COMMONWEALTH OF MASSACHUSETTS
SUPREME JUDICIAL COURT

No. SJC-13139

VAS HOLDINGS & INVESTMENTS LLC,

Plaintiff-Appellant,

v.

COMMISSIONER OF REVENUE,

Defendant-Appellee.

On Appeal from a Decision of the Appellate Tax Board

BRIEF OF THE AMERICAN COLLEGE OF TAX COUNSEL AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT

December 15, 2021

Richard L. Jones (BBO# 631273)
David J. Nagle (BBO# 638385)
Caroline A. Kupiec (BBO# 698786)
SULLIVAN & WORCESTER LLP
One Post Office Square
Boston, Massachusetts 02109
(617) 338-2800
rjones@sullivanlaw.com
dnagle@sullivanlaw.com
ckupiec@sullivanlaw.com

Counsel for Amicus Curiae
American College of Tax Counsel

CORPORATE DISCLOSURE STATEMENT

Amicus curiae, the American College of Tax Counsel states, pursuant to Mass. R. App. P. 17(c)(1), that it is a nonprofit corporation that has no parent corporation, and there are no publicly held companies that hold 10% or more of its stock.

TABLE OF CONTENTS

Page

CORPORATE DISCLOSURE STATEMENT 2
TABLE OF AUTHORITIES 5
INTEREST OF *AMICUS CURIAE* 8
I. The American College of Tax Counsel 8
II. Constitutional Limitations on State Taxation of Extraterritorial Values are Important to the ACTC 9
ISSUES PRESENTED 10
STATEMENT OF THE CASE 10
SUMMARY OF THE ARGUMENT 12
ARGUMENT 15
I. The Commonwealth Cannot Constitutionally Tax Capital Gain that is Not Related to a Unitary Business Conducted Within Massachusetts..........15
A. The Constitutional Framework for the Unitary Business Principle 15
1. The Constitution Limits States' Ability to Tax Values Beyond Their Borders 15
a. Apportionability 16
b. Fair Apportionment 17
c. Exclusion of Non-Unitary Income from the Apportionable Tax Base 18
2. VASHI Lacked a Unitary Business Relationship with Cloud5 18
B. The Unitary Business Principle is Mandatory, Not Optional 19
1. Supreme Court and Massachusetts Decisions Have Consistently Recognized that a Unitary Relationship is a Prerequisite to Apportionment 19

2. The Board Misinterpreted *Allied-Signal*, Which did Not Authorize States to Substitute Alternative Tests for Apportionment in Lieu of the Unitary Business Principle 22

C. "Investee Apportionment" is Not a Constitutional Alternative to the Unitary Business Principle 24

1. *International Harvester* Does Not Support Jettisoning the Unitary Business Principle........24

2. Massachusetts May Not Adopt a New Ground for Apportionability 27

3. In a Similar Case, the Supreme Court of Ohio Rejected Investee Apportionment........28

II. Regardless of Constitutionality, the Imposition of the Tax at Issue is Not Authorized Under Massachusetts' Own Tax Statutes and Regulations 30

A. Massachusetts Explicitly Follows the Unitary Business Principle and Has Not Adopted "Investee Apportionment" 33

1. Massachusetts Adheres Exclusively to the Unitary Business Principle 33

2. Massachusetts Regulations Define the Apportionable Tax Base 34

3. 830 C.M.R. 63.38.1(9)(d)3.e is Inapposite to the Question of Apportionability 37

B. A Tax Cannot Be Imposed if it is Not Statutorily Authorized 38

III. Apportioning 100% of VASHI's Gain to Massachusetts is Unconstitutional........40

CONCLUSION 43

CERTIFICATE OF COMPLIANCE........45

CERTIFICATE OF SERVICE 46

TABLE OF AUTHORITIES

Cases

Allied-Signal, Inc. v. Comm'r of Fin.,
79 N.Y.2d 73 (1991) 28, 30, 40

Allied-Signal, Inc. v. Dir., Div. of, Tax'n,
504 U.S. 768 (1992) .... *passim*

ASARCO Inc. v. Idaho State Tax Comm'n,
458 U.S. 307 .... 19, 20, 21, 22, 25

Bacchus Imps., Ltd. v. Dias,
468 U.S. 263 (1984) 15

Complete Auto Transit, Inc. v. Brady,
430 U.S. 274 (1977) 16, 30

Comptroller of Treasury of Md. v. Wynne,
575 U.S. 542 (2015) 41

Container Corp. of America v. Franchise Tax Board,
463 U.S. 159 (1983) 19, 40, 41

Corrigan v. Testa,
149 Ohio St. 3d 18 (2016) 28, 29, 39

Cruz v. Comm'r of Public Welfare,
395 Mass. 107 (1985) 33

Curtis v. Commiss'r of Corps. & Tax'n,
340 Mass. 169 (1959) 39

Dennis v. Comm'r of Corps., & Tax'n,
340 Mass. 629 (1960) 39

Dep't of Revenue of Ky. v. Davis,
553 U.S. 328 (2008) 15

General Mills, Inc. v. Comm'r of Rev.,
440 Mass. 154 (2003) 21, 22

Gillette Co. v. Comm'r of Revenue,
425 Mass. 670 (1997) 38

Goddard v. Goucher,
89 Mass. App. Ct. 41 (2016)....................32

Graves v. Schmidlapp,
315 U.S. 657 (1942)....................43

Hoffer v. Comm'r of Correction,
412 Mass. 450 (1992) 33

Hormel v. Helvering,
312 U.S. 552 (1941)....................32

Hughes v. Oklahoma,
441 U.S. 322 (1979)....................15

Hunt-Wesson, Inc. v. Franchise Tax Bd. of Cal.,
528 U.S. 458 (2000).................... 17, 27

International Harvester v. Wisconsin Dep't of Tax'n,
322 U.S. 435 (1944).................... 13, 24, 25, 26, 30

McLeod's (Dependents') Case,
389 Mass. 431 (1983) 33

MeadWestvaco Corp. ex. rel. Mead Corp. v. Illinois Dep't of Revenue,
553 U.S. 16 (2008).................... *passim*

Miller Bros. Co. v. State of Md.,
347 U.S. 340 (1954)....................15

Mobil Oil Corp. v. Comm'r of Taxes of V.,
445 U.S. 425 (1980).................... 16, 17, 20, 30

Nashville, C. & St. L. Ry. v. Browning,
310 U.S. 362 (1940)....................41

Norfolk & W. Ry. Co. v. Missouri State Tax Comm'n,
390 U.S. 317 (1968)....................40

Riesman v. Comm'r of Corps.,& Tax'n,
326 Mass. 574 (1950) 38

Shaffer v. Comm'r of Revenue, 485 Mass. 198, 204 *cert. denied sub nom. Shaffer v. Snyder*, 141 S. Ct. 819 (2020) 485 Mass. 198 43

