

COMMONWEALTH OF MASSACHUSETTS

APPELLATE TAX BOARD

BARRY M. & DIANE PORTNOY

v.

COMMISSIONER OF  
REVENUE

Docket No. F239882

Promulgated:  
January 7, 2000

This is an appeal under the formal procedure pursuant to G.L. c. 62C, § 39, from the refusal of the appellee to abate personal income tax assessed to the appellants for tax years ended December 31, 1990 through December 31, 1993.

Commissioner Scharaffa heard the appeal and was joined in the decision for the appellants by Chairman Gurge and Commissioners Burns, Gorton and Egan.

These findings of fact and report are made pursuant to a request by the appellee under G.L. c. 58A, § 13 and 831 CMR 1.32.

*Jonathan B. Dubitzky, Esq. and Cynthia M. Clarke, Esq.,* for the appellants.

*Wendy E. McClellan, Esq. and Diane M. McCarron, Esq.,* for the appellee.

## FINDINGS OF FACT AND REPORT

At all relevant times, Barry M. and Diane Portnoy (the "taxpayers") were residents of New Hampshire. During the years at issue Mr. Portnoy's principal employment was as a partner in the law firm of Sullivan & Worcester. He was also a 50% shareholder and director of and consultant to HRPT Advisors, Inc. ("Advisors"), and the managing trustee of Health and Rehabilitation Properties Trust ("HRPT"). Mrs. Portnoy owned rental property located in Chatham, Massachusetts, which she operated under the name "Quiet Woman Properties."

The taxpayers timely filed their joint non-resident tax returns for the periods ended December 31, 1990 through December 31, 1993 (collectively "periods at issue").<sup>1</sup> On their tax returns, the taxpayers reported Mr. Portnoy's income earned as an attorney, his 50% distributive share of Advisors' pass-through income, his 1099 consulting income paid by Advisors and Mrs. Portnoy's income from the rental properties. The taxpayers did not, however, include (1) Mr. Portnoy's distributive share of dividends that Advisors received from HRPT; (2) Mr. Portnoy's distributive share of interest and dividend income earned on accounts

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<sup>1</sup> The taxpayers requested and were granted an automatic six-month extension for filing their income tax returns and timely made the required estimated tax payments. 831 CMR 62C.19.1(5)(a).

held in the name of Advisors; and (3) Mrs. Portnoy's interest income from the Quiet Woman Properties' bank account. After conducting an audit, the Commissioner of Revenue ("Commissioner") concluded that the dividend and interest income excluded by the taxpayers should have been included in their Massachusetts taxable income.

On July 5, 1995, pursuant to consents to extend the time for assessment, the Commissioner issued a Notice of Intention to Assess additional taxes plus interest, and on August 5, 1995, the Commissioner issued a Notice of Assessment in the amount of \$295,668. On July 18, 1996, the taxpayers timely filed applications for abatement for all periods at issue. The Commissioner took no action on the applications, and on January 18, 1997, the applications were deemed denied. The taxpayers timely filed their appeal with the Appellate Tax Board ("Board") on February 14, 1997. Based on the foregoing, the Board found that it had jurisdiction over the subject appeal.

On the basis of a statement of agreed facts, testimony and exhibits introduced by the parties at the hearing of these appeals, the Board made the following findings of fact. Mr. Portnoy and Mr. Gerard Martin organized Advisors in 1986 for the purpose of providing management and administrative services with respect to the ownership of

health care and related properties, specifically HRPT. Advisors is a subchapter S corporation doing business in Massachusetts with its office location at 400 Centre Street, Newton, Massachusetts. Mr. Portnoy and Mr. Martin are each 50% shareholders and directors of Advisors.

At or about the same time Advisors was organized, Mr. Portnoy formed HRPT. HRPT is a widely held real estate investment trust traded on the New York Stock Exchange. Mr. Portnoy is the managing trustee. In addition to Mr. Portnoy and Mr. Martin, HRPT has trustees who are not owners or directors of Advisors. HRPT invests in income-producing property, particularly health care related facilities, by providing mortgage financing to various health care and related facilities and also by acquiring and leasing health care facilities.

On November 30, 1986, Advisors and HRPT entered into an Advisory Agreement ("Agreement"). Pursuant to the Agreement, Advisors, through its employees, would provide numerous services to HRPT including: serving as HRPT's investment advisor; managing HRPT's short-term investments, including the purchase and sale of money-market instruments; investing and reinvesting any money of HRPT; and, maintaining the day-to-day operations of HRPT,

including providing office space and personnel when necessary.

In return for its services, Advisors received a base fee, payable monthly, and an incentive fee, payable quarterly, equal to 20% of the amount by which HRPT's "Cash Available for Distribution to Shareholders" exceeded 15% of HRPT's equity as shown on the balance sheet. The agreement was renewable annually and the amount of compensation paid to Advisors was to be determined by the independent trustees, who were not officers of HRPT or shareholders of Advisors.

