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New DOR Directive Expands the Reach of Massachusetts Income Tax on Nonresidents

In January 2004 the Massachusetts Department of Revenue issued a final directive, Directive 03-12, interpreting legislation enacted in 2003 that applies for tax years beginning on or after January 1, 2003. The legislation specifies that items of gross income that derive from a Massachusetts trade or business, including employment carried on in Massachusetts, remain Massachusetts-source income of a nonresident regardless of the year in which the income is received by the nonresident and regardless of the taxpayer's residence in the year in which it is received. The legislation also specifies that gross income derived from a Massachusetts trade or business (including employment) may include 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, and income from a covenant not to compete.

Directive 03-12 provides examples of the application of these statutory provisions. However, several of these examples may be controversial, and in several instances the import of the examples is far from clear.

Here is a review of the high points of Directive 03-12, focusing particularly on items which are unclear or perhaps subject to challenge. In every case, it is assumed that the recipient is a nonresident at the time the income item is realized.

1. 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.

2. 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, such payments may not be taxed 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 the recipient and the beneficiary of the recipient) or in installments of 10 or more years, an important planning point. 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. (Under the same federal law and under its own regulations, Massachusetts may never tax qualified plan payments to a nonresident.)

3. Nonqualified Pension Benefits Arising From Multi-State Employment. Suppose a person works for a company for several years, partly in Massachusetts, partly in another state, and subsequently receives nonqualified pension payments. Directive 03-12 states that a portion of the pension payments will be treated as Massachusetts-source income based on the apportionment rules found in the DOR regulations that apply to nonresidents who earn compensation from services partly within and partly without Massachusetts. Those regulations in most cases apportion the income based on the period of employment in each location. Arguably, such a methodology will often 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% 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. However, it is not clear that the directive permits the use of such an alternative method.

4. Withdrawn Partners in a Massachusetts LLP. A somewhat mysterious example discusses an individual who was a partner in a limited liability partnership that conducted business in Massachusetts, and who subsequently withdrew from the partnership but was entitled to continued payments after the withdrawal. It is unclear whether these 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. In any case, the example concludes that all of such 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 contributed or goodwill that he created and left behind.

5. Withdrawn Partners of LLP That Conducts Multi-State Business. The next example considers a limited liability partnership doing business in more than one state. It appears that the example assumes 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 receives based on the partnership's average apportionment percentage during the period that he 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.

6. Equity Compensation: Stock Grants, Nonqualified Stock Options and Incentive Stock Options. 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 employment, when he exercises the nonqualified stock option all of the federal compensation income he realizes will be Massachusetts-source income.

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 receives the grant, 100% 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. If such a result is intended, it makes little sense, and may be subject to constitutional challenge. (And even if the option was 100% vested when the employee left Massachusetts, if it remained unexercised and grew in value while he was employed elsewhere, the Massachusetts claim to tax 100% of the income is questionable.)

An equally puzzling conclusion is a pro-taxpayer one: 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, since, 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 even if 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.

7. 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, stating that this is true "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 conducted entirely in Massachusetts and sold the business and entered into a covenant not to compete in Massachusetts. To a large extent, the directive's conclusion may be dictated by the statute;

nevertheless 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 that the individual was an employee or the owner of a business. It is questionable that Massachusetts may under the federal constitution 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.

8. 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." In interpreting this rule, the directive quite surprisingly distinguishes between interests in different sorts of business. 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. 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. However, the DOR reserves broad discretion nevertheless to assert that in a particular case the sale of an interest in a limited partnership or 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 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 such transactions.

Conclusion. A Department of Revenue directive lacks the force of law of a statute, judicial decision or regulation. Taxpayers may have a basis for departing from some of Directive 03-12's conclusions. In any event, both nonresidents who formerly had Massachusetts ties and their employers, who have reporting and withholding obligations, will need to analyze the directive carefully.

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