COMMONWEALTH OF MASSACHUSETTS

APPELLATE TAX BOARD

FLEET FUNDING, INC. & FLEET FUNDING II, INC. **v.** **COMMISSIONER OF REVENUE**

Docket Nos. C271862-63 Promulgated: February 21, 2008

These are appeals under the formal procedure pursuant to G.L. c. 58A, § 7 and G.L. c. 62C, § 39(c) from the refusal of the appellee Commissioner of Revenue ("appellee" or "Commissioner") to grant an abatement of financial institution excise, interest and penalties assessed against the appellants Fleet Funding, Inc. ("FFI") and Fleet Funding II, Inc. ("FFII")(collectively "appellants" or "REITs") pursuant to G.L. c. 62C, § 26(b) for the tax year 1999 ("tax year at issue").

Commissioner Scharaffa heard these appeals and was joined in the decisions for the appellee by Commissioners Egan, Rose, and Mulhern. Chairman Hammond took no part in the deliberations or decision of these appeals.

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

John S. Brown, Esq., Donald-Bruce Abrams, Esq., Joseph L. Kociubes, Esq., George P. Mair, Esq., Darcy A. Ryding, Esq., and Shu-Yi Oei, Esq. for the appellants.

Thomas W. Hammond, Esq., Patricia M. Good, Esq., Anne P. Hristov, Esq., Mireille T. Eastman, Esq., and Hal Scott, Esq. for the appellee.

FINDINGS OF FACT AND REPORT

I. INTRODUCTION

The principal issue raised in these appeals is whether certain inter-corporate transactions were a sham that lacked economic substance and business purpose and, therefore, must be disregarded for tax purposes.

The transactions at issue in the present appeals were part of a sophisticated tax-saving plan involving: the creation of two Massachusetts Real Estate Investment Trusts, the REITs, and two Rhode Island passive investment companies ("PICs"); the transfer of residential and commercial real estate loans from two related parent banking companies ("parent banks" or "Fleet")[1] to the two REITs; and intercompany transfers of stock in the REITs and of the interest income from the real estate loans.

[1] As detailed below, the two related parent banks were Fleet Bank, N.A. and Fleet National Bank. The parent banks, along with their parent bank holding company, Fleet Financial Group, will be collectively referred to as "Fleet" unless the context requires specific identification of a particular entity.

Appellants in the present appeals are the two Massachusetts REITs, which received interest income from the real estate loans transferred to them by the two parent banks and paid out the interest income in the form of dividends to the two Rhode Island PICs, which in turn paid dividends to the parent banks. Prior to the transactions at issue, the parent banks were taxable in Massachusetts on the interest income received from their real estate loans; after the transactions, the parent banks were taxable only on 5% of the interest income distributed to them by the PICs because of the ninety-five percent dividends-received deduction they claimed under Massachusetts law. The REITs were not taxed on the income because they distributed substantially all of their income to the PICs in the form of dividends for which they claimed a dividends-paid deduction, and the PICs were exempt from state taxation on the dividends they received from the REITs by operation of Rhode Island law.

For the reasons detailed below, the Board ruled that the contested transactions were instituted for the sole purpose of avoiding Massachusetts tax. Because the transactions lacked business purpose and economic substance, the Board ruled that the transactions were a sham and upheld the Commissioner’s disallowance of appellants’ dividends-paid deductions.

In addition, the Board heard and decided a preliminary issue concerning the procedural validity of the subject assessments. After an evidentiary hearing on this issue, the Board determined that the assessments were procedurally valid and a hearing on the substantive tax issue followed. The Board’s findings of fact concerning both the procedural and substantive issues follow.

II. FINDINGS OF FACT

On the basis of a Statement of Agreed Facts with accompanying exhibits, and the testimony and exhibits offered at the hearings of both the procedural and substantive issues raised in these appeals, the Board made the following findings of fact.

A. JURISDICTION AND PROCEDURAL VALIDITY OF ASSESSMENTS

1. PROCEDURAL VALIDITY OF ASSESSMENTS

On July 19, 2004, appellants filed a Motion for Separate Hearing of a Dispositive Issue with the Board. The dispositive issue raised by appellants in their motion was whether the assessments at issue were procedurally invalid because the Commissioner failed to send notice of the assessments to appellants “as soon as may be” as required by G.L. c. 62C, § 31. Because a ruling in favor of appellants on this issue would result in an abatement in the full amount of the subject assessments, the Board bifurcated the hearing of these appeals and conducted an evidentiary hearing on the procedural issue prior to the hearing on the substantive tax issue.

On August 4, 2000, appellants each timely filed a Massachusetts Financial Institution Excise Return for the tax year at issue reporting the minimum excise due of $456. Each appellant claimed a dividends-paid deduction for the dividends it paid to its shareholders, 133 Fleet employee shareholders and the two Rhode Island PICs.

Subsequent to completion of a “desk audit” for which Department of Revenue (“DOR”) auditor Mark Lettich was primarily responsible, the Commissioner prepared Notices of Intention to Assess (”NIAs”) dated June 18, 2003. The Commissioner sent the NIAs to appellants at 100 Federal Street, Boston, MA, the address on appellants’ Financial Institution Excise Returns. Appellants do not contest that they received the NIAs, which reflected proposed additional assessments of Financial Institution Excise for the tax year at issue in the amount of $16,018,540 for FFI and $12,837,883 for FFII.

Mr. Lettich testified that approximately thirty days after issuance of the NIAs, he notified his supervisor that

DOR had received no response from appellants, and requested that the cases be placed in “040 status,” a code on DOR’s MASSTAX computer system entered prior to and in anticipation of making an assessment and issuing a Notice of Assessment (“NOA”).[2] Patrick Hagar, Supervisor of the Banking and Insurance Unit within DOR’s Audit Division, testified that on July 23, 2003, he signed a “Warrant,” also known as an “Instruction to Bill,” relating to appellants for the tax year at issue. This act caused the cases to go to “100 status” within the MASSTAX system, which in turn resulted in generation of the NOAs at issue (“the NOAs”) on July 29, 2003.[3]

Mr. Robert Fiore, a Senior Systems Analyst in DOR’s Information Service Organization (“ISO”), was responsible for overseeing programming of the MASSTAX computer system as it related to the generation of notices. Mr. Fiore testified that he reviewed DOR’s computer records, which indicated that on July 29, 2003, the Commissioner issued fifty-one groups of notices. One of these groups contained the NOAs, which were addressed to appellants at 100 Federal

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[2] The assessment and issuance of a Notice of Assessment are distinct, the former occurring when “the Commissioner determines or verifies and records the amount of the tax due.” ***Charles R. and Joan M. Menard v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Reports 1990-222, 232. *See also* 830 CMR 62C.26.1(2).

[3] The NOAs, which bore an assessment date of July 27, 2003, included additional assessments of excise, interest and penalties totaling $21,108,235 for FFI and $16,916,963 for FFII.

Street, Boston, MA, the same address appellants used on its returns and the Commissioner used on the NIAs received by appellants.

The Supervisor of Distribution in the ISO Data Center, Mr. Gary Palmieri, testified that the fifty-one groups of notices generated on July 29, 2003 were grouped together in ISO's Distribution Center after they were printed and were designated "Batch #814." Batch #814 was sent to the mailroom in DOR's Information Technology Division ("ITD").

Mr. Jack Shea, ITD's Director of Printing and Mailing Services, was responsible for supervising the automated mailing of notices generated by DOR. Mr. Shea testified that on July 29, 2003, ITD received fifty-one groups of notices labeled Batch #814 from ISO's Data Center. The notices were mechanically folded, placed in envelopes, and given a postmark with applicable postage. Mr. Shea further testified that each notice in Batch #814 was postmarked July 30, 2003, and delivered to the U.S. Post Office on that day.

Subsequent to mailing, no further action was taken by a DOR employee with regard to the NOAs until appellants' counsel inquired about the status of the cases in late September, 2003. In response to this inquiry, Mr. Lettich reviewed the cases' status within the MASSTAX system and found the entry “RPO” for each of the NOAs, indicating that they had been returned to DOR by the post office.[4] Mr. Lettich attempted to locate the returned NOAs, but was unable to do so. He printed copies of the NOAs which he sent, via facsimile, to appellants’ counsel on September 29, 2003.[5] In their Petitions to the Board, appellants acknowledged receipt of the Notices on September 29, 2003.

Based on the credible, detailed, and internally consistent testimony of DOR’s witnesses, the Board found that the Commissioner generated and mailed the NOAs to appellants at 100 Federal Street, Boston, MA, on July 30, 2003. The Board also found that appellants received copies of the NOAs on September 29, 2003 and that appellants were not prejudiced by any delay between the date of assessment and their receipt of actual notice of the assessments. Finally, the Board found that the assessment was timely made within the three-year period provided by G.L. c. 62C, § 26(b). Accordingly, for the reasons detailed in the

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[4] The entries reflect that the NOAs had been returned to DOR on August 12, 2003 and August 20, 2003, respectively. There was no mechanism by which MASSTAX entries of this type were routinely monitored.

[5] On April 21, 2003, appellants executed powers of attorney granting counsel the right to act on appellants’ behalf and receive copies of notices with regard to the matters at issue in these appeals.

Opinion section below, the Board issued an Order affirming the procedural validity of the assessments.

2. JURISDICTION

Appellants each timely filed an Application for Abatement on October 22, 2003, seeking abatement of the additional excise, interest and penalties. On December 26, 2003, the Commissioner issued Notices of Abatement Determination to appellants notifying them that their abatement applications had been denied. On January 6, 2004, appellants timely filed Petitions with the Board for the tax year at issue.

On the basis of these facts, the Board found that it had jurisdiction to hear and decide these appeals.

B. SUBSTANTIVE ISSUE

1. FORMULATION OF THE REIT STRATEGY

(a) STATE TAX AVOIDANCE

The idea of avoiding Massachusetts taxation on interest earned from real estate loans by transferring the loans to REITs and receiving the income from the loans back largely tax-free in the form of dividends from the Rhode Island PICs ("REIT strategy") was devised and marketed by the accounting firm of KPMG Peat Marwick, LLP ("KPMG"). KPMG first approached Fleet with the basic concept of the REIT strategy as early as 1993; it also marketed similar strategies to several bank holding companies in addition to Fleet.

