Massachusetts Appellate Court disallows interest expense, royalty expenses, and rebate payments

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In brief

On January 11, 2013, the Massachusetts Court of Appeals affirmed the Massachusetts Appellate Tax Board's decision disallowing certain expenses that occurred between related entities during the 2001 to 2003 tax years, including interest expenses on transfers made through the taxpayer's cash-management system, patent royalties paid to an affiliate, and rebate payments made to related entities. [*Kimberly-Clark Corp. v. Commissioner of Revenue*, Mass. App. Ct., slip opinion No. 11-P-632 (1/11/13)]

In detail

Kimberly-Clark Corporation (Kimberly-Clark) is a Delaware corporation with no physical locations in Massachusetts. In 1995, Kimberly-Clark acquired all of the outstanding shares of Scott Paper Company, and in 1996 Scott was renamed Kimberly-Clark Tissue Company (KCTC). In 2002, Kimberly-Clark formed Kimberly-Clark Global Sales, Inc. (Global), a wholly owned subsidiary, in an effort to consolidate and centralize several business functions.

At all times relevant to this appeal, Kimberly-Clark's affiliated entities also included Kimberly-Clark Financial Services, Inc. (Financial), which maintained a lock box central to the group's cash-management system, and Kimberly-Clark Worldwide, Inc. (Worldwide), a wholly owned subsidiary of KCTC.

The Massachusetts Appellate Tax Board (Board) disallowed the taxpayer's interest expenses on transfers made through the taxpayer's cash-management system, patent royalties paid to an affiliate, and rebate payments made to related entities. On appeal, the Massachusetts Court of Appeals affirmed the Board's holdings, generally providing that the evidence substantially supported the Board's findings.

Massachusetts add back law

Applicable for taxable years beginning on or after January 1, 2002, Mass. Gen. Laws ch. 63, §§ 31I and 31J (add back statutes) generally require taxpayers to add back to net income otherwise deductible intangible expenses and costs and otherwise deductible interest expenses paid to one or more related members.

Both the section 31I (intangible expenses) and section 31J (interest expenses) add backs provide an exception when "the taxpayer establishes by clear and convincing evidence, as determined by the commissioner," that the adjustment or disallowance is unreasonable.

Add back burden of proof before the Board is clear and convincing

As a threshold matter, the parties disagreed with the burden of proof a taxpayer is required to meet when appealing certain add back decisions from the Commissioner of Revenue (Commissioner) to the Board. The add back statute provides that a deduction may be allowed if a taxpayer establishes by clear and convincing evidence, as determined by the Commissioner, that the disallowance was unreasonable.

Kimberly-Clark maintained that the phrase 'as determined by the Commissioner' means that the clear and convincing standard is limited to decisions made by the Commissioner and does not extend to appeals of those decisions to the Board, which should use the general preponderance of the evidence standard. The Commissioner argued that a taxpayer must show by clear and convincing evidence that the adjustments are unreasonable, whether the parties are before the Commissioner or the Board.

The Court of Appeals determined that the add back statutes are ambiguous and so must be interpreted to (1) avoid absurd or unreasonable results and (2) give effect to the Legislature's intent. The Court agreed with the Commissioner's interpretation, noting that the interpretation suggested by Kimberly-Clark would yield an absurd result. Using the taxpayer's interpretation, decisions of the Commissioner to disallow a deduction, based upon a taxpayer's failure to meet the clear and convincing standard, could be overturned by the Board on identical evidence if a taxpayer succeeds in meeting the lower preponderance standard.

Interest expense relating to cash-management system was not deductible because it did not constitute bona-fide debt

Kimberly-Clark and its affiliated entities utilized a central cash-management system. In general, all of Kimberly-Clark's subsidiaries' cash receipts were deposited on a daily basis into a lock box maintained by Financial. The cash was swept up to Kimberly-Clark into a single pool of cash from which various expenses of the subsidiaries were paid.

