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## BUSINESS LAW & LITIGATION

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TO: Clients & Interested Parties

FROM: Paul Peter Nicolai

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RE: SOME RELATIVELY UNREPORTED MASSACHUSETTS TAX CHANGES

Some aspects of Chapter 4 of the Acts of 2003 have been widely reported, especially those dealing with the taxation of Sub-S corporations with over \$6,000,000 in revenue and single member LLCs.

Much less notice, however, has been given to two other provisions that will affect business transaction planning. This memorandum reviews them.

### **Section 7**

Section 7 of this new law says:

Subsection (a) of section 5A of chapter 62 of the General Laws, as so appearing, is hereby amended by striking out the last 2 sentences and inserting in place thereof the following 5 sentences: -- 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; (2) the participation in any lottery or wagering transaction within the commonwealth; and (3) the ownership of any interest in real or tangible personal property located in the commonwealth. In computing the taxable income of each Part, the nonresident shall be allowed the deductions and exemptions provided as to each Part in section 3. For purposes of this section, gross income derived from or effectively connected with any trade or business, including any employment, carried on by the taxpayer in the commonwealth shall mean the income that results from, is earned by, is credited to, accumulated for or otherwise attributable to either the

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taxpayer's trade or business in the commonwealth in any year or part thereof, regardless of the year in which that income is actually received by the taxpayer and regardless of the taxpayer's residence or domicile in the year it is received. It shall include, but not be limited to, gain from the sale of a business or of an interest in a business, distributive share income, separation, sick or vacation pay, deferred compensation and nonqualified pension income not prevented from state taxation by the laws of the United States and income from a covenant not to compete. The foregoing shall not be deemed to include income from qualified tax-deferred retirement plans which are exempt from taxation under any other provision of this chapter.

The old language of Section 5A, which was replaced and expanded by Section 7, read:

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; (2) the participation in any lottery or wagering transaction within the commonwealth; or (3) the ownership of any interest in real or tangible personal property located in the commonwealth. In computing the taxable income of each Part, the non-resident shall be allowed the deductions and exemptions provided as to each Part in section three.

This revision overrules several standing decisions:

**Gersh v. Commissioner of Revenue (1997) A.T.B. Nos. 204089, F205738, F217847**

In this case, the A.T.B. ruled that a nonresident taxpayer was not engaged in trade or business because he entered into a non-competition agreement where he was required to refrain from rendering services or engaging in any activity in competition with his former business, even though that former business was in Massachusetts. The payment was, in fact, made for him to *refrain* from being in a trade or business. The consequence of the *Gersh* rule was that payments made under a separate non-competition agreement in the sale of a business with a nonresident were not subject to Massachusetts taxation.

The addition of "(i)t shall include, but not be limited to, ... income from a covenant not to compete" and "gross income derived from or effectively connected with any trade or business, including any employment, carried on by the taxpayer in the commonwealth shall mean the income that results from, is earned by, is credited to, accumulated for or otherwise attributable to either the taxpayer's trade or business in the commonwealth in any year or part thereof, regardless of the year in which that income is actually received by the taxpayer and regardless of the taxpayer's residence or domicile in the year it is received" should effectively overrule *Gersh*.

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

In this case, the Supreme Judicial Court ruled that the income tax statute which defines "items of gross income from sources within the commonwealth" to include gross income derived from or effectively connected with any trade or business, including any employment carried on by the taxpayer in the commonwealth, does not permit taxation of nonresident income derived from or

effectively connected with past Massachusetts employment, where the taxpayer has not carried on any business in the Commonwealth during the taxable year of receipt.

For the years at issue, the taxpayer was domiciled in Florida. Before his retirement, he had been employed in Massachusetts by Hancock Advisers and its parent company, John Hancock Mutual Life Insurance Company (John Hancock), for over twenty-eight years. He entered into a severance agreement. The severance arrangement provided him with deferred compensation payments to commence on his retirement. During those years, the taxpayer did not perform any services for his former employer and was not present in Massachusetts for any business purposes.

The change of definition of items of gross income to 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, 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 [and which is] ... income that results from, is earned by, is credited to, accumulated for or otherwise attributable to either the taxpayer's trade or business in the commonwealth in any year or part thereof, regardless of the year in which that income is actually received by the taxpayer and regardless of the taxpayer's residence or domicile in the year it is received ... [and] shall include ... separation, ... deferred compensation and nonqualified pension income" should have the effect of overruling this decision.

## **Section 10**

Section 10 of this new law says:

Chapter 62C of the General Laws is hereby amended by inserting after section 3 the following section: --

Section 3A. In applying the laws referred to in section 2, the commissioner may, in his discretion, disallow the asserted tax consequences of a transaction by asserting the application of the sham transaction doctrine or any other related tax doctrine, in which case the taxpayer shall have the burden of demonstrating by clear and convincing evidence as determined by the commissioner that the transaction possessed both: (i) a valid, good-faith business purpose other than tax avoidance; and (ii) economic substance apart from the asserted tax benefit. In all such cases, the taxpayer shall also have the burden of demonstrating by clear and convincing evidence as determined by the commissioner that the asserted nontax business purpose is commensurate with the tax benefit claimed. Nothing in this section shall be construed to limit or negate the commissioner's authority to make tax adjustments as otherwise permitted by law.