KPMG’s marketing materials indicated that the primary purpose of its REIT strategy was a reduction in Fleet’s state-tax liability, which KPMG quantified to be approximately $9,000,000 in annual state-tax savings to Fleet. In promoting the concept to Fleet, KPMG lauded the REIT strategy’s capacity to “isolate . . . gains . . . in tax favored jurisdiction[s][,] shelter commercial real estate loan income in a REIT [and] generate deductions through intercompany financing.” In an April 25, 1994 letter to Fleet, KPMG stated that it was “excited about proceeding with the state tax minimization project for Fleet . . . with a focus on results.” In marketing another tax-savings strategy to Fleet in 2001, KPMG stated that Fleet’s creation of the REIT in furtherance of the REIT strategy had been “for the principal purpose of reducing [Fleet’s] state income tax liability.”

During the six years prior to the tax year at issue, Fleet’s corporate tax department was aware of, and contemplated implementing, KPMG’s REIT strategy. Fleet’s tax department exchanged numerous interoffice memoranda regarding how, when, and where to establish the necessary entities and Fleet and KPMG exchanged numerous communications and held several meetings to discuss KPMG's REIT strategy.

For example, in one exchange between Fleet and KPMG during late 1994 and early 1995, Fleet expressed concern about the reliability of utilizing favorable Rhode Island tax laws in implementing what Glenn Eichen, Fleet's Manager of Corporate Tax Research and Planning and its REIT strategy director ("REIT director"), referred to as "the tax reduction strategy." Regarding this point, Fleet sought KPMG's long-term view of "whether the legislature will close this loophole" just a "year or two" after Fleet adopted the REIT strategy. KPMG responded that it knew "of no pending or suggested legislation that would eliminate the viability of the REIT strategy."

KPMG conceded that if Rhode Island were "to determine that [the REIT strategy] should be subject to tax . . . . then Fleet would need to assess its REIT structure and determine an appropriate course of action." KPMG assured Fleet, however, that even if the Rhode Island Legislature were to take steps toward impeding the "law that makes this strategy so attractive," Fleet would still benefit by saving millions of tax dollars in the interim. In the end, KPMG was "comfortable that the REIT strategy provid[ed] an excellent opportunity for Fleet to reduce its annual tax cost."

A discussion point outline for a May 31, 1995 meeting between Fleet and KPMG underscores the fact that tax-savings motivated Fleet's adoption of the REIT strategy. The first point expressed that the "basic idea" behind the REIT strategy was that income on real estate loans would continue to be taxed once for federal tax purposes, but would be "sheltered from state income tax." The outline also stated that KPMG's REIT strategy would result in "the gross interest on [the] real estate loans . . . escap[ing] state income tax."

In a May 26, 1995 memorandum, Fleet's REIT director advised Eugene McQuade, Fleet's Executive Vice-President and Chief Financial Officer ("CFO"), of a concern raised by a member of Fleet's commercial lending department, Ken Witkin,:

> Ken cautions that if we put the equity in the hands of 100 individuals, word will certainly get out over time. Consequently, Ken cautions that it will be impossible to assure that the transaction does not come to the attention of a particular state, possibly in a manner over which we have no control. Thus, we should only do this where we are willing to accept the consequences of having a state find out we have detected and exploited a loophole in their taxing scheme . . .

The same memorandum revealed the concerns of Fleet's REIT director that "[even] if we set [the REIT strategy] up in the soundest possible way, we may still be challenged by the state."

The memorandum makes it clear that there was considerable discussion within Fleet and between Fleet and KPMG concerning where the REIT should be incorporated in order to maximize tax savings while at the same time portraying a plausible non-tax purpose. With respect to establishing a REIT in Rhode Island, Fleet's REIT director lamented that despite greater tax savings compared to what New York had to offer "[t]here don't seem to be [any] compelling non-tax reasons" to create the REITs in Rhode Island.

In comparing the New York and Rhode Island options, one of the meeting discussion points summed up the issue by stating that "[Fleet] may be more willing to make aggressive use of [a] loophole in the tax law in New York, where [Fleet is] not expecting legislative favors and where [Fleet has] consequently less to lose, than in Rhode Island." According to Fleet's REIT director, "the value of the legislative relief [Fleet] expect[ed] [in Rhode Island was] greater than the value of the tax savings [Fleet] would accomplish" through implementation of the REIT strategy. Thus, Fleet’s REIT director suggested that “[Fleet] settle for less bang for [its] buck” by steering clear of establishing a REIT in Rhode Island. This cost-benefit analysis revealed that Fleet strove to accomplish the greatest tax savings, but not at the risk of jeopardizing Rhode Island legislative tax relief.

Further, Fleet’s REIT director agreed with Fleet’s Director of Taxes, Richard Angelone, that Fleet should “only . . . [move] forward with the transaction in any state if the REIT is established to accomplish substantive non-tax business purposes of the corporation, in addition to the tax savings.” However, with regard to purported non-tax business purposes, such as taking a mortgage REIT “public in a couple of years” or using stock in a REIT as “an additional form of compensation to senior management and real estate employees,” Fleet’s REIT director conceded that “no one [had] found them overwhelming.”

On March 12, 1997, KPMG presented Fleet with its “Final REIT Manual,” which provided an in-depth analysis of the benefits associated with the REIT strategy. The matter of tax savings was covered in a section entitled “State Tax Considerations.” In an attempt to disclaim any possible legal impediments facing its strategy, KPMG led off this section by pointing out that the strategy’s ability to generate tax savings was "based [solely] on existing federal and state tax law and [was] not dependent on [judicial] interpretation of existing law." According to KPMG, "a legislative change to the tax laws regarding REITs would be required at the federal or state level in order to eliminate the state tax benefits associated with the REIT strategy."

The state tax section goes on to give an in-depth breakdown of the tax advantages and disadvantages associated with creation of entities in various states. A sub-section on how the strategy would best produce tax savings if Massachusetts entities were used stressed the need for an additional corporate layer to realize Massachusetts tax benefits. KPMG noted that Massachusetts law did not permit financial institutions to deduct dividends received from subsidiaries in which they owned more than 15 percent of the outstanding stock. Accordingly, in order to take advantage of the dividends-received deduction and maximize Massachusetts tax savings, KPMG opined that it was

> necessary to interpose [a Rhode Island PIC] between Fleet Bank and FFI. A [Rhode Island PIC would] be entitled to deduct 95 percent of the dividends received from FFI. Consequently, 95 percent of the income generated by the FFI's assets [would] not be subject to Massachusetts income tax.

KPMG’s Final REIT Manual completes the picture of the circular flow of funds back to Fleet itself by stating that, after the income is returned to Fleet in the form of dividends, “virtually all of the income generated by the REIT and subsequently distributed to Fleet Bank will not be subject to state income taxation” resulting in “significant savings opportunities in Massachusetts.”

Notwithstanding the detailed tax analysis requiring the use of Rhode Island PICs to make Massachusetts REITs a realistic tax-savings alternative, Fleet’s REIT director professed to be unaware of this requirement, testifying that “I don’t know that it was necessary [to use the Rhode Island PICs] . . . it’s the way we chose to do it.”

(b) PURPORTED BUSINESS PURPOSES

The appellants do not dispute the Commissioner’s assertion that Fleet intended to use the REIT strategy to reduce its state tax liability. The two sides differ, however, as to whether there existed any other motivations behind the strategy. The appellants assert that the REIT strategy was attractive not only for its tax savings, but also as a vehicle to raise capital. The Commissioner counters by arguing that Fleet did not intend to establish the REITs to raise capital because the REITs were established without a federally mandated “exchange provision” in the REITs’ Articles of Organization.

Federal regulations applicable at the time the REITs were formed required banks seeking to raise capital by selling preferred stock in a REIT to include an exchange feature in the stock, which provided that the preferred shares in the REIT would be automatically exchangeable for comparable shares in the bank in the event that the bank’s financial condition were to decline. The appellants conceded that an

> [exchange] provision for the 9% Preferred Stock [did not exist] in any version of the Articles of Organization for either FFI or FFII, nor is there any reference to such a feature in the Stock Restriction and Repurchase Agreement that FFI and FFII entered into with the holders of the 9% Preferred Stock.

Appellants’ Brief at 49. Because Fleet chose to organize the REITs without including an exchange provision in the REIT’s Articles of Organization or in the documentation concerning the issuance of preferred stock at the creation of the REITs, it is reasonable to infer that Fleet did not intend to raise capital by selling shares in the REITs when it organized the REITs. In fact, Fleet did not raise capital through sales of stock in the REIT at any time between the organization of the REITs and the tax year at issue; it was not until two years after the tax year at issue that Fleet sold shares in the REIT for reasons, as will be discussed below, having more to do with another tax-savings strategy than raising capital.

This inference is further supported by uncontroverted testimony from Douglas Jacobs, Fleet's Treasurer and a member of the REITs' Boards of Directors at all material times ("Treasurer"), that Fleet did not intend to raise capital using the REITs at the time Fleet organized the REITs. The Treasurer further testified that Fleet would have had to seek permission of the federal Office of the Comptroller of Currency in order to use the REITs to raise capital.

Further, Fleet's Treasurer testified that it is the treasury department's "job to raise capital." However, Fleet's REIT director, who was the individual responsible for implementing and coordinating the REIT tax strategy, was a member of Fleet's Tax Department, not its Treasury Department. In addition, the memoranda and correspondence introduced into the record concerning the REIT strategy focus on state tax savings. In contrast, there is relatively little reference in the documentary evidence concerning Fleet's ability to raise capital by selling shares in the REITs or a cost-benefit analysis concerning the amount of assets needed to collateralize the issuance of shares; rather, discussions concerning capital raising, which for the most part occurred well after the tax year at issue, focused on the ability to achieve still more tax benefits for Fleet.

Moreover, as testified to by the Commissioner's witness, Dr. Alan Shapiro, whom the Board qualified as an expert witness in the fields of banking, corporate finance and financial transactions, appellants' argument that they had to establish a "track record" for the REITs prior to raising capital by selling shares in the REITs is without merit. First, a REIT cannot create a track record of compliance with REIT requirements because there are monthly compliance tests that have to be met in order for the REIT to maintain its tax-favored status. Dr. Shapiro referred to monthly-compliance requirement as a "memory-less process," meaning that "[t]he fact that you qualified in 1997 doesn't really do anything for you in 1998 or 1999 and so on." In that regard, REITs could not generate a truly meaningful track record from an investor's point of view.

