COMMONWEALTH OF MASSACHUSETTS

APPELLATE TAX BOARD

MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY AND MASSMUTUAL HOLDING LLC **v.** **COMMISSIONER OF REVENUE**
Docket No. C305276

MML INVESTOR SERVICES, INC. **v.** **COMMISSIONER OF REVENUE**
Docket No. C305277

Promulgated:
June 12, 2015

These are appeals filed under the formal procedure pursuant to G.L. c. 58A, § 7 and G.L. c. 62C, § 39(c) from the refusal of the appellee, the Commissioner of Revenue ("Commissioner" or "appellee"), to abate corporate excise and penalties assessed against the combined reporting group ("MassMutual Combined Group") of which MassMutual Holding Company ("MMH")[1] was the principal reporting entity for the tax year ended December 31, 2003 and MML Investor Services, Inc. ("MML") was the principal reporting entity for the tax years ended December 31, 2004 and December 31, 2005 ("periods at issue").[2]

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[1] As detailed further below, MassMutual Holding Company was converted to a limited liability company ("LLC"), MassMutual Holding LLC, in 2004. Hereinafter, "MMH" will be used to refer to both MassMutual Holding LLC and its predecessor in interest.

[2] MML, together with MMH and Massachusetts Mutual Life Insurance Company, are referred to herein as the "appellants".

Chairman Hammond heard the appeals. Commissioners Scharaffa, Rose, Chmielinski, and Good joined him in the decisions for the appellants.

The Appellate Tax Board ("Board") promulgates these findings of fact and report on its own motion pursuant to G.L. c. 58A, § 13 and 831 CMR 1.32 simultaneously with the decision in Docket No. C305277.[3]

John S. Brown, Esq., *George P. Mair,* Esq., *Donald-Bruce Abrams,* Esq., *Darcy A. Ryding,* Esq., and *M. Kathryn Seevers*, Esq. for the appellants.

Frances M. Donovan, Esq., *Christopher Glionna,* Esq., *Yuliya Kuzokova,* Esq., *and Jamie Szal*, Esq. for the appellee.

FINDINGS OF FACT AND REPORT

The appeals were presented through the testimony of six witnesses and a Statement of Agreed Facts with exhibits. Additional exhibits were entered into evidence at the hearing of the appeals. The appellants offered the testimony of four fact witnesses: James Lynch, an assistant vice president of MMLIC; Dave Carlson, a vice president of MMLIC and a licensed actuary; Kris Costanzo, the Director of Non-life and International Tax at MMLIC and a licensed certified public accountant; and Derek Darley, an assistant vice president at MMLIC. The appellant also called Neil Winward, a Managing Director at EA Capital Markets, an investment bank that advises and facilitates debt and equity

[3] The decision in Docket No. C305276 was issued on May 19, 2015.

offerings for corporate clients. The Board qualified Mr. Winward as an expert in credit markets. The Commissioner offered the testimony of Vaughn Pearson, whom the Board qualified as an expert in commercial banking and lending practices, as a rebuttal witness. Neither expert prepared a report.

On the basis of the foregoing, the Board made the following findings of fact.

I. INTRODUCTION AND JURISDICTION

These appeals concern whether certain intercompany advances made by Massachusetts Mutual Life Insurance Company ("MMLIC") to its wholly-owned subsidiary, MMH, constituted *bona fide* debt for Massachusetts tax purposes. The Commissioner asserted that they were not *bona fide* debt and even if the Board were to find that they were, G.L. c. 63, §§ 31I and 31J, which require any deductions for interest paid to a related party to be added back to income, would have prevented MMH from deducting any interest paid to MMLIC. The appellants argued that MMLIC, acting according to a clear non-tax business purpose, advanced funds to MMH based on MMH's unconditional obligation to repay them, thus creating a *bona fide* debt obligation that also qualified as an exception to the add-back requirement.

The MassMutual Combined Group filed a corporate excise return for each of the periods at issue. Following an audit of these returns, the Commissioner issued a Notice of Assessment on November 3, 2009 for the year ended December 31, 2003, assessing $3,078,546 of additional excise and $119,140 of late filing penalties, and a Notice of Assessment for the year ended December 31, 2004, assessing $3,506,222 of additional excise. For the year ended December 31, 2005, for reasons outlined further in this Opinion, the advances at issue no longer provided a tax benefit.

However, the Commissioner assessed additional excise to MML in that year as a result of the denial of net operating loss carryforwards which had been previously adjusted under audit to offset the increased income of MMH after the disallowance of its interest deductions in the tax years ended December 31, 2003 and 2004. Despite this increase in tax, no Notice of Assessment was issued for the tax year ended December 31, 2005 due to an offsetting refund arising from an unrelated issue that the appellants affirmatively raised through the audit appeals process. While the Commissioner agreed with the appellant's assertion that it was due a refund on the unrelated issue, no amounts have been paid to the appellants pending the outcome of these appeals. The parties stipulated that, if the Board decided the appeals for the appellant, the amount properly refundable to the appellants for the tax year ended December 31, 2005 would be determined pursuant to an order under 831 CMR 1.33.

The appellants filed an Application for Abatement on January 21, 2010, which the Commissioner denied on February 9, 2010. The appellants then timely filed these appeals with the Board on March 26, 2010. Therefore, the Board found and ruled that it had jurisdiction to decide these appeals.

The Commissioner asserted that the appellants did not timely file their return for the tax year ended December 31, 2003. The parties agreed that the appellants received a valid extension of time to file a tax return until December 15, 2004. The Commissioner asserted that the return was not received until December 20, 2004. However, based on the postmark date, the Board found that the appellants mailed the return on December 15, 2004. Thus, pursuant to G.L. c. 62C, § 33A, which treats the date of a valid postmark as the date of filing, the Board found and ruled that the return for the tax year ended December 31, 2003 was timely filed.

II. BACKGROUND OF APPELLANTS

1. MassMutual Life Insurance Company (MMLIC)

MMLIC, originally founded in 1851 and headquartered in Springfield, Massachusetts, is one of the largest insurance companies in the United States. MMLIC is a mutual company, meaning it is owned by its policy holders to whom it is obligated to pay dividends. As an insurance company, MMLIC is regulated in all fifty states, including by the Division of

Insurance in Massachusetts, with which it is required to make annual disclosures and detailed filings regarding its financial position.

MMLIC receives premiums from its policy holders and is required to make benefit payments to them according to the terms of each insurance policy. Generally, life insurance policies are structured in the expectation that the policy holder will regularly pay premiums over a long-term with a benefit to be paid at a future date upon the death of the insured. Mr. Lynch testified that MMLIC invests the premiums that it receives in order to generate a return over the course of the policy term. In 2003, MMLIC held over $300 billion of assets under management. A substantial portion of MMLIC's investments were in debt instruments issued by a wide variety of third-party borrowers. During the periods at issue, MMLIC's book of debt instruments ranged from approximately $46 billion to $54 billion. Many of these debt instruments had maturities of five years or greater - - in 1998, for example, 59% of the third-party bonds held by MMLIC were for five years or longer, with 18% of its bond holdings having ten-year or longer maturities.

MMLIC is the principal reporting entity of a federal consolidated group that includes both its insurance and non-insurance subsidiaries. For Massachusetts tax purposes, MMLIC is classified as a life insurance company and is required to file on a separate company basis. *See* G.L. c. 63, § 32B.

2. MassMutual Holdings LLC (MMH)

MMLIC wholly owns MMH, which acted as a holding company for MMLIC's non-insurance subsidiaries. MMH was originally formed as a corporation, MassMutual Holding Company, but was converted to an LLC effective July 1, 2004. During the periods at issue, MMH held an interest in a number of subsidiaries including, but not limited to, Oppenheimer Acquisition Corporation ("Oppenheimer"), David L. Babson & Company ("Babson"), Antares Capital Corporation ("Antares"), Cornerstone Real Estate Advisors, Inc. ("Cornerstone"), and MassMutual International, Inc. ("MMI").

MMH was the principal reporting corporation of the MassMutual Combined Group until the date of its conversion, at which point it became an entity disregarded as separate from its owner for tax purposes. Until 1998, when it revoked its election, MMH was classified as a security corporation for Massachusetts tax purposes.

3. MassMutual Benefits Management, Inc. (MMBMI)

MassMutual Benefits Management, Inc. ("MMBMI") was a wholly owned subsidiary of MMH that supported MMLIC with benefit plan administration and planning services. MMBMI was taxable as a general business corporation in Massachusetts and filed as part of the federal consolidated group and the MassMutual Combined

Group. MMBMI’s apportionment factor in Massachusetts ranged from a high of 98% to a low of 91% during the periods at issue.

4. MML Investor Services, Inc. (MML)

MML was a broker-dealer which was wholly owned by MMH during the periods at issue. MML became the principal reporting corporation of the MassMutual Combined Group in 2004, upon the conversion of MMH to an LLC.

III. RISK-BASED CAPITAL

The appellants argued that the advances at issue were not motivated by tax considerations, but instead by insurance regulatory considerations. Every insurance company subject to oversight by regulatory authorities, including MMLIC, is given a score judging the adequacy of its capital reserves known as a “risk-based capital score” or “RBC score.” Dave Carlson, a licensed actuary and MMLIC executive who has been with the company since the 1980s and is familiar with the history of RBC scores, testified that in the wake of two high profile insurance company failures in the early 1990s, the National Association of Insurance Commissioners (“NAIC”) introduced the RBC score system, which was imposed on insurance companies to serve as a more rigorous check against the soundness of their capital reserves. The RBC score is calculated according to a model regulation issued by the NAIC, which has been adopted in all fifty states and is updated on a yearly basis. An insurance company’s RBC score must be provided to insurance regulators and is publicly available information. James Lynch testified that, in his experience, an insurance company’s RBC Score is one of the most important factors in the purchasing decision of a sophisticated buyer of insurance.

