COMMONWEALTH OF MASSACHUSETTS

APPELLATE TAX BOARD

CAMBRIDGE BRANDS, INC. v. COMMISSIONER OF REVENUE

Docket No. C259013

Promulgated:
July 16, 2003

This is an appeal under the formal procedure pursuant to G.L. c. 58A, § 7 and G.L. c. 62C, § 39 from the refusal of the appellee to abate corporate excise assessed against the appellant, Cambridge Brands, Inc., under G.L. c. 63, § 38 for tax years 1996 through 1998.

Commissioner Gorton heard the appeal and was joined in the decision for the appellant by Chairman Burns and Commissioners Egan and Rose.

These findings of fact and report are made at the request of the appellee pursuant to G.L. c. 58A, § 13 and 831 CMR 1.32.

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Lutof George Awdeh, Esq., *Michael T. Fatale*, Esq., and *Thomas W. Hammond, Jr.*, Esq. for the appellee.

FINDINGS OF FACT AND REPORT

On the basis of testimony and exhibits introduced at the hearing of this appeal, the Appellate Tax Board ("Board") made the following findings of fact. During all times relevant to this appeal, Cambridge Brands, Inc. ("CBI") was a wholly-owned subsidiary of Tootsie Roll Industries, Inc. ("TRI") a Virginia corporation whose stock was traded on the New York Stock Exchange. TRI, a manufacturer of candy for over ninety years, produced and sold well-known brands of candy, particularly Tootsie Rolls and Tootsie Pops. TRI's corporate headquarters were located in Chicago, Illinois.

For each of the tax years at issue, CBI filed Massachusetts corporate excise returns. Following an audit, the Commissioner issued a Notice of Intention to Assess ("NIA") dated July 26, 2000 and a Notice of Assessment ("NOA") dated August 31, 2000 assessing additional corporate excise in the amount of $2,453,675 plus statutory interest in the amount of $622,964.00. The assessment was based on two adjustments: (1) the denial of deductions for royalty payments made to an affiliate for use of certain trademarks and other intellectual property; and (2) the application of the "throwback" rule to treat certain sales of product delivered to purchasers out-of-state as Massachusetts sales.

On September 13, 2000, the appellant filed separate applications for abatement of the amounts attributable to each of the tax years at issue. On March 26, 2001, CBI withdrew its consent to the failure of the Commissioner to act on its abatement applications within six months. On March 29, 2001, CBI filed its petition with the Board. On the basis of these facts, the Board found it had jurisdiction over this appeal.

During the mid-1980s, appellant's parent corporation, TRI, began seeking to grow its business by acquiring new brands of candy. Pursuant to that policy, TRI acquired Cella Confections ("Cella") in 1985, and then the Charms Company ("Charms") in 1988. During 1993, TRI discovered that Warner-Lambert Company ("Warner-Lambert"), an unrelated public company, was interested in selling the trademarks, formulas, trade dress,[1] and associated intellectual property for a collection of candy brands, collectively referred to as the "Cambridge Brands." The Cambridge Brands included such well-known candy brands as

[1] "Trade dress" refers to the specific colors and styles of writing found on the packaging of a particular product.

Junior Mints, Charleston Chew, Sugar Daddy, Sugar Babies, and Pom Poms.

Warner-Lambert, however, also wanted to sell the factory in Cambridge where the Cambridge Brands were being manufactured (the “Cambridge Factory”). To this end, Warner-Lambert conducted an auction requiring bidders to submit a single bid for both the Cambridge Brands and the Cambridge Factory. TRI won the right to make the purchase, and on September 29, 1993, TRI and Warner-Lambert entered into an Asset Sale Agreement for the purchase and sale of the Cambridge Brands as well as the tangible assets located in Cambridge. The agreement indicated that this sale included the tangible assets associated with the brands but did not include any marketing, sales, distribution, or other service functions that would have supported the brands being sold, because the sale was not the sale of a business or division of Warner-Lambert.

The Asset Sale Agreement between the parties specified that the Cambridge Brands and the Cambridge Factory together were being sold for a total of $82 million, plus the value of Warner-Lambert’s inventories of finished goods. On October 5, 1993, TRI and Warner-Lambert, as unrelated parties, executed an arm’s-length Purchase Price Allocation, allocating the total purchase price among the transferred assets for purposes of reporting pursuant to Section 1060 of the Internal Revenue Code ("Code"). The agreed-upon Purchase Price Allocation valued the Cambridge Factory and related tangible assets at $24.5 million and the Cambridge Brands at $57.85 million. The parties' assessments of the values of the Cambridge Factory and related assets were confirmed by appraisals that TRI obtained of the real estate and other tangible property. In accordance with the agreement of the parties, Warner-Lambert transferred to TRI the Cambridge Brands on October 15, 1993 for $57.85 million, pursuant to a Bill of Sale and Assignment of Intellectual Property Rights.

Prior to the closing of the agreement with Warner-Lambert, TRI decided that it would be beneficial to continue to use the Cambridge Factory to manufacture the Cambridge Brand candies, even though it was not a state-of-the-art facility. John Newlin, the vice president of manufacturing for TRI and a TRI employee for about twenty-seven years, explained that the decision was based principally on the presence of a long-term workforce at the Cambridge Factory. Accordingly, TRI decided to retain and make some improvements to the antiquated Cambridge Factory to make the operation more profitable.

G. Howard Ember, Jr., who had worked for TRI for almost eighteen years and who had served as the chief financial officer for TRI and several of its subsidiaries since 1992, testified, and the Board found, that in accordance with an acquisition structure that had been followed by TRI since the mid-1980s, TRI planned to use a separate, newly-organized company to acquire the Cambridge Factory and other tangible personal property and assets. On September 24, 1993, CBI, the appellant, was formed as a Delaware corporation and a wholly-owned subsidiary of TRI. CBI's officers during the taxable period were: Mel Gordon, chairman; Ellen Gordon, president; John Newlin, vice president of manufacturing; G. Howard Ember, Jr., vice president of finance; and Barry Bowen, secretary. Mr. Ember testified, and the Board found, that CBI's officers were generally the same as those of TRI.

On October 14, 1993, prior to the closing with Warner-Lambert and as permitted by the Asset Sale Agreement executed between Warner-Lambert and TRI, TRI entered into an Assignment Agreement with CBI, specifying that TRI was assigning its rights in the Cambridge Factory and related tangible assets to CBI and requiring TRI "to cause Warner-Lambert to sell" the Cambridge Factory and related tangible assets to CBI rather than to TRI. Accordingly, pursuant to a separate Bill of Sale and Assignment, Warner-Lambert transferred the Cambridge Factory and related tangible assets to CBI on October 15, 1993, the same day that TRI purchased the Cambridge Brands from Warner-Lambert. CBI borrowed $20 million of the $24.5 million purchase price from the Northern Trust Company, an unrelated lender. The balance of the funds was provided by means of TRI capitalizing CBI.