Shell Oil Co. v. Iowa Dep't of Revenue,
488 U.S. 19 (1988).. 16, 17, 30, 31

State of Wisconsin v. J.C. Penney Co.,
311 U.S. 435 (1940)..25

Swift & Co. v. Hocking Valley Ry. Co.,
243 U.S. 281 (1917)..32

Statutes

G.L. c. 63, § 38(b) 31, 34, 39

G.L. c. 63, § 39...42

Rules

Mass. R. App. P. 17(c) 2, 8

N.Y. City Admin. Code § 11-604(3)(a)...40

Ohio Rev. Code Ann. § 5742.212 .... 39, 40

Regulations

830 C.M.R. 63.38.1 (2013) 18, 31, 34, 35, 36, 37

Other Authorities

An Act Further Regulating the Department of Commerce, 2004 Mass. Acts….. 34

Hellerstein, Hellerstein & Appleby, State Taxation, Thomson Reuters/Tax *& Accounting, 3r*d ed. 2001 & Supp. 2021-2 .... 15, 17, 18, 19, 20, 31

TIR 04-22 (Dec. 8, 2004) 32, 34, 39

TIR 92-5 (Oct. 9, 1992).. 32, 33, 34, 39

Uniform Division of Income for Tax Purposes Act 17, 18

INTEREST OF *AMICUS CURIAE*

I. The American College of Tax Counsel

The American College of Tax Counsel ("ACTC")[1] is a nonprofit professional association of tax lawyers in private practice, in law school teaching positions, and in government, who are recognized for their excellence in tax practice and for their substantial contributions and commitment to the profession. The purposes of the ACTC are:

- To foster and recognize the excellence of its members and to elevate standards in the practice of the profession of tax law;
- To stimulate development of skills and knowledge through participation in continuing legal education programs and seminars;
- To provide additional mechanisms for input by tax professionals in development of tax laws and policy; and
- To facilitate scholarly discussion and examination of tax policy issues.

The ACTC is composed of approximately 700 Fellows recognized for their outstanding reputations and contributions to the field of tax law, and is governed

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[1] Pursuant to Mass. R. App. P. 17(c)(5), ACTC hereby certifies as follows: no party or party's counsel authored this brief in whole or in part; no party, or party's counsel, or other person or entity contributed money that was intended to fund preparing or submitting this brief; and neither ACTC nor its counsel represents or has represented one of the parties to this appeal in another proceeding involving similar issues, or was a party or represented a party in a proceeding or legal transaction that is at issue in the present appeal.

by a Board of Regents consisting of one Regent from each federal judicial circuit, two Regents at large, the Officers of the ACTC, and the last retiring President of the ACTC.

This *amicus* brief is submitted by the ACTC's Board of Regents and does not necessarily reflect the views of all members of the ACTC, including those who are government employees, academics, and law school professors, some of whom have appeared separately before the Court as amicus curiae in this case.

II. Constitutional Limitations on State Taxation of Extraterritorial Values are Important to the ACTC

The Appellate Tax Board's ("Board") opinion in this case is inconsistent with a significant body of state tax case law, as the Commissioner himself acknowledged in his response to Appellant's motion for direct appellate review. DAR-28258, Response filed June 4, 2021. This case is therefore important not only for the Commonwealth, but potentially for the development of constitutional principles in the state taxation of income throughout the country. We hope ACTC's discussion of the law assists the court.

ISSUES PRESENTED

1. Is it constitutionally permissible for Massachusetts to tax capital gain recognized by a nondomiciliary corporation upon sale of an interest in an LLC absent a unitary relationship between the corporation and the LLC?

2. May the Commissioner impose tax based on "investee apportionment" in lieu of the unitary business principle without a Massachusetts statute or regulation authorizing this?

3. If so, may the Commissioner apportion 100% of such gain to Massachusetts where a portion of the gain is attributable to the LLC's operations outside Massachusetts?

STATEMENT OF THE CASE

ACTC incorporates the facts set forth in Appellant's brief, as summarized here. Appellant, VAS Holdings & Investments LLC ("VASHI" or "Appellant"), an S corporation organized and commercially domiciled in Florida, held 50% of the membership interests in Cloud5, LLC ("Cloud5"), a Massachusetts LLC. App. I-15, 16.[2] Cloud5, through wholly owned subsidiaries, engaged in an integrated business in Massachusetts and elsewhere. Appellant engaged in no business activities in Massachusetts, had no property or payroll in Massachusetts, and had no Massachusetts resident shareholders. App. I-15, 17. Appellant's only material assets were bank accounts and its membership interest in Cloud5. App. I-17.

[2] The Record Appendix is cited as "App. [Vol.]-[page number]". Appellant's brief is cited as "App. Br. [page number]". Appellee's brief is cited as "COR. Br. [page number]".

The parties have stipulated to the fact that Appellant was not engaged in a unitary business with Cloud5 or its subsidiaries. App. I-18.

On October 11, 2013, Appellant sold its interest in Cloud5. App. I-19. Appellant excluded the resulting capital gain from its tax base on Massachusetts returns for itself and its shareholders, none of whom were Massachusetts residents. App. I-15, 19. In prior years, Appellant's shareholders paid Massachusetts income tax on their distributive shares of Cloud5's Massachusetts-source income. App. II-281-330.

The Commissioner issued notices assessing Massachusetts tax on 100% of Appellants' capital gain from the sale of its Cloud5 LLC interest. App. I-14, 125, 129.

SUMMARY OF THE ARGUMENT

The central issue in this appeal is whether Massachusetts may tax VASHI, an S corporation incorporated and commercially domiciled in Florida, on gain from its sale of Cloud5, even though VASHI had no unitary business relationship with Cloud5. The "unitary business principle" has long been regarded as *the* constitutional linchpin governing whether a state may impose an apportioned tax on income from business activities outside its borders. This principle ensures a sufficient constitutional connection between a state and the values it seeks to tax by requiring that such values relate to a "unitary business" conducted within the state. Here the parties agree, and the Board found, that "none of the . . . hallmarks of a unitary business [was] present" between VASHI and Cloud5 (p. 18). App. IV-383.

Satisfying the unitary business principle is a prerequisite for apportionment under Supreme Court of the United States ("Supreme Court") precedents (pp. 15-28). The Board's opinion nevertheless omits any meaningful analysis of the unitary business principle, misinterprets the Supreme Court's decision in *Allied-Signal, Inc. v. Dir., Div. of, Tax'n,* 504 U.S. 768 (1992), and ignores the clarification of that decision in *MeadWestvaco Corp. ex. rel. Mead Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16 (2008) (pp. 22-28).