In order to pay the claims of policy holders, insurance companies need to have sufficient capital on hand at the point when obligations become due. The RBC score compares a company’s actual total capital to the minimum level of capital reserves deemed required for the insurance company to successfully meet those obligations. The riskier an asset on a company’s books is judged to be, such as a poorly rated bond which may not be repaid, the higher the risk that it may not be available in the event that the company needed to use it to pay a claim. Thus, the company must hold a certain percentage of that asset in reserve to ensure that the company could satisfy the claims of a policy holder.

The RBC score calculation assigns each asset on an insurance company’s balance sheet to one of hundreds of categories. Each category has a numerical risk factor associated with it which is then multiplied by the value of the asset. The result is the amount of risk-based capital which the insurance company is required to hold in reserve. Fixed income debt instruments, like promissory notes, may fall into one of six classes that are generally based on the credit rating of the instrument. Major debt offerings are usually evaluated by a third-party credit rating agency which issues an opinion with respect to the issuer's creditworthiness. These opinions take the form of a credit "rating" which generally ranges from AAA, the very highest rating, to D, which indicates a belief that the debtor will default on the debt.[4] Anything rated BBB- or higher is considered to be an "investment grade" asset. The credit rating, if available, determines an asset's class for purpose of the RBC score. For example, a bond which has received the highest series of rating of AAA to A- by a major credit ratings agency is classified as a Class 1 bond and assigned a risk factor of 0.3%, while a bond which has received the next highest rating of BBB+ to BBB- is classified as a Class 2 bond and assigned a risk factor of 0.9%. Accordingly, if a life insurance company held a $1,000 bond categorized as a Class 1 asset, it would be required to hold $3 ($1,000 x 0.3%) of reserve capital on its balance sheet versus $9 ($1,000 x 0.9%) if that same bond were categorized as a Class 2 asset. To the extent a third-party rating is not available, the classification is determined in consultation with the NAIC.

[4] Different credit rating agencies may have different nomenclature, but all have the same purpose of rating the likelihood that a debt will be repaid.

Mr. Carlson gave extensive testimony regarding the original implementation of the RBC score system at MMLIC in 1993. He testified that he was part of the working group that was tasked with evaluating MMLIC's initial RBC score ("RBC Working Group"). According to Mr. Carlson's testimony, the RBC Working Group realized that the risk factor associated with an equity investment, which included an investment in a subsidiary, of 30%[5] was much higher than the risk factor associated with highly rated debt instruments, such as the 0.3% assigned to Class 1 debt or 0.9% associated with Class 2 debt. Mr. Carlson testified that MMLIC had historically funded MMH solely through equity contributions of capital. Thus, for every $1,000 that was advanced to MMH in the form of a capital contribution (increasing its investment in its subsidiary by $1,000), under the RBC rules, MMLIC would need to hold $30 ($1,000 x 30%) in reserve, in contrast to the $3 or $9 it would need to hold if that money were instead loaned by MMLIC to MMH as a Class 1 or Class 2 debt.

The RBC Working Group concluded, according to Mr. Carlson's testimony, that the capital structure of MMH should be modified to include debt as well as equity in order to receive a more favorable RBC score and a lower required reserve. Mr. Carlson testified that there were no members of the tax department

[5] This factor was later lowered to 20%.

present during the RBC Working Group's meetings or discussions of tax planning ramifications. As the RBC Working Group considered including debt in MMH's capital structure, Mr. Carlson testified that MMLIC recognized it would need to be prudent about the level of debt incurred by MMH in order to receive a Class 1 or 2 designation on any intercompany loans made to MMH, as higher classes attracted higher risk factors and thus higher levels of required reserves. MMLIC worked with representatives of the Securities Valuation Office ("SVO"), the arm of the NAIC which analyzes the credit worthiness of privately placed debt owned by insurance companies, which assigned a Class 2 designation to loans made by MMLIC to MMH beginning in 1993 through 1997.

The RBC score only applies to insurance companies; therefore, MMLIC was the only member of the MassMutual consolidated group for which it was calculated. Accordingly, Mr. Carlson testified there was no discussion of recapitalization of any other entities and all of the subsidiaries of MMH continued to be funded through capital contributions. The Board found Mr. Carlson's testimony to be highly credible and found that the principal motivation for altering the capital structure of MMH to a mix of equity and debt was to increase the RBC score of MMLIC, reducing the amount of its required capital reserves and leaving more capital free to be used in its business operations.

IV. Fitch Ratings

As the balance of intercompany debt owed by MMH grew, Mr. Carlson testified that MMLIC and the SVO agreed that the analysis should be undertaken by one of the major credit ratings agencies. Beginning in 1997, MMLIC engaged Fitch, IBCA, Duff & Phelps ("Fitch"), one of the country's largest agencies, to analyze the debt owed by MMH to MMLIC on a yearly basis. In order to determine the proper rating of the MMH Notes for purposes of its RBC score, MMLIC engaged Fitch each year, beginning in 1997, to analyze its debt with MMH. Fitch is one of the three largest third-party credit rating agencies in the U.S., in the business of reviewing a variety of debt instruments and issuing an independent opinion on their creditworthiness. Fitch consistently rated the debt owed by MMH to MMLIC as BBB, investment-grade debt every year.

In order to formulate its rating, Fitch was given a financial presentation by MMLIC regarding its debt with MMH and given an opportunity to review its financial records. Fitch based their ratings in part on a set of financial ratios to gauge whether MMH was capable of servicing the debt. These ratios included: (1) the interest coverage ratio (earnings before interest, tax, depreciation, and amortization ("EBITDA")

/interest expense); (2) the debt to EBITDA ratio; (3) the debt leverage ratio (total debt/total equity); (4) the market value to debt ratio; and (5) the double leverage ratio (total investment in subsidiaries/market value of equity). Fitch maintained certain "target levels" for each ratio that correlated to a credit rating level.

The MMH debt to MMLIC comfortably met the target levels for the interest coverage, debt to EBITDA, and debt leverage ratios. However, MMH did not meet the targets for the final two ratios in several instances. Despite this shortcoming, based on the MMH's overall financial position and results, Fitch issued a BBB rating in each year. For example, in Fitch's letter re-affirming the BBB rating of the MMH Notes for 2004, the company explained its rationale for issuing a BBB rating although MMH's double leverage ratio fell slightly below the target:

> The rating reflects strong cash flows generated by MMH subsidiaries Oppenheimer Acquisition Corp. and Babson Capital Management, adequate sources of liquidity held by MMH and its subsidiaries, and Fitch's view of the effectiveness of risk management practices. MMH's financial performance, as measured by debt/EBITDA, EBITDA/Interest Expense, and leverage ratios, has strengthened in recent periods. Fitch believes that these strengths offset MMH's high level of double leverage and the inherent sensitivity of MMH's principal operating subsidiaries to external market conditions.

The Commissioner did not present any evidence that Fitch did not act independently or that the rating was otherwise issued in a manner at odds with its normal business practices.

LOANS FROM MMLIC TO MMH

1. Summary of Loans

Beginning in 1993, MMLIC began to issue loans to MMH (hereinafter, the aggregate advances from MMLIC to MMH will be generally referred to as the "MMH Notes"). Generally, the original MMH Notes were made for seven-year terms, with principal due at maturity and interest payable monthly. The MMH Notes generally assessed interest at the applicable federal rate ("AFR") plus 2 percent. The stated purpose for each advance varied, but the majority of the funds were directed either to the expansion of the international operations of MMI or to fund MMH's ownership stake in Oppenheimer. All loans were evidenced by a promissory note which contained a fixed date of maturity, provisions for the computation and payment of interest, covenants, and remedies in event of default. Some of the loans were so-called "revolving" lines of credit whereby MMH could draw down funds as needed, up to the face value of the note. Mr. Lynch testified that MMLIC kept records of all amounts advanced. MMH covenanted that it would not obtain any other outside financing with a maturity date of more than one year and that it would maintain net income equal to its interest expense.[6] Beginning in 1996, each MMH Note loan document included a provision making the note convertible to equity at the option of MMLIC. However, no note was ever converted, nor was there evidence of any plan that contemplated doing so.

On December 17, 1998, two years prior to the date when the oldest note was due to mature, MMH refinanced all of its then existing debt to MMLIC, which amounted at that point to $544,753,465.[7] The newly issued notes reflected ten-year terms, with principal due at maturity, and interest payable quarterly at the mid-term AFR plus 1.5%. Mr. Lynch testified that the new interest rate was set by MMLIC's treasurer in conjunction with MMLIC's investment team in attempt to set a market rate based on comparable notes. Also on December 17, 1998, MMLIC transferred five then outstanding loans from MMH, constituting $253.1 million, to MMBMI, a subsidiary of MMH. An additional $10 million loan was transferred by MMLIC to MMBMI in 1999. The Commissioner did not challenge the deduction of interest paid by MMH on the notes which were transferred to MMBMI or the validity

[6] The appellee argued that this second covenant was "meaningless" as the appellee mistakenly asserted that "net income" was defined by the promissory note as gross income less expenses "plus taxes, plus interest charges," which would effectively "double count" the interest. What the Commissioner failed to note, however, was that these two items were to be added back in the computation of net income, only to the extent they had already been deducted in determining that net income. In other words, if MMH owed $100 of interest payable to MMLIC (assuming zero taxes), it covenanted that it would earn gross income less other expenses of at least that $100 necessary to pay its interest obligation.

[7] Not including the $143,052,100 of additional debt issued on December 17, 1998.

of the debt, despite the fact that the terms of those notes were identical in all practical respects to the rest of the MMH Notes.