Appellants' claim that they could create a track record for the performance of their assets is also baseless because, as Dr. Shapiro testified, the REITs had no impact on the performance of the assets. The REITs were passive entities collecting income, and the change in ownership of the loans from Fleet to appellants was a mere change in title; the same Fleet subsidiary continued to service the loans and the same Fleet employees tracked loan performance, including interest and principal payments, both before and after the transfer of the loans to the REITs. Any potential performance track record related to the assets themselves and was already in place when the loans were transferred to the REITs.

Moreover, the loans were not static; they were constantly being repaid and new loans were also transferred to the REITs by Fleet. As Dr. Shapiro testified, this made it impossible to form a true performance track record over time, as the assets were constantly in flux. A prospective investor would have to look at the track record of the specific assets held by the REITs at the time of the investor's proposed purchase of shares in the REIT and not at the historical analysis of the performance of the REIT itself.

Further, as Dr. Shapiro observed, if capital-raising were truly the purpose of transferring the loans to the REITs, the fewer assets transferred the better. There is a cost to the bank for transferring assets to the REIT: once an asset is put into the REIT, the asset's flexibility for other uses by the bank is sacrificed, time and resources are expended to identify and transfer suitable assets, and compliance with REIT requirements have to be monitored. Accordingly, from a pure cost-benefit analysis, the bank would want to put into the REIT only enough assets to justify a given amount of stock to be sold.

However, if the motivation was to maximize state tax savings, the more assets transferred to the REIT, the greater potential tax savings. In the present appeal, Fleet transferred approximately $2 billion in real estate loans to one of the REITs, FFI, which sat in the REIT for four years before there was any sale of FFI stock. Moreover, the amount raised in the 2001 public offering of FFI stock and the transfer of additional assets by Fleet immediately before the stock offering reveal that this sale was not the culmination of a planned capital-raising initiative contemplated when the REITs were formed; rather, it was motivated by still another tax-saving strategy.

In 2001, two years after the tax year at issue and one year after the liquidation of one of the appellants and its corresponding PIC,[6] Fleet entered into a so-called "Tax

[6] In connection with BankBoston's acquisition of Fleet, Fleet was required to divest some of its assets, including substantially all ($844 million) of the residential mortgage loans held by FFII. After the divestiture of those assets, FFII was liquidated and dissolved on May 31, 2000. Similarly, FFII's corresponding PIC, FFGB, filed an Intent to Dissolve with the State of Rhode Island on May 10, 2000, and was dissolved on December 11, 2000.

Efficient Minority Preferred Equity Sale Transaction ("2001 TEMPEST Transaction"). A form of TEMPEST transaction previously had been marketed to Fleet by KPMG; although the 2001 TEMPEST transaction differed in some respects from the transaction marketed by KPMG, the basic structure and purpose of the transactions were the same.

The 2001 TEMPEST Transaction involved a $100 million offering of REIT stock made within 30 days of Fleet's contribution of certain leasehold assets to the REIT's corresponding PIC. The leasehold assets had imbedded net losses for federal tax purposes, which Fleet planned to realize by following a series of transactions: the leasehold assets were transferred by Fleet to the PIC; the PIC transferred the same leasehold assets to the REIT in return for series B and series C preferred stock in the REIT; the series B and series C preferred stock were then offered for sale using Lehman Brothers as the underwriter.

Appellants argued that the 2001 TEMPEST Transaction was in furtherance of their stated business purpose of raising capital. However, the facts surrounding the 2001 TEMPEST Transaction do not support appellants' position. First, one of the appellants, FFII, was dissolved one year before the transaction. FFII was not and could not have been part of this transaction. There is no evidence that

Fleet ever intended FFII to be part of this transaction. In fact, there is no evidence that FFII ever held leasehold assets, the center point of the TEMPEST Transaction.

Second, there is no evidence in the record to suggest that the 2001 TEMPEST Transaction, or anything like it, was contemplated by Fleet when it set up the REITs and PICs in 1997. The 2001 TEMPEST Transaction was designed to save federal tax and occurred just 30 days after the contribution of Fleet’s leasehold assets. In contrast, the real estate loan portfolio had been held by the REIT with no sales of REIT stock for 4 years at the time of the 2001 TEMPEST Transaction.

Further, there were ample assets already held by the REIT prior to the transfer of the leasehold assets to justify a $100 million stock offering. Dr. Shapiro testified that, with nearly $2 billion in real estate loans held by the REIT, a $100 million offering represented a “20 to one over-collateralization of the issue.” With sufficient assets already held by the REIT to collateralize the offering, the contribution of leasehold assets 30 days before the stock sale underscored that the 2001 TEMPEST Transaction was not intended to effect the capital-raising purpose claimed to have been contemplated when the REITs and PICs were initially set up but was principally a federal tax-savings device to realize losses embedded in the leasehold assets contributed by Fleet.

Finally, the sale of REIT stock in 2001 necessitated the amendment of the REIT's Articles of Organization to provide for an exchange provision. Had such a sale been contemplated in 1997 when the REITs were organized, it is doubtful that Fleet would have created the REITs without this necessary provision. The fact that the Articles were amended in 2001 to effectuate the 2001 TEMPEST Transaction indicates that a sale of REIT stock was not contemplated when the REITs were organized or, indeed, until the federal tax advantages flowing from a TEMPEST Transaction were brought to Fleet's attention.

Accordingly, the Board agreed with the opinion of Dr. Shapiro that the primary motivation of the 2001 TEMPEST Transaction was to reduce Fleet's taxes:

> Had the primary purpose been to raise capital, I would have seen other indicia of that, such as laying out capital raising alternatives as well as the costs and benefits of the different capital raising mechanisms. And I see none of that here.

Dr. Shapiro also saw no reason, from a capital-raising standpoint, for the leasehold interests to be transferred to the REIT or for the PIC to be involved in the stock offering. Rather, the transfer of the leasehold interests and the use of the PIC in the transactions had only one purpose: to effectuate federal tax savings.

On the basis of the above facts, the Board found that the appellants' purported business purpose for entering into the transactions involved in the REIT strategy –- to create an alternative capital-raising mechanism -– was a pretext, developed in an effort to legitimize transactions that had no economic substance or business purpose other than tax avoidance.

(c) BUSINESS PURPOSE FOR TRANSFERS TO AND FROM PICs

Although appellants focused on the purported business purposes of establishing the REITs and transferring Fleet's loan portfolios to the REITs, they offered essentially no evidence regarding any purported business purpose for establishing the PICs or transferring interest income from the loan portfolios in the form of dividends from the REITs to the PICs for largely tax-free distribution to Fleet. As will be discussed in detail below, appellants failed to show that the PICs were viable business entities engaging in substantive business activity; rather, the evidence of record showed that the PICs did nothing beyond acting as a conduit between the REITs and Fleet in order to convert taxable dividend income into largely tax-free dividend income.

2. IMPLEMENTATION OF THE REIT TAX STRATEGY

(a) ENTITIES

(i) PARENT COMPANIES

At all material times, Fleet Financial Group ("FFG") was a bank holding company, with its headquarters in Rhode Island.[7] Two of the banks held by FFG were Fleet Bank, N.A. ("FBNA") and Fleet National Bank ("FNB"). Both FBNA and FNB were subject to Massachusetts taxation at all material times.

(ii) FFI AND RELATED PIC

On February 28, 1997, FFI was organized under the laws of Massachusetts as a subsidiary of FNB. FFI was set up by Fleet to qualify as a REIT under Internal Revenue Code ("IRC") § 856(a). On its Applications for Employer Identification Number, Form SS-4, filed with the IRS, FFI indicated that the principal activity of the new corporation was to "hold loans" and "receive income."

On February 27, 1997, one day prior to FFI's organization, FFG Asset Holding Company A, Inc. ("FFGA") was organized as a wholly owned subsidiary of FNB under the laws of Rhode Island as a PIC.

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[7] In October, 1999, FFG merged with another bank holding company, BankBoston Corporation, and subsequently became known as Fleet Boston Corporation. Fleet Boston Corporation was later renamed FleetBoston Financial Corporation in April of 2000. These entities will be collectively referred to as FFG or Fleet in these findings of fact.

(iii) FFII AND RELATED PIC

On April 17, 1997, FFII was organized under the laws of Massachusetts as a wholly owned subsidiary of FBNA. FFII was also set up by Fleet to qualify as a REIT under IRC § 856(a). Like FFI, FFII filed an Applications for Employer Identification Number, Form SS-4, with the IRS indicating that the principal activity of the new corporation was to "hold loans" and "receive income."

On April 18, 1997, one day after FFII's organization, FFG Asset Holding Company B, Inc. ("FFGB") was organized as a wholly owned subsidiary of FBNA under the laws of Rhode Island as a PIC. Approximately four years later, FFII and FFGB were also dissolved at approximately the same time: FFII filed Articles of Dissolution with the Massachusetts Secretary of the Commonwealth on May 31, 2001 and FFGB filed an Intent to Dissolve with the State of Rhode Island on May 10, 2001, and was dissolved shortly thereafter.

(b) INTERCOMPANY TRANSFERS OF STOCK AND LOANS

On formation, FFI and FFII issued all of their authorized common and preferred stock to FNB and FBNA, respectively. On the day of its creation, February 28, 1997, FFI received from FNB residential real estate loans[8]

[8] The loans were secured by mortgages on real estate located in 11 states: California; Connecticut; Florida; Maine; Massachusetts; New Hampshire; New Jersey; New York; Rhode Island; Texas; and Vermont.

valued at approximately $1.5 billion in exchange for 100 shares of FFI common stock and 1,000 shares of FFI 9% preferred stock ("preferred stock").[9] On the same day that it received these shares, FNB contributed all of the FFI common stock and 880 shares of the preferred stock to FFGA, one of the Rhode Island PICs. FFGA later transferred 13 shares of FFI preferred stock back to FNB, leaving FNB with a total of 133 shares of FFI preferred stock. These 133 shares of FFI preferred stock were distributed to individuals employed by Fleet or its subsidiaries for no consideration.

