**COMMONWEALTH OF MASSACHUSETTS**

**APPELLATE TAX BOARD**

**DAVID J. POGORELC        v. COMMISSIONER OF REVENUE**

Docket No. C328710 Promulgated:

 October 4, 2018

 This is an appeal filed under the formal procedure pursuant to G.L. c. 58A, § 7 and G.L. c. 62C, § 39, from the refusal of the Commissioner of Revenue (“Commissioner” or “appellee”) to abate personal income tax assessed against David J. Pogorelc (“appellant”) for the tax year ending December 31, 2011 (“tax year at issue”).

 Commissioner Good decided this appeal. Chairman Hammond and Commissioners Scharaffa, Rose, and Chmielinski joined her in the decision for the appellee.

 These findings of fact and report are issued pursuant to a request by the appellant under G.L. c. 58A, § 13 and 831 CMR 1.32.

 *David J. Pogorelc, pro se*, for the appellant.

 *Jamie E. Szal,* Esq. and *Brett M. Goldberg,* Esq. for the appellee.

**FINDINGS OF FACT AND REPORT**

This case was presented by a Statement of Agreed Facts, exhibits, and briefs. The Appellate Tax Board (“Board”) made the following findings of fact.

On October 15, 2012, pursuant to a valid request for extension, the appellant filed his Massachusetts income tax return for the tax year at issue (“Original 2011 Massachusetts Income Tax Return”). On December 27, 2012, the appellant timely filed his Application for Abatement and Amended Return (“Amended Return”) for the tax year at issue, which the Commissioner denied on July 28, 2015. The appellant timely filed a Petition Under Formal Procedure with the Board on August 26, 2015 challenging the Commissioner’s denial. Based on these facts, the Board found and ruled that it has jurisdiction to hear and decide the instant appeal.

The appellant was a Massachusetts resident who regularly purchased and sold properties through a series of pass-through entities. The tax consequence of one such complex real estate transaction is the subject of the instant appeal.

In 2006, the appellant and a partner (“Partner 2”) utilized a lower-tier, disregarded entity, 7 Seaport, LLC (“Seaport”), to purchase a building in Quincy, Massachusetts. Seaport was wholly owned by Heaven at Seven, LLC (“Heaven”), which was at all relevant times treated as a partnership formed by the appellant and Partner 2.

One year later, in 2007, the appellant refinanced the acquisition debt that Seaport had incurred in acquiring the property. In connection with this refinancing, Meadows at Marina Bay, LLC (“Meadows”), an unrelated third party that was treated as a partnership, legally assumed half of the acquisition debt in exchange for 50% of Heaven’s interest in Seaport. Heaven liquidated and distributed its adjusted partnership basis in Seaport to the appellant and Partner 2, who immediately contributed that interest to a newly formed entity, DB Member, LLC (“DB Member”). At all relevant times, DB Member was treated as a partnership.

The gist of this transaction (“2007 Transaction”) was that 2 partnerships, DB Member and Meadows, now owned all of the assets of Seaport. Seaport, a formerly disregarded single-member entity, was now treated as a partnership for federal and Massachusetts tax purposes.

On his 2007 Massachusetts Income Tax Return, and in accordance with Revenue Ruling 99-5 (“Rev. Rul. 99-5”), the appellant treated the 2007 Transaction as a deemed sale of assets, whereby Heaven sold 50% of the assets it held in Seaport to Meadows, in exchange for Meadows assuming 50% of Seaport’s acquisition liability. As a result of the deemed sale of assets, Heaven recognized a capital loss, and the appellant’s distributive share of this capital loss was $4,206,134. The appellant was able to utilize a portion of this loss to offset other 2007 capital gains in the amount of $922,257; he then carried forward the remaining $3,256,168 capital loss to 2008, which he used in its entirety to offset capital gains realized that year. In total, the appellant realized a tax benefit in excess of $200,000 by use of the capital loss against other capital gains in 2007 and 2008.