The Commissioner argued that because, pursuant to the refinancing, the MMH Notes originally issued prior to 1998 were technically retired and replaced by new notes, the original notes and the context in which they were issued in the refinancing are not relevant to the determination as to whether the reissued constituted *bona fide* debt. However, the reissued notes were a refinancing of existing debt and therefore the Board found and ruled that it was relevant to consider them as part of the same overall extension of credit. The Board found that circumstances under which the original notes were issued, their terms, and MMH's history of payments were just as pertinent to the inquiry of whether the balances at issue in these appeals are *bona fide* debt as those same considerations after the original notes were refinanced.[8]

From 1993 to 2002, when MMLIC ceased issuing new lines of credit to MMH, MMLIC advanced a total of approximately $1.2 billion, not including the loans transferred to MMBMI which are not at issue in these appeals. The Board found credible Mr. Lynch's testimony that the decision to cease new lending was

[8] Therefore, the term "MMH Notes" shall hereinafter refer to both the originally issued notes and the notes issued as part of the refinancing of those originally issued notes, unless otherwise specified.

made due to MMLIC's concern regarding the level of debt that existed at that point in time and retention of the BBB investment-grade rating from Fitch.

2. MMLIC Approval and Funding of Loans

James Lynch, an MMLIC accounting and finance executive with the company since the 1990s, testified at length about the appellants' lending procedures with respect to the MMH Notes. Mr. Lynch testified that MMLIC had a formal process for issuing loans to MMH. The process began with the initiation of a request for funding from the subsidiary. MMLIC would then discuss the funding needs and analyze the proposed borrowing based on projected cash flows, debt service requirements to make the interest payments, and financial ratios indicative of MMH's creditworthiness. The Chief Operating Officer of MMLIC had the delegated authority to approve transfers of up to $25 million. Any transfers in excess of that threshold required approval of the Board of Directors.[9]

Mr. Lynch testified that loan proceeds were transferred via wire transfer once the legal documents evidencing the debt had been executed. The Commissioner cites to one instance where the wire transfer request, prepared by MMLIC employees to instruct

[9] The Commissioner asserted that on a number of occasions, Ann Lomeli, the Secretary of the Board of MMLIC, improperly and unilaterally approved loans. However, the Board found that the Commissioner misunderstood the relevant documents. The Board found that the documents signed by Ms. Lomeli were simply a memorialization of votes of the Board to approve loans, which Ms. Lomeli recorded in her capacity as Secretary.

the bank to transfer funds to MMH, was prepared five days earlier than the date when the related loan documents were executed. However, the Board found that while the request may have been readied in advance, the actual transfer did not occur until the date the loan documents were signed, as evidenced by MMLIC's general ledger.[10] The Commissioner also noted two instances where the amount actually transferred to MMH exceeded the amount approved by the Board of MMLIC. One instance involved the transfer of $25,000 above the total amount stated on the loan documents of $14 million, a variance of 0.18% of the total loan amount. The Board of MMLIC approved the full funding of $14,025,000.

The second instance occurred when MMH requested a $25 million loan to fund its initial investment in MassMutual Japan Company. The purchase price for the investment was quoted in Japanese yen, while the approval by MMLIC's Board of Directors had been stated in U.S. dollars. During the short time between when the funding was approved and when the sale was completed,

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[10] The Commissioner argued that she was prejudiced by the admission of a general ledger query which showed that the funds were actually posted on the date of the promissory note. During discovery, the Commissioner had requested the production of any "general ledgers" of MMLIC. The general ledger of MMLIC is not a physical record but is a software database recording the immense number of transactions that MMLIC engages in. Accordingly, the appellants objected to the production of the entire general ledger as overly broad and burdensome and the Board denied the Commissioner's motion to compel production. In response to the allegation at the hearing of these appeals that the funds in this instance were advanced before the execution of the note, the appellants produced the general ledger entry which was able to clarify the record.

the fluctuation of the exchange rate between the Japanese yen and the U.S. dollar resulted in the final purchase price rising to $25,789,827. The Board found that these two isolated incidents occurred in the normal course of business and did not indicate that MMLIC did not treat the advances as a *bona fide* debt obligation.

3. Loan Documents

All of the loans between MMLIC and MMH were contemporaneously documented in written promissory notes. Each note provided for the payment of principal at a fixed date of maturity, with requirements to pay interest at stated intervals. The Board found that the MMH Loan documents were conventional in form and unambiguous on their face as purporting to establish a debt. The Commissioner noted that six of the notes issued as part of the 1998 refinancing showed a maturity date of December 17, 1998 - - the same date the notes were executed – - instead of December 17, 2008, the maturity date of all of the other notes issued in the refinancing. All six of the notes had the correct maturity date elsewhere in the document and the correct maturity date was reflected on MMLIC's annual filings with regulators.[11] Subsequently, in March 2000, MMLIC executed another loan document that had a mistaken reference to the issue date as the maturity date. The incorrect dates used appear to have been

[11] Five of these six notes were among those transferred to MMBMI, which, as previously noted, are not at issue in this appeal.

scrivener's errors and, based on the documents as a whole, the Board found that the manifest intent of the parties was to create notes with a ten-year term. When examined as part of the record of the almost one hundred promissory notes executed between the parties from 1993 to 2002, the Board found and ruled that these isolated mistakes did not indicate that MMLIC failed to properly document the advances as loans.

4. Use of Proceeds

Mr. Lynch testified that the proceeds from the MMH Notes advanced by MMLIC were used by MMH to fund its rapid growth and expansion. The Board found that the overwhelming majority of advances were made for one of four purposes: to fund MMH's investment in Antares; to fund MMH's investment in Oppenheimer; to fund MMI's expansion of the company's international operations; and to fund new investment vehicles and real estate ventures. The Commissioner did not offer any evidence or elicit any testimony challenging MMH's business needs for the funds advanced or that the funds were not used for their stated purposes.

5. Loan Payments

a. Payments of Interest

MMH paid all interest due in a timely manner and in cash. However, there were several instances during the period of late 1997 through 2001 where MMH borrowed additional amounts from

MMLIC to fund its interest payments ("Interest Advances"). In December 1997, a portion of a $42 million loan from MMLIC was used by MMH to pay interest. On December 17, 1998 (the same date the promissory notes were refinanced), MMH borrowed $16.5 million from MMLIC to pay a portion of the accrued interest due at that time. On that date, MMLIC and MMH also entered into a revolving credit facility with a face amount of approximately $31.3 million. That credit facility was drawn down by MMH in each quarter of 1999 and the funds were used to make payments of interest due to MMLIC and MMBMI: $11.5 million for the first and second quarters, and approximately $13.3 million in the third quarter. For the fourth quarter of 1999, MMH borrowed $15 million from MMLIC to use for the payment of interest to MMLIC and MMBMI. On June 30, 2000, MMH borrowed approximately $21.5 million in order to make payments of interest to MMLIC and MMBMI for the second quarter of the year 2000. Finally, on September 14, 2001, MMH borrowed $25 million to make interest payments to MMLIC and MMBMI for the third quarter of 2001.

All of the Interest Advances were documented by promissory notes with terms similar to the other MMH Notes. No interest was ever forgiven. Mr. Lynch testified that during the period that the Interest Advances were made, MMH was experiencing exponential expansion in its business. MMH's portfolio of investment fund subsidiaries like Oppenheimer, Babson, and

Antares, which were acknowledged by both parties to be "homerun" investments, experienced large-scale growth in the late 1990s and early 2000s. According to financial records offered into evidence, during the period of 1998 through 2001, MMH and its subsidiaries' consolidated EBITDA doubled from approximately $321 million to $641 million and total consolidated assets increased twelve-fold from $1.1 billion to $12.1 billion.

During this period, the consolidated EBITDA of MMH and its subsidiaries consistently amounted to five to six times the amount of MMH's interest obligations. Mr. Lynch testified that MMLIC believed it to be prudent for cash to remain at MMH to fund the growth of its subsidiaries rather than to be used to pay interest and therefore extended additional credit to MMH. The Board found credible Mr. Lynch's testimony that MMH's borrowing of further sums to service its debt was not due to insolvency, an inability, or absence of intent to pay, but to allow its existing cash to fund its expansion and found that his testimony was supported by the financial statement data for the relevant periods.

b. Payments of Principal

MMH did not make any payments of principal on the MMH Notes which were issued from 1993 until they were refinanced in 1998. MMH recognized significant proceeds from the sale of Antares, one of its most profitable subsidiaries, in 2005. On December

1, 2005, MMH made a number of repayments of principal to retire debt facilities related to the Antares investment. MMH made a principal payment of $145.9 million, including a repayment of the $140 million of loans that had originally been made to fund MMH's acquisition of its interest in Antares. MMH also used $29.9 million of Antares sale proceeds to repay the portion of the Interest Advances which were attributable to interest on the Antares loans that were retired on December 1, 2005. On July 14, 2006, MMH repaid a loan of $15 million that had been made in 2001 to provide seed funding for a mutual fund managed by one of its subsidiaries, after that fund had been closed out. The remaining debt of approximately $1 billion was refinanced at maturity in 2008.

V. Expert Witness Testimony

1. Neil Winward

The appellant offered the testimony of Neil Winward as an expert witness in credit markets. Mr. Winward is currently a Managing Director at EA Markets, but spent most of his over thirty year career at Dresdner Kleinwort, a large British-based investment bank, where he eventually became its co-head of global capital markets. Mr. Winward testified that "capital markets" refers to the various sources of funding and credit available to borrowers, which in addition to commercial banks, includes investment banks, insurance companies, and hedge funds.

