New DOR Directive Expands Reach Of Massachusetts Income Tax Over Nonresidents

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In 2003, Massachusetts enacted legislation, applicable for tax years beginning on or after January 1, 2003, intended to extend the ability of the state to tax income received by nonresident individuals, as well as by nonresident estates and trusts. A major impetus for the legislation was a series of defeats for the commonwealth based on narrow interpretations of previously existing provisions taxing nonresidents on their "items of gross income derived from or effectively connected with . . . any trade or business, including any employment carried on by the taxpayer in the commonwealth."[1] After last year's legislation, the statute now explicitly provides that the taxpayer need not be actively engaged in a trade or business in Massachusetts during the year of receipt for the income to be taxable, and defines "derived from or effectively connected with" to include "income that results from, is earned by, is credited to, accumulated for or otherwise attributable to" a taxpayer's trade or business, including employment.

A DOR directive states the official position of the DOR but lacks the force of law of a statute, judicial decision, or regulation, and taxpayers may have a basis for departing from some of the conclusions of Directive 03-12.

Also, the statute provides a nonexclusive list of items of income received by a nonresident that could be considered derived from or effectively connected with a trade or business and therefore could be taxable by Massachusetts, such as:

- gain from the sale of a business or an interest in a business;
- distributive share income;
- separation, sick, or vacation pay;
- deferred compensation and nonqualified pension income (to the extent not otherwise prohibited by federal law)[2]; and
- income from a covenant not to compete.[3]

In January 2004, the Massachusetts Department of Revenue issued Directive 03-12 to interpret the legislation with a series of examples. (For the full text of Directive 03-12, see *Doc 2004-4958 (8 original pages)* or *2004 STT 47-13*.) A DOR directive states the official position of the DOR[4] but lacks the force of law of a statute, judicial decision, or regulation, and taxpayers may have a basis for departing from some of the conclusions of Directive 03-12. With one notable exception, the DOR has taken expansive but often ill-defined positions. The following article provides highlights of the DOR's positions and, when some perspective might be helpful, compares them with provisions of other states, with guidance on the subjects addressed in the directive. Every scenario discussed below assumes that the recipient is a nonresident at the time the income item is realized.

Severance and Accumulated Sick Leave

Payments of this sort that are entirely attributable to prior employment in Massachusetts are treated as taxable by Massachusetts, even if received after Massachusetts employment has terminated. Although the DOR does not explicitly address it, when a nonresident has worked both in and out of Massachusetts, he or she will presumably need to report only the amount of that income that reflects the proportion of days worked in Massachusetts to total days worked over some relevant period.[5] Before the change in the statute, the DOR's claim to tax the compensation could be defeated by a nonresident who received it in a year when he or she otherwise did not carry on any trade or business in Massachusetts.[6]

[1] Mass. Gen. Laws Chapter 62, section 5A(a).

[2] *See* 4 U.S.C. section 114, enacted by Pub. L. 104-95.

[3] Mass. Gen. Laws Chapter 62, section 5A(a), as amended by 2003 Mass. Acts Chapter 4, section 7.

[4] Code of Mass. Regs., Chapter 830, section 62C.3.1(6)(d).

[5] *See* Code of Mass. Regs., Chapter 830, section 62.5A.1(6)(a) (2001).

[6] *Commissioner of Revenue v. Destito*, 23 Mass. App. Ct. 977, 503 N.E.2d 986 (1987).

