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Client Briefing

State Tax

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Massachusetts State Tax Developments

Welcome to the latest Reed Smith update on recent developments in Massachusetts state tax. In this update, we'll discuss the following developments:

- Corporate excise tax implications of the Department's decision to treat software as tangible personal property
- The corporate excise tax treatment of excess inclusion income
- A challenge to the Department's authority to adjust net operating loss ("NOL") carryforwards
- Sales tax sourcing appeals pending at the Appellate Tax Board ("ATB")
- The application of the manufacturing classification to sales companies included in a combined report
- The sales tax directive on economic nexus, and the recently issued proposed regulation that replaced the directive
- Administrative and budget updates
- The latest in Massachusetts tax controversy

The Department defines software as "tangible personal property"; can taxpayers include the value of software in property factor for corporate excise tax purposes?

The draft nexus regulations issued by the Department generated significant coverage for sales tax purposes (see alert here and additional coverage below), but there are potential implications for the corporate excise tax as well. For example, the Department's reasoning could impact the treatment of software for purposes of computing a taxpayer's property factor.

When computing their property factor, taxpayers are required to include the value of their real and tangible personal property.[1] While the statute does not indicate whether software is included in the definition of "tangible personal property," the Department's nexus analysis would support the conclusion that software is tangible personal property, and the value of software is included in the factor.

For example, in its now revoked Directive, the Department reasoned: "Software is generally considered to be tangible personal property. Specifically, software is generally considered to be tangible personal property under this term's common law definition…"[2] This same reasoning was referenced by the Department in its hearing notice for the recently proposed sales tax nexus regulation.[3]

If software is considered tangible personal property at common law, this certainly raises a question of legislative intent behind the current version of the apportionment statute (G.L. c. 63, § 38). When interpreting technical words and phrases in a statute, the Legislature is presumed to intend to use the specific legal meaning those words and phrases may have acquired.[4] If tangible personal property is commonly understood to include software, the fact that the Legislature did not exclude software from the definition of tangible personal property would indicate that it intended for taxpayers to include the value of software in the property factor.

Including software in the property factor raises interesting questions regarding both sourcing and valuation. Taxpayers with significant internally developed or purchased software should review whether the value of its software has been included in their property factor, and if not, the potential impact.

Additional Reed Smith Comments

- *Is the Department's market-based sourcing regulation treatment of software valid?* Another question raised by the Department's assertion that software constitutes tangible personal property is its treatment of software for sales factor purposes.

  As with the property factor, the sales factor apportionment statute does not indicate whether "tangible personal property" includes software. However, the Department's market-based sourcing regulations take the position that electronically delivered software should be treated as an intangible or a service.

  If software is commonly understood to be tangible personal property, this would call into question the validity of the Department's interpretation of the sales factor statute in the regulation.

  Sourcing software as tangible personal property would create significant refund opportunities for certain taxpayers that license hosted software to

third-parties and other software providers. It would also impact whether those taxpayers are subject to the throwout rules that apply for services and intangibles, or the throwback rules that apply to sales of tangible personal property.

REMIC Excess Inclusion Income - Is It Included in Net Income?

Corporations and financial institutions that hold REMIC residual interests may have a Massachusetts corporate excise tax refund opportunity.

REMICs are essentially pools of mortgages that are taxed on a pass-through basis for federal income tax purposes. Interests in REMICs fall into two general categories: regular interests and residual interests. Typically, the holders of the REMIC residual interests are not entitled to any payments with respect to their interests until the regular interests have been fully satisfied. However, under the federal income tax rules governing REMICs, residual interest holders may still be required to recognize income in years in which they receive no payments with respect to their interests. This "phantom" income recognition is referred to as "excess inclusion income".

Mechanically, excess inclusion income is reported as an annual "true up" to the federal taxable income of a residual interest holder. Thus, REMIC residual interest holders are instructed that the taxable income they report on Line 30 of their federal income tax return (Form 1120) for each year must be no less than the excess inclusion amount.

Many residual holders assume that excess inclusion income must also be included in net income for Massachusetts corporate income tax purposes. However, it is not clear that this treatment is correct.

