Massachusetts Tax Update—2009 Developments
Massachusetts Bar Association 2010 Annual Conference
March 11, 2010

Richard M. Stone, Esq.
rick@rickstonelaw.com
Chair: MBA State Tax Practice Group

1. **Combined Reporting**
   Forty-six states and DC impose some sort of corporate income, franchise or excise tax based on income (not NV, SD, WA or WY). Historically, Massachusetts has been a separate filing state—every company with nexus in Massachusetts has filed a state tax return and apportioned its income among its activities in all states where it does business. In 2008 (effective in 2009), Massachusetts adopted "Combined Reporting", which is designed to address questionable income shifting, abusive tax shelters, and other inter-company transactions among members of a corporate group. With Combined Reporting, the income of a unitary group of affiliates is combined and then apportioned among the members of the entire group. This includes all members of the unitary group, whether or not they have nexus in the taxing state (although some states do exclude members without nexus). In general, Combined Reporting under certain circumstances apportions to Massachusetts the multistate income of a unitary business (whether conducted through several divisions or affiliated corporations), not just the multistate income of a single corporate entity. All activities constituting a single business are viewed as a whole, rather than as separate activities conducted in the state.

   Combined Reporting was developed in the late 1800s as western states sought to impose property taxes on railroad companies. The general idea is to fairly tax the entire unitary business. For some companies, their overall tax burden will decrease, but for most it will increase, as each state has different rules. Massachusetts expects to bring in as much as $400 million in new revenue.

   Combined Reporting differs from consolidated return filings in several ways (50% v. 80% ownership, apportionment methodology, unitary business requirement, worldwide/water's-edge combinations, etc.) and has generated much more litigation in other states than disputes involving consolidated returns, primarily in California.

   So far, about 20 states have mandatory Combined Reporting; 15 other states generally allow separate filing, but also require or permit a combined unitary report if certain conditions are satisfied. In 2009, 10 states considered and then rejected mandatory Combined Reporting.

My thanks to Steven M. Burke, Esq. and Donna L. Killmon, Esq. of McLane, Graf, Raulerson & Middleton Professional Association for their help with the New Hampshire sections of this outline. Donna and Steve are members of MBA's State Tax Practice Group, and they encourage others to join. If you're interested in becoming a member of this Practice Group, please contact Rick Stone at (617) 848-9360 or rick@rickstonelaw.com.

The issues involved are complex. They range from defining the unitary group, understanding and applying the various tests used by Courts to define the group, deciding whether to report on a world-wide basis or on a "water's-edge" basis, understanding the difference between business and non-business income, analyzing nexus issues, etc. As other states have experienced, we can expect much litigation involving these issues.

2. **Geoffrey and Capital One cases—Nexus without a Physical Presence**

Geoffrey, Inc. v. Commissioner of Revenue, 453 Mass. 17 (2009), cert. denied 6/22/09.
Capital One Bank v. Commissioner of Revenue, 453 Mass. 1 (2009), cert. denied 6/22/09.
For many years, taxpayers have argued, mostly without success, that the "physical presence" test of Commerce Clause nexus that was mandated by the U.S. Supreme Court in its Quill decision—*Quill Corp. v. North Dakota, 504 U.S. 298 (1992), based on National Bellas Hess, Inc. v. Department of Revenue of Illinois, 386 U.S. 753 (1967)*—should apply to all taxes, not just sales and use taxes. Congress and the U.S. Supreme Court have consistently refused to address this issue (see #3 below discussing HR 1083, which has been sitting in the House for over a year). The U.S. Supreme Court insists that Congress should address this issue, since it has broad power under the Commerce Clause to do so. Congress' failure to act has resulted in litigation in many states, including Massachusetts.

Following the precedents set by several other states, the Massachusetts Supreme Judicial Court in its *Geoffrey* decision upheld the imposition of income tax on an out-of-state intangible holding company that received royalty income from affiliates in Massachusetts but had no physical presence in the state. Following its holding in the *Capital One* case, the Court held that physical presence is not required for an entity to be subject to a state tax based on income. Instead, a taxpayer must only have established substantial nexus with the state. In the *Capital One* case, the Court noted that significant, purposeful economic activity in a state is enough to establish significant nexus required by prior U.S. Supreme Court decisions. In the *Geoffrey* case, the Court noted that substantial nexus can be established through the licensing of intangible property to a Massachusetts business that generates income for the licensing company.

