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Massachusetts Department of Revenue Restricts VDA Program for Banks and Intangible Holding Companies that Have Not Filed Returns

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Background—Voluntary Disclosure Agreements Generally

Taxpayers that have not filed returns in a particular state generally are not protected by any statute of limitations for assessment. Their exposure for back taxes therefore may run as far back as the activity that gives rise to a state's jurisdiction to tax them.

Most states have recognized for many years that such open-ended exposure can create a strong disincentive for delinquent filers to come into compliance. Accordingly, states have adopted "voluntary disclosure" programs, under which taxpayers can come forward, initially on an anonymous basis, pay tax and interest for a specified period—typically three years—and avoid imposition of penalties for late filing of returns and late payment of tax pursuant to a "voluntary disclosure agreement" or VDA. These programs have become increasingly popular as companies have come under pressure to better identify and capture state tax liabilities for financial statement purposes under the Sarbanes-Oxley Act and Financial Accounting Standards Board Interpretation 48 (FIN 48).

This article reviews a new and important Massachusetts technical information release—TIR 08-4—relating to VDAs for banks and intangible holding companies, but first

sets forth some historical context for the Massachusetts approach to VDAs generally, and reviews the Massachusetts treatment of corporations having only an "economic presence" in the state, so that the implications of the new TIR can be better understood.

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Massachusetts VDA Program

The Massachusetts Department of Revenue long resisted creation of a VDA program, questioning whether it had administrative authority to depart from an unlimited lookback period. In 1996, however, it finally put such a program in place. The terms of the most recent iteration of the program, which is described in TIR 03-17, have been conventional, featuring:

- a seven-year lookback period for corporations whose non-compliance comes to light otherwise than through voluntary disclosure;
- a three-year lookback period, potentially with waiver of penalties, for foreign corporations that voluntarily disclose past due filing obligations; and
- anonymity in the first taxpayer contact with DOR.

Is Physical Presence in State a Prerequisite to Corporate Income Tax Jurisdiction?

In *National Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753 (1967) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Supreme Court held that, under the Commerce

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Clause of the U.S. Constitution, a vendor with no physical presence in a state (for example, a mail-order or Internet retailer based outside the state) could not be required to collect the state's use tax. Since *Quill Corp.* was decided, state courts have been grappling with the question whether the Commerce Clause likewise prohibits a state from asserting income tax jurisdiction over a corporation that has no physical presence in the state. The recent weight of authority has been decidedly in the states' favor on the question, but only the Supreme Court can answer definitively, and so far the Court has declined to do so.

There are two very different principal contexts in which the physical presence issue has arisen. The first is jurisdiction over out-of-state financial institutions, such as credit card companies, that may have a significant market in a state without a presence "on the ground." The second is jurisdiction over companies that have been set up, often for state tax savings purposes, to hold valuable intangibles and to charge a royalty to operating affiliates for the use of those intangibles.

Massachusetts and the Physical Presence Question

At least until recently, Massachusetts seemed to have taken a relatively cautious approach to asserting jurisdiction on the basis of mere economic presence in the Commonwealth. Before *Quill* was decided, the definition of "engaging in business in the Commonwealth" for use tax collection purposes was amended specifically to capture, among others, mail-order and Internet retailers with customers in the state, but DOR in TIR 88-13 declined to assert jurisdiction over such companies "until federal statutory or case law specifically authorizes each state to require foreign mail order vendors to collect sales and use taxes on goods delivered to that state." Eight years later, in TIR 96-8, DOR revoked the earlier release and asserted that it would enforce the expanded nexus provisions "to the extent allowed under constitutional limitations."

On the income tax side, a major overhaul of the regime for taxing financial institutions in 1995 included a change in the definition of doing business in the state for purposes of the bank tax to include "regularly engaging in transactions with customers in the commonwealth that involve intangible property and result in income flowing to the taxpayer from residents of the commonwealth" and "regularly receiving interest income from loans secured by tangible personal or real property located in the commonwealth." While DOR seems to have begun enforcing these provisions more or less from their enactment, it was more circumspect in dealing with the jurisdictional issue in the case of non-bank, regular business corporations such as intangible holding companies.