First, the starting point for computing net income for Massachusetts corporate excise tax purposes is "gross income as defined under the provisions of the Internal Revenue Code".[5] Excess inclusion income is not included in gross income. Instead, excess inclusion income operates as a minimum, or floor, imposed on the calculation of federal taxable income after NOL and special deductions (Form 1120, Line 30).[6] As a consequence, excess inclusion income should not be included in the calculation of net income for Massachusetts purposes. The corporate excise tax return instructions support this position, because they direct taxpayers to use taxable income before NOL and special deductions (Line 28 of Form 1120), rather than Line 30, as the starting point for computing net income.[7]

Second, the Massachusetts courts have long viewed the authorization for the imposition of an income tax in Article 44 of the Amendments to the Massachusetts Constitution as limited to taxes imposed on "true" income. Thus, in several cases, the Supreme Judicial Court ("SJC") has found taxes to be invalid to the extent

imposed on "fictional" or "paper" income.[8] Excess inclusion income would seem to fall squarely within the scope of fictional income—because it can be recognized by a residual interest holder independent of any distribution, disposition or other realization event.

Disallowance of Deduction for Interest Paid to Hungarian Affiliate Serves as a Reminder of Department's Continued Audit Scrutiny of Intercompany Debt

A case recently resolved at the Appellate Tax Board serves as a reminder that Massachusetts' auditors continue to aggressively challenge the following intercompany transactions:

- Interest deductions for interest paid to foreign affiliates that are not members of the unitary combined group—even if the foreign affiliate is domiciled in a country with a comprehensive tax treaty
- Net worth deductions for obligations to any affiliate that is classified as debt on the company's books and records.

While Massachusetts' adoption of unitary combined reporting ended some disputes related to intercompany debt because transactions with members of the combined reporting group are eliminated, many issues remain. Many taxpayers continue to face audit challenges to deductions from net worth related to intercompany debt obligation on the basis that the obligation is not "true debt." In addition, taxpayers with obligations to foreign affiliates that are not members of the water's edge combined group are still subject to Massachusetts' burdensome addback regime when computing the income portion of the corporate excise.[9]

A recently resolved appeal at the Appellate Tax Board highlights the issues facing taxpayers with obligations to foreign affiliates. In this appeal, members of the affiliated group borrowed funds from a Hungarian affiliate and deducted interest paid to the affiliate in computing the group's combined income. The group claimed an exception to addback on interest paid to the Hungarian affiliate because Hungary has a comprehensive tax treaty with the United States; the Hungarian affiliate was not a controlled foreign corporation; and the interest was deductible for federal income tax purposes. The taxpayer alleged that there was valid business purpose, and the loan terms were at arm's length. The debtor entity also deducted the value of the loan to the affiliate when computing net worth.

At audit, the Department challenged the treatment of the intercompany debt. First, the Department argued that the intercompany loan from the Hungarian affiliate was not "true debt." As a result, no deduction was allowed for the interest paid to the Hungarian affiliate for purposes of computing the group's combined income, and the obligation was not treated as a liability for purposes of computing net worth. Second, the Department asserted that even if the loan constituted "true debt," the interest was not deductible because the interest did not qualify for an exception to Massachusetts' addback for interest paid to related entities.

While this case was eventually resolved before trial, the taxpayer was first required to appeal the adjustments relating to its intercompany debt all the way to the Appellate Tax Board. The case illustrates that even taxpayers with seemingly strong facts supporting an addback exception and deduction for net worth related to intercompany interest should expect pushback at audit, and therefore, should be sure to maintain sufficient documentation to show that an intercompany obligation is true debt, and that any interest paid to a foreign affiliate is eligible for an addback exception.

Taxpayer Challenges Department Authority to Adjust NOL Carryforward, When NOL Was Generated in Tax Years Otherwise Closed by Statute

Can a Department auditor reduce a taxpayer's deduction for a net operating loss ("NOL") carryforward, even if the NOL was generated in a tax year that is closed under the statute of limitations? This question is the subject of an appeal currently pending at the ATB.

The appeal involves a telecommunications company that was audited for the 2007 – 2009 tax years. The taxpayer had an NOL carryforward that it applied to reduce Massachusetts taxable income for years during the audit period. As part of the audit, the Department disallowed the taxpayer's deductions for interest paid to affiliates under a cash management system, increasing the taxpayer's income subject to tax. But the Department then went a step further. According to the taxpayer's petition, the Department also reviewed the taxpayer's interest deductions for the years in which the taxpayer generated the NOL carryforward deducted in the years included in the audit period. The Department disallowed the interest deductions claimed for payments to affiliates under the cash management system for these otherwise closed years, resulting in a reduction to the taxpayer's claimed deduction for NOL carryforwards during the years included in the audit. In effect, the Department conducted an audit of a year that would otherwise have been closed by statute, in order to make adjustments that could be carried forward to open tax years.

