TIR 10-16: Non-U.S. Corporation with U.S. Income Exempt from U.S. Tax Pursuant to a Bilateral U.S. Income Tax Treaty

I. Introduction

This Technical Information Release (TIR) explains a recent statutory change that is set forth in section 125 of chapter 240 of the Acts of 2010 ("the Act") as made to the Massachusetts combined reporting statute, G.L. c. 63, § 32B, and issues related to this statutory change. That recent statutory change applies in the instance where a "water's edge" combined group includes a non-U.S. corporation that has one or more items of income that are exempt from federal income tax pursuant to the provisions of a bilateral U.S. income tax treaty. The recent statutory change, like the combined reporting statute itself, is effective for taxable years beginning on or after January 1, 2009. St. 2010, c. 240, § 204.

Section 125 of the Act applies to a non-U.S. corporation that is a member of a combined group, irrespective as to whether such member is individually subject to tax in Massachusetts or not (i.e., whether the corporation is a "taxable" or "non-taxable" member of the combined group). Although section 125 of the Act specifically applies only to non-U.S. corporations that are included in a "water's edge" combined group, this TIR also addresses the similar situation in which a non-U.S. corporation is subject to tax in Massachusetts individually and not as a member of a combined group.

II. Background; Massachusetts Combined Reporting Law

a. *Combined Reporting Requirement; Inclusion Within the "Water's Edge" Combined Group*

The Massachusetts combined reporting statute is set forth at G.L. c. 63, § 32B. A Massachusetts combined report is generally required when a corporation that is taxable in Massachusetts is engaged in a unitary business with one or more other corporations, whether or not those other corporations are similarly subject to Massachusetts tax.[1] Pursuant to § 32B one or more taxable members of a combined group may elect to determine their apportioned share of the taxable net income or loss of the combined group on a worldwide basis. G.L. c. 63, § 32B(c)(3). If the taxable members of the combined group do not make this worldwide election, the taxable group members must determine their apportioned share of the combined group's taxable net income or loss on a "water's edge" basis. *Id.* General Laws chapter 63, section 32B(c)(3) explains the mechanics of making a worldwide election. *Id.* Further rules concerning the worldwide and water's edge combined group filings, including rules that explain the determination of the combined group's taxable income in these respective situations, are set forth in the state's combined reporting regulation, 830 CMR 63.32B.2.[2]

The state's combined reporting regulation provides, with respect to the determination of the "water's

edge" combined group, that:

> If the taxable members of a combined group do not make a worldwide election, each member shall determine its share of the aggregate taxable net income or loss of the combined group on a water's edge basis under which each member shall take into account the income and apportionment information of the taxable members of the group and of those non-taxable members of the group that are described in any one or more of 830 CMR 63.32B.2(5)(b)1.a. through c.

830 CMR 63.32B.2(5)(b)1. The non-taxable corporations that are to be included in a water's edge combined group as referenced at 830 CMR 63.32B.2(5)(b)1.a. through c. are the corporations referenced at G.L. c. 63, § 32B(c)(3)(i) to (iii), as follows:

> (i) any member incorporated in the United States or formed under the laws of the United States, any state, the District of Columbia, or any territory or possession of the United States;
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> (ii) any member, regardless of the place incorporated or formed, if the average of its property, payroll, and sales factors within the United States is 20 per cent or more;
>
> (iii) any member that earns more than 20 per cent of its income, directly or indirectly, from intangible property or service-related activities the costs of which generally are deductible for federal income tax purposes, whether currently or over a period of time, against the business income of other members of the group, but only to the extent of that income and the apportionment factors related thereto.

G.L. c. 63, § 32B(c)(3)(i) to (iii); 830 CMR 63.32B.2(5)(b)1.a.-c.

b. ***Income to be Included in the Combined Group's Taxable Income***

The combined reporting regulation provides that, in the context of a water's edge combined group, "the income to be included in the total income of the combined group shall be the taxable net income for the corporation [member] as determined under M.G.L. c. 63, subject to any further adjustments as required by 830 CMR 63.32B.2." 830 CMR 63.32B.2(6)(c)2.a(i). That regulation further provides that:

> In general, the taxable net income of a corporation as determined under M.G.L. c. 63, is gross income as defined under the Code, with certain Massachusetts adjustments, less the deductions (with certain Massachusetts adjustments) but not the credits that are allowable under the Code. *See, e.g.,* M.G.L. c. 63, § 30.4, 38(a) (which determine Massachusetts net income and then taxable net income for general business corporations by beginning with federal "gross income" as described in M.G.L. c. 63, § 30.3).