Similarly, FFII received from FBNA residential real estate loans[10] valued at approximately $880 million in exchange for 100 shares of FFII common stock and 1000 shares of FFII 9% preferred stock. FBNA contributed all of the FFII common stock and 800 shares of the FFII preferred stock to FFGB, the other Rhode Island PIC. FBNA later contributed an additional 67 shares of FFII preferred stock to FFGB, leaving FBNA with a total of 133 shares of FFII preferred stock. These 133 shares of FFII preferred stock were distributed to the same individuals employed by

[9] Later that year, FNB made a further transfer of approximately $230 million of commercial real estate loans to FFI.

[10] The loans were secured by mortgages on real estate located in 10 states: Connecticut; Florida; Maine; Massachusetts; Missouri; New Hampshire; New Jersey; New York; Pennsylvania; and Rhode Island.

Fleet or its subsidiaries that received the shares in FFI, again for no consideration.

The employee-shareholders of both FFI and FFII received their shares along with a "gross-up," consisting of a sufficient amount of cash to effectively offset the income taxes resulting from the employees' receipt of the shares. The employee-shareholders also paid tax on the annually distributed dividends. The REIT shares were transferable, subject to Fleet's right of first refusal. Termination of employment ties with Fleet did not result in the shareholder being forced to sell back his or her shares.

(c) FLOW OF INCOME AMONG ENTITIES

The REITs received interest income from the real estate loan portfolios transferred to them by Fleet. Prior to the transfer, Fleet was subject to Massachusetts tax on the interest income. The REITs did not participate in the origination or servicing of the loans; rather, the loans were originated by another member of the Fleet corporate family, Fleet Mortgage Group, Inc. ("FMG"). Further, FMG serviced the loans both before and after the transfer of the loan portfolios to the REITs. In fact, Fleet borrowers did not receive notice that their loans had been transferred to the REITs, since the same entity continued to service their loans.

Taking advantage of a dividends-paid deduction available to REITs under IRC § 857(b)(2)(B),[11] the REITs transferred the interest income they received to their shareholders in the form of dividends. The appellants each took a dividends-paid deduction for the full amount of the dividends they paid to their shareholders, the 133 employee-shareholders and the PICs. The employee-shareholders received a fixed dividend of 9% of the $2,500 face value of the preferred shares per year; for the tax year at issue, the two appellants paid out a total of $59,850 to the 133 employee-shareholders of each appellant. In contrast, appellants paid dividends to the two PIC shareholders in the amount of $274,830,845 for the tax year at issue.

Pursuant to a Rhode Island statutory exemption, the Rhode Island PICs paid no state tax on the dividends they received from the REITs. Further, when the PICs distributed the income they received from the REITs to FNB

[11] For a full discussion of the Massachusetts taxation of REITs and their shareholders, *see* ***BankBoston Corporation v. Commissioner of Revenue,*** Mass ATB Findings of Fact and Reports 2005-450, 477-78, *aff'd* 68 Mass.App.Ct. 156 (2007) (ruling that dividends received from a REIT by a corporate shareholder are not deductible for purposes of calculating the shareholder's net income under G.L. c. 63, § 30(4) and they are not deductible "dividends" for purposes of the dividends-received deduction under G.L. c. 63, § 38(a)(1).

and FBNA, the banks claimed a dividends-received deduction of ninety-five percent for Massachusetts tax purposes, because they owned in excess of fifteen percent of the outstanding stock in the PICs. Accordingly, interest income from loan portfolios that started out as fully taxable to Fleet in Massachusetts became, as a result of the REIT strategy, ninety-five percent tax-free.

The key to the REIT strategy was the transfer of the loan portfolio proceeds in the form of dividends to the Rhode Island PICs. Absent the transfer to and from the PICs, KPMG and Fleet recognized that the transfer of the proceeds in the form of dividends from the REITs directly to Fleet would not have achieved the same state-tax savings. As further recognized by KPMG and Fleet, by interposing the Rhode Island PICs in the transactions, the PICs received dividends from the REITs free of state tax because of the Rhode Island exemption for passive investment companies, and FNB and FBNA could claim a dividends-received deduction of ninety-five percent when the PICs paid them the dividends.

3. ECONOMIC SUBSTANCE AND BUSINESS PURPOSE OF TRANSACTIONS

The Board found that the subject transactions had neither economic substance nor any business purpose. The transactions at issue –- the transfer of loan portfolios to the REITs and the payment of loan proceeds in the form of dividends from the REITs to the PICs and from the PICs to Fleet -– were part of a tax-savings scheme that had no practical economic effect other than the creation of tax benefits. In particular, the interposing of the PICs to act as an intermediary for the transfer of income from the REITs to Fleet had no purpose other than to insulate the income from state taxation; the REITs and PICs acted merely as conduits for a circular flow of interest income from the loan proceeds which, both before and after the subject transactions, were ultimately paid to Fleet. Prior to the transactions, Fleet was taxable in Massachusetts on the interest income; after the transactions, the same income was transformed into ninety-five percent tax-exempt dividend income.

There is no indication that either the REITs or the PICs were engaged in substantive business activity for their own account. The REITs had no employees; both REITs reported zero salaries paid on their tax returns for the tax year at issue. Every officer or other person affiliated with the REITs was an employee of Fleet. The various Fleet employees who were officers and directors of the REITs met to discuss compliance with the REIT statute and aspects of the loan portfolios in order to maximize the income payable to Fleet and not for the REITs' own business enterprises. None of these individuals billed the REITs separately for their time or were compensated separately for their duties with respect to the REITs; rather, the REIT's paid Fleet or a Fleet-related entity an "intercompany allocation charge" set by Fleet.

Further, there was no testimony or documentary evidence showing that the REITs owned, leased or otherwise occupied office space. Both REITs reported zero rents paid on their tax returns for the tax year at issue. Moreover, in its application to the Office of the Comptroller of the Currency to form the REITs and the PICs, Fleet stated that

> [Fleet] intends to conduct all of the activities of [the REITs and PICs] at the main office of [Fleet] (or a nearby authorized location) or a previously approved branch of [Fleet] . . . The management of [the REITs and PICs] is anticipated to consist exclusively of officers and employees of [Fleet].

The REITs did not engage in business with any unrelated third parties. They did not service the loans they held, nor did they originate any of their own loans. Rather, the loans were serviced by the same related Fleet entity –- Fleet Mortgage Group, Inc. –- exactly as they had been prior to their transfers to the REITs. In fact, as described in a February 24, 1997 memorandum from Fleet's REIT Director to Fleet's Director of Tax:

> Rather than interfere with existing intercompany financial arrangements, we have chosen to leave the amounts being paid for servicing intact, and merely to rewrite the contracts themselves so that the terms are all standard third party terms. This leaves us no exposure to state challenge of the intercompany servicing amounts or arrangements, since a state has no incentive to argue that the mortgage company's charges to the REIT are overstated.

The REITs not only did not engage in business with the unrelated third parties in these transactions -– the mortgagors –- but the mortgagors were not even informed that the REITs held their mortgages. Further, every loan that the REITs ever held came to the REITs through Fleet, not through any unrelated third party.

Moreover, there is no showing on this record that the REITs earned additional income from any business activities other than receiving interest from the loans transferred to them by Fleet. As appellants conceded, "substantially all of the receipts that [the REITs] reported on their tax returns for the year at issue consisted of interest on mortgage loans." Appellants' Brief at 17. Although some of the REITs' receipts were temporarily invested on a short-term basis for fifteen to thirty days, the funds were eventually returned to Fleet either in the form of a dividend via the PICs or in exchange for other mortgage loans that Fleet wanted to transfer to the REITs. There is simply no showing on this record that either the REITs or the PICs invested any receipts for their on-going business operations; rather, their receipts were returned to Fleet for its business operations.

Similarly, the record is devoid of any indication that the PICs conducted substantive business activities for their own account; rather, the sole reason for the existence of the PICs was to function as an intermediary between the REITs and Fleet in order to create tax benefits for Fleet. Although each PIC purported to have five employees, which is the minimum required under Rhode Island law,[12] these same five individuals were also “staffed” to “numerous” of Fleet’s other PICs located in Rhode Island. Appellants provided no evidence concerning any services that these employees may have performed on behalf of the PICs. There was no evidence as to whether these employees were hired upon the formation of the PICs, whether any were relieved of duty when one of the PICs, FFGB, was dissolved, how or whether they billed the PICs for their time, or how the employees allocated their time or billings among Fleet’s various PICs.

[12] R.I. Gen. Laws § 44-11-1(vii).

Moreover, the PICs’ simultaneous creation -- and, in the case of FFGB, its simultaneous dissolution -- with their corresponding REITs showed that the PICs and the transactions with them lacked independent economic substance and business purpose. Neither PIC was an existing, functioning business prior to the creation of the REITs, and when one REIT was dissolved, its corresponding PIC was also dissolved. Neither PIC could be considered a viable business entity engaging in substantive business activity; rather, they acted as mere conduits for a circular flow of income in order to create tax benefits for Fleet.

Moreover, a review of the PICs’ tax returns for the year at issue underscores their lack of substantive business activity. The returns show that the PICs deducted virtually identical –- and exceedingly minor -– operating expenses. The PICs each deducted: $150 for light, heat, and power; $128 for office supplies; $124 for business travel; $1,242 for telephone and telegraph; $39 for books and subscriptions; $1,267 for insurance; $300 for directors fees; $66 for schools and seminars; $4 for meals and entertainment; and $153 for “other expenses.” The only deduction that varied between the two was the deduction for printing and mailing: FFGA deducted $796.00 while FFGB deducted $769.00 –- just one transposed digit off. Not only do these expenses bear a remarkable similarity, but the total of just under $7,000.00 for both PICs represents a mere 0.0025 percent of the REITs total income of $274,830,845.

Appellants offered no evidence as to a business purpose for interposing Rhode Island PICs between the original loan holders and the REITs. Rather, the sole purpose of the PICs was to receive dividend income that would have been taxable to the original loan holders if paid directly to them and convert that income into ninety-five percent tax-free income to the original loan holders. The record is devoid of evidence suggesting a business purpose for payment of dividends to the PICs other than to generate a tax deduction where none would otherwise be available –- or, in the words of KPMG's Final REIT Manual delivered to Fleet, to ensure that "virtually all of the income generated by the REIT and subsequently distributed to Fleet Bank will not be subject to state income taxation." Accordingly, because there was no economic substance to, or business purpose for, the REITs' payment of dividends to the PICs, the Board found and ruled that the Commissioner was correct in disallowing a dividends-paid deduction to the REITs.

