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VAS Holdings and the Battle Over Taxing Non-Unitary Capital Gains

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Background

VAS Holdings & Investments LLC v. Commissioner of Revenue, No. SJC-13139, currently on appeal before the Massachusetts Supreme Judicial Court, seeks to answer whether a state can tax a non-domiciliary on 100%—or any—of its capital gain derived from the sale of its interest in a subsidiary solely because the subsidiary did business in that state. At its heart, the case considers whether, as the authors believe, the unitary business principle remains the sole test for determining whether a state can tax an apportioned share of a non-domiciliary's capital gains under the U.S. Supreme Court's Due Process Clause and Commerce Clause jurisprudence.

The appellant, VAS Holdings & Investments LLC ("VASHI"), is a Florida limited liability company taxed as an S corporation that in 2011 was based in and formed under the laws of Illinois. Through a business combination in 2011, VASHI acquired a 50% membership interest in Cloud5, LLC ("Cloud5"), a Massachusetts LLC taxed as a partnership. Cloud5, in turn, owned a Massachusetts-based subsidiary, Thing5, LLC ("Thing5"), that grew more profitable after the 2011 combination. In 2013, VASHI sold its 50% interest in Cloud5 in one transaction and excluded the resulting capital gain from its and its shareholders' Massachusetts income tax bases. At the time, VASHI did no business in Massachusetts, had no Massachusetts resident shareholders, and its only material assets were bank accounts and its membership interest in Cloud5. Notably, VASHI and its shareholders paid Massachusetts income tax on their distributive shares of Cloud5's operating income without dispute.

The Massachusetts Commissioner of Revenue audited and assessed corporate excise tax and nonresident composite tax on 100% of VASHI's capital gain, based on a Massachusetts regulation that taxes a non-domiciliary owner on all capital gains from the sale of a partnership interest if the dollar amounts of the partnership's property and payroll factors are greater in Massachusetts than in any other state. VASHI appealed the commissioner's assessments on Due Process Clause and Commerce Clause grounds. Despite VASHI's lack of Massachusetts contacts and agreement by the parties that VASHI did not share the hallmarks of a unitary business with Cloud5, the Massachusetts Appellate Tax Board ("ATB") affirmed the assessments.

Under an all-or-nothing approach referred to as “Investee Apportionment,” the ATB found in VAS Holdings & Investments, LLC v. Comm’r of Revenue, Mass. that 100% of a non-domiciliary taxpayer’s capital gain could be taxed by Massachusetts if that income was derived—albeit indirectly—from a subsidiary with property and employees in that state. It was constitutionally sufficient, the ATB concluded, that through its partial ownership of Cloud5, VASHI had “avail[ed] itself of the protections and benefits afforded by the commonwealth.”

The Unitary Business Principle

It has often been said, as in Mobil Oil Corp. v. Commissioner of Taxes of Vt., that the unitary business principle is “the linchpin of apportionability in the field of state income taxation.” The Supreme Court has described a unitary business relationship as existing when three unities are present: centralized management, functional integration, and economies of scale. The Commissioner of Revenue stipulated that such a relationship did not exist between VASHI and Cloud5.

The commissioner nevertheless asserted the power to tax this capital gain based on some of the Court’s statements that appeared to sanction taxing a non-domiciliary corporation on its income in the absence of these three properties. In Allied-Signal, Inc. v. Dir., Div. of Taxation, the Court said that it has never “establish[ed] a general requirement that there be a unitary relation between the payor and the payee to justify apportionment[.].” Taken out of context, this language caused many to mistakenly believe that a unitary relationship wasn’t necessary to apportion—and to tax—a non-domiciliary owner’s capital gain. However, in Allied-Signal and other apportionment cases before 2008, the Supreme Court required states to show something more before taxing such capital gain: “that the capital transaction serve an operational rather than an investment function[]” in the non-domiciliary taxpayer’s interstate business.

