COMMONWEALTH OF MASSACHUSETTS

APPELLATE TAX BOARD

VAS HOLDINGS & INVESTMENTS LLC v. **COMMISSIONER OF REVENUE**

Docket Nos. C332269 & C332270

Promulgated: October 23, 2020

These are appeals 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 ("appellee" or "Commissioner") to grant abatements of taxes related to assessments issued to VAS Holdings and Investments LLC ("appellant") for the tax year ended December 31, 2013 ("tax year at issue").[1]

Commissioner Scharaffa heard these appeals. Chairman Hammond and Commissioners Rose, Good, and Elliott joined him in the decisions for the appellee.

These findings of fact and report are made at the requests of the appellant and the appellee pursuant to G.L. c. 58A and 831 CMR 1.32.

Michael J. Bowen, Esq., for the appellant.

Brett M. Goldberg, Esq., *Andrew P. O'Meara,* Esq., and *Michael P. Clifford*, Esq., for the appellee.

[1] Docket No. C332270 is an appeal from the Commissioner's refusal to abate corporate excise assessed under G.L. c. 63, § 32D. Docket No. C332269 relates to personal income tax assessed under G.L. c. 62, §§ 5A and 17A, and 830 CMR 62.5A.1 ("nonresident composite tax").

FINDINGS OF FACT AND REPORT

I. INTRODUCTION

These appeals involve a constitutional challenge to the Commissioner's imposition of taxes on a capital gain realized by the appellant, a nonresident S corporation, from the sale of the appellant's interest in Cloud5 LLC ("Cloud5"), a Massachusetts limited liability company that for federal and Massachusetts tax purposes was a partnership from its formation through the tax year at issue.

The appeals were presented through an Agreed Statement of Facts, various exhibits, and the testimony of three witnesses who were offered by the appellant: Mr. Richard Gray, a strategic investor and the largest single shareholder in the appellant; Mr. Raymond Cohen, Mr. Gray's business partner and, with his spouse, the owner of the most shares of the appellant after Mr. Gray; and Mr. David Thor, the founder and managing director of Thing5, LLC, ("Thing5"), which is discussed below. On the basis of the evidence of record, the Appellate Tax Board ("Board") made the following findings of fact.

II. PROCEDURAL HISTORY

On September 12, 2014, the appellant, formerly known as VAS Holdings, Inc., timely filed a Form 355S, S Corporation Excise Return and, on behalf of its shareholders, a Form MA

NRCR Nonresident Composite Return, both relating to the tax year at issue. Following issuance of Notices of Intent to Assess, the Commissioner timely issued a Notice of Assessment to the appellant with respect to corporate excise on September 7, 2016, and with respect to nonresident composite tax on September 12, 2016 ("NOAs").[2]

On January 23, 2017, the appellant timely filed two Massachusetts Forms ABT, Applications for Abatement, to protest the adjustments reflected in the NOAs. On January 27, 2017, the Commissioner issued two Notices of Abatement Determination denying each of the appellant's abatement applications in its entirety. On March 20, 2017, the appellant timely filed petitions before the Board initiating the present appeals.

Based on the foregoing, the Board found and ruled that it had jurisdiction to hear and decide these appeals.

[2] The NOAs included penalties under G.L. c. 62C, § 35A, which apply if the tax shown on a return substantially understates the tax due. ***Id.*** Though the appellant's opposition to the § 35A penalties was referenced in its Petitions to the Board and the parties' Agreed Statement of Facts, the appellant did not present evidence or arguments in support of its opposition, either during the hearing of the appeals or in its post-trial briefs. Consequently, the Board found and ruled that, with respect to this issue, the appellant failed to sustain its burden of demonstrating its entitlement to an abatement, *see, e.g.*, ***Boston Prof'l Hockey Ass'n v. Comm'r of Revenue***, 443 Mass. 276, 285 (2005), and was therefore not entitled to relief from liability for the penalties.

