayers' favor, almost a decade of Department guidance would be overturned, and numerous taxpayers would be entitled to refunds.

Multiple points of use certificate appeal:

In another pending ATB appeal, a vendor is challenging the denial of its application for abatement related to sales of software products that were concurrently available for, and used by, its customer in multiple tax jurisdictions. In the appeal, the vendor invoiced the customer at a Massachusetts address and collected Massachusetts sales tax on the entire purchase price. After the vendor had remitted the tax to Massachusetts, the purchaser provided the vendor with information indicating that the software was concurrently available for, and used by, its employees in multiple jurisdictions, and requested a refund for the percentage of the purchase price attributable to use outside Massachusetts. The vendor granted a conditional refund and

filed an application for abatement, but was denied, allegedly on the basis that the vendor's failure to obtain a multiple-points-of-use certificate before the tax was remitted to Massachusetts barred the vendor from later claiming a refund.

Other Taxes

Motor Fuels Excise Tax

Motor fuels excise taxes increased:

The Transportation Finance Act raised the excise tax rate on gasoline and special fuels (diesel, ethanol, biodiesel, and gasohol) from 21 cents a gallon to 24 cents a gallon, effective July 31, 2013.

Effective January 1, 2015, the excise taxes on gasoline and special fuels will be subject to future increases based on increases in the consumer price index. Ch. 46, Acts of 2013.

Tax Administration

Mediation Program Extended

Responding to taxpayer concerns that the appeal process in Massachusetts can be costly, document intensive, and take several years to complete, the Department issued guidance late last year regarding a pilot early mediation program. The pilot program was intended to resolve disputes within four months after the finalization of an audit, through the use of mediation.

The Department has now completed the pilot program, with three of the four pilot cases resulted in a mediated settlement.

Speaking at the Boston Bar Association, Commissioner Amy Pitter stated that the Department would be continuing the program. While no guidance to this effect has been issued, the Department is still accepting mediation applications, and our understanding is that the Commissioner has expanded the program to permit taxpayers with assessments greater than $250,000 to request mediation (previously, $1M had to be at issue).

In order for an issue to be eligible for mediation, both the taxpayer and the Department must agree that mediation is appropriate—otherwise, standard appeal rules apply. Administrative Procedure 635 lays out some broad guidelines for the types of cases that the Department will deem appropriate for mediation, while allowing a considerable amount of flexibility in practice. *AP 635 Early Mediation Program*.

Department's Right to Offset

The Fiscal Year 2014 Budget extends the Department's right to offset tax refunds by the amount of any outstanding liabilities. Under G.L. c. 62D the Department has the authority to offset income tax refunds with outstanding tax liabilities. The Fiscal Year 2014 Budget has given the Department additional tools to collect unpaid state taxes:

- It expands the type of tax refunds that can be offset to include refunds of all tax types, not just income tax
- It authorizes the Commissioner of Revenue to participate in a Reciprocal Offset Agreement with the U.S. Department of the Treasury. The agreement will allow the Commissioner to submit state tax liabilities to be offset against federal payments to vendors and contractors, while permitting federal agencies to submit federal nontax liabilities to be offset against tax refunds due to Commonwealth taxpayers.
- It authorizes the Commissioner of Revenue to participate in Reciprocal Offset Agreements with other states, allowing the Commissioner to submit state tax liabilities to be offset against tax refunds of another state. These agreements will also permit other states to submit their tax liabilities to be offset against tax refunds due to Commonwealth taxpayers.

Ch. 38, Acts of 2013.

Biographies

Michael A. Jacobs
Reed Smith LLP
One Liberty Place
1650 Market St
Philadelphia, PA 19103
Phone: 215-851-8868
mjacobs@reedsmith.com

Mike is a partner in Reed Smith's State Tax Group. He focuses his practice on state tax planning and controversy matters, particularly in income/franchise and sales and use taxes. Prior to joining Reed Smith, Mike was a partner at the Boston-based law firm of Choate, Hall & Stewart. He is admitted in Massachusetts and has more than 15 years of experience handling Massachusetts state tax matters. Mike writes and speaks frequently on Massachusetts tax issues, including the following:

Massachusetts Delays Reporting for Software Services Tax; Repeal Imminent?
Co-Author(s): Robert E. Weyman, Brent K. Beissel

Reed Smith Client Alert
16 September 2013

Massachusetts Rules Against Taxpayer on Treatment of Intercompany Debt—Again
Co-Author(s): Robert E. Weyman, Brent K. Beissel
Reed Smith Client Alert
6 September 2013

Reed Smith Massachusetts Corporate Tax Teleseminar
Co-Presenter: Rob E. Weyman
21 August 2013

Reed Smith Massachusetts Sales Tax Teleseminar
Co-Presenter: Rob E. Weyman
7 August 2013

Massachusetts Quarterly Update
Co-Author(s): Robert E. Weyman, Brent K. Beissel
Reed Smith Client Alert
16 July 2013

Massachusetts Department of Revenue and Appellate Tax Board Look to Expand Tax Dispute Mediation Programs
Co-Author(s): Robert E. Weyman, Brent K. Beissel
Reed Smith Client Alert
21 June 2013

Massachusetts Tax Developments
Co-Author(s): Robert E. Weyman, Brent K. Beissel
Reed Smith Client Alert
25 April 2013

Software Vendor Challenges Massachusetts' Restrictive Policy on Multiple Points of Use Certificates
Co-Author(s): Robert E. Weyman
Reed Smith Client Alert
12 April 2013

Reed Smith Massachusetts Quarterly Update
Co-Author(s): Robert E. Weyman
Reed Smith Client Alert
4th Quarter 2012

Title Transfer Not Enough to Establish Resale in Massachusetts
Co-Author(s): Robert E. Weyman
Reed Smith Client Alerts
13 November 2009

Massachusetts Appellate Tax Board Expands Availability of Sales Tax Exemption for R&D Corporations—But Constitutional Issues Still Remain Unresolved

Reed Smith Client Alerts
8 September 2007

Robert E. Weyman
Reed Smith LLP
One Liberty Place
1650 Market St
Philadelphia, PA 19103
Phone: 215-851-8160
rweyman@reedsmith.com

Rob is an associate in Reed Smith's State Tax Group. He focuses his practice on state tax planning and controversy matters, particularly in income/franchise and sales and use taxes. Rob writes and speaks frequently on Massachusetts tax issues and has worked on several significant Massachusetts tax appeals.