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Deloitte Tax LLP | July 15, 2022

MULTISTATE INCOME/FRANCHISE TAX

Massachusetts Supreme Court denies motion for reconsideration in apportionment case

Tax Alert

Overview

On May 16, 2022, the Massachusetts Supreme Judicial Court ("SJC") overturned an earlier decision of the Massachusetts Appellate Tax Board ("Board") in *VAS Holdings & Investment LLC v. Commissioner* ("*VAS Holdings*"). The Commissioner of the Massachusetts Department of Revenue ("Department") filed a motion for reconsideration of that decision and on June 30, 2022, the motion was denied by the SJC without further comment.

In its decision, the SJC held that using the apportionment factors of an underlying partnership to source the sale thereof, regardless of the existence of a unitary business, was constitutionally permissible. However, the SJC ultimately found in favor of the taxpayer, an S corporation, and its shareholders, concluding that the Massachusetts statutory and regulatory rules looked to the unitary business principle as the foundation of the state's apportionment rules. In other words, while under the U.S. Constitution, the Commonwealth *could* source gain from the sale of a non-unitary partnership using the partnership's own factors, the Massachusetts statutes do not provide the requisite authority to do so.

This Tax Alert summarizes the SJC's decision.

SJC rules that investee apportionment of partnership gain is constitutional, but not statutorily permitted

Background

The taxpayer, VAS Holdings & Investment LLC ("VASHI") was an S corporation with no Massachusetts property, payroll, or resident shareholders. In 2011, to facilitate a merger with Thing5, a Massachusetts based business, VASHI contributed its shares of stock in its subsidiary, Virtual-Agent Services Canada, Inc. ("VAS USA"), and VAS USA's subsidiary,

Virtual-Agent Services Canada Corp. ("VAS Canada") to a newly formed entity, Cloud5, in return for a 50% partnership interest. In turn, the owners of Thing5 contributed their membership units in exchange for the remaining fifty percent.

Following the merger, the business operations of VAS Canada and Thing5 were integrated and much of the new business was conducted in Massachusetts, where the CEO of Cloud5 resided. From 2011 to 2013, there was significant growth in the Cloud5 business. In 2013, VASHI sold its partnership interest in Cloud5 for a material gain. The parties stipulated that there was no unitary business between VASHI and Cloud5.

Holding

Before the Appellate Tax Board, the case turned on whether the gain on the sale should be apportioned using the factors of the owner, *i.e.*, "investor apportionment," or using the factors of the underlying partnership, *i.e.*, "investee apportionment."

The taxpayer argued that the unitary business principle required that for Massachusetts to tax a corporation, that itself does not do business in the Commonwealth, on a capital gain, that gain must be related to an asset used in that corporation's unitary business. The Appellate Tax Board ("Board") held that since the appreciation in value of Cloud5 was "inextricably connected to and in large measure derived from property and business activities in Massachusetts," the gain could be apportioned using the apportionment factors of Cloud5 and that no unitary relationship was required. In the Board's opinion, "the protection, opportunities and benefits afforded by Massachusetts, for Constitutional purposes, supplied the requisite connection between Massachusetts and business activities that resulted in the [gain on the sale of Cloud5.]"

On appeal, the SJC, on its own motion, took direct appellate review of the case from the Board. It looked to an earlier U.S. Supreme Court case, *International Harvester Co v. Wisconsin*, 322 U.S. 435 (1944), which found the taxation of dividends received by nonresident shareholders could be taxed by Wisconsin to the extent of the corporation's activity within the state. The Court held that, while subsequent cases in the area have focused on the unitary business principle, the unitary business principle was not the sole permissible method of apportioning income.

However, the SJC, again on its own motion, requested additional briefing following oral arguments on Massachusetts' statutory regime for taxing gains on the sale of partnership interests. Before the Board, the taxpayer had agreed that the tax could be assessed under Massachusetts law but argued that the exercise of that law was unconstitutional. The SJC examined the statutory framework for the taxation of the nonresident shareholders, which imposes tax on the capital gain associated with the sale of a business. The SJC held that the regulations implementing this provision generally require apportionment of gains and losses in a manner consistent with the unitary business principle.

The operative regulation taxed nonresidents conducting a trade or business in Massachusetts on capital gains from the sale of an interest in a partnership or limited liability company, even where the partner took no part in its management or operations, which would generally be indicative of a non-unitary relationship. However, the SJC distinguished the case at bar by stating that VASHI did not carry on a trade or business in Massachusetts. Accordingly, the SJC held that, while investee apportionment does not offend the Constitution, none of the gain was taxable in Massachusetts under the current law.

Considerations

An analysis of the applicability of *VAS Holdings case* should consider:

(1) whether the partner and partnership are unitary and

(2) whether the partner is actually engaged in a trade or business in Massachusetts.

It is expected that the Department will issue a public written statement to provide their view of the decision and how they intend to apply it to other taxpayers.

Get in touch

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