III. FACTUAL BACKGROUND:

A. APPELLANT'S BUSINESS OPERATIONS PRIOR TO OCTOBER 31, 2011

Prior to October 31, 2011, the appellant was a subchapter S corporation organized under the laws of Illinois and headquartered in Illinois, where its various administrative, sales, marketing and financial functions were performed. The appellant was the sole shareholder of Virtual-Agent Services Canada, Inc., also an Illinois corporation ("VAS USA"). Prior to the 2011 merger of the appellant and Thing5, discussed below, VAS USA was a qualified subchapter S subsidiary for federal and Illinois tax purposes. Following the merger, VAS USA was a C corporation for federal and Massachusetts purposes. VAS USA was a holding company that had no employees or active business activity, and was the sole shareholder of Virtual-Agent Services Canada Corp., at all relevant times a Canadian C corporation ("VAS CANADA").

VAS Canada operated telephone call centers in Canada, and facilitated hotel and travel reservations for a variety of industries, with a majority of clients in the hotel industry. As of October 31, 2011, VAS Canada had approximately 1400 employees, and its employees and property were located in Canada. Neither the appellant, nor VAS USA or VAS Canada had clients or business connections in Massachusetts.

B. BUSINESS OPERATIONS OF THING5 PRIOR TO OCTOBER 31, 2011.

Thing5 was formed as a Massachusetts limited liability company under G.L. c. 156C. Prior to the 2011 merger of the appellant and Thing5, Thing5 was a partnership for federal and Massachusetts tax purposes. After the merger, Thing5 was disregarded as an entity separate from Cloud5 for federal and Massachusetts tax purposes.

Thing5 was 100% owned by Mr. Thor, its CEO, and his spouse, Maura Thor, who were both Massachusetts residents. Thing5 provided hosted PBX, hosted voicemail, mobile applications for guests, and support of legacy PBX systems, primarily to clients in the hotel industry.

Thing5 was headquartered and conducted its business from its offices in Springfield and Longmeadow, Massachusetts, and had between 40 and 50 employees, the majority of whom were located in Massachusetts. Except for backup computer servers and equipment housed in Florida, Thing5 did not own or lease property outside of Massachusetts.

C. DAVID COLER

Mr. Coler was hired by the appellant's CEO prior to 2011 to provide IT consulting services to the appellant, and he also added value to the appellant based on his industry connections. Mr. Thor had known Mr. Coler for several years prior to the tax year at issue and was aware of his IT consulting business, including Mr. Coler’s provision of services to the appellant.

Sometime prior to October 31, 2011, Mr. Coler approached the appellant’s shareholders about the possibility of a merger between the appellant and Thing5, and subsequently introduced the appellant’s shareholders to Mr. Thor to facilitate merger negotiations.

D. 2011 MERGER OF THE APPELLANT AND THING5

The parties participated in negotiations relating to the merger of the appellant and Thing5, and having exchanged financial information, agreed on a valuation of approximately $17.5 million for each entity and a resultant 50/50 split of the equity in the merged entity.

Cloud5 was formed on or about August 22, 2011, for the sole purpose of effecting the merger. On October 31, 2011, in a single integrated transaction (“2011 Merger”), the appellant contributed all its shares of stock in its subsidiary VAS USA to Cloud5 in exchange for 50% of the membership units of Cloud5. David and Maura Thor contributed all of their membership units in Thing5 to Cloud5 in exchange for 50% of the membership units of Cloud5.

Following the 2011 Merger, VAS USA and Thing5 were wholly-owned subsidiaries of Cloud5. VAS Canada remained a wholly-owned subsidiary of VAS USA. After the 2011 Merger, the appellant had no employees or operations, and did not own or lease any real or tangible property. Its only material asset, other than bank accounts, was its 50% ownership interest in Cloud5.