The taxpayer is arguing that the adjustments to its NOL carryforwards are invalid, in part, because the Department does not have the authority to revise its net income (or loss) for years that are otherwise closed by the statute of limitations.

Additional Reed Smith Comments

- *Opportunity for taxpayers:* This case should serve as a reminder to taxpayers under audit or filing a refund claim to consider whether they have additional issues that could create or increase an NOL in a prior year, which could then be carried forward and used in the year that is the subject of the audit or refund claim, even if the prior year would otherwise be outside the statute of limitations.

For example, suppose a taxpayer faces an audit adjustment for the 2012 tax year. However, for the 2008 tax year (a year for which the limitations period for filing a refund claim has closed), the taxpayer erroneously added back interest paid to an affiliate for which an exception to add back was available. If the exception had been claimed, the interest deduction would have resulted in an NOL that would have been available for carryforward to the 2012 tax year. When appealing the 2012 tax year assessment, the taxpayer should consider both challenging the audit adjustment for the 2012 tax year and arguing for an increase in its NOL carryforward from the 2008 tax year as an offset issue.

- *Closing agreements can address NOL carryovers:* This case should also serve as a reminder to taxpayers settling an audit or appeal through a closing agreement to carefully review how NOL carryforwards are addressed in the agreement.

  In many cases, a closing agreement can address NOLs that are carried forward to years beyond those covered by the agreement (especially for unitary combined filing tax years, where the various members of a unitary group may have "siloed" NOLs). Our experience is that the Department, in some cases, is open to including a provision in a closing agreement that specifies the amount of NOLs available for carryforward out of the years covered by the closing agreement on an entity-by-entity basis. This type of agreement provides certainty to both the Department and the taxpayer regarding the total amount of net operating losses that can be carried forward.

  Taxpayers should consider their NOL situation carefully before entering into a closing agreement, and consider whether it is beneficial to request an agreement that specifies the amount of NOL carryforwards or that is silent on the issue.

Combined Reporting Appeal—Classification of Sales Company as a Manufacturer for Apportionment Purposes Based on Purchases of Intangible Property from Affiliate

In a recent appeal at the ATB, a taxpayer challenged the Department's assertion that the creation and sale of intangible property is a qualified manufacturing activity subjecting the taxpayer to single-factor apportionment. The taxpayer alleged the Department's policy has been to require that the new product produced by a manufacturing corporation be "tangible" property. Thus, because the taxpayer only creates intangible property for sale, it argued that it cannot be a manufacturing corporation.

The case is particularly interesting because it involved an audit adjustment to the apportionment of a corporation that, by itself, did not create any tangible or intangible property. The tax years at issue were after the adoption of combined reporting. The combined reporting regulations promulgated in 2009 include special

rules for determining whether members of a combined group are classified as manufacturing corporations, when the members are involved in intercompany transactions with other group members. If a member of the combined group purchases property or services from an affiliated member for resale to a third-party, that sales company determines whether it is classified as a manufacturing corporation by looking to both its own activities and those of the affiliated member. This rule can have a significant impact if a corporation acting as a sales company for affiliated member engaged in manufacturing has a Massachusetts payroll and/or property factor that differs significantly from its Massachusetts sales factor.

Additional Reed Smith Comments

- *Refund opportunity for resale of intangibles:* This appeal illustrates the broad scope of the manufacturing classification in Massachusetts—including its application to corporations producing intangibles. Any Massachusetts-based corporation that creates intangible property should consider whether it is eligible to apportion its income as a manufacturer if that would benefit the company—regardless of whether the intangible property created by the corporation is sold to an affiliate or a third-party.