Mr. Ember testified, and the Board found, that after the closing of the sale, various manufacturing personnel based at the Cambridge Factory voluntarily transferred their employment from Warner-Lambert to CBI. However, no other employees or departments of Warner-Lambert transferred to CBI or to TRI. CBI operated solely as the manufacturer of the Cambridge Brands, and it employed about two hundred manufacturing employees, about the same number as had been employed when Warner-Lambert had owned the factory. CBI began operating the Cambridge Factory to produce the candies covered by the Cambridge Brands, using ingredients from suppliers that were pre-approved by TRI and at prices bargained for by TRI. CBI was subject to oversight by its parent in the manufacturing of the candies covered by the Cambridge Brands. While CBI made some efforts to improve the efficiency of the Cambridge Factory, the basic functioning of the factory did not change after CBI purchased it from Warner-Lambert. CBI's staff consisted solely of manufacturing personnel; there were no brand managers or any other employees who performed marketing, advertising, or promotional tasks. CBI then sold the finished candies to TRI Sales Co. ("TRI Sales"), another wholly-owned subsidiary of TRI that marketed and distributed the products that CBI and other TRI affiliates manufactured.

CBI had its corporate headquarters in Chicago, where TRI provided management services, including marketing, purchasing and legal services, as well as maintenance of registrations and permits, to CBI pursuant to a Management Agreement between the two parties. This agreement had been executed on October 15, 1993, the day that Warner-Lambert transferred the Cambridge Brands and the Cambridge Factory to TRI and to CBI, respectively. CBI's corporate officers, who were generally the same officers as those of TRI, were also located in Chicago, where they performed the same functions for CBI as they did for TRI and TRI's other subsidiaries. Manufacturing personnel at the Cambridge Factory regularly interacted with the management, purchasing, and marketing personnel in Chicago. However, the Board found that no management activities were performed at the Cambridge Factory. Moreover, CBI did not employ any of the Chicago personnel performing these functions. Instead, CBI paid for these services through the fees paid to TRI pursuant to the Management Agreement. The agreement specified that CBI was responsible for its pro rata share of allocable expenses, which was based on the gross sales of all products sold by CBI during each period.

CBI’s available storage space at the Cambridge Factory was minimal, enabling the storage of only a day or two’s worth of both raw materials and finished products. Therefore, CBI chose to store its inventory of finished goods at the same locations where its main customer, TRI Sales, picked up its inventories of products. TRI Sales was a subsidiary of TRI that purchased the finished products from TRI and its other subsidiaries and resold them to retailers throughout the country. CBI sold substantially all of its products to TRI Sales. One location where TRI Sales picked up products manufactured by TRI and other TRI subsidiaries was in Chicago, a major distribution center for TRI Sales and the same location where TRI maintained its headquarters and a large manufacturing and warehouse facility. TRI leased out portions of this particular facility that it did not use.

CBI and TRI entered into a lease for 60,000 square feet of temperature-controlled warehousing space. Mr. Ember testified, and the Board found, that this space was built and conditioned specifically for storage of CBI's products, and that this space was occupied exclusively by CBI's products. Mr. Ember also testified, as supported by a document prepared by CBI's centralized data processing system in Chicago, and the Board found, that CBI's shipments of products to the Chicago facility accounted for between 60 to 70 percent of CBI's volume of sales for the years at issue. CBI also leased smaller amounts of warehouse space from another TRI subsidiary, Charms Company, in Covington, Tennessee and from an unrelated party in Memphis, Tennessee.

Mr. Ember explained that the goods remained in storage at these various facilities for thirty to ninety days. He stated that CBI owned the merchandise while it was in storage in the warehouses and that CBI thus retained the risk of loss for those stored products. CBI filed tax returns in Illinois and Tennessee. These returns, and its return for Massachusetts, indicated that CBI owned the Cambridge Brands products stored at these warehouses. These returns also indicated its rental expenses for the warehouse spaces in Illinois and Tennessee.

TRI Sales, the centralized reseller of products manufactured by TRI and its subsidiaries, consisted of two divisions. The Charms division generally distributed non-chocolate products, including the Cambridge Brands' Sugar Daddies and Sugar Babies, and the Tootsie Roll division generally distributed chocolate products, including the Cambridge Brands' Junior Mints and Charleston Chew. Most of TRI Sales' employees were sales managers, who were responsible for managing approximately one hundred brokers from unrelated brokerage firms. These brokers entered into sales representation contracts with the TRI Sales divisions. The brokers employed approximately one thousand employees to solicit orders on behalf of TRI sales. CBI did not have a contractual relationship with the brokers or their employees.

CBI and TRI Sales entered into a distribution agreement by which TRI Sales purchased CBI's products and resold them to TRI Sales' customers, which included retailers like Wal-Mart, CVS, and Safeway. Pursuant to the Distribution Agreement, CBI sold its manufactured candies to TRI Sales at approximately 25 percent below the candies' wholesale list prices. Mr. Ember explained that the wholesale list price is the market-published price for a product. Charms Marketing, a subsidiary of TRI, sets this wholesale list price and determines the price that CBI will charge TRI Sales for the products. TRI then determines the price that it will charge its customers for these products. TRI Sales may offer promotions whereby it makes sales at prices lower than the market-published wholesale list price, in which event this discount becomes a sales expense borne by TRI Sales, reducing TRI Sales' profits with no effect on CBI's profits.

TRI Sales sends a truck to pick up candies at the CBI warehouse when it is ready to distribute the products to its customers. The Distribution Agreement specifically provides that "title to all Cambridge Products purchased by Distributor [TRI Sales] shall be transferred from CBI to Distributor upon delivery to Distributor," either at TRI Sales' distribution center in Chicago or at another location that may be owned by TRI Sales. Mr. Ember testified, and the Board found, that the parties understood that title to the goods passed when CBI loaded the goods onto a truck under the control and supervision of TRI Sales at CBI's warehouse. Once TRI Sales took delivery from CBI, CBI was entitled to receive the purchase price of the products. TRI Sales assumed virtually all of the subsequent risks and responsibilities for the products, including pricing risks, credit risks for sales to its customers, risk of loss or damage to the products, the risk of "customer deductions" for outdated or slow-moving products, and all the costs and risks of carrying out its responsibilities under the Distribution Agreement. CBI was required only to refund the price of the products if TRI Sales returned the products to CBI at TRI Sales' own expense or if there was a product recall. The agreement also specifically provided that TRI Sales bore the risk of all loss or damage that may have resulted from shipping and handling of the products after they left the CBI warehouse.

TRI and its subsidiaries manufactured and distributed well-known brand candies, including Tootsie Rolls, Tootsie Pops, Charms Blow Pops, Cella's Chocolate Covered Cherries, Junior Mints, and Andes. The Cambridge Brands were in existence for at least fifty years and existed on a standalone basis, as evidenced by the changes in the entity that owned them over the course of their production.[2] Mr. Ember explained the importance in the candy industry of brand names and trade dress. Mr. Ember explained that the owners of the Cambridge Brands, TRI and

[2] The creator of several brands included in the Cambridge Brands was James Welch, who had purchased the Cambridge Factory from a tannery and converted the property for use as a confectionary factory where he began to produce fudge. Mr. Welch operated the factory for about thirty years, manufacturing such popular brand candies as Sugar Daddies, Sugar Babies, Pom Poms, and Junior Mints. He eventually sold the factory and surrounding property to Nabisco, which in turn sold it to Warner-Lambert around 1988.