The movement of cash was documented with daily ledger entries, resulting in a net payable to or net receivable from each entity. Interest on the net payable or receivable was calculated on the last day of each calendar month. The interest rate was typically 130% of the monthly Applicable Federal Short Term Rate as determined under IRC § 1274(d). At the end of each of the tax years at issue, Kimberly-Clark was in a net borrowing position.

On its 2001-2003 Massachusetts corporate excise tax returns, Kimberly-Clark claimed the interest paid to subsidiaries under the cash management systems as a deductible interest expense. Pursuant to Massachusetts' add back statutes, Kimberly-Clark did not add back such interest paid to related member in determining its Massachusetts net taxable income for the 2002 and 2003 tax years.

Because the add back statutes were not effective in the 2001 tax year, the Board supported its disallowance of Kimberly-Clark's 2001 intercompany interest expense by holding that such expense did not relate to a bona-fide debt. The Board noted the 'well settled' position that a distribution by a subsidiary to its parent is a loan and not a dividend if, at the time of its payment, the parties intend it to be repaid. The Board found that the subsidiaries' advances to Kimberly-Clark were not bona-fide debt, but rather were permanent advances, for several reasons, including:

- the failure of any subsidiary to request or receive a return of excess advances (which suggested that such advances were not intended to be repaid)
- the absence of security, default, or collateral provisions attendant to the purported debt
- the failure to establish that the promissory notes represented arm's length transactions.

For tax years 2002 and 2003, the Board ruled in a similar manner since the underlying facts regarding the cash management systems had not changed. From the Board's perspective, the sole issue in dispute for these years was the heighted standard of proof required under the add back statutes. The Board reasoned that because Kimberly-Clark did not prevail under the less burdensome 'preponderance of the evidence' standard for tax year 2001, the taxpayer could not prevail under the more burdensome 'clear and convincing' standard.

The Court of Appeals found that substantial evidence supported the Board's conclusion, and it declined to overrule the Board's decision regarding the interest expense deductions.

2002 royalty expenses

Following the acquisition of Scott Paper Company (renamed KCTC), Kimberly-Clark sought to consolidate and centralize operational functions, including management, sales, distribution, and research and development. To this end, Kimberly-Clark and KCTC each entered into substantially similar agreements with Worldwide, to centralize ownership and control of intangible assets as follows:

- *Patents*. Kimberly-Clark and KCTC each contributed substantially all of their patents and proprietary know-how (Patents) to Worldwide. Worldwide granted Kimberly-Clark and KCTC licenses to the Patents in return for a royalty payment, described below.

- *Trademarks*. Ownership of trademarks, tradenames, service marks, and logos (Trademarks) were retained by Kimberly-Clark and KCTC. Both Kimberly-Clark and KCTC appointed Worldwide as the exclusive agent with respect to their Trademarks. In return for a royalty payment, described below, Worldwide sublicensed the Kimberly-Clark Trademarks to KCTC and sublicensed the KCTC Trademarks to Kimberly-Clark.
- *Royalty Payments*. Kimberly-Clark paid Worldwide a royalty equal to 3% of sales for the Patent license and the Trademark sublicense. KCTC paid Worldwide a royalty ranging from 3.1% to 3.3% of sales for the Patent license and the Trademark sublicense. KCTC paid a higher royalty fee because the Kimberly-Clark Trademarks were more valuable.

For the 2002 tax year, Kimberly-Clark deducted such intercompany royalty expenses and did not add them back pursuant to the add back statutes. Applying a 'clear and convincing' review standard of proof, the Board found that Kimberly-Clark failed to support the elements that would make the application of add back unreasonable: (1) that the reduction of tax was not a principal purpose of the transactions; (2) that the transactions served a business purpose; and (3) that the transactions had economic substance. The reasons provided by the Board included:

- The circular flow of funds between Kimberly-Clark, KCTC, and Worldwide, which effectively returned Kimberly-Clark's royalty payments back to itself, undermined the position that the royalty payments were supported by economic substance.
- The record did not indicate Worldwide entered into any third-party licensing agreements with respect to the Patents or Trademarks, therefore the licenses were *de facto* exclusive licenses and not at arm's-length.
- The unexplained inconsistent treatment of the Trademarks and Patents.
- An internal document indicated that the transfers were implemented to produce better operational, administrative, and financial efficiencies, including 'significant tax savings.'
- The existence of significant internal controls dedicated to tax considerations, but no level of planning or oversight for addressing intellectual property issues.