During the years at issue, Mr. Portnoy provided consulting services to Advisors, including raising debt and equity capital and providing advice on various business transactions. In return for his services, Mr. Portnoy received 1099 consulting income from Advisors which he included in his Massachusetts taxable income.

Mr. Portnoy was also a director of Greenery Rehabilitation Group, Inc. ("Greenery"). Due to a change in the federal accounting rules for sale-leaseback arrangements, Greenery was forced to sell the more than 900,000 shares of stock it owned in HRPT. Greenery explored several options including selling its HRPT stock on the open market and a block trade through an investment

bank. Both options, however, presented the possibility and likelihood that such a transaction would not generate the full value for the stock because placing such a large number of shares into the market would likely decrease the per share market value.

Based on his knowledge of HRPT, gained through his ownership and involvement in Advisors and his experience as a trustee of HRPT, Mr. Portnoy concluded that the 900,000 shares of HRPT stock would be a good investment. He discussed with Mr. Martin the possibility of the two of them purchasing the Greenery stock as an investment. Mr. Portnoy and Mr. Martin approached Greenery and proposed that they pay a portion of the price in cash with Greenery financing the balance. Mr. Portnoy and Mr. Martin negotiated with the three outside directors of Greenery to establish a price. Greenery agreed to provide 85% of the financing.

After the financial negotiations were completed, Mr. Portnoy and Mr. Martin decided to purchase the stocks in the name of Advisors. The Greenery directors had insisted that Mr. Portnoy and Mr. Martin guarantee the note jointly and severally. Neither Mr. Portnoy nor Mr. Martin wanted to guarantee a separate obligation for the other. They then concluded that since they each owned 50% of

Advisors' stock, that it would make more sense to have Advisors purchase the stock and guarantee the note. In November 1989, Advisors purchased 996,250 shares of HRPT stock. Advisors paid Greenery \$1,374,000 in cash and executed a note in the amount of \$7,780,000. During the years at issue, HRPT paid dividends to all of its shareholders, including Advisors. Mr. Portnoy received 50% of these dividends as his distributive share of the income from Advisors. Mr. Portnoy did not include this dividend income in his Massachusetts taxable income.

Based on the foregoing, the Board found that Advisors' purpose for purchasing the HRPT stock was as an investment. Advisors paid a significant price to acquire the HRPT shares, approximately \$9,000,000. The dividends received were simply a return on this investment and were the same as those paid to all other shareholders of HRPT. The Board further found that the dividends were not paid as compensation for the services provided by Advisors. The advisory agreement, entered into three years prior to the purchase of the stock, provided for Advisors' compensation for its services to HRPT.

Lastly, the Board also found that although Advisors performed services for HRPT, it was not engaged in HRPT's trade or business. The Board further found that the HRPT

dividends received by Advisors were not derived from or effectively connected with Advisors' trade or business within the Commonwealth and therefore were not subject to the Massachusetts personal income tax as pass-through income taxable to Mr. Portnoy.

Also at issue in the present appeal is Mr. Portnoy's distributive share of interest income and mutual fund dividends earned by Advisors' bank account and money market account. Mr. David Hegarty was the treasurer for Advisors and HRPT during the years at issue. In his role as treasurer, it was his responsibility to make certain that all reporting requirements were met and that all tax returns were completed and timely filed. Also, his job description included cash management for the entities.

According to Mr. Hegarty, the primary source of revenue for Advisors was the advisory fee which it earned under the agreement with HRPT. He testified that the revenue generated through the advisory agreement was sufficient to cover Advisors' immediate expenses. When Advisors' cash exceeded \$100,000, the excess over \$100,000 was deposited into overnight accounts, certificates of deposit, repurchase agreements, and other similar accounts through State Street Bank as well as a money market account with Scudder Fund. Mr. Hegarty claimed that the money

which was deposited was surplus cash "put away for a month at a time or a week at a time." The taxpayer offered no persuasive evidence to support its claim that the invested money was "surplus" cash as opposed to operating capital of the business.

Advisors earned interest and dividend income from these accounts. Through his ownership in Advisors, Mr. Portnoy received 50% of this interest and dividend income as pass-through income. Mr. Portnoy did not, however, include this income in his Massachusetts taxable income.

The Board found that the taxpayer failed to prove that the money deposited with State Street and Scudder was truly an investment as opposed to being a part of Advisors' working capital. The deposits were made with the expectation that they would be withdrawn, "in a month or a week" to cover Advisors' expenses. The Board found that these monies were held to meet Advisors' business needs. Furthermore, the Board found that the taxpayer failed to show that there was an intent to invest these funds apart from their use in connection with the ongoing business of Advisors. The Board therefore found that this interest and dividend income was derived from or effectively connected with Advisors' trade or business within the Commonwealth

and as such was taxable as pass-through income to Mr. Portnoy.