In addition to participating in credit committees overseeing the direct extension of credit by Dresdner Kleinwort, Mr. Winward's work was focused in a number of areas of finance, including private debt placements, transactions where corporations received debt funding from institutional investors like insurance companies, and lending to financial services companies and asset managers. Mr. Winward testified that he was very familiar with the evaluation processes used by credit rating agencies, having regularly worked with them in the context of debt offerings.

Mr. Winward was engaged by the appellant to evaluate three things: (1) the creditworthiness of MMH; (2) the reasonableness of the terms on which MMLIC extended credit to MMH; and (3) whether that credit would have been available in the credit markets generally. Mr. Winward reviewed the reports which had been compiled by Fitch as part of its ratings process and also performed a similar analysis for the years prior to when MMLIC engaged Fitch. Mr. Winward reviewed the underlying loan documents and spoke at length with MMLIC personnel to understand the approval process and flow of funds between MMLIC and MMH, opining that MMLIC did a "very, very competent job of handling [the MMH Notes] as if it were a third-party lender." Mr. Winward also examined the use of the proceeds for the MMH Notes. Like Fitch, Mr. Winward looked to the various ratios indicative of financial strength, solvency and ability to service debt. He concluded that the MMH Notes were investment-grade debt and that to a prospective lender, "these financial ratios would suggest that [MMH] would be a very eligible borrower for those investment dollars."

Mr. Winward highlighted two of the ratios that had also been used by Fitch: the interest coverage ratio, which measured MMH's available earnings to pay its interest obligations, and the debt to EBITDA ratio, which measured MMH's total debt relative to its available earnings. The other ratios used by Fitch looked to the total equity value and market value of MMH if it were sold or liquidated, as opposed to the level of current earnings. Like Fitch, Mr. Winward testified that he based his analysis on the overall financial situation of MMH during the periods at issue and therefore, the value of an isolated ratio did not alter his conclusion that MMH was a creditworthy borrower.

With respect MMLIC's additional loans to MMH for the payment of interest and that most of the debt was refinanced, Mr. Winward testified that:

> [G]enerally speaking, the extension of credit to pay interest is not particularly unusual. Nor is it unusual to find refinancings of credit. In fact, as borrowers grow, it would be typical to see if there was a target amount of debt in the capital structure. As the company

> is growing, you would expect to see the debt growing over time.

Mr. Winward further explained why refinancing of loan balances is common for large, growing corporations that have a "permanent financing need," as opposed to borrowers that need credit for a specific project or to acquire a specific asset:

> Q. Given that, sir, would you expect that over time companies would repay all of their loans?
>
> A. I think it really depends on the nature of the loan in question. If the loan is very heavily tied to a particular set of assets... [such as] project financing, I would expect that the cash flows from that specific set of assets ought to be able to repay the debt in its entirety over a particular period of time depending on the projection of cash flow from those assets and the general life of those assets. In terms of a company who has an on-going permanent financing need and that company is growing then I would expect there to be a growing level of debt. And I would expect that maturities of a particular debt issuance would serve the purpose of providing to lenders a key measurement point of the company's creditworthiness. If you get to the end of a five year loan and the company says I'm supposed to pay this loan back but I actually need to continue to borrow because my business is growing, then the lender whose interest always in business is to be in the business of lending and extending credit, would generally speaking say let me look at the credit criteria to use to determine your creditworthiness. And if those criteria are consistent with what they have been and what [a lender] would expect for a particular credit quality, [a lender] would be delighted to continue to extend credit.

Mr. Winward also compiled a summary listing of examples of publicly traded corporations that issued non-amortizing debt with similar year terms to the MMH Notes during the periods at issue.

Finally, Mr. Winward analyzed the interest rates to which the MMH Notes were subject. The rates were based on the long-term or mid-term AFR, which Mr. Winward opined was a common and suitable index for notes of maturities similar to the MMH Notes. Above the AFR base-rate, the MMH Notes provided for a "spread" of additional interest, which Mr. Winward concluded, based on his examination of the historical interest rate spread of similarly rated borrowers, was reasonably in line with market rates.

Given Mr. Winward's extensive background with lenders and borrowers with the size and complexity of MMLIC and MMH, in all areas of the credit markets, the Board found that his testimony was highly credible regarding MMH's creditworthiness and the prevalence of refinancing to repay principal when a borrower remains creditworthy. The Board also found his testimony credible that an isolated number of additional borrowings for interest, making up less than 10 percent of total borrowings, would not lead to a lender finding that the borrower was no longer creditworthy when the borrower's overall financial position indicated that it was.

2. Vaughn Pearson

The Commissioner offered the testimony of Vaughn Pearson as a rebuttal witness. Mr. Pearson had a twenty-five year career as a commercial banker and served for five years as a supervisor for troubled banks for the Texas Department of Banking, prior to his current employment as a consultant to commercial banks. The Board qualified him as an expert in commercial banking and lending practices. During his career, Mr. Pearson specialized in "middle market" lending, which he defined as commercial loans ranging from $100,000 to $50 million, with most of his experience falling towards the lower end of that spectrum. Apart from a small number of occasions where he was involved with loans made to community bank holding companies, Mr. Pearson testified that he had no experience with financial institution lending. He similarly testified that he had no experience with private placement debt, the type of debt typically held by insurance companies, and had no experience in working with credit-rating agencies to evaluate debt.

Mr. Pearson testified that he did not believe a commercial bank would have made loans to MMH on the same terms as contained in the MMH Notes, pointing specifically to the ten-year maturity, the non-amortizing principal, and the fact that additional loans were made for interest payments. However, he specified on multiple occasions that his opinion was limited to the credit decision-making process of a hypothetical commercial bank. Mr. Pearson recognized the difference inherent between commercial banks, which have stricter capital requirements, and other types of lenders. For example, when confronted with the real-life example of a public debt issuance of twenty-year, non-amortizing bonds with interest due at maturity to fund the construction of a baseball stadium, Mr. Pearson stated that while that debt would automatically be treated as a "problem asset" if held on the books of a commercial bank due to the lack of current interest payments, that would not be the case with the bonds, "because of who the lender [was]." In other words, Mr. Pearson recognized that the characteristics of a loan that could be problematic from the perspective of a commercial banker could be perfectly reasonable, depending on whom the lender was. Mr. Pearson could not and did not opine whether MMH would have been able to obtain the credit at issue in these appeals in other areas of the credit markets outside of a commercial bank, such as debt held by insurance companies, admitting that he "[could not] address the credit markets."

Accordingly, the Board found the testimony of Vaughn Pearson to be of virtually no probative value. Mr. Pearson's experience was limited to middle-market commercial lending, which was often project specific. Mr. Pearson had no relevant experience with the type of debt held by insurance companies, lending to financial services companies, or advances of the size and scope of those at issue. Therefore, the Board afforded his opinions little to no weight in determining whether the MMH Notes constituted *bona fide* debt.

VI. Tax Treatment of MMH Notes

1. Federal Tax Treatment

MMLIC and its subsidiaries file a consolidated life insurance and non-life insurance return for federal income tax purposes. Pursuant to Treas. Reg. § 1.1502-47, certain intercompany transactions, including the payment of interest from one member of the consolidated group to another, are eliminated in consolidation. Accordingly, the loans between MMLIC and MMH generally had no effect for federal income tax purposes. Since 1998, the members of the federal consolidated group have been party to a tax allocation agreement ("MMLIC Tax Allocation Agreement"), whereby members that generated losses are compensated for the deemed "use" of those losses by profitable members of the group. The MMLIC Tax Allocation Agreement had no impact whatsoever on the group's ultimate tax liability to the relevant taxing authority; it merely served to allow the various members of the group to account for their proper share of the consolidated group's liability among themselves.

Effective July 1, 2004, MMH converted to an LLC. Subsequent to the conversion, MMH has been treated as an entity disregarded as separate from its owner, MMLIC, which thereafter recognized all of MMH's income and expenses as if it had earned or incurred them directly. *See* Treas. Reg. § 301.7701-2. MMH continues to be treated as a separate entity for purposes of the MMLIC Tax Allocation Agreement.

2. Massachusetts Tax Treatment

In 1993, when the original decision was made for MMLIC to loan funds to MMH, the debt had no benefit for Massachusetts tax purposes - - in fact it was detrimental. In 1993, MMLIC, as a life insurance company, was subject to the tax on premiums that it is still subject to today, but was also subject to a tax on its investment income at a rate of 14%. *See* G.L. c. 63, § 22B. MMH was classified at the time as a security corporation, meaning that it paid an unapportioned tax on its total revenue, not the taxable income after deductions on which general business corporations pay tax. *See* G.L. c. 63, § 38B. As a result, MMH paid interest, which it was not able to deduct, to MMLIC, which was taxed at a rate of 14% thereon.

Security corporations are required to file on a separate company basis, *see* G.L. c. 63, § 32B, while MMH's subsidiaries filed together as a combined group of general business corporations. In 1998, MMH elected to revoke its classification as a security corporation. At that point, it was required to file with its subsidiaries as part of the MassMutual Combined Group and its current year apportioned losses became available to offset the current year apportioned income of other group members. *See* G.L. c. 63, § 32B (1998). Also in 1998, the Legislature passed legislation to phase out the tax on the investment income of insurance companies over a five-year period ending in 2003. Stat. 1998, c. 259, § 2(c)(1). As a result of the Legislature's action and MMH's revocation of its election, MMH was able to share its current year losses with its profitable subsidiaries and MMLIC was no longer fully subject to tax on the interest income. Despite this favorable change, in 1998 and 1999, MMLIC transferred $263.1 million of notes it received in the December 17, 1998 refinancing to MMBMI, a general business corporation, which <u>was</u> subject to tax on its interest income and which had an apportionment factor in Massachusetts that ranged from a high of 98% to 91% during the periods at issue. By the end of 1998, MMLIC had already issued approximately half of the debt it would issue to MMH through 2002.