Seaport later disposed of the property in 2011 (“2011 Transaction”). Seaport realized a capital gain on the sale. The appellant’s distributive share of that capital gain was $7,562,915. For federal purposes, the appellant was able to offset the entire gain from the 2011 Transaction with net operating losses (“NOLs”) carried forward from prior years; these NOLs were unrelated to the appellant’s Seaport activities. However, for Massachusetts purposes, the NOL carry forwards were not allowed as a deduction to the appellant. For Massachusetts purposes, the appellant was able to offset only a portion of the capital gains with expenses incurred in 2011. He did not have sufficient current-year losses to offset the gain in full.

After filing his Original 2011 Massachusetts Income Tax Return in a manner consistent with having previously treated the 2007 Transaction as a deemed sale of assets, the appellant later filed the Amended Return, seeking a refund of taxes for the tax year at issue based on the premise that the 2007 Transaction was not, in fact, a deemed sale of assets. The appellant contended that Massachusetts does not recognize deemed asset sales. Had he not originally treated the 2007 Transaction as a deemed sale of assets, the appellant would have recognized neither a capital loss for tax year 2007 nor a capital gain on the 2011 Transaction. In other words, now that the time to amend his 2007 Massachusetts Income Tax Return has expired, and it is too late to forego the 2007 capital loss, the appellant now challenges the 2011 capital gain.

For the reasons stated more fully in the following Opinion, the Board found that the appellant properly treated the 2007 Transaction as a deemed sale of assets on his 2007 Massachusetts Income Tax Return, and thus, the appellant properly realized a capital gain on the 2011 Transaction. Therefore, the Board found and ruled that his Original 2011 Massachusetts Income Tax Return was proper as filed.

Accordingly, the Board issued a decision in favor of the appellee, upholding the denial of the appellant’s abatement request in the instant appeal.

**OPINION**

The question raised on appeal is whether the Commissioner properly denied the appellant’s request for abatement of income tax based on the treatment of the 2007 Transaction as a deemed sale of assets held by a disregarded entity, consistent with federal tax law.

Rev. Rul. 99-5, promulgated pursuant to the authority granted under Internal Revenue Code (“Code”) § 721 and related sections, prescribes the federal income tax consequences of transactions in which a single-member domestic LLC, which is disregarded for tax purposes, later becomes an entity with more than 1 owner, which is then treated as a partnership. Rev. Rul. 99-5 describes 2 different scenarios whereby the disregarded single-member entity becomes a partnership. In Situation 1, the buyer purchases the membership interest from the existing single member. In Situation 2, the buyer acquires the membership interest by investing directly in the LLC. Situation 1 is treated as a deemed sale of the assets of the former LLC, where Situation 2 is treated as a nontaxable direct contribution into a new partnership.

Central to the Commissioner’s position in the instant appeal is that the appellant followed Rev. Rul. 99-5 in filing its 2007 federal tax return and 2007 Massachusetts Income Tax Return. The appellant filed his 2011 federal tax return and his Original 2011 Massachusetts Income Tax Return in a manner consistent with having treated the 2007 Transaction as a Situation 1 scenario. The appellant does not dispute that, for federal purposes, the 2007 Transaction was a Situation 1 transaction, which generated a capital loss to Heaven, and which was realized by the appellant. However, the appellant now contends, after he has already reaped the benefit of the capital loss in tax year 2007, that Massachusetts somehow does not follow Rev. Rul. 99-5 and its prescribed tax consequences for Situation 1.

A single-member LLC is disregarded in Massachusetts if it is treated as a disregarded entity for federal income tax purposes. G.L. c. 63, § 30 para. 2. By contrast, an LLC with more than 1 member is treated as a partnership for Massachusetts tax purposes if it is classified as a partnership for federal income tax purposes. G.L. c. 63, § 30 para. 16. The Commissioner’s regulation at 830 CMR 63.30.3(4)(a), para. 3 specifies that, in general, federal rules of classification are incorporated into Massachusetts law, unless a Massachusetts statute explicitly states otherwise:

To the extent rules or principles are not otherwise described in this regulation, the Massachusetts tax consequences of reclassifications pursuant to the Act[[1]](#footnote-1) and of transactions and deemed transactions that result in a change in the entity classification will generally be determined by applying federal rules and principles, including those related to income recognition and basis adjustments.