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Nonqualified Pension Benefits

Nonqualified pension and other deferred compensation benefits that derive entirely from prior employment in Massachusetts will be taxable by Massachusetts to the extent permitted under federal law. Under federal law a state may not tax those payments to a nonresident if the payments are part of a series of substantially equal payments made at least annually over the life expectancy of the recipient (or joint life expectancy of recipient and the beneficiary of the recipient) or in installments of 10 or more years, an important planning point.[7] The federal law also provides that a payment received after termination of employment and under a plan maintained solely to provide retirement benefits in excess of benefit or contribution limits imposed by the Internal Revenue Code on qualified plans may not be taxed to a nonresident.[8] Under the same federal law and under its own regulations, Massachusetts may never tax qualified plan payments to a nonresident.[9] As with accumulated sick or vacation pay, before the change a nonresident who otherwise had no trade or business in Massachusetts in the year of receipt of nonqualified pension benefits was not subject to Massachusetts tax on them.[10]

Arguably, if a portion of a pension is earned in Massachusetts and the individual then ceases to work in Massachusetts, Massachusetts should not be able to tax any more than the accrued value of the pension at the time employment in Massachusetts terminated.

When nonqualified pension payments pertain to services performed both in Massachusetts and in other states, Directive 03-12 states that a portion of the pension payments will be treated as Massachusetts-source income as determined under the DOR's regulations.[11] Those regulations in most cases apportion the income based on the period of employment in each location.[12] Arguably, such a methodology often will be inappropriate in the case of a nonqualified pension. For example, an individual may have worked 10 years inside Massachusetts and 10 years outside Massachusetts, but the nonqualified pension he or she receives may be 90 percent attributable to accruals that occurred during the period of employment outside Massachusetts (or vice versa). Arguably, if a portion of a pension is earned in Massachusetts and the individual then ceases to work in Massachusetts, Massachusetts should not be able to tax any more than the accrued value of the pension at the time employment in Massachusetts terminated, but it is not clear that the directive permits the use of such an alternative method. By contrast, Connecticut and New York provide that such benefits are apportioned based on the relative amounts of compensation, not the relative amounts of days worked, and generally by counting compensation only of the year of termination of employment and the three preceding years.[13] Unlike an apportionment method based on days worked, this method gives more weight to the most recent years before termination of employment, and it is more sensitive to differences in compensation amounts from year to year.

Partners Who Have Withdrawn From a Massachusetts LLP

A somewhat mysterious example in the directive discusses an individual who was a partner in a limited liability partnership that conducted business in Massachusetts and subsequently withdrew, but was entitled to continued payments after the withdrawal.[14] It is unclear whether those payments are attributable to profits of the LLP before or after the withdrawal; if they are attributable to profits up through the withdrawal date, one would have thought they already would have been taxed on a flow-through basis while the person was rendering services in Massachusetts. It might be that the DOR assumes that the LLP is a cash-basis partnership for which a portion of uncollected receivables accrued prior to the partner's withdrawal constitutes "undistributed profits." In any case, the example concludes that all of those continuing payments are Massachusetts-source income to the nonresident, without considering the possibility that the payments may be attributable economically not to services the person had previously performed in Massachusetts but to the value of capital he or she contributed or goodwill that he or she created and left behind.

The next example considers an LLP doing business in more than one state.[15] The example seems to assume that the former partner in question had performed services in Massachusetts and then withdrew from the partnership. The example concludes that the individual will have Massachusetts-source income from continuing payments he or she receives based on the partnership's average apportionment percentage during the period that he or she was active. If the example assumes that the payments derive from LLP income realized after the withdrawal, one would have thought the LLP's apportionment percentage at the time the income was realized should instead be applied. In a slightly different context, the DOR previously held that payments to a retired nonresident partner that constitute guaranteed payments under IRC section 736 are attributable to Massachusetts sources based on the partnership's apportionment of income to Massachusetts in the year of payment.[16]

Grants of Nonqualified Stock Options and Restricted Property Transfers

The directive specifies that stock or nonqualified stock options granted in connection with an employee's Massachusetts employment will give rise to Massachusetts-source income when federal income occurs. For example, if an employee is granted a nonqualified stock option while working in Massachusetts, and then terminates his or her employment,

[7] 4 U.S.C. section 114(b)(1)(I)(i).

[8] 4 U.S.C. section 114(b)(1)(I)(ii).

[9] Code of Mass. Regs., Chapter 830, section 62.5A.1(5)(e) (2001).