Warner-Lambert before it, understood the importance of “maintain[ing] the integrity of the trademarks and the package design and trade dress intact for many years because your value is in the brand.”

Paul Broderick, an account manager and business manager with the brokerage firm, Johnson, O’Hare, managed the Charms Marketing line of candies, including Blow Pops, Sugar Babies, Sugar Daddies, and Ande’s Mints, at his firm. He testified, and the Board found, that generic candies are somewhat comparable to brand name, or premium, candies in terms of the actual product, but the fundamental difference is the name recognition. Premium candies command much higher prices, somewhere between twenty to thirty percent above generics, because customers come to expect a certain quality and flavor from the candy, and they are willing to buy those brands repeatedly. In fact, as both Mr. Ember and Mr. Broderick explained, establishing a new premium brand of candy in the current American economy is a very difficult, if not impossible, task, because of the importance of name recognition to the American candy consumer. Accordingly, candy manufacturers might attempt to expand their lines of candy through a “line extension,” where an existing brand name is extended to a somewhat different product and sold with the same recognition as the original premium candy.[3] However, TRI had not had any meaningful success in establishing completely new brands. Moreover, CBI eventually discontinued the Pom Poms candy brand, one of the Cambridge Brands purchased from Warner-Lambert, which was in the process of being phased out at the time of the acquisition because it could not compete with the Milk Duds brand of candies, which had a much stronger brand name recognition.

Since the mid-1980s, TRI had adopted an acquisition strategy whereby it managed its trademarks and other intangible assets relating to products manufactured by TRI and its subsidiaries on a centralized basis. TRI and its subsidiaries had trademarks that were being managed by TRI in Chicago at the time of the sale of the Cambridge Brands by Warner-Lambert. These trademarks included Tootsie Rolls, Tootsie Pops, Mason Dots, Charms Blow Pops, Charms Squares, and Cella's Chocolate Covered Cherries. The same marketing staff who performed planning for the other brands owned by TRI and its subsidiaries designed and implemented marketing plans for the Cambridge Brands, including, for example, the marketing plan to discontinue heavy discounts on the brands that had been offered by Warner-Lambert.

[3] One example of a line-extension brand of candy cited by Mr. Broderick was Nutrageous by Reese's, which was enjoying only limited success in the candy industry at the time of the hearing.

This same marketing staff was also responsible for preparing sales forecasts that determined the production schedules for the Cambridge Factory, marketing the Cambridge Brands, establishing wholesale list prices for the brands, and performing other similar management activities. All management, marketing, and artistic or creative work relative to the Cambridge Brands was performed by TRI employees working in Chicago, who were not CBI employees.

TRI also handled the formulas used in the manufacturing of the candies manufactured by TRI and its subsidiaries. These formulas were kept confidential in order to protect the formulas from being duplicated by TRI's competitors. The formulas were handled by TRI's quality control and research and development departments in Chicago, where they were carefully parceled out on a "need-to-know" basis to the various manufacturers of the candies. TRI licensed to CBI the rights to use the trademarks and formulas covered by the Cambridge Brands in exchange for a royalty payment established by TRI's employees. The Board found that the purchase of the Cambridge Brands by TRI, rather than CBI, was consistent with TRI's business strategy to centrally manage the various brands of candies which TRI and its family of corporations manufactured and sold.

The license agreement for CBI's use of the Cambridge Brands trademarks and formulas originally entered into between CBI and TRI provided for CBI to pay TRI a license fee equal to 10 percent of "sales," subject to a minimum annual payment of $4.5 million. In the first year of the agreement with TRI, 10 percent of the wholesale list price was used as a reasonable estimate of a fair licensing rate until a complete appraisal could be obtained. CBI began and continued to pay royalties to TRI equal to 11 percent of the wholesale list price of the candies. Mr. Ember testified that TRI established the royalty rate and based its estimate on the business modeling that had just been performed in connection with the purchase of the intangibles from Warner-Lambert. TRI also based the rate on its previous experience in licensing its other brands. For example, the Charms brands commanded a 14 percent royalty rate, but Mr. Ember explained that this rate was justified by the higher profitability for the Charms line of products. The appraisal report prepared by Lloyd-Thomas/Coats & Burchard Co. (the "Lloyd-Thomas appraisal report") indicated that a reasonable, arm's-length royalty rate would range from 9 to 11 percent of the wholesale list price for the Cambridge Brands products. On the basis of the Lloyd-Thomas appraisal report, the parties agreed to adjust the royalty rate from 10 percent to 11 percent.[4] The royalties at issue amounted to approximately $6 million for each of the years at issue.

Charms Marketing, a subsidiary of TRI, was formed in 1992 to manage brands and administer the trademarks used by TRI and its subsidiaries. Upon its formation in 1992, TRI transferred to Charms Marketing the Charms line of brands, including Blow Pop, Charms Blue Razz, Charms Flat Pops, Charms Squares, and Charms Zip-A-Dee-Doo-Da. In October of 1994, TRI then sold the Cambridge Brands, together with TRI's licensing agreement with CBI, to Charms Marketing. The purchase price was equal to the book value of the Cambridge Brands. Charms Marketing paid for the Cambridge Brands by means of an interest-bearing note. In accordance with the sale, CBI began to pay its license fees to Charms Marketing rather than to TRI. Mr. Ember testified, and the Board found, that this change in ownership of the Cambridge Brands was not motivated by tax considerations, nor did it

[4] The Commissioner argued that the royalties paid were higher than 11 percent of the total sales as reported by CBI. However, the Board found that the royalties were consistent with the agreement between CBI and TRI Sales, which based the royalty rate on the wholesale list price for the candies, not on CBI's sales to TRI Sales.

result in any change in the taxes or profitability of the Cambridge Brands.

Upon its purchase of the Cambridge Brands, Charms Marketing assumed the functions relating to management and marketing of the Cambridge Brands. No CBI personnel were involved in these management functions. Charms Marketing and not CBI bore the expenses relating to management and marketing of the Cambridge Brands. CBI began paying the royalties to Charms Marketing. CBI paid TRI pursuant to a management agreement for its allocated share of standard corporate services that TRI provided. The royalties were the only costs that CBI incurred for the use of the Cambridge Brands.