The appellant points to no such statute that would exclude federal LLC classification principles including those stated in Rev. Rul. 99-5. Moreover, the Commissioner’s regulation cited above notes that the federal classification principles of LLCs “have applied in Massachusetts . . . since 1997.” 830 CMR 63.30.3(1)(a). *See* ***SAHI, Inc. v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 2006-794, 816 (finding that, where there was congruence between federal and Massachusetts tax law with respect to the allowance of depreciation deductions, “there is no ground for variation”).

Furthermore, the Supreme Judicial Court and the Board have adhered to federal tax consequences where the result does not conflict with relevant Massachusetts tax authorities. In ***General Mills v. Commissioner of Revenue***, 440 Mass. 154 (2003), the SJC upheld the Board’s ruling that, where both the taxpayer and its subsidiary had made an election under Code § 338 to treat the sale of the subsidiary’s stock as a sale of the subsidiary’s assets, and there was no Massachusetts statute specifically disregarding a Code § 338 election or otherwise excluding income resulting from such an election, the federal treatment of a Code § 338 sale was carried over to Massachusetts.

It is when a federal tax statute, which creates a fiction for tax purposes, actually conflicts with an existing Massachusetts law that the federal tax fiction will not be followed for Massachusetts tax purposes. For example, in ***Combustion Engineering. Inc. v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 2000-207, the taxpayer made a Code § 338 election to have the sale of its stock treated as if its subsidiary had sold its assets for fair market value. However, G.L. c. 63, § 38(f), in effect at that time, excluded the sale of stock for purposes of calculating the corporate excise’s sales factor. Therefore, because a specific Massachusetts provision conflicted with the federal provision, the Board ruled that “the federal treatment of the sale - based on a fictitious recasting of the actual transaction for purposes of federal tax law – does not determine whether the proceeds of the transaction should be treated as a ‘sales’ for purposes of the Massachusetts apportionment formula.” ***Id.*** at 2000-216.

Moreover, recognition of a federal tax treatment is warranted where the transaction was not a fiction but instead an actual sale resulting in real gain or loss to the taxpayer. For example, the taxpayer in ***Bill DeLuca Enterprises, Inc. v. Commissioner of Revenue***, 431 Mass. 314 (2000) owned a fleet of vehicles for which he took depreciation deductions each year that exceeded the company’s income, thus generating substantial NOLs. ***Id***. at 316-17. For federal tax purposes, the taxpayer reported NOLs for each of the tax years between the fleet’s purchase date and the sale date. For Massachusetts, the taxpayer reported NOLs in those years, but the version of G.L. c. 63, § 30 then in effect did not allow carry forward and carry back of excess NOLs from one year to another. ***Id***. at 317. When the company later sold part of its fleet, the sale generated a sizeable gain because of the depreciated value of the vehicles. ***Id.*** For Massachusetts tax purposes, the taxpayer could not offset the sale with excess NOLs as he could for federal purposes. ***Id***. at 318. The taxpayer argued that the gain was fictional for Massachusetts purposes and thus prohibited from being taxed pursuant to Article 44 of the Massachusetts Constitution. ***Id***. at 322. In rejecting this claim, the Supreme Judicial Court emphasized the real nature of the transaction’s end result:

[f]rom a strict annual accounting perspective, there is no question that DeLuca realized an actual gain in 1989. DeLuca sold vehicles and received $8,282,105 in return. This was real income, which DeLuca could spend, as it chose, and which the Commonwealth could tax.