[10] *Commissioner of Revenue v. Oliver*, 436 Mass. 467, 765 N.E.2d 742 (2002).

[11] *See* DOR Directive 03-12, Ex. 1.b.2.

[12] Code of Mass. Regs., chapter 830, section 62.5A.1(6)(a) (2001).

[13] Conn. Agencies Regs. section 12-711(b)-19(c) (1994); N.Y. Code Rules and Regs. Title 20, chapter II, section 132.20 (1992). In each case a taxpayer can include the relative amounts of compensation from additional earlier years if he or she can provide sufficient evidence to establish the apportionment for each of those prior years.

[14] DOR Directive 03-12, Ex. 1.c.1.

[15] DOR Directive 03-12, Ex. 1.c.2.

[16] Mass. DOR Ltr. Rul. 80-56 (Aug. 20, 1980).

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when he or she exercises the nonqualified stock option all of the federal compensation income he or she realizes will be Massachusetts-source income.

States have adopted various methods of taxing compensation related to transfers of property, and the DOR might draw on those examples to address the situation when a nonresident has worked within and outside of Massachusetts.

This rule does not seem so rational, however, if the individual worked partly outside Massachusetts while the option was unexercised. None of the examples takes cognizance of the fact that virtually all stock and option grants are subject to periodic vesting. The grants have little or no value unless the grantee remains employed until the equity interests vest. The examples seem to assume that if the person is in Massachusetts when he or she receives the grant, 100 percent of the subsequent compensation income is Massachusetts-source income even if exercise of the option was contingent upon (say) four years of continued employment, all or most of which in fact occurred in another state.[17] If such a result is intended, it makes little sense and may be subject to constitutional challenge. The DOR's claim to tax the entire gain might be questionable even if the option was 100 percent vested when the employee left Massachusetts, if the option remained unexercised and grew in value while he or she was employed elsewhere.

States have adopted various methods of taxing compensation related to transfers of property,[18] and the DOR might draw upon those examples to address the situation when a nonresident has worked within and outside of Massachusetts. For example, California and New York tax a portion of income on exercise of a nonqualified stock option, based in general on the proportion of days worked in the state to total working days for the period from the date of grant to the date of exercise for options that lack an ascertainable fair market value when granted.[19] Connecticut allocates by relative amounts of total compensation rather than days worked and measures those amounts beginning with the first day of the recipient's tax year in which the option is transferred and ending on the last day of that person's tax year during which he or she exercises the option.[20]

With respect to transfers of restricted property, if the service provider does not make an election under IRC section 83(b), New York and Connecticut use the same basis for apportionment as they do for nonqualified stock options (days worked versus compensation as apportioned), but the period is generally limited from the date of transfer to the date the property becomes taxable under IRC section 83(a) (in the case of Connecticut, for the tax years that include the transfer and income recognition, and all tax years in between).[21] Income from an election under IRC section 83(b) is apportioned to both states based on the factor for the year in which the property is transferred.

Incentive Stock Options

In contrast to its generally expansive interpretation of the statute, in the directive the DOR concludes that income derived from incentive stock options (ISOs) "generally" will not be taxable to nonresidents. Why ISOs "generally" will not give rise to Massachusetts-source income is unclear, because, economically, the income may be every bit as much attributable to Massachusetts employment as is the case with a nonqualified stock option. The fact that ISOs give rise to capital gain if the ISO holding period requirements are satisfied should not make any difference; it is clear from the statute and the directive that capital gain items may be Massachusetts-source income if derived from Massachusetts employment. The directive is not clear as to whether this favorable rule applies in the event the ISO is the subject of a "disqualifying disposition" (in which case the income would be ordinary rather than capital gain), nor is there any indication of what the exceptions from the favorable rule are that are implied by the statement that the ISO income will generally (but not necessarily always) be nontaxable to nonresidents.

The DOR's general position on ISOs is at odds with those of many other states.