E. BUSINESS OPERATIONS OF CLOUD5 AFTER THE 2011 MERGER

The 2011 Merger resulted in the integration of the business operations of VAS Canada and Thing5. Pursuant to an Operating Agreement addressing the operation and management of Cloud5,[3] Mr. Thor became CEO of Cloud5 and assumed responsibility for the call center operations of VAS Canada in addition to his prior responsibilities at Thing5. Employees of Thing5 in Massachusetts performed all of the functions previously conducted by the appellant out of its Illinois offices, which were closed.

Under Mr. Thor's management, Cloud5 consolidated the business operations of VAS Canada, and increased its overall profitability. In particular: the staffing model of VAS Canada was changed based on data and tools available to Thing5 that

[3] The agreement also provided for: management of Cloud5's "business and affairs" under the direction of a Board of Managers, which included Mr. Cohen, Mr. Gray, and David and Mora Thor; and appointment of Mr. Cohen as Chairman of the Board of Cloud5 and its "tax matters partner." Between October 31, 2011 and October 11, 2013, the Board of Managers was not active and its only formal meeting took place to approve the sale of Cloud5 in October of 2013. Similarly, Mr. Cohen was not active as Cloud5's tax matters partner.

had not been available to the appellant; the number of VAS Canada’s employees was reduced from 1400 to approximately 800; unprofitable client contracts of VAS Canada were not renewed; and the total number of VAS Canada’s clients was reduced.

Thing5’s operations grew significantly: Thing5 established a call center in Springfield, Massachusetts, and for that purpose leased approximately 10,000 square feet of office space in Springfield; the number of employees working at the Springfield center varied, reaching a maximum of approximately 300; the number of Thing5 employees working in its outsourcing and hosting business increased from between 40 and 50 to approximately 70; Thing5’s product offerings increased; and the number of Thing5’s customers increased.

F. THE APPELLANT’S 2012 FLORIDA REINCORPORATION

On or about December 17, 2012, the appellant moved its state of organization from Illinois to Florida. At the time of the Florida reincorporation, and through the 2013 sale of its interest in Cloud5, four of the shareholders of the appellant, who collectively owned more than 64% of the appellant’s shares, were residents of Florida. No shareholders of the appellant were residents of Massachusetts. After the Florida reincorporation, and having closed its Illinois offices the year before, the appellant was not required to, and did not file, Illinois tax returns.

G. 2013 SALE OF CLOUD5

On October 11, 2013, the appellant sold its entire 50% interest in Cloud5 to an unrelated party, realizing a taxable capital gain slightly in excess of $37 million ("Sale Gain"). The majority of the Sale Gain was attributable to the increase in value of Cloud5 between the date of the 2011 Merger and the date of the sale of Cloud5, and was related to business activities in Massachusetts. The increase in value resulted from: improved management and staffing of the call center business; expansion of the product offerings of Thing5's outsourcing and hosting technology business; the integration of the call center business with Thing5's outsourcing and hosting technology business; and the increase in the number of customers and properties served by Thing5's outsourcing and hosting technology business.

The appellant, as a pass-through entity for federal tax reporting purposes, was not required to pay federal taxes with respect to the Sale Gain. Instead, the appellant's shareholders each paid federal personal income tax on the gain. The appellant's shareholders who were required by operation of state law to report and pay tax to their state of residence did so with respect to the gain.[4]

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[4] The appellant made no argument that the Massachusetts personal income taxes at issue in these appeals were duplicative, perhaps because the states

IV. CONCLUSION

On the basis of the evidence presented and the reasonable inferences drawn therefrom, as well as consideration of relevant authority, which is discussed below, the Board found and ruled that: (1) the contested assessments were proper under applicable Massachusetts statutes and regulatory authority; and (2) the appellant failed to demonstrate that the assessments resulted in taxation of extraterritorial values in violation of the United States Constitution. Accordingly, the Board issued decisions for the appellee in these appeals.