An analysis of *Geoffrey* might be helpful. Geoffrey was a Delaware company wholly owned by Toys "R" Us, Inc. Geoffrey did not own any real or tangible personal property in Massachusetts, nor did it have any employees or offices located in Massachusetts. Geoffrey had never used state or federal courts in Massachusetts. Geoffrey held all trademarks, trade names, and service marks associated with Toys "R" Us and its related companies, and licensed the intangible property to various Toys "R" Us affiliates throughout the United States, including Massachusetts. These affiliates made market-rate royalty payments to Geoffrey.

The DOR assessed Geoffrey with unpaid corporate taxes, interest, and penalties. Geoffrey protested the assessment, but the Appellate Tax Board upheld the Department's findings.

The Supreme Judicial Court, saying basically that "everyone else is doing it", disagreed with Geoffrey's argument that "physical presence" was required for a state to impose an

income-based tax on an out-of-state taxpayer. The Court maintained that Geoffrey engaged in business activities having a substantial nexus with Massachusetts, including entering into contractual relationships with Toys "R" Us in Massachusetts and marketing to consumers in Massachusetts. These activities generated substantial income for Geoffrey, and the Court concluded that they established a substantial nexus with Massachusetts.

The effect of these cases on future tax litigation in Massachusetts is unclear, since the new Combined Reporting requirements certainly will affect the issues involved in nexus determinations and tax reporting. However, their effect on pre-2009 tax years is significant.

3. **Limits on States' Taxation Powers**
   50th Anniversary of Northwestern States Portland Cement case and
   50th Anniversary of Public Law 86-272 (15 U.S.C. §381)
   Northwestern States Portland Cement Co. v. Minnesota, 358 US 450 (1959), upheld a state's power to tax income generated from interstate activities. This case held, arguably for the first time, that that the Commerce Clause does not prohibit a state from imposing a "fairly apportioned" direct corporate income tax on an out-of-state business carrying on an exclusively interstate business within the state.

   In 1959, seven months after the *Northwestern States* decision, P.L. 86-272 was adopted by a panicked Congress as a "temporary stopgap measure", designed to address several issues that were raised by that decision and its broad opinion. It offers a very limited safe harbor from the imposition of state income taxes by preventing state income taxation of out-of-state corporations if their only in-state activity is the solicitation of orders for sales of tangible personal property that are sent outside the state for approval or rejection and are filled from outside the state. This safe harbor applies only to income taxes (not sales taxes or franchise taxes based on net worth or capital), protects only the sale of tangible personal property (not leasing, not services, not intangibles, and not real estate), and offers no protection if the soliciting employees do anything other than solicit orders (make repairs, approve orders, provide customer training, etc.). This "temporary" measure was designed to last until Congress addressed the overall power of states' taxation rights. Despite many failed attempts to expand or limit its reach, P.L. 86-272 remains intact 50 years later, and is the major federal statutory limit to state corporate income taxation.

   Recent Proposed Legislation
   U.S. House of Representatives
   Hearing on 2/4/10 (State Taxation – The Role of Congress in Defining Nexus)

   HR 1083 Nexus Standards (Introduced 2/13/09)
   The "Business Activity Tax Simplification Act of 2009" expands the federal prohibition against state taxation of interstate commerce to: (1) include within the protection of P.L. 86-272 all transactions involving services and all forms of property, including intangible personal property (currently, only sales of tangible personal property are protected); and (2) prohibit state taxation of an out-of-state entity unless that entity has a

physical presence in the taxing state. It also sets forth criteria for determining whether a business has a "physical presence" in a state.

4. **State Transfer Pricing Case**
IDC Research, Inc. v. Commissioner of Revenue
(MA Appellate Tax Board Findings of Fact and Report, 2009-399)
This case is one of the few state tax transfer pricing cases (almost all these cases are from New York), so it's had much national attention. IDC charged its out-of-state affiliates for concentrated services such as accounting and marketing. The charges to its affiliates were deemed to be "not at arms length" (i.e. too low) by the Department of Revenue. However, this ruling by the Appellate Tax Board determined that the prices IDC charged its affiliates were at arms-length, although it did apply the "sham transaction" doctrine to certain royalty payments. Although the case's significance is limited in Massachusetts by the new Combined Reporting rules, it is still relevant for years prior to 2009, and for all related party transactions that are not eliminated by Combined Reporting because the parties are not in the same unitary group. Also, the IRS and federal courts may take note of it, since it addresses issues raised by Massachusetts' version of IRC Section 482.

   This case is a reminder that intercompany arrangements can no longer be expected to escape the attention of state taxing authorities, and that the "sham transaction" doctrine will be used aggressively by the DOR.

