Massachusetts – Nexus creating transactions disregarded as sham transactions

June 25, 2014

In brief

The transfer of Massachusetts employees from an in-state company to its out-of-state parent was disregarded for tax purposes by the Massachusetts Appeals Court. The transfer, which purportedly established Massachusetts nexus for the parent and caused the parent to be included in the 'nexus combined' corporate excise tax return, allowed the parent's losses to offset the income of other members of the nexus combined group. The court affirmed that, pursuant to the sham transaction doctrine, the transfers had no valid business purpose other than tax avoidance and therefore the parent was not included in the nexus combined return.

Massachusetts taxpayers should be aware that expansion of the sham transaction doctrine to nexus determinations could subject a new area of business transactions to state scrutiny. *Allied Domecq Spirits and Wines USA Inc. v. Commissioner of Revenue*, Mass. App. Ct. No 2013-P-0984 (6/18/14) (unpublished)]

In detail

For the fiscal tax years 1996 through 2004 at issue, Allied Domecq Spirits and Wines USA (Allied USA) was the principal reporting corporation for a nexus combined group of affiliated corporations filing a Massachusetts Corporate Excise Return. Prior to the years at issue, Allied USA's parent, Allied Domecq North America Corporation (ADNAC) had no physical presence in Massachusetts and therefore was not a member of Allied USA's Massachusetts nexus combined reporting group.

During the 1996 fiscal year, Allied USA transferred employees from three of its business departments – insurance, taxation, and internal audit – to ADNAC, which created a physical presence in Massachusetts for ADNAC. Accordingly, Allied USA included ADNAC in its Massachusetts combined reporting group for the years at issue. Due to the application of ADNAC's losses against the income of other group members, the Allied USA combined group's Massachusetts income tax liability was significantly reduced during the tax years at issue.

In May 2013, the Massachusetts Appellate Tax Board upheld the Massachusetts Department of Revenue's disregarding of the employee transfers because, under the sham transaction doctrine, the transfers had no valid business purpose other than tax avoidance (**click here** for our review of the Board decision). On June 18, 2014, the Massachusetts Appeals Court affirmed, for the reasons set forth below.

Company communications describe the transfers

Several internal memoranda and communications from Allied USA's tax department indicated that the employee transfer was motivated by tax avoidance. A July 1996 memo provided that Massachusetts state income tax could be 'reduced to nil' by creating 'sufficient in-state activities for ADNAC.' The memo also outlined the steps needed to establish a Massachusetts physical presence (sublease office space, transfer employees to create in-state payroll, purchase office furniture, and charge intercompany management fees).

An August 1996 email described the proposed transactions as the 'state tax planning project' that would 'create the required nexus.' Another August 1996 email provided that the project could only move forward if there was 'no impact to the management results' and that 'management relief' would have to be available. Testimony before the Board provided that 'management relief' meant that management bonuses would not be adversely affected by any economic changes related to the plan. The Board found that these communications supported the conclusion that the plan was intended to have tax ramifications only.

An August 26, 1996, memo provided that certain events "must occur prior to the end of this fiscal year [August 31] to establish a state presence in MA for FY 1996 and forward . . . . to realize the full group tax benefit estimated at $500,000 (after Federal benefit) for FY 1996."

Sham transaction treatment affirmed

The court's review was limited to determine whether the Board's factual findings were supportable. The court would not reverse the Board's decision unless it was based on an incorrect application of the law. The burden was not on the state to show a tax purpose, the burden was on the taxpayer to show that the transaction had a legitimate business purpose. Because Allied USA failed its burden to demonstrate a legitimate non-tax avoidance benefit, the court affirmed the Board's decision.

The court determined that the following facts supported a finding that the employee transfers had "no practical economic effect other than the creation of a tax benefit and that tax avoidance was a motivating factor and only purpose:"

- tax department communications demonstrate a tax purpose
- tax department communications provide assurance that there would be "no impacts to the management results
- the employees' work did not change following the transfer

Communication/collaboration with in-state entity did not create nexus

The taxpayer argued that employees in the in-state entity's tax, insurance, and internal audit departments were "representatives" of the out-of-state entity – thus creating nexus for the out-of-state entity. The court found that applying this standard would mean that almost any communication or collaboration between a foreign parent corporation and an in-state subsidiary would create nexus. The court declined to adopt such an understanding.

Appeals Court decision has no precedential value

Note that the court's decision is a rule 1:28 decision, which means that the opinion was not circulated to the entire court of appeals and, therefore represents only the views of the panel that decided the case. As a summary decision pursuant to rule 1:28 that was issued after February 25, 2008, the court's decision in *Allied Domecq* may be cited for its persuasive value but, because of the limitations noted above, not as binding precedent.

The takeaway

The Appeals Court's decision was brief. The court affirmed the Board's decision.

The Board did not categorically reject that centralizing operations or leasing property could support a valid business purpose. The Board explored the specific facts here and found that centralization was not advanced by the employee transfers. Additionally, the Board expressed that "failure to ever attend to the details, like the lease, is further indication that tax avoidance reigned over economic substance." Given different facts, it remains unknown how the Board would have ruled.

In support of its decision, the Board reviewed Massachusetts case law applying the sham transaction doctrine. Nearly every cited decision had one common fact - they involved the disallowance of related party payments. The court and Board's decisions in *Allied*, however, appear to be the first publicly available Massachusetts decisions that would permit applying the sham transaction doctrine to questions of nexus (with the caveat that the court's decision is not precedential). Massachusetts taxpayers should be aware that expansion of the sham transaction doctrine to nexus determinations could subject a new area of business transactions to state scrutiny.

Finally, the court's decision rests primarily on common law principles of the sham transaction doctrine. While Massachusetts codified its version of the sham transaction doctrine under G.L. c. 62C, sec. 3A, that provision is effective as of January 1, 2002 and would only apply to the last two tax years at issue. As a result, the Board relied "primarily on the principles derived from cases before the courts and the Board" to render its decision. Neither the court nor the Board examined application of the statutory standard.

The tax, penalties, and interest at issue for the 1996-2004 tax years exceed $15 million. Given the amount at issue, the decision may be appealed. We will monitor the progress of an appeal and report on any significant developments.

Let's talk

If you have questions about the *Allied* decision, please contact:

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