4. APPORTIONMENT

Appellants argue that even if the dividends-paid deductions claimed for the tax year at issue are disallowed and the amounts distributed to the PICs included in the REITs taxable income, the REITs should be allowed to apportion their taxable income. However, the threshold for apportioning financial institution income is that the institution must have income which is taxable in another state; "if the financial institution does not have income from business activity which is taxable in another state, the whole of its net income shall be taxable" in Massachusetts. G.L. c. 63, § 2A(a).

Appellants offered no evidence that they were taxable in another state; rather, they argued, based on the Massachusetts definition of "engaged in business" under G.L. c. 63, § 1, that they were taxable in any state in which they had at least $10 million of loans outstanding or from which they received at least $500,000 in interest income during the year. However, the relevant definition of "taxable" found in G.L. c. 63, § 1 focuses on whether another state subjects, or has jurisdiction to subject, a financial institution to tax, not whether the institution was "engaged in business" in another state. Appellants failed to establish that they were either subject to tax in any other jurisdiction or that any other state had jurisdiction to tax them.

Appellants are Massachusetts-domiciled entities receiving passive interest income from loans originated and serviced by others. They had no employees and their only significant assets were the notes transferred to it by Fleet and the interest income they received from those notes. There is simply no showing on this record that these activities are sufficient to establish the jurisdiction of any other state to impose an income-based tax. Accordingly, the Board found and ruled that the appellants failed to establish that their income should be apportioned among the various states in which real estate securing the loans was located.

On the basis of the foregoing, the Board found and ruled that the Commissioner’s disallowance of the dividends-paid deduction was warranted and that the appellants failed to establish that they were entitled to apportion the income attributed to the REITs by the disallowance of the deductions. Accordingly, the Board issued a decision for the appellee in these appeals.

OPINION

I. PROCEDURAL VALIDITY OF ASSESSMENTS

General Laws chapter 62C, § 26(b) provides, in pertinent part:

> If the commissioner determines, from the verification of a return or otherwise, that the full amount of any tax has not been assessed or is not deemed to be assessed, he may, at any time within three years after the date the return was filed or the date it was required to be filed, whichever occurs later, assess the same with interest as provided in section thirty-two to the date when the deficiency assessment is required to be paid, first giving notice of his intention to the person to be assessed . . . After the expiration of thirty days from the date of such notification, the commissioner shall assess the amount of tax remaining due the commonwealth, or any portion thereof, which he believes has not therefore been assessed. Failure to receive the notice provided for by this paragraph shall not affect the validity of the tax.

Appellants do not contest that the Commissioner complied with § 26(b) by timely assessing the tax at issue, first giving notice to appellants of his intention to assess.

After assessing a tax, the Commissioner is required by G.L. c. 62C, § 31 to issue a written notice of the assessment as follows:

> If the assessment of any tax is in excess of the amount shown on the return as the tax due, the commissioner shall, as soon as may be, give written notice to the taxpayer of the amount of the assessment, the amount of any balance due and the time when the same is required to be paid. Failure to receive such notice shall not affect the validity of the tax.

In issuing notices under § 31, as well as other notices under Chapter 62C, the Commissioner is permitted by G.L. c. 62C, § 71 to give notice in the following manner:

> Any notice authorized or required under the provisions of this chapter may be served personally or may be given by mailing the same, postage prepaid, to the person for whom it is intended, addressed to such person at his address as it appears in the records of the commissioner.

Appellants' challenge to the procedural validity of the subject assessments centers on whether the Commissioner failed to comply with the notice requirements of § 31. Appellants bear the burden of demonstrating that this failure occurred, and that the assessments are invalid. *See* ***Waban Inc. d/b/a BJ's Wholesale Club v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Reports 1997-472.

Appellants first asserted that they did not receive the NOAs prior to September 29, 2003. They further asserted that the evidence presented did not establish that the Commissioner mailed the NOAs, speculating that errors, either human or mechanical, may have thwarted attempts to do so. Moreover, according to appellants, even if the NOAs were mailed, the Commissioner's failure to take affirmative action upon notification in the MASSTAX system that the NOAs had been returned by the post office was fatal to the assessments. Appellants also argued that receipt of the NOAs by facsimile approximately two months after the assessment date did not cure the alleged procedural defects. The Board found these arguments unavailing.

Through several witnesses, all of whom the Board found credible, the Commissioner detailed each of the various steps involved in the generation and mailing of the NOAs, from the issuance of the NIAs and execution of the Warrant to delivery of the properly addressed NOAs to the post office. Based on this evidence, the Board found that the Commissioner mailed the NOAs to appellants on July 30, 2003. Thus the Board found and ruled that the Commissioner gave timely notice of the assessments in a manner specified by § 71, thereby complying with the requirements of § 31.

Appellants' assertion that they did not receive the NOAs, even if accurate, does not affect the validity of the assessments. Section 31 explicitly provides that "[f]ailure to receive such notice shall not affect the validity of the tax." The Board affirmed the meaning of this unambiguous language in ***Michael J. Ducheine v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Reports 2001-568, ruling that failure to receive an NOA had no effect on the validity of the tax. ***Id.*** at 575. *See also* ***Tambrands, Inc. v. Commissioner of Revenue,*** 46 Mass.

App. Ct. 522, 527 (1999); ***Interface Group-Nevada, Inc. v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Reports 1998-1017.

Further, even if the Board had found that the NOAs were not mailed by the Commissioner, their receipt by appellants on September 29, 2003 would suffice for purposes of satisfying the requirements of § 31. Section 31 provides that written notice of an assessment must be given to a taxpayer "as soon as may be." This phrase, which is temporally indeterminate in nature, does not require that an NOA be issued the same day as the assessment is made. *See* ***Menard,*** Mass. ATB Findings of Fact and Reports 1990 at 231. Moreover, even when the gap between assessment and notice significantly widens, the validity of assessments has been consistently upheld where taxpayers are not prejudiced by the delay.

In ***Tambrands, Inc., v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 1998-1017, *aff'd*. 46 Mass. App. Ct. 522 (1999), the Board ruled that an NOA sent between fifteen and eighteen months after the Commissioner made an assessment was given "as soon as may be" within the meaning of § 31. Adopting a facts and circumstances approach to the issue, the Board noted that the taxpayer had suffered no prejudice as a result of the delay, which was caused by a transition in DOR's computer system. Affirming the Board's decision, the Appeals Court held that "[u]nder a fluid time limitation like 'as soon as may be,' attendant circumstances need to be considered. Among those circumstances would be whether the tax collector or the taxpayer [had] been prejudiced." *See also* ***Pippins, Inc. v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Reports 1997-444 (ruling that, absent prejudice to taxpayer, mailing of NOAs between eighteen and twenty months after assessment was "as soon as may be" for purposes of § 31.)

In ***Standard & Poors Compustat Services, Inc. v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 1999-228, the Board ruled that a time lapse of between three and four months between the Commissioner's assessment and an NOA, absent extenuating circumstances and not resulting in prejudice to the taxpayer, did not violate the terms of § 31.

As with the taxpayers in ***Tambrands, Pippins*** and ***Standard & Poors***, appellants suffered no prejudice and were denied none of their statutory rights as a result of their receipt of the NOAs on September 29, 2003, approximately two months after the assessments were made. Indeed, appellants timely filed Applications for Abatement with the

Commissioner and Petitions with the Board. Absent prejudice to the appellants, and given the duration of the alleged time lapse between assessment and receipt of notice, the Board found and ruled that the notice requirements of § 31 would have been met even if the NOAs had not been mailed by the Commissioner on July 30, 2003.

Finally, appellants relied on several federal cases in support of their argument that the assessments were invalid because the Commissioner failed to take affirmative action to notify appellants of the assessments after the MASSTAX system reflected that the NOAs had been returned by the post office. The Board found this reliance misplaced.

Each of the cases cited by appellants construed the requirement in Internal Revenue Code § 6212 that notice of a deficiency be sent to a taxpayer "at his last known address," with particular focus on the meaning of "last known address" and the Internal Revenue Service's obligations to ascertain and send deficiency notices to that address. *See* ***Teong-Chan Gaw; Rossana W. Gaw v. Commissioner***, 45 F.3d 461 (D.C. Cir. 1995); ***Lewis E. Johnson and Jeanne K. Johnson v. Commissioner***, 611 F.2d 1015 (5th Cir. 1980); ***John E. Kennedy and Mary A. Kennedy v. United States*** 403 F.Supp. 619 (W.D. Mich 1975); ***Estate of Francis P. Mckaig, Jr. v. Commissioner***, 51 T.C. 331

(1968). These cases have no bearing on the instant appeals in which the Commissioner mailed the NOAs to an address the parties agree was correct and satisfied the requirements of § 71. Thus, the Board found that appellants' argument was without merit.

In sum, the Board found and ruled that the Commissioner complied with the notice requirements of § 31. The Board also found and ruled that appellants failed to meet their burden of demonstrating that the assessments were procedurally invalid.

II. SHAM TRANSACTION ANALYSIS UNDER *SHERWIN-WILLIAMS* AND *SYMS*

The present appeals raise the issue of whether certain intercompany transactions were a sham that lacked economic substance and business purpose and, therefore, must be disregarded for tax purposes. The sham-transaction issue has been thoroughly analyzed in a number of recent appeals. *See* ***The Sherwin-Williams Company v. Commissioner of Revenue,*** 438 Mass. 71 (2002); ***Syms Corp. v. Commissioner of Revenue,*** 436 Mass. 505 (2002); ***The TJX Companies, Inc. v. Commissioner of Revenue***, Mass. ATB Findings Of Fact and Reports 2007-790.

In analyzing this issue in the present appeals, the Board was cognizant of the fundamental principle that every taxpayer has the right to decrease the amount of taxes owed, or avoid them altogether, by any legal means. *See* ***Gregory v. Helvering,*** 293 U.S. 465, 469 (1935). However:

> [w]hile the courts recognize that tax avoidance or reduction is a legitimate goal of business entities, the courts have, nonetheless, invoked a variety of doctrines . . . to disregard the form of a transaction where the facts show that the form of the transaction is artificial and is entered into for the sole purpose of tax avoidance and there is no independent purpose for the transaction.