Id. In addition, the combined reporting regulation states that:

> The definition of federal gross income that is used as the starting point in determining taxable net income under M.G.L. c. 63 generally … includes in the case of a corporation that is not

> incorporated in the United States and not treated as a U.S. corporation under the Code, only (1) gross income that is effectively connected with the conduct of a trade or business within the U.S. ("effectively connected income") and (2) gross income that is derived from sources within the U.S. and that is not effectively connected income, which would include among other things items of non-effectively connected income on which the U.S. federal income tax may be collected through withholding imposed on the payers of such items. *See* Code § 882(b); *see also* Code §§ 881(a), 882(a). Therefore, any income that is effectively connected income as well as any non-effectively connected income that is U.S. source income are generally included in the determination of the taxable net income of a combined group member that is not incorporated in the United States and not treated as a U.S. corporation under the Code, whereas income that is neither U.S. source income nor effectively connected income is generally excluded from the determination of taxable net income of such member.

Id.

c. ***Effect of Bilateral U.S. Income Tax Treaty***

The combined reporting regulation also explains the effect of a U.S. bilateral income tax treaty that applies to one or more items of income of a combined group member in the context of the determination of the combined group's taxable income. The regulation states that:

> The U.S. source income and the effectively connected income of a member to be included in the total income of the combined group shall not be reduced on account of any U.S. bilateral income tax treaty, except to the extent, if any, that such treaty results in the exclusion of an item from such member's federal gross income as determined under the Code and thereby decreases the member's taxable net income as determined under M.G.L. c. 63.

Id. This regulatory treaty provision is further explicated by newly-enacted Section 125 of the Act, as further discussed below.

III. Recent Statutory Amendment; Discussion

a. ***The Recent Statutory Amendment***

Newly-enacted section 125 of chapter 240 of the Acts of 2010 provides in its entirety as follows:

> Paragraph (3) of subsection (c) of section 32B of said chapter 63, as appearing in the 2008 Official Edition, is hereby amended by adding the following clause:-
>
> (iv) an item of income of a corporation that is organized outside of the United States shall not be included in the combined group's taxable income to the extent that such item is exempt from United States federal income tax by virtue of a federal income tax treaty. Any items of expense and apportionment factors related to such item of exempt income shall be excluded in the determination of taxable net income or loss to the extent provided in regulations issued by the commissioner. However, any such item of exempt income shall be taken into account to determine whether the corporation is included in the water's edge group under clause (ii) or (iii). If a corporation organized outside of the United States is included in a water's edge combined group and has an item of income that is exempt from United States federal income tax by virtue of a federal tax treaty, the corporation shall be considered to be included in the combined group under that clause only with regard to any items of income described in that clause that are not so exempt, taking into account items of expense and apportionment factors associated with

> such items of non-exempt income to the extent provided by regulations issued by the commissioner. Nothing in this clause shall prevent the commissioner from adjusting, under sections 31I, 31J, 31K or 39A of this chapter, section 3A of chapter 62C, or any other provision of law, any deduction claimed by the payer for amounts that are excluded from the combined group's taxable income under this clause. The commissioner may require the reporting of the amounts of such excluded income and the documentation of any claimed treaty exemption as conditions to be met by a payer claiming a deduction of such payments.

St. 2010, c. 240, § 125.

b. ***Effect on Non-U.S. Corporations Included in the Combined Group***

1. ***Income exclusion***

As noted above, the Act amends G.L. c. 63, § 32B(c)(3) by adding new clause (iv), which states, *inter alia,* that where a combined group determines its taxable net income or loss on a water's edge basis, "an item of income of a corporation that is organized outside of the United States shall not be included in the combined group's taxable income to the extent that such item is exempt from United States federal income tax by virtue of a federal income tax treaty." St. 2010, c. 240, § 125. Pursuant to this newly-enacted provision, such exempt items of income of such non-U.S. corporations that are members of a water's edge combined group are excluded from the combined group's taxable income.[3] An example of such excluded income can include an item of interest or royalty income of a non-U.S. corporation that is U.S. source income where the applicable treaty states that such income may only be taxed by the corporation's resident country. Also, an example of such excluded income can include an item of income of a non-U.S. corporation that is U.S. effectively connected income under the Code where the applicable treaty results in an exemption of such income because the non-U.S. corporation does not carry on business through a permanent establishment in the U.S.