The Board also errs in adopting "investee apportionment" to justify taxing a nondomiciliary corporation's non-unitary investment income based on the

subsidiary LLC investee's operations in Massachusetts. "Investee apportionment" is the Board's term for its alternative "test" for the apportionability of investment income based solely on the *subsidiary investee's* independent connection in the taxing state, and without regard to whether the taxpayer investor has a unitary business relationship with the investee or the assets sold, or any other connection to the taxing state. App. IV-384-386. The Supreme Court has never adopted investee apportionment or any other substitute for the unitary business principle (pp. 24-27). Further, the Board's reliance on *International Harvester v. Wisconsin Dep't of Tax'n*, 322 U.S. 435 (1944) is misplaced. That case did not involve, as here, a tax on capital gain realized by a nondomiciliary investor upon its sale of its ownership interest in another, non-unitary company (pp. 24-27).

Even if it were constitutionally permissible for a state to adopt "investee apportionment" as an alternative to the unitary business principle, it would still be statutorily unauthorized in this matter. Massachusetts has never adopted "investee apportionment" as a basis for apportionability. To the contrary, Massachusetts' statutes, regulations, and other guidance adhere to the unitary business principle as the linchpin of apportionability (pp. 30-40).

Finally, even if VASHI's capital gain were apportionable, the Board errs in allowing 100% of such gain to be apportioned to and taxed by Massachusetts. As applied, the apportionment disregards the value and activities attributable to

Cloud5's non-Massachusetts operations and thus impermissibly taxes extraterritorial values in violation of the Due Process and Commerce Clauses (pp. 40-43).

ARGUMENT

I. The Commonwealth Cannot Constitutionally Tax Capital Gain that is Not Related to a Unitary Business Conducted Within Massachusetts

In adjudicating this appeal, this court must apply the longstanding constitutional framework that adopts the unitary business principle to prevent states from taxing extraterritorial values. We start by discussing that framework.

A. The Constitutional Framework for the Unitary Business Principle

1. The Constitution Limits States' Ability to Tax Values Beyond Their Borders

The Constitution of the United States (the "Constitution") was adopted partly to address the risk of "economic Balkanization" among the states and the attendant threats to free-flowing commerce if states could export their tax burdens. *Bacchus Imps., Ltd. v. Dias*, 468 U.S. 263, 276 (1984); *Hughes v. Oklahoma,* 441 U.S. 322, 325 (1979); *Dep't of Revenue of Ky. v. Davis*, 553 U.S. 328, 337–338 (2008). The Due Process Clause and the Commerce Clause both limit a state's ability to tax values outside its borders. The Due Process Clause derives from the basic premise that a state may not tax a taxpayer's property, income, or gross receipts unless there is "some definite link, some minimum connection" between the state and the taxpayer's activities within the state and "generally confines the exercise of a state's tax power to activities conducted within its borders". *Miller Bros. Co. v. State of Md.*, 347 U.S. 340, 344–345 (1954); HELLERSTEIN, HELLERSTEIN & APPLEBY, *STATE TAXATION,* ¶ 8.07[1] (Thomson Reuters/Tax &

Accounting, 3rd ed. 2001 & Supp. 2021-2). The Supreme Court's Commerce Clause jurisprudence defines the limits for determining whether a state tax has impermissibly reached extraterritorial values. *See Shell Oil Co. v. Iowa Dep't of Revenue*, 488 U.S. 19 (1988); *Mobil Oil Corp. v. Comm'r of Taxes of V.*, 445 U.S. 425, 458-459 (1980). The seminal *Complete Auto* decision sets forth a four-factor test for determining the validity of a state tax, including the requirement that a state tax be "fairly apportioned." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 277-279 (1977).

a. Apportionability

Before a tax can be fairly apportioned, the first step is to determine what values may be included in the taxpayer's "apportionable tax base". This is the portion of income that bears a connection to, and hence is potentially taxable by, the taxing state. *See Mobil Oil, 445 U.S.* at 458-459. The requisite connection for "apportionability",[3] meaning the condition precedent for the state to include in the apportionable tax base income arising from a taxpayer's out-of-state activities, is defined by the unitary business principle, which the Supreme Court has described

[3] The determination of apportionability is not a question of *whether* income is subject to a state tax, but rather of *which* state is permitted to tax it. As discussed in Section I.A.1.c., investment income that is not apportionable is generally allocated entirely to the state of the taxpayer's commercial domicile.

many times as "the linchpin of apportionability in the field of state income taxation". *Id.* at 439.

The unitary business principle ensures that the state has "the requisite connection to the out-of-state activities of the business" to warrant taxation of values related to those activities and precludes the impermissible taxation of extraterritorial values. *See* Hellerstein ¶ 8.07[1]; *Shell Oil*, 488 U.S. at 30-31. Thus, a "[s]tate may tax a proportionate share of the income of a nondomiciliary corporation that carries out a particular business both inside and outside that State." *Hunt-Wesson, Inc. v. Franchise Tax Bd. of Cal.*, 528 U.S. 458, 460 (2000). *See also*, *Allied-Signal,* 504 U.S. at 772. By contrast, non-unitary income having "no special connection with the taxpayer's operations in the taxing [s]tate" is excluded from the apportionable tax base. *Mobil Oil,* 445 U.S. at 458.

b. Fair Apportionment

Once an apportionable tax *base* is determined in accordance with the unitary business principle, the second step is ensuring that the tax is fairly "apportioned", meaning that tax applies only to "the portion of a unitary business' income that can be fairly attributed to in-state activities." *Shell Oil,* 488 U.S. at 31. *See also, Mobil Oil,* 445 U.S. at 458-459. State apportionment statutes generally look to factors such as the taxpayer's payroll, property, or sales in the taxing state. *See, e.g.,* Uniform Division of Income for Tax Purposes Act ("UDITPA"), § 9.

c. Exclusion of Non-Unitary Income from the Apportionable Tax Base

Under the unitary business principle, income that is not related to a unitary business conducted within a state must be excluded from that state's apportionable tax base. In the case of non-unitary investment income from the sale of an intangible asset, the non-apportionable gain typically is "allocated" to the state of the taxpayer's commercial domicile. *See, e.g.,* 830 C.M.R. 63.38.1(2); UDITPA § 6(c); Hellerstein ¶ 9.02.

Massachusetts' regulations define an "allocable item of income, in the instance of a taxpayer with income from business activity in more than one state", as "income from a transaction or activity that, consistent with the Constitution, can only be taxed in the state of the taxpayer's commercial domicile, because the item of income was not derived from a unitary business or from transactions that serve an operational function." 830 C.M.R. 63.38.1(2).

2. VASHI Lacked a Unitary Business Relationship with Cloud5

Here, Appellant had no connection to Massachusetts other than its ownership interest in Cloud5. App. IV-372. The parties have stipulated, and the Board found, that VASHI lacked a unitary relationship with Cloud5 and that "none of the . . . hallmarks of a unitary business [was] present." App. IV-383. Thus, in accordance with the controlling constitutional principles and Massachusetts law

discussed below, VAHSI's gain must be excluded from its apportionable tax base and instead allocated to VASHI's commercial domicile.