OPINION

Pursuant to G.L. c. 63, § 39, a foreign corporation "actually doing business in the commonwealth" is subject to tax on its net income derived from business conducted in the commonwealth. The statute defines "doing business" to "mean and include each and every act, power, right, privilege, or immunity exercised or enjoyed in the commonwealth, as an incident to or by virtue of the powers and privileges acquired by the nature of such organizations . . . ." G.L. c. 63, § 39(1).

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to which taxes had been paid by its shareholders offered credit for taxes paid to other jurisdictions, including Massachusetts.

Under G.L. c. 63, § 32D, which discusses determination of the net income measure of the corporate excise as it relates to S corporations, an S corporation is subject to a corporate excise at a specified rate, which is linked to its total receipts for a given taxable year.

Non-resident individual shareholders of an S corporation are subject to Massachusetts personal income tax, in relevant part, via application of G.L. c. 62, §§ 5A and 17A ("Section 5A," and "Section 17A"). In particular, Section 5A(a) imposes a tax on the Massachusetts gross income of a non-resident, and states:

> Items of gross income from sources within the commonwealth are items of gross income derived from or effectively connected with: (1) any trade or business, including any employment carried on by the taxpayer in the commonwealth, whether or not the nonresident is actively engaged in a trade or business or employment in the commonwealth in the year in which the income is received.

Id.

Section 17A(b) provides, in pertinent part, that:

> [a] nonresident of the commonwealth who is a shareholder of an S corporation . . . which is subject to tax under chapter sixty-three shall be subject to the tax imposed by section five A on his distributive share of the income realized by the S corporation as would be subject to taxation under section five A if realized by a nonresident.

Section 17A(c) also states that:

> [t]he character of any item of income, loss, deduction or credit included in a shareholder's distributive share shall be determined as if such item were realized or incurred directly by the shareholder from the source from which realized by the corporation or incurred in the same manner as incurred by the corporation.

Treatment of a partnership’s business is addressed, in part, in G.L. c. 63, § 32B(b)(3), which provides, in pertinent part:

> Any business conducted by a partnership shall be treated as the business of the partners, whether the partnership interest is directly held or indirectly held through a series of partnerships, to the extent of the partner's distributive share of the partnership's income, regardless of the magnitude of the partner's ownership interest or its distributive share of partnership income.

Finally, regulatory authority at 830 CMR 63.38.1(9)(d)3.e, as in effect for the tax year at issue, attributed sales of a partnership interest to Massachusetts if, as in the present appeals:

> the sum of the partnership’s Massachusetts property and payroll factors for the taxable year in which the sale occurred exceeds the sum of its property and payroll factors for any other one state.

There is no disagreement between the parties regarding the tax status – for either federal or Massachusetts purposes - of the various entities involved in these appeals. Similarly, the parties agree as to the elements of Massachusetts law, outlined above, that apply to and are dispositive of the appeals. Finally, the parties agree that 100% of the appellant's distributive share of Cloud5's income derived from its regular business operations should be apportioned or allocated to Massachusetts under G.L. c. 63, § 38, and that such income is both: (1) subject to Massachusetts personal income tax under G.L. c. 62, § 5A, as if realized directly by the appellant's shareholders under G.L. c. 62, § 17A; and (2) subject to corporate excise tax under G.L. c. 63, § 32D. Indeed, in its brief, the appellant stated that "there can be no serious question that Massachusetts has a constitutional right to tax the distributive share income received by a nonresident from a partnership engaged in business in the commonwealth," explicitly acknowledging both that such income "is derived from business activities conducted in the commonwealth," and that the appellant, through Cloud5, "avail[ed] itself of the protections and benefits afforded by the commonwealth."

Though the appellant acknowledges taxable nexus with Massachusetts, the parties disagree as to whether application of relevant Massachusetts law results in impermissible taxation of the Sale Gain. In the appellant's view, the sale of its interest in Cloud5 did not involve the requisite "minimum connection" to Massachusetts or availment of the protections and benefits of Massachusetts law as required by the Due Process and Commerce Clauses of the United States Constitution.

