Massachusetts State Developments Fall 2014

Michael A. Jacobs
Reed Smith LLP
Three Logan Square
1717 Arch St., Ste. 3100
Philadelphia, PA 19103
Phone: 215 851 8868
mjacobs@reedsmith.com

Robert E. Weyman
Reed Smith LLP
Three Logan Square
1717 Arch St., Ste. 3100
Philadelphia, PA 19103
Phone: 215 851 8160
rweyman@reedsmith.com

Brent K. Beissel
Reed Smith LLP
Three Logan Square
1717 Arch St., Ste. 3100
Philadelphia, PA 19103
Phone: 215 851 8869
bbeissel@reedsmith.com

I. Corporate Excise Tax

A. Legislative Developments

1. *Market sourcing and throwout effective January 1, 2014:* Massachusetts enacted legislation replacing Massachusetts' cost-of-performance sourcing regime for receipts from sales other than sales of tangible personal property. The new law implements 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 from sales other than sales of tangible personal property are sourced to Massachusetts as follows:

   i. Sales, rentals, leases or licenses of real property are sourced to Massachusetts if the property is located in the commonwealth
   ii. Rentals, leases or licenses of tangible personal property are sourced to Massachusetts if and to the extent the tangible personal property is located in the commonwealth
   iii. Sales of services are sourced to Massachusetts if the service is delivered to a location in the commonwealth
   iv. Leases or licenses of intangible property are sourced to Massachusetts if the intangible property is used in the commonwealth
   v. Sales of intangible property, if receipts are contingent on the productivity, use, or disposition of the intangible, are sourced to Massachusetts to the extent the intangible property is used in the commonwealth
   vi. 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

We would like to thank Michael Penza, a member of Reed Smith's State Tax Practice, for his significant contributions to this outline.

The legislation also institutes a throwout rule for certain sales. Under this rule, sales are excluded from the sales factor 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). Furthermore, the statute expands the class of receipts from intangible property that is excluded from the sales factor. Any receipts from intangibles that are not covered by I.A.1.(iv)–(vi) above are excluded from the sales factor.

On March 25, 2014, the Department of Revenue released draft regulations to implement the new sourcing rules. These regulations are discussed below in I.C.1.

2. *Massachusetts finalizes fiscal year 2015 budget:* On July 11, 2014, Gov. Deval Patrick signed into law the budget for fiscal year 2015. The budget delays the implementation of the FAS 109 deduction for yet another year, and extends the historic buildings rehabilitation credit for another five years (it was originally set to expire at the end of 2017).

   The budget also created a tax amnesty program. The program allows taxpayers to pay delinquent taxes without incurring penalties. The program began September 1 and will run until October 31. The Department has invited more than 300,000 individuals and businesses owing a combined $1.01 billion in taxes and interest to participate in the program. The program covers a variety of taxes, including:

   - Personal income tax
   - Personal use tax
   - Sales and use tax
   - Meals tax
   - Room occupancy excise tax
   - Gasoline excise tax

   According to the budget, the legislature estimates that the program will raise $35 million in revenue.

3. *Utility excise tax repealed:* For tax years beginning on or after January 1, 2014, utility companies formerly subject to the 6.5% excise tax on net income will be taxed as business corporations for corporate excise tax purposes. As a consequence, utility companies will now be subject to tax on the sum of (i) 8% of net income; plus (ii) $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. Any losses incurred by a utility for years prior to 2014 will not be available to be carried forward. Ch. 46, Acts of 2013.

4. *Research and Development Credit Expanded:* On August 13, 2014, Gov. Patrick signed an $80 million economic development bill into law. The law includes an expansion of the research and development credit. For calendar years 2015, 2016, and 2017, taxpayers may now elect to take a credit equal to 5% of their qualified research expenses that exceed 50% of the taxpayer's average qualified research expenses for the previous three years. The credit will be increased to 7.5% for 2018, 2019, and 2020; and then increased to 10% for years thereafter. If the taxpayer did not have qualified research expenses in any one of the three taxable years preceding the year for which the credit is claimed, the credit equals 5% of the taxpayer's qualified research expenses for the year for which the credit is claimed. The term "qualified research expense" is defined under IRC section 41. These provisions only apply to qualified research expenses conducted in the commonwealth. Ch. 287, Acts of 2014.