- *Regulatory overreach?* The appeal also raises the question of whether the Department had the authority to promulgate its special manufacturing rules for combined groups. The Department has indicated that its regulations allowing a business corporation to be classified as a manufacturing corporation based, in part, on the activities of its affiliated member are intended to prevent "distortion." 830 CMR 63.32B.2(7)(g)(2). This would seem to be an exercise of the Department's alternative apportionment authority under G.L. c. 63 § 38(j). That authority is limited to situations where the standard apportionment rules result in the apportionment of income in a manner not "reasonably adapted to approximate the net income derived from business carried on within this commonwealth." Given that the statutory apportionment formula for business corporations that are not classified as manufacturers is a three-factor formula with a double-weighted sales factor, it would seem that the alternative formula adopted by the Department—requiring the single sales factor applied to manufacturers—would be more likely to result in distortion if the standard statutory apportionment formula is viewed as the benchmark.

Multiple-Points-of-Use Sourcing Appeals Pile Up at the ATB

Several sales tax refund appeals involving multiple points of use sourcing for software have been filed at the ATB over the past year. Each of the appeals involve purchases of software billed or delivered to a purchaser's Massachusetts address. In each case, the vendor charged Massachusetts sales tax on the full sales price and remitted the tax to Massachusetts. The software, however, was

ultimately accessed and used by employees of the purchaser located outside of Massachusetts. In each case, the vendors are requesting refunds on behalf of the purchasers for sales tax paid on the portion of the purchase price attributable to the out-of-state users.

These cases follow two related appeals involving multiple points of use sourcing that were recently decided by the ATB. In the recently-decided appeals, the taxpayer challenged the Department's authority to deny refund claims based on multiple points of use by requiring taxpayers to submit any multiple points of use exemption certificates at the time of purchase. On May 22, 2017, the ATB issued decisions in favor of the Department in these cases. Findings of Fact and Report were requested but have not yet been published.

Further details regarding the issue can be found in our previous updates here and here.

Additional Reed Smith Comments

- *Refund opportunity:* These cases highlight a continued refund opportunity for taxpayers that have purchased software that was billed to a Massachusetts address and paid Massachusetts sales tax on the full purchase price.

  If the software is used, even in part, by employees located outside of Massachusetts, the taxpayer may be entitled to a refund of a portion of the Massachusetts sales tax paid—even if the software is located in Massachusetts and remotely accessed by out-of-state customers.

- *Preserving additional issues:* In addition to raising the multiple points of use issue, taxpayers should closely review the nature of the software transaction to determine whether additional issues may apply.

  For example, taxpayers purchasing software as a service or cloud computing products may be able to argue that their purchases are properly classified as the purchase of service—not software—and that the purchase is exempt from tax regardless of the location of use.

  And if the software is remotely accessed, there is recently settled and ongoing litigation on whether a variety of software products that are remotely accessed over the internet can be subject to tax. For more information on these appeals, see our prior alert here.

Department Proposes Nexus Regulation—Asserts Many Remote Sellers Have Nexus Under *Quill*

Massachusetts is the latest state seeking to impose sales tax collection obligations on remote sellers lacking the in-state contacts that have traditionally been viewed as constituting a "physical presence." However, the Massachusetts approach

differs significantly from the "Kill *Quill*" bills that have been passed in South Dakota and other states around the country. The Department of Revenue believes that most remote internet vendors already have sufficient contacts with Massachusetts to satisfy the physical presence requirement under *Quill*, and are obligated to collect Massachusetts sales tax regardless of whether *Quil*l is overturned.

In our view, by arguing that most remote internet vendors already have contacts with the Commonwealth that satisfy the physical presence requirement of *Quill*, the Massachusetts' approach potentially poses an even greater threat to remote sellers than the "Kill *Quill*" statutes because (1) its effectiveness is not contingent on the U.S. Supreme Court actually granting *certiorari* in a nexus case and deciding it in a manner that would overturn *Quill*; and (2) it could mire any vendor seeking to challenge constitutionality of the regulation "as applied" in extensive discovery and litigation without resulting in an outcome that would provide meaningful guidance for other vendors.