***Id***. at 323.

Likewise, the 2007 Transaction at issue in this appeal was not a fiction; it resulted in a new and unrelated partner, Meadow, owning a share of the assets, along with its respective shares of the liabilities, of Seaport. Analogous to ***Bill DeLuca Enterprises***, where the taxpayer realized an actual gain, the appellant here realized an actual loss, which he “spent” as an offset against his Massachusetts taxable income. The appellant did not dispute the “real” nature of the 2007 Transaction when he utilized the loss that it generated to offset gains in tax years 2007 and 2008. Moreover, the Supreme Judicial Court recognizes that a fiction, which the Court described as an “imaginary transaction that was deemed to have taken place for the sole purpose of assessing taxes,” ***id***. at 324, is fundamentally distinct from a transaction that results in a later inequity between the federal and Massachusetts tax systems: “Transactional inequities, by contrast [with fictional gain], cannot practically be eliminated from the annual tax system.” ***Id.*** at 323.

Moreover, because the 2007 Transaction had consequences beyond tax reporting, namely a new ownership structure for Seaport and the partial discharge of indebtedness for Heaven, the instant appeal differs from ***Weston Marketing v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 1994-34, *aff’d,* 40 Mass. App. Ct. 1108 (1996), a case cited by the appellant as an example of Massachusetts not recognizing a federal fiction. ***Weston Marketing*** pertained to federal “mark to market” rules of Code § 1256, pursuant to which a Subchapter S taxpayer holding regulated futures contracts was required to recognize gain or loss as if the commodities had been sold on the last day of the year. ***Id***. at 1994-37. On its federal return, the taxpayer was allowed to recognize a capital loss based on a fictitious sale under Code § 1256. ***Id***. at 1994-37. The federal recapture of income compensated for a loss that the taxpayer was required to report under federal but not Massachusetts taxing statutes. However, because Massachusetts at the time did not recognize Subchapter S during the tax years there at issue, the taxpayer could not and did not recognize a capital loss for Massachusetts tax purposes. ***Id***. at 1994-40. *See also* ***T.H.E. Investment Corp. v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 1986-473 (finding no basis for recapturing the taxpayer’s subsidiary’s losses that it was able to deduct on its federal but not on its state tax return, since “no Massachusetts tax was ever deferred”).

Under the facts of the instant appeal, the contested item of income - gain generated from the 2011 Transaction, calculated with reference to the basis adjustment resulting from the 2007 Transaction – does not represent a conflict between the Massachusetts and federal tax systems. Unlike in ***Weston***, it does not represent a recapture of a federal benefit that the taxpayer did not receive in Massachusetts. In fact, the appellant did receive a benefit from the 2007 Transaction when he was able to offset income in tax years 2007 and 2008 with the losses that the 2007 Transaction generated. The fact that the subsequent 2011 Transaction resulted in disparate tax treatment under the federal and Massachusetts systems does not somehow transform the 2007 Transaction into a fiction. Having chosen the structure of the 2007 Transaction, the appellant must now accept all of the resulting tax consequences that it begets, not just those that result in a tax benefit to him. *See* ***National Alfalfa v. Commissioner***, 417 U.S. 134, 149 (1974) (“[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not.”) (citations omitted); *c.f*., ***Route 231, LLC v. Commissioner***, 810 F.3d 247, 258 (4th Cir. 2016) (“A taxpayer may be barred from taking one factual position in a tax return and then taking an inconsistent position later in a court proceeding in an effort to avoid liability based on the altered tax consequences of the original position.”).

**Conclusion**

Based on the foregoing, the Board ruled that the appellant failed to meet his burden of proving that he was entitled to an abatement of the taxes based on his theory that the 2007 Transaction was a fiction for Massachusetts tax purposes. Accordingly, the Board issued a decision for the appellee in this appeal.

 **THE APPELLATE TAX BOARD**

**By: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**Thomas W. Hammond, Jr., Chairman**

**A true copy,**

**Attest: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

 **Clerk of the Board**

1. “Act” refers to Chapter 173 of the Acts of 2008, pertaining to the classification and treatment of unincorporated businesses for purposes of the Massachusetts corporate excise and personal income taxes. [↑](#footnote-ref-1)