B. The Unitary Business Principle is Mandatory, Not Optional

1. Supreme Court and Massachusetts Decisions Have Consistently Recognized that a Unitary Relationship is a Prerequisite to Apportionment

The Due Process and Commerce Clauses prohibit states from taxing extraterritorial values. They condition states' ability to tax an apportioned share of value generated by the activities of a multi-state enterprise on those activities being part of a unitary business conducted within the taxing state. *See MeadWestvaco,* 553 U.S. at 24-25; *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 164-165 (1983). The Supreme Court has used the unitary business principle to ensure that states include in an apportionable tax base only income that is related to a unitary business conducted within their borders. *See ASARCO Inc. v. Idaho State Tax Comm'n,* 458 U.S. 307, 320 n. 14 (1982). A taxpayer that lacks the requisite connection to income arising from out-of-state non-unitary activities must exclude such income from its apportionable tax base. *See* Hellerstein ¶ 8.07.

In *ASARCO*, the Supreme Court identified the hallmarks of a unitary business as functional integration, centralization of management, and economies of scale. *ASARCO*, 458 U.S. at 317. Because "these factors of profitability arise from the operation of the business as a whole," the Court found that they "could

justify a State's otherwise impermissible inclusion of income derived from corporate activities beyond the State's borders." *Id.* The Court thus summarized: "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Id.* (quoting *Mobil Oil*, 445 U.S. at 439-440). Income that is not unitary and derives instead from a discrete business that is insufficiently related to operations in the taxing state must be excluded from the apportionable tax base. *See Allied-Signal,* 504 U.S. at 780 ("The constitutional question becomes whether the income derive[s] from unrelated business activity which constitutes a discrete business enterprise.") (internal cites and quotations omitted).

The Supreme Court has consistently adhered to the unitary business principle as the exclusive test for the apportionability of capital gains arising from sales of interests in businesses.[4] In *ASARCO*, the Supreme Court considered whether Idaho could tax an out-of-state corporation on dividend income from, and capital gain realized upon the sale of, its 34% interest in a publicly traded corporation. *ASARCO*, 458 U.S. at 320-324. The Supreme Court affirmed "that a unitary business relationship between ASARCO and [this] subsidiar[y] is a

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[4] The Supreme Court has never suggested that the unitary test for including income in the apportionable tax base depends the form of the business sold. *See, e.g., Mobil Oil* at 440-441 ("One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability." Further, whether income is received from legally separate entities or not "ought not to affect the apportionability of income the parent receives.").

necessary prerequisite to [Idaho's] taxation of the dividends at issue" and applied the same analysis to the capital gains. *Id.* at 325, 330. The Court found that neither dividends nor capital gains were apportionable because ASARCO and its subsidiary did not comprise a unitary business. *Id.* at 328-330.

In *Allied-Signal*, the issue was whether New Jersey could tax an out-of-state corporation on its gain from the sale of its 20.6% ownership interest in a New Jersey corporation. *Allied-Signal,* 504 U.S. at 773-774. After reviewing its unitary business principle jurisprudence, the Supreme Court concluded that the "facts make clear that under our precedents New Jersey was not permitted to include the gain . . . [in the taxpayer's] apportionable tax base", because the investment was not "an integral operational one", and the taxpayer and the New Jersey corporation "were unrelated business enterprises." *Id.* at 788-791.

Finally, in *MeadWestvaco*, Mead sold one of its unincorporated divisions—Lexis. *MeadWestvaco,* 553 U.S. at 21-22. Even though both Mead and Lexis engaged in business in Illinois, the Supreme Court held that Illinois could not tax Mead's gain because the Lexis division lacked a unitary relationship with the business that Mead conducted in Illinois. *Id.* at 30.

In Massachusetts, this court has consistently applied the unitary business principle. In *General Mills, Inc. v. Comm'r of Rev.,* 440 Mass. 154 (2003), this court found that the taxpayer's gain from the sale of stock in Eddie Bauer, Inc. was

not apportionable because it constituted non-unitary investment income. *Id.* at 166. Absent a unitary relationship between the taxpayer/investor and the underlying subsidiary or the intangible assets sold, Massachusetts could not constitutionally tax the gain. *Id.*

The Commissioner argues that Massachusetts may tax VASHI's capital gain simply because Cloud5 conducted business in Massachusetts, notwithstanding that VASHI had no unitary relationship with Cloud5 or "asset unity" with the Cloud5 interests sold. App. IV-383. Just as in *ASARCO, Allied-Signal, MeadWestvaco*, and *General Mills*, here the unitary business constitutional prerequisite to apportionment is lacking. Thus, VASHI's capital gain is not includible in the Massachusetts apportionable tax base.

2. The Board Misinterpreted *Allied-Signal*, Which did Not Authorize States to Substitute Alternative Tests for Apportionment in Lieu of the Unitary Business Principle

The Board critically misinterprets *Allied-Signal* as "opening the door" for Massachusetts to include VASHI's capital gain in the apportionable tax base without regard to the unitary business principle. The Supreme Court in *Allied-Signal* did not invite states to sidestep the unitary business principle, and most recently in *MeadWestvaco*, which the Board never cites, the Supreme Court expressly rejected any such interpretation.

The Board nevertheless found that VASHI's focus on the unitary business principle was "too narrow", as if the Board were somehow authorized to adopt some other linchpin to justify taxing the gain. The Board mistook the following language from *Allied-Signal* as conferring such authorization:

> [t]o be sure, the existence of a unitary relation between the payor and the payee is one means of meeting the constitutional requirement. * * * 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.

Allied-Signal, 504 U.S. at 787; App. IV-384. This language, however, did not signal that the unitary business principle had ceased to be a constitutional prerequisite to apportionment. Rather, the Supreme Court affirmed in *Allied-Signal* that the requisite unitary relationship may exist between the taxpayer and its subsidiary (i.e., the "payor" and the "payee", generally known as "enterprise unity") *or* between the taxpayer and the asset sold (generally known as "asset unity"). *See id.* at 788-789; App. Br. p. 37. In the latter case, "the capital transaction [must] serve an operational rather than an investment function" in order for the asset to be part of the taxpayer's unitary business.[5] *Allied-Signal,* 504 U.S.

[5] An example of asset unity would be interest earned on short-term bond deposits in an unrelated bank "if that income forms part of the working capital of the [taxpayer's] unitary business". *Allied-Signal*, 504 U.S. at 787. Thus, even though the payor bank and payee taxpayer are not engaged in a unitary business, the interest income is still apportionable because the *assets themselves*, the bond deposits, were utilized in the unitary business.

at 787. In either instance, the linchpin remains the unitary business principle. *Id.* at 787.

To the extent that this language in *Allied-Signal* may have confused the analysis, in 2008 the Supreme Court in *MeadWestvaco* reasserted the indispensability of the unitary busines principle and clarified that:

> our references to "operational function" in . . . *Allied-Signal* were not intended to modify the unitary business principle by adding a new ground for apportionment. The concept of operational function simply recognizes that an asset can be a part of a taxpayer's unitary business even if what we may term a "unitary relationship" does not exist between the "payor and payee." * * * Our decision [] in . . . *Allied-Signal* did not announce a new ground for constitutional apportionment of extrastate values in the absence of a unitary business.