MMH continued to fund its own subsidiaries with equity contributions, even though its operating subsidiaries could have been able to benefit from the deduction of interest for Massachusetts tax purposes (as well as in any other states in which they did business that required filing on a separate company basis) if those funds had instead been loaned.[12] Mr. Carlson testified that MMLIC did not consider modifying the capital structure of any of MMH's subsidiaries as it was only MMLIC to which the RBC framework applied.

In 2004, MMH became an entity disregarded for tax purposes as separate from its owner, an event which had three major effects on the Massachusetts tax treatment of its intercompany debt: (1) MMH became effectively a division of MMLIC, meaning that, for tax purposes, any payments of interest by MMH to MMLIC were eliminated; (2) all of the activity of MMH was reported as if it were engaged in directly by MMLIC; and (3) MMH surrendered any net operating loss carryover it had generated prior to conversion to an LLC, pursuant to G.L. c. 63, § 30(11). Because MMLIC was taxed on its gross premiums without any deductions, any interest paid to MMBMI was still subject to tax in Massachusetts with no offsetting deduction. Yet, despite this, the appellants kept the MMH Notes in place long after they ceased to have any tax benefit, and in the case of the loans transferred to MMBMI - - which were not challenged by the Commissioner - - continued to have a tax detriment.

[12] While MMH would not have been permitted to hold intercompany loans as an asset while classified as a security corporation, *see* G.L. c. 63, § 38B, it would have been able to do so after it revoked its security corporation designation in 1998. This would have allowed an interest deduction at the operating subsidiary level in determining pre-apportioned income.

The conversion of MMH to an LLC was done as part of a larger transaction where several of MMH's operating subsidiaries were also converted to LLCs. Because MMH and its converted subsidiaries were, as a result, all treated as divisions of MMLIC for tax purposes, the operating profits of the converted subsidiaries were treated as being realized directly by MMLIC. Because MMLIC was taxed only on insurance premiums it received, those operating profits were not subject to tax in Massachusetts.[13] The Commissioner points to this impact of the conversion transaction as indicative that the appellants were motivated by tax avoidance. However, the conversion was entirely unrelated to the deduction of interest on the MMH Notes, which was then eliminated in consolidation. The conversion effectively ended any tax benefit of the MMH Notes. Despite this, even after the interest ceased to be deductible after the conversion, MMLIC did not forgive the debt, nor did MMH stop paying interest.

As MMLIC began issuing loans to MMH at a time when it was detrimental from a tax perspective to do so and continued to respect those loans long after the conversion of MMH ended any tax benefit they eventually did create, the Board found and ruled that the issuances of the MMH Notes were not motivated by a desire to avoid tax.

[13] This benefit was offset by the fact that the losses generated by MMH were no longer available. *See* 830 CMR 63.30.2(11).

6. Net Operating Loss

MML carried a net operating loss ("NOL") forward into the tax year ended December 31, 2003, and incurred additional losses on a separate company basis for the years ended December 31, 2003 and 2004. Under the rules then applicable to combined filing groups, each member of a combined group was required to first use any NOLs to offset its separate company income, but any excess could be used to offset a portion of the income of other group members. G.L. c. 63, §32B (2003). Because MML incurred a loss for the 2003 and 2004 tax years, as did the MassMutual Combined Group, MML was able to carry over its NOL to the tax year ended December 31, 2005, when it was fully utilized against MML's separate company income.

When the interest deductions of MMH were disallowed, it caused MMH's income to increase. As part of the adjustments made by the Commissioner, the auditor reflected a portion of MML's NOL carryforward in his workpapers as having been used to offset this additional income of MMH. Under this recasting of income, none of MML's NOL carryforward was available to be used for the year ended December 31, 2005. The appellants are seeking a refund of the tax on the income which would have been offset by the NOL. If MMH were permitted to fully deduct the interest paid to MMLIC for the tax years ended December 31, 2003 and 2004, MML would have been able to fully benefit its NOL in 2005.

VII. Summary of Findings

Based on the testimony and exhibits and reasonable inferences drawn therefrom, the Board found and ruled that: (1) the amounts advanced to MMH were used for the valid business purposes of funding and expanding the operations of its subsidiaries; (2) in advancing the funds in the form of loans instead of equity, MMLIC was motivated by regulatory concerns, not by a desire to avoid tax; and (3) the MMH Notes constituted *bona fide* indebtedness with economic substance. Accordingly, the Board found and ruled that the interest paid pursuant to the MMH Notes was fully deductible for Massachusetts tax purposes. Additionally, as the Board found and ruled that income of MMH was improperly adjusted, the Board found and ruled the NOL carryover of MML was similarly improperly adjusted and should have been fully available for use in the tax year ended December 31, 2005.

Accordingly, the Board issued a decision on May 19, 2015 for the appellants granting an abatement in the amount of $3,197,686, including the $119,140 of penalties assessed, plus interest, for the tax year ended December 31, 2003. The Board has issued a decision, concurrently with the promulgation of these finding of fact and report, for the appellants granting an abatement $3,506,222 for the tax year ended December 31, 2004, plus interest, and in accordance with the Board's Order under

831 CMR 1.33, granting a refund in the amount of $1,236,022, plus interest, for the tax year ended December 31, 2005.

OPINION

General Laws c. 63, § 30 defines a corporation's net income as gross income, less the deductions, but not credits allowed under the Internal Revenue Code, which would include the deduction of "all interest paid or accrued within the taxable year on indebtedness," under I.R.C. § 163. In order for a transaction to give rise to a valid interest deduction, the transaction must constitute true indebtedness. ***National Grid Holdings, Inc. v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 2014-357, 397 ("***National Grid***"); ***Sysco Corporation v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 2011-918, 940. The hallmarks of whether an advance is *bona fide* indebtedness for tax purposes are: (1) whether the advance satisfies the core definition of debt; and (2) whether the conduct of the parties was consistent with that of a debtor and creditor, based on various factors. *See* ***Overnite Transportation Company v. Commissioner of Revenue,*** 54 Mass. App. Ct. 180, 186 (2002) ("***Overnite***").

I. The MMH Notes Satisfy the Core Definition of Debt

By the "core definition" of indebtedness adopted by the Massachusetts Appeals Court in ***Overnite,*** debt is "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage of interest payable regardless of the debtor's income or lack thereof." ***Id.***

By the express terms of the MMH Notes, each required an obligation to repay a sum certain at a fixed maturity date with a fixed percentage of interest and the repayment was not contingent on MMH's income. Therefore, the Board found and ruled that the MMH Notes fulfill the essential requirements to qualify as debt under that core definition.

II. THE CONDUCT OF THE PARTIES WAS CONSISTENT WITH A DEBTOR-CREDITOR RELATIONSHIP

"In pursuit of the question whether the note was true debt, there is need to consider not only the text but the circumstances of issuance and performance." ***Id.*** The Board found and ruled that the MMH Notes were unambiguous and on their face evidenced an intent between the parties to create a debt. Nevertheless, the issue is "whether the intent and acts of these parties should be disregarded in characterizing the transaction for ... tax purposes." ***Kraft Foods Company v. Commissioner of Internal Revenue***, 232 F.2d 118, 123 (2nd Cir. 1956). The Board recently decided ***National Grid***, the latest in the line of "numerous cases in Massachusetts that address[ed] the debt/equity dichotomy." ***National Grid***, Mass. ATB Findings of Fact and Reports at 2014-406. The Board noted that there are a number of multifactor tests which courts have used to determine whether an advance is properly treated as debt or equity as part of an analysis where no one factor is decisive and all factors are weighed in light of the particular circumstances of each case. ***Id.*** at 2014-407-9. While generally these multifactor tests cover similar ground, the Board in ***Overnite*** cited to the sixteen-factor test adopted by the Third Circuit in ***Fin Hay Realty Co. v. Commissioner of Internal Revenue***, 398 F.2d 694, 696 (3d Cir. 1968) ("***Fin Hay***") which looks to:

> (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the 'thinness' of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.

Overnite, Mass. ATB Findings of Fact and Reports at 1999-372. After considering each of the above factors, the Board found and ruled that the relationship between MMLIC and MMH was consistent with that of creditor and debtor and that the underlying MMH Notes constituted debt for Massachusetts tax purposes.

A. The MMH Loans Were Issued Pursuant to a Compelling Non-Tax Business Purpose and Were Intended to Create a Debt (Factors 1-3)

The first three of the factors look to the intent of the parties, the relationship between them, and the participation by the lender in the management of the borrower. Substantial and uncontroverted evidence led the Board to find that the decision in 1993 to capitalize MMH with both debt and equity was motivated by a desire to improve the RBC score of MMLIC, a consideration the Board found was central to the appellants' business. The Commissioner argued that the fact that the appellants were acting in furtherance of a business purpose unrelated to taxes is irrelevant to whether the MMH Notes constitute *bona fide* debt. While the fact that a taxpayer has a business purpose for entering into a loan agreement is not, standing alone, dispositive as to whether that loan agreement should be treated as debt for tax purposes, the Board found and ruled that it certainly has relevance in providing insight into the intent of the parties. In order to receive the RBC score it desired, MMLIC needed to ensure that its debt receivables from MMH were categorized as at least a Class 2 asset in the RBC classification framework, as governed by the NAIC. To achieve that classification, the appellants needed to receive a BBB- or better rating from a rating agency, meaning that the debt was "investment grade." Therefore, MMLIC intended the advances to be debt, not just for tax purposes, but more importantly for regulatory purposes. MMLIC reported its advances to MMH as debt on its financial statements and with its yearly filings with insurance regulators. Accordingly, the Board found and ruled that the intent of the parties supported a characterization of the MMH Loans as debt.[14]

The second and third factors consider the ownership of the debtor by the creditor and the creditor's participation in management. While it may not be presumed that a note between a subsidiary and its controlling parent is "automatically disqualified" as a debt, the "self-dealing involved calls for close scrutiny." ***Overnite***, 54 Mass. App. Ct. at 186 (citing ***Kraft Foods Co.***, 232 F.2d at 123-124); ***Fin Hay***, 398 F.2d at 697.