B. Judicial Developments

1. *Interest deductions on intercompany debt:* The Appellate Tax Board ("ATB") issued another decision denying true-debt treatment for intercompany obligations. 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. 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, the DSAs 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) SPE could employ penalty, interest, and other enforcement mechanisms if National Grid did not make the call payments. Furthermore, National Grid did 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 ATB ultimately rejected the taxpayer's argument. It found that DSAs were not true indebtedness because although the SPE had a legally enforceable right to demand payment, the taxpayer was not under an unconditional obligation to pay. Accordingly, the Board found in favor of the commonwealth. *National Grid Holdings, Inc., et al. v. Commissioner*, Docket No. C292287-89, 2014 WL 2535189 (Mass. App. Tax Board, June 4, 2014).

In a separate appeal, the Board found that the taxpayer could not challenge the commissioner's denial of deductions for its interest payments based on the treatment of those payments in a closing agreement with the IRS. As discussed above, the Department denied National Grid's interest deduction for payments to the SPE for the 2002 tax year and issued an assessment. Subsequent to National Grid's appeal of that assessment, the taxpayer resolved a federal tax audit for the same tax year through a closing agreement. The closing agreement allowed the taxpayer to deduct a portion of its interest payments to the SPEs. Following the agreement, the taxpayer filed a separate application of abatement, this time challenging the commissioner's audit assessment based upon the terms of the taxpayer's closing agreement with the IRS.

The commissioner took no action with respect to the second application for abatement; as a result, the taxpayer appealed to the Board. The Board noted that a taxpayer may not file a second application for abatement that challenges an item of tax that has been challenged in a previous application, unless warranted by a change in fact or law. The taxpayer argued the IRS closing agreement created sufficient grounds for a second application, because the Department was bound by the IRS closing agreement, specifically the allowance of interest deductions. The Board disagreed, holding that the commissioner was not bound by the closing agreement. Although Massachusetts net income is premised on federal net income, the court noted that the dollar amounts for each need not match. Accordingly, it granted the commissioner's motion to dismiss the appeal. *National Grid USA Service v. Commissioner*, Docket No. C314926, (Mass. App. Tax Board, Sept. 19, 2014).

2. *Securitization entity qualifies as financial institution:* The ATB issued a decision that provides insight into the treatment of bankruptcy remote entities that are used for securitization transactions. The appeal

involved Gate Holdings, a wholly owned subsidiary of First Marblehead Corporation. Gate Holdings held beneficial interests in trusts that purchased and held 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 rejected the Department's argument, holding that Gate Holding was properly classified as a financial institution because it was engaged in lending activity (through its trust subsidiaries) that was in substantial competition with other financial institutions. See M.G.L. ch. 63 § 1 "Financial institution" (e).

- *Purchasing loans is a "lending activity":* In reaching its determination, the ATB broadly applied the term "lending activity," finding that although Gate Holdings and its trusts did not issue loans to the public, Gate Holdings still 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, but the Department is not challenging the ATB's determination that Gate Holding's is a financial institution—see I.B.3 for further information regarding additional issues in the appeal. *First Marblehead Corp. & Gate Holdings, Inc. v. Commissioner*, Docket Nos. C293487, C305217, C305240, C305241 (Mass. App. Tax Board, April 17, 2013), appeal pending on other grounds, Supreme Judicial Court, Docket No. 2013-P-0935. Oral argument is scheduled for October 7, 2014.

3. *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.2 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. Gate Holdings argued that in determining where the SINAA activities occurred pertaining 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 of Massachusetts, and sourced the loans to Gate Holding's commercial domicile in Massachusetts.

- *Third-party activity insufficient to establish taxpayer is "taxable" in other jurisdictions:* The taxpayer also 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, and based merely on the fact that those third parties were paid by the taxpayers.