In MeadWestvaco Corp. v. Ill. Dep’t of Revenue, the Court seemingly acknowledged the confusion its statement in Allied-Signal had created, and harmonized the requirement of an operational function with its earlier unitary jurisprudence, by bluntly stating that Allied-Signal, among others, “did not announce a new ground for the constitutional apportionment of extrastate values in the absence of a unitary business.”

Despite this, Massachusetts and New York, among a few other jurisdictions—including New York City, as recently as last March in the Goldman Sachs Petershill Fund appeal—persist in advancing a faulty interpretation of older Supreme Court decisions. In particular, they construe Int’l Harvester v.

Wis. Dep't of Taxation and Wisconsin v. J.C. Penney Co. as permitting them to tax a nonresident on its capital gains because the gains represent income somehow earned in the state. However, in addition to relying on outdated case law, these jurisdictions ignore a fundamental distinction present in those very cases. The tax at issue in those two cases was a tax on paying out the operational income from the entity itself—not a tax on the investment gains of nonresident owners. It was a tax on dividend income, paid directly from the corporation's earnings and profits—not a capital gain of the shareholder, derived from a purchaser's motivations that may be unrelated to the fundamental value of the enterprise.

Investee Apportionment Is Bad Tax Policy

The purpose of the Commerce Clause is to prevent states from discriminating against non-domiciliary taxpayers and imposing undue burdens on interstate commerce by multiple taxation. The Supreme Court clarified that the unitary business principle is the single test for apportionability in MeadWestvaco because it had to; allowing states to have multiple standards for apportionability invites the kind of multiple taxation the Commerce Clause was intended to avoid. It's telling, then, that neither the commissioner nor the ATB rely on MeadWestvaco as authority, and even more telling that the Multistate Tax Commission's amicus brief in favor of the commissioner conveniently declined to present any arguments under the Commerce Clause.

Mentioning the Commerce Clause would have invited a discussion on what should be the fundamental point of VAS Holdings: that some income must be sourced by constitutional rules because it cannot easily be said to have been "earned" in any particular location and that each state must allow other states their own sovereignty to tax—or not tax—the income properly sourced under those rules. During the Jan. 5 oral arguments, two justices of the Supreme Judicial Court asked questions that suggested they were concerned with the idea that if Massachusetts couldn't tax the capital gain at issue, then the gain would escape taxation by any state. This isn't the result of a constitutional rule that allows capital gains to escape taxation, but a rule that assigns much of the income to a state that chooses not to tax it. However, the ATB's ruling indicates that some 36% of the owners of VASHI were taxed by their states of residence, but implies they were allowed a credit for the Massachusetts tax paid—an assertion that is not clear from the record.

The alternative to the unitary business principle, and the breathtaking rule the Supreme Judicial Court seems to be considering, would allow any state to tax any capital gain if the state's relationship with the investee, versus the investor, is sufficient—a fundamentally flawed policy. In Massachusetts' case, the connection is the investee's property and payroll factors in the state being greater than anywhere else. Accepting the investee apportionment approach as constitutional could allow another state to say that the state with the investee's greatest proportion of in-state sales has the greatest connection and tax 100% of the gain. Under this approach, a state could conceivably go even further and argue that any time it has given benefits, protections, or opportunities to the investee entity, it can tax some part or all of a non-domiciliary investor's capital gain on the sale of their ownership interest.

Investee apportionment would lead to multiple taxation for investors with no connection to the taxing state—including Massachusetts residents—and invites interstate disputes. The Supreme Court's recent reluctance to resolve such tax disputes between states, as evidenced by denying motions for leave to file a bill of complaint in New Hampshire v. Massachusetts, No. 22O154, and in Arizona v. California, No. 22O150, suggests the Supreme Judicial Court has in its hands more power than it may realize. Let us hope that rather than defer to their state's narrow interest in generating revenue, the justices show to their fellow state courts the respect they would want to be shown to Massachusetts as part of this republic. As counsel for VASHI pointed out during oral argument, other states may apply the rule the court adopts to Massachusetts' own residents in return.

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