The Board found the appellant's arguments in support of its position unpersuasive.

The Board began with the well-settled principle that "'[a] tax measure is presumed valid and is entitled to the benefit of any constitutional doubt, and the burden of proving its invalidity falls on those who challenge the measure.'" ***WB&T Mortgage Co. v. Assessors of Boston***, 451 Mass. 716, 721 (2008)(quoting ***Andover Savings Bank v. Commissioner of Revenue***, 387 Mass 229, 235 (1982)). In this regard, an appellant "always has the 'distinct burden' of showing by 'clear and cogent evidence' that [the state tax] results in extraterritorial values being taxed." *See* ***Container Corp. of Am. v. Franchise Tax Bd.,*** 463 U.S. 159, 175 (1983) (citation omitted.) Based on the facts of the present appeals, and the application of Massachusetts law that gave rise to the disputed assessments, the Board found and ruled that the appellant failed to sustain this burden.

1. **INVESTEE TAXATION**

The appellant first correctly observed that a state may not tax extraterritorial values, *i.e.*, "value[s] earned outside its borders," ***Container Corp.,*** 463 U.S. **at** 164, and that this principle:

> rests on the fundamental requirement of the Due Process and Commerce Clauses that there be 'some definite link, some minimum connection, between a

> state and the person, property or transaction it seeks to tax. [citation omitted.]

Allied-Signal v. Director, Division of Taxation, 504 U.S. 768, 777 (1992).

The appellant next focused on "the unitary business principle" as the "linchpin" of a state's authority to consider out-of-state values in taxing a corporation for the privilege of conducting business in the state. ***Bear Hill Nursing Center v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Reports, 2004-586, 606 (citing ***Mobil Oil Corp. v. Commissioner of Taxes of Vt.,*** 445 U.S. 425, 439 (1980)).

The unitary business principle "requires that there be some bond of ownership or control uniting the purported 'unitary business.'" ***Container Corp.,*** 463 U.S. at 166. "[T]he constitutional test focuses on functional integration, centralization of management, and economies of scale." ***Allied-Signal,*** 504 U.S. at 783.

The appellant and the Commissioner agreed that none of the three hallmarks of a unitary business is present in these appeals. That is, the relationship between the appellant and Cloud5 was not characterized by functional integration, centralization of management, or economies of scale. Neither did the Commissioner argue that the Sale Gain resulted from an investment that served an "operational function," which would provide an alternate basis for passing constitutional muster.

Id. at 787. In turn, the appellant concluded that Massachusetts law, as written and as applied in these appeals, resulted in assessments that seek to tax extraterritorial values in violation of the United States Constitution.

The Board found that the appellant's almost singular focus on the unitary business principle was too narrow. Indeed, as the Supreme Court stated in ***Allied Signal***:

> To be sure, the existence of a unitary relation between the payor and the payee is one means of meeting the constitutional requirement. Thus, in *ASARCO* and *Woolworth* we focused on the question whether there was such a relation. We did not purport, however, to establish a general requirement that there be a unitary relation between the payor and the payee to justify apportionment, nor do we do so today.

Id.

The so-called "investee apportionment" methodology focuses on taxation of a taxpayer's income that is derived from another entity, via investment or otherwise, which is based on the other entity's property and activities in the taxing state. This methodology is distinct from "investor apportionment," the more familiar methodology generally applicable under the unitary business principle, which is based on the in-state activities of the taxpayer/investor.

The Supreme Court, in ***International Harvester v. Wisconsin Dep't of Taxation***, 322 U.S. 435 (1944), upheld application of the Wisconsin Privilege Dividend Tax, which imposed a tax on dividends out of corporate income derived from property and business activities in Wisconsin. The tax was paid by investors who had no connection to Wisconsin other than their ownership of the business entity that had in-state business operations. The Court noted that the statute at issue:

> by directing deduction of the tax from declared dividends, distributes the tax burden among the stockholders differently than if the corporation had merely paid the tax from its treasury and that the tax is thus, in point of substance, laid upon and paid by [non-resident] stockholders.