MeadWestvaco, 553 U.S. at 29-30. Accordingly, *Allied-Signal* does not invite states to adopt apportionment methods that disregard the unitary business principle.

C. "Investee Apportionment" is Not a Constitutional Alternative to the Unitary Business Principle

1. *International Harvester* Does Not Support Jettisoning the Unitary Business Principle

The Board relies on a "so-called investee apportionment methodology"[6] as an alternative to the unitary business principle to justify taxing VASHI's capital

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[6] One consequence of adopting "investee apportionment" is that it would expose Massachusetts businesses and residents to other states' taxes when investing in out-of-state companies. For example, if a Massachusetts business or resident invests in General Motors stock, then pursuant to the investee apportionment methodology, gain upon the sale of that stock would be taxable by Michigan, or perhaps any

gains and cites to *International Harvester v. Wisconsin Dep't of Tax'n* as supporting authority. App. IV-384. The Board's reliance on *International Harvester* is misplaced. Unlike here, that case did not involve the sale of an interest in a nonunitary entity by nondomiciliary investors. Rather, in *International Harvester*, Wisconsin imposed a tax upon the in-state earnings of a corporation doing business in Wisconsin at the time those earnings were distributed to the shareholders. The Supreme Court explained that:

> the practical operation of the tax is to impose an additional tax on corporate earnings within Wisconsin, but to postpone the liability for payment of the tax until such earnings are paid out in dividends[.]

International Harvester, 322 U.S. at 438 (citing *State of Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 442 (1940)). Consequently, the Court concluded: "the power to tax the corporation's earnings includes the power to postpone the tax until the distribution of those earnings, and to measure it by the amounts distributed." *Id*. at 441.

International Harvester did not involve, and the Supreme Court did not allow, the taxation of out-of-state shareholders on gain from the sale of their interests in the company. Importantly, *International Harvester* preceded the subsequent line of Supreme Court cases (*ASARCO*, *Allied Signal*, *MeadWestvaco*)

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other state in which General Motors does business, even if the seller never engaged in any activities outside of Massachusetts.

that expressly deal with the limitation upon taxing gains received by an out-of-state company from the sale of a nonunitary business, and certainly cannot be read to prospectively overrule that subsequent line of cases.

The Wisconsin tax that the Supreme Court upheld mirrors in operation the manner in which Massachusetts taxes income earned by a pass-through entity to the owners. Thus, *International Harvester* may support Massachusetts' authority to tax the distributive shares of pass-through entities' business income, but it does not support the taxation of an investor's gain on the sale of an intangible interest in that business entity.

The Supreme Court has never allowed states' constitutional ability to tax gain from sales of ownership interests in an entity in the absence of a unitary business relationship between the entity or asset sold and the in-state business of the seller. Here, because VASHI did not have a unitary business relationship with Cloud5, Supreme Court precedent mandates that VASHI's capital gain is not includible in Massachusetts apportionable income.[7]

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[7] Perhaps to avoid this requirement, the Board justifies taxing VASHI's gain from the sale of its interest in Cloud5 by stating "the taxes at issue . . . are not transaction taxes. They are capital gains taxes on the increase in value of [VASHI's] interest in Cloud5, which accrued over time through the business activities of the operating entities." App. IV-391. However, given that a substantial portion of the gain Massachusetts seeks to tax is derived from values that preceded the very existence of Cloud5, labelling the tax as simply a tax upon the increase in the value of VASHI's Cloud5 interest is both disingenuous and disregards the constitutional limitations inherent in the unitary business principle.

2. Massachusetts May Not Adopt a New Ground for Apportionability

In *MeadWestvaco*, Illinois sought to have the Supreme Court recognize "investee apportionment" as "a new ground for the constitutional apportionment of intangibles" pursuant to which "Lexis' own contacts with the State [would] suffice to justify the apportionment of Mead's capital gain." *MeadWestvaco,* 553 U.S. at 30-31. The Supreme Court declined to rule on investee apportionment because it was not timely raised. *MeadWestvaco*, 553 U.S. at 31.

Whether the Supreme Court may someday entertain arguments for fashioning a new, alternative test for apportionability based solely on the taxing state's connection to the investee, we cannot say. But Supreme Court case law, including *MeadWestvaco*, consistently offers the unitary business principle as the exclusive test for apportionability. Notably, following the *MeadWestvaco* decision, other states (including Massachusetts) have not enacted statutes to implement investee apportionment.

Despite the Board's semantics, the tax at issue operates exactly like a tax upon the capital gain from a sale. The tax was not measured by the periodic increase in the value of VASHI's Cloud5 interest (such as an annual *ad valorem* tax or wealth tax) but instead was measured solely by VASHI's gain from the sale of that interest. As the Supreme Court so aptly repeated in *Hunt-Wesson,* 528 U.S. at 464 (citations omitted), "a tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes."

Upholding the Board's decision in this appeal would require this court to adopt a new ground for apportionability, which the Supreme Court itself has never adopted, and which would contradict the Supreme Court's clear and consistently articulated constitutional standards. This court should reverse the Board's decision.

3. In a Similar Case, the Supreme Court of Ohio Rejected Investee Apportionment

In support of its findings with respect to the validity of "investee apportionment," the Board cites a New York appellate court case from 1991, *Allied-Signal, Inc. v. Comm'r of Fin.*, 79 N.Y.2d 73 (1991). That case was decided prior to the Supreme Court's decisions in *Allied-Signal* (1992) and *MeadWestvaco* (2008) affirming the Court's adherence to the unitary business principle. Moreover, the Board does not reference another, more recent state supreme court decision addressing the same issue.

In *Corrigan v. Testa*, 149 Ohio St. 3d 18 (2016), the Ohio Supreme Court firmly rejected the use of investee apportionment absent a unitary business relationship. In that case, Corrigan, a resident of Connecticut, sold to an unrelated party his majority interest in an LLC that operated in Ohio and other states. *Id.* at 19-20. An Ohio statute expressly provided that the gain from a sale of an interest in a pass-through entity was taxable based upon the apportionment factors of the sold entity (investee) when the investor had at least a 20% ownership interest in the

entity. *Id.* at 24. Accordingly, following the Ohio statute, the Ohio tax commissioner taxed the gain without regard to whether there was a unitary business relationship between the seller and the entity sold. *Id.*

The Ohio Supreme Court initially observed that "due process requires that a person whom a state proposes to tax have 'purposefully availed' himself of benefits within the taxing state." *Id*. at 32. The Ohio court further observed that "there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax." *Id* at 33. The Ohio court further observed that a "State may not tax a nondomiciliary corporation's income . . . if it is derived from unrelated business activity which constitutes a discrete business enterprise." *Id.* (citing *Allied-Signal*, 504 U.S. at 773) (internal citations omitted).

