Massachusetts Taxing Issues

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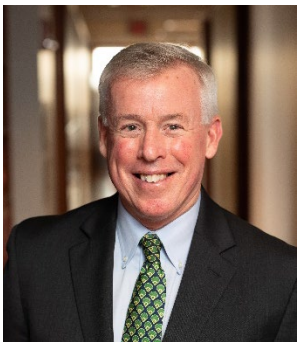
Changing with the times at the DOR

By: **Phil Olsen, Davis Malm**



The expression "changing with the times" means to adapt actions, beliefs and behaviors to be more modern or in line with current trends. It requires staying current with new technologies and developments. In doing so, one can adjust their thinking and plan accordingly. Important to this process is having flexibility and the ability to change direction as evolving circumstances warrant.

Over the years, the Department of Revenue has responded to adverse decisions, evolving technology or demographic shifts with an aggressive "change with the times" mindset. This evolution can be seen throughout all tax types administered by the commissioner of revenue.

Thirty-plus years ago, when state tax planning was an art, many corporations set up intellectual property holding companies to generate state income tax deductions.

A corporation would organize a subsidiary in a low-tax state like Delaware and transfer intellectual property, usually trademarks, to the subsidiary. The Delaware subsidiary would then license the use of the trademark back to the parent or to affiliates that were operating in high-tax states. The royalty payments made to the holding company were taken as income tax deductions by the parent or affiliates.

Many states, including Massachusetts, challenged the structure as a sham created only to generate tax savings. The DOR was initially successful in litigating cases against Delaware holding companies.

However, in October 2002, in *The Sherwin-Williams Company v. Commissioner of Revenue*, the Supreme Judicial Court ruled against the DOR in a case involving whether such royalty payments made to a holding company of Sherwin-Williams were tax deductible or an unlawful scheme.

The court determined that tax motivation was irrelevant where a business reorganization resulted in the creation of a viable business entity engaged in substantive business activity.

The DOR realized the decision could open the door to further tax chicanery and immediately responded. In early 2003, the Legislature gave the commissioner broad powers to disallow the tax consequences of any transaction that the commissioner determined to be a sham transaction, in a direct response to the *Sherwin-Williams* decision.

Another area where the DOR struggled mightily to keep up with taxpayer innovation was the application of sales and use tax to the sale of computer software.

Before 2005, the method by which software was delivered determined whether standardized software was subject to sales tax. A computer software vendor sold pre-written "canned" software to its customers via a floppy disk. The disk was tangible property, so the transaction was taxable.

This led to vendors traveling to the customer's site and installing the software directly onto the customer's computer using tangible storage media (e.g., a hard drive, a tape or a disk).

In this "load and leave" transaction, the vendor did not actually transfer the disk to its customer as part of the sale. Rather, the vendor retained the tangible medium to be used with other customers. This transaction was not subject to sales tax because no tangible personal property was transferred to the customer.

Interestingly, in the early 2000s, the DOR did not worry about electronic transfers of software.

Software downloads were seen as too time-consuming and costly to be viable.

Further, as the DOR noted, the download of large software programs could "sometimes be impossible."

The reality of technological advancements caught up with the DOR, and in 2005 the statutory definition of tangible personal property was amended to include "transfer[s] of standardized computer software, including but not limited to electronic, telephonic, or similar transfer." The sales tax treatment for sales of standardized software no longer depended on the method of delivery.

This was just a single battle in the decades-long computer software sales tax war. Disputes with taxpayers arose and continue over, among other things, cloud computing products, software as a service, and software apportionment.

This brings us to the DOR's recent tactical move to tax non-residents on income that historically was not considered taxable in Massachusetts.

For income of a nonresident to be taxable in Massachusetts, it must be derived from or effectively connected with a trade or business, including any employment carried on by the taxpayer in state. It does not matter if the nonresident is not actively engaged in the trade or business or employment in Massachusetts when the income is received.

For example, stock option income, income from stock shares issued as compensation, deferred compensation, and payments for covenants not to compete are all considered Massachusetts source income because they are attributed directly to employment or a trade or business that was conducted in Massachusetts.

The sale of shares of stock in a corporation, not given as part of the taxpayer's compensation, was

universally understood to not be taxable Massachusetts source income when received by a nonresident. This includes "founder's stock" issued upon the formation of the corporation, as it is generally not considered to be derived from or effectively connected with the carrying on of a trade or business.

This long-held view was successfully challenged by the DOR in the recent case of *Welch v. Commissioner of Revenue,* in which the Appellate Tax Board's decision was affirmed by the Appeals Court.

Despite language in the commissioner's regulation supporting the non-taxability of gain from the sale of founder's stock, and despite the fact that the taxpayer, Mr. Welch, was no longer "actively engaged in a trade or business or employment in the commonwealth" at the time of the sale, the DOR successfully argued that the stock issued to Welch after he formed his company was essentially compensation for services rendered to the company over the course of many years.

Welch was not considered a passive investor in the company, but a founder whose continued employment with the company was key to the company's success. The court held that the stock gain was the payout for his contributions to the corporation and was compensation for his years of service in Massachusetts, and therefore taxable in Massachusetts.

The Appeals Court acknowledged that the case presented unique circumstances. The taxpayer in *Welch* emphasized his important contributions to the corporation and admitted frustration over his compensation. According to the court, Welch expected a payout for his years of sweat equity, coming in the form of a stock gain that was compensatory in nature and not simply a passive investment.

The *Welch* case is another example of the DOR changing direction as evolving circumstances warrant. When determining whether to litigate an issue that may impact numerous taxpayers, it will push the case with the most favorable set of facts,

and *Welch*'s facts presented a good opportunity for the DOR to expand its authority to tax non-residents.

The newly enacted "Millionaires Tax" has arguably started an exodus of wealthy residents to states with lower tax burdens, a cause for concern at the DOR. Like Mr. Welch, many of these individuals founded corporations. Practitioners now worry that the DOR will not view *Welch* as an

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isolated case with "unique circumstances" and instead leverage the case to extend tax obligations to other forms of income received by nonresidents from Massachusetts.

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