Financial statements for CBI, prepared from its general ledgers maintained in the regular course of business, demonstrate that even after accounting for the royalty payments it made, CBI was very profitable during the periods from 1993 through 2000, earning about a 24 to 27 percent annual return on its assets. Charms Marketing earned about an 8½ to 11 percent annual return on its assets. Dr. Irving Plotkin, a microeconomist specializing in financial economics and an expert witness with respect to transfer pricing issues, testified for the appellant that the fairness of royalty payments should be evaluated after the agreement has taken effect by analyzing the rate of return of the licensee. Upon his observation of the antiquated Cambridge Factory, Dr. Plotkin would have expected CBI, as a contract manufacturer,[5] to be earning only a "very pedestrian" rate of return,[6] about 5 to 8 percent, which was far less than CBI's actual rate of return of 24 to 27 percent. Dr. Plotkin then testified that based on his research of 2,261 individual companies reported by Standard and Poor's,[7] CBI's profitability, even after its payment of royalties, was above the 95th percentile of the average returns realized by American industries, equating CBI with a drug or high-tech company rather than a contract manufacturer. Based on this data, it was Dr. Plotkin's expert opinion that the royalty rate paid by CBI was too low. Accordingly, Dr. Plotkin's expert opinion was that the adjustments proposed by the Commissioner, the elimination of royalties paid by CBI, would render CBI more profitable than 99 percent of all

[5] Dr. Plotkin gave as a basic economics definition of contract manufacturer "someone whose raison d'etre is just to make a product without having a commercial interest in the design of the product or the ultimate marketing and sale of the product to the next level of trade, to the next level of customer."

[6] Dr. Plotkin defined "rate of return" as the ratio of operating income to operating expenses.

[7] Dr. Plotkin explained that he did not cherry-pick which companies to include in his analysis, but rather, he chose companies based on whether the data that he needed for his analysis – net operating income and operating assets, which would be fundamental to any accounting statement - was reported by Standard and Poor's.

American industries, a result that would be “ludicrous” and not appropriate from an economic standpoint.

Based on all the evidence, the Board made the following findings. The Board found that Charms Marketing owned the Cambridge Brands during the years at issue and that CBI had no right to use the Cambridge Brands other than as the licensee of Charms Marketing pursuant to the license agreement executed between the parties. The Board also found that CBI used the Cambridge Brands for the manufacture and sale of the candies covered by the brands, and that CBI thereby enjoyed a higher profit margin by virtue of its selling of branded candies. The Board found that evaluating CBI’s rate of return on its assets was an accurate and acceptable method of measuring the fairness of the license arrangement between the related parties, CBI and Charms Marketing. The Board ultimately found that, based on CBI’s very high rate of return, the royalties that CBI paid to Charms Marketing did not exceed the fair value for CBI’s use of those brands.

The Board also found that during the years at issue, CBI had its corporate headquarters in Chicago. All of the corporate officers and senior management personnel who managed CBI’s business and performed many functions on behalf of CBI operated out of TRI’s Chicago corporate office. CBI paid for the services performed on its behalf through the Management Agreement executed between CBI and TRI. CBI also leased and paid for warehouse space in Chicago and Tennessee, and CBI stored Cambridge Brand candies in these warehouses. The Board also found that CBI was taxable in both Illinois and Tennessee. The Board additionally found that the Cambridge Brand candies that were stored at the Chicago and Tennessee warehouses were sold by CBI to TRI Sales and, pursuant to the Distribution Agreement between CBI and TRI Sales, title to these candies transferred to TRI Sales upon the delivery to TRI Sales.

Based on these findings of fact, the Board found and ruled that the appellant was entitled to an abatement of $2,453,675.00 of tax, the amount pertaining to the Commissioner’s disallowance of royalty deductions and his application of the throwback rule to sales in Illinois and Tennessee, plus statutory additions. Accordingly, the Board issued a decision for the appellant in this appeal.

OPINION

Domestic and foreign corporations that conduct business in the Commonwealth are required to pay a corporate excise based in part on their net income derived from business activities carried on in Massachusetts.

G.L. c. 63, §§ 32, 38, and 39. The "gross income" of a corporation for Massachusetts tax purposes is generally equal to gross income as defined under the Internal Revenue Code ("Code") as amended and in effect for the taxable year, with some exceptions not relevant to these appeals. G.L. c. 63, § 30(4). Massachusetts net income is equal to gross income minus the deductions allowable under the Code, with a few exceptions. G.L. c. 63, § 30(4).

1. Deductibility of CBI's royalty expenses.

In determining net income, the Code allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Code § 162(a). The first issue in this appeal pertains to the deductibility of royalty expenses paid by a subsidiary to another subsidiary with the same parent.

The issue of the deductibility of royalty expenses paid to a related entity for the license of trademarks was addressed by the Board in two appeals, ***Syms Corp. v. Commissioner of Revenue***, 26 Mass. App. Tax Bd. Rep. 166, *aff'd*, 436 Mass. 505 (2002), and ***The Sherwin-Williams Co. v. Commissioner of Revenue***, 26 Mass. App. Tax Bd. Rep. 63, *rev'd*, 438 Mass. 71 (2002). In those appeals, the Board found that the Commissioner properly disallowed the deductions for royalty expenses on several grounds, including sham transaction, ordinary and necessary business expenses, and the Commissioner's authority under G.L. c. 63, § 39A to adjust payments made in non-arm's length transactions between affiliated corporations. The Supreme Judicial Court took direct review of both appeals, affirming the Board in ***Syms*** and reversing the Board in ***Sherwin-Williams***. The Supreme Judicial Court ruled in ***Sherwin-Williams*** that the Board erred in its factual findings that the transfer and license-back transaction in question lacked economic substance and that the payments of royalties and interest were not ordinary and necessary business expenses. The Supreme Judicial Court further ruled that, "[a]ssuming that § 39A, construed to give effect to its broad remedial purpose, permits the commissioner to eliminate payments made by a parent to a subsidiary corporation, it does so only to the extent that those payments are in excess of fair value," and the court there found that the payments were not in excess of fair market value. 438 Mass. at 95.

In reviewing both the ***Syms*** and ***Sherwin-Williams*** cases, the Board found that the Supreme Judicial Court upheld the Board's use of certain legal theories for analyzing transactions between related parties, namely, that these transactions must not be sham transactions, the expenses must be ordinary and necessary, and § 39A allows the Commissioner to eliminate payments between a foreign parent corporation and its subsidiaries if these payments are in excess of fair market value. *See* ***Syms***, 436 Mass. at 506, 509-514 and ***Sherwin-Williams***, 438 Mass. at 73. The Board accordingly will continue to analyze transactions between related parties under the same theories as it did in the ***Syms*** and ***Sherwin-Williams*** appeals.

a. The Commissioner did not properly deny the deductions for royalty fees pursuant to the sham transaction doctrine.

The Board found that the Commissioner improperly disallowed the deductions for royalty payments from CBI to Charms Marketing, another subsidiary of TRI, because the license of the Cambridge Brands to CBI had both a valid business purpose and economic substance. The tax effects of a transaction must be disallowed where a given transaction is not supported by a valid business purpose other than tax avoidance, or where the transaction lacks economic substance beyond the creation of tax benefits. ***Casebeer v. Commissioner of Internal Revenue***, 909 F.2d 1360, 1363 (9^{th} Cir. 1990), ***James v. Commissioner of***

Internal Revenue, 899 F.2d 905, 908-09 (10th Cir. 1990). Under the “better approach” to the sham transaction analysis, “the consideration of business purpose and economic substance are simply more precise factors to consider in whether the transaction had any practical economic effects other than the creation of income tax losses.” ***James***, 899 F.2d at 908-09 (quoting ***Sochin v. Commissioner of Internal Revenue***, 843 F.2d 351, 354 (9th Cir.), *cert. denied*, 488 U.S. 824 (1988)).