The Ohio court concluded that, under these principles, while Corrigan was taxable on his share of income distributed by the LLC, he was not taxable with respect to the gain from the sale of his ownership interests in the LLC. *Id.* at 26. In the latter instance, the activity Ohio sought to tax was the transfer of an intangible interest in the entity, an activity that did not take place in Ohio. *Id.* Although the Ohio court reasoned that Corrigan's availment of Ohio's protections and benefits was clear with respect to the pass-through of the LLC's income to him, in selling his interest in the LLC, Corrigan did not avail himself of Ohio's protections and benefits in any direct way. *Id.* at 26-27. In so concluding, the

Ohio court rejected the same argument that the Board relied upon in this case, namely that *International Harvester* supports applying the so-called investee apportionment methodology to capital gain received by an out-of-state taxpayer that was not engaged in a unitary business with the sold entity. *Id.* at 27-30. The Ohio Supreme Court also declined to follow the majority opinion in *Allied-Signal (New York)*, which the Board relied upon in its decision. Instead, it expressly found the dissenting opinion from Judge Hancock in the New York case to be persuasive. *Id.* at 32. Accordingly, the Ohio court rejected the assessment of tax on the capital gain as a violation of due process because the owner-seller did not have a unitary business relationship with the sold entity. *Id.* at 27-33.

II. Regardless of Constitutionality, the Imposition of the Tax at Issue is Not Authorized Under Massachusetts' Own Tax Statutes and Regulations

As discussed above, under the Due Process and Commerce Clauses, a state may not impose an apportioned tax on values outside its borders unless such income is determined to be both (1) apportionable, and (2) fairly apportioned. *See Shell Oil*, 488 U.S. at 30-31; *Mobil Oil*, 445 U.S. at 458-459; *Complete Auto*, 430 U.S. at 277-279. Apportionability controls *whether* income may be included in the apportionable tax base, based on whether the state has a sufficient connection, as defined by the unitary business principle, with the activities that produce the income the state seeks to tax. If the income is properly apportionable, then fair

apportionment controls *how much* income is fairly attributable to in-state activities and accordingly apportioned to a state and taxed. *See Shell Oil*, 488 U.S. at 30-31.

While these federal constitutional restraints mark the outer limits of state taxation of corporate income, a state's taxing statutes may provide further restrictions.

Here, the Commissioner contends that Appellant's capital gain, while not from a unitary business activity, was nonetheless apportionable based on the "investee apportionment" theory. But even if this were permissible under the Constitution, it is unauthorized as a matter of Massachusetts law. Notwithstanding the arguments advanced by the Commissioner in this appeal, Massachusetts has never adopted "investee apportionment" as a basis for apportionability. To the contrary, Massachusetts' statutes, regulations, and other guidance adhere to the unitary business principle as the linchpin of apportionability.[8] *See* G.L. c. 63, § 38(b); 830 C.M.R. 63.38.1(1)(b) (General Rule), (2) (definitions of "allocable item of income", "unrelated business

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[8] Hellerstein, ¶ 9.01.

> The two principal constitutional restraints with special relevance to division of the corporate income tax base—the unitary business principle and the fair apportionment requirement—are reflected in most states' corporate income tax regimes. The unitary business principle finds expression in the line that the states have drawn between allocable and apportionable income; the fair apportionment requirement is embodied in the formulas that the states have adopted to divide apportionable income among the states with power to tax it.

activities”), (3) (“Income Subject to Apportionment”), (4) (“Related Business Activities”); TIR 04-22 (Dec. 8, 2004); TIR 92-5 (Oct. 9, 1992). Nowhere in its statutes or regulations does Massachusetts authorize an apportioned tax on a nondomiciliary taxpayer based on the in-state connections or value of its non-unitary investee.

It appears that Appellant has not disputed whether the Commissioner has statutory or regulatory authority to impose the assessment. App. IV-380, Stipulation ¶ 16. Nevertheless, it is axiomatic that courts are not bound by stipulations of law when such stipulations are based on incorrect applications of the law. *See, e.g., Goddard v. Goucher*, 89 Mass. App. Ct. 41, 46-47 (2016), citing *Swift & Co. v. Hocking Valley Ry. Co.*, 243 U.S. 281, 289 (1917) (“Parties may not stipulate to the legal conclusions to be reached by the court.”). Further, as the Supreme Court has recognized in *Hormel v. Helvering*, 312 U.S. 552, 556 (1941), a case often cited by this court for the proposition that an appellate court may consider new issues in certain circumstances:

> There may always be exceptional cases or particular circumstances which will prompt a reviewing or appellate court, where injustice might otherwise result, to consider questions of law which were neither pressed nor passed upon by the court or administrative agency below.

See, e.g., *Hoffer v. Comm'r of Correction*, 412 Mass. 450, 457 (1992); *Cruz v. Comm'r of Public Welfare*, §5 Mass. 107, 111 (1985); *McLeod's (Dependents') Case*, 389 Mass. 431, 434 (1983).

A. Massachusetts Explicitly Follows the Unitary Business Principle and Has Not Adopted "Investee Apportionment"

1. Massachusetts Adheres Exclusively to the Unitary Business Principle

Prior to 2004, Massachusetts was known as a "full-apportionment" state, where all of a corporation's taxable income was apportioned and none was allocated to a specific situs. This might have been problematic because, as discussed above, the Constitution prohibits states from including amounts derived from out-of-state, non-unitary activities in a taxpayer's apportionable tax base. Fortunately, the Commissioner understood these constitutional limitations and issued guidance that permitted taxpayers to exclude such items from their apportionable tax bases to avoid the unconstitutional taxation of extraterritorial values. In TIR 92-5 (Oct. 1992), the Commissioner acknowledged that

> [t]he literal application of "full apportionment" principles . . . may encounter jurisdictional limitations . . . where a nondomiciliary corporation has income from an investment that is unrelated to any business it conducts in Massachusetts.

The Commissioner further explained that a nondomiciliary corporation's income from the disposition of an investment is properly excluded from its taxable (*i.e.*,

apportionable) net income if the corporation is "not unitary" with the business represented by the investment security and such business does not otherwise have an operational function. *Id.*

In 2004, Massachusetts enacted legislation that acknowledged the importance of the unitary business principle in determining the apportionable tax base by requiring the *allocation* of income that may not be included in a taxpayer's apportionable tax base. *See* An Act Further Regulating the Department of Commerce, 2004 Mass. Acts. 262 (amending G.L. c. 63, § 38(b)); TIR 04-22 (Dec. 8, 2004). The Commissioner issued TIR 04-22 to explain the 2004 legislation, noting:

> the state in which the corporation has its commercial domicile is generally the only state that has authority under the U.S. Constitution to tax income that is not derived from a unitary business or from transactions serving an operational function. *See generally Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 787 (1992)*; TIR 92-5.