Id. at 440.

In rejecting the taxpayer's constitutional challenge, the Court also rejected the assertion that a state's power to tax must be based on the taxpayer's in-state activities:

> Wisconsin may impose the burden of the tax either upon the corporation or upon the stockholders who derive the ultimate benefit from the corporation's Wisconsin activities. Personal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them. A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers.
>
> We think that Wisconsin may constitutionally tax the Wisconsin earnings distributed as dividends to the stockholders. It has afforded protection and benefits to appellants' corporate activities and transactions within the state. These activities have given rise to the dividend income of appellants' stockholders and this income fairly measures the

> benefits they have derived from these Wisconsin activities.

Id. at 441, 442.

The constitutionality of investee apportionment has also been affirmed in two New York appellate cases, both of which relate to taxation of the same transaction that was at issue in ***Allied-Signal,*** in which the Supreme Court construed a New Jersey tax. *See*, ***Allied-Signal, Inc. v. Commissioner of Finance***, 580 N.Y.S. 2d 696 (1991)(involving a New York city tax)("***NY Allied 1***"); and ***Allied Signal Inc. v. Tax Appeals Tribunal of Dep't of Taxation & Fin.,*** 645 N.Y.S. 2d 895 (1996)(involving a New York state tax))("***NY Allied 2***").

The transaction reviewed both by the Supreme Court and the New York court related to Bendix Corporation, a Delaware corporation commercially domiciled in Michigan that conducted business in all 50 states. ***Allied-Signal,*** *504 U.S. at* 773. Bendix's operations in New Jersey included development and manufacture of aerospace products. ***Id.*** Bendix's operations in New York City involved activities of its International Group, which developed business abroad. ***NY Allied 1,*** 580 N.Y.S. 2d at 698. ASARCO, Inc. a New Jersey Corporation commercially domiciled in New York, was a leading producer of non-ferrous metals. ***Allied-Signal,*** *504 U.S. at* 774.

Bendix purchased 20.6% of ASARCO's stock on the open market, which it later sold, realizing a gain of $211.5 million. New Jersey, New York State and New York City all taxed Bendix on an apportioned share of its gain from the sale of ASARCO. The operative difference between the New Jersey tax considered and rejected by the Supreme Court, and the New York cases, was the apportionment methodology employed by each state.

New Jersey determined its apportioned share of the ASARCO gain using Bendix's New Jersey allocation factor, which was based on Bendix's property, sales, and payroll, and did not in any way account for ASARCO's property, sales, and payroll. This was an example of investor apportionment, because it was based on the in-state activities of Bendix, the investor/taxpayer.

Bendix and ASARCO were unrelated businesses that were not unitary, and the Supreme Court held that New Jersey's apportionment methodology, as applied to the ASARCO gain, was unconstitutional. As the Court had held in Container Corp., "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." ***Container Corp.***, 463 U.S. at 169. Given that Bendix and ASARCO were unrelated, an apportionment formula based only on Bendix's New Jersey property, sales, and payroll, could not satisfy this requirement.

Unlike the New Jersey taxing scheme, the contested New York taxes, which were almost identical to each other, were measured by the New York activities of the investee, ASARCO, and reflected the degree of its New York presence. ***NY Allied 1,*** 645 N.Y.S. 2d at 697. Upholding the constitutionality of the disputed tax, the New York appellate court made explicit reference to relevant Supreme Court precedent:

> In determining whether a sufficient nexus exists between a taxing jurisdiction and the income it seeks to tax, the Supreme Court has emphasized that the inquiry should focus upon whether "the taxing power exerted . . . bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return" (citations omitted)

Id. at 701.

Relying on ***International Harvester***, the court then concluded:

> Here, it is undisputed that New York City has afforded privileges and opportunities to ASARCO. That these privileges and opportunities have contributed to ASARCO's capital appreciation and thus also inured to the benefit of all its shareholders, including Bendix, is also beyond question. Thus, we agree with the City that it has given Bendix something "for which it can ask return," and that consequently a sufficient nexus existed to support the City's tax.

