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Massachusetts Appellate Tax Board Rules Income Distributed to Out-of-State Corporate Partner Subject to Tax

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On October 27, 2006, the Massachusetts Appellate Tax Board (the "Board") published its decision in *SAHI USA, Inc. v. Commissioner of Revenue* ("*SAHI*"),[1] holding an out-of-state corporation taxable in Massachusetts on its distributive share of gain from a partnership that sold its interest in another partnership that owned and operated a Boston hotel.

Without addressing whether a unitary business relationship existed between the corporation and lower-tier partnership, the Board ruled that the corporation had nexus in, and the gain should be sourced to, Massachusetts due to the activities of the lower-tier partnership in Massachusetts.

In addition to issues of nexus and sourcing, the Board addressed whether prior year depreciation and other costs should be allowed to offset the gain because such depreciation and other costs provided no tax benefit to the corporation in Massachusetts in prior years. On this issue, the Board ruled that the corporation's deductions earned in previous years could not be used to offset its income subject to Massachusetts tax.

Following is a discussion of the case.

Facts

During 1995, SAHI USA, Inc. ("SAHI"), the appellant, owned a 56.875 percent limited partnership interest Meridien Boston Group ("MBG"), a New York limited partnership. In addition to owning a limited partnership interest, SAHI owned a 3.125% general partnership interest in MBG and was the sole general partner.[2] MBG in turn owned a 60 percent general partnership interest in Oliver Street Associates ("OSA"), a Massachusetts general partnership that owned Le Meridien Hotel located in Boston ("Meridien" or "Hotel"). Neither SAHI, MBG nor OSA had any employees. Neither SAHI nor MBG had any offices or property other than their partnership interests. SAHI had

[1] No. C262668 (Mass. App. Tax Bd. October 27, 2006).

[2] Two unrelated parties each owned 20 percent limited partnership interests in MGB.

historically filed Massachusetts corporate excise tax returns and paid the minimum tax of $456 imposed on foreign corporations.[3]

On October 12, 1995, MBG sold its 60 percent interest in OSA and reported a gain of $31,494,076 for federal income tax purposes. After distributing the sale proceeds to its partners, MBG liquidated. On its 1995 Massachusetts corporate excise return, SAHI reported the gain, but computed its apportionment percentage as zero and paid the minimum tax of $456. SAHI also took the position that it did not have nexus with Massachusetts with respect to the gain.[4]

Analysis

Corporate Partner Was "Doing Business" Through the Imputed Activities of the Lower-Tier Partnership

Foreign corporations are subject to the Massachusetts Excise Tax if they are "actually doing business in the commonwealth."[5] "Doing business" is defined as "each and every act, power, right, privilege, or immunity exercised or enjoyed in the commonwealth, as an incident to or by virtue of the powers and privileges acquired by the nature of such organizations, as well as the buying, selling or procuring of services or property."[6] The Board held that SAHI was doing business in Massachusetts because the activities of OSA, which owned and operated the Hotel in Boston, were imputed to MBG and then to SAHI.

The Board first found that Massachusetts law has adopted the aggregate theory of partnership taxation. Under the aggregate theory, as interpreted by Massachusetts law, all the activities and items of income, deductions, losses, credits, etc. pass through to the partners and are reported at the partner level.[7] The Board noted that the aggregate theory had been recently applied in its decision in *Utelcom, Inc. v. Commissioner of Revenue*.[8]

The Board then noted that a Massachusetts regulation provides that a foreign corporation which is a general or limited partnership "does business in Massachusetts" if the partnership's activities, "if conducted directly by a foreign corporation, would

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[3] *SAHI USA, Inc. v. Comm'r of Revenue*, No. C262668, at ATB 2006-797 (Mass. App. Tax Bd. Oct. 27, 2006).

[4] *Id.*

[5] MASS. GEN. LAWS ch. 63, § 39.

[6] *Id.* § 39(1).

[7] *SAHI USA, Inc*, No. C262668 at ATB 2006-801 through 2006-802. The entity theory would treat a partnership as an individual entity separate from its partners.