2. Massachusetts Regulations Define the Apportionable Tax Base

Beyond G.L. c. 63, § 38(b), the Commissioner's Regulation, 830 C.M.R. 63.38.1 (the "Apportionment Regulation"), subsections (2) through (4) set forth detailed rules for apportionability.[9]

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[9] The Apportionment Regulation provisions cited herein are as they appeared during 2013, the year at issue in this appeal.

The Apportionment Regulation subsection (3), titled "Income Subject to Apportionment", provides that "[f]or Massachusetts tax purposes, a taxpayer's income subject to apportionment is its entire income derived from its related business activities . . . not including any allocable items of income". 830 C.M.R. 63.38.1(3)(a). "Allocable items of income" are defined as:

> income from a transaction or activity that, consistent with the U.S. Constitution, can only be taxed in the state of the taxpayer's commercial domicile, *because the item of income was not derived from a unitary business or from transactions that serve an operational function*.

830 C.M.R. 63.38.1(2) (emphasis supplied). The Apportionment Regulation subsection (4)(a) similarly identifies "unrelated business activities" as those that are "*not unitary* under U.S. constitutional principles" or lack an operational function. 830 C.M.R. 63.38.1(4)(a) (emphasis supplied). Accordingly, Massachusetts follows the unitary business principle in determining apportionability.

With respect to any allocable item of income, the Apportionment Regulation subsection (3)(c) specifies that it "is not allocated to Massachusetts if the taxpayer's commercial domicile is outside the Commonwealth." 830 C.M.R. 63.38.1(3)(c). Similarly, income derived from unrelated business activities must be excluded from the apportionable tax base if Massachusetts does not have

jurisdiction to tax the items of income under the Constitution. 830 C.M.R. 63.38.1(3)(d).

The following example set forth in the Apportionment Regulation corresponds to the facts of this appeal and is analogous for VASHI:

> *Example 1.* Famous Corporation is a corporation doing business in Massachusetts but domiciled in another state. Famous acquires a minority interest in the shares of Unknown Corporation as a long-term investment. The operations of Famous and Unknown are not related business activities. Any gain or loss on the sale of the Unknown stock is excluded from Famous' taxable net income and is not apportioned to Massachusetts.

830 C.M.R. 63.38.1(3)(d). Like Famous Corporation, VASHI is a nondomiciliary that acquired an interest in another entity, Cloud5, as a long-term investment. Like Famous and Unknown, the operations of VASHI and Cloud5 were not unitary or related business activities. Therefore, like the gain from Famous' sale of Unknown's stock, VASHI's gain on the sale of its interest in Cloud5 also must be excluded from VASHI's taxable net income and not apportioned to Massachusetts.

There is nothing in the statute or the Commissioner's Apportionment Regulation that permits a nondomiciliary's "income subject to apportionment" to be determined without regard to the unitary business principle or based upon the activities of the nonunitary investee's business.

In his brief, the Commissioner points to Apportionment Regulation subsection (4)(d), which sets forth a special, separate accounting rule applicable

only to corporate limited partners that own a minority interest in a limited partnership. COR Br. pp. 50-52. It is not applicable to this appeal, which does not involve a limited partnership interest. Furthermore, and most importantly, subsection (4)(d) does not adopt "investee apportionment" in lieu of the unitary business principle. Rather, subsection (4)(d) provides for separate accounting and apportionment for a corporate partner's income from the limited partnership's unrelated business activities "*to the extent that Massachusetts has jurisdiction to tax income from each such activity*". 830 C.M.R. 63.38.1(4)(d) (emphasis supplied).[10] The separate inquiry of whether Massachusetts has jurisdiction to tax the gain on the sale of a limited partnership interest is determined in accordance with the Apportionment Regulations' apportionability and allocation rules set forth above.

3. 830 C.M.R. 63.38.1(9)(d)3.e is Inapposite to the Question of Apportionability

The Commissioner's Apportionment Regulation addresses the salient question of apportionability, that is, *whether* an item of income may be apportioned, primarily at subsections (3) and (4) as described above. The Apportionment Regulation's rules for apportionment methodology, that is, for

[10] In his brief, the Commissioner block quoted Apportionment Regulation subsection (4)(d), but this important, qualifying language was inexplicably omitted and replaced with ellipses. COR Br. p. 50.

determining *how much* to apportion, are found in subsections (7) through (13). These formulary apportionment provisions determine the apportionment percentage that is applied to properly apportionable income. They are not relevant for determining what is included or excluded from the apportionable tax base.

Apportionment Regulation subsection (9)(d)3.e, upon which both the Board and the Commissioner appear to rely as Massachusetts' authority for the investee apportionment theory, is an apportionment provision, not an *apportionability* provision. It directs the sourcing of receipts from the sale of a partnership interest for purposes of determining a taxpayer's sales factor in the apportionment formula. It has no bearing on income that is not apportionable to begin with, and thus has no relevance to the threshold question of whether VASHI's gain from the sale of its interest in Cloud5 should be included in its apportionable base.

B. A Tax Cannot Be Imposed if it is Not Statutorily Authorized

Massachusetts case law is clear that "[n]o method of determining tax liability is valid unless authorized by statute and assessed in conformity to its terms." *Gillette Co. v. Comm'r of Revenue*, 425 Mass. 670, 675 (1997). *See also, Riesman v. Comm'r of Corps. & Tax'n*, 326 Mass. 574, 575 (1950) ("Our income tax statutes do not tax all gains which a resident may receive during the tax year but only such as are of the kind and nature described in the taxing statutes."). As

such, “taxing statutes are to be construed strictly against the taxing authority, and all doubts resolved in favor of the taxpayer”, and it is well established that the right to tax is “not to be extended by implication”. *Dennis v. Comm’r of Corps. & Tax’n*, 340 Mass. 629, 631 (1960); *Curtis v. Comm’r of Corps. & Tax’n*, 340 Mass. 169, 173 (1959).

While the Board’s opinion cites to a number of Massachusetts tax statutes and regulations, it does not reference any authority governing the essential question of whether VASHI’s capital gain is subject to apportionment and hence taxable by the Commonwealth. In its opinion, the Board states that “the parties disagree as to whether application of relevant Massachusetts law results in [constitutionally] impermissible taxation of the Sale Gain.” App. IV-381. This statement erroneously presupposes that, constitutional issues aside, the relevant Massachusetts law *would* result in the taxation of VASHI’s capital gain. To the contrary, and as explained above, VASHI’s capital gain is not apportionable to and therefore not taxable under Massachusetts statutes or the Commissioner’s own regulations, particularly by G.L. c. 63, § 38(b), Apportionment Regulation subsections 2-4, and TIRs 92-5 and 04-22. Yet none of these authorities is referenced in the Board’s opinion.

By contrast, there was no such statutory defect in *Corrigan*, where the Ohio Supreme Court considered and then rejected the constitutionality of Ohio Rev.

