Section 7
THE DEATH OF INTELLECTUAL PROPERTY HOLDING COMPANIES?

MASSACHUSETTS JOINS A GROWING NUMBER OF STATES ELIMINATING THE STATE TAX AVANTAGES OF IPHCS

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I. SCOPE NOTE

Intellectual property holding companies (*IPHCs*) are commonly used by large corporations to divert income from a state with a high tax rate to another state where the income will result in little or no additional tax. In response to this trend, a number of states have sought ways to tax the revenue that is diverted elsewhere. Massachusetts began its efforts when the Department of Revenue (*DOR*) began asserting that the IPHCs were shams, and seeking to collect tax on the income of Massachusetts companies paying royalties to their affiliated IPHCs in other jurisdictions. The DOR met with mixed results in the courts. *See Sherwin-Williams Co. v. Commissioner of Revenue*, 438 Mass. 71, 778 N.E.2d 504 (2002) (IPHC upheld), and *Syms Corp. v. Commissioner of Revenue*, 436 Mass. 505, 765 N.E.2d 758 (2002) (IPHC disregarded). In 2003, the Massachusetts legislature enacted chapter 4 of the 2003 Acts & Resolves ("*Chapter 4*"), which sought to raise revenues. One of the means of doing so was to close some perceived tax loopholes, including the use of IPHCs. This article will explain how IPHCs work, and how Massachusetts legislation removes the tax incentive for establishing them as a means of reducing Massachusetts tax.

II. HOW—AND WHERE—THE IPHC STRATEGY WORKS

A parent corporation that does business in many states may seek to reduce the income tax that it pays to those states by establishing an IPHC to hold the trademarks and/or other intellectual property of the parent corporation. For example, Toys'R'Us established a subsidiary named "Geoffrey, Inc.", named after the cute giraffe character found in its stores. Geoffrey, Inc. was domiciled in Delaware, which imposes no tax on royalty income of passive investment companies. Then Toys'R'Us transferred its trademarks to Geoffrey, which licensed the marks to the separate corporations that own Toys'R'Us stores. Those corporations paid royalties to Geoffrey, shifting income from Massachusetts and other states (where Toys'R'Us would otherwise pay tax on the income) to Delaware (where the royalty income was not subjected to state income tax). Geoffrey then remitted the funds to Toys'R'Us as a dividend, or lent it to affiliates, charging interest. That interest income also escaped state taxation.

This tax planning opportunity arises because many states, including Massachusetts, tax corporations individually, rather than by taxing affiliated groups of corporations. Many states, however, tax the affiliated group, even if the parent corporation is domiciled elsewhere. Those states (called "unitary tax jurisdictions") apportion the revenue of the affiliated group between in-state and out-of-state business, and tax the business that is apportioned to that state.[1]

The IPHC strategy does not work in unitary tax jurisdictions because those jurisdictions look at the net income of the entire group of corporations. In the case of an IPHC structure, one affiliate's royalty expense is another's royalty income. The royalty payment is a wash, resulting in no change to the taxable income.

A corporation that has subsidiaries in both unitary and non-unitary jurisdictions can domicile an IPHC in one of the unitary tax jurisdictions, such as California, where it already has a business establishment, rather than in Delaware. The payment of royalty income from Massachusetts to California would reduce taxable income in Massachusetts but have no effect on its California tax, since California pays no attention to revenues received by the California subsidiary, focusing instead on the consolidated income of the affiliated group.

III. TWO RECENT MASSACHUSETTS CASES

The Massachusetts Supreme Judicial Court (SJC) issued two decisions regarding IPHCs in 2002. *Sherwin-Williams Co. v. Commissioner of Revenue*, 438 Mass. 71, 778 N.E.2d 504 (2002), and *Syms Corp. v. Commissioner of Revenue*, 436 Mass. 505, 765 N.E.2d 758 (2002). Both *Sherwin-Williams* and *Syms* involved corporate taxpayers who sold their trademarks to IPHCs which they established as subsidiaries under Delaware law. The IPHCs then licensed the trademarks back to their affiliates at allegedly "reasonable" royalty rates.

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[1] According to Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue For Many States*, Center on Budget and Policy Priorities (Rev. May 23, 2003) [hereinafter, *Mazerov*], available at http://www.cbpp.org/4-9-02sfp.pdf, there are 15 such states: AL, AZ, CA, CO, HW, ID, IL, KN, ME, MN, NE, NH, ND, OR, UT.

The Syms IPHC had no employees, licensed its marks only to its parent corporation, and returned virtually all royalty income to its parent within two weeks of receipt. Sherwin-Williams established two subsidiaries: one to hold and license IP, and the other to invest and manage the royalty income. The board of directors cited at least 11 corporate purposes in establishing these entities, including improved quality control, improved borrowing capacity, and better accounting.

In both cases, the DOR considered these arrangements to be "sham" transactions entered into for the sole purpose of lowering Massachusetts tax liability. Both taxpayers argued that other reasons drove these reorganizations, including the benefits obtains from consolidating trademark ownership under separate, experienced, professional management, and to shield these assets from legal liability arising from the business of the original trademark user.

The SJC ruled that the *Syms* IPHC was a sham, but that the *Sherwin-Williams* IPHC was not. The key factual differences can be summarized as follows:

Factor	Syms	Sherwin-Williams
Payment of expenses related to maintaining marks	Parent	IPHC
Frequency of Royalty Payments	Once a year	Not clear
Substantiality of Expenses	$1,200 / yr	Rent expenses, part-time manager, legal fees
Licensing Activity	Restricted to Parent	Licensed to some non-affiliates
"Circular" flow of funds back to licensee	Yes	No

IV. THE LEGISLATIVE RESPONSE

In March 2003, the Massachusetts legislature enacted Chapter 4. This legislation provides that a company doing business in Massachusetts must add back to its taxable income any "intangible expense" paid to affiliates. "Intangible expense" includes patent, trademark and copyright royalties and licensing fees. The taxpayer can avoid this result if the affiliate receiving the royalties must itself pay that amount to an unrelated third party; or if it can persuade the Commissioner of Revenue by clear and convincing evidence that this add-back to income would be unreasonable. The legislation accomplishes this result by adopting M.G.L. chapter 62C, §3A and chapter 63, §§31I and 31J; and by amending chapter 63, §§33 & 39A. A copy of the statutory provisions is attached as Exhibit 1.

V. SHAM TRANSACTION DOCTRINE CLARIFIED—AND EXPANDED?

In addition to dealing specifically with IPHCs, the legislature also clarified the sham transaction doctrine, another subject addressed in *Sherwin-Williams*. In *Sherwin-Williams*, the SJC reviewed the cases from other jurisdictions dealing with the sham transaction doctrine. It observed that some jurisdictions have adopted a "two prong" sham transaction inquiry.

> The first prong of the inquiry examines whether the transaction has economic substance other than the creation of a tax benefit, which has been labeled the "objective" economic substance test. The second prong examines whether the transaction was motivated by any business purpose other than obtaining a tax benefit, which has been labeled the "subjective" business purpose test. [FN8] ... According to *Rice's Toyota World, Inc. v. Commissioner of Internal Revenue*, 752 F.2d 89 (4th Cir.1985) and its progeny, if a taxpayer's transaction satisfies the requirements of either prong of the test it must be respected for taxing purposes.

438 Mass. 84-85, 778 N.E. 2d at 515-516.

The SJC rejected this analysis, however, agreeing with other courts "that have concluded that whether a transaction that results in tax benefits is real, such that it ought to be respected for taxing purposes, depends on whether it has had practical economic effects beyond the creation of those tax benefits." *Id.* at 516.