[14] The appellants argue that the Board is compelled to "respect the form adopted by the parties" and treat the MMH Notes as debt because they were reported as such on MMLIC's regulatory filings. As support, they cite to ***Frank Lyon Co. v. United States***, 435 U.S. 561 (1978), where a taxpayer was entitled to certain depreciation deductions in property it did not have total ownership of, where the ownership structure was driven by regulatory concerns and publicly disclosed on financial statements. The Board has previously made clear that the way in which a transaction was treated on a taxpayer's financial statements or other filings does not control whether the result will be treated as debt or equity for Massachusetts tax purposes. *See* ***New York Times Sales, Inc. v. Commissioner of Revenue,*** 40 Mass. App. Ct. 749, 753; ***National Grid***, Mass. ATB Findings of Fact and Reports at 2014-417. Indeed, the factors which the Supreme Court outlined in ***Frank Lyon Co.*** as determinative of whether a transaction's form should be respected, including, *inter alia*, the existence of a business purpose, whether the transaction had economic substance, and whether the transaction was on arm's-length terms, are generally the same as those which the Board considers in the debt-equity context. *See* ***Frank Lyon Co.***, 435 U.S. at 583-4; ***Newman v. Commissioner of Internal Revenue,*** 902 F.2d 159, 163 (1990).

MMLIC was the sole shareholder of MMH during the periods at issue and was in a position to direct the management of its operations. However, a "sole stockholder can be, and can enforce the rights of a creditor," ***Kraft Foods Co.***, 232 F.2d at 124, and a transaction "cannot be disregarded for tax purposes merely because of the presence of a parent-subsidiary relation." ***Id.*** at 126. Therefore, the Board found that the second and third factors of the identity of interest between MMLIC and MMH and its management were neutral. *See* ***Pepsico Puerto Rico, Inc. v. Commissioner of Internal Revenue***, T.C. Memo 2012-269, 2012 Tax Ct. Memo LEXIS 270, **99-**100 (holding that second and third factors were neutral in debt between a parent and wholly-owned subsidiary); ***NA General Partnership v. Commissioner of Internal Revenue***, T.C. Memo 2012-172, 2012 Tax Ct. Memo LEXIS 172, *23 (same).

B. MMH Was a Credit-Worthy Borrower, Consistent With Credible to Formal Analysis by MMLIC Personnel and Third-Party Experts (Factors 4-6)

The fourth factor, the ability of the corporation to obtain funds from outside sources, considers whether the debtor was actually worthy of the credit which was extended. Generally, this consideration has previously taken the form of querying whether "an outside investor [would] have advanced funds on terms similar to those agreed to by the shareholder." ***Scriptomatic, Inc. v. United States***, 555 F.2d 364, 368 (3rd Cir.

1977). The fifth and sixth factors also look to the creditworthiness of the borrower in terms of the likelihood of repayment.

1. **Because MMLIC Is a Third-Party Lender Active in the Credit Markets With a Lending Model Different Than a Commercial Bank, Comparisons to Commercial Bank Lending are Irrelevant**

The Commissioner called Vaughn Pearson as an expert witness in commercial banking, with a background in middle-market lending, to testify at length as to whether a commercial bank would have made the MMH Loans on similar terms. The Commissioner urged the Board to find that the considerations of a commercial banker are the only relevant benchmarks to judge whether a hypothetical third-party lender would have made the MMH loans. This supposition, however, ignores the fact that the credit markets extend well beyond commercial banking. MMLIC itself is a third-party lender which holds debt receivables in the billions of dollars. Extending credit through the purchase of bonds or other private debt placements is a core part of MMLIC's business, because, as a mutual insurance company, it must invest the premiums it receives in order to secure a return for its policy holders.

As Mr. Pearson himself testified, commercial banks have different lending objectives and capital reserve requirements than insurance companies do, which Mr. Lynch testified need to hedge long-term liabilities with long-term income producing assets. Therefore, the Board found and ruled that the proper standard should be to look to whether MMH would have been able to obtain similar credit from the credit markets as a whole, especially from a life insurance company like MMLIC. Consequently, the Board found and ruled that Mr. Pearson's opinions relative to commercial banking were largely irrelevant. *See* ***National Grid***, Mass. ATB Findings of Fact and Reports at 2014-392 (Board found and ruled that the testimony of a commercial lending expert was of "limited probative value," given his lack of experience and inability to render an opinion regarding the wider credit market as a whole).

2. The MMH Loans Were Rated as BBB Investment Grade Debt and MMH Continued to Be a Credit-worthy Borrower With Sufficient Cash and Assets to Service Its Debts

The quintessential example of an intercompany borrower receiving advances that a third-party lender would never make is ***Overnite***. In 1986, Union Pacific Corporation ("Union Pacific") acquired the stock of Overnite Transportation Company ("Overnite") for a total cost of $1.2 billion. ***Overnite***, 54 Mass. App. Ct. at 181. This purchase price included a goodwill premium on the approximately $300 million of assets held on Overnite's balance sheet at the time of acquisition. ***Id***. Because purchase accounting rules required Overnite to write up the assets on its balance sheet to reflect that goodwill, its taxable net worth was correspondingly increased. ***Id.*** In 1988, Overnite declared a $600 million note payable with a ten-year term as a dividend to Overnite Holding, Inc., a newly created subsidiary of Union Pacific to which it had contributed its interest in Overnite. ***Id.*** at 181-182. Although income projections performed by Overnite in 1987 for 1988 through 1997 predicted that it would be able to service the related interest, these projections proved wildly optimistic and, as a result, Overnite was in arrears on its payments from the beginning. ***Id.*** at 184. At the time the notes came due in 1998, Overnite was approximately $96 million in arrears on the approximately $492 million of interest which had accrued over the life of the loan. ***Id.*** Overnite Holding, Inc. forgave this shortfall along with $400 million of the principal, issuing a new note for $200 million. ***Id.*** The Appeals Court, affirming the Board's decision that the dividend note was not properly treated as debt for tax purposes, found that due to Overnite's history of erratic payments and the "long-foreseeable risk of non-repayment" on a note originally made for twice the amount of Overnite's tangible assets, there was no reasonable expectation of repayment. ***Id.*** at 189-190.

The Board found that, unlike Overnite, MMH was a credit-worthy borrower with sufficient revenue and assets to service its debt to MMLIC. MMH made every payment required under the MMH Notes in a timely manner. It made payments of principal ahead of schedule on debt related to its holding in Antares when it sold that asset. MMH was a holding company with consolidated assets worth billions of dollars during the periods at issue and consistently reported consolidated EBITDA of five to six times the interest burden on the MMH notes. The Commissioner asserted that it was incorrect for Fitch and Neil Winward to use the consolidated financial statements of MMH and its subsidiaries to analyze whether MMH was creditworthy because the subsidiaries were "not on the hook" as guarantors for the liabilities and thus it was "absurd" to look to whether MMH could service its debt based on the cash flow of its subsidiaries. MMH is a holding company. Because MMH does not have any operations, all of the cash used to service its debts came from the operations of its subsidiaries. Therefore, it did not matter whether its subsidiaries officially acted as guarantors of the MMH notes - - the assets and cash flow of those subsidiaries could generally be marshalled to fulfill MMH's obligations.[15] Therefore, the Board agreed with the appellants' expert that looking to the consolidated financials of MMH and its subsidiaries was the only sensible measure of MMH's true assets and earnings and the level

[15] A limitation on the amount of dividends which could be issued by Oppenheimer did exist until 2000.

of debt which it could sustain. Indeed, the Board found and ruled that for a lender to look only at a holding company's separate company financial statements in this context is the measure which would be absurd.

3. The Fact that the MMH Notes Had Seven to Ten-year Terms and Were Non-Amortizing was Not Inconsistent With A Debtor-Creditor Relationship

The Commissioner and her expert argued that a commercial bank would not issue ten-year, non-amortizing notes where the principal was paid through refinancing. While Mr. Pearson could hypothetically be correct that a middle market commercial bank might not extend credit with a ten-year term, MMLIC routinely did. In 1998, the year in which the MMH Notes were refinanced, 59% of the third-party bonds held by MMLIC were for five years or longer, with 18% of its bonds holdings having ten-year or longer maturities. As Mr. Lynch and Mr. Winward testified credibly, because MMLIC's insurance policies are by nature intended to be long-term obligations, the company has a preference for long-term assets which can generate income over a long period to offset those obligations. Thus, the Board found whether the loan term was consistent with that of a commercial bank loan is irrelevant as MMLIC did in fact hold debt obligations with similar terms from third parties.

The Commissioner further argued that the MMH Notes were not *bona fide* debt because they did not call for the amortization of principal and no lender would have made loans on similar terms. The fact that principal is payable on demand at a fixed future date and not required to be amortized does not mean that it is any less of an enforceable debt obligation. *See* ***Kraft Foods Co.,*** 232 F.2d at 121-124 (holding non-amortizing debentures between a parent and subsidiary to be *bona fide* debt). Similarly, "[c]orporate debt does not become equity because it is contemplated that principal will be retired by refinancing." ***Fin Hay,*** 398 F.2d at 703. As Neil Winward credibly testified, the maturity date of a debt issuance can serve as "a key measurement point of the [borrower's] creditworthiness" to decide whether to further extend credit. Unlike the lender in ***Overnite*** who let payment date after payment date pass without receiving full payment and appears to have done limited diligence regarding Overnite's ability to pay, MMLIC personal closely monitored the debt obligations of MMH and from the inception of the loans engaged impartial third-party experts in rating debt securities, the SVO and Fitch, to help evaluate the risk and quality of the loans.