Falcone v. Commissioner of Revenue, Mass. ATB Findings of Fact and Report 1996-727, 734-735. The sham transaction doctrine is one such judicially-created doctrine "for preventing the misuse of the tax code." ***Horn v. Commissioner of Internal Revenue,*** 296 U.S. App. D.C. 358, 968 F.2d 1229, 1236 (D.C. Cir. 1992).

In both ***Syms*** and ***Sherwin-Williams***, the court agreed that "Massachusetts recognizes the 'sham transaction doctrine' that gives the commissioner the authority 'to disregard, for taxing purposes, transactions that have no economic substance or business purpose other than tax avoidance.'" ***Sherwin-Williams***, 438 Mass. at 79 (quoting ***Syms,*** 436 Mass. at 509-10). Furthermore, this doctrine "prevents taxpayers from claiming the tax benefits of transactions that, although within the language of the tax code, are not the type of transaction the law intended to favor with the benefit." ***Syms***, 436 Mass. at 510. Moreover, "[t]he question whether or not a transaction is a sham for purposes of the application of the doctrine is, of necessity, primarily a factual one, on which the taxpayer bears the burden of proof in the abatement process." ***Id.*** at 511. Analyzing these decisions, and applying them to subsequent appeals, thus requires careful attention to the specific facts presented in each appeal.

In applying the sham transaction doctrine to the transfer and license-back of trademarks between a parent and a wholly-owned subsidiary, the court in ***Sherwin-Williams*** observed that "[s]ham transaction cases most often involve discrete transactions by businesses or individuals rather than business reorganizations." ***Sherwin-Williams***, 438 Mass. at 84. Because it viewed the transfer and license-back arrangement between the parent and subsidiary as a business reorganization, the court in ***Sherwin-Williams*** set out to "decide what an established business enterprise must prove . . . [for] the taxing authorities [to] recognize the reorganization for tax purposes, rather than disregard it as a sham." ***Id.*** at 82. The court ruled that, in the case of a business reorganization, the viability of the resulting business should be the focus of the inquiry:

> In the context of a business reorganization resulting in new corporate entities owning or carrying on a portion of the business previously held or conducted by the taxpayer, this requires inquiry into whether the new entities are "viable," that is, "formed for a substantial business purpose or actually engag[ing] in substantive business activity." In making this inquiry, consideration of the often interrelated factors of economic substance and business purpose, is appropriate.

Id. at 85-86 (internal citations omitted). The court also rejected a "rigid two-step analysis," applied in one line of federal cases, which separately investigates the business purpose and economic effect of a transaction. ***Id***. at 84 (quoting ***Rice's Toyota World, Inc. v. Commissioner of Revenue***, 752 F.2d 89, 91 (4th Cir. 1985)). Instead, the court declared that "whether a transaction that results in tax benefits is real, such that it ought to be respected for taxing purposes, depends on whether it has had practical, economic effects beyond the creation of those tax benefits." ***Id***. at 85. In fact, "tax motivation is irrelevant where a business reorganization results in the creation of a viable business entity engaged in substantive business activity rather than in a 'bald and mischievous fiction.'" ***Id.*** at 89 (citing ***Moline Properties,*** 319 U.S. at 439).

After applying the above standards to the particular facts of ***Sherwin-Williams***, the court found that the transfer and license-back arrangements "[were] a product and intended part of a business reorganization, and their economic substance and business purpose must be assessed not in the narrow confines of the specific transactions between the parent and the subsidiaries, but in the broader context of the operation of the resultant business." ***Id.*** at 86 (citing ***Northern Ind. Pub. Serv. v. Commissioner of Internal Revenue***, 115 F.3d 506, 512 (7th Cir. 1997)). The court then "conclud[ed] that the reorganization, including the transfer and licensing back of the marks, had economic substance in that it resulted in the creation of viable business entities engaging in substantive business activity." ***Id***. In particular, the court relied on the following to determine that the Sherwin-Williams subsidiaries were engaged in substantive business activity: legal title and physical possession of the marks passed from the parent to the subsidiaries, as did "the benefits and burdens of owning the marks"; "[t]he subsidiaries entered into genuine obligations with unrelated third parties for use of the marks"; "[t]he subsidiaries received royalties, which they invested with unrelated third parties to earn additional income for their businesses"; and "[t]he subsidiaries incurred and paid substantial liabilities to unrelated third parties and to Sherwin-Williams to maintain, manage, and defend the marks." ***Id***.

The Board is cognizant of the fact that every properly incorporated entity that has a business purpose or is engaged in business activity must be recognized for tax purposes. *See* ***Moline Properties, Inc. v. Commissioner***, 319 U.S. 436, 439 (1943). As the Board noted in ***Syms Corp.***, Mass. ATB Findings of Fact and Reports at 2000-749, "the degree of corporate purpose and activity required for the recognition of a corporation as a separate legal entity for tax purposes is extremely low." (citing ***Strong v. Commissioner***, 66 T.C. 12 (T.C. 1976), *aff'd*, 553 F.2d 94 (2nd Cir. 1977)). In the present appeals, there is no question that the REITs and PICs should be recognized as corporate entities for tax purposes.

Similarly, despite the Commissioner's arguments to the contrary, the Board ruled that the appellants qualified as REITs for the tax year at issue. Of the several requirements for qualification as a REIT found at IRC § 856(a), the Commissioner challenged only one: whether the appellants met the requirement under IRC § 856(a)(5) that the "beneficial ownership" of the REIT be held by 100 or more persons.

On this record, the Board could not find that the 133 individual employee-shareholders were not the beneficial owners of the preferred stock in the REITs. The employee-shareholders received dividends, could maintain ownership of the shares after their employment with Fleet ended, had the right to transfer the stock to others, and were required to include the dividends in their gross income.[13] *See* Treas. Reg. § 1.857-8(b) (the "actual owner" of REIT stock is "the person who is required to include . . . the dividends received on the stock [in his or her gross income]"). Although the interests of the employee-shareholders paled in comparison to the interests held by the PIC stockholders, and the transfer of stock to the employees was clearly an effort to achieve the desired tax benefits by meeting the minimum REIT-qualification requirements under IRC § 856(a)(5), the form of the REITs satisfied the requirements under IRC § 856(a). Accordingly, the Board ruled that the appellants should be recognized as REITs for the tax year at issue.

However, in these appeals, it is the transactions, not the entities, that the Board must examine to determine

[13] Although Fleet compensated the employee shareholders with a "gross up" amount to cover the amount of tax due from the shareholders on their receipt of stock as compensation for services, the shareholders were required to report the receipt of shares and the annual dividends received and to pay any resulting tax.

whether the deductions resulting from the transfers at issue should be allowed. An analysis that focused only on whether the subsidiaries, rather than the transactions, should be recognized for tax purposes would essentially require the Board and the reviewing court to accept any and all business activity that occurs between two properly established entities. Such an interpretation would eviscerate the sham transaction doctrine, thereby preventing the Board and appellate courts from reviewing and disregarding inter-company transactions designed to manipulate the tax system for the taxpayer's benefit. In this regard, the Supreme Court has determined that:

> [T]he existence of an actual corporation is only one incident necessary [for the recognition of a transaction]. . . . The government may look to actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction.

Higgins v. Smith, 308 U.S. 473, 476-77 (1941). *See also* ***Gregory***, 293 U.S. at 469 ("No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described.").

The instant appeals involved the creation of new subsidiaries and a series of transactions involving the transfer of real estate loans and intercompany payments of dividends between the newly created entities and the parent banks. As described more fully below, although the appellants contended that the creation of the appellants had the type of "legal, practical, and economic effects" the court found persuasive in ***Sherwin-Williams,*** they largely ignore the issue of whether the transfers to and from the PICs had any economic substance or business purpose. Further, the Board found several factors that aligned these appeals with ***Syms,*** distinguished them from ***Sherwin-Williams,*** and supported the conclusion that the transfer of dividends to and from the PICs, even when viewed in the "broader context of the operation" of the REITs and PICs, lacked economic substance and any business purpose. ***Sherwin-Williams,*** 438 Mass. at 86.

In ***Sherwin-Williams,*** the court characterized its holding in ***Syms*** as follows:

> In ***Syms,*** . . . 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; 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. The court went on to find that the facts in ***Sherwin-Williams*** were "substantially different" from those it found in ***Syms:***

> There is no evidence that the transfer of the marks to the subsidiary corporations and their licensing back to Sherwin-Williams was specifically devised as a tax avoidance scheme. The revenue earned by the subsidiaries, including the proceeds from the royalty payments made by Sherwin-Williams, was not returned to Sherwin-Williams as a dividend but, rather, was retained and invested as part of their ongoing business operations, earning significant additional income. The subsidiaries entered into nonexclusive license agreements not only with Sherwin-Williams, but also with unrelated parties. The subsidiaries assumed and paid the expenses of maintaining and defending their trademark assets.

As the following analysis reveals, the factual distinctions on which the court relied in ***Sherwin-Williams*** to distinguish ***Syms*** are not present in these appeals. Rather, the evidence in these appeals is at least as strong -- in many ways, stronger –- than the evidence on which the court in ***Syms*** relied to uphold the Board's ruling that the transactions at issue were a sham.

A. DESIGN OF REIT STRATEGY AS TAX AVOIDANCE SCHEME

As described in KPMG's marketing materials, the REIT strategy at issue in these appeals was a "state tax minimization project" designed by KPMG "for the principal purpose of reducing [Fleet's] state income tax liability."

The topic of state tax avoidance dominated the memoranda and discussions between KPMG and Fleet and internally among Fleet officers. These memoranda and discussions concerned, among other issues: where to incorporate the REITs to effectuate the greatest tax savings at the smallest political cost; Fleet's understanding that the transactions could "come to the attention of a particular state, possibly in a manner over which we have no control" and its realization that "we should only do this where we are willing to accept the consequences of having a state find out we have detected and exploited a loophole in their taxing scheme"; the need to "assess its REIT structure and determine an appropriate course of action" if a state challenged the REIT strategy; the need to develop "substantive, non-tax business purposes" to justify the strategy to an auditing state, while acknowledging that no one at Fleet had found the proffered purposes "overwhelming"; the need to "interpose" Rhode Island PICs between Fleet and the REITs in order to insulate ninety-five percent of the income from Massachusetts taxation.

Similarly, in ***Syms,*** the taxpayer was approached by a third-party with the promise that his organization "had a method of saving state taxes." ***Syms,*** 436 Mass. at 507.