The new legislation adopts a formulation of the sham transaction doctrine that resembles the analysis of *Rice's Toyota World* that the SJC (and other courts) rejected, but with a twist: instead of authorizing the Commissioner to disallow the asserted tax consequences of a transaction as a sham if *both* of the factors cited in *Rice's Toyota World* are present, it authorized the use of the sham transaction doctrine if *either* factor is present. In such a case, the taxpayer has the burden of proof that the transaction possessed both a valid, good-faith business purpose other than tax avoidance; and economic substance apart from the tax benefit. See Chapter 4, section 10 (enacting MGL ch. 62C § 3A).

It is not clear what effect this legislation will have. *Rice's Toyota World* has been criticized by other jurisdictions as being too easy a test for the taxpayer to meet, and the courts may view the legislation as being just another repudiation of that case. A very recent Massachusetts opinion, promulgated after the adoption of Chapter 4, makes no mention of the statutory definition, expressing the sham transaction doctrine as it was expressed in *Sherwin-Williams*. *Cambridge*

Brands, Inc. v. Commissioner (App. Tax. Bd. July 16, 2003). Nonetheless, the statute might be used to broaden the sham transaction doctrine so as to overlook a transaction that, although having economic substance, is one that was clearly motivated by tax considerations, with no regard to profit.

VI. DRAFT DEPARTMENT OF REVENUE INTERPRETATION (TECHNICAL INFORMATION RELEASE)

On July 1, 2003, the DOR circulated for comment a draft of a proposed Technical Information Release (TIR) that expresses its interpretation of the legislation. A copy of the draft TIR is attached as Exhibit 2 and is available at www.dor.state.ma.us/rul_reg/tir/TIR_03_XX-SW.htm. In the TIR, the DOR emphasizes, as a basis for avoiding the add-back of royalties, proof that the add-back will actually result in double-taxation of the royalty income. The TIR also states that if the royalties payable to the IPHC are either not paid or make a "round trip" back to the licensee (regardless of the form of the transaction) the add-back of royalties will be required. In one respect, the TIR draws upon the distinctions made by the SJC in *Sherwin-Williams*. The TIR indicates that separation of management between the IPHC and its licensees will be a factor in evaluating the taxpayer's claim that the add-back would be unreasonable as applied the deduction claimed.

VII. DEVELOPMENTS IN OTHER JURISDICTIONS

As noted earlier, the IPHC strategy has no tax value in the 15 states that are unitary jurisdictions. *See* Mazerof, note 1 *supra*. The IPHC has also been successfully attacked either through the courts, in administrative proceedings, or by legislation, in another eleven states. For court and administrate challenges in Maryland, New Mexico, New York, North Carolina and Tennessee, s*ee Comptroller of the Treasury v. Syl, Inc.*, ---Md.---, 825 A.2d 399 (Md. 2003); *Kmart Properties, Inc. v. Taxation and Revenue Department* (N.M. Ct. App. 2001) (Docket No. 21,140, *appeal granted* 131 N.M. 564 (January 9, 2002) *case stayed* pursuant to bankruptcy law 11 U.S. § 362(a)) (trademark is inseparable from goodwill, which exists in-state and is a basis for asserting jurisdiction); *In re Sherwin Williams Co.* (NY Tax App. Tr., June 5, 2003) (DTA 816712, available at http://www.nysdta.org/ Decisions/ 816712.dec.pdf); Administrative Decision No. 381, 7 May 2002, as described at *http://www.dor.state.nc.us/ press/limited_final.html* (Wake County N.C. Superior Court upholding decision against a trademark-holding subsidiary); and *JC Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999). For legislation in Alabama, Connecticut, Mississippi, New Jersey, North Carolina and Ohio, *see* 2001 Ala. Act

2001-1088 (HB 2); 1998 Conn. Acts. 98-110 § 20 (SB 416); 2001 Miss. Laws. ch. 586, § 4, HB 1695; N.J. Assembly Bill 2501 of 2003; 2001 N.C. Session Laws ch. 327 (House Bill 1157); and Ohio Rev. Code § 5733.042.

Not all states are successful in their challenges against taxpayers: *see e.g.* Missouri, *Acme Royalty Co. v. Director of Revenue*, 96 S.W. 3d 72 (Mo. 2002).

VIII. NON-TAX CONSIDERATIONS

Corporations that wish to save on state tax have been thorough in developing non-tax justifications for establishing IPHCs. As noted earlier, in *Sherwin-Williams,* the SJC cited eleven justifications set forth in the minutes of the Sherwin-Williams board meeting, while suggesting that there were more reasons that they chose not to include in their decision. Without reviewing the merits of those justifications, they are:

(1) improvement of quality control oversight

(2) increased efficiencies by virtue of having profit centers separate from the parent company;

(3) easier profit analysis by having profit centers for the marks that were separate from it;

(4) enhanced ability to enter into third-party licensing arrangements at advantageous royalty rates;

(5) maximized investment returns associated with the marks due to separate and centralized investment management;

(6) enhanced borrowing capabilities;

(7) subsidiaries could be used in certain instances to acquire businesses;

(8) provided ability to take advantage of the well-developed body of corporate law and expeditious legal system in Delaware;

(9) insulated the marks from parent company liabilities;

(10) increased flexibility in preventing a hostile takeover; and

(11) increased liquidity.

The non-tax reasons *not* to establish an IPHC are seldom discussed. Here are a few. First, trademarks are inextricably bound up with good will. If the good will of the parent company is transferred to a subsidiary, how is that accounted for? How is it valued? Does the transfer of the good will to the subsidiary place the good will at any special risk? Are there any intent-to-use applications (ITUs) that, by regulation, *cannot* be assigned unless the existing business associated with the mark is also being transferred? 15 U.S.C § 1060(a)(1). If the ITUs remain with the parent, does it create problems because there are related marks that are being transferred that ought not be separated from the ITUs to avoid possible conflicts and resulting problems in registering and enforcing the mark?

If the IPHC receives patents from a parent that manufactures goods covered by the patent, there is some risk that the IPHC arrangement will place in jeopardy the ability for the company to collect lost profits for patent infringement. *See Patent-Holding Companies Hold Risks*, National Law Journal, June 16, 2003 at 87. In addition, the taxpayer may wish to be conservative in the royalty rate that the IPHC imposes on its affiliates, to avoid challenge of the royalties under Internal Revenue Code section 482 (as applied under state law). In doing so, however, the taxpayer may be setting a low threshold for a "reasonable royalty" measure of damages in a subsequent patent infringement case against a third party.

In many cases, it is important to think through the IP issues presented by a transfer before committing to an IPHC, particularly with respect to the future enforcement of trademarks and patents against third parties. A full review of the potential problems is beyond the scope of this article.

IX. CONCLUSIONS

Recent Massachusetts legislation has effectively overruled *Sherwin-Williams* and made IPHCs ineffective as a vehicle for tax savings in Massachusetts. Massachusetts thus joins a collection of 25 other states where the IPHC is ineffective as a tax-planning device. The logic of *Sherwin-Williams* may have some vitality for companies wishing to establish IPHCs for use in some of the other 25 states, and for Massachusetts cases involving tax years prior to 2002. For those companies, a careful assessment of the particulars of the IP portfolio in question should be undertaken. And the IPHC should be viewed as a tax-planning vehicle with a limited lifespan, since it is commonly viewed as a tax loophole by state tax authorities nationally, and is a likely to be a target for states eager to make up budget shortfalls.

EXHIBIT 1

Excerpts from Chapter 4 of the Acts of 2003

AN ACT MAKING APPROPRIATIONS FOR FISCAL YEAR 2003 TO PROVIDE FOR SUPPLEMENTING CERTAIN EXISTING APPROPRIATIONS AND FOR CERTAIN OTHER ACTIVITIES AND PROJECTS.

Whereas, The deferred operation of this act would tend to defeat its purpose, which is to make forthwith supplemental appropriations and related changes in certain general and special laws, therefore it is hereby declared to be an emergency law, necessary for the immediate preservation of the public convenience.