The taxpayer appealed to the Massachusetts Appeals Court; however, the Supreme Judicial Court has taken the case sua sponte. The only remaining issue in the appeal involves the computation of Gate Holding's property factor. The taxpayer continues to argue that it can look to the activities of third-party loan servicers for purposes of the SINAA sourcing analysis. Both parties have filed their briefs, and on January 16, 2014, the court issued an order inviting amicus briefs. Oral argument is set for October 7, 2014. *First Marblehead Corp. & Gate Holdings, Inc. v. Commissioner*, Docket Nos. C293487, C305217, C305240, C305241 (Mass. App. Tax Board, April 17, 2013), appeal pending, Supreme Judicial Court, Docket No. 2013-P-0935. Oral argument is scheduled for October 7, 2014.

4. *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 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 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 an internal memorandum indicating: (i) that state tax savings was the purpose of the transfer; and (ii) that the employee transfer could be accomplished with no effect on the business.

The ATB's decision raises significant questions regarding the extent to which the sham-transaction doctrine can be applied in Massachusetts. The appeal covers the 1996-2004 tax years. While the original 1996 taxpayer memorandum describing the tax benefits of a specific internal employee transfer to Parent is difficult to overcome, several other internal functions in later years were transferred to Parent and no memorandum indicated that these subsequent transfers were tax motivated. As one justice pointed out at oral argument at the Appeals Court, the fact that the taxpayer thought its 1996 actions established nexus would seem to be evidence that any later internal transfers had no tax motivation at all, and thus, must have had a valid business purpose and economic substance. Furthermore, according to sworn testimony at the ATB hearing supported by documents included in the record by the commonwealth, by 2000, Parent went on to make external hires of employees who were based in Massachusetts, and yet under the ATB's determination, those hires still constituted "shams" and barred Parent from claiming nexus. Such a determination seems almost impossible to square with traditional sham-transaction jurisprudence—if Parent had gone on to hire a CEO in 2004 based in Massachusetts, could that hiring still be considered a "sham," based in part on internal employee transfers that took place eight years earlier?

The taxpayer appealed the Board's decision to the Massachusetts Appeals Court. The court affirmed, holding that the Board's finding of a sham transaction was supported by sufficient evidence. *Allied*

Domecq Spirits and Wines USA, Inc. v. Commissioner, 85 Mass. App. Ct. 1125 (2014), further appellate review denied, 469 Mass. 1104 (2014).

C. Administrative Developments

1. *Department releases new market sourcing regulations:* On March 25, 2014, the Department released draft regulations implementing the new market-sourcing laws for sales other than the sale of tangible personal property. See I.A.1. The regulations provide specific sourcing rules based on the characterization of a sale.

   i. **Sourcing of receipts from services:** The regulations specify three types of services, each with its own sourcing rules.

   (1) *In-Person Services:* These services are those that are physically provided in person, such as cleaning, medical, and repair services. They are sourced to the state where the services are performed.

   (2) *Professional Services:* These are services that require specialized knowledge and in some cases require a license, degree, or professional certification. Sales to individuals are sourced to the customer's state of primary residence. Sales to businesses are sourced to the state where the contract of sale is principally managed by the customer. Receipts from financial institutions that are not covered by the existing Financial Institution Excise Tax sourcing rules, such as broker's fees, are sourced under the rules for professional services.

   (3) *Services Delivered to the Customer or Through or on Behalf of the Customer:* These are services that are neither in-person services nor professional services. These receipts are sourced to the state where the service is delivered or received, depending on (1) the delivery method (electronic or tangible) and (2) the nature of the customer (individual or business).

   ii. **Sourcing of receipts from the licensing of intangibles:** The regulations distinguish between the licensing of marketing, production, and mixed intangibles.

   (1) *Licensing of Marketing Intangibles:* These are licenses granted for the right to use intangible property in connection with the sale, lease, license, or other marketing of goods, services, or other items. Royalties or other licensing fees paid by the licensee for such right are sourced to Massachusetts to the extent that the fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by customers in Massachusetts.