DOR did, however, issue a directive in 1996—DOR Directive 96-2—asserting that it would require a filing by companies whose intangible property was used in

Massachusetts, where:

- the intangible property generates, or is otherwise a source of, gross receipts within the state for the corporation, including through a license or franchise;
- the activity through which the corporation obtains such gross receipts is purposeful; and
- the corporation's presence in the state, as indicated by its intangible property and its activities with respect to that property, is more than de minimis.

The directive included a series of examples showing how these criteria would be applied. None of DOR's examples illustrated the classic intangible holding company structure. Rather, in all examples in which DOR asserted jurisdiction, the foreign corporation subject to tax charged a royalty to an unrelated licensee or franchisee in Massachusetts.

Rather than assert jurisdiction over such companies after issuing its directive, DOR attacked holding company structures by arguing that their creation, and the contribution to them of valuable intangibles, constituted "shams" having no business purpose or economic substance. When the Supreme Judicial Court in *Sherwin-Williams Co. v. Comm'r of Revenue*, 438 Mass. 71 (2002), suggested that structures established with no motive other than tax avoidance would sometimes be respected, DOR reacted by drafting the first of its nearly annual series of "loophole closers," which codified a more restrictive business purpose/economic substance test. The legislation also called for the presumptive disallowance, subject to a "reasonableness" exception, of intercompany royalty deductions (add-back rules). Both of these provisions can be seen as tools for DOR to eliminate the tax savings associated with intangible holding company structures without actually asserting jurisdiction over the holding company.

Only recently has DOR advanced jurisdictional attacks on intangible holding companies, culminating in the decision of the Appellate Tax Board last year in *Geoffrey, Inc. v. Comm'r of Revenue*, ATB Findings of Fact and Reports 2007-690, and taxpayers have been left to wonder whether these attacks were either (1) held in reserve to ensure that DOR would have a second option if its "sham"-based theory did not pass muster in the courts; or (2) limited to companies that were immune from the initial line of attack because they had adequate economic substance and business purpose.

Technical Information Release 08-4—The New Lookback Rules

In its latest release, dated March 24, 2008, DOR announced without warning that it would preclude financial institutions and intangible holding companies from participating in its conventional VDA program. Instead, such companies will face harsher conditions and consequences for their voluntary disclosures, as well as an extended lookback period if they choose not to disclose.

The release provides that:

- The VDA lookback period for such companies, effective for VDAs reached after March 23, 2008, is five years.
- Companies must notify DOR that they wish to participate in the program by September 30, 2008, and file returns and make full payment of tax, interest and penalties by December 31, 2008, in order to limit the lookback period to tax years ending after January 1, 2003. (While it is not expressly stated, it thus appears that taxpayers that come forward after September 30 will not be able to limit the lookback period even to five years.)
- As the previous paragraph suggests, DOR generally will not waive late filing and payment of tax penalties for participating companies. These penalties accrue monthly, and taken together they can reach 36 percent of the tax liability in just two years and max out at 50 percent in just over four years.
- If such companies do not come forward by the due date, or if they come forward but do not prepare their returns "in accordance with all applicable tax rules," DOR will apply a lookback period "appropriate to the circumstances," but by implication typically longer than seven years.
- VDA applications are required to name the taxpayer.
- Where the royalty add-back rules referred to above have been applied by an operating company with respect to royalties received by a participating company, DOR will

allow the taxpayer to propose appropriate adjustments so as to avoid double taxation. The way these adjustments work, however, a corporation afforded relief may nevertheless pay more tax to Massachusetts than if the intangible holding company receiving the royalty had never been created.

The ostensible premise underlying the adoption by DOR of these new, harsher rules is that in the case of the covered taxpayers, "an extensive level of business activity conducted in this state removes any reasonable doubt as to the taxpayer's prior filing obligation." This rationale is dubious, where the Supreme Court has not yet resolved the general question whether corporate excise nexus can be based upon a mere economic presence, and where, in attacking intangible holding companies as shams, DOR generally has argued that such companies do not in reality own the intangibles whose use in the state is now supposed to justify the assertion of jurisdiction. In any case, financial institutions and intangible holding companies falling within the scope of the new release are well advised to revisit their financial statement exposure in light of the new rules and to consider whether it is prudent to participate in the new, harsher VDA program.

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