SECTION 10. Chapter 62C of the General Laws is hereby amended by inserting after section 3 the following section:-

Section 3A. In applying the laws referred to in section 2, the commissioner may, in his discretion, disallow the asserted tax consequences of a transaction by asserting the application of the sham transaction doctrine or any other related tax doctrine, in which case the taxpayer shall have the burden of demonstrating by clear and convincing evidence as determined by the commissioner that the transaction possessed both: (i) a valid, good-faith business purpose other than tax avoidance; and (ii) economic substance apart from the asserted tax benefit. In all such cases, the taxpayer shall also have the burden of demonstrating by clear and convincing evidence as determined by the commissioner that the asserted non-tax business purpose is commensurate with the tax benefit claimed. Nothing in this section shall be construed to limit or negate the commissioner's authority to make tax adjustments as otherwise permitted by law.

SECTION 15. Said paragraph 4 of said section 30 of said chapter 63, as amended by said section 9 of said chapter 300, is hereby further amended by adding the following clause:-

(v) except as otherwise provided in section 31J, interest expense paid, accrued or asserted in connection with a dividend of a note or similar obligation stating the requirement that such interest is to be paid by the corporation that dividends such obligation to its shareholders.

SECTION 17. Said chapter 63 is hereby further amended by inserting after section 31H the following 2 sections:-

Section 31I. (a) As used in this section, the following words shall, unless the context requires otherwise, have the following meanings:-

"Code", the federal Internal Revenue Code as amended and in effect for the taxable year.

"Intangible expenses and costs", includes (1) expenses, losses and costs for, related to, or in connection directly or indirectly with the direct or indirect acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of intangible property to the extent such amounts are allowed as deductions or costs in determining taxable income before operating loss deductions and special deductions for the taxable year under the Code; (2) losses related to, or incurred in connection directly or indirectly with, factoring transactions or discounting transactions; (3) royalty, patent, technical and copyright fees; (4) licensing fees; and (5) other similar expenses and costs.

"Intangible property", patents, patent applications, trade names, trademarks, service marks, copyrights, mask works, trade secrets and similar types of intangible assets.

"Interest expenses and costs", amounts directly or indirectly allowed as deductions under section 163 of the Code for purposes of determining taxable income under the Code to the extent such expenses and costs are directly or indirectly for, related to, or in connection with the direct or indirect acquisition, maintenance, management, ownership, sale, exchange or disposition of intangible property.

"Related member", a person that, with respect to the taxpayer during all or any portion of the taxable year, is: (1) a related entity, (2) a component member as defined in subsection (b) of section 1563 of the Code; (3) a person to or from whom there is attribution of stock ownership in accordance with subsection (e) of section 1563 of the Code; or (4) a person that, notwithstanding its form of organization, bears the same relationship to the taxpayer as a person described in (1) to (3), inclusive.

"Related entity", (1) a stockholder who is an individual, or a member of the stockholder's family set forth in section 318 of the Code if the stockholder and the members of the stockholder's family own, directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; (2) a stockholder, or a stockholder's partnership, limited liability company, estate, trust or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts and corporations own directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; or (3) a corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of the Code if the taxpayer owns, directly, indirectly, beneficially or constructively, at least 50 per cent of the value of the corporation's outstanding stock. The attribution rules of the Code shall apply for purposes of determining whether the ownership requirements of this definition have been met.

(b) For purposes of computing its net income under this chapter, a taxpayer shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related members.

(c) (i) The adjustments required in subsection (b) shall not apply if: (A) the taxpayer establishes by clear and convincing evidence, as determined by the commissioner, that the adjustments are unreasonable; or (B) the taxpayer and the commissioner agree in writing to the application or use of an alternative method of apportionment under section 42. Nothing in this subsection shall be construed to limit or negate the commissioner's authority to otherwise enter into agreements and compromises otherwise allowed by law.

(ii) The adjustments required in subsection (b) shall not apply to the portion of interest expenses and costs and intangible expenses and costs that the taxpayer establishes by a preponderance of the evidence meets both of the following: (A) the related member during the same taxable year directly or indirectly paid, accrued or incurred such portion to a person that is not a related member, and (B) the transaction giving rise to the interest expenses and costs or the intangible expenses and costs between the taxpayer and the related member did not have as a principal purpose the avoidance of any portion of the tax that would be otherwise due.

(d) Nothing in this section shall be construed to limit or negate the commissioner's authority to make adjustments under sections 33 and 39A.

Section 31J. (a) For purposes of computing its net income under this chapter, a taxpayer shall add back otherwise deductible interest paid, accrued or incurred to a related member, as defined in section 31I, during the taxable year, except that a deduction shall be permitted when either: (1) the taxpayer establishes by clear and convincing evidence, as determined by the commissioner, that the disallowance of the deduction is unreasonable, or (2) the taxpayer and the commissioner agree in writing to the application of an alternative method of apportionment under section 42. Nothing in this subsection shall be construed to limit or negate the commissioner's authority to otherwise enter into agreements and compromises otherwise allowed by law.

(b) The adjustments required in subsection (a) shall not apply if the taxpayer establishes by clear and convincing evidence, as determined by the commissioner, that: (i) a principal purpose of the transaction giving rise to the payment of interest was not to avoid payment of taxes due under this chapter; (ii) the interest is paid pursuant to a contract that reflects an arm's length rate of interest and terms; and (iii) (A) the related member was subject to tax on its net income in this state or another state or possession of the United States or a foreign nation; (B) a measure of said tax included the interest received from the taxpayer; and (C) the rate of tax applied to the interest received by the related member is no less than the statutory rate of tax applied to the taxpayer under this chapter minus 3 percentage points.

(c) For purposes of subsection (a), interest payments by the taxpayer to a person or entity that is not a related member will be treated as if made to a related member if the interest is paid in connection with a debt incurred to acquire the taxpayer's assets or stock in a transaction that is referenced in section 368 of Internal Revenue Code, as amended and in effect for the taxable year. For purposes of this subsection, subsection (b) shall not apply.

(d) Nothing in this section shall be construed to limit or negate the commissioner's authority to make adjustments under sections 33 and 39A.

SECTION 19. Section 33 of said chapter 63, as so appearing, is hereby amended by inserting after the word "subsidiary", in lines 2 and 17, the following words:- or parent corporation.

SECTION 20. Said section 33 of said chapter 63, as so appearing, is hereby further amended by inserting after the word "corporation", in lines 4 and 6, the following words:- or subsidiary.

SECTION 21. Said section 33 of said chapter 63, as so appearing, is hereby further amended by inserting after the word "parent", in lines 20 and 24, the following words:- or subsidiary.

SECTION 22. The last paragraph of said section 33 of said chapter 63, as so appearing, is hereby amended by adding the following sentence:- This section shall be broadly construed to include the situation in which the corporations referenced transact with one another through persons or entities that are not corporations within the meaning of this chapter.

SECTION 25. Section 39A of said chapter 63, as so appearing, is hereby amended by inserting after the word "subsidiary", in lines 1 and 2, and in line 16, the following words:- or parent corporation.

SECTION 26. Said section 39A of said chapter 63, as so appearing, is hereby further amended by inserting after the word "corporation", in lines 4 and 6, the following words:- or subsidiary.

SECTION 27. Said section 39A of said chapter 63, as so appearing, is hereby further amended by inserting after the word "parent", in lines 18 and 22, the following words:- or subsidiary.

SECTION 28. The last paragraph of said section 39A of said chapter 63, as so appearing, is hereby amended by adding the following sentence:- This section shall be broadly construed to include the situation in which the corporations referenced transact with one another through persons or entities that are not corporations within the meaning of this chapter.

SECTION 84. By the enactment of sections 10, 15, 17, 19 to 22, inclusive, and 25 to 28, inclusive, the general court clarifies its original intention that the taxpayer is required to possess for a transaction, both: (1) a valid, good-faith business purpose, other than tax avoidance; and (2) economic substance apart from the asserted tax benefit in order to claim a deduction, exemption or other tax benefit.