Background: On April 3, 2017, the Department issued Directive 17-1 (the "Directive"), which would have imposed sales tax collection responsibilities on any vendor that had more than 100 sales delivered into Massachusetts, and Massachusetts sales in excess of $500,000 during the preceding 12-month period. The new collection and reporting requirements were scheduled to take effect July 1, 2017, but they were revoked by the Department prior to the effective date. In its notice revoking the Directive, the Department indicated that it would instead be proposing regulations that would seek to achieve the objectives laid out in Directive 17-1.[11]

On July 28, the Department issued Proposed Regulation 830 CMR 64H.1.7 (the "proposed regulation") that, if adopted, would require "internet vendors" to collect and remit sales tax on sales to customers in Massachusetts.[12] The Department based the proposed regulation on the analysis detailed in the Directive.[13]

T*ax Imposed on "Internet Vendors" with sufficient contacts with Massachusetts:* The regulation asserts that most internet vendors have physical presence in Massachusetts through their own contacts or those of a representative. Specifically, the following contacts can create physical presence under *Quill*:

- In-state software;
- In-state cookies;
- Contracts with a content distribution network ("CDN");
- In-state representatives;
- Provision of additional services beyond delivery.

Any vendor that has the contacts outlined in the regulation would be required to collect and remit Massachusetts sales tax for its sales to Massachusetts customers if two conditions are satisfied during the prior calendar year:[14]

- The internet vendor made $500,000 or more in sales to Massachusetts customers completed over the internet; and
- The internet vendor completed 100 or more transactions that were delivered to Massachusetts.

What's next? The Department will be accepting written comments regarding the regulation through August 24. There will also be a hearing held regarding the draft regulation on August 24. Unlike a typical regulatory hearing in Massachusetts, we expect this one to be well-attended with several practitioner and taxpayer comments submitted.[15]

Additional Reed Smith Comment

- *Broader Reach than Directive 17-1?:* The proposed regulation appears have a slightly broader scope than the Directive. The Directive asserted that "ownership and use" of software in Massachusetts constituted physical presence in Massachusetts. In contrast, the proposed regulation seems to go further by asserting that a vendor could have Massachusetts nexus based merely on having a "property interest" or "use" of software in Massachusetts. Thus, even if an internet vendor does not actually own or have a property interest in software (including cookies) located on a computer in Massachusetts, it could still have nexus with Massachusetts as a result of its use of software owned by others on a computer located in Commonwealth.

For further discussion regarding the constitutional implications of the proposed regulation, including potential challenges under the Internet Tax Freedom Act, see our prior alert here.

Other Administrative Updates

Update to Department's Audit Manual

The Department has released an updated version of its Audit Manual that includes a revised section that reflect changes to the amended return and abatement process. Specifically, the updated version reflects that Form CA-6, Application for Abatement/Amended Return, is no longer in use as of October 31, 2016. Taxpayers seeking to challenge a deficiency or penalty assessment must now use Form ABT. Taxpayers seeking to a refund are now required to follow the same procedures as filing original tax returns.

Alternative Apportionment Revision

The Department adopted a revised alternative apportionment regulation, 830 CMR 63.42.1, on February 24, 2017.

Under the new regulation, a taxpayer must file a request for alternative apportionment when it files its tax return. However, even if a timely request for alternative apportionment is submitted, the taxpayer must still pay tax computed based on the statutory apportionment rules. If the Department grants the taxpayer's request for alternative apportionment, then the taxpayer must file a refund claim using the approved alternative apportionment method.

The alternative apportionment regulation sets a higher bar for a taxpayer than for the Commissioner in asserting the need for alternative apportionment. A taxpayer seeking to use an alternative apportionment method must show by "clear and cogent evidence that the income attributed to Massachusetts using statutory apportionment does not fairly represent the extent of the [taxpayer's Massachusetts business activity]." On the other hand, the regulation provides the Department may assert the need to use an alternative apportionment method based on the "Commissioner's judgment." There may be an opportunity to challenge the validity of these standards. The alternative apportionment statute, G.L. c. 63 § 42, does not contemplate different standards for the taxpayer and Commissioner. As such, the regulation may be invalid as contrary to Massachusetts statute.

If you believe your business is entitled to use an alternative apportionment method, or if the Department asserts the need to use an alternative apportionment as part of an audit of your business' returns, Reed Smith's team of lawyers is available to discuss potential challenges to the new regulation.

New DOR Commissioner In Office Beginning August 14

On July 18, 2017, Massachusetts Governor Charlie Baker announced he would be appointing Commissioner of Revenue Michael Heffernan as Secretary of Administration and Finance, effective August 14. The Secretary of Administration and Finance is a cabinet-level position that supervises the Department, among other agencies. At the time of his appointment as Secretary of Administration and Finance, Mr. Heffernan had been Commissioner for fifteen months. Chris Harding, who had been serving as Mr. Heffernan's Chief of Staff, succeeded him as Commissioner. Mr. Harding joined the Department in 2016 from a leadership position in private industry. Mr. Harding is the third Commissioner to lead the Department in the last two years.