The DOR's general position on ISOs is at odds with those of many other states. For example, New York has established that it can tax a nonresident on a portion of the difference between the value of an ISO on exercise and the strike price paid by the nonresident employee.[22] The taxable portion is proportionate to the amount of days worked in New York to total working days over the period from the date of grant to the date of exercise of the ISO. The state does not seek to tax any gain that accrues beyond the date of exercise and limits gain subject to taxation if the stock is sold for less than the value at the date of exercise. The state waits to assess any tax until the employee recognizes gain upon disposition, and the gain retains for New York purposes the character it has as ordinary income or capital gain for federal income tax purposes.[23] Other states have developed various regimes for taxing all or a portion of nonresidents' ISO income, some of which resemble New York's.[24]

Covenants Not to Compete

Tracking the statute, the directive specifies that income received by a nonresident from a covenant not to compete may be Massachusetts-source income "to the extent that the original covenant was based on the taxpayer's Massachusetts based activity." An example is given of a person who had a business

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[17] *See* DOR Directive 03-12, examples under Directives 3 and 4.

[18] *See* Michael J. Nathanson, et al., "Multistate Taxation of Stock Options: An Undiscovered Territory," *State Tax Notes*, Jan. 19, 2004, p. 179; *2004 STT 12-2;* or *Doc 2004-632 (9 original pages)*.

[19] N.Y. State Department of Taxation and Finance Technical Services Bureau Mem. No. TSB-M-95(3)I (Nov. 21, 1995); Cal. Franchise Tax Board Publication 1004 (2002). New York reserves the right to use a different basis of apportionment under special circumstances.

[20] Conn. Agencies Regs. section 12-711(b)-18 (1994).

[21] Conn. Agencies Regs. section 12-711(b)-17 (1994); N.Y. State Department of Taxation and Finance Technical Services Bureau Mem. No. TSB-M-95(3)I (Nov. 21, 1995).

[22] *Michaelsen v. N.Y. State Tax Commission*, 67 N.Y.2d 579, 496 N.E.2d 674 (1986).

[23] N.Y. State Department of Taxation and Finance Technical Services Bureau Mem. No. TSB-M-95(3)I (Nov. 21, 1995).

[24] *See generally* Nathanson, *supra* note 18.

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conducted entirely in Massachusetts and sold the business and entered into a covenant not to compete in the state.[25] The statutory provision from which this particular directive is derived is a reaction to a decision adverse to the government.[26] The primary basis for the decision was that the noncompetition agreement did not constitute a trade or business because by its nature it required the taxpayer to refrain from a trade or business, and the statute requires that the income be from a trade or business to be taxable. The decision comports with decisions made on similar grounds in other states where the governing statute specifically provides for taxation of income from a trade or business or from the provision of personal services.[27] By contrast, in a California case in which the governing statute asserts jurisdiction to tax items of gross income "from sources within" California, as opposed to a trade or business or employment carried on within California, California's ability to tax the covenant income was upheld.[28] The Massachusetts legislature's reaction was the wholesale statutory redefinition of "gross income derived from or effectively connected with any trade or business" to include income from a covenant not to compete.[29] In that the statute now explicitly also asserts jurisdiction to tax gain from the sale of a business or an interest therein, taxing income from covenants not to compete can be considered to some extent a backstop to ensure taxation of gain on the sale of a business or business interest.

While it is clear that a nonresident has a better chance of avoiding Massachusetts taxation if he or she sells interests in a limited partnership or in a C or S corporation, it is far from clear what standards will govern the DOR's analysis of those transactions.

To a large extent, the directive's conclusion may be dictated by the statute; however, it may be subject to challenge. At least for federal tax purposes, income from a covenant not to compete is conceptualized as income from the activity (or nonactivity) of the individual during the period of the covenant, *not* as income derived from the prior period during which the individual was an employee or the owner of a business. It is questionable whether under the federal constitution Massachusetts may tax (say) a Florida resident simply because the person, in essence, agrees not to come back to Massachusetts to engage in business and receives payments for honoring that agreement, although it appears that in other jurisdictions the issue has not been litigated to the point of a judicial decision.