(2) *Licensing of a Production Intangible:* These are licenses granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, and the license is to be used in a production capacity. The licensing fees paid by the licensee for the right of use are sourced to Massachusetts to the extent that the use for which the fees are paid takes place in Massachusetts.

(3) *License of a Mixed Intangible:* These are licenses that include both licenses for marketing and production intangibles. Fees attributable to the license of mixed intangibles are presumed to be for the license of marketing intangibles, and are sourced accordingly, unless the fees are separately stated in the licensing agreement.

(4) *License of an intangible that resembles a sale of an electronically delivered good or service:* These are sales that do not involve the license of a marketing or production intangible. Examples include the sale of digital goods, database access, or certain electronically delivered software. Receipts attributable to these sales are sourced as though they are derived from sales of services delivered directly to the customer through electronic delivery. See I.C.1(ii)(3).

iii. **Sourcing receipts from the sale of intangibles**: The regulations implement different sourcing rules depending on the type of sale:

(1) *Contract Right or Government License that Authorizes Business Activity in Specific Geographic Area:* Receipts are sourced to Massachusetts if and to the extent that the right or license is used or otherwise associated with Massachusetts.

(2) *Agreement Not to Compete:* Receipts are sourced to Massachusetts if and to the extent that the U.S. geographic area governed by the contract is in Massachusetts.

(3) *Sales where the payment is based on productivity, use, or disposition of the intangible property:* These sales are treated as licenses and are sourced in accordance with the rules discussed above in I.C.1.(vii).

(4) Receipts from all other sales of intangibles are excluded from the sales factor.

iv. **Licenses of software transferred on a tangible medium:** Licenses of software transferred to the licensor on a disk or other tangible medium are treated as sales of tangible personal property. The regulations provide an exception to this rule for licenses to duplicate the software, which would likely be treated as production, marketing, or mixed intangibles. See I.C.1(ii).

v. **Rules of reasonable approximation:** If the state to which a sale is attributed under the specified rules cannot be determined, the taxpayer must source sales by a method of reasonable approximation. The taxpayer may use the approximation method of its choice (subject to the Department's review). However, the draft regulations provide that the taxpayer's choice becomes final once the return is submitted: the taxpayer cannot modify its approximation method by filing an amended return or an abatement claim under the draft regulations. The draft regulations also provide that the taxpayer must use the same approximation method consistently from year to year. Should the taxpayer wish to modify or change its approximation method, the taxpayer must obtain the Department's approval.

vi. **Throwout rules:** Throwout is required for the following sales:

(1) Sales other than sales of tangible personal property, where the taxpayer is not taxable in the state to which the sale is assigned

(2) Sales other than sales of tangible personal property, where the Department determines that the taxpayer's method of reasonable approximation is unreasonable (unless the Department substitutes its own "reasonable approximation method")

(3) Sales of securities, goodwill, going concern value, and workforce in place

(4) Sales of patented technology (unless the purchaser's payments are based on the productivity, use, or disposition of the patented technology)

(5) Sales of other intangible property, unless specifically included in the factor (as discussed above in I.C.1.(ix))

(6) Sales other than sales of tangible personal property, where the taxpayer cannot determine or reasonably approximate the state to which a sale should be assigned

The Department's second draft of the regulations is expected in the fourth quarter of 2014, with a second period for comments to follow. Working Draft 830 CMR 63.38.1: Apportionment of Income (March 25, 2014).

2. *Department proposes new regulations on adjustments to basis of property:* The Department has promulgated new regulations interpreting G.L. c. 63, section 31N. The regulations implement rules governing adjustments to federal gross income and to the basis of property:

i. **Adjustment of federal gross income:** Section 31N requires adjustments to federal gross income when it includes gain or loss from the disposition of property, the basis of which differs for federal and Massachusetts tax purposes. The regulations provide that federal gross income must either be: (1) reduced by the excess of the disposed-of property's Massachusetts basis over its federal basis; or (2) increased by the excess of the disposed-of property's federal basis over its Massachusetts basis.