SECTION 87. Sections 10, 15, 17, 19 to 22, inclusive, and 25 to 28, inclusive, shall be in effect for tax years beginning on or after January 1, 2002. Nothing in this act shall be construed to restrict any authority the commissioner had prior to this act to adjust taxpayer transactions for want of an adequate business purpose or on other grounds.

EXHIBIT 2

Technical Information Release 03-__

Effect of the Supplemental Budget (St. 2003, c. 4) as to Certain

Related Member Interest or Intangible Expenses and Costs and the Commissioner's Interpretation of *The Sherwin-Williams Company v. Commissioner*, 438 Mass. 71 (2002), *rehearing denied* (Feb. 28, 2003).

This TIR explains the application of newly enacted chapter 63, sections 31I and 31J, which were added by chapter four of the recently enacted supplemental budget. *See* St. 2003, c. 4, § 17. Sections 31I and 31J, along with several additional provisions that were added by the supplemental budget legislation, were partly a reaction to the Supreme Judicial Court's decision in *The Sherwin-Williams Company v. Commissioner*, 438 Mass. 71 (2002), *rehearing denied* (Feb. 28, 2003). *See* St. 2003, c. 4, §§ 10, 15, 17, 19-22, 25-28, 84, 87. This TIR also explains the Commissioner's response to the decision in *Sherwin-Williams* and the similar case, *Syms Corp. v. Commissioner*, 436 Mass. 502 (2002), both of which evaluated the deduction of an inter-affiliate trademark royalty expense.

The two new sections, chapter 63, sections 31I and 31J, require that a taxpayer must add back to net income certain interest or intangible expenses and costs. In addition, the recent legislation has modified the chapter 63, section 30.4 definition of "net income" as it pertains to "dividend notes,"[*1*] and has clarified and amended the Commissioner's authority to adjust transactions pursuant to chapter 63, sections 33 and 39A. *See* St. 2003, c. 4, §§ 15, 19-22, 25-28. The supplemental budget also includes a provision that codifies the "sham transaction doctrine." *See* G.L. c. 62C, § 3A, *added by* St. 2003, c. 4, § 10. In sum, these various provisions (the "related party provisions") are generally intended to protect the operation of the state's tax laws to ensure that they function as intended, and are not intended to override the application of any specific Massachusetts statute that confers a tax benefit.

The related party provisions were made effective for tax years beginning on or after January 1, 2002. St. 2003, c. 4, § 87. The Legislature also stated that these provisions were intended to clarify its "original intention" as embodied in the General Laws that a taxpayer seeking to claim a tax benefit in connection with a transaction must show "a valid, good-faith business purpose, other than tax avoidance" and "economic substance apart from the asserted tax benefit." St. 2003, c. 4, § 84. *See also* St. 2003, c. 4, § 87 (noting the Commissioner's authority, even prior to the date of the recent legislation, to "adjust taxpayer transactions for want of an adequate business purpose").

I. TAX YEARS BEGINNING ON OR AFTER JANUARY 1, 2002: THE REQUIRED STATUTORY ADD BACK OF CERTAIN INTEREST AND INTANGIBLE EXPENSES AND COSTS.

The two new sections, chapter 63, sections 31I and 31J, require that a taxpayer add back to net income certain interest and intangible expenses and costs. G.L. c. 63, §§ 31I, 31J, *added by* St. 2003, c. 4, § 17.[2] However, although these sections are mandatory, they do allow for certain exceptions. The statutory exceptions are generally predicated on the taxpayer being able to show by clear and convincing evidence that a particular add back would be unreasonable. *See id.* A taxpayer that seeks to claim that an add back would be unreasonable must do so in the form of a schedule ("Schedule") completed as required by the Commissioner and filed as part of its tax return. A copy of the Schedule is set forth at the end of this TIR.

A taxpayer that completes and submits the Schedule as required may take a claimed deduction on its tax return despite the fact that its underlying transaction is subject to a statutory add back. This tax reporting is permitted as a matter of administrative convenience. Although a taxpayer may claim a deduction on its tax return when that deduction is subject to a statutory add back, the taxpayer retains the burden of proving that the application of the add back is unreasonable. *See* G.L. c. 63, § 31I(c), 31J(a) *added by* St. 2003, c. 4, § 17. A taxpayer must state the basis for its claimed exception on the Schedule, which will then be subject to review as more generally set forth below.

The Schedule consists of two parts. A taxpayer that seeks an exception to a statutory add back must check the box on the first page of the Schedule stating which of the two parts supports its claim. The Schedule's first part permits a taxpayer to claim that an add back would be unreasonable because it would result in actual double taxation. The Schedule's second part permits a taxpayer that cannot use Part 1 to attach a statement explaining why it should be entitled to an add back exception. The two parts of the Schedule are discussed in greater detail below.

A. Part 1: Double Taxation – Presumptive Approval

Part 1 of the Schedule permits a taxpayer to claim that an add back would be unreasonable because it would result in actual double taxation. Part 1 of the Schedule is intended to provide an easy way for a corporation to prove the existence of actual double taxation as to the taxpayer and one or more of its related members. Two specific exceptions relating to double taxation may be claimed in Part 1. Further, when a taxpayer qualifies for one of the specific exceptions referenced in Part 1 and duly files its Schedule with its tax return, the Commissioner will presume that the asserted exception is warranted subject only to a subsequent review for accuracy.

There are two Part I exceptions, which will apply to either an interest or intangible cost or expense. First, Part 1 applies to the situation in which the taxpayer incurs a cost or expense to a related member entity that is taxed on the corresponding income by a U.S. state or foreign jurisdiction at an effective rate of tax that is within 3 percentage points of the taxpayer's effective Massachusetts tax rate. In these cases, the significance of the actual double taxation will be sufficient to demonstrate that the transaction was not intended for tax avoidance purposes and therefore the taxpayer will be entitled to a full exception for the entire amount of the add back. This component of Part 1 applies to one or more related members. However, for purposes of verifying the taxpayer's claim, the Commissioner requires that the taxpayer attach a copy of each related member's tax return to its Schedule. Also, this component of Part 1 does not apply to tax that is applied to a related member when that related member files in another jurisdiction with the taxpayer on a combined or unitary basis. In these cases, the claim of significant actual double taxation must be made pursuant to Part 2 below, assuming that this claim can be made at all.

Second, Part 1 applies to the specific portion of a taxpayer's cost or expense that is taxed to one or more related member entities on a Massachusetts corporate excise return. In these cases, the exception will apply to that portion of the cost or expense that is subject to double tax. Also, the taxpayer need not attach a copy of the related member's return to its Schedule since the Commissioner will be able to independently verify the taxpayer's add back claim.[3]

In any case in which a taxpayer may utilize each of the two Part 1 exceptions stated above with respect to the same cost or expense, the taxpayer must choose only one exception. Part 1 applies to dividend notes, but does not apply to certain transactions in which interest is paid to an unrelated party in connection with debt that was used to acquire the taxpayer's assets or stock. *Compare* G.L. c. 63, § 30.4(4), *added by* St. 2003, c. 4, § 15 *with* G.L. c. 63, § 31J(c), *added by* St. 2003, c. 4, § 17.

The Commissioner recognizes that there may be instances of actual double taxation that cannot be evidenced on Part 1 of the Schedule. For example, *inter alia,* it may be that the related member is not taxed as an entity or files in another jurisdiction with the taxpayer on a combined or unitary basis. In these cases, the taxpayer may seek to claim the existence of actual double taxation through Part 2 of the Schedule, as discussed below.

B. Part 2: Statement Supporting an Add Back Exception

When a taxpayer seeks to claim an exception to a statutory add back that cannot be claimed under Part 1 of the Schedule, this claim must be made pursuant to Part 2. In these cases, the taxpayer may assert the claimed exception on a statement ("Statement") that is included in its Schedule.