This exclusion applies irrespective as to whether the non-U.S. corporation that is a member of the combined group is included in the group because such member is taxable in Massachusetts or because such member is not taxable in Massachusetts and is included by reason of G.L. c. 63, § 32B(c)(3)(ii) or (iii), *supra*. However, in any case in which the U.S. treaty merely reduces the federal rate of tax to be applied to an item of federal gross income of the non-U.S. corporation in the context of a water's edge combined group filing, e.g., by reducing the federal rate of tax to be applied to the non-U.S. corporation's royalty or interest income, say from 30% to 15%, this item of income is not exempt from federal income tax within the meaning of G.L. c. 63, § 32B(c)(3) and therefore must be included in the combined group's taxable income without any reduction.

2. ***Implications of Income Exclusion***

Newly-enacted G.L. c. 63, § 32B(c)(3)(iv), *supra*, explains the implications of the exclusion of an item of income of a non-U.S. corporation from the combined group's taxable income by reason of the application of a bilateral U.S. income tax treaty, including the implications as to: (1) the threshold determination as to whether a non-taxable non-U.S. corporation that has such an item of income is to be included in the water's edge combined group; (2) the exclusion of expenses that are related to the excluded treaty income and the effect of the income exclusion in the context of determining the income measure apportionment calculation to be applied by the taxable members of the water's edge combined group; and (3) the possibility of an expense "add back" or other state tax adjustment.

(a) ***Determination as to a Group Member's Inclusion***

Newly-enacted G.L. c. 63, § 32B(c)(3)(iv) has no impact on whether a non-U.S. corporation is to be included in a combined group. A non-U.S. corporation is to be included in a combined group when the statutory requirements for inclusion are otherwise met, including the fact that the non-U.S. corporation is engaged in a unitary business with one or more other group members, and that the non-U.S. corporation is either taxable in Massachusetts or meets the requirements of G.L. c. 63, § 32B(c)(3)(ii) or (iii). Those latter two statutory sections require that a non-U.S corporation that is not taxable in Massachusetts is to be included in a combined group when its average U.S.

apportionment formula consisting of property, payroll and sales exceeds a certain percentage threshold[4] or the corporation derives a certain percentage of its income from transactions with affiliates where certain other specific requirements are also satisfied.[5] *See* 830 CMR 63.32B.2(5)(c). For purposes of determining whether a non-taxable non-U.S. corporation is to be included in a water's edge combined group pursuant to either of these two statutory inclusions, G.L. c. 63, § 32B(c)(3)(iv) provides that any item of income that is to be excluded from the combined group's taxable income pursuant to G.L. c. 63, § 32B(c)(3)(iv), i.e., because such item of income is exempt from federal income tax pursuant to the provisions of a bilateral U.S. income tax treaty, "shall be taken into account." Therefore, analytically, a non-U.S. corporation is first determined to be included in a water's edge combined group by reference to its attributes, including any items of income that may be exempt from federal income tax pursuant to the terms of a bilateral U.S. income tax treaty, and only then, if the corporation is to be included in the combined group, is it determined whether one or more items of such corporation's income subject to the treaty are to be included in or excluded from the combined group's taxable income. Consequently, *inter alia,* a non-taxable corporation can be included in a combined group even if all of its income is exempt from federal income tax pursuant to the terms of a bilateral U.S. income tax treaty.

(b) ***Excluded related expenses; apportionment impact***

Newly-enacted G.L. c. 63, § 32B(c)(3)(iv), *supra*, further states:

> …that if a non-U.S. corporation is included in a water's edge combined group and has an item of income that is exempt from United States federal income tax by virtue of a federal tax treaty, the corporation shall be considered to be included in the combined group under that clause only with regard to any items of income described in that clause that are not so exempt, taking into account items of expense and apportionment factors associated with such items of non-exempt income to the extent provided by regulations issued by the commissioner.