This addition is apparently designed to overrule two Supreme Judicial Court decisions:

**Sherwin-Williams Company v. Commissioner Of Revenue**, (2002) 778 N.E.2d 504, 438 Mass. 71.

The contested assessment was the result of the commissioner's disallowance of approximately \$47 million that Sherwin-Williams had deducted from its taxable income for royalty payments to two wholly owned subsidiaries for the use of certain marks that Sherwin-Williams had transferred to the subsidiaries and licensed back as part of a corporate reorganization of its intangible assets. The

commissioner and the A.T.B. disallowed these expenses as a result of finding that the creation of the subsidiaries and the transfer of the marks was a sham transaction in that it was done for no business purpose other than tax avoidance. The Supreme Judicial Court reversed the A.T.B. ruling.

The Court concluded that there was sufficient evidence to support the board's finding that Sherwin-Williams failed to prove that it undertook the reorganization for any of the reasons adopted by its board of directors other than reducing its State tax burden. The Court went on, however, to say that this finding was not conclusive on the ultimate question whether the reorganization was real. The Court ruled that that tax motivation is irrelevant where a business reorganization results in the creation of a viable business entity engaged in substantive business activity. Because the record established that the reorganization and subsequent transfer and licensing transactions were genuine, creating viable businesses engaged in substantive economic activities apart from the creation of tax benefits for Sherwin-Williams, they cannot be disregarded by the commissioner as a sham regardless of their tax-motivated purpose.

The new language here specifically gives the commissioner discretion to disallow the asserted tax consequences of a transaction by asserting the application of the sham transaction doctrine or any other related tax doctrine. It raises the proof a taxpayer must give to "clear and convincing evidence as determined by the commissioner" that the transaction possessed both: (i) a valid, good-faith business purpose other than tax avoidance; and (ii) economic substance apart from the asserted tax benefit. In all such cases, the taxpayer shall also have the burden of demonstrating by clear and convincing evidence as determined by the commissioner that the asserted nontax business purpose is commensurate with the tax benefit claimed.

**Commissioner of Revenue v. Dupee (1996) 670 N.E.2d 173, 423 Mass. 617.**

The commissioner denied the taxpayer's application for abatement of individual nonresident income tax on the capital gain from the sale of a portion of an interest in a Sub-S corporation. The A.T.B. concluded that the gain realized was not subject to tax in Massachusetts and granted an abatement to the taxpayer. The Supreme Judicial Court affirmed the A.T.B.

The shareholders agreed to liquidate the corporation and transfer its assets to a partnership, which would allow members of the public to obtain interests. Upon receiving an undivided 32 per cent interest in the assets, the taxpayer made a tax-free exchange of 14.72 per cent of his assets for an equivalent percentage interest in the new partnership. The taxability of his gain on the sale of his remaining interest corporate assets to the partnership resulting in a long-term capital gain of \$16,712,072, was at issue.

The commissioner argued the step-transaction doctrine should apply to collapse the liquidation, distribution, and new partnership transactions and allows the Commonwealth to tax the distributive share of the assets of the liquidated corporation. The Court upheld the board's finding that the steps in the transaction had independent economic significance and were undertaken for a valid business purpose. The Court upheld the taxpayer's legal right to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means the law permits.

Insofar as the commissioner asserts that the step transaction doctrine is "related" to the sham transaction doctrine, this new language allows him to assert the higher standards in the statute to the transactions.

Substantively, this language creates new requirements that the taxpayer: (1) meet a higher standard of proof on these issues; (2) prove, to that standard, a valid, good-faith business purpose other than tax avoidance; (3) prove, to that standard, economic substance apart from the asserted tax benefit; and (4) prove, to that standard, that the asserted nontax business purpose is commensurate with the tax benefit claimed. This standard will be extremely difficult to meet.

This provision is not without constitutional problems. It is unclear whether the legislature can mandate a higher level of proof for some issues over others. Further, unless the commissioner adopts regulations on what "clear and convincing evidence" is, there may be a constitutional problem with enforcement. Finally, whether the constitutional requirements of due process and equal protection can be sustained where a public official who will be a party in a litigation can set the evidentiary requirements the other must meet is an open issue.

## **Conclusions**

1. Business tax planning, especially with regard to post business sale payments, has now become much more restricted. The idea that a business owner can sell the operation and take post sale payments which avoid Massachusetts taxation is gone.
2. The new standard for "sham transactions or related doctrines" will effectively allow the commissioner to call any transaction that has an income tax avoidance effect into question. The standard imposed will allow the commissioner to substitute his own judgment as to whether the "nontax business purpose is commensurate" with the tax benefit. This is a dangerous new "hindsight" test being applied to business transactions in the name of raising taxes.
3. Insofar as payments are made in 2003 and beyond on deals that were created before 2003, these new statutory provisions will reach back and be applied to those transactions. All such payments need to be reviewed and a position taken in light of this law.