Massachusetts - Corporation properly classified as a financial institution

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In brief

On April 17, 2013, the Massachusetts Appellate Tax Board ruled that a Delaware holding company involved in the securitization and lending of student loans was a financial institution subject to the financial institution excise tax because it derived more than 50% of its gross income from lending activities, including activities of its pass-through entities, and was in substantial competition with other financial institutions. Massachusetts taxpayers questioning their entity classification as a financial institution should consider the qualifying factors in this decision, especially with regard to pass-through entity activity, what it means to be engaged in 'lending activities,' and what it means to be 'in substantial competition.' [*First Marblehead Corporation & Gate Holdings, Inc. v. Commissioner of Revenue*, Mass. App. Tax Bd., Dkt. No. C293487, C305217, C305240, C305,241 (4/17/13)]

In detail

Facts

During the fiscal years 2004 to 2006, First Marblehead Corporation (FMC) facilitated the processing of private student loans by bringing together various interested parties. Gate Holdings, Inc. (Gate), a Delaware corporation with its commercial domicile in Massachusetts and a wholly owned subsidiary of FMC, was engaged in the business of holding interests in a number of Delaware statutory trusts (Trusts) that purchased student loan portfolios. Gate had no employees or tangible assets and did not own or lease office space. Gate's material assets consisted of its interest in the Trusts.

A simplified student loan transaction coordinated by FMC would generally occur as follows.

- A bank originates a student loan with a customer.
- The bank sells the loan to one of Gate's Trusts.
- The Trust 'securitizes' the loans by issuing to investors securities that are serviced by the cash flows of the loan. In other words, the securities are 'backed' by the loans (i.e., asset backed securities).

Procedural history

For the 2004 tax year, FMC included Gate in its combined Massachusetts Corporate Excise Return. Subsequently, Gate determined that it was a financial institution within Massachusetts law, subject to the financial institution excise tax (FIET) (therefore ineligible for inclusion in FMC's combined group). Accordingly, FMC amended its 2004 combined return, which excluded Gate, and requested a refund. Gate filed Massachusetts FIET returns for tax years 2004 to 2006.

The Trusts at issue were treated as partnerships for federal income tax purposes and filed Massachusetts partnership returns for the 2004 to 2006 tax years. The partnership returns reported loan interest, which passed through to Gate, and comprised substantially all of Gate's gross income for these years.

FMC and Gate's appeal to the Appellate Tax Board challenged: (1) the Commissioner's assessment of tax and penalties due to FMC excluding Gate from the combined return and (2) the Commissioner's alternative assessment of tax and penalties due to Gate's application of the financial institution apportionment provisions.

Gate classified as a financial institution

For purposes of FIET, a corporation is required to file as a financial institution under a 'catch all' provision if it (1) is in substantial competition with financial institutions and (2) derives more than 50% of its gross income from lending activities.

The Board found that the Trusts' lending activities were attributable to Gate and that Gate was engaged in 'lending activities' in 'substantial competition' with other financial institutions.

Trusts' activities properly attributed to Gate

During the years at issue, Massachusetts followed standards under the federal 'Kintner regulations' for entity classification. Under such rules, a Delaware statutory trust would be classified as a corporation if it possessed the majority of the following characteristics: perpetual life, transferable equity interests, centralized management, limited liability for debts of the entity on the part of the equity owners who participate in management, the ability to merge or consolidate with corporations and other entities, and the imposition of conditions on the ability to maintain a derivative action. The Commissioner argued that the Trusts exhibited characteristics of corporations, and therefore their activities could not be attributed to Gate.

The Board determined whether the Trusts had these corporate attributes by analyzing the trust agreements and found that the Trusts lacked the majority of the characteristics for corporation classification. Specifically, the Trusts did not have perpetual lives; rather, each had a fixed maximum duration. The Trusts were explicitly precluded from merging or consolidating with any other business entity. Finally, derivative actions under the trust agreements relating to the Trusts were not governed by provisions substantially identical to those governing corporations.

The Board found that the absence of corporate characteristics, consistent with their treatment as partnerships for federal income tax purposes and their filing of Massachusetts partnership returns, supported the finding that the Trusts were 'pass-through' entities whose activities were attributable to Gate.

For tax years beginning on or after January 1, 2009, Massachusetts conforms with the federal business entity classification (check-the-box) rules, therefore rendering moot the Kintner regulation analysis above.

Lending activities encompass more than making loans

The Board held that Gate was engaged in lending activities within the meaning of the 'catch all' provision. The term 'lending activities' is not defined by Massachusetts law or regulation. The Commissioner sought to restrict its meaning to only "lending, just strictly lending."