Similarly, newly-enacted G.L. c. 63, § 32B(c)(3)(iv) further states that "Any items of expense and apportionment factors related to such item of exempt income shall be excluded in the determination of taxable net income or loss to the extent provided in regulations issued by the commissioner." St. 2010, c. 240, § 125. The effect of these two provisions is to clarify that where a non-U.S. corporation is included in a water's edge combined group but has one or more items of exempt treaty income that are to be excluded from the combined group's taxable income, the related expense items of the corporation are also to be excluded, and the factor attributes of the corporation to be used for apportioning the combined group's taxable income will also require adjustment. For purposes of making these adjustments, the statutory language references the Commissioner's combined reporting regulation, which includes provisions that address the exclusion of items of expense and apportionment attributes where a combined group member's related income is to be excluded from the combined group's taxable income. *See* 830 CMR 63.32B.2(5)(b)3; 830 CMR 63.32B.2(6)(c)2.a(i) and 830 CMR 63.32B.2(7)(f).

(c) ***Possibility of Expense Add Back or Other Adjustment***

Newly-enacted G.L. c. 63, § 32B(c)(3)(iv), *supra*, further states:

> Nothing in this clause shall prevent the commissioner from adjusting, under sections 31I, 31J, 31K or 39A of this chapter [i.e., the state's add back and arm's length pricing statutes], section 3A of chapter 62C [i.e., the state's sham transaction statute], or any other provision of law, any deduction claimed by the payer for amounts that are excluded from the combined group's taxable income under this clause.

St. 2010, c. 240, § 125. Consequently, even in the instance of the application of G.L. c. 63, §

32B(c)(3)(iv), i.e., where income is excluded from the combined group's taxable income by reason of the application of a bilateral U.S. income tax treaty, the Commissioner may potentially make an adjustment with respect to such income or with respect to the underlying transaction pursuant to the referenced provisions in chapter 62C and chapter 63.

IV. Income and Non-Income Measure Tax Filings in the Instance of a Taxable or Non-Taxable Combined Group Member

a. Income Measure Excise; Taxable or Non-Taxable Combined Group Members

A water's edge combined group that claims that it includes a member that has one or more items of exempt treaty income that are to be excluded from the combined group's taxable income must complete a schedule stating this claim and include the information related to this claim as part of the group's combined report, as required by the Commissioner, even if such member has no other income that is to be included in the combined group's taxable income.[6] With respect to this requirement, newly-enacted G.L. c. 63, § 32B(c)(3)(iv), *supra*, states that "The commissioner may require the reporting of the amounts of such excluded [treaty] income and the documentation of any claimed treaty exemption as conditions to be met by a payer claiming a deduction of such payments." Consequently, in any instance in which a combined group that claims that it includes a member with exempt treaty income does not properly file the required disclosure schedule, the Commissioner may deny an expense deduction to one or more members of the combined group as to the corresponding payments that resulted in such income, and also may make any other such adjustments as would be appropriate.

b. *Non-Income Measure Excise; Taxable Combined Group Members*

A taxable member of a combined group is required to file a non-income measure tax return on a separate entity basis in addition to filing an income measure tax return as part of the combined group's combined report. For purposes of such non-income measure tax return, the taxable corporation's apportionment percentage is to be determined on a separate entity basis. *See, e.g.,* 830 CMR 63.32B.2(6)(b)3. Significantly, for purposes of determining its non-income measure excise a taxable combined group member must include in the determination of its apportionment formula to be applied *for non-income measure* purposes any of its property, payroll and receipts that are to be excluded from the computation of the *income measure* apportionment formula to be applied by the taxable members of the combined group of which it is a member.

For example, assume that a taxable member of a combined group, corporation X, has an item of income in the amount of $10,000 that is to be excluded (along with any related expenses) from the combined group's taxable income by reason of the application of G.L. c. 63,§ 32B(c)(3)(iv). In determining the amount of the combined group's taxable income to be apportioned to X and to the other taxable members of the combined group, the apportionment attributes of X to be contributed to the combined group members' apportionment computations (including the computation of X) are reduced to remove X's property, payroll and receipts that relate to the excluded treaty income, consistent with 830 CMR 63.32B.2(7)(f). However, when X computes its apportionment percentage as applied in the context of determining its non-income measure, X must add back the property, payroll and receipts that it eliminated pursuant to G.L. c. 63, § 32B(c)(3)(iv). Further, the application of G.L. c. 63, § 32B(c)(3)(iv) does not impact X's net worth determination as calculated pursuant to G.L. c. 63, § 30 (i.e., the determination that is to then be multiplied by X's non-income measure apportionment computation to calculate X's non-income measure excise).

c. Examples

The rules set forth in section IV.a and IV.b, *supra*, are further explained by the examples set forth below.