With one exception as noted in section B(1) below, a taxpayer's Statement must state that the taxpayer possesses "clear and convincing evidence" to prove that the application of the statutory add back to its claimed deduction would be unreasonable. In general, the taxpayer's evidence must prove that its transaction was not for tax avoidance purposes, as discussed in more detail below. Clear and convincing evidence is evidence that is so "clear, direct and weighty" that it will permit the Commissioner to "come to a clear conviction, without hesitancy" of the validity of the taxpayer's claim. *See United States v. Goba*, 220 F. Supp. 2d 182, 188 (W.D.N.Y. 2002) (*quoting Cruzan v. Missouri Dep't of Health*, 497 U.S. 261, 285 (1990)).[4] On its Statement, the taxpayer must identify its clear and convincing evidence. Also the taxpayer must retain this evidence so that it can be made available to the Commissioner upon his request. *See* 830 CMR 62C.25.1 (pertaining to taxpayer record retention).

The Commissioner will recognize three types of Part 2 claims, as set forth below. Any taxpayer that seeks a Part 2 exception must specify on the first page of the Schedule the specific type of exception that is being claimed. The taxpayer's Statement should be drafted using the following guidelines. These guidelines are meant to assist a taxpayer in providing the Commissioner with clear and convincing evidence to support its add back exception claim. In each case, the taxpayer should state the requested information and identify the requested evidence, as indicated. Further, the taxpayer should provide any additional information and identify any additional evidence that would be necessary or helpful to process its add back exception claim.

(1) Royalty Payments through a Related Member Conduit

In the specific instance of an intangible property transaction, the taxpayer may claim in its Statement that, although its royalty payments were made to a related member, in substance the payments were a direct payment by the taxpayer to an unrelated party and that there was no tax avoidance intent. *See* G.L. c. 63, § 31I(c)(ii), *added by* St. 2003, c. 4, § 17. In these cases, the taxpayer may state that its claim is supported by a preponderance of the evidence and not the more rigorous clear and convincing evidentiary standard. *See id.* In general, a taxpayer should state on its Statement that the intangibles payments were made, first, between the taxpayer and a related member and, second, between the related member and an unrelated party. If the two sets of payments are not identical in kind or amount or in any other respect the taxpayer should explain the basis for the discrepancy. Also, the taxpayer should state whether the payments were made in either case pursuant to a written contract and if so should briefly describe the contract or contracts, including the date thereof and the general subject matter. Further, the taxpayer should state in what manner the taxpayer actually used the intangible property in question.

(2) Other Instances of Double Taxation

A taxpayer that is unable to use Part 1 pertaining to actual double taxation may nonetheless claim in Part 2 that it possesses clear and convincing evidence to support a similar claim. As in the case of Part 1, the taxpayer may make one of two double taxation claims. First, the taxpayer may claim that it should be entitled to an add back exception for its entire interest or intangible cost or expense since this cost or expense is subject to significant actual double taxation in another jurisdiction. A claim of significant actual double taxation requires that the taxpayer state that its related member or members are taxed on the income in question at an effective rate of tax that is substantially equivalent to the taxpayer's effective Massachusetts tax rate. A rate of tax that is substantially equivalent to the taxpayer's Massachusetts tax rate is the taxpayer's effective rate of tax pursuant to chapter 63 minus three percentage points. *See* G.L. c. 63 § 31J(b), *added by* St. 2003, c. 4, § 17. Second, the taxpayer may claim that it should be entitled to an exception for the specific amount of the interest or intangible cost or expense that is subject to actual double taxation in either Massachusetts or some other state or foreign jurisdiction.

A taxpayer that states in Part 2 that it is subject to actual double taxation, as noted above, should explain in detail in its Statement the basis for this claim. The Statement should identify the tax jurisdiction or jurisdictions in which the related member or members are subject to tax and also state whether the related member or members made a tax filing in each of the jurisdictions referenced. Further, assuming that a related member did make such a filing, the Statement should also specify whether the related member paid tax to this jurisdiction in connection with the cost or expense in question.

In general, a claim of double taxation should not be based upon taxation applied to a related member by a state in which that related member is filing with the taxpayer on a combined or unitary basis. Typically, in these cases, the taxpayer's expense and the payment made to the related member will "wash" for purposes of the combined or unitary filing and therefore the latter filing will not result in actual double taxation. A taxpayer can claim double taxation vis-à-vis a state in which the taxpayer and its related member file on a combined basis when the taxpayer can prove that the taxpayer and its related member have separately computed their taxable income for filing purposes. *See, e.g.,* G.L. c. 63, § 32B (permitting "consolidated" filings of this type). In these cases, in addition to the information stated above, the taxpayer should identify the referenced state as having a combined or unitary tax filing requirement and should also explain the mechanics of that state's separate tax computation. Also, the taxpayer should specifically explain how the application of the tax law in the state in question resulted in double taxation.

As in the case of Part 1, a claim of actual double taxation may be made under Part 2 in the context of a dividend note. *See* G.L. c. 63, § 30.4(4), *added by* St. 2003, c. 4, § 15. In these cases, the taxpayer should describe the transaction and state the material terms of the note, including the date, term, principal and the interest payment schedule. In contrast, a claim of double taxation cannot be made in the context of certain transactions in which interest is paid to an unrelated party in connection with debt that was used to acquire the taxpayer's assets or stock. *See* G.L. c. 63, § 31J(c), *added by* St. 2003, c. 4, § 17.

(3) Other Transactions

In all other cases the Statement in support of a claim for a Part 2 exception should be supported by clear and convincing evidence that the transaction was not intended for tax avoidance purposes. *See* G.L. 63, §§ 31(c)(i), 31J(a), *added by* St. 2003, c. 4, § 17. In general, this means that the taxpayer should state that there is clear and convincing evidence that its transaction possesses both a valid business purpose other than tax avoidance and also economic substance. *See* G.L. c. 62C, § 3A, *added by* St. 2003, c. 4, § 10. *See also* St. 2003, c. 4, §§ 84, 87. Further, the taxpayer should state that there is clear and convincing evidence to show that its interest or intangibles payments were appropriate within the meaning of G.L. c. 63, §§ 33 and 39A. See G.L. c. 63, §§ 33, 39A (requiring that there be "fair value" or "fair consideration" paid in connection with affiliate transactions). The business purpose(s) referenced on the taxpayer's Statement should also be commensurate with the value of the deduction claimed. *See* G.L. c. 62C, § 3A, *added by* St. 2003, c. 4, § 10. Thus, for example, if the amount of the claimed deduction is substantial, the asserted business purpose should be comparably substantial.

a. Statement of Business Purpose and Economic Substance

The taxpayer's statement of the business purpose or purposes for its transaction should be specifically worded. The purpose or purposes stated should relate to the particular transaction for which the deduction is being claimed and not, for example, to the formation of a related member entity with which the taxpayer transacts. *Compare Carpenter Technology Corp. v. C'mmr*, 779 A.2d 239, 242-243 (Conn. Sup. Ct 2000), *aff'd*, 772 A.2d 592 (2001) (focusing on the validity of the corporation that made a purported loan) *with In re Carpenter Technology Corp*, 295 A.D.2d 830, 833 (N.Y. App. Div. 2002) (focusing on the validity of the specific loan transaction). Further, the taxpayer's business purpose or purposes must relate to discrete business activity conducted by the taxpayer and this specific business activity should be described. In addition to its statement of business purpose, the taxpayer should identify each of the elements of the transaction that it relies upon to support a finding of economic substance. The business purpose(s) and economic substance that are relevant for purposes of the add back analysis are those that existed at the time of the transaction, and not justifications that are deemed reasonable "after-the-fact." *See Syms*, A.T.B. Docket No. F215484, F228324, 2000 Mass. Tax LEXIS 79, at 21 (Sept. 14, 2000), *aff'd*, 436 Mass. 505. For this reason, the Commissioner will not generally evaluate statements of business purpose and economic substance unless they are clearly set forth on the taxpayer's Statement since this Statement will be generally contemporaneous with the expenses or costs that are in question.