ii. **Corporations not previously subject to Massachusetts tax:** When a corporation not previously subject to the corporate excise tax becomes subject to the tax, its property takes its federal tax basis as its basis for Massachusetts purposes. The corporation, however, may elect to determine and adopt a Massachusetts basis in its property as though the corporation were subject to the Massachusetts tax when it acquired the property.

iii. **Intercompany transactions:** The regulations largely mirror federal rules when determining the adjusted basis of property subject to intercompany transfers. The Department will apply the federal rules governing transactions between affiliated entities that are members of the same consolidated group, found in Treas. Reg. section 1.1502-13, to transactions between affiliated entities that are members of the same combined group (regardless of whether the entities are actually members of the same consolidated group for federal purposes). Similarly, the Department will apply the federal rules governing transactions between affiliated entities that are not members of the same consolidated group, generally found in IRC sections 163 and 267, to transactions between affiliated entities that are not members of the same combined group (regardless of whether the entities are actually members of the same consolidated group for federal tax purposes).

iv. **Basis in the stock of subsidiaries:** Where a parent corporation and its subsidiary are part of the same combined group, the parent's basis in the subsidiary's stock will be adjusted to reflect distributions from the subsidiary, as well as the subsidiary's items of income, gain, deduction and loss. The adjustments will be made consistent with the federal rules and principles set forth in Treas. Reg. section 1.1502-32. A parent's basis in its subsidiary's stock will generally be adjusted upward to reflect the subsidiary's earnings, and downward to reflect the subsidiary's losses and distributions paid to the parent.

The provisions relating to basis adjustments in subsidiary stock are effective January 1, 2014. All other provisions are effective January 1, 2009. 830 CMR 63.31N.1: Massachusetts Property Basis Adjustments (May 9, 2014).

3. *Corporate members of LLC qualify as mutual fund service corporations based on pass-through principals:* On March 13, 2014, the Department issued Letter Ruling 14-2, which ruled that the members

of an LLC—four S Corporations—qualified as mutual fund services corporations, because the income passed through from the LLC to its members qualified as income from mutual fund services.

The LLC was treated as a partnership for federal and Massachusetts tax purposes. It provided services to a fund advisor, on behalf of a regulated investment company ("RIC"). The fund advisor, with the advice of the LLC, determined which securities should be purchased, held, or sold by the RIC. The LLC also selected brokers and dealers, and arranged for the purchases and sales by the RIC through those brokers and dealers. The Department found these activities were mutual fund services within the meaning of M.G.L. ch. 63, section 38(m).

The LLC's members were found to be mutual fund services corporations because the income that passed through to each member as part of its distributive share retained its character as income from the provision of mutual fund services. The members had no operations or activities other than the interests held in the LLC.

M.G.L. ch. 63, section 38(m) defines a mutual fund service corporation as any corporation doing business in the commonwealth that derives more than 50% of its gross income from the provision of certain mutual fund services to or on behalf of an RIC. Thus, the members of the LLC qualified as mutual fund service corporations because they had no income other than the income passing through the LLC, and that income was derived from the provision of mutual fund services. Letter Ruling 14-2: Qualification as Mutual Fund Services Corporation under G.L. c. 63, s. 38(m) (March 13, 2014).

D. Hot Issues for 2015

1. *Market sourcing and throwout are here*: Market sourcing and throwout go into effect for tax years beginning January 1, 2014. As discussed above, the Department's proposed rules are lengthy and complex, and contain several traps for the unwary. Some areas of potential concern are the Department's attempt to prevent taxpayers who use a "reasonable approximation" method from later filing amended returns; the disparate treatment of sales of intangible property compared with licenses; the exclusion of receipts from sales of partnership interests from the sales factor; and the increasing potential for distortion created by various throwout rules.

   The Department is expected to issue a second draft of the regulations in the fourth quarter of 2014 after addressing the first round of public comments. After releasing the draft, the Department will likely accept additional comments, so taxpayers will still have an opportunity to have their voices heard before the regulations become final.