Id.

Unlike the New Jersey taxes considered by the Supreme Court in ***Allied Signal***, the New York court found that New York's tax on income that "Bendix derived from its ASARCO investment bore. . . . an inherently rational relationship to the manner in which that income was generated." ***NY Allied 1*** at 703.

As previously noted, the majority of the Sale Gain was attributable to the increase in value of Cloud5 between the date of the 2011 Merger and the date of the sale of Cloud5. The parties stipulated that this additional value resulted from: improved management and staffing of the call center business; expansion of the product offerings of Thing5's outsourcing and hosting technology business; the integration of the call center business with Thing5's outsourcing and hosting technology business; and the increase in the number of customers and properties served by Thing5's outsourcing and hosting technology business. Thus the increase in value, and likewise the Sale Gain, were inextricably connected to and in large measure derived from property and business activities in Massachusetts. The business activities that gave rise to the Sale Gain necessarily involved availment of the protection, opportunities and benefits given by Massachusetts, which inured to the benefit of the appellant, and which "b[ore] an inherently rational relationship to the manner in which that income was generated." ***Id.*** Thus, the protection, opportunities and benefits afforded by Massachusetts, for Constitutional purposes, supplied the requisite connection between

Massachusetts and business activities that resulted in the Sale Gain.

2. DISTRIBUTIVE SHARE INCOME VERSUS CAPITAL GAIN

The appellant also argued that for Constitutional purposes, there is crucial distinction between a Massachusetts tax measured by its distributive share income from its regular business activities and a tax measured by its Sale Gain income, which the appellant argued was derived from the sale of a partnership interest. According to the appellant, the distinction lies in the activity that Massachusetts seeks to tax. More specifically, distributive share income is taxable because the taxable activity was Cloud5's business operations, which are indisputably linked to Massachusetts. In contrast, the appellant posited that the activity subject to tax in connection with the Sale Gain was the appellant's act of selling its interest in Cloud5. The appellant argued that this discrete act had only "an indirect link" to Massachusetts that did not provide the requisite minimum connection to Massachusetts or availment of the protections and benefits of Massachusetts laws that are required by the United States Constitution.

The Board found that the appellant misapprehended the nature of the tax on the Sale Gain. As the Commissioner noted, the taxes at issue, which are imposed pursuant to G.L. c. 63, § 32D and G.L. c. 62, §§ 5A and 17A, are not transaction taxes. They are capital gains taxes on the increase in value of the appellant's interest in Cloud5, which accrued over time through the business activities of the operating entities. The 2013 Sale was simply the event by which the Sale Gain was realized:

> Rather than assessing tax liability on the basis of annual fluctuations in the value of a taxpayer's property, the Internal Revenue Code defers the tax consequences of a gain or loss in property value until the taxpayer "realizes" the gain or loss. . . . As this Court has recognized, the concept of realization is "founded on administrative convenience." ***Helvering v. Horst,*** 311 U.S. 112, 116 (1940). Under an appreciation-based system of taxation, taxpayers and the Commissioner would have to undertake the "cumbersome, abrasive, and unpredictable administrative task" of valuing assets on an annual basis to determine whether the assets had appreciated or depreciated in value. See 1 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts P 5.2, p. 5-16 (2d ed. 1989). In contrast, "[a] change in the form or extent of an investment is easily detected by a taxpayer or an administrative officer." R. Magill, Taxable Income 79 (rev. ed. 1945)
>
> [26 U.S.C., § 1001]'s language provides a straightforward test for realization: to realize a gain or loss in the value of property, the taxpayer must engage in a "sale or other disposition of [the] property."

Cottage Savings Ass'n v. Commissioner, 499 U.S. 554, 559 (1991).