In cases that evaluate the legitimacy of a claimed intangible cost or expense, the Commissioner will not generally accept as valid any of the business purposes that were rejected by the Supreme Judicial Court in *Syms Corp. v. Commissioner*. *See* 436 Mass. at 511-512 & 512 n. 12 (2002) (noting the Court's rejection of the taxpayer's asserted almost one-dozen non-tax business purposes). *See also Sherwin-Williams*, 438 Mass. at 88-89 (similar).[5] Further, it shall not be sufficient in cases that resemble *Syms* and *Sherwin-Williams* for the taxpayer to claim that the related member holding the intangibles was not established in a "tax haven" state like Delaware since the same tax-motivated transaction is possible as to a state that is not a tax haven. *See, e.g., KMART Props., Inc v. Taxation & Revenue Dep't.*, No. 21140 (N.M. Ct. App. Nov. 27, 2001), *reprinted in* 2001 State Tax Today 233-18 (Dec. 4, 2001).[6]

b. Description of Transaction; Basis for the Payment Amounts

The taxpayer's Statement should provide a detailed description of the transaction that generated the claimed deductions in question. This description should identify the parties to the transaction and also describe the history of the transaction, including a description of the actions by which the transaction was originally commenced. If the deduction was claimed pursuant to a written contract, the taxpayer should briefly describe the contract, including the date and the relevant terms.[7] Further, the taxpayer must state the basis for its determination that the amount of the cost or expense in question was substantially identical to what would be expended in an arm's length transaction under substantially similar circumstances. *See* G.L. c. 63, §§ 33, 39A. *See also In re Tropicana Sales, Inc.*, DTA Nos. 815253, 815564, 2002 N.Y. Tax. LEXIS 162 (NY Tax Trib. 2002) (evaluating how "uncontrolled comparables" can be used to show "arm's length" pricing). If for purposes of this latter statement, the taxpayer is relying upon an appraisal or a study, either prepared by itself or a related or non-related party, the taxpayer should identify this study or appraisal, and state the preparer, the date and the general conclusions thereof. The Commissioner will generally reject a Part 2 "other" claim when a taxpayer cannot show by clear and convincing evidence that the amount of the deduction was fair as stated above.

c. Statement that there was no "Circular Flow of Funds"

The taxpayer's Statement should also specifically set forth whether the taxpayer is seeking to deduct a cost or expense that was either not paid in whole or in part or, if the cost or expense was paid, whether it was substantially returned to the taxpayer within a short period of time. As to these facts, the Commissioner notes that he will generally reject a Part 2 "other" claim when it is based upon a purported cost or expense in which no actual transfer of funds was made or, if some funds were in fact transferred, the cost or expense was substantially not paid.[8] Further, the Commissioner will generally reject a Part 2 "other" deduction in any case in which a payment was in fact made, but the funds were substantially returned to the payer-taxpayer, either directly or indirectly, within a short period of time. In the latter cases, the manner and means of the "circular flow of funds," e.g., through a dividend, loan, capital contribution, or some other method of payment, or any combination thereof, will generally not be considered relevant. *See* G.L. c. 63, § 31I(a), *added by* 2003, c. 4, §17 (providing an add back for certain intangible transactions and also for any interest cost or expense that directly or indirectly relate to an intangibles transaction).[9] If the taxpayer's Statement is addressing the second or subsequent year of a multi-year transaction, the taxpayer's Statement should update the information for its prior tax year, assuming that an add back exception was sought for that prior year. In particular, the taxpayer should state whether a cost or expense paid by the taxpayer during its prior tax year was returned to the taxpayer in whole or in substantial part during said prior tax year and the tax year in question.

d. Statement as to the Management of the Transacting Parties

The Statement should also identify what persons are responsible for the day-to-day control or management of the business of the taxpayer and the related member with which the taxpayer contracts, and also what persons were responsible for the negotiation of the transaction. In general, the Commissioner will be more likely to accept an add back claim when the two affiliates are not controlled or managed on a day-to-day basis by the same persons and the same persons did not "occupy both sides of the bargaining table." *See Overnite Transportation*, 54 Mass. App. Ct. at 186. This will be particularly so when the two companies were previously independent entities or, if not previously independent, function like independent entities without interconnected activities or overlapping interests.

e. Statement as to the Acquisition of Intangibles

In the instance of an intangibles transaction, the taxpayer's Statement should also explain in what manner the related member obtained the intangibles for which the taxpayer is making payment. In general, the Commissioner will be more likely to approve an intangible cost or expense when the intangibles were either originated by the related member that receives the payment or were purchased by this related member in a bona fide sales transaction. In general, the Commissioner will not consider the purchase of intangible property to be a bona fide sales transaction when the funds used for making the purchase were substantially transferred or contributed to the purchaser by another related member for the purposes of the sales transaction.

f. Statement of Capitalization for Purposes of Loan Payments

In the instance of an interest deduction, the taxpayer's Statement should reference what the taxpayer's capital structure was at the time that it received the asserted underlying loan and also what its capital structure was during the tax year in question. In general, when interest payments are made by a "thinly capitalized" entity this fact suggests that the underlying transaction does not reflect valid debt. *See, e.g., Overnite Transportation*, 54 Mass. App. Ct. 180.

g. Statement as to Whether the Loan is "Acquisition Debt"

In the instance of an interest deduction, the taxpayer's Statement should also reference whether the underlying debt reflects in whole or in part, directly or indirectly, debt that was originally used to acquire the stock or assets of the taxpayer. In general, an interest loan deduction is not appropriate when the underlying debt either is, or generally replicates, debt that was used to acquire the taxpayer's stock or assets. *See* G.L. c. 63, § 31J (c), *added by* St. 2003, c. 4, § 17 (addressing these transactions when the acquisition is referenced by Internal Revenue Code § 368); G.L.. 63, § 3A, *added by* St. 2003, c. 4, §10 (requiring that the taxpayer show business purpose and economic substance in support of a transaction). In these cases, the deduction is not justified because the taxpayer is in effect claiming that it must pay for its own acquisition. *See, e.g., In re St. Johnsbury Trucking Co.*, 206 B.R. 318, 324 (Bankr. S.D.N.Y. 1998) (applying Massachusetts law), *aff'd*, 173 F.3d 846 (2d Cir. 1999). Also, to the extent that the debt was conferred based upon the assets of the taxpayer's related members and not the assets of the taxpayer, it is not debt that rightfully belongs to the taxpayer.[*10*]

h. Examples

The following examples are intended to illustrate the application of the Part 2 "other" exception. In each of these examples, it should be assumed that there is no significant actual double taxation that would result from the add back in question and that the issue is whether an add back exception should be allowed for the entire expense. Also, it should be assumed that in each case the taxpayer has duly filed a completed Schedule requesting an exception to the statutory add back as part of its tax return. Further, it should be assumed that there are no additional facts or circumstances that would alter the determination as stated in each example.

1. A taxpayer, ABC Corp., is engaged in manufacturing operations in Massachusetts and has been licensing technology from XYZ Corp, an unrelated out-of-state corporation. XYZ Corp. acquires a controlling interest in ABC Corp., but ABC Corp. continues to use XYZ Corp's technology pursuant to the pre-

existing licensing contract. The Commissioner will not seek to add back a claimed deduction for royalties paid by ABC Corp. to XYZ Corp. pursuant to the pre-existing licensing contract.

2. Same as example 1, except that the pre-existing licensing contract expires and the officers of ABC Corp. and XYZ Corp. negotiate a new licensing contract for the use of the same technology. Assuming that different persons continue to run the day-to-day operations of ABC Corp. and XYZ Corp. as was true prior to the acquisition and that these different persons negotiate the licensing contract, the Commissioner will not generally seek to add back the royalty payments. However, the Commissioner will add back the royalty payments if he determines that the payments do not closely resemble what would be paid in an arm's length transaction between unrelated parties under substantially similar circumstances. For purposes of substantiating its royalty payment, the taxpayer should analogize to the expired licensing contract, which is a close comparable, and should explain the basis for any material modification in the terms.