Example 1.

Corporation X, a non-U.S, corporation, licenses trademarks to Corporation Y, an affiliated corporation, and to other non-affiliate corporations, for use in Massachusetts and in other states in

connection with the sale of branded products at stores owned or leased in Massachusetts by Corporation Y and such other non-affiliate corporations. By reason of such activities X has nexus with Massachusetts pursuant to DD 96-2. Further, X and Y are related through common ownership and are engaged in a unitary business that is conducted by only X and Y. Therefore, X and Y are required to file a Massachusetts combined report, which they will file on a water's edge basis.

Assume that X's royalty income from its licensing activity is exempt from federal income tax pursuant to the provisions of a bilateral U.S. income tax treaty and that such federal income tax treatment is consistent with the Internal Revenue Code and federal law generally. Therefore, for purposes of filing the XY combined report, X's royalty income and any expenses related to this income are to be excluded from the combined group's taxable income. *See* 830 CMR 63.32B.2(6)(c)2.a(i). Further, for purposes of filing this combined report, the property, payroll and receipts of X that relate to such exempt income are also excluded from the combined group's income apportionment computation, in particular from the numerator of X and the denominator of both X and Y. *See* 830 CMR 63.32B.2(7)(f). As part of the combined report, a schedule must be properly completed on behalf of X in the manner required by the Commissioner stating that the combined group is claiming that X received an item of income that is exempt from federal income tax pursuant to the provisions of a bilateral U.S. income tax treaty and otherwise providing such information as required by the Commissioner. If such schedule is not properly filed, the Commissioner may deny any expense deductions claimed by Y in connection with its royalty payments to X and make any other appropriate adjustments.

Because X has nexus with Massachusetts it must also file a non-income measure tax return on a separate entity basis. For purposes of completing that latter separate entity tax return X's property, payroll and receipts that were excluded from the determination of the combined group's apportionment computations are to be taken into account in both X's numerator and denominator. Therefore, X is to apply a different apportionment calculation for income measure purposes than for non-income measure purposes.[7] Note that the computation of X's net worth computation pursuant to G.L. c. 63, § 30 is not impacted by the application of G.L. c. 63, § 32B(c)(3)(iv).

It is assumed for purposes of this example that the royalty expense paid by Y to X is not subject to the provisions of G.L. c. 63, § 31I or § 39A, and that the transaction is not questioned by the Commissioner pursuant to G.L. c. 62C, § 3A or otherwise under Massachusetts law.

Note that if the royalty income of X were merely subject to a reduced rate of tax by reason of the application of the provisions of the U.S. treaty, rather than being exempt from federal income tax by reason of the provisions of such treaty, such income would be included in full in the combined group's taxable income.

Example 2.

Corporation X, a non-U.S, corporation, licenses trademarks to Corporation Y, an affiliated corporation, and to other non-affiliate corporations, for use in states *other than Massachusetts* in connection with the sale of branded products at stores owned or leased in those states (i.e., none of the licensees owns or leases stores in Massachusetts or makes sales in Massachusetts using the trademarks). Y has nexus with Massachusetts, but X does not. Further, X and Y are related through common ownership and are engaged in a unitary business that is conducted by only X and Y. Also, X is to be included in a water's edge combined group pursuant to 830 CMR 63.32B.2(5)(b)1.b. Therefore, X and Y are required to file a Massachusetts combined report, which they will file on a water's edge basis.