Massachusetts follows federal case law reasoning for disregarding transactions that are a sham. ***Falcone v. Commissioner of Revenue***, 20 Mass. App. Tax Bd. Rep. 61, 64 (1996). As with the federal courts, the Supreme Judicial Court recognizes that transactions with economic substance and substantive business purpose are to be respected for tax purposes. ***Koch v. Commissioner of Revenue***, 416 Mass. 540, 554 (1993) (taxpayer’s transfers of stock respected for tax purposes because they were motivated by substantive business objectives).

In the instant appeal, the Board found and ruled that both the economic substance and business purpose requirements were satisfied because the license of the trademarks had very real practical economic effects beyond the creation of income tax deductions. A significant factual distinction between the facts of this appeal and those of ***Syms*** is that the trademarks at issue were never owned by the entity which was leasing them because the trademarks were separately allocated at the time of TRI's purchase of the Cambridge Brands and CBI's purchase of the Cambridge Factory from Warner-Lambert. While not a necessary factor in the determination of economic substance and business purpose, the separation in ownership between the trademarks and the factory where the goods were manufactured enabled the taxpayer to demonstrate more clearly that the transaction had real practical economic effects because the entity paying to lease the trademarks was not the same entity that was paying and continued to pay all of the expenses of maintaining and defending the trademarks. *Compare* ***Syms***, 2000 ATB Adv. Sh. at 757-58.

Moreover, unlike the facts of ***Syms***, there is no evidence that the lease arrangement was a tax scheme designed to create deductions while at the same time creating a circular tax-free distribution back to the paying entity:

> In ***Syms***, we upheld a finding of the board that a transfer and licensing back of trademarks between a parent and its newly formed subsidiary was a sham transaction for taxing purposes. There, the evidence that the transaction was specifically designed as a tax avoidance scheme; royalties were paid to the subsidiary once a year and

> quickly returned to the parent company as dividends[8]; **the subsidiary did not do business other than to act as a conduit for the circular flow of royalty money**; and the parent continued to pay all of the expenses of maintaining and defending the trademarks it had transferred to the subsidiary, fully supported the board's findings that the transaction had no practical economic effect other than the creation of a tax benefit and that tax avoidance was its motivating factor and only purpose.

Sherwin Williams, 438 Mass. at 80 (emphasis added). In the facts of the licensing arrangement at issue, however, there was no circularity of payments between entities. There was no mismatch of expenses where one entity paid licensing fees to an entity while still paying all of the expenses of maintaining the trademarks, no payment of dividends with the funds that had been previously paid as royalty expenses, and no other evidence suggesting that tax avoidance was the only, or even primary, consideration for the transaction.

Furthermore, both CBI and Charm Marketing were viable business entities which actually engaged in the businesses for which they were organized. The Supreme Judicial Court in ***Sherwin-Williams*** found that this factor was important in

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[8] The Code provides a deduction for dividends received by a corporation which is a member of the same affiliated group and owns at least eighty percent of the corporation that distributed the dividend. See Code § 243. In ***Syms***, because the parent, Syms, owned one hundred percent of SYL, Syms would receive a one hundred percent deduction for dividends received from SYL.

applying the sham transaction doctrine, citing two Supreme Court cases, ***Gregory v. Helvering***, 293 U.S. 465 (1935) and ***Frank Lyon Co. v. United States***, 435 U.S. 561 (1978).

In ***Gregory***, the taxpayer was the sole owner of a corporation, which in turn owned 1,000 shares of a second corporation. ***Gregory***, 293 U.S. at 467. "For the sole purpose of procuring a transfer of these shares to herself in order to sell them for her individual profit, and, at the same time, diminish the amount of income tax which would result from a direct transfer by way of dividend, she sought to bring about a 'reorganization' under [the applicable section of the Code]." ***Id***. To achieve this tax plan, the corporation created a subsidiary and, three days later, transferred the stock to this entity. Three days after that, the subsidiary was dissolved and liquidated by transferring all its assets, the shares of stock, to the taxpayer. ***Id***. The taxpayer realized substantial tax benefits by means of the transaction, particularly the avoidance of less favorable tax treatment that would have resulted through the payment of a dividend. However, "[n]o other business was ever transacted, or intended to be transacted, by that company." ***Id***. The Court thus found that the new subsidiary "was nothing more than a contrivance to the end last described. . . . When that limited function had been exercised, it immediately was put to death." ***Id***. at 469-70. Accordingly, the Court affirmed the finding of a tax deficiency. ***Id.***

However, in ***Frank Lyon***, the Court concluded that a sale and leaseback of real property should be respected for tax purposes. In that case, the transaction consisted of a sale-leaseback by which a bank sold a building under construction to the taxpayer company, which simultaneously leased the building back to the bank for the bank's use. 435 U.S. at 566. The lease specified that the bank would be responsible for all expenses usually associated with the maintenance of a building, and the bank had the option to repurchase the building pursuant to a schedule of prices at certain dates. ***Id***. at 567. The taxpayer claimed various tax deductions and depreciation allowances pursuant to its ownership of the building, which the Commissioner of Internal Revenue denied, finding that the taxpayer was not the true owner of the building because the transaction was a sham. ***Id***. at 568. However, the Court concluded that, regardless of the tax benefits of the transaction to the taxpayer, the transaction had economic substance, specifically because the taxpayer also assumed the risk of the transaction, becoming liable to repay the loan, while "the lessor retain[ed] significant and genuine attributes of the traditional lessor status." ***Id***. at 584.

The Supreme Judicial Court explained the impact of these two cases on the sham transaction doctrine:

> Taken together, the ***Gregory*** and ***Lyon*** decisions suggest that for a business reorganization that results in tax advantages to be respected for taxing purposes, the taxpayer must demonstrate that the reorganization is "real" or "genuine," and not just form without substance. Stated otherwise, the taxpayer must demonstrate that the reorganization results in "a viable business entity," that is ***one which is "formed for a substantial business purpose or actually engage[s] in substantive business activity***."

Sherwin-Williams, 438 Mass. at 84 (emphasis added) (quoting ***Northern Ind. Pub. Serv. Co. v. Commissioner of Internal Revenue***, 115 F.3d 506, 511 (7th Cir. 1997)) (other citations omitted).

Here, the Board found that the creation of CBI and Charms Marketing was pursuant to an actual and substantial business purpose, namely, the consolidation of tangible assets for a distinct line of candies manufactured by a separate factory (the formation of CBI) and the consolidation of the intangible assets to be held and protected separately and apart from the tangible assets in another corporation (the formation of Charms Marketing). The Board found that the consolidation of the trademarks in a single corporation provided many business benefits to the Cambridge Brands candies, particularly the benefit of a marketing plan by the same marketing staff who performed planning for the other TRI brands and the benefit of sales forecasts and production schedules for the Cambridge Factory that were consistent with other TRI brands of candies. Moreover, the separation of tangible and intangible assets was hardly a scheme invented solely for the newly-acquired Cambridge Brands, but instead, part of a business organization plan practiced by TRI since the mid-1980s. The Board also found that the form of the transaction was reflected in its substance, where Charms and not CBI was charged with paying expenses associated with the management and maintenance of the Cambridge Brands.