3. An out-of-state corporation, XYZ Corp., licenses trademarks that it owns and originated to unrelated out-of-state entities for these entities to use for the purpose of selling products that are manufactured by these entities. In connection with these sales, the unrelated entities pay to XYZ Corp. a royalty fee pursuant to XYZ Corp.'s standard form licensing contract. XYZ Corp. forms ABC Corp., a wholly owned corporation that is to operate stores in Massachusetts. XYZ Corp. causes ABC Corp. to enter into a contract pursuant to which ABC Corp. will sell products that are manufactured by another subsidiary of XYZ Corp. using the trademarks that are owned by XYZ Corp. Pursuant to this licensing contract, ABC Corp. agrees to pay XYZ Corp. a royalty fee in connection with its in-state retail sales. Although ABC Corp., unlike XYZ Corp.'s unrelated licensees, merely sells products that it purchases from XYZ Corp., the percentage royalty that ABC Corp. seeks to deduct is similar to that paid by XYZ Corp's unrelated licensees. The Commissioner will add back the royalty deductions that are asserted by ABC Corp. in connection with its in-state retail sales.

4. A taxpayer, ABC Corp., has an outstanding loan in place with XYZ Corp., which is an unrelated corporation doing business outside the state. XYZ Corp. later acquires ABC Corp. and ABC Corp. continues to make interest payments to XYZ Corp.

in accordance with the pre-existing loan agreement. The Commissioner will not seek to add back a claimed deduction for the interest paid by ABC Corp. to XYZ Corp. pursuant to the pre-existing loan contract.

5. A taxpayer, ABC Corp., is engaged in manufacturing operations in Massachusetts and is acquired by XYZ Corp., which is an out-of-state corporation engaged in service retailing. Although XYZ. Corp. formally controls ABC Corp. by reason of its acquisition, XYZ Corp. retains the separate management of ABC Corp., which continues to run the operations of that entity in an independent manner. The officers of ABC Corp. determine that they require loan funding to engage in a certain aspect of their manufacturing business. Although ABC Corp. could borrow these loan funds from an unrelated party, its officers decide to borrow these funds from XYZ Corp., then immediately use most of the these funds in their business as planned. Although ABC Corp. does not immediately use all of the loan proceeds received from XYZ Corp., it retains the remaining funds for future use and does not return any portion of these funds to XYZ Corp. either in the tax year in question or thereafter. Assuming that the interest paid by ABC Corp. to XYZ Corp. closely resembles what would be paid in an arm's length transaction under substantially similar circumstances, the Commissioner will not add back the interest payments

6. XYZ Corp., an out-of-state corporation, enters into an agreement with an unrelated corporation, Sell Corp., to acquire ABC Corp., a Massachusetts corporation that is a wholly owned subsidiary of Sell Corp. For purposes of completing this acquisition, XYZ Corp. forms a wholly owned subsidiary, Acquire Corp. Also, XYZ Corp. capitalizes Acquire Corp. with monies to be used for purposes of the acquisition and causes an unrelated lender to loan Acquire Corp. the remainder of the funds needed to complete the acquisition. Using the funds referenced that it receives from XYZ Corp. and the unrelated lender, Acquire Corp. purchases ABC Corp. from Sell Corp., then merges into ABC Corp. The Commissioner will add back the interest deductions that are asserted by ABC Corp. in connection with the debt that was used to acquire ABC Corp.

7. Same facts as example 7, except that instead of initially placing the acquisition debt with Acquire Corp., XYZ Corp. is the stated debtor on this loan. Subsequent to the acquisition of

ABC Corp., XYZ Corp. enters into a loan agreement with ABC Corp. that substantially replicates the terms of XYZ Corp.'s loan agreement with the unrelated lender. The Commissioner will add back the interest deductions that are asserted by ABC Corp. in connection with the debt that was used to acquire ABC Corp.

8. XYZ Corporation, an out-of-state corporation, wholly owns ABC Corp., which is a Massachusetts corporation. For purposes of activities to be conducted by XYZ Corp., ABC Corp. dividends to XYZ Corp. a note obligation, pursuant to which it promises to make principal and interest payments over a period of years. ABC Corp. receives no loan proceeds in connection with this dividend note transaction. The Commissioner will add back the interest deductions that are asserted by ABC Corp. in connection with the dividend note transaction.

9. An individual, IP, owns and operates ABC Corp., a profitable Massachusetts corporation engaged in a specific line of business. Subsequently, IP acquires DEF Corp., a second Massachusetts corporation engaged in a similar line of business, which IP will also operate. DEF Corp. is profitable during the tax year in question, but because it has substantial net operating losses from prior years it will have not have any Massachusetts tax liability for the tax year. IP causes DEF Corp. to loan monies to ABC Corp. to use in ABC Corp.'s general operations and also causes ABC Corp. to make timely payments on this loan. For tax purposes, the interest payments have the potential effect of reducing ABC Corp's Massachusetts' tax liability on a dollar for dollar basis. Very little of the loan proceeds are actually used by ABC Corp. in its general operations during the tax year at issue. The Commissioner will add back the interest deductions that are asserted by ABC Corp. in connection with the asserted loan transaction.

C. 2002 Tax Year Filings Made Prior to the Issuance of this TIR

In any case in which a taxpayer is subject to a statutory add back for its 2002 taxable year and has filed its tax return for that year prior to the date of the issuance of this TIR, the following rules apply. In all such cases, the taxpayer must submit a completed Schedule in the form of an amended return within nine months of the date of this TIR. If the taxpayer fails to meet this timing requirement, the Commissioner will presume that the taxpayer is unable to establish that the application of the statutory add back is unreasonable.

In general, the Commissioner will process Schedules that are filed as an amended return for a taxpayer's 2002 tax year in the same manner described above for filings that are made subsequent to the date of this TIR. When the taxpayer's amended return for its 2002 tax year includes a Schedule that asserts a Part 1 exception, the Commissioner will presume that the exception is warranted at the time of the taxpayer's filing, subject only to a subsequent review for accuracy. When the taxpayer's amended return for its 2002 tax year includes a Schedule that asserts a Part 2 exception, the Commissioner will evaluate the reasonableness of the asserted exception using the same analysis that is described for Part 2 filings above.

D. Requests for Additional Information; Penalties for Noncompliance

The above-stated rules permit a taxpayer to assert either an intangible or interest deduction on its tax return, notwithstanding the fact that the underlying expense or cost is subject to a statutory add back. However, the fact that the taxpayer may assert this deduction on its tax return is for administrative convenience and is not intended to suggest that the claimed add back exception is appropriate. In all cases, although a taxpayer may assert a deduction that is subject to a statutory add back on its tax return, the taxpayer nonetheless retains the burden of proving that the application of the statutory add back is unreasonable. *See* G.L. c. 63, § 31I(c), 31J(a) *added by* St. 2003, c. 4, § 17.

When a taxpayer claims an exception to an add back provision on its tax return without filing the Schedule as required by this TIR, the Commissioner will notify the taxpayer that its has filed an incorrect or insufficient return. In these cases, the Commissioner may, in his discretion, apply the penalty provisions of chapter 62C, section 28. *See* G.L. c. 62C, § 28 (pertaining, *inter alia*, to the filing of an incorrect or insufficient return). In these cases, the Commissioner will consider whether the taxpayer's failure to file the Schedule is due to reasonable cause.

In all cases, the Commissioner may request additional information or evidence in addition to that provided by the taxpayer in connection with its Schedule if he determines that this additional submission would be necessary or helpful to evaluate the taxpayer's asserted add back claim. Upon examination of the taxpayer's submitted information and evidence, the Commissioner shall disallow a claimed Part 2 exception if he concludes that the exception has not been sufficiently substantiated by the taxpayer. In these latter cases, the Commissioner may in appropriate circumstances, in his discretion, apply the penalty provisions of chapter 62C, section 28.