2. *The Department continues to challenge deductions for payments to affiliated entities:* The Department continues to aggressively challenge intercompany payments between affiliated entities at audit—especially in audits involving tax years before mandatory combined filing went into effect. In pending or recently resolved cases, the Department has been arguing for:

    - The reclassification of payments made by a distribution company for purchases of products from its affiliate as embedded royalties
    - The disallowance of deductions for amounts paid to affiliates for various services
    - The increase of a taxpayer's net income derived from sales of pharmaceuticals to an affiliated retailer, based on general industry financial ratios
    - The increase of a taxpayer's net income derived from sales to affiliates despite two third-party transfer-pricing studies supporting taxpayer's sales price

    A recent filing with the ATB by a national restaurant chain is illustrative. The chain had a centralized purchasing and distribution entity that handled just-in-time purchasing for food, as well as centralized purchasing for other products used at the chain's restaurant locations around the country. Separate legal entities operated the chain's restaurant locations. These entities purchased food and other products from the purchasing and distribution company.

    The auditor first asserted that the purchase price charged by the purchasing and distribution company was greater than an arm's-length price and, thus, limited the deductions claimed by the restaurant entities for the cost of their purchases, pursuant to the Department's authority under M.G.L. ch. 63 section 39A. The auditor then made a second adjustment, further reducing the cost-of-goods-sold deduction for the restaurant entities, by treating a portion of the purchase price paid as an "embedded royalty" that was not deductible under intangible expense add-back provision.

    The Department appears to be making transfer pricing adjustments on a case-by-case basis. As cases proceed through the appeal process, the Department will likely be required to develop standards to justify its adjustments. Taxpayers should keep a close eye on briefs and other Department filings in which the Department sets forth standards for determining fair intercompany pricing.

3. *Cost of performance litigation continues:* While market sourcing is in effect for tax years beginning on or after January 1, 2014, the application of the cost of performance sourcing rules for earlier tax years continues to be a major source of controversy at the ATB. Dozens of recently settled or pending appeals involve situations in which either the taxpayer or the Department is arguing for "all or nothing" cost-of-performance sourcing of certain receipts. Examples of the types of receipts for which the Department has objected to sourcing entirely outside Massachusetts, based on using an "operational approach," include:

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

4. *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 sourcing legislation as the change in the statutory apportionment rules arguably rescinds industry-specific 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. But now that the statutory rules have been amended to incorporate market-based sourcing, the Department's prior determination should no longer be relevant. For example, in 1989, the Department promulgated regulations governing the delivery and courier industry. The regulations 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 enactment of the market sourcing legislation, the Department should be required to make a new finding that sourcing the receipts of a delivery or courier company based on its market does not reasonably approximate the net income of the industry in Massachusetts.

   The Department, however, apparently views the situation differently. In its working draft regulations implementing market sourcing (See I.C.1), the Department has taken the position that the existing special industry apportionment regulations are unaffected by its new market sourcing rules. Working Draft 830 CMR 63.38.1: Apportionment of Income (March 25, 2014). Taxpayers subject to special-industry apportionment rules should pay close attention to the revised draft regulations expected to be released in the fourth quarter of 2014.

II. Sales and Use Tax

A. Administrative Developments

1. *The Department revises its position on cloud computing services:* The Department revised and reissued Letter Ruling No. 12-8 regarding the taxability of a vendor's cloud computing services, finding that the services are not subject to sales tax.

   In Letter Ruling 12-8, the vendor sold cloud computing products that gave customers access to the vendor's computer infrastructure and operating system, allowing the customer to use the vendor's computer resources and storage space to perform various activities.

   Customers needed an operating system that would enable them to use the vendor's cloud computing products. They had three options: (1) provide their own operating system; (2) use an open-source system; or (3) use an operating system the vendor licenses from a third party. The vendor charged its customers by the hour, and imposed a higher hourly rate for customers that used a third-party operating system.

   In the original version of the ruling, the Department found that charges associated with the third option were subject to tax, because the customer's object in choosing that option was to obtain the right to use software—not the vendor's cloud computing services. (The Department previously found that when customers chose the other two options, the vendor's charges were not subject to tax.) In its revision, the Department reversed course, finding that the vendor's services were not subject to tax, regardless of the operating system option selected by the customer.