With regard to Mrs. Portnoy's interest income, she owned a strip-mall in Chatham, Massachusetts, which consisted of three retail stores and three apartments. Mrs. Portnoy generated revenue from renting the properties which she deposited into a bank account maintained in the name of Quiet Woman Properties.

The rental receipts, which were deposited into the account, were used to pay the business expenses. From time to time, Mrs. Portnoy deposited additional funds into this account and also paid certain personal expenses. During the years at issue, the deposits generated interest income. Mrs. Portnoy did not report this income on her non-resident tax return.

The Board found that the taxpayers failed to offer any evidence showing that Mrs. Portnoy was not engaged in the trade or business of real estate. The Board further found that the taxpayers failed to prove that the purpose of the Quiet Woman Properties' bank account was merely to invest money apart from Mrs. Portnoy's ongoing business operations. Accordingly, the Board found that the Quiet Woman Properties' bank account was maintained in the ordinary course of business. The Board therefore found

that the taxpayer failed to prove that the interest income was not derived from or effectively connected with a trade or business.

Based on the foregoing, the Board issued a decision for the appellants in the total amount of \$212,719, plus all statutory additions, representing an abatement of the tax assessed on Mr. Portnoy's distributive share of the HRPT dividends paid to Advisors.

#### OPINION

Pursuant to G.L. c. 62, § 17A, a non-resident shareholder of a subchapter S corporation is subject to tax on his/her distributive share of the income realized by the S corporation to the same extent that a non-resident would be subject to tax under G.L. c. 62, § 5A if realized directly by the non-resident. Non-residents of the Commonwealth are required to pay Massachusetts personal income tax to the extent that their taxable income is "*derived from or effectively connected with* (1) any trade or business, including any employment carried on by the taxpayer in the commonwealth . . . or (3) the ownership of an interest in real or tangible personal property located in the commonwealth." G.L. c. 62, § 5A(a)(Emphasis added).

All types of income, including investment income, which is derived from or effectively connected with the carrying on of a trade or business within Massachusetts, is Massachusetts source income. 830 CMR 62.5A.1(3)(a)(2). The Massachusetts statute, however, does not define the term "effectively connected." In its recent decision in **Rosse v. Commissioner of Revenue**, 431 Mass. 430 (1999), the Supreme Judicial Court noted that the "phrase 'effectively connected' certainly conveys something more than any connection." *Id.* at 437. The Court did not, however, define what connection is needed. However, because the Internal Revenue Code ("Code"), Treasury Regulations and federal cases have defined or addressed the issue of whether income is effectively connected to a trade or business, the Board looks to these federal sources for guidance.

Section 864(c) of the Code provides that:

In determining whether income [from interest and dividends] . . . is effectively connected with the conduct of a trade or business, . . . the factors taken into account shall include whether -

(A) the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business, or

(B) the activities of such trade or business were a material factor in the realization of the income.

I.R.C. § 864(c)(2).

The Tax Court has interpreted § 864(c) to provide for either of two tests to be applied when determining whether income is effectively connected with a trade or business: (1) the asset use test and (2) the business activities test. See *Taiyo Hawaii Company, LTD. v. Commissioner of Internal Revenue*, 108 T.C. 590, 610 (1997); *Inverworld, Inc. v. Commissioner of Internal Revenue*, T.C. Memo 1996-301 (June 27, 1996).

The regulations interpreting § 864(c) provide that an asset is treated as used in, or held for use in, the conduct of a trade or business if the asset is "held in a **direct relationship** to the trade or business," that is, "whether the asset is needed in that trade or business." Treas. Reg. 1.864-4(c)(2)(Emphasis added).

It is uncontested that Advisors was engaged in a trade or business in the Commonwealth and that Mr. Portnoy's distributive share of the S corporation's compensation income, as an actively involved 50% shareholder, was subject to the Massachusetts personal income tax. The issue in this appeal is whether dividend income which Advisors received from its investment in HRPT, and passed

through to Mr. Portnoy, was also subject to Massachusetts income tax.

The Commissioner argues that since Advisors and Mr. Portnoy provided investment services to HRPT they actively participated in the production of the dividend income and therefore were engaged in that trade or business. The Commissioner also suggests that since the dividend income was derived from HRPT's trade or business it cannot be passive income to Advisors.

