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Massachusetts Legislature Paints over Sherwin-Williams, Modifies State Tax Treatment of IP Holding Companies

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Introduction

Intellectual property holding companies have long been an integral part of business plans for companies that own valuable intellectual property. In general, an IP holding company is created and used by a company operating in a high-tax U.S. state that taxes royalty income. The company creates a subsidiary or, in some cases, utilizes an existing subsidiary to operate in a low-tax U.S. state and transfers some or all of its intellectual property to the subsidiary. The subsidiary, in turn, attempts to establish and maintain an independent presence, including its own offices, in the low-tax state and licenses the intellectual property to the parent and/or third parties as part of its business of maintaining and managing its holdings.

Through the use of an IP holding company, a company may be able to:

- deduct against its income in the high-tax state the royalties that it pays to the subsidiary;
- mitigate the effect of any net worth taxes imposed by the high-tax state;
- have its subsidiary pay relatively little tax on the subsidiary's receipt of royalties; and
- access the subsidiary's cash through loans, dividends, payments for administrative services, or other conventions, depending on what is most tax-efficient. Where the subsidiary makes loans to the parent, the parent may be able to deduct the interest that it pays the subsidiary.

Among the non-tax benefits that can be achieved through the use of an IP holding company are that:

- it may be easier to contract for, maintain, and account for intellectual property and licenses to third parties if the intellectual property is located in a separate corporation, the primary or sole business of which is licensing;
- it ultimately may be easier to sell intellectual property that has been isolated within a saleable subsidiary; and
- the establishment of terms for a license to the parent may provide helpful information about the market value of the intellectual property, which, in turn, may be useful for transactions with third parties and for tax and financial accounting purposes.

In an effort to preserve their shrinking tax bases, however, high-tax states have aggressively pursued and challenged companies that establish IP and other holding companies. These states typically assert:

- that the subsidiary is a sham and/or is merely the alter ego of the parent, and should therefore be ignored for state tax purposes;
- that a taxing nexus exists between the subsidiary and the states from which royalties are paid; and
- that royalties paid by the parent should be reallocated to the parent based on transfer-pricing or similar principles.

In order to maximize the company's chances for realizing the above described state tax benefits and for successfully defending itself against any challenges, the company typically endeavors to ensure that the subsidiary establishes and maintains a substantive, independent, business-like presence in the low-tax state. The parent and the subsidiary attempt to justify the subsidiary's existence with non-tax business purposes, and all corporate formalities—including those necessary to effect and sustain the transfer of intellectual property—are strictly observed so as to preserve the separate identities of the parent and subsidiary.

Recent Judicial Activity

States have litigated the above issues, often successfully, particularly where they believe they can establish that the subsidiary has no substance, is a sham, and/or is merely the alter ego of the parent. States have been less successful where the subsidiary has a substantive, independent, business-like presence in the low-tax state.

In Massachusetts, *Sherwin-Williams Company v. Commissioner of Revenue*, 438

Mass. 71 (2002) is the most recent example of such litigation. In Sherwin-Williams, the Massachusetts Supreme Judicial Court ruled in favor of Sherwin-Williams, embracing "the reasoning of courts that have concluded that tax motivation is irrelevant where a business reorganization results in the creation of a viable business entity engaged in substantive business activity rather than in a 'bald and mischievous fiction.'"

The Legislature's "Broad Brush"

On March 5, 2003, before the paint was dry on the court's decision in *Sherwin-Williams*, the Governor of Massachusetts signed legislation that effectively repeals the *Sherwin-Williams* case. In particular, this legislation appears to give the Commissioner broad powers to disallow the tax consequences of any transaction that the Commissioner determines to be a sham transaction and requires the taxpayer to demonstrate by clear and convincing evidence that the transaction at issue has both a valid good-faith business purpose other than tax avoidance and economic substance apart from the asserted tax benefit.

In perhaps an even more direct assault on the *Sherwin Williams* case, the legislation also purports to disallow the deduction of any expenses relating to intangible property when such expenses are paid to a related party, except in certain limited circumstances. In order to avoid this result, a taxpayer must establish "by clear and convincing evidence" that the adjustments proposed by the Commissioner are unreasonable, or the taxpayer and the Commissioner must agree in writing to the application or use of an alternative method of apportionment.

These provisions are effective for tax years beginning on or after January 1, 2002, and are referred to as a "clarification."

Conclusion

In all likelihood, the above legislation will be challenged as being unconstitutional (at least with respect to its retroactivity), but its constitutionality, while questionable, may ultimately be upheld even if on a

prospective basis. As to the *Sherwin-Williams* case, the Commonwealth petitioned the Supreme Judicial Court for a re-hearing, but its petition was denied. In any event, at this point, companies seeking to establish holding companies, and even companies that already have them, must brace themselves, and begin preparations, for attacks under the new legislation and, ultimately, litigation.

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