COMMONWEALTH OF MASSACHUSETTS

Supreme Judicial Court

SUFFOLK, ss. No. SJC-11609

THE FIRST MARBLEHEAD CORPORATION AND GATE HOLDINGS, INC.,
Plaintiffs-Appellants,

v.

COMMISSIONER OF REVENUE,
Defendant-Appellee.

ON APPEAL FROM A DECISION OF THE APPELLATE TAX BOARD

SUPPLEMENTAL BRIEF OF AMICUS CURIAE MULTISTATE TAX COMMISSION IN SUPPORT OF DEFENDANT-APPELLEE THE COMMISSIONER OF REVENUE ON REMAND FROM THE SUPREME COURT OF THE UNITED STATES

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INTEREST OF THE AMICUS CURIAE

Amicus curiae Multistate Tax Commission ("the Commission") submits this brief in response to an invitation from this Court on October 21, 2015, to address the constitutional issue raised by First Marblehead Corp. and its subsidiary, Gate Holdings, Inc. ("the taxpayer") in its petition for certiorari to the U.S. Supreme Court, which remanded this case for consideration of its recent holding in Comptroller of Treasury of Maryland v. Wynne, ___ U.S. ___, 135 S. Ct. 1787 (2015).

The Commission was established by the Multistate Tax Compact ("Compact"), which became effective in 1967. See RIA All States Tax Guide, ¶ 701 et seq. (RIA 2005). The Commission has a significant interest in this case because the Massachusetts statutes at issue, G.L. c. 63, §§ 1-2A, incorporate one of the Commission's model apportionment formulas, the Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions, adopted by the Commission on November 17, 1994.

Accurately apportioning the income of financial institutions is generally a challenge because the income-producing property of those institutions

includes loan portfolios and other intangible property that can be easily transferred among related entities, and because those same assets are sometimes held in non-operating legal entities, as is the situation here. The model formula recommended by the Commission was designed, in part, to assist states in using loans as part of the apportionment formula for dividing the income of financial institutions among states where they operate and to enable states to locate those loans in a particular state for that purpose.

ARGUMENT

I. The internal consistency doctrine is implicated in the formulary apportionment context where the formula would apportion more than 100% of a taxpayer's income if applied by every jurisdiction in which the taxpayer operates.

The taxpayer claims that the Massachusetts apportionment formula as applied to its multistate income by this Court violates the internal consistency requirement under the dormant Commerce Clause. The concept of internal consistency was first explicitly articulated by the U.S. Supreme Court in Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983). There, the Court said that to be internally

consistent, an apportionment formula "must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed." Id. at 169.

While the U.S. Supreme Court first articulated the internal consistency requirement in the context of formulary apportionment, the requirement has more often been applied to judge the validity of other aspects of state tax systems. Most recently, the U.S. Supreme Court applied the internal consistency test to Maryland's personal income tax system. In Comptroller of Treasury of Maryland v. Wynne, ___ U.S. ___, 135 S. Ct. 1787 (2015), the court found that Maryland's system, under which residents are taxed on 100% of their total income and nonresidents are taxed on their Maryland source income, was internally inconsistent since the state failed to give a full credit for tax paid by residents to another state. If every state did the same, then individuals with multistate income would pay tax on more than 100% of their income.

Internal consistency has often been raised in the context of alternative taxes which may apply to a taxpayer. When certain alternative taxes are assumed to be imposed in every jurisdiction, courts have

concluded that taxpayers operating across multiple jurisdictions would be subject to duplicative taxation compared to those operating within a single jurisdiction. See, e.g., General Motors Corp. v. City of Los Angeles, 42 Cal. Rptr. 2d 430 (Cal. Ct. App. 1995), and Union Oil Co. of Cal. v. City of Los Angeles, 94 Cal. Rptr. 2d 81 (Cal. Ct. App. 2000). In these cases, the city imposed two alternative taxes upon those engaging in business within its borders. The California Court of Appeals found the taxing schemes unconstitutional, saying in Union Oil:

> [T]he taxpayer in the City selling across the City lines would pay the payroll tax in the City and be subject to the business license tax in the other jurisdiction [assuming it had the same taxing scheme]. And, the taxpayer outside the City would pay two taxes, the City's business license tax and the other jurisdiction's payroll tax. However, the taxpayer located in the City and selling inside the City would pay only one tax, the City's payroll tax. Id. at 85.

See also Tennessee Gas Pipeline Co. v. Urbach, 750 N.E.2d 52 (N.Y. 2001) and Home Interiors & Gifts, Inc. v. Strayhorn, 175 S.W.3d 856 (Tex. Ct. App. 2005).

This court has previously applied the internal consistency doctrine in two tax cases. In Am. Trucking Ass'ns, Inc. v. Sec'y of Admin., 613 N.E.2d 95 (Mass.

1993), this court invalidated a flat tax on interstate trucking, finding that the tax would have to be fairly apportioned to meet the requirements of the internal consistency test. Id. at 100. And in Perini Corp. v. Comm'r of Revenue, 647 N.E.2d 52 (Mass. 1995), the question was whether the state could impose different rules for calculating the taxable net worth of domestic and foreign intangible property corporations. Not only did this Court conclude that the tax in that case facially discriminated against interstate commerce, it also found the scheme to be internally inconsistent because, if every state adopted it, it would penalize businesses choosing to operate across state lines. Id. at 57.

Although the internal consistency requirement has most often been applied in contexts other than formulary apportionment, the common denominator, as it were, is the same. The question is whether, if every state adopted the tax rule at issue, a multistate taxpayer could be subjected to duplicative taxation, which an in-state taxpayer would avoid. A taxpayer seeking to demonstrate that an apportionment formula is internally inconsistent must demonstrate that, if the same formula were applied in every jurisdiction,

more than 100% of the taxpayer's multistate income would be apportioned. In this case, the taxpayer asserts that under the statutory formula at issue, the particular rules for determining the in-state portion (the numerator) of the property factor would result in a loan being located in more than one state. If true, then that formula could apportion more than 100% of multistate income, resulting in duplicative taxation.

II. The apportionment formula adopted by Massachusetts is not internally inconsistent.

We begin our analysis of this issue with the language of the statute itself which is, in all relevant respects, identical to the Multistate Tax Commission's model formula. Then we examine the taxpayer's claim in light of what the Appellate Tax Board and this Court said in applying the statute to the taxpayer's facts and circumstances.

Under the Massachusetts Financial Institutions Excise Tax, G.L. c. 63, §§ 1-2A, the property factor (one of the three factors generally used in the apportionment formula) includes, among other things, the value of the taxpayer's loan portfolio. The general substantive rule for determining loans deemed

to be "located" in Massachusetts is set out in § 2A(e)(vi). In addition to this general substantive rule, certain sub-rules govern the burden of proof and what happens if a taxpayer assigns a loan to a location improperly. The taxpayer here misreads one of these sub-rules, which creates a basis for locating loans improperly assigned by the taxpayer as, in effect, controlling the general substantive rule.

The general substantive rule of § 2A(e)(vi) can be stated simply. A loan will be considered "located" within Massachusetts (and is therefore included in the numerator of the Massachusetts property factor) if it is "properly assigned to a regular place of business of the taxpayer within the commonwealth." § 2A(e)(vi)(A)(1). A loan is "properly assigned" when the loan is assigned by the taxpayer to "the regular place of business with which it has a preponderance of substantive contacts." § 2A(e)(vi)(A)(2) (first sentence). The types of substantive contacts to be considered are set out in § 2A(e)(vi)(C). Under this general substantive rule, if a loan were assigned by the taxpayer to a location in Massachusetts, but the taxpayer has no regular place of business in Massachusetts, or if the preponderance of the

substantive contacts did not occur there, then it will not have been "properly assigned" in Massachusetts and would not be considered located in the commonwealth (unless the sub-rule in 2A(e)(vi)(B) applies and the commonwealth is the taxpayer's commercial domicile).

What we are characterizing as "sub-rules" establish presumptions, allocate the burden of proof between the Commissioner and the taxpayer in certain circumstances, and establish the location of loans not properly assigned. Those sub-rules can be found in §§ 2A(e)(vi)(A)(2) and (B). The first sub-rule, in § 2A(e)(vi)(A)(2), concerns the ability of taxpayers to rely on their business records when assigning a loan to a regular place of business outside Massachusetts. The taxpayer will have the benefit of a rebuttable presumption of correctness if (1) the business records are kept consistently with regulatory requirements; (2) the assignment is based on substantive contacts; and (3) those same business records are used when filing tax returns in other states sourcing loans to a regular place of business. See § 2A(e)(vi)(A)(2)(a)-(c). Assuming these criteria are met, the burden shifts to the Commissioner who can rebut the presumption by showing (by a preponderance

of the evidence) that the preponderance of substantive contacts did not occur at the regular place of business to which the loan was assigned in the taxpayer's records. If the Commissioner successfully rebuts the presumption, and if there is a regular place of business in Massachusetts, then the loan shall be presumptively located there. The taxpayer then has the burden to show (again, by preponderance of the evidence) that the preponderance of substantive contacts did not occur at the Massachusetts location. This sub-rule does not apply to the instant case, because Gate had no regular place of business (as defined in G.L. c. 63, § 1) anywhere.

The second sub-rule, found in § 2A(e)(vi)(B), is the one about which the taxpayer complains. This provision also allocates the presumptions and burdens of proof but, in this case, applies when the taxpayer has assigned the loan "to a place without the commonwealth which is not a regular place of business" (emphasis added) and, at the time the loan was made, the taxpayer's commercial domicile was in Massachusetts. When those two conditions are met, then there is no need for the Commissioner to show that the preponderance of substantive contacts did not occur at

the location to which the loan was assigned. The Commissioner may simply presume that the preponderance of substantive contacts regarding the loan occurred within Massachusetts. The provision puts the burden on the taxpayer to demonstrate (by the preponderance of the evidence) that the preponderance of substantive contacts with the loan did not occur in Massachusetts. Again, this provision allocates the burdens and presumptions between the Commissioner and the taxpayer, and determines the location of loans when they have not been properly assigned to a regular place of business.

According to the taxpayer, a portion of its loans were "assigned" to Florida (although it is not clear that this is where the loans were treated as assigned in the taxpayer's records). If Florida had the same rule as Massachusetts, the taxpayer contends, it would not be able to locate those loans in Massachusetts when filing in Florida. In effect, the taxpayer contends, it would have no choice but to continue to locate those loans in Florida, since the sub-rule in § 2A(e)(vi)(B), which provides for locating the loans in the taxpayer's state of domicile, governs only loans assigned "to a place without" the state. This,

it claims, creates internal inconsistency. But that assumes that the sub-rule of § 2A(e)(vi)(B) controls the general substantive rule as to when loans are deemed to be "properly assigned" in the first place – which it does not.

Substituting Florida for Massachusetts in that general substantive rule, a loan would be considered to be located in Florida only "if it is properly assigned to a regular place of business of the taxpayer within [Florida]." But the sub-rule of § 2A(e)(vi)(B), about which the taxpayer complains, specifies that it applies only if the loan is assigned to a place which is not a regular place of business—in essence—if the taxpayer improperly assigns the loan. There is no basis, therefore, for the taxpayer to contend that it must locate any of its loans in Florida simply because it assigned the loan to that state, improperly. Nor does the taxpayer contend that its commercial domicile might be in more than one state.

III. The apportionment formula was not applied to the taxpayer in an internally inconsistent manner.

Nothing in the decisions of the Massachusetts Appellate Tax Board nor of this Court indicates that the sub-rule of § 2A(e)(vi)(B) has been applied in an internally inconsistent manner. Before the Board, the taxpayer argued that the loans in question should be located in the state where third-party loan servicers worked on behalf of the trusts in which the loans were held. But the board concluded (correctly) that the location of the third-party servicers was not a regular place of business of the taxpayer. Under these circumstances, the board concluded that the loans should be presumed to be located in Massachusetts, the taxpayer's commercial domicile. This presumption was subject to rebuttal by the taxpayer "on a showing supported by the preponderance of evidence" that the preponderance of its substantive contacts with the loans occurred outside of Massachusetts. The Taxpayer failed to present any evidence the loan servicers were operating at the direction and control of the Taxpayer or were in fact agents of the trusts or, in turn, the Taxpayer. Nor did the taxpayer offer another basis for

the attribution of the loan servicers' activities to the taxpayer. This court held that whether or not the loan servicers were agents was irrelevant to determining the taxpayer's predominance of substantive contacts.

This Court found the language of § 2A(e)(vi)(B) to be unambiguous in establishing the rebuttable default presumption described by the board. The taxpayer argued the words "at the time the loan was made" meant the presumption of commercial domicile applies only in the context of an original lender. But this Court determined that a more reasonable interpretation is that the phrase "at the time the loan was made" is intended to resolve any ambiguity in the case of a taxpayer whose commercial domicile may have changed from within to outside the Commonwealth during the life of the loan. Because the taxpayer's commercial domicile was always in Massachusetts, application of the § 2A(e)(vi)(B) presumption to the taxpayer meant that "the preponderance of substantive contacts regarding the loan occurred within the commonwealth" for purposes of calculating the property factor, unless the presumption was rebutted by the taxpayer. Ultimately, this court concluded that the activities

of the third-party loan servicers here (even if they had been agents of the trusts) could not be understood as constituting activities of the taxpayer for purposes of determining the preponderance of substantive contacts.

The taxpayer complains that the application of the rule constituted, in effect, the creation of an irrebuttable presumption. But the fact that it was not possible for the taxpayer to rebut the presumption, given its circumstances, does not make the presumption itself irrebuttable. Again, the taxpayer claims that it assigned loans to Florida (for tax purposes at least), creating the internal inconsistency here. But in order to claim that it <u>properly</u> assigned those loans to Florida, then it must also claim that a regular place of business of the Taxpayer having the predominance of the substantive contacts with the loans was located in Florida. If this had in fact been the case, not only would the taxpayer have been able to rebut the presumption, the presumption would not have applied. If, instead, the taxpayer claims to have located the loans in Florida despite the fact they would not have been properly assigned there, then it is admitting that it did so in contradiction of the

rules that Florida must be presumed to follow. Either way, the taxpayer fails to support a claim that the rule in this case is internally inconsistent, or was applied in an internally inconsistent manner.

IV. The taxpayer's proposed remedies are unwarranted given that it cannot demonstrate that the apportionment formula applied was internally inconsistent.

The taxpayer contends that this Court must reconsider its application of the statutory formula and proposes an alternative reading of the statutory rules for that purpose. We do not address the taxpayer's proposed alternative reading, since there is no basis for claiming that the formula, as it is set out in the statute or applied here, is internally inconsistent. Suffice it to say that the taxpayer's alternative reading would substantially change how loans are located in conflict with this Court's own reading of the rules which it determined to be unambiguous.

CONCLUSION

The taxpayer has failed to show how the apportionment formula applied by Massachusetts in this case violates the internal consistency requirement. The loans in question, determined to be assigned improperly by the taxpayer, were determined instead to be located in Massachusetts by virtue of the fact that the taxpayer's domicile was in the state, and because the taxpayer failed to show that the predominance of substantive contacts with those loans did not occur in Massachusetts. It is not possible that any other state could claim that the loans were located, that is, properly assigned to that state under identical rules. For the reasons set forth above, the Commission believes that this court should uphold its previous decision.

Respectfully submitted,

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Dated: December 28, 2015

CERTIFICATION UNDER MASS. R. APP. P. 17

I, Lila Disque, hereby certify that the foregoing brief complies with all of the rules of court that pertain to the filing of briefs, including, but not limited to, Mass. R.A.P. 17 (brief of an Amicus Curiae) and Mass. R.A.P. 20 (form of briefs, appendices and other papers).

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CERTIFICATE OF SERVICE

I, Lila Disque, hereby certify that I have on this day caused the accompanying Brief of Amicus Curiae Multistate Tax Commission in Support of Defendant-Appellee the Commissioner of Revenue to be served upon all parties by causing two copies thereof to be mailed first class, postage prepaid, to:

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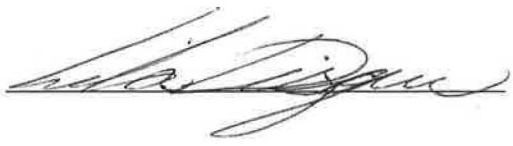

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