Millionaires' Tax on the Ballot for 2018

During the 2018 general election, Massachusetts taxpayers will have the opportunity to vote on a ballot measure to impose a four percent surtax on individuals with annual incomes over $1 million—the so-called "millionaires' tax". Supporters argue it would raise an additional $1.9 billion per year to be spent on public education and transportation infrastructure. If the measure passes, Massachusetts would join California, New York, and the District of Columbia in imposing a higher tax rate on individuals with annual incomes of over $1 million.

Department Issues Guidance Regarding Massachusetts Partnership and C Corporation Tax Return Filing Due Dates

Effective for tax years beginning after December 31, 2015, the due date for filing federal tax returns for C corporations and partnerships were revised. As shown in the table below, C Corporations now have an additional month—until April 15—to file their federal returns, whereas partnerships now have one month less to file their federal returns, which are now due March 15.

Tax Return Filing Deadlines			
	Prior Law	**New Law**	**Effective Date**
C Corporation	15th day of 3rd month* March 15**	15th day of 4th month April 15	**Federal:** tax years beginning after 12/31/15 **Massachusetts:** tax returns due on/after 1/1/18***
Partnership	15th day of 4th month	15th day of 3rd month March 15	

*Following the close of the taxpayer's tax year
**Calendar-year taxpayers.
*** Relief granted by TIN 17-3 and TIN 17-5.

Subsequently, the Massachusetts Legislature enacted conforming legislation to change the due dates of Massachusetts returns to match the new federal due dates.[17] However, the Massachusetts conformity legislation is only effective for tax returns due on or after January 1, 2018 (determined without regard to extensions), which creates a gap from the time the federal changes first take effect. Taxpayers with Massachusetts corporate excise tax returns due during this gap period will be required to file their Massachusetts returns before their corresponding federal income tax returns are due.

To help taxpayers with Massachusetts corporate excise tax returns due during this gap period, the Department has issued guidance agreeing to waive penalties assessed against any taxpayer with a corporate excise tax return during the gap period (i.e., a return for a tax year beginning after December 31, 2015 that is due on or before December 31, 2017), so long as the taxpayer files its corporate excise tax return within one month of the statutory due date or the statutory due date on extension. See Technical Information Release ("TIR") 17-3 (March 2, 2017) and TIR 17-5 (May 31, 2017).

Other cases to watch:

Two other cases involving corporate taxpayers are of note: one currently before the Supreme Judicial Court ("SJC") on direct appellate review from the ATB; a second decided by the SJC in July.

Dental Service of Massachusetts, Inc. v. Commissioner of Revenue, Docket No. SJC-12346 involves a taxpayer's challenge to the application of Massachusetts 2.28% excise tax on gross premiums received with respect to preferred provider arrangements.[18] Dental Services is a non-profit dental services company located in Boston, and a member of Delta Dental Plans Association, a nationwide provider of dental insurance coverage. Dental Services contracted exclusively with employers headquartered in Massachusetts to provide insurance for their employees. However, the coverage provided by Dental Services extended to employees of these Massachusetts employers who were not Massachusetts residents.

The premium excise tax imposed on preferred provider arrangements is based on "gross premiums received during the preceding calendar year for **covered persons residing in the commonwealth**." Dental Services is arguing the emphasized phrase includes individual plan subscribers (employees) who are residents of Massachusetts. Conversely, the Department is arguing that the phrase is limited to employers based in Massachusetts that contract to offer coverage to their employees. The ATB agreed with Dental Services' interpretation of the scope of gross premiums subject to the tax.

If the SJC affirms the decision of the ATB, taxpayers subject to the preferred provider premiums excise tax may have a refund opportunity to the extent that they have been remitting tax based on premiums paid with respect to covered employees who are not Massachusetts residents.