However, the Board recognized that inclusion of the word 'activities' evidenced an intent to extend 'lending activities' beyond just the making of loans. Additionally, including the 'purchase' of an extension of credit (not just the credit extension itself) within the definition of 'loan' served as further evidence that 'lending activities' extend beyond just loan making. The Board acknowledged that the sale of a loan does not change the essential character of the loan in the hands of purchaser and that those who purchase loans are engaged in lending activities.

The Board also found that the appellants' activities facilitated lending by coordinating and effecting securitization of the loans. Further, student loan securitization was a significant contributing factor in the growth of the student loan industry that incentivized banks' origination of more student loans than would otherwise have been made. The Board concluded that such activities properly fell within the meaning of 'lending activities.'

Taking into account activities of the Trusts (the purchasers of the loans), Gate facilitated lending by coordinating and effecting securitization of loans and therefore was engaged in lending activities as contemplated by the 'catch all' definition of financial institutions.

Gate was in substantial competition with other financial institutions

Gate's lending activities were in competition with other financial institutions because banks earned the same type of income as Gate by making, purchasing, and securitizing the same type of loans.

At issue was whether such competition was 'substantial.' The term is not defined in statute or regulation for Massachusetts tax

purposes. The Board found that substantiality is determined by comparing the competitive activities of a taxpayer to the taxpayer's overall activities. The Board recognized that to do otherwise would result in applying distinctions between larger and smaller taxpayers as well as their relative size in the marketplace. The Board found Gate's competition to be substantial because virtually all of Gate's income was derived from the lending activities of the Trusts, which were attributed to Gate.

The Board found that the following facts supported the conclusion that the Trusts were engaged in lending activities in substantial competition with other financial institutions: (1) banks regularly made or purchased student loans similar to the loans purchased by the Trusts; (2) banks regularly engaged in securitizations of student loans similar to those arranged by FMC; (3) the securitization transactions facilitated lending by the banks; (4) the purchase and securitization of loans reduced investment opportunities available to other banks and financial institutions; and (5) banks earned the same type of income as Gate by making, purchasing, and securitizing the same type of loans.

Gate entitled to apportion its income, 100% property factor

Gate would only be able to apportion income under the FIET if it was taxable in Massachusetts and a state outside Massachusetts. Without employees or property, Gate's potential for being taxable in other states depended on whether the location of its intangible property (the student loans) satisfied taxability requirements in other states. The Board recognized that having a borrower located in Massachusetts would satisfy the criteria for taxability under the FIET. As a result, the Board found that, under the FIET standard, Gate was taxable and 'engaged in business' in all fifty states (presumably where its borrowers were) and, therefore, was entitled to apportion its income for purposes of the FIET.

As neither Gate nor the Trusts had employees, Gate's apportionment percentage was the average of its receipts and property factors. The numerator of Gate's Massachusetts receipts factor included interest from loans not secured by real property where the borrower had a Massachusetts billing address. In this case, 2% of Gate's total receipts were Massachusetts receipts.

For property factor purposes, a loan is assigned to the "regular place of business with which it has a preponderance of substantive contacts." Because neither Gate nor the Trusts had an office or employees, and therefore no regular place of business, all of Gate's loans were presumed to be located in Massachusetts. Gate could have rebutted that presumption by showing that the preponderance of substantive contacts with the loans occurred outside of the state. Because Gate outsourced servicing the loans to a third party, Gate had no contacts with the loans. Accordingly, the Board found that the presumption was not rebutted, and all of Gate's loans (comprising all of its property), should be assigned to Massachusetts, resulting in a 100% property factor.

The takeaway

The Board's decision is significant for several reasons. First, the decision provides the first legal interpretation of statutory terms 'lending activities' and 'in substantial competition,' thereby providing guidance to other taxpayers seeking to determine whether or not they would be properly classified as financial institutions. Particularly instructive is the Board's interpretation of substantial competition. Prior to this decision, taxpayers may have believed that they needed to have a measurable impact on other financial institutions to be in substantial competition with them. However, the Board found that the relevant test is not the relative size of a taxpayer; but rather, the test compares the competitive activities of a taxpayer to the taxpayer's overall activities.

Second, the Board's ruling on the right to apportion for a financial institution confirms a view practitioners have long held: the principles that the Massachusetts Department of Revenue use to assert economic nexus over a taxpayer should also be applied to determine whether a taxpayer would be subject to tax in another state. The Board recognized that Gate was subject to tax in other states, and therefore could apportion income, using the same economic nexus standard that the Department uses to subject out-of-state corporations to Massachusetts tax.

We expect the Department to appeal the Board's decision. A Notice of Appeal would need to be filed 60 days from April 17, 2013, which is the date the Board promulgated its findings of fact and report.

Let's talk

For any questions on the *First Marblehead/Gate Holdings* decision, please contact:

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