Similarly, the instant appeals are wholly distinguishable from ***The TJX Companies, Inc. v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 2007-790, where the Board found that purported advances from a subsidiary to a parent which were continually "rolled over" were not *bona fide* debt. As part of what the Board found and ruled to be a scheme to avoid tax, The TJX Companies, Inc. ("TJX") paid so-called royalties to a newly created subsidiary to which it had assigned its trademarks for the rights to continue to use them in TJX's retail business. ***Id.*** at 2007-842. In an apparent effort to return the cash from the royalty payments to TJX, the subsidiary made "loans," amounting to approximately 90% of its income each year, to TJX. ***Id.*** at 2007-822-3. These loans were routinely rolled over into new notes at maturity. ***Id.*** Unlike MMLIC, which the Board found took diligent care to document and regularly evaluate its debt with MMH, including the decision to refinance the existing debt in 1998, TJX's subsidiary simply made advances on demand, sometimes without written promissory notes. ***Id.*** While TJX's subsidiary advanced to its parent almost all of its income, the source of which were sham royalties driven by a desire to avoid Massachusetts tax, MMLIC advanced funds to MMH to help the latter further the growth of its businesses, in a manner which was driven by a desire to improve MMLIC's RBC score. This lack of economic substance stands in stark contrast to the refinancing of the MMH Notes. Thus, the Board found and ruled that the MMH Notes were *bona fide* debt, notwithstanding the fact that they were refinanced at maturity.

4. The Fact that MMH Borrowed Further to Make Interest Payments Is Not Inconsistent With A Debtor-Creditor Relationship as MMH Remained Creditworthy

The Commissioner argued that the seven occasions between 1998 and 2001 on which MMH borrowed further from MMLIC to pay interest it owed on earlier loans are evidence that MMH was not able to meet its obligations. Moreover, the Commissioner's expert asserted that a commercial lender would never make further advances to allow a borrower to pay interest in these circumstances. As the Tax Court has previously held, "an advance from a parent corporation to its subsidiary may be characterized as a debt even though the parent makes subsequent readvances to cover interest on the initial advance." ***NA General Partnership***, 2012 Tax Ct. Memo LEXIS 172 at *29 (citing ***Litton Business Systems, Inc. v. Commissioner of Internal Revenue***, 61 T.C. at 380). The Board found and ruled that the Interest Advances, which were formally documented as separate loans, should be subject to the same analysis as the other MMH Notes.

The Board found that Mr. Lynch testified credibly, supported by the financial data in evidence, that the period from 1998 to 2001 was a period of expansive growth for MMH and there was a need for MMH to retain the cash on hand to invest in its business. As opposed to Overnite, which was unable to pay its interest obligations due to a downturn in business operations, the record showed that MMH could have produced the cash to service the debt when due, but not without disruption to its subsidiaries' businesses. The Commissioner seemed concurrently to point to the fact that MMH received advances to pay its interest as indicative that MMH was not able to meet its obligations, while noting that there was sufficient consolidated cash held by MMH and its subsidiaries that it could have "forced" a dividend to pay the interest but chose not to. The Board found that Mr. Lynch testified credibly that a decision was made by MMLIC that, instead of forcing MMH's subsidiaries to pay a cash dividend, the cash was better served growing the "homerun" investments in its business and that MMH was sufficiently healthy to take on additional borrowings to enable that to happen. Because, according to the financial data, the Fitch ratings, and the credible testimony of Mr. Winward, MMH remained credit-worthy relative to the level of additional debt it sought to borrow and there was an unconditional obligation to repay, the Board found that the Interest Advances did not affect the characterization of the other MMH Notes as *bona fide* debt.

5. The Fact that the MMH Notes Were Convertible to Equity is Not Inconsistent With A Debtor-Creditor Relationship

MMH Notes that were drafted in 1996 or later each contained a provision that granted MMLIC the option to convert them into an equity interest in MMH. MMLIC has always been the sole owner of MMH; therefore, if MMLIC did exercise its convertible option, it would only receive more shares in a corporation that it already owned. The Commissioner and her expert witness, Mr. Pearson, argued that no third-party lender who already owned 100% of the stock of a borrower would include such a provision, as there would have been no value in the right to additional equity in a wholly owned corporation. However, this ignores transactional and legal considerations which a corporate parent might have for convertible debt with its subsidiary, which may not be present between a bank and outside borrower. For example, this type of provision could be included in case of the possibility of a future sale of the debtor-subsidiary to a third-party where the debt could be converted and sold to the purchaser as part of the transaction, as opposed to leaving the debt in place after the sale. The MMH Notes were never converted to equity nor did the evidence reflect any plan to ever convert them. The fact that a debt instrument includes a convertibility clause does not necessarily indicate any intention between the parties to treat the instrument as equity.

Based on the relative financial position of MMH at all relevant points in time as reflected in the Fitch Reports and the credible testimony of Mr. Winward, the Board found and ruled that a third-party would have extended similar credit to MMH in the credit markets. Therefore, the Board found and ruled fourth, fifth, and sixth factors indicate the presence of debt.

C. The MMH Loans Were Evidenced by Binding Legal Agreements With Conventional Indicia of Debt Which Contained Sufficient Terms to Enforce Repayment (Factors 7-16)

The seventh factor looks to the presence of "formal indicia" of the arrangement. Each advance was memorialized in writing. As the Commissioner points out, these written documents were not without errors or omissions, such as a series of six notes showing the maturity date as the date of issue. However, the Board found and ruled that these isolated incidents did not indicate that MMLIC and MMH did not take the debtor-creditor relationship, or the underlying debt seriously. A mistaken date may be corrected to reflect the parties' manifest intent and the corrected note would remain enforceable. *See* ***Ames v. Colburn***, 77 Mass. 390, 391 (1858). The Board found and ruled that the parties clearly intended for all of the notes to have a maturity of ten years and the MMH Notes, if not uniformly perfect, evidenced an intent to create debt and were conventional in form. Therefore, the Board found and ruled that the seventh factor indicated the presence of debt.

The eighth and ninth factors consider the relative position of the lender to other creditors regarding the payment of interest and principal and the voting power of the debt instrument holder. Per a covenant contained in the MMH Notes, MMH was permitted to borrow only from MMLIC for debt with terms longer than one year. If a creditor's right to repayment is subordinated to that of other creditors, that fact supports an equity characterization. ***Hardman v. United States***, 827 F.2d 1409, 1413 (9th Cir. 1987); ***NA General Partnership***, 2012 Tax Ct. Memo LEXIS 172 at *23. MMLIC limited the ability of MMH to obtain funds from other lenders, which would support the fact that MMLIC intended to enforce its right as the first to be paid back. Therefore, the Board found and ruled that the eighth factor indicated the MMH Notes constituted debt. While the MMH Notes did not contain any voting power, unless the conversion option was exercised, by the nature of its ownership of MMH, MMLIC possessed all of the voting power. Accordingly, like MMLIC's level of participation in management, the Board found and ruled that this factor was neutral.

Factors ten through fifteen examine whether the following indicia of debt are present in the agreement between the parties: a fixed rate of interest (indicative of debt); a contingency on the obligation to repay (indicative of equity); the source of the interest payments (indicative of equity if the source is restricted); a fixed maturity date (indicative of debt); a provision for redemption by the corporation (indicative of debt); and a provision for redemption at the option of the holder (indicative of debt). The MMH Notes had a fixed rate of interest and maturity date, were payable without contingency or restriction on the source of payments, and were fully redeemable. Therefore, the Board found and ruled that factors ten through fifteen supported a finding of debt.

The final factor cited by ***Fin Hay,*** looks at the timing of the advance with reference to the organization of the corporation, where an advance at the commencement of a corporation's business would be more likely to come in the form of an equity investment, given the attendant risks, as opposed to an advance to an established business which has a prior record of achievement to support a loan. *See* ***Scriptomatic, Inc. v. United States***, 1973 U.S. Dist. LEXIS 10546, *34. At the time MMLIC made the advances to MMH, MMH had been in existence for almost ten years and was already the parent company of a number of successful businesses. Therefore, the Board found and ruled that this final factor was neutral as MMH was not a newly organized entity at the time the loans were made, if not arguably indicative of debt, given the solid track record of MMH's operating subsidiaries.

D. All Relevant Factors Considered Together Lead to a Finding that the MMH Notes Constituted *Bona Fide* Debt

"[N]either any single criterion nor any series of criteria can provide a conclusive answer in the kaleidoscopic circumstances which individual cases present" concerning the classification of an advance as debt or equity. ***Fin Hay***, 398 F.2d at 697. However, the Board found and ruled that each one of the sixteen factors cited by ***Fin Hay*** were either neutral or indicative of a creditor and debtor relationship between MMLIC and MMH with respect to the MMH Notes at issue.