In *D&H Distributing Co. v. Commissioner of Revenue*, Docket No. SJC-12260a, the SJC considered whether the taxpayer, a distributor located outside of Massachusetts, bore the burden of proving that a drop shipment to a Massachusetts customer was a "sale at retail" upon which the distributor had an obligation to collect Massachusetts sales or use tax. The transactions at issue were drop shipments where a Massachusetts customer purchased products from an out-of-state retailer, which then directed D&H Distributing ("D&H") to package, label, and ship products to the Massachusetts customer. D&H had nexus with Massachusetts, but did not have warehouses in the Commonwealth. D&H collected sales tax on transactions where the retailer making a purchase on behalf of a customer had a Massachusetts billing address and the vendor did not provide D&H with a resale certificate.

The Massachusetts statute governing drop shipments treats an out-of-state distributor with Massachusetts nexus delivering products to a Massachusetts customer, where the order is made by an out-of-state retailer not engaged in business in Massachusetts as a "sale at retail" subject to Massachusetts sales tax.[19]

The Department's auditor identified drop-shipment transactions with a ship-to address in Massachusetts, but a bill-to address outside of Massachusetts, on which D&H had not collected Massachusetts sales tax. The auditor then eliminated those transactions where the order was placed with D&H by a retailer that D&H knew to have a presence in Massachusetts. The Department assessed Massachusetts sales and use tax on the remaining transactions.

D&H argued that the burden was on the Department to prove the transactions included in the assessment were limited to transactions with retailers not doing business in Massachusetts. If the transactions were with retailers doing business in Massachusetts, then D&H would not be required to collect Massachusetts sales tax under the drop shipment statute. The ATB rejected D&H's argument, finding the drop shipment statute treated D&H as the vendor, and the Massachusetts statute places the burden on the vendor to prove that a sale of property is not a "sale at retail". In July, the SJC affirmed the decision of the ATB, based on reasoning similar to that adopted by the ATB in its decision.[20]

Reed Smith in the News:

- "Massachusetts Tax Board Upholds Sales Tax on Distributor's Drop Shipments" – Tax Notes
- "Massachusetts Tax Planning for Professional Athletes: Taking Advantage of the Special Treatment Afforded for Signing Bonuses" – Bloomberg BNA
- "Securitized Loan Interests Properly Assigned to Massachusetts, High Court Holds" – Tax Notes
- "Bad News For Loan Co. Spells Refund Opportunity For Others" – Law 360
- "Refunds Possible After Massachusetts Loan Securitizer Case" – Bloomberg BNA
- "Disproportionate Tax on Telecom Property Is Constitutional, Massachusetts High Court Holds" – Tax Notes
- "Massachusetts DOR Releases Updated Field Audit Manual" – Tax Notes
- "Scope Of Mass. Sales Tax Rule May Go Beyond Online Sales" – Law 360
- "Massachusetts DOR Updates Tax Return Guidance for Non-U.S. Corporations" – Tax Notes

- "Wholesaler Liable for Tax in Massachusetts Drop Shipment case" – Tax Notes
- "Massachusetts DOR Proposes Remote Sales Tax Collection Reg" – Tax Notes

About Reed Smith State Tax

Reed Smith's state and local tax practice is composed of more than 35 lawyers across seven offices nationwide. The practice focuses on state and local audit defense and refund appeals (from the administrative level through the appellate courts), as well as planning and transactional matters involving income, franchise, unclaimed property, sales and use, and property tax issues. Click here to view our State Tax team.

Reed Smith's Massachusetts tax practice is built on more than 15 years of experience in Massachusetts state tax planning and controversy matters, focusing on income and sales and use taxes. The Massachusetts tax team writes and speaks frequently on Massachusetts tax issues, and handles significant Massachusetts tax appeals for some of the nation's largest companies. For more information, visit our website at www.reedsmith.com/statetax and look for updates posted on our blog at www.MassachusettsSALT.com.

