June 29, 2022 - Out-of-State Entity is Not Subject to Massachusetts Tax on Sale of Interest in Massachusetts Business

By: Marc T. Finer

On May 16, 2022, the Massachusetts Supreme Judicial Court ruled in *Vas Holdings & Investments LLC vs. Commissioner of Revenue* that Massachusetts had no statutory authority to tax the gain recognized by an out-of-state investor on the sale of its interest in a Massachusetts limited liability company because the investor had no business activity in Massachusetts other than this investment.

In 2011, Vas Holdings & Investments LLC, ("VASHI") became a 50% member of a Massachusetts limited liability company, Cloud5 LLC ("Cloud5"). Between 2011 and 2013, Cloud5 increased significantly in value and in 2013, VASHI sold its Cloud5 interest realizing over $37 million in capital gain.

Both the Massachusetts Commissioner of Revenue ("DOR") and the Appellate Tax Board ("ATB") applied the "investee apportionment" methodology to establish that VASHI, through its investment in Cloud5, owed Massachusetts tax on the capital gain. The reasoning was that "the increase in value, and likewise, the [Cloud5] [g]ain, were inextricably connected to and in large measure derived from property and business activities in Massachusetts."

VASHI appealed the ATB decision to the Massachusetts Supreme Judicial Court ("SJC"). In its appeal, VASHI argued that the "unitary business principle" was the only permissible method under which Massachusetts could impose a tax on the capital gain. Under this principle, an out-of-state entity may be subject to Massachusetts tax if it has functional integration (e.g., common programs or systems, shared information or property), centralized management (e.g., common management or directors, shared staff functions) or economies of scale (e.g., commingling of funds, providing centralized services) with a Massachusetts entity. Applying this principle, VASHI argued that the capital gain was not subject to Massachusetts tax because it had no integrated business with Cloud5 and none of the investors in VASHI had any connection to Massachusetts. Importantly, the DOR had stipulated that no unitary business relationship existed between VASHI and Cloud5.

The SJC agreed that investee apportionment is a permissible methodology for subjecting an out-of-state investor to in-state taxation under the Due Process and Commerce Clauses of the US Constitution because they establish the appropriate nexus between an out-of-state investor and a sale of a business within the state. However, the SJC determined that Massachusetts statutes permit the taxation of out-of-state taxpayers based only on the unitary business principle. As a result, because VASHI and Cloud5 were not engaged in a unitary business, the SJC concluded that the DOR lacked the statutory authority to tax VASHI's capital gain on the sale of its Cloud5 interest. As a result, the SJC reversed the ATB decision.

The *VASHI* decision comes as a surprise as it interprets Massachusetts taxing statutes to permit a more limited basis for taxing out-of-state entities than Massachusetts would otherwise be permitted under the US Constitution. This decision benefits both out-of-state investors who will not be subject to Massachusetts tax on the sale of their Massachusetts business investment in the absence of a unitary business relationship and Massachusetts businesses (e.g., startups) which can attract non-Massachusetts investors due to this favorable tax treatment. In addition, taxpayers who have paid Massachusetts tax under similar facts based on the "investee apportionment" methodology may wish to consider filing amended returns to request a refund.

If you have questions regarding the *VASHI* decision or how it may impact your business or investments, please contact Marc T. Finer, Tax Partner, at 860-240-6096 or mfiner@murthalaw.com.

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