The Court of Appeals upheld the Board's decision because it found that the evidence substantially supported the Board's findings.

2003 rebate expenses

As part of its plan to consolidate and centralize functions, Kimberly-Clark undertook to improve its supply-chain management, including the process of purchasing raw materials, manufacturing product, maintaining inventory, and selling and distributing product. In 2002, Kimberly-Clark formed Global to coordinate the entire supply-chain management process.

In 2003, Global sold products that were manufactured primarily by Kimberly-Clark, but also by Worldwide and other affiliated entities (certified suppliers). Neither Kimberly-Clark nor any certified supplier paid a royalty for the use of Patents as they did in 2002 (per the prior Patent royalty discussion above). The only acknowledged royalty was a $1 million royalty paid by Global to Worldwide allowing Global to sublicense the technology to the certified suppliers. It was not this royalty, but rather the 'rebate payment' that was at issue.

Receipts received by Global from such product sales flowed as follows:

- Global received receipts from customers. Global retained an agreed upon amount of receipts based on a pre-determined mark-up and provided the remaining amount to the certified suppliers.
- The certified suppliers retained an amount based on an agreed upon mark-up.
- The remaining balance in the hands of the certified suppliers was characterized as 'cost savings' and was returned to Global. The cost savings enjoyed by the certified suppliers were a result of the increased efficiency derived from the use of such Patents
- Global returned this cost savings amount to Worldwide as a 'rebate' payment. According to Kimberly-Clark, the rebate payments represent compensation paid to Worldwide for its assumption of business risk.

The Board found the rebate' payments represented payment for the use of the Patents, and this use constituted an embedded royalty. The Board based its findings on:

- the effective discontinuance of substantial royalty payments during the tax year 2003, which had previously been characterized as fair compensation for use of Worldwide's Patents

- the certified suppliers' continued use of the Patents, without which production would not have been possible
- the 'untenable assertion' that the rebate payments represented compensation to Worldwide for its full assumption of risk associated with the sale of products.

Based on the Board's finding that the payments constituted embedded royalties, it applied the add back statutes to the payments. The Board found that Global did not present any evidence to support an assertion that the payments qualified for an exception from add back. The Board upheld the Department's add back of the sums associated with the purported rebate payments.

The Court of Appeals found that the Board's findings supported the conclusion that the rebate payments were expenses "for, related to, or in connection directly or indirectly" with the use of intangible property. Accordingly, tax avoidance was a "principal purpose" of the transactions, and the taxpayer did not carry its burden of proving by clear and convincing evidence that the required add backs were unreasonable.

The takeaway

Commonly owned corporations may employ a cash management system to create efficiencies in the use of cash within the corporate group's treasury function. To the extent that a cash management system creates amounts due between related parties that might be characterized as indebtedness, Massachusetts has long embraced a policy that such indebtedness and any related interest expense deductions are invalid. When Massachusetts adopted its intercompany expense disallowance rules, a statutory exception to those rules allowed deductions for intercompany interest expense if their denial would be unreasonable. As applied to a cash management system, if its use is viewed as a good business practice, the denial of interest expense deductions arising from its operation could be viewed as unreasonable. However, whatever the merits may be to this belief, the Massachusetts Court of Appeals in *Kimberly-Clark* disagreed and denied the interest deductions arising from this cash management system.

Let's talk

If you have questions about the *Kimberly-Clark* decision, please contact:

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