E. Requests for Alternative Apportionment

The add back provisions contemplate that a taxpayer and the Commissioner may agree in writing that the taxpayer may use an alternative method of apportionment pursuant to G.L. c. 63, § 42. *See* G.L. c. 63, §§ 31I(c)(i), 31J(a), *added by* St. 2003, c. 4, § 17. In these cases, although the focus is the taxpayer's apportionment methodology and not the statutory add back, the nature of the request, if approved, could cause the add back to be unreasonable. Therefore, an exception to the statutory add back might be appropriate in these cases, and for this reason the Commissioner will treat a request for alternative apportionment as potentially including a request for an add back exception. However, a taxpayer that files a request for alternative apportionment is not entitled to claim an add back exception on its tax return merely by virtue of its apportionment request. Further, in these cases, the add back exception will be granted only if the Commissioner approves the taxpayer's alternative apportionment claim and the add back exception is specifically referenced in the written agreement by which the claim is approved.

II. TAX YEARS BEGINNING PRIOR TO JANUARY 1, 2002: INTER-AFFILIATE INTANGIBLES AND INTEREST COSTS AND EXPENSES AND THE REQUIREMENT THAT A TAXPAYER MUST PROVE A VALID BUSINESS PURPOSE AND ECONOMIC SUBSTANCE.

The following discussion applies to inter-affiliate intangibles and interest deductions asserted for tax years beginning prior to January 1, 2002, i.e., prior to the effective date of newly-enacted chapter 63, sections 31I and 31J. In particular, the following discussion explains the Commissioner's response to the Supreme Judicial Court's decisions in *The Sherwin-Williams Company v. Comm'r*, 438 Mass. 71 (2002), *rehearing denied* (Feb. 28, 2003) and *Syms Corp. v. Comm'r*, 436 Mass. 502 (2002), as considered in light of the recent legislation.

In the cases, *Sherwin-Williams* and *Syms*, the Supreme Judicial Court reached different results using different analyses on similar facts relating to an asserted inter-affiliate royalty deduction. The differing decisions in *Syms* and *Sherwin-Williams* generated confusion concerning the standard to be applied in similar cases. Consequently, the recent legislation states that the Legislature's "original intention" as embodied in the state's tax laws is that a taxpayer seeking to claim a tax benefit in connection with a transaction must show "a valid, good-faith business purpose, other than tax avoidance" as well as "economic substance apart from the asserted tax benefit." St. 2003, c. 4, § 84. Also, the related party provisions enacted by the recent legislation were made effective as of January 1, 2002, prior to the Court's decision in *Sherwin-Williams,* in which the business purpose standard was not applied. This was to emphasize that the Commissioner is to continue to apply the business purpose standard for tax years prior to 2002. *See also* St. 2003, c. 4, § 87 (noting the Commissioner's authority, even prior to the date of the recent legislation, to "adjust taxpayer transactions for want of an adequate business purpose").

Pursuant to the recent legislation, the Commissioner will require for tax years beginning prior to January 1, 2002 that a taxpayer must prove economic substance and a valid business purpose other than tax avoidance for an inter-affiliate royalty or interest expense. *See Syms*, 436 Mass. at 511 (noting that in cases of this nature "the taxpayer bears the burden of proof in the abatement process"). In general, the Commissioner's approach to these cases and the evidence that he will require is similar to that outlined in the first part of this TIR, pertaining to newly-enacted chapter 63, sections 31I and 31J. As noted in the first part of this TIR, the Commissioner will not generally consider as valid any of the business purposes that were rejected in the cases, *Syms* and *Sherwin-Williams*.[*11*]

An out-of-state corporation that receives trademark royalties or similar intangible receipts in connection with in-state sales is subject to the corporate excise in connection with these sales. *See* Directive 96-2. *See also* G.L. c. 63, § 39 (a foreign corporation is subject to this state's tax jurisdiction when it owns property in the state or is doing business here). Therefore, in any case in which a taxpayer contends that its intangible payments to a related member are bona-fide, the Commissioner may seek to impose tax on the related member pursuant to Directive 96-2, assuming that the provisions of that Directive otherwise apply.

ENDNOTES

1. *See Overnite Transportation Co. v. C'mmr*, 54 Mass. App. Ct. 180 (Ct. App. 2002).

2. The term "intangible expenses and costs" includes losses related to or incurred in connection directly or indirectly with factoring or discounting transactions. G.L. c. 63, § 31I(a), *added by* St. 2003, c. 4, § 17.

3. This component of Part 1 might be implicated if, for example, the related member is receiving trademark or similar intangible receipts from the tax-

payer in connection with in-state sales and therefore is filing a corporate excise return with Massachusetts. *See* Directive 96-2.

4. *See also Stone v. Essex County Newspapers, Inc.*, 367 Mass. 849, 871 (1975) (the "clear and convincing" standard is a heightened standard that has been construed to mean "a degree of belief greater than the usually imposed burden of proof by a fair preponderance of the evidence"; the standard requires proof that is "strong, positive and free from doubt") (quotes omitted); *Tosti v. Ayik*, 394 Mass. 482, 493 n. 9 (1985) (similar).

5. The New York State Tax Tribunal also recently rejected the business purposes that were asserted for the year that was at issue in the *Sherwin-Williams* case. *See In re Sherwin-Williams Company*, DTA No. 816712, 2003 N.Y. Tax LEXIS __ (NY Tax Trib. June __, 2003). *See also Comptroller of the Treasury v. SYL, Inc.*, 2003 Md. LEXIS 313 (Md. 2003) (applying a similar analysis to two different taxpayers).

6. In particular, the Commissioner recognizes that this same tax-motivated transaction is often structured by a transfer of intangible property to a related member that has been established in a state that applies the unitary method of taxation when the taxpayer also has a related member with employees in this state. In these cases, some of the persons that are employed in the unitary state are often "assigned" to the corporation to which the intangibles are transferred in an attempt to legitimize the subsequent royalty payments.

7. Although relevant, the fact that a payment is made pursuant to a contract does not "standing alone" render that payment a deductible expense. *See Syms*, 436 Mass. at 514 n.14.

8. Consequently, for example, in cases that do not involve significant actual double taxation, the Commissioner will only approve a Part (2) "other" claim as to interest deductions that are asserted in the context of a dividend note to the extent that actual loan proceeds were advanced to the subsidiary. *Cf. Overnite Transportation*, 54 Mass. App. Ct. 180 (Ct. App. 2002).

9. The cases, *Syms Corp. v. C'mmr*, 436 Mass. 505 (2002) and *Carpenter Technology Corp.*, 779 A.2d 239 (Conn. Sup. Ct. 2000), represent particularly egregious examples of a "circular flow of funds."

10. This same analysis may also be true in cases in which non-acquisition third-party debt is placed with the taxpayer. 11. The list of purposes in each case included the following rejected rationales: that the parent-taxpayer's scheme would (1) protect its trademarks from a hostile takeover, (2) protect the marks from a creditor of the parent, (3) enable the parent to borrow money at lower rates of interest through the subsidiaries, (4) assist the par-

ent in making acquisitions, (5) better facilitate the management of the marks, (6) create a separate "profit-center" that would make it easier to evaluate the profitability of the marks, (7) facilitate third-party licensing, and (8) permit the parent to generally benefit by having a subsidiary incorporated under Delaware law. *See Syms*, A.T.B. Docket No. F215484, F228324, 2000 Mass. Tax LEXIS 79, at *18-26 (Sept. 14, 2000), *aff'd*, 436 Mass. 502 (2002); *Sherwin-Williams*, A.T.B. Docket No. F233560, 2000 Mass. Tax LEXIS 59, at *12-20 (July 19, 2000), *rev'd on other grounds*, 438 Mass. 71 (2002).