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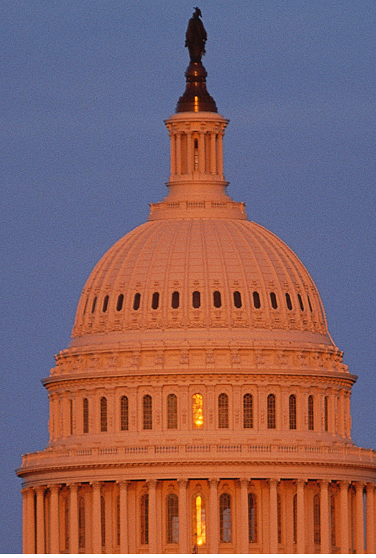

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Massachusetts: Taxpayer prevails in capital gain tax dispute on statutory, but not constitutional grounds

The Massachusetts Supreme Judicial Court—in a case addressing whether a state can tax capital gain from the sale of an interest in another business when the in-state business and the out-of-state owner are not in a unitary relationship—held in the Commissioner's favor on the constitutional question but ultimately concluded that the Massachusetts tax statutes did not authorize taxation of the capital gain at the level of the taxpayer or its shareholders.

The case is: *VAS Holdings & Investments LLC v. Commissioner of Revenue,* SJC-13139 (May 16, 2022). Read the **decision** [PDF 156 KB]

Background

Following a merger, the taxpayer (a nonresident S corporation with shareholders who were not Massachusetts residents) acquired a 50% interest in a Massachusetts LLC, which was treated for tax purposes as a partnership.

The S corporation taxpayer had no activity other than holding the interest in the Massachusetts LLC. The Massachusetts LLC, in turn, had a significant presence in the state, with at least 300 employees at one point.

The LLC's value and operations grew significantly in the years after the merger and before the sale. In 2013, the taxpayer sold its interest in the Massachusetts LLC and generated capital gain of approximately $37 million. On audit, the Department applied "investee apportionment," and calculated corporate excise and nonresident composite taxes owed by the taxpayer on 100% of the gain based solely on the payroll and property factors of the investee—that is, the factors of the Massachusetts LLC— as opposed to those of the nonresident S corporation taxpayer.

Under Massachusetts law, an S corporation's income, losses, and deductions are passed through the S corporation to the shareholders and are subject to tax at the shareholder level. Further, an S corporation is generally subject to the non-income measure of the corporate excise and to the income measure of the corporate excise on any income that is taxable to the S corporation federally at the full corporate excise rate (i.e., 8% for 2021) with a minimum excise of $456 annually. Finally, an S corporation with gross receipts of $6 million or more is subject to the income measure of the corporate excise tax on its net income at a specified rate, which is linked to its total receipts for a given taxable year (i.e., 2% rate if total receipts are $6 million or more and less than $9 million; and a 3% rate if total receipts are $9 million or more for 2021).

The taxpayer and its shareholders paid Massachusetts tax on the distributive share of income from the LLC's operations in the year of the sale and prior tax years. However, following the sale of the 50% LLC interest, the S corporation taxpayer and its shareholders took the position that the gain was not taxable in Massachusetts. The Commissioner disagreed with this treatment and the matter eventually came before the Appellate Tax Board.

Before the Board, the taxpayer argued that because it had no unitary relationship with the LLC and the investment in the LLC did not serve an operational function, the Commissioner was attempting to tax extraterritorial values in violation of the U.S. Constitution. The Board disagreed, determining that the taxpayer's "almost singular" focus on the unitary business principle was too narrow. Pointing to the U.S. Supreme Court's statement in *Allied-Signal Inc. v. Director, Division of Taxation*, the Board held that Massachusetts could constitutionally tax the gain and that the lack of unity did not preclude the Department's application of an investee apportionment method. The taxpayer subsequently appealed directly to the Massachusetts high court.

Supreme Judicial Court opinion

After reviewing two cases addressing investee taxation—*International Harvester* and *J.C. Penney*—the court determined that there was "strong support" for the Commissioner's position that the tax at issue would pass constitutional muster. In the court's view, the protections, opportunities, and benefits provided by the Commonwealth of Massachusetts to the LLC owned by the S corporation taxpayer would be sufficient to meet the constitutional requirement of nexus between the Commonwealth and the taxpayer so that the gain could be taxed by Massachusetts.