   The Department, however, also commented that the vendor would be required to pay Massachusetts use tax on the "apportioned cost of prewritten operating system software that it consumes in the provision of the nontaxable services to customers in Massachusetts." This appears to be an expansion of the Department's policy regarding the taxability of remotely accessed software.

   The Department also ruled that the vendor's remote storage services were not subject to tax. *Letter Ruling 12-8: Cloud Computing* (July 16, 2012, revised November 8, 2013).

2. *The Department rules that sales of online database access are not taxable:* On February 10, 2014, the Department released Letter Ruling 14-1, responding to a taxpayer's inquiry into whether its sales of subscriptions to its online database were taxable sales of prewritten software, or nontaxable sales of web database services.

The taxpayer sold its customers subscriptions to a database that provided information on suppliers and purchasers of goods and services located throughout the world. Using the taxpayer's website, customers could view the database to find suppliers and purchasers best suited to meet their needs. The taxpayer relied heavily on the use of software to compile the data and organize it in a way that was user-friendly; however, no software was transferred to or downloaded by the customer. In addition to accessing the database, customers could create profiles viewable by other customers; upload information about their business; receive reports provided by the taxpayer's analysts; and send emails to purchasers or suppliers through the taxpayer's website.

The Department concluded that the taxpayer's subscription sales were not taxable. Applying the object of the transaction test, the Department determined that the customers sought access to the taxpayer's database, not the software facilitating its use. Accordingly, the Department found that the taxpayer's activities were the sale of "database services," not subject to Massachusetts sales tax. Letter Ruling 14-1: Sales/Use Tax on Subscription to On-line Merchandise Database (February 10, 2014).

3. *Training services provided online are not subject to sales and use tax:* On May 29, the Department issued Letter Ruling 14-4, ruling that corporate training programs accessed online were not subject to sales and use tax.

   The Taxpayer sold training programs focused on corporate ethics and compliance. The programs were available only online, and were hosted on a third-party server. The training programs had both audio and visual components, as well as interactive features: users could take quizzes and answer questions. Purchasers were able to access the training programs through use of an ID number and password provided by the Taxpayer. The purchasers had no ability to direct or control the training programs' underlying software. The Taxpayer inquired whether the sales of its online training programs were subject to sales and use tax.

   The Department ruled that the Taxpayer's sales were not subject to tax, relying on the "object of the transaction" test. The Department determined that the object of the transaction was the information contained in the online training programs, rather than the software used to communicate that information to the user. Accordingly, the Department concluded that the Taxpayer sold nontaxable database access services, rather than taxable prewritten software. Letter Ruling 14-4: On-Line Compliance and Ethics Training (May 29, 2014).

4. *Draft Directive issued to provide guidance on the "object of the transaction" test for mixed software and 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 nontaxable services and access to prewritten 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 prewritten software, or a nontaxable service. The Draft Directive lays out eight criteria that may indicate that the object of a transaction is 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 10 criteria that may indicate that the object of a transaction was the purchase of a nontaxable 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; and
- 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. The timeline for issuing the final Directive is unclear. *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).

5. *Draft Directive issued to provide guidance on sales tax exemption for certain direct mail promotional advertising materials:* Sales of direct promotional advertising materials distributed to residents of the commonwealth are exempt from sales and use tax. M.G.L. c. 64H, § 6(ff). The Department issued a Draft Directive to provide guidance on the exemption.

   The Draft Directive provides that materials are exempt if they meet the following criteria:

   - The materials contain discount coupons;
   - The materials are no longer than six pages;
   - The materials qualify as direct mail;
   - The materials are distributed by U.S. mail or common carrier;
   - The materials are distributed at no charge to the mailing recipient; and
   - The materials are not be mixed-use publications.

The Draft Directive defines "direct mail" as material mailed directly to a specific or prospective customer that is listed in the sender's mailing lists or database. "Coupon" is defined in the Draft Directive as a printed piece of paper, scan card, code, or other identifier that, upon presentation to a vendor, entitles a retail customer to receive a service or product for free or at a lower price. Working Draft Directive 14-XX: Sales and Use Tax Exemption for Certain Direct Mail Promotional Advertising Materials under G.L. c. 64H, s. 6(ff) (September 25, 2014).