The taxpayer in ***Syms,*** like appellants here, also recognized the risks inherent in the tax-savings strategy:

> There have been cases when corporations attempted to do this and did not do it properly and thus had problems in various states. It is everyone[’]s feeling that New York is the most sophisticated state in terms of tax audits and most other states will not even realize the impact of the transactions.”

Id. at 508.

In contrast, the court in ***Sherwin-Williams*** found that legitimate business concerns -– and not just tax savings -– motivated the taxpayer’s interest in transferring its intellectual property to a subsidiary.

> Sherwin-Williams’s senior management had concerns dating as far back as 1983 regarding the maintenance and effective management of its marks because one of its marks, the “Canada Paint Company,” which was to be used in a Canadian joint venture had been lost. The corporate official who had been most vocal in expressing these concerns, Conway Ivy, was put on the boards of [the subsidiaries] when they were formed in 1991. the testimony of senior corporate managers further established that before 1991, the multiple divisions of Sherwin-Williams, its decentralized management and culture, and the use of many of the marks across divisions, created uncertain authority and diffuse decision-making regarding the maintenance and exploitation of the marks, contributing to their ineffective and inadequate management as a company asset. Finally, board members of [the subsidiaries] and Sherwin-Williams’s associate general counsel for patents and trademarks testified that these concerns had been effectively addressed by the transfer of the marks to the subsidiaries whose sole focus was on their maintenance and management.

Sherwin-Williams, 438 Mass. at 78-79.

No such finding of legitimate business concerns is appropriate in the subject appeals. Regarding the REITs, for the reasons detailed in the Board's findings of fact above, the purported business purpose of creating an alternative capital-raising mechanism was a pretext; Fleet neither intended to nor could have raised capital by selling shares in the REITs when they were created or during the year at issue and the subsequent sale of REIT shares in 2001 was part of yet another tax-savings plan. *See* ***Syms,*** 436 Mass. at 513 (upholding Board's rejection of purported business purposes "concocted to provide faint cover for the creation of a tax deduction"). As for the PICs, the record is silent as to any business purpose that motivated the transfer of dividends to and from the PICs.

Accordingly, there is no indication on this record that Fleet had business concerns which were addressed by transferring part of their loan portfolio to a REIT and receiving the interest income back, mostly tax-free, from a subsidiary. Rather, like the plan at issue in ***Syms,*** the REIT strategy was specifically devised, marketed, purchased and implemented as a tax avoidance scheme.

B. RETURN OF INCOME TO FLEET AS DIVIDEND

In ***Syms,*** the subsidiary held royalty payments received from the taxpayer "for a few weeks" before paying it back to the taxpayer, with interest and less expenses, as a tax-free dividend. ***Syms*** 436 Mass. at 509. The subsidiary's only income came from the taxpayer's royalty payments and its expenses amounted to approximately one-tenth of one percent of its income. ***Id.***

The court in ***Sherwin-Williams,*** however, noted that the taxpayer there earned income for its own account: "setting their own investment policies," Sherwin-Williams's subsidiaries earned a return on its investments "greater than that earned on comparable funds by their parent." ***Sherwin-Williams*** 438 Mass. at 511. Further, the revenue earned by the subsidiaries "was not returned to Sherwin-Williams as a dividend but, rather, was retained and invested as part of their ongoing business operations, earning significant additional income." ***Id.*** at 513.

In the present appeals, there is no dispute that substantially all of the appellants' income came from the assets transferred to them by Fleet and that the vast majority of this income was returned to Fleet in the form of a dividend, via the PIC intermediaries. In fact, as REITs, the appellants were required to pay out substantially all of their ordinary income as dividends. *See* IRC § 857(a).

Further, although some of the REITs' receipts were temporarily invested on a short-term basis for fifteen to thirty days, the funds were eventually returned to Fleet either in the form of a dividend via the PICs or in exchange for other mortgage loans that Fleet wanted to transfer to the REITs. There is simply no showing on this record that either the REITs or the PICs invested any receipts for their on-going business operations; rather, their receipts were returned to Fleet for its business operations.

Finally, the expenses of the REITs and PICs, like those of the subsidiaries in ***Syms,*** were a small fraction of their overall income. For example, while the court in ***Syms*** observed that Syms's expenses were just one-tenth of one percent of its income, the disparity between the PICs' income and expenses is even more glaring in the present appeals: $7,000 in expenses compared to $274,830,845 of income, or just 0.0025 percent.

Accordingly, the REITs and PICs here, like the Syms subsidiaries, returned the only income that they received to the transferor of the assets generating that income, and the expenses associated with the operation of their "businesses" were a small fraction of that income.

C. AGREEMENTS WITH THIRD-PARTIES

Although largely silent on this issue in ***Syms,*** the court in ***Sherwin-Williams*** stressed the fact that the subsidiaries entered into "genuine obligations with unrelated third parties for use of the marks." ***Sherwin-Williams,*** 438 Mass. at 86. *See also,* ***Id.*** at 78, 81 (noting that subsidiaries entered into nonexclusive licensing agreements with Sherwin-Williams and other unrelated licensees for the use of the marks).

In the present appeals, the unrelated third parties involved with the assets transferred to the REITs –- the mortgagors –- did not even know that their loans had been transferred to the REITs. The borrowers continued to pay the same servicing company –- another Fleet subsidiary –- both before and after the loans were transferred.

Further, all loans held by the REITs were transferred to them by Fleet; they did not originate new loans from borrowers or purchase loans on the secondary market from any unrelated third party. Moreover, as discussed below, all of the expenses related to the interest income were paid to Fleet or Fleet-related entities. Accordingly, unlike ***Sherwin-Williams,*** no finding that the REITs or PICs were engaged in business with unrelated third parties is appropriate on this record.

D. PAYMENT OF EXPENSES ASSOCIATED WITH TRANSFERRED ASSETS

In ***Syms,*** all of the work necessary to maintain and protect the trademark assets transferred to the subsidiary continued to be performed by the same unrelated, third-party law firm and the parent continued to pay all of the attendant expenses. ***Syms,*** 436 Mass. at 509. All advertising expenses were paid either by the parent or another wholly owned subsidiary. The choice of which products were sold under the marks and quality control of the products remained with the same officers and employees of the parent who had done that work before the transfer.

In ***Sherwin-Williams,*** the court noted that the subsidiaries, and not the parent, paid expenses related to the transferred assets: "The subsidiaries incurred and paid substantial liabilities to unrelated third parties and Sherwin-Williams to maintain, manage, and defend the marks." ***Sherwin-Williams,*** 438 Mass. at 86. The court further found that the subsidiaries were:

> hiring and paying professionals to audit the companies and to perform occasional quality control testing on Sherwin-Williams's products. They also hired and paid their own lawyers to represent them in multiple trademark proceedings. To assist them with the filings

> necessary to maintain the marks, both companies contracted with Sherwin-Williams and paid market rates on periodic invoices for the services they received.

Id. at 78.

In contrast to both ***Syms*** and ***Sherwin-Williams,*** there is no indication on the present record that the appellants here paid a single significant expense to an unrelated third-party during the tax year at issue. The loan servicing continued to be performed by the same Fleet subsidiary that performed those services before the transfer. The “investment services,” such as they were, as well as accounting and general ledger services were all provided by Fleet employees or Fleet-related entities based on “intercompany allocation charges” set by Fleet. The REITs’ bank accounts were set up by Fleet’s treasury group, who also monitored the cash balances in those accounts. Decisions regarding transfer of cash to the accounts and to Fleet, as well as what Fleet assets to transfer to the REITs, were the exclusive province of Fleet officers and employees.

Accordingly, for all of the foregoing reasons, the Board ruled that the four factors that the ***Sherwin-Williams*** court relied on to distinguish ***Syms*** and to support its finding of economic substance and business purpose are not present in these appeals.

E. TRANSFER OF TITLE, BENEFITS AND BURDENS OF LOANS

Appellants argued that, like the transactions at issue in ***Sherwin-Williams,*** "legal title" to the loans passed to appellants "as did the benefits and burdens of owning" the loans. ***Sherwin-Williams,*** 438 Mass. at 86. First, holding legal title to the income-producing asset alone is not sufficient to establish that a transaction has economic substance and business purpose; the taxpayer in ***Syms*** also held legal title to the assets at issue and the court still upheld the Board's determination that the transactions at issue were a sham with no economic substance or business purpose. ***Syms,*** 436 Mass. at 508, 513.

Regarding the benefits of owning the loan portfolios, the fundamental benefit of ownership of these assets is the ability to receive income. However, as detailed above, substantially all of that income was transferred back to the transferor of the assets in the form of dividends. The income was not used for the benefit of the REITs or PICs; rather, they were conduits for the return of that income to Fleet.

With regard to the burdens of ownership of the loan portfolio, all of the expenses associated with ownership were paid to Fleet or a Fleet subsidiary; no such expenses were paid to third-parties. As detailed in the preceding section, these expenses were either the same as those paid by Fleet to the same Fleet subsidiary prior to the transactions or were paid directly to Fleet or a Fleet-related entity pursuant to intercompany charges set by Fleet.

Further, the court's reference in ***Sherwin-Williams*** to the subsidiaries' payment for services was in the overall context of the subsidiaries' independent dealings with third-parties unrelated to the parent. Throughout its opinion, the court found that Sherwin-Williams' subsidiaries interacted with independent third parties in a variety of circumstances and situations. *See, e.g.,* ***Sherwin-Williams,*** 438 Mass. at 86 ("The subsidiaries entered into genuine obligations with unrelated third parties for use of the marks"); ***id.*** ("The subsidiaries incurred and paid substantial liabilities to unrelated third parties . . . to maintain, manage, and defend the marks"); ***id.*** at 88 (The subsidiaries invested money "with third parties outside of Sherwin-Williams's control"); and ***id.*** ("The subsidiaries paid the expenses of running their businesses . . . to other unrelated professionals"). In fact, this interaction with independent third parties was one of the primary reasons why the court found the subsidiaries of Sherwin-Williams to be "viable business entit[ies]" and Sherwin-Williams to be engaged in economically substantive activity. ***Id.*** at 86.

In contrast, there is no showing on this record that the appellants or the PICs interacted in a meaningful way with a single unrelated third-party. Accordingly, the Board ruled that, although the REITs held legal title to the loan portfolios, they did not possess the benefits and burdens of ownership as described in ***Sherwin-Williams***.