Assume that X's royalty income from its licensing activity is exempt from federal income tax pursuant to the provisions of a bilateral U.S. income tax treaty and that such federal income tax treatment is consistent with the Internal Revenue Code and federal law generally. Therefore, for purposes of filing the XY combined report, X's royalty income and any expenses related to this income are to be excluded from the combined group's taxable income. *See* 830 CMR 63.32B.2(6)(c)2.a(i). Further, for purposes of filing this combined report, the property, payroll and receipts of X that relate to such exempt income are also excluded from the combined group's income apportionment computation, in particular from the denominator of Y, the only taxable member of the combined group. *See* 830 CMR 63.32B.2(7)(f). As part of the combined report, a schedule must be properly completed on

behalf of X in the manner required by the Commissioner stating the combined group is claiming that X received an item of income that is exempt from federal income tax pursuant to the provisions of a bilateral U.S. income tax treaty and otherwise providing such information as required by the Commissioner. If such schedule is not properly filed, the Commissioner may deny any deductions claimed by Y in connection with its royalty payments to X and may make any other appropriate adjustments.

Because X does not have nexus with Massachusetts it is not required to file a non-income measure tax return on a separate entity basis. It is assumed for purposes of this example that the royalty expense paid by Y to X is not subject to the provisions of G.L. c. 63, § 31I or § 39A and that the transaction is not questioned by the Commissioner pursuant to G.L. c. 62C, § 3A or otherwise under Massachusetts law.

Note that if the royalty income of X were merely subject to a reduced rate of tax by reason of the application of the provisions of the U.S. treaty, rather than being exempt from federal income tax by reason of the provisions of such treaty, such income would be included in full in the combined group's taxable income.

V. Income and Non-Income Measure Tax Filings in the Instance of a Taxable Corporation that is Not Included in a Combined Group

A corporation that is subject to tax in Massachusetts that is not a member of a combined group is responsible for both an income and non-income measure tax filing, which are both to be completed on a separate entity basis.[8] While there is no statutory provision that addresses the treatment of an item of income that is exempt from federal income tax pursuant to the provisions of a bilateral U.S. income tax treaty in the instance of a corporation that is not a member of a combined group, the Commissioner will exercise her discretion to treat the provisions of newly-enacted G.L. c. 63, § 32B(c)(3)(iv) as also generally applying in such latter instances for income measure purposes. Therefore, in any case in which a corporate taxpayer that is organized outside the United States and that is not a member of a combined group has an item of income that is exempt from federal income tax pursuant to the provisions of a bilateral U.S. income tax treaty, the taxpayer may treat that income as excluded from the corporation's Massachusetts income computation. However, a corporation that excludes such an item of income from its Massachusetts income computation must also, for consistency purposes, exclude any expenses that relate to that item of income and also must adjust its apportionment formula to exclude any factor attributes that relate to that income.[9] In addition, a taxable corporation that excludes an item of income from its Massachusetts income computation because that item of income is exempt from federal income tax pursuant to the provisions of a bilateral U.S. income tax treaty must also disclose this exclusion of income in such manner as may be required by the Commissioner.

Conversely, when determining its non-income measure excise the taxable corporation must include in the determination of its apportionment formula any property, payroll and receipts that it excludes from the computation of its income measure excise, as such factor attributes are not excluded for purposes of determining the corporation's non-income measure. This apportionment calculation must then be multiplied by the corporation's total assets worldwide less its applicable deductions, consistent with the provisions of G.L. c. 63, § 30. Further, note that the computation of the taxable corporation's net worth computation pursuant to G.L. c. 63, § 30 is not impacted by the application of G.L. c. 63, § 32B(c)(3)(iv).

The rules stated in this section IV of this TIR shall apply to all open tax years.

Example 3.

Corporation X, a non-U.S. corporation, licenses trademarks to non-affiliated corporations for use in Massachusetts and in other states in connection with the sale of branded products at stores owned or leased in Massachusetts by such other non-affiliated corporations. By reason of such activities X has nexus with Massachusetts pursuant to DD 96-2. Further, Corporation X is not affiliated with any other corporations and therefore is not required to file a tax return as a member of a Massachusetts combined group.

Assume that X's royalty income from its licensing activity is exempt from federal income tax pursuant to the provisions of a bilateral U.S. income tax treaty and that such federal income tax treatment is consistent with the Internal Revenue Code and federal law generally. Therefore, for purposes of filing its separate entity tax return, X's royalty income is excluded from its income measure excise computation. Further, for consistency purposes, X's expenses that relate to this income must also be excluded from this income measure computation and its property, payroll and receipts that relate to this income must be excluded from X's income apportionment computation. *See* 830 CMR 63.32B.2(6)(c)2.a(i); 830 CMR 63.32B.2(7)(f).