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[1] G.L. ch. 63 § 38(d)
[2] *See* Directive 17-1: Requirement that Out-of-State Internet Vendors with Significant Massachusetts Sales Must Collect Sales or Use Tax (April 3, 2017, revoked).
[3] Notice of Public Hearing, August 24, 2017, regarding 830 CMR 64H.1.7: Vendors Making Internet Sales.
[4] G.L. c. 4, § 6, Third.
[5] G.L. c. 63, §§ 1, 30.
[6] *See* 2016 Instructions for Form 1120, U.S. Corporation Income Tax Return, p. 15.
[7] *See*, e.g., 2016 Massachusetts Corporate Excise Return, Form 355, Instructions, p. 12.
[8] *See, e.g., Bill DeLuca Enterprises, Inc. v. Commissioner*, 431 Mass. 314 (2000).
[9] 830 CMR 63.31.1
[10] Directive 17-1 (Apr. 3, 2017); Directive 17-2 (June 28, 2017). Following the publication of Directive 17-1, a suit was brought by the American Catalog Mailers Association and NetChoice in the Superior Court of Suffolk County alleging, among other things, that the Directive violated the Massachusetts Administrative Procedure Act ("Massachusetts APA") as a regulation issued without the required notice and comment period. On June 28, 2017, the same day that Directive 17-1 was withdrawn, the Superior Court issued a memorandum of decision and order granting summary judgment on the plaintiffs claim that Directive 17-1 was promulgated in a manner that violated the Massachusetts APA. *American Catalog Mailers Association and NetChoice v. Heffernan*, Superior Court Civil Action No. 2017-1772 BLS1 (June 28, 2017).
[11] Directive 17-2 (June 28, 2017).
[12] Proposed 830 CMR 64H.1.7.
[13] *See* Notice of Public Hearing, August 24, 2017, regarding 830 CMR 64H.1.7: Vendors Making Internet Sales.
[14] For the period October 1, 2017 through December 31, 2017, the 12-month period October 1, 2016 through September 30, 2017 is used in lieu of the prior calendar year.
[15] *See* Notice of Public Hearing, August 24, 2017, regarding 830 CMR 64H.1.7: Vendors Making Internet Sales, available here.
[16] Public Law 114-41, the "Surface Transportation and Veterans Healthcare Choice Improvement Act of 2015"
[17] St. 2017, c. 5, §§ 11-14.
[18] G.L. c. 176I, § 11.
[19] G.L. c. 64H, § 1.
[20] *D&H Distributing Company v. C.I.R.*, 477 Mass. 538 (2017) ("we conclude that the commissioner and the board correctly determined that D & H was responsible as the vendor for collecting and remitting the sales tax due on products it sold to the out-of-State retailers and then delivered to consumers where it failed to meet its burden of proving that the retailers were engaged in business in Massachusetts.").

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Upcoming Speaking Engagements

Members of our State Tax team are presenting at the following upcoming events:

- Webinar: New York State (and Local Tax) of Mind Webinar Series "I'm Not Taxed as a Manufacturer… am I?" **R. Gregory Roberts** and **Jennifer S. White** (August 23, 2017 at 2 pm ET)
- Webinar: Massachusetts State Tax Webinar: What's New In Massachusetts Tax Litigation **Michael A. Jacobs**, **Robert E. Weyman** and **Brent K. Beissel** (September 13th, 2017 at 2 pm ET)
- Institute for Professionals in Taxation (IPT) Sales Tax Symposium San Antonio, TX (September 17-20, 2017)
  - "General Session: Year in Review" and "Nasty States – Aggressive and Unreasonable Approaches by the States" **Lee A. Zoeller**
  - "Taxing Shared Economies – A Whole New World!" **R. Gregory Roberts**
  - "Sales and Use Tax Research: Fundamental Blocking and Tackling" **Aaron M. Young**
  - "Internet of Things – What Is It and Why Do I Care?" **Jonathan E. Maddison**
  - "I Scream, You Scream, We all Scream for . . . Resale?" **Jennifer S. White**
- Webinar: New York State (and Local Tax) of Mind Webinar Series **R. Gregory Roberts** and **Jennifer S. White** (September 28, 2017 at 2 pm ET)
- Council on State Taxation (COST) Annual Conference Orlando, FL (October 22-25, 2017)
  - "If It's Broken, Fix It: Changing Unfavorable or Antiquated State Tax Laws Through Lobbying and Litigation" **David J. Gutowski**
  - "Are You Prepared? MTC and States to Finally Begin Transfer Pricing Effort" **Jonathan E. Maddison**
- Pennsylvania Institute of Certified Public Accountants (PICPA) Multistate Tax Conference Malvern, PA (October 24, 2017)
  - "Pennsylvania State and Local Taxes – What's New?" **Stephen J. Blazick**
- Webinar: "California Unclaimed Property Reporting" **Sara A. Lima** and **Freda L. Pepper** (October 31st, 2017 at 1 pm EST)

For more information, click here.

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