4. ECONOMIC SUBSTANCE AND BUSINESS PURPOSE OF TRANSACTIONS INVOLVING PICS

The focus of the appellants' case was on the business purpose for creating and utilizing the REITs as a potential capital-raising vehicle and the economic substance of the REITs' business activities. However, appellants did not even attempt to argue that the introduction of the PICs into the transactions and their activities constituted substantive business activity. There is no indication that the PICs were designed for, or in fact conducted, any activity other than tax-avoidance; they merely received dividends from the REITs and transferred dividends to Fleet, acting as conduits for a circular flow of interest income from the loan proceeds which, both before and after the subject transactions, were ultimately paid to Fleet. "Such a circular flow of funds among related entities does not indicate a substantive economic transaction for tax purposes." ***Merryman v. Commissioner of Internal Revenue***, 873 F.2d 879, 882 (5th Cir. 1989); *see also* ***Zirker v. Commissioner***, 87 T.C. 970, 976 (1986), ***Estate of Franklin v. Commissioner***, 544 F.2d 1045 (9th Cir. 1976).

There is simply no indication on this record that the PICs were “viable business entities engaging in substantive business activity.” ***Sherwin-Williams,*** 438 Mass. at 86. Therefore, it cannot be reasonably argued that the appellants’ transfer of dividends to the PICs had any business purpose or economic substance other than converting taxable dividends into largely tax-free dividends to Fleet. The Board therefore ruled that the Commissioner was correct in denying a dividends-paid deduction to appellants.

III. APPORTIONMENT

Appellants argued that, even assuming the Commissioner’s disallowance of the dividends-paid deduction was proper, the assessment was excessive because appellants were not allowed to apportion their income. Appellants did not compute apportionment percentages on their returns because the dividends-paid deduction they claimed on the return rendered apportionment meaningless.

Under G.L. c. 63, § 2A,

> If the financial institution does not have income from business activity which is taxable in another state, the whole of its net income shall be taxable under section two. For purposes of this section, a financial institution is taxable in another state as defined in the definition of "taxable" in section one.

The term "taxable" is defined under G.L. c. 63, § 1 to mean either:

> (a) that a taxpayer is subject in another state to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, a corporate stock tax, including a bank shares tax, a single business tax, or an earned surplus tax, or any tax which is imposed upon or measured by net income; or
> (b) that another state has jurisdiction to subject the taxpayer to any of such taxes regardless of whether, in fact, the state does or does not.

Appellants provided no evidence that they were subject to any of the taxes enumerated in § 1(a). Rather, they asserted that the definition of "engaged in business" in Massachusetts under § 1 controls the question of whether foreign states have jurisdiction to tax the REITs.

Appellants read the definition of "engaged in business" in Massachusetts under § 1 as creating a "presumption" that a financial institution is taxable in

Massachusetts if it has either more than $10 million of assets attributable to sources in the Commonwealth or more than $500,000 in receipts attributable to sources in the Commonwealth.

Although the asset and receipts thresholds create a presumption that a corporation is "engaged in business" in Massachusetts, the statute is silent as to whether these same thresholds create jurisdiction to tax the corporation. Appellants blurred any distinction between "engaged in business" and "jurisdiction to tax" and assumed, without analysis, that appellants were "presumed to have been taxable in the states in which they had at least $10 million of loans outstanding at some point during the year or from which they received at least $500,000.00 of interest income during the year." However, as described below, jurisdiction to tax requires a constitutional, not statutory, analysis.[14] *Cf.* G.L. c. 63, § 52 (providing for

[14] The constitutional analysis is the same whether the corporation is subject to a financial institution excise or the corporate excise. The language of G.L. c. 63, § 38(b) regarding allocation to Massachusetts of all taxable income of a corporation if the corporation "does not have income from business activity which is taxable in another state" and the § 38(b) definition of "taxable" to include being subject to another state's "jurisdiction" to tax is, in all meaningful respects, identical to the comparable provisions governing Massachusetts allocation of a financial institution's taxable income under G.L. c. 63, §§ 1 and 2A(a). Although both parties assumed, without explanation, that the appellants were "financial institutions" subject to the financial institution excise, the same principles and analysis would be applicable if the appellants were subject to the corporate excise.

contingency that parts of corporate excise statute may be declared unconstitutional).

Appellants cited ***Amray, Inc. v. Commissioner of Revenue,*** 7 Mass. App. Tax Bd. Rep. 13 (1986) for the proposition that, in determining whether a foreign state has jurisdiction to tax the REITs, "the test is the same as the test that Massachusetts itself uses in determining whether it has any basis for imposing a tax." Appellants' Reply Brief at 49. However, all that ***Amray*** determined was that the taxability question

> does not depend on the various tax laws of the other states. Rather, operation of the provision depends on whether or not a business has sufficient contact with the state of purchaser to bring it within the taxing jurisdiction of that state.

Id. at 17 (ruling that appropriate inquiry is whether the jurisdiction of foreign states to tax was limited by U.S. Constitution or Public Law 86-272). Accordingly, the question of whether a foreign state has jurisdiction to tax is based on constitutional concerns and federal legislative action pursuant to the Commerce Clause, and not on the statutes of Massachusetts or any other state. *See* ***Tech-Etch, Inc. v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Report 2005-279, 288, *aff'd* 67 Mass.App.Ct. 1113 (2006) (ruling that threshold question of taxability in foreign state must be determined based on constitutional concerns and P.L. 86-272 without reference to statutory presumptions of taxability in sales factor of apportionment formula).

Appellants cite no authority for the proposition that a Massachusetts REIT, which has no employees or property and which conducts no business activity other than the passive receipt of interest income from loans transferred to it which it neither originated nor serviced, has nexus with a non-domiciliary state for purposes of an income-based tax. *Cf.* ***Sasol North America, Inc. v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Reports 2007-942 (ruling that taxpayer met its burden of proving that interrelated business activities in more than one state provided a basis for apportionment under G.L. c. 63, § 38).

Recent cases upholding a state's constitutional right to tax out-of-state corporations with no physical presence in the taxing jurisdiction do not go that far. In ***Capital One Bank, et al. v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Report 2007-544, the Board ruled that physical presence is not required to satisfy the "substantial nexus" requirement under the Commerce Clause. ***Id.*** at 573. *See* ***Complete Auto Transit, Inc. v. Brady,*** 430 U.S. 274, 279 (ruling that Commerce Clause requires, *inter* *alia,* that tax be applied to an activity with a substantial nexus with the taxing state). Rather, guided by the decisions of the Supreme Court and other jurisdictions that had addressed the question, the Board ruled that the Banks' "deliberate and targeted exploitation" of the Massachusetts market and its use of the Commonwealth's infrastructure and resources constituted substantial nexus under ***Complete Auto*** test:

> The Banks' derived substantial economic gain from the Massachusetts market through a sophisticated marketing campaign that targeted Massachusetts customers and by use of the Visa and MasterCard network, which included Massachusetts retailers and their "acquiring banks" as well as Massachusetts consumers armed with "Capital One"-branded credit cards. The customer's use of the Capital One cards provided the user with instant buying and borrowing power and informed merchants that the Banks were guaranteeing prompt payment for the goods or services purchased by the customers, since the Banks assumed all credit risk and paid the merchant its charges, less the "merchant discount" charged by the Banks and the acquiring banks. It was the financial resources and stability of the Banks, as represented by the Capital One logo on the credit cards, together with the Visa and MasterCard networks of which the Banks were a part, that enabled the transactions from which the Banks derived substantial revenue to occur. Accordingly, like the ***Geoffrey***-line of cases, the use of Capital One's intangible property –- the Capital One trademark on the cards –- within the Massachusetts economic market to generate substantial revenue further supports the Board's ruling that there was substantial nexus. *See, e.g.,* ***Kmart,*** 139 N.M. at 186.

Similarly, the Board in ***Geoffrey, Inc. v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Report 2007-690, ruled that the taxpayer, which owned trademark assets that it used in Massachusetts but had no employees or physical presence in the Commonwealth, was subject to Massachusetts tax. In so ruling, the Board relied on the fact that, "as in ***Capitol One***, Geoffrey here purposefully 'derived substantial economic gain from the Massachusetts market through a sophisticated marketing campaign' that harnessed the value of its intangibles to induce Massachusetts customers to make purchases from which it profited." ***Geoffrey,*** at 713. In addition, the Board found that Geoffrey maintained significant control over how the trademarks were put to use in Massachusetts, including the right to review product samples and specifications, signs, labels, tags, packaging material, advertising and sales promotion materials, bills, catalogs, pamphlets or the like, which displayed any Trademark information. ***Id.*** at 698.

Unlike the taxpayers in ***Capital One, Geoffrey,*** and the line of cases which they followed, the appellants here conducted no deliberate activities to exploit markets in other states. In fact, they had no contact whatsoever with the mortgagors in other states; they neither serviced nor originated the loans but merely received interest payments on the loans transferred to them. The interest payments they received were derived from intangible assets -– the promissory notes –- and not from an interest in the real estate securing those loans. *See* ***Indursky v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Report 1998-589 (ruling that non-resident was not taxable in Massachusetts on interest received on promissory note secured by Massachusetts real estate because the income was derived from the intangible note, not from an ownership interest in real estate).

Therefore, the Board ruled that appellants failed to meet their burden of proving that they had "income from business activity which is taxable in another state" and, accordingly, the "whole of [their] net income shall be taxable" in Massachusetts. G.L. c. 63, § 2A(a).

IV. CONCLUSION

For all of the foregoing reasons, the Board ruled that there was no economic substance or business purpose to the payment of dividends by the appellants to the PICs. The PICs were not engaged in any substantive business activity; rather, their insertion into the subject transactions was for the exclusive purpose of tax avoidance. Accordingly, the Board ruled that the Commissioner's disallowance of the dividends-paid deduction was warranted.

The Board further ruled that the appellants failed to prove that they were taxable in any state other than Massachusetts. Accordingly, appellants failed to meet their burden of proving that they were entitled to apportion the income attributed to them by the Commissioner's disallowance of the dividends-paid deductions. For all of the foregoing reasons, the Board issued a decision for the appellee in these appeals.

THE APPELLATE TAX BOARD

By: ______________________________________
Frank J. Scharaffa, Commissioner

A true copy,

Attest: ___________________________________
Clerk of the Board