III. THE MMH NOTES COME WITHIN THE EXCEPTION TO THE STATUTORY ADD-BACK REQUIREMENT FOR INTERCOMPANY INTEREST BECAUSE THEY WERE *BONA FIDE* DEBT, PRIMARILY MOTIVATED BY A VALID BUSINESS PURPOSE, AND SUPPORTED BY ECONOMIC SUBSTANCE

General Laws c. 63, § 31I ("Section 31I") provides that a taxpayer is required to add back otherwise deductible interest expenses and costs directly or indirectly paid, accrued, or incurred to a "related party." As MMLIC was the sole owner of MMH, the two entities met the definition of related parties for purposes of Section 31I. ***Id.*** However, otherwise deductible interest paid to a related party is nevertheless deductible for Massachusetts tax purposes if the taxpayer establishes by "clear and convincing evidence" that the disallowance of the deduction would be "unreasonable." G.L. c. 63, §§ 31I and 31J.[16] "Clear and convincing evidence" is that which is "so clear, direct and weighty that it will permit... a clear conviction without hesitancy of the validity of the taxpayer's claim." 830 CMR 63.31.1(2). An add-back of interest expense is considered

[16] Another exemption exists for certain interest deductions that have been subject to tax in other jurisdictions as income in the hands of the recipient, which the appellant also claimed was applicable. The Commissioner had allowed a small portion of the total interest deductions under this exemption on audit. However, because the Board found and ruled that all of the interest deductions at issue should qualify under the exemption for a situation where an add-back would be "unreasonable," the Board need not address other potentially applicable exemptions.

unreasonable where the taxpayer establishes by clear and convincing evidence that the expense: (1) was incurred as the result of a transaction that was primarily entered into for a valid business purpose; (2) was incurred as the result of a transaction which was supported by economic substance; (3) was incurred because of an underlying *bona fide* indebtedness; and (4) reflects fair value or consideration. 830 CMR 63.31.1(4)(a)(1)(b). A taxpayer will not have met this burden unless it can demonstrate that the reduction of tax was not a principal purpose for the transaction. ***Id.***

1. The MMH Notes Were Entered into for A Valid Business Purpose and Tax Avoidance was not a Principal Purpose for the Transaction

In order for an add-back to be deemed unreasonable, the interest expense must be the result of a debt which was entered into for a valid business purpose other than tax avoidance. ***Id.*** A "valid business purpose" in this context is a "good faith business purpose, other than tax avoidance, that was, either alone or in combination with one or more other good-faith business purposes, the primary motivation for entering into a transaction." 830 CMR 63.31.1(2). The Commissioner argued that even if MMLIC had a business purpose in extending the MMH Notes to improve MMLIC's own RBC score, MMH had no business purpose in borrowing the funds. The Commissioner presented no evidence and elicited no testimony to contradict the credible testimony of Mr. Lynch that MMH needed the capital that was advanced to support the rapid expansion of its subsidiaries' businesses. A wholly-owned subsidiary generally does not have a right to make demands regarding its capital structure - - this is the purview of its parent, which may advance funds outright through capital contributions or may require that those funds be repaid.

The Commissioner in her regulation governing the add back of intercompany interest, 830 CMR 63.31.1, provides an example of such an instance where an add back would be unreasonable:

> Ms. Victor, who is a resident of Massachusetts, is the president and sole owner of Wire Inc., a C corporation that owns several video stores and is only doing business in this state. To help fund expansion of the business, Ms. Victor makes a loan of $100,000 to Wire Corp. on arm's-length terms, and Wire Inc. executes a ten-year note reflecting these terms. Funding the business expansion appears to be the sole purpose for the loan and the transaction does not appear to have been entered into for tax avoidance purposes. There are no other circumstances suggesting that the loan should be re-characterized as a capital contribution, and also the required payments generally are made timely. The Commissioner will not add back the interest expense incurred by Wire Inc. because disallowing the deduction would be unreasonable in these circumstances... In the seventh year of the loan, Ms. Victor turns over day-to-day management of Wire Corp. to her son and retires to Florida, where she establishes her exclusive tax domicile. Even though Florida imposes no personal income tax, the Commissioner will not add back the interest expense incurred by Wire Inc. for the years after Ms. Victor moves to Florida.

830 CMR 63.31.1(4)(a)(1)(b)(Example 10)("Example 10"). As previously discussed in this Opinion, the Board found and ruled

that the MMH Notes were not entered into for tax avoidance purposes. Like the taxpayer in Example 10, while the MMH Notes may have provided attendant tax benefits, they were driven by a non-tax business purpose. The interest on the notes in Example 10 continued to be deductible, even after the interest was no longer taxable in the hands of the recipient, due to a change in circumstance and not tax planning on the part of the taxpayer. Similarly, when the MMH Notes were originally put in place and refinanced in 1998, MMLIC was taxable on the interest, albeit it at a lower rate than MMH. Due to a law change which took full effect beginning in 2004, after all of the MMH Notes had been issued, MMLIC, like Ms. Victor who moved to Florida in Example 10, was no longer subject to tax on the interest income. Because the loans were made for a non-tax business reason, were made according to arm's length terms, and all payments required under the terms of the loan were timely made, the interest continued to be deductible. The Board found and ruled that the interest on the MMH Notes was likewise deductible.

By contrast, the Commissioner cites a different example in 830 CMR 63.31.1 which outlines an instance of interest paid by a subsidiary to its insurance company parent which would not be eligible for an exemption to the add-back requirement:

> A parent corporation, Parent, owns a controlling interest in two subsidiaries, Result Corp. and Sister Inc., which conduct business operations solely in

> Massachusetts. Result Corp. conducts general business operations, whereas Sister Inc. is an insurance company... Parent capitalizes Sister Inc. with more money than it needs to conduct its insurance operations and then causes Sister Inc. to lend the excess cash to Result Corp. Interest payments made by Result Corp. to Sister Inc. are not taxable to Sister Inc. because insurance companies are only taxable on their insurance premiums. Result Corp. seeks to claim significant tax savings in Massachusetts by reason of this transaction. Assuming that a principal purpose for the loan transaction was tax avoidance, the Commissioner will not recognize an exception to the statutory add back for the interest deductions that are asserted by Result Corp.

830 CMR 63.31.1(4)(a)(1)(b)(Example 8)("Example 8"). The taxpayers in Example 10 and Example 8 both sought to deduct interest expenses, which would necessarily result in the reduction of tax. However, the key distinction between Example 10 and Example 8 was whether tax avoidance was a "principal purpose" for the loan. All interest-bearing debt usually provides tax benefits; it is only where a taxpayer cannot demonstrate via clear and convincing evidence that the debt was not principally motivated by tax avoidance that is subject to the add-back requirements of G.L. c. 63, §§ 31I and 31J. Thus, as the Board found and ruled that the MMH Notes were not entered into as part of a tax avoidance scheme, but instead were intended to finance the expansion of MMH's various subsidiaries in a manner that benefitted the MassMutual business as a whole by increasing MMLIC's RBC score, the interest thereon was not subject to add-back.

2. The MMH Notes Were Supported by Economic Substance

In order for an add-back to be unreasonable, the transaction giving rise to the related party interest must be supported by economic substance. The Commissioner defines "economic substance" in a transactional context as involving "material economic risk and [having] material practical economic consequences other than the creation of tax benefit." 830 CMR 63.31.1(2). As opposed to the large dividend note in ***Overnite*** where the debtor took on all of the burden of debt without any cash consideration for purely tax-motivated reasons, MMLIC loaned MMH billions in cash which was directly used to fund its subsidiaries' operations and to finance new investments. The advances were documented by legally enforceable agreements with all of the usual indicia of debt. The appellant's finance department took reasonable measures to monitor the outstanding debt and observed standard practices for funding and documentation. One of the largest credit rating agencies in the country was hired by the appellant to independently evaluate the MMH Notes each year, which were consistently given an investment-grade rating.

As opposed to other instances where the Board has found a lack of economic substance including those involving a "circular flow of funds," such as the purported loans to upstream the cash to TJX from the royalty payments made to its subsidiaries in ***The***

TJX Companies, Inc., the Board found that the proceeds of the MMH Notes were used to expand MMH's business, as exhibited by its growth in the 1990s and 2000s. The Board found credible the testimony of Mr. Lynch that the amounts loaned were necessary for MMH's business and found that they likely would have been advanced absent any tax benefit.

Therefore, the Board found and ruled that the MMH Notes were supported by economic substance.

3. The Interest Deductions Paid Pursuant to the MMH Notes Were Incurred Because of an Underlying *Bona Fide* Indebtedness and Reflect Fair Value or Consideration

As previously discussed, because MMH Notes satisfy the core definition of debt and the conduct between MMLIC and MMH was consistent with that of a creditor-debtor relationship, the Board found and ruled that MMH Notes were *bona fide* debt. While the Commissioner's expert argued that a commercial bank would not have made loans to MMH on the same terms, he did not controvert Neil Winward's conclusion that the interest rates, which were tied to the prevailing federal applicable rate, reflected an arm's length rate. Therefore, the Board found and ruled that the interest deducted was a fair value.

Accordingly, because the appellant proved through clear and convincing evidence that the MMH Notes were entered into for a valid, non-tax business purpose, were supported by economic substance, constituted *bona fide* debt, and the related interest deducted reflected fair value and consideration, the Board found and ruled that it would be unreasonable, pursuant to G.L. c. 63, §§ 31I and 31J to require that the appellant's interest deductions be added back.

CONCLUSION

Because the MMH Notes met the core definition of debt for Massachusetts tax purposes and the conduct of the parties was consistent of that of a debtor-creditor relationship, the Board found and ruled that they were *bona fide* debt. Furthermore, the Board found and ruled that the interest deducted pursuant to the MMH Notes was exempt from the general requirement to add back related party interest because the MMH Notes constituted *bona fide* debt primarily entered into for a valid business purpose, were supported by economic substance, and reflected fair value or consideration. Accordingly, the Board decided these appeals for the appellants and granted abatements in the amount of $3,197,686 for the tax year ended December 31, 2003, including the $119,140 of penalties assessed, $3,506,222 for the tax year ended December 31, 2004, and a refund of $1,236,022 for the tax year ended December 31, 2005, plus interest.

THE APPELLATE TAX BOARD

By: ______________________________
Thomas W. Hammond, Jr., Chairman

A true copy,

Attest: ______________________
Clerk of the Board