Code Ann. § 5742.212. *See supra* at Section I.D. Similarly, in *Allied-Signal (New York)*, the analysis centered on a New York City statutory provision, N.Y. City Admin. Code § 11-604(3)(a). Constitutional issues aside, no statute or regulation permits the Commissioner to sidestep the unitary business principle or otherwise supports including the sale gain in VASHI's Massachusetts apportionable tax base.

III. Apportioning 100% of VASHI's Gain to Massachusetts is Unconstitutional

The Board's opinion contains yet another fatal flaw. Even assuming, *arguendo*, that the Massachusetts statutes and regulations permit taxing VASHI's capital gain as measured by Cloud5's own apportionment factors and that it is constitutionally permissible to do so, the Board errs in upholding the apportionment of 100% of VASHI's sale gain to Massachusetts.

It bears repeating that "[t]he Due Process and Commerce Clauses forbid the States to tax 'extraterritorial values.'" *MeadWestvaco,* 553 U.S. at 19 (quoting *Container,* 463 U.S. at 164). But assuming, as is required, that the person *and* the activity the State seeks to tax are subject to the State's taxing jurisdiction, *see Allied-Signal,* 504 U.S. at 778, "the inquiry shifts from whether the State may tax to what it may tax." *MeadWestvaco,* 553 U.S. at 25. "A State will not be permitted, under the shelter of an imprecise allocation formula or by ignoring the peculiarities of a given enterprise, to 'project the taxing power of the state plainly beyond its borders.'" *Norfolk & W. Ry. Co. v. Missouri State Tax Comm'n*, 390

U.S. 317, 325 (1968) (quoting *Nashville, C. & St. L. Ry. v. Browning*, 310 U.S. 362, 365 (1940)). The Commerce Clause requires that a state tax imposed on activities in interstate commerce be "fairly apportioned." *See Comptroller of Treasury of Md. v. Wynne*, 575 U.S. 542, 547 (2015). Fair apportionment requires "what might be called external consistency—the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." *Container,* 463 U.S. at 169. Here, however, the assessment of tax on 100% of VASHI's gain from the sale of its interest in Cloud5 does not reasonably reflect either VASHI's or Cloud5's business activities in Massachusetts; rather it unreasonably taxes value earned elsewhere.

The Board expressly recognized that Cloud5's Canadian and Massachusetts operations were consolidated into an integrated business, and that the Canadian business increased its overall profitability following the integration in 2011. App. IV-375. The Board also expressly found that 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". App. IV-377. The Board concluded "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" and that "much of the additional value that gave rise to the Sale Gain" was due to Cloud5's Massachusetts operations. App. IV-391-392.

The Board's own findings condemn its conclusion: the quoted language set forth above ("large measure", "much of", "majority") clearly indicates that some portion, *but not all of the sale gain*, was attributable to Cloud5's Massachusetts business operations. The Commissioner's brief confirms this point, calculating that one-third of VASHI's gain was attributable to its development of the Canadian call-center business before the Cloud5 merger. *See* COR. Br. p. 17 n.7; App. IV-374. Because the Canadian and Massachusetts operations were "consolidated" and the business operations were "integrated", any apportionment of the capital gain should account for the Canadian operations' factors.

Taxing 100% of VASHI's gain from the sale of its interest in Cloud5 disregards the value and activities attributable to the Canadian operations. Thus, the apportionment, as applied here, necessarily imposes tax on extraterritorial values in violation of the Due Process and Commerce Clauses.

It is also dubious that VASHI's ownership and sale of its interest in Cloud5, as a passive investor, constituted "owning or using any part or all of its capital, plant or other property in the commonwealth." *See* G.L. c. 63, § 39. Moreover, to reach the conclusion that 100% of VASHI's gain is attributable to Massachusetts, from an external consistency perspective, necessarily suggests that VASHI and its shareholders did ***not*** "own or use" their intangible property at their respective domiciles. Such a view would be contrary to this court's recent conclusion that the

ownership of intangibles is entirely allocated to the state of domicile for purposes of Massachusetts' estate tax. *See Shaffer v. Comm'r of Revenue*, 485 Mass. 198, 204 *cert. denied sub nom. Shaffer v. Snyder*, 141 S. Ct. 819 (2020) ("Intangibles . . . in fact have no geographic location," and are taxable on death at the owner's domicile" (quoting *Graves v. Schmidlapp*, 315 U.S. 657, 660 (1942)). To conclude that a nondomiciliary corporation's passive investment in a Massachusetts legal entity constitutes a local use of capital in Massachusetts is in tension with the *Shaffer* decision and could disrupt the integrity of the Massachusetts estate tax.

CONCLUSION

For the reasons set forth above, this court should reverse the Board's ruling that VASHI was taxable in Massachusetts with respect to the capital gains at issue in this case.

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Respectfully submitted,

AMERICAN COLLEGE OF TAX COUNSEL

By its Attorneys,

December 15, 2021

/s/ Richard L. Jones

Richard L. Jones (BBO# 631273)
David J. Nagle (BBO# 638385)
Caroline A. Kupiec (BBO# 698786)
SULLIVAN & WORCESTER LLP
One Post Office Square
Boston, Massachusetts 02109
(617) 338-2800
rjones@sullivanlaw.com
dnagle@sullivanlaw.com
ckupiec@sullivanlaw.com

CERTIFICATE OF COMPLIANCE

I hereby certify that the foregoing brief complies with the rules of court that pertain to the filing of amicus briefs, including, but not limited to, the requirements imposed by Mass. R. App. P 16 and Mass. R. App. P. 20. I further certify that the foregoing brief complies with the applicable length limit in Mass. R. App. P. 20 because it uses a 14-point Times New Roman font and is 7,500 words long (not including the portions of the brief excluded under Mass. R. App. P. 20), counted with the word-count function of Microsoft Word for Office 365.

December 15, 2021

/s/ Richard L. Jones

Richard L. Jones (BBO #631273)
rjones@sullivanlaw.com
Sullivan & Worcester LLP
One Post Office Square
Boston, Massachusetts 02109
(617) 338-2800

CERTIFICATE OF SERVICE

I hereby certify that on December 15, 2021, I filed this brief electronically through the Supreme Judicial Court's e-filing system and that all counsel of record are shown as having received electronic notice:

Michael J. Bowen
Akerman LLP
50 North Laura Street, Suite 3100
Jacksonville, Florida 32202
(904) 798-3700
Michael.bowen@akerman.com

Maura Healey
Michael T. Fatale
Brett M. Goldberg
Andrew P. O'Meara
Massachusetts Department of
Revenue, Litigation Bureau
100 Cambridge Street
Boston, Massachusetts, 02114
(617) 501-1062
goldbergb@dor.state.ma.us

December 15, 2021

/s/ Richard L. Jones
Richard L. Jones (BBO #631273)
rjones@sullivanlaw.com
Sullivan & Worcester LLP
One Post Office Square
Boston, Massachusetts 02109
(617) 338-2800