The mere fact that a non-resident receives dividends from a corporation that is engaged in business in the Commonwealth is not enough to subject the dividends to the Massachusetts personal income tax. See **Dupee v. Commissioner of Revenue**, 16 Mass. App. Tax. Bd. Rep. 114 (1994) *aff'd*, 423 Mass. 617 (1996). In **Dupee**, the Board concluded that the only reasonable interpretation of § 5A is that "in order for a nonresident to be taxable on income derived from or effectively connected with a trade or business, the nonresident must conduct that trade or business" from which the income is derived. **Dupee**, 16 Mass. App. Tax Bd. Rep. at 121; see also **Rosse v. Commissioner of Revenue**, 1998 ATB Adv. Sh. 889, 902 *aff'd* 430 Mass. 431 (1999)(income is effectively connected only to the specific activity that generates it).

Quoting the Board's decision, the Commissioner's own Letter Rulings and Regulations, and the instructions to the Form 1-NR, the Supreme Judicial Court ruled that the Commissioner could not properly tax "income derived from or connected with a Massachusetts business where [the taxpayer] did not personally carry on a Massachusetts trade or business." *Dupee*, 423 Mass. at 623.

Accordingly, in order for the HRPT dividends to be taxable to Mr. Portnoy, the dividends must be derived from or effectively connected with the trade or business which he or, by virtue of his subchapter S shareholder status, Advisors conducted in Massachusetts. In *Rosse*, the Board concluded that a taxpayer's "expert and sometimes proactive involvement in enhancing his value of an equity position was not itself the conduct of a recognized trade or business." *Rosse*, 1998 ATB Adv. Sh. at 908. The Board noted that the pursuit of dividends through ownership of stock is characteristic of investing, not involvement in a trade or business. *Id.* Further, applying the asset use test as outlined above, the Internal Revenue Service has stated that "stock of a corporation . . . shall not be treated as an asset used in, or held for use in, the conduct of a trade or business." Treas. Reg. 1.864-4(c)(2)(c)(iii).

In the present appeal, the Board found that Advisors' purpose for purchasing the HRPT stock was as an investment. The Board found that (1) the stock was not used in or held for use in the conduct of Advisors' trade or business and (2) the activities of its trade or business were not a material factor in the realization of the dividend income. *See generally* I.R.C. § 864(c). Based on the foregoing, the Board found that the HRPT dividends received by Advisors were not derived from or effectively connected with Advisors' trade or business within the Commonwealth and therefore were not subject to the Massachusetts personal income tax as pass-through income taxable to Mr. Portnoy.

Also at issue in the present appeal are Mr. Portnoy's distributive share of dividends and interest received by Advisors from short-term investments. The taxpayers, *citing Anderson Sales v. Commissioner of Revenue*, 1997 ATB Adv. Sh. 431, maintain that the interest and dividend income is not effectively connected with a trade or business and therefore not subject to tax. In *Anderson*, the Board found that the taxpayer did not prove that the invested funds were necessary for the operation of the business. The Board further found that Anderson's investment activities, while "for the production of income," did not rise to the level of a "trade or business"

and were not a continuation of his business purpose.  
**Anderson Sales**, 1997 ATB Adv. Sh. at 439.

In the present appeal, the taxpayers concede that Advisors was engaged in a trade or business within the Commonwealth. Accordingly, Mr. Portnoy's share of income which was derived from or effectively connected with these activities is subject to tax. G.L. c. 62, §§ 5A and 17A. The Board found that as part of its customary business operations, Advisors took income, which it earned through its business activities carried on in the Commonwealth, and deposited it into short-term interest bearing accounts and mutual funds. These accounts in turn generated interest and dividends.

Based on the evidence presented, the Board found that these monies were part of the business assets necessary and available to Advisors at all times to meet its business needs. The Board therefore found that the interest and dividends were derived from assets used or held for use in Advisors' trade or business. See generally I.R.C. § 864(c); Treas. Reg. 1.864-4(c)(v)(Ex.1).

Also at issue is the interest generated from Mrs. Portnoy's real estate rental operations carried on in the Commonwealth. Mrs. Portnoy generated rental income from Massachusetts real estate which she owned and rented. As

part of her rental operations, she maintained a bank account in the name of her business into which she deposited her business revenues and from which she paid both business and personal expenses. The account generated interest.

Based on the evidence presented, the Board found that the taxpayers failed to meet their burden of proving that the interest income was not derived from or effectively connected with the trade or business of renting real estate within the Commonwealth and that it therefore was taxable under G.L. c. 62, § 5A, (1). Not only was the money available to meet the business needs, but the account was used primarily for that purpose. The Board further found that maintaining the bank account was not merely an "investment" activity on the part of Mrs. Portnoy, distinguishing this case from **Anderson**, and that the account was used or held for use in the business of Quiet Woman Properties.

Accordingly, the Board found that Mr. Portnoy's distributive share of the interest and dividends received by Advisors from short-term investments and the interest received by Mrs. Portnoy from her Quiet Woman Properties' bank account were subject to the Massachusetts personal income tax. Cf. **Champion International Corporation v.**

**Bureau of