Because X has nexus with Massachusetts it must also file a non-income measure tax return on a separate entity basis. For purposes of completing that separate entity tax return X's property, payroll and receipts that were excluded from the determination of its income measure apportionment computation are to be taken into account in both X's numerator and denominator. Therefore, X is to apply a different apportionment calculation for income measure purposes than for non-income measure purposes. X must multiply its apportionment percentage as determined for non-income measure purposes by its total assets worldwide less its applicable deductions, consistent with the provisions of G.L. c. 63, § 30. Note that the computation of X's net worth computation pursuant to G.L. c. 63, § 30 is not impacted by the application of G.L. c. 63, § 32B(c)(3)(iv).

Note also that if the royalty income of X were merely subject to a reduced rate of tax by reason of the application of the provisions of the U.S. treaty, rather than being exempt from federal income tax by reason of the provisions of such treaty, such income would be included in full in its income for purposes of its income measure excise determination.[10]

/s/Navjeet K. Bal
Navjeet K. Bal
Commissioner of Revenue

NKB:MTF

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[1] Note, however, that Massachusetts security corporations, non-profit corporations and certain insurance companies, even if engaged in such unitary business, are not included in a Massachusetts combined report. *See* 830 CMR 63.32B.2(4).

[2] In some cases, the taxable members of the combined group may choose to make an affiliated group election, in which case the "water's edge" combined group will be the "affiliated group" as determined pursuant to such election. *See generally* 830 CMR 63.32B.2(10). The analysis in this TIR also applies in such cases.

[3] Note that for such income to be exempt from federal income tax it must be the case that both the treaty expresses an intention to exempt such income from federal income tax and that such exemption is otherwise recognized under the Internal Revenue Code and other federal law. *See generally* IRC § 894(a)(1) (stating that "The provisions of this title shall be applied to any taxpayer *with due regard to* any treaty obligation of the United States which applies to such taxpayer") (emphasis added)

[4] G.L. c. 63, § 32B(c)(ii) applies to a non-taxable member "regardless of the place of incorporation or formation, if the average of its property, payroll and sales factors is 20% or more."

[5] G.L. c. 63, § 32B(c)(iii) applies to a non-taxable member "that earns more than 20% of its income, directly or indirectly, from intangible property or service-related activities, the costs of which generally are deductible for federal income tax purposes, whether currently or over a period of time, against the business income of other members of the group, but only to the extent of that income and the apportionment factors related thereto."

[6] In any case in which the combined group's taxable year begins on or after January 1, 2010, the schedule on which to make this claim is Schedule U-TTP.

[7] Note that the numerator of the apportionment formula as applied by a taxable corporation that is subject to combined reporting can also differ because of other adjustments that are only required in the context of combined reporting, such as the inclusion of "Finnegan" sales, *see* 830 CMR 63.32B.2(7)(b) or the elimination of, or other adjustments with respect to, intercompany transactions, see 830 CMR 63.32B.2(7)(g), as these adjustments are not made in the context of the non-income measure.

[8] The form to be filed to report both the income and non-income measure excise in such cases is typically Form 355 or 355S.

[9]The exclusion of expenses and factor attributes must be consistent with the analysis set forth in 830 CMR 63.32B.2(6)(c)2.a(i) and 830 CMR 63.32B.2(7)(f), even though the corporation in question will not be filing as a member of a combined group. Assuming that the transaction that results in the excluded item of treaty income is with an affiliated corporation, the transaction could also result in an adjustment pursuant to G.L. c. 63, § 31I-31K or § 39A or be questioned by the Commissioner pursuant to G.L. c. 62C, § 3A or otherwise under Massachusetts law.

[10] Note that there are other instances where receipts that are not taken into consideration in determining a sales factor for a taxpayer for income measure purposes will nonetheless be considered for purposes of determining the taxpayer's sales factor for non-income measure purposes. For example, a corporation that is engaged in making sales of tangible personal property in Massachusetts and that is exempt from the requirement of filing an income measure tax return with the state pursuant to the provisions of Public Law 86-272 is nonetheless required to file a non-income measure tax excise return. G.L. 63, § 39, *as amended by* St. 2008, c. 173, § 84; *see also* TIR 08-11. In these cases, the corporation's Massachusetts receipts that are not considered for purposes of the determination of an income measure excise are nonetheless considered in determining the corporation's non-income measure excise.