5. **Economic Nexus Legislation in Other States**
Several states (CA, WI, CT, OH and MI) have adopted economic nexus legislation basing their power to impose income taxes on companies simply because they have a threshold level of sales in the state. These states' goal is to broadly tax out-of-state companies that derive any income from their state. Obviously, these statutes are heading to federal court where there is no clear precedent for whether a physical presence in a state is required to impose an income tax (see #2 above). Despite much case law, the U.S. Supreme Court has only required a physical presence for the imposition of a sales tax–*Quill v. North Dakota 504 U.S. 298 (1992)*–but has not ruled on this requirement for income taxes. See also the H.R. 1083 discussion in #3 above.

6. **New York City case involving post 9/11 Rent on World Trade Center Buildings**
In the Matter of the Petition of 1 World Trade Center LLC, TAT(H) 07-34(CR), et al.
(New York City *Tax Appeals Tribunal 12/03/09)*
After 9/11, the master entities controlling the World Trade Center buildings were obligated to continue to make payments to their landlord, the Port Authority, even though the buildings were destroyed. These payments were funded primarily by insurance proceeds. New York City attempted to collect $35 million of NYC commercial rent tax, penalties and interest for the years after 9/11, but the NYC Tax Appeals Tribunal decided that those payments did not constitute "base rent" because New York City (and later the Port Authority) had taken over the site, the master lessees had no right to rebuild on the same site, and no one else had the right to occupy any space on the site.

   This was a bold and obviously controversial attempt by NYC to tax some of the insurance proceeds, but it does raise interesting questions about rent and other payments

made after a building's destruction, whether by fire, storm or otherwise, if the destroyed building cannot be rebuilt on the same site.

7. **W.R.Grace Appellate Tax Board case**
W.R. Grace & Co.-Conn. V. Commissioner of Revenue
(MA Appellate Tax Board Findings of Fact and Report, 2009-261)
W.R. Grace continued its ongoing battles with the DOR about payments to its out-of-state affiliates. This case involved dividend and interest payments that Grace made to an affiliate that Grace contended was not part of its "unitary" business. This case applies pre-2009 law that deals with the issues of unitary businesses and applicable constitutional principles such as functional integration, centralization of management, economies of scale, and an investment/operational analysis. The Board held in favor of Grace, but this case's relevance for future Combined Reporting unitary issues is unclear.

8. **Work Product Doctrine**
U.S. v. Textron, Inc., 577 F.3d 21 (1st Cir. 2009) held that certain tax work papers prepared by Textron's Tax Department were not protected from IRS scrutiny by the work product doctrine, which protects documents prepared in anticipation of litigation. The opinion seems to create a troubling new standard dealing with whether documents were prepared "because of" litigation or with the "primary purpose" of litigation.

   In Commissioner of Revenue v. Comcast Corporation 453 Mass. 293 (2009), the Court held that tax accrual papers shared between in-house counsel and outside tax consultants were protected because they were prepared in anticipation of litigation, but were not protected by the attorney-client privilege.

   These two cases may be in conflict, and Textron is seeking U.S. Supreme Court review, although any effect of that Court's ruling on Rule 26(b)(3) of the Massachusetts Rules of Civil Procedure is unclear. At least the Supreme Court could resolve the conflicting decisions among the Circuits. At this point, many tax litigators worry that providing work papers in one jurisdiction might result in a waiver of protection in other jurisdictions.

9. **Sales Tax increase**
On August 1, 2009, the sales tax rate in Massachusetts increased to 6.25% from 5.00%. The state's alcohol, satellite television, meals, and hotel taxes also were increased.

10. **State Income Tax Credit for Donated Conservation Land**
Effective in 2011, this is an effort to "encourage private landowners to make lasting contributions to our natural and cultural heritage". Eligible lands include those that protect drinking water supplies, wildlife habitat and scenic vistas, and those that boost the tourism, agricultural and forest product industries. The incentive requires that gifts of land be permanently protected. The credit (up to $50,000) is valued at 50% of the appraised fair market value of the land, and the credit cannot exceed the donor's tax liability, although it can be carried forward.

11. **Streamlined Sales Tax Project**
Massachusetts is not yet a full member of the Project (MA is an "Advisor State"), which seeks to simplify interstate sales tax collection by participating retailers in the member states. In February 2009, the Project's Governing Board amended its "essential clothing" rules to make it possible for Massachusetts, New York and Connecticut to join. If these states don't join, the Board has announced that it "may" repeal its amendment in April 2010, which probably would end any near-term full participation by Massachusetts.