Sales of Equity Interests In Massachusetts Businesses

As noted above, the new statute states that Massachusetts-source income may include gain from "the sale of a business or of an interest in a business." As with income from a covenant not to compete, the statute has redefined "gross income derived from or effectively connected with any trade or business" to include such gain. This is a reaction to cases the government lost because gain from the disposition of an intangible property interest in an entity doing business in Massachusetts did not necessarily constitute income effectively connected with a trade or business carried on by the taxpayer in Massachusetts.[30] In interpreting this rule, the directive quite surprisingly distinguishes between interests in different sorts of business entities. The directive states that gain from the sale of an interest in a proprietorship, general partnership, limited liability partnership, or limited liability company that carries on a business in Massachusetts generally will be Massachusetts-source income, generally to the extent of its business income apportionment to Massachusetts during the seller's holding period. For reasons that are not articulated, the directive states that this rule generally will not apply to the sale of a limited partnership interest, or the sale of shares of stock in a C or an S corporation. In any case, the DOR reserves broad discretion to assert that in a particular case the sale of an interest in a limited partnership or in a C or S corporation does give rise to Massachusetts-source income "where it is appropriate for the Commissioner to recharacterize the form of a transaction, including the form of the business that gives rise to income, so as to disallow the asserted tax consequences of the transaction." Thus, while it is clear that a nonresident has a better chance of avoiding Massachusetts taxation if he or she sells interests in a limited partnership or in a C or S corporation, it is far from clear what standards will govern the DOR's analysis of those transactions.

Conclusion

Directive 03-12 asserts a broad authority to tax nonresidents, but in many instances it is not clear, and its guidance might not withstand challenge as to some matters. The DOR should clarify the directive in several respects, as suggested above. Any business that employs individuals in Massachusetts must consider how the statute and directive will affect its income reporting and income tax withholding obligations. When the appropriate treatment is debatable, an employer's desire to avoid liability for failing to withhold sufficient income tax could well conflict with the desire of a nonresident to minimize the income reported to Massachusetts. Also, many nonresident individuals, estates, and trusts with ties or former ties with Massachusetts will need to analyze the directive carefully. ✰

[25] DOR Directive 03-12, example of Directive 5.

[26] *See Gersh v. Commissioner of Revenue*, Mass. App. Tax Bd. Docket Nos. 204089, F205738, F217847 (1997). (For the full text of the Massachusetts Appellate Tax Board's decision in *Gersh*, see *Doc 97-16988 (26 pages)* or *97 STN 117-8*.)

[27] *See, for example*, *Matter of Penchuk*, N.Y. Tax Appeals Tribunal Docket No. 812646 (Apr. 24, 1997); *Haberman v. Tax Commissioner*, Ohio Bd. of Tax Appeals Docket No. 91-A-1639 (Mar. 19, 1993). (For the full text of the New York State Tax Appeals Tribunal's decision in *Penchuk*, see *Doc 97-15316 (13 pages)* or *97 STN 114-15*.)

[28] *See, for example*, *Matter of Pesiri*, Cal. State Bd. of Equalization Docket No. 89-SBE-027 (Sept. 26, 1989); Cal. Revenue and Taxation Code section 17951.

[29] *See also* Minn. Stat. section 290.17(2)(c) for another explicit provision to tax income from a covenant not to compete.

[30] *See Cohen v. Commissioner of Revenue*, Mass. App. Tax Bd. Docket Nos. 205165, 205166, 206601 (Aug. 30, 1995) (sale of partnership interest); *Dupee v. Commissioner of Revenue*, 423 Mass. 617, 670 N.E.2d 173 (1996) (sale of S corporation shares). (For the full text of the Massachusetts Appellate Tax Board's decision in *Cohen*, see *95 STN 195-20*. For the full text of the Massachusetts Supreme Judicial Court's decision in *Dupee*, see *Doc 96-26314 (11 pages)* or *96 STN 190-11*.)

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