In the present appeals, the capital gain income at issue, like the concededly taxable distributive share income, was dependent upon Massachusetts business operations, without which much of the additional value that gave rise to the Sale Gain would not have existed. As previously noted, the increase in Cloud5's value resulted from: improved management and staffing of the call center business; expansion of the product offerings of Thing5's outsourcing and hosting technology business; the integration of the call center business with Thing5's outsourcing and hosting technology business; and the increase in the number of customers and properties served by Thing5's outsourcing and hosting technology business.

To argue that the activities underlying Sale Gain and the appellant's connection to Massachusetts were distinct for Constitutional purposes would "'trivialize[] the years of work and business effort that developed the value'" of the appellant's interest in Cloud5. ***SAHI USA, Inc. v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Reports, 2006-794, 812. (quoting ***General Mills Inc. v. Commissioner of Revenue,*** 440 Mass. 154, 175 (2003), cert. denied, 541 U.S. 973 (2004)).

SAHI involved entities in a tiered partnership structure, within which SAHI USA, Inc., a Delaware corporation, held a partnership interest in a Massachusetts partnership that had been formed to own and operate a hotel in Boston, Massachusetts. In ***SAHI***, the Board considered whether the appellant was subject to tax on its distributive share of a gain realized from the sale of its interest in the Massachusetts partnership that had owned and operated the Boston hotel. Finding that the appellant was subject to tax, the Board rejected the proposition that a gain realized on the disposition of a partnership interest should be allocated to the seller's commercial domicile and not Massachusetts, stating that:

> [t]he value of the partnership interest giving rise to the gain at issue is directly related to the ownership, operation and management of the Meridien Hotel. Because the work and business effort associated with these activities was, on this record, performed exclusively in Massachusetts, the receipts derived from the sale of [its partnership interest] is a Massachusetts sale for purposes of § 38(f).

Though the issue in ***SAHI*** was not precisely the same as in the present appeals, and the appellant did not mount a constitutional challenge to application of the tax, the Board's reasoning in ***SAHI*** applies here. The Sale Gain was "directly related to the ownership, operation and management of" Cloud5, and the "work and business effort associated with these activities was. . . performed," in large measure, in Massachusetts. ***Id***.

In sum, the Board found and ruled that through its ownership interest in Cloud5, the appellant's distributive share income and the Sale Gain resulted, in similar measure, from its connection to Massachusetts and its availment of the protections and benefits afforded by the commonwealth. On this basis, the Board found and ruled that the appellant failed to demonstrate an adequate basis for the proposition that there was a distinction grounded in Constitutional concerns between Cloud5's partnership distributive share income and the Sale Gain that would render the former taxable by Massachusetts and the latter beyond its reach.

3. **WHETHER THE APPELLANT AND CLOUD5 COMPRISED A UNITARY BUSINESS**

Finally, the Commissioner argued that the contested assessments should be upheld based on the theory that a holding company and an operating subsidiary should be considered unitary where either (a) the holding company was formed to benefit the operating subsidiary, and not merely for purposes of passive investment, or (b) the holding company is not engaged directly or indirectly in related activities comprising a distinct business enterprise.

The Board's findings and rulings, discussed above, render consideration of this theory unnecessary to disposition of these appeals. Consequently, the Board made no findings or rulings as to whether, under the Commisioner's argument, the appellant and Cloud5 possessed the necessary unity to justify imposition of the Massachusetts tax at issue in the appeals.

4. CONCLUSION

Based on the record in its entirety and the application of relevant authority, the Board found and ruled that the appellant failed to sustain its burden of demonstrating by clear and cogent evidence that the assessments at issue in the present appeals resulted in taxation of extraterritorial values in violation of the United States Constitution.

Accordingly, the Board issued decisions for the appellee in these appeals.

APPELLATE TAX BOARD

By: /S/ Thomas W. Hammond
Thomas W. Hammond, Jr., Chairman

A true copy,

Attest: /S/ William J. Doherty
Clerk of the Board