12. **New Hampshire Update**
New Hampshire's reaction to Town Fair Tire case
The Massachusetts DOR's failed attempt to assess sales/use tax collection duty on a NH retailer's sales in NH to Massachusetts customers generated an angry legislative response from NH.

Town Fair Tire Centers, Inc. v. Commissioner of Revenue, 454 Mass. 601 (2009) was a narrow decision testing whether Massachusetts has the right to compel the tire company, which also has stores in Massachusetts and has nexus in Massachusetts, to collect Massachusetts use tax on tires sold and installed in NH on vehicles bearing Massachusetts license plates and registrations. Instead of applying constitutional principles, as the Appellate Tax Board had done, the Supreme Judicial Court decided this case on narrow grounds, prohibiting the DOR from making a presumption that an out-of-state purchase is for use in Massachusetts, and stated that:
"There is no Massachusetts statutory presumption of use in the Commonwealth where personal property is sold to a Massachusetts resident outside the Commonwealth, even where the goods purchased out of State may be affixed to property registered in Massachusetts. We will not recognize a presumption that the Legislature has not established."
The Court went on to say that Massachusetts could create a statutory presumption, but that it had not done so, and therefore it did not exist. Since there was no other proof that the tires were used in Massachusetts, the Court reversed the Appellate Tax Board's decision in favor of the Commissioner.

In response, the Commissioner of Revenue has recently (2/11/2010) issued Sales and Use Tax TIR 10-2, which makes clear that:
"Absent evidence of actual storage or use in the Commonwealth, the Commissioner will not assess a use tax against an out of state registered vendor on sales to a Massachusetts resident where a Massachusetts resident purchases and takes possession of tangible personal property entirely outside the Commonwealth."
The TIR also reminds taxpayers that a use tax return must be filed and the tax must be paid by a purchaser storing, using or consuming tangible personal property in the state:
"The Town Fair Tire decision does not exempt purchasers who purchase property elsewhere and bring it into Massachusetts from their use tax filing or payment obligation."

The TIR leaves open two approaches by the DOR. First, the DOR could seek evidence of actual use in Massachusetts. Second, the DOR could ask the Legislature to adopt a statutory presumption of use.

In reaction to the DOR's aggressive position in the Town Fair Tire case, New Hampshire passed S.B. 5 (NH RSA 78-D), which restricts a New Hampshire retailer from providing any information to other states in connection with sales completed in New Hampshire. This appears to be a unique statutory provision, subject to attack on constitutional grounds, but New Hampshire argues that its retailers may cooperate as long as other states adopt appropriate legislation and the NH Department of Justice approves. As a practical matter, no state's laws are appropriate, so everyone is waiting for the Bay State to take the next shot—either litigation or legislation. This law has attracted much national attention, since it could be the start of a free-for-all among neighboring states who can't behave themselves.

Distributions from New Hampshire LLCs and Partnerships
The other big news in New Hampshire has been the state's efforts to tax distributions from LLCs and partnerships. Effective January 1, 2009, New Hampshire's tax law was amended to tax certain distributions from limited liability companies and partnerships to New Hampshire owners. The law requires the recipient of the distribution to report it as a dividend under the New Hampshire Interest and Dividends Tax, which imposes a tax on interest and dividend income at the rate of 5%.

The law is *not* a new tax; rather, the change is intended to subject "distribution income" that resembles dividend income to an existing tax, New Hampshire's Interest and Dividends Tax.

The tax is intended to place businesses that operate as corporations on a par with businesses that operate as limited liability companies or partnerships. More precisely, the objective of the law was to tax distributions made by limited liability companies and partnerships to their owners to the same degree—and only to the same degree—that dividends paid by corporations to shareholders are taxed as dividends.

The tax will apply to recipients of LLC or partnership distributions who are NH residents, regardless of where the LLCs or partnerships making the distributions are located or under which state's laws they are formed. Payments made to owner-employees of LLCs and partnerships that constitute compensation for the services of the owner-employees of the business are not intended to be taxed, any more than compensation paid to shareholder-owners is taxed.

A FINAL NOTE:

MBA's Taxation Law Section has a State Tax Practice Group that has recently held the first in a series of open meetings discussing Combined Reporting and other state tax topics. The January 2010 meeting featured Kevin Brown, the DOR's General Counsel, who discussed the final regulations and other efforts to clarify the DOR's position on various issues. Future meetings will be announced on MBA's website. These meetings will focus on not only Combined Reporting, but also some of the other topics discussed above and general topics of interest with respect to Massachusetts tax law.