[8] *Utelcom, Inc. v. Comm'r of Revenue*, ATB 2005-09 (Jan. 31, 2005). Utelcom, Inc. was a direct and indirect 7 percent *limited partner* in a telecommunications partnership doing business in Massachusetts. Utelcom claimed that it was not doing business for purposes of the Utility Corporation Excise tax. The Utility Corporation Excise tax did not define "doing business," so the Board looked to the definition of "doing business" contained in the general Corporate Excise provisions and found the definition to be broad enough to include income earned from a limited partnership interest.

subject that corporation to the corporate excise [tax]."[9] Based on this, the Board found that the partnership's activities are imputed to the corporate partner. The regulation further provides that in the case of a tiered partnership, the activities of the partnership occupying the lower tier are imputed, proportionally, to all partners holding interests in partnerships occupying higher tiers. The Board applied the regulation to SAHI after finding that the Board had approved the application of the regulation in prior cases, including *Utelcom*.

The Gain from the Sale of the Partnership Interest Was Attributable to Massachusetts

Massachusetts law provides that sales other than sales of tangible personal property are attributable to Massachusetts if a greater proportion of income-producing activity is performed in the commonwealth than in any other state.[10] The Board first noted that SAHI offered no evidence as to the performance of any income-producing activity outside of Massachusetts. The Board then determined that the business activities of OSA (i.e., owning, operating and managing the Hotel) is attributable to MBG and the partners of MBG, including SAHI, and that the operation and management of the Hotel were exclusively performed in Massachusetts.

The Board also discussed a regulation promulgated by the Commissioner, which provides that receipts from the sale of a partnership interest are attributable to Massachusetts if "the 'sum of the partnership's Massachusetts property and payroll factors for the taxable year in which the sale occurred exceeds the sum of its property and payroll factors for any other one state.'"[11] Because OSA's activities were imputed to MBG, OSA's activity determined whether the sale receipts were attributable to Massachusetts under the applicable regulation. The Board determined that "OSA's only activity was the ownership, operation, and management, in Massachusetts, of the Meridien Hotel, and all of its property and sales were in Massachusetts. Therefore, OSA's Massachusetts property and sales factors for the tax year at issue exceeded its property and sales factors for any other one state. . . . SAHI's gross receipts attributable to the sale by MBG of a partnership interest in OSA is thus attributable to Massachusetts." [12] The Board concluded that the regulation was a "reasonable administrative interpretation of a statute by the agency charged with its enforcement."[13]

The Board also found as an additional basis for attributing the sale receipts to Massachusetts that the work and business effort associated with the management and operation of the Hotel occurred exclusively in Massachusetts, and that, therefore, the sale receipts from the partnership interest were fairly attributable to Massachusetts. According to the Board, the "value of the partnership interest giving rise to the gain at

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[9] 860 MASS. CODE REGS. 63.39.1.

[10] MASS. GEN. LAW ch. 63 § 38(f).

[11] *SAHI USA, Inc.*, No. C262668 at ATB 2006-813 (citing 830 Mass. Code Regs. § 63.38.1(9)(d)(3)(d)).

[12] *Id.* at ATB 2006-814.

[13] *Id.* at ATB 2006-813.

issue is directly related to the ownership, operation and management of the Merdien Hotel."[14]

Depreciation Deductions Not Allowed to Offset Gain

In the years prior to the sale of the Hotel, SAHI filed Massachusetts returns, but paid only the minimum tax. For federal income tax purposes, SAHI had taken depreciation deductions and incurred other costs for which it received no Massachusetts tax benefit. SAHI argued that because it received no benefit for the depreciation (and other costs) for Massachusetts excise tax purposes, the deductions were "suspended" pursuant to Internal Revenue Code section 704(d), and they became available for Massachusetts tax purposes in the form of net operating losses. These losses could be used to offset SAHI's gain from its distributive share of income from MBG. The Board found there was no authority for deviating from the federally calculated basis in determining the gain for Massachusetts tax purposes and that SAHI could not use its deductions earned in previous tax years to offset its income subject to tax.

Conclusion

The Board's decision in *SAHI* is not surprising given the Massachusetts regulations and the Board's prior decisions. Nonetheless, the decision is troubling because of its analysis of how receipts from the sale of a partnership interest should be sourced, particularly in the case of tiered partnerships. Because the Board relied heavily on Massachusetts's unique and broadly drafted regulations and failed to address the unitary business limitations, one hopes the decision will not prove persuasive in other states.■

[14] *Id.* at ATB 2006-812.

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