6. *Department rules sales of portable medical device are exempt from tax*: On April 11, the Department issued Letter Ruling 14-3, ruling that a device used to treat brain tumors was exempt from sales tax. The taxpayer sold portable medical devices used to treat solid tumors in the head. The device generated alternating electric fields, delivered through insulated arrays placed directly onto the skin surrounding the tumors. These electric fields disrupted the division of cancerous cells in the user's brain, while enabling the user to maintain a normal daily routine.

   Sales of "other equipment worn as a correction or substitute for any functioning portion of the body" are exempt from tax. G.L. c. 64H § 6(l). The Department concluded that the devise fell under this exemption because it was worn to "correct" the brain, a functioning portion of the human body. Letter Ruling 14-3: Application of Massachusetts sales tax to portable medical device under G.L. c. 64J, s. 6(1) (April 11, 2014).

B. Hot Issues for 2015

1. *Mobile telecommunications company challenges sales tax assessment on early termination fees*: In a petition filed recently with the ATB, a mobile telecommunications company is contesting a sales tax assessment by the Department. The assessment resulted from the Department asserting that the sales tax on telecommunications services applies to "early termination fees."

   For sales tax purposes, taxable telecommunications services are defined as the "transmission of messages or information by electronic or similar means." At audit, the Department adopted an expansive view of this definition, and issued an assessment against the petitioner for failure to collect sales tax on "early termination fees" that the petitioner charged when a customer with a contract cancelled the contract prior to its expiration date. Moreover, the Department's assessment—according to the petitioner—included tax on early termination fees that were waived and thus never collected from customers.

   In its ATB petition, the telecommunication company is arguing that the early termination fees received were not charges for the transmission of messages and information. Indeed, the fees in question were

charged because the customer informed the vendor that it did not want the vendor to "transmit" any messages.

2. *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 (see II.A.4.) 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—while not determinative of the tax treatment—is 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.

3. *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 of 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 vendors' favor, almost a decade of Department guidance would be overturned and numerous vendors would be entitled to abatements.

4. *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. Accordingly, the purchaser 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 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.

III. Tax Administration

A. *Department makes mediation program permanent:* The Department officially made its early mediation program permanent and expanded the program to include audits with $250,000 or more at issue (the previous threshold was set at $1 million by Administrative Procedure 635).

The early mediation program was introduced in 2012 as a pilot program for taxpayers with fully developed audit issues who had requested to participate in the program before they had received a Notice of Intent to Assess.

The Department will only consider mediating an issue under the program in situations where (1) the issue and facts have been fully developed during the course of the audit; (2) the taxpayer has stated in writing its disagreement with the handling of the issue in the audit; and (3) the parties are genuinely willing to resolve all disputed issues through the mediation.

The results from the program have been encouraging so far. As of early December, six of the first seven mediations had resulted in a settlement. Furthermore, those mediations produced settlements in three-and-one-half to five months, a far cry from the years that it might have otherwise taken to resolve the same issues at the Office of Appeals or the Appellate Tax Board.

B. *Department is currently offering a tax amnesty program:* The fiscal year 2015 budget authorized a tax amnesty program, permitting taxpayers to pay delinquent taxes without incurring penalties. See above, I.A.2., for more details about the program.

IV. Biographies

A. Michael A. Jacobs

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:

Reed Smith Massachusetts Corporate Tax Teleseminar: Massachusetts Releases Proposed Market Sourcing and Throwout Regulations, What Does it Mean for You?
Co-Presenters: Robert E. Weyman, Brent K. Beissel
10 April 2014

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

11 February 2014

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

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: Robert E. Weyman
21 August 2013

Reed Smith Massachusetts Sales Tax Teleseminar
Co-Presenter: Robert 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 Alert
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 Alert
8 September 2007

B. Robert E. Weyman

Rob is an associate in Reed Smith's State Tax Group. He focuses his practice on state tax planning and controversy matters, concentrating 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.

C. Brent K. Beissel

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