Furthermore, the Board could find no facts supporting the Commissioner's assertion that the transaction was motivated solely by tax benefits with no economic substance, where there was no circular flow of income between CBI and Charms Marketing or any other TRI entity, and the lessee of the trademarks was not the same entity that was paying for the maintenance and administration of those trademarks. The Board also found no definitive proof of an actual tax saving scheme in the arrangement at issue.

The leasing of the trademarks did create deductions for CBI. However, the Board also found that CBI actually earned a higher profit by using the trademarks to sell branded candies. CBI, as a typical contract manufacturer, would have enjoyed a far lower profitability margin if it had simply sold candies that were not branded with the Cambridge Brand trademarks. More importantly, forcing CBI to own its own trademarks would have denied the corporation the benefit of the centralized management, purchasing and marketing strategies provided by having a consolidated entity manage the trademarks for the many candies manufactured by TRI and its subsidiaries. Accordingly, the Board found and ruled that the Commissioner improperly denied the deductions for royalty payments by CBI to Charms Marketing under the sham transaction doctrine.

b. The royalty fees were deductible as ordinary and necessary business expenses.

The Board found that CBI's payment of royalties to Charms Marketing for the use of the Cambridge Brands was deductible as an "ordinary and necessary" business expense, as that term is used in Code § 162. Unlike the facts of ***Syms***, where the Board found, and the Supreme Judicial Court affirmed, that the subsidiary did not provide any value or protection that justified the parent’s payment of royalties, the facts here establish that Charms Marketing, not CBI, was responsible for paying expenses associated with protection and maintenance of the Cambridge Brands. *Contrast* ***Syms***, 26 Mass. App. Tax Bd. Rep. 166, 187 (“[T]he royalty fees paid by Syms were not ordinary or necessary considering that SYL had not developed the Marks in any way, or built any goodwill, or created anything of value that could be licensed back to the parent. The royalty payments were not determined by taking into consideration the expenditures made by Syms and Syms Advertising for advertising and continued maintenance of the Marks.”).

“An ‘ordinary’ expense is one that is normally to be expected, in view of the circumstances facing the business, and a ‘necessary’ expense is one that is appropriate and helpful to the business.” ***Palo Alto Town & Country Village, Inc. v Commissioner of Internal Revenue***, 565 F2d 1388, 1390 (9th Cir. 1977) (reversing Tax Court decision denying portion of payments for stand-by use of an airplane, finding that chartering the plane on a stand-by basis was useful to taxpayer’s business) (citing ***Commissioner of Internal Revenue v. Heininger***, 320 U.S. 467, 471 (1943). In this appeal, the Board found that a valid business purpose justified the payment of the license fee, because the use of the Cambridge Brands enabled CBI to sell its products at a higher price than if it had not had the benefit of using those trademarks. The payment of the license fee, therefore, was "ordinary" because it enabled the business to turn a profit, and it was also "necessary" because the use of the trademarks was not only helpful but essential to CBI in the realization of its higher profit margin.

The Board found that the maintenance of the Cambridge Brands provided by Charms Marketing and the higher profit margin realized by CBI through the use of the trademarks provided sufficient factual circumstances justifying the payment of license fees by CBI to Charms Marketing. Accordingly, the Board upheld the deduction of the license fees as ordinary and necessary business expenses as that term is defined for purposes of Code § 162.

c. The Commissioner was not justified in exercising his authority under § 39A to adjust the license payments at issue.

G.L. c. 63, § 39A provides that the Commissioner has authority to eliminate certain payments between related entities. The pertinent language of that provision provides that:

> [t]he net income of a foreign corporation which is a subsidiary of another corporation or closely affiliated therewith by stock ownership shall be determined by eliminating all payments to the parent corporation or affiliated corporation ***in excess of fair value***, and by including fair compensation to such foreign corporation for all commodities sold to or services performed for the parent corporation or affiliated corporations. (emphasis added).

The purpose of § 39A is to prevent a corporation from “artificially depress[ing]” its taxable net income by entering into “less than arm’s length transactions between affiliates.” ***Polaroid Corp. v Commissioner of Revenue***, 393 Mass. 490, 497 (1984). However, there is a limit to the powers of the Commissioner under this provision. Unlike Code § 482, the federal provision upon which it is based, § 39A authorizes the Commissioner only to eliminate payments if they are “in excess of fair market value.” *See* ***Chateau deVille, Inc. v. Commissioner of Revenue***, 11 Mass. App. Tax Bd. Rep. 102, 106-07. *Contrast* ***Syms***, 26 Mass. App. Tax Bd. Rep. at 188-89 (Board upholds the Commissioner’s elimination of royalty payments where payments were not at arm’s length and did not reflect fair market value).

The Board found that under the facts of this appeal, the royalty fees, set at 11% of the wholesale list price for the Cambridge Brand candies, were not shown to exceed fair market value. CBI sold its candies to TRI Sales at about 75% of the wholesale list price, and after accounting for the royalty fees, the audited financial statements for CBI reveal that CBI still earned about a 24 to 27 percent annual rate of return on its assets. According to Dr. Plotkin, this is a far higher rate of return on assets than would be expected of a contract manufacturer, especially one working out of an antiquated factory such as the Cambridge Factory. In fact, the Board found convincing Mr. Plotkin's testimony that CBI's profitability placed it above the 95th percentile for average rates of return on assets that is realized by American industries, equating CBI with a drug or high-tech company rather than a contract candy manufacturer. Dr. Plotkin thus concluded that the license fees paid by CBI were actually too low. Based on the data and Dr. Plotkin's testimony, the Board found and ruled that the royalty fees paid by CBI to Charms Marketing were not in excess of fair market value. Accordingly, the Board found and ruled that the Commissioner did not properly employ § 39A in eliminating the deduction for license fees paid by CBI to Charms Marketing.

The Board found the facts of this appeal to be distinguishable from those of ***Syms***, where the Board found that the Commissioner properly eliminated license fees paid by the parent-licensee to its subsidiary-licensor pursuant to § 39A, because those license fees could not be justified where the licensor did nothing to enhance the value of trademarks and thus justify the license fees: "[t]he fact that Syms as licensee had created its own obligation to pay for the use of these Marks, and yet retained responsibility for maintaining and enhancing the Marks, demonstrated further that the royalty rates were not the result of arm's length bargaining. An arm's length price would have considered the user's expenses of maintaining and enhancing the value of the Marks in establishing the royalty rate." ***Syms***, 26 Mass. App. Tax Bd. at 189.

In stark contrast to the situation in ***Syms***, CBI did not retain control or responsibilities over the trademarks at issue, and in fact, CBI never possessed control or responsibilities over those trademarks in the first place. In the absence of a "mismatch of income and expenses" as was present in ***Syms***, the Commissioner had no power to eliminate the license fees paid by CBI under the facts of this appeal. The Board further found and ruled that the market value of the license fees at issue was bolstered by the fact that TRI employees relied upon data which was relatively fresh from the business modeling that was performed in connection with the sale from Warner-Lambert, an unaffiliated third party. That CBI was so profitable even after taking into account the license fees served as further proof of the fairness of the license fee paid by CBI to Charms Marketing.

The Commissioner faulted the appellant for agreeing to adjust the license fee an additional percentage point after the Lloyd-Thomas appraisal report was issued but not demanding to adjust the fee when the Pom Poms candies were discontinued by TRI. The Board found no merit in this contention. The license agreement was based on the wholesale price of the candies that CBI actually sold to TRI Sales. Therefore, any deflation in sales resulting from the discontinuation of a particular product or other poor market conditions for a product would translate into comparably lower license fees. The Board thus found and ruled that the discontinuation of the Pom Poms brand had no bearing on the arm's-length nature of the license fee at issue.

The Commissioner also found many faults with the Lloyd-Thomas appraisal report, including, among other supposed defects, that the report was based on "unsubstantiated financial figures" which were often inflated, and that the entity relied upon as a comparable, Grist Mills, Inc., was not even a competitor of CBI. The

Board acknowledges that perhaps these assertions, if proven to be true, could produce serious flaws in the appraisal report. However, the Board found and ruled that, under the facts of this appeal, where the license fees were supported by valid business purposes and economic substance, and where the high profitability of CBI justified the amount of the royalty fees, the Lloyd-Thomas appraisal report was merely a subsidiary piece of evidence which could not detract from the finding that the license agreement was based on the fair market price of the Cambridge Brands. *Contrast* ***Syms***, 26 Mass. App. Tax Bd. Rep. at 190-91 (finding that appraisal reports submitted by appellant failed to prove the necessity of royalty fees where "the transferor/parent continued to expend substantial sums for the maintenance and enhancement of the Marks after the transfer").

Based on the evidence, the Board found and ruled that the Commissioner improperly denied the deduction to CBI for its payment of license fees to Charms Marketing for the use of the Cambridge Brands trademarks and formulas.

2. The Commissioner improperly applied the "throwback" rule to sales made by CBI to TRI Sales.

The second issue on appeal is whether the Commissioner properly treated the sales of candy by CBI to TRI Sales as "throwback" sales includible in the numerator of CBI's sales factor as calculated under G.L. c. 63, § 38(f).

The taxable net income of a corporation that has income from business activity that is taxable both within and without the commonwealth must be apportioned. G.L. c. 63, § 39(b). The specific allocation and apportionment of net income of a corporation to the commonwealth is achieved by means of "multiplying its taxable net income, determined under the provisions of subsection (a), by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four." G.L. c. 63, § 38(c).

The parties to this appeal disputed the Commissioner's calculation of CBI's sales factor. G.L. c. 63, § 38(f) provides that the sales factor "is a fraction, the numerator of which is the total sales of the corporation in this commonwealth, during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year." A sale of tangible personal property is considered to be made "in this commonwealth” if either of the following two conditions applies:

> 1. the property is delivered or shipped to a purchaser within this commonwealth regardless of the f. o. b. point or other conditions of the sale; or
> 2. the corporation is not taxable in the state of the purchaser and the property was not sold by an agent or agencies chiefly situated at, connected with or sent out from the premises for the transaction of business owned or rented by the corporation outside this commonwealth . . .

G.L. c. 63, § 38(f). The first condition is referred to as the “destination” rule, and the second is referred to as the “throwback” rule. *See* LR 00-4. The Commissioner applied the “throwback” rule to virtually all of the sales of products to TRI Sales that CBI shipped to Illinois and Tennessee. The Board found and ruled that the Commissioner improperly included these sales in the numerator of CBI’s factor, because CBI’s sales to TRI Sales were completed in Illinois or Tennessee and CBI was taxable in both of these disputed jurisdictions during the tax years at issue.

The Commissioner here argued that CBI had completed its deliveries in the Commonwealth and that, in any event, CBI was not taxable in the states of Illinois and Tennessee, because the warehouse arrangements were fictitious and that CBI had no selling agents outside of Massachusetts. The Commissioner thus concluded that the throwback rules were properly applied to the sales of candies destined for Illinois and Tennessee by CBI to TRI Sales.

Under the Commissioner's regulations, CBI's leasing of warehouse space and ownership of inventories in Illinois and Tennessee were sufficient to establish nexus for tax purposes. *See, e.g.*, 830 CMR 63.39.1(4)(d)(2) (use of property under a lease, license or similar arrangement is a taxable activity under G.L. c. 63, § 39); 830 CMR 63.39.1(5)(d)(19)(e) (leasing or use of warehouse is not solicitation so not protected under Public Law 86-272, 15 U.S.C. §381); 830 CMR 63.39.1(5)(d)(19)(f) (owning stock of goods is not solicitation so not protected under Public Law 86-272) Pursuant to these regulations, CBI was taxable in Illinois and Tennessee, if it did lease warehouse space and own inventories in those jurisdictions.

The Distribution Agreement between the parties provided that "[t]itle to all Cambridge Brands Products purchased by Distributor [TRI Sales] hereunder shall be transferred from CBI to Distributor upon delivery to Distributor at Distributor's distribution center . . . or at the destination of such shipments as determined by Distributor's special instructions, as applicable" and that risk of loss or damage passes to TRI Sales "after such products leave CBI’s warehouse facility(ies).” According to the Commissioner, “CBI’s warehouse facility(ies)” refers to the Cambridge Factory, because he found that CBI did not actually lease any space in Illinois or Tennessee. The Commissioner based this assertion on the testimony of CBI’s plant controller, who claimed that no one that he knew from CBI’s warehouse staff ever “cut a check” for warehouse space in Illinois or Tennessee, that he did not know who might have paid for the warehouse space, and on the fact that CBI did not have any employees working in Illinois or Tennessee.

Moreover, the Commissioner contended that even if the warehouses were in existence, they were “fictitious” arrangements in which CBI was simply shipping its product to a warehouse that it “supposedly signed a lease for,” but which was “probably in the same factory” as that used by TRI Sales. The Commissioner claimed that TRI was the one performing warehousing activities on behalf of CBI, and that the warehouse arrangement was merely a ploy by CBI to achieve nexus. He also claimed that the Tennessee tax return, which reflects the taxability of inventory at the Tennessee warehouse to CBI, should be ignored because the Commissioner could find no economic benefit or business purpose for CBI’s lease of warehouse space in Tennessee (or in Illinois, for that matter) from TRI Sales. Therefore, he reasoned, TRI Sales assumed responsibility for the candies as soon as they left the Cambridge Factory and, accordingly, the sales of candies were completed in Massachusetts and should be considered Massachusetts sales for the throwback rules.

However, the Board found that the Commissioner's assertions were not sufficient to disprove the existence of CBI's warehouses and its agreement on the passage of title with TRI Sales. "'Evidence of a party having the burden of proof may not be disbelieved without an explicit and objectively adequate reason. . . . If the proponent has presented the best available evidence, which is logically adequate, and is neither contradicted nor improbable, it must be credited . . . .'" ***New Boston Garden Corp. v. Assessors of Boston***, 383 Mass. 456, 470-71 (1981) (quoting L.L. Jaffe, *Judicial Control of Administrative Action* 607-08 (1965)). The Board found that the Commissioner was merely reaching for straws as he attempted to discredit the evidence at issue. For example, the fact that CBI's plant controller could not identify who might have "cut a check" for warehouse space in Illinois or Tennessee was not indicative of any misdealing on the part of CBI, especially where the Board could find no logic in the Commissioner's assumption that a plant controller would be duly charged with making such financial plans rather than CBI's officers and directors in Chicago.

The Board found that the leases between CBI and TRI Sales, together with tax returns reflecting CBI's treatment of inventory at those locations as taxable to CBI, were the "best available evidence" on CBI's leasing of warehouse space from TRI Sales. ***New Boston Garden***, 383 Mass. at 470-71. The Commissioner did not successfully discredit this evidence and, accordingly, the Board found and ruled that CBI met its burden of proving the existence and operation of the warehouse space in Illinois and Tennessee.

Moreover, the Commissioner's theory that the warehouse arrangements should be disregarded because TRI was handling the activities on behalf of CBI did not further its position. A finding that TRI was performing activities on behalf of CBI would actually further the taxpayer's position, because the Commissioner's regulations require that TRI's activities be imputed to CBI for nexus purposes. 830 CMR 63.39.1(7) provides that "[f]or the purposes of determining whether a foreign corporation is subject to the excise under M.G.L. c. 63, § 39, the activities of employees, agents, or representatives, however designated, of the foreign corporation will be imputed to the corporation." The regulation specifically provides that "[a]n agent or representative may be an individual, corporation, partnership, or other entity." ***Id***. The only exception to this rule is for activities of independent contractors. *See* ***Id***. According to the requirements for an independent contractor listed in that regulation, the Board found and ruled that TRI could not be considered an independent contractor of its subsidiary, CBI, most particularly because TRI did not "hold[] [it]self out to the public as an independent contractor in the regular course of its business." 830 CMR 63.39.1(7)(c). Accordingly, the Board found and ruled that the Commissioner's arguments regarding TRI's involvement in the Illinois and Tennessee warehouses did not successfully discredit CBI's evidence that the candies were sold by agents connected with those warehouses.

Based on the facts presented by the appellant, the Board found also that title and possession to the Cambridge Brands candies passed from CBI to TRI Sales at the warehouses leased by CBI in Illinois and Tennessee, as specified in the Distribution Agreement executed between the parties. A sale occurs where title to or possession of the property passes to the purchaser. See G.L. c. 64H, § 1 (definition of "sale"), 830 CMR 64H.6.7(2) (definition of “sale”). CBI and TRI Sales were free to dictate the terms of the passage of title in their Distribution Agreement. G.L. c. 106, § 2-401(2) (“[T]itle to goods passes from the seller to the buyer in any manner and on any conditions explicitly agreed on by the parties.”); *see also* 830 CMR 64H.6.7(3)(a)(5)(a) (“If a contract specifies where title will pass, title passes in accordance with the terms of the contract.”). The parties to the Distribution Agreement, CBI and TRI Sales, understood that the terms of the agreement provided for title to the candies to pass to TRI Sales at CBI’s warehouse when CBI loaded the goods onto a truck that was under the control and supervision of TRI Sales and operated by TRI Sales. Moreover, the agreement’s other provisions regarding the risk of loss were consistent with this passage of title.

Pursuant to the Commissioner’s regulations, title to the goods passes to TRI Sales at the site of the warehouses when “the purchaser or the purchaser’s agent takes possession of the property . . . whether or not for redelivery or use outside [the state].” 830 CMR 64H.6.7(3)(a)(1). Moreover, the Distribution Agreement was in accordance with the parties’ understanding that title would pass to TRI Sales at CBI’s warehouses, as the agreement specified that TRI Sales was entitled to receive the purchase price once it took delivery from CBI, and that TRI Sales would assume virtually all of the subsequent risks and responsibilities for the products. The facts of this appeal were thus similar to ***George S. Carrington Co. v. State Tax Commission***, 375 Mass. 549 (1978). In that case, the Supreme Judicial Court affirmed the Board's ruling that title to goods passed in Massachusetts, when buyers assumed the responsibility for delivery of the goods by specifically instructing the seller to use their mailing permits in order to effect their delivery. ***Id***. at 552 (finding that "Carrington's entire performance of the contract occurred within the State"). The Board thus found and ruled that the sale of the candies occurred in Illinois and Tennessee.

The Board found and ruled that CBI proved that it was taxable in the states where title to the candies passed to TRI Sales and that the candies were sold by agents connected with these premises located outside of the commonwealth and leased by CBI for the transaction of its business. The Board accordingly found and ruled that the "throwback" rule did not apply to the sales made from Illinois and Tennessee, which was virtually all of the sales made by CBI to TRI Sales during the tax years at issue.

3. Net operating losses

The final issue raised by the appellant at the hearing and in its post-hearing brief is whether the appellant should have been entitled to take a net operating loss (“NOL”) deduction on its 1996 return. The appellant argued that CBI was entitled to an NOL deduction in 1996 for loss generated in tax years 1993 through 1995. The prior years’ losses arose, at least in part, because CBI claimed royalty expense deductions for its use of the Cambridge Brands intangible property and treated sales to TRI Sales in Illinois and Tennessee as non-Massachusetts sales. The Commissioner had challenged these positions for tax years 1993 through 1995 but conceded the issue shortly before the hearing of the taxpayer’s appeals for those years.

The Board found that this NOL issue was not raised in the pleadings or on the appellant’s application for abatement. The appellant raised this issue for the first time during the hearing when it obliquely made reference to the issue before submitting into evidence a settlement agreement between the appellant and the Department for tax years 1993 through 1995 and in its brief, in a three-paragraph argument at the end of its 87-page submission.

For the reasons stated in ***Deveau v. Commissioner of Revenue***, 51 Mass. App. Ct. 420 (2001), the Board failed to reach the issue of whether the appellant was entitled to an NOL deduction for tax year 1996. The appellant failed to show why “equity and good conscience [would] require” the Board to make a finding on this issue, where the issue was not raised in the pleadings and there is no substantial evidence that an audit adjustment was made with respect to this issue.[9] *See* G.L. c. 58A, § 7.

4. Conclusion

The Board found and ruled that the royalties paid by CBI to Charms Marketing for the lease of the Cambridge Brands trademarks and accompanying formulas were properly deductible as an ordinary and necessary business expense. The Board also found that CBI’s sales of candies to TRI Sales from its warehouses in Illinois and Tennessee were completed in those jurisdictions and that CBI was taxable in those states. The Board thus found and ruled that the Commissioner improperly denied the deductions for the royalty payments and applied the “throwback” rules to the sales by CBI to TRI Sales.

[9] Audit workpapers concerning the audit for tax years 1996 through 1998, submitted into evidence in this appeal, do not reflect any adjustment for NOL carryforwards.

Accordingly, the Commissioner issued a decision granting abatement to the appellant in the amount of $2,453,675 plus statutory additions.

APPELLATE TAX BOARD

By:________________________________
Abigail A. Burns, Chairman

A true copy:

Attest: ________________________
Clerk of the Board