The court next addressed the taxpayer's position that the U.S. Supreme Court effectively repudiated its jurisprudence embodied in *International Harvester* and *J.C. Penney* and that the unitary business principle constituted the only constitutionally permissible methodology when it comes to a state's authority to tax a nondomiciliary business entity's capital gains.

At the outset, the court observed that the U.S. Supreme Court acknowledged that the existence of a unitary relationship between a taxpayer and an investee "is one justification for apportionment, but not the only one." The court distinguished cases when the "taxing state had no connection to entity that was the source of the income and thus the state chose to rely on the unitary business principle to reach out of state income." In other cases, the taxing state had such a connection, but applied the unitary business principle to tax the recipient of the income, rather than the entity that was the source of the income.

In contrast, in the instant case, the Commissioner did not rely on the existence of a unitary business relationship between the taxpayer and the investee LLC. Instead, the Commissioner relied on the connection between the Commonwealth and the LLC—the entity that was the source of the capital gain—to satisfy the constitutional requirement of a nexus between the Commonwealth and the source of the income that the state sought to tax under the principles developed by the Court in *Allied-Signal*.

Furthermore, unlike the cases when the taxing state relied on the unitary business relationship and used the apportionment percentage of the recipient of the income, in the instant case, the tax assessed by the Commissioner on the gain was based on the LLC's apportionment—not the taxpayer's apportionment. This satisfied the constitutional requirement that there must be a rational relationship between the tax and the activities of the entity that is the source of the value under the principles developed by the Court in *MeadWestvaco*. In the Massachusetts high court's view, there was nothing in the U.S. Supreme Court's jurisprudence that would preclude the Commonwealth from asserting its taxing authority based on the nexus to the LLC and to determine the tax using the LLC's apportionment percentage.

Having concluded that the constitution was not a bar to the taxation of the gain, the court next looked at whether the gain was statutorily taxable. Pursuant to the decision in *Gillette Co. v. Commissioner of Revenue*, "no method of determining tax liability is valid unless authorized by statute and assessed in conformity to its terms." This was an argument that the taxpayer had not raised before the Appellate Tax Board. The statutes established that the legislature has chosen to rely on the unitary business principle for determining taxability. Specifically, under Massachusetts law, apportionable income is defined with reference to the unitary business principle. Allocable income is attributed to Massachusetts if the taxpayer's commercial domicile is in the Commonwealth. Because there was no unitary relationship between the S corporation taxpayer and the LLC, the gain was not apportionable income. Further, the taxpayer's commercial domicile was not in Massachusetts. As such, the corporate excise tax statutes did not authorize tax on the gain as either apportionable or allocable income.

Similarly, the individual shareholders were not subject to composite tax on the gain because the S corporation was not engaged in a trade or business in the Commonwealth.

The statute asserting composite tax pursuant to G.L. chapter 62 section 5A was amended in 2003 to provide that taxable income "shall include gain from the sale of a business or an interest in a business." The regulations (830 Mass. Regs. Section 62.5A.1(3)) further clarify that such income "may" include capital gains and set forth rules for the apportionment and allocation of income for nonresident members of a pass-through entity. The Commissioner argued that the tax was allowable under the regulations providing that if a nonresident has carried on a trade or business in Massachusetts, state-source income includes, among other things, capital gains from the sale of an interest in a partnership or a limited liability company, even when the partner did not participate in the partnership's management or operations. However, the court found that the taxpayer S corporation did not carry on a trade or business in Massachusetts. Moreover, the regulations clearly limit the income subject to tax to that falling within the unitary business principle as a prerequisite to apportionment, which was not satisfied in the instant case.

Although the statutory argument was not raised before the Board, the Massachusetts high court concluded that the taxes (including a corporate excise tax and a nonresident composite tax) asserted by the Commissioner were invalid because the Commissioner lacked statutory authority to assert such taxes, notwithstanding that they were permitted under the U.S. Constitution. Therefore, the Board's decision was reversed.

KPMG observation

Given that the taxpayer prevailed on statutory grounds, tax professionals believe that a state petition for certorari to the U.S. Supreme Court is unlikely to be granted. However, there may continue to be disputes between state taxing authorities and taxpayers as to whether a state can tax the gain of a nondomiciliary taxpayer related to the sale of a business entity operating in the taxing state.

For more information, contact a KPMG State and Local Tax professional:

Dilyana Antevil | dantevil@kpmg.com
Jamie Posterro | jposterro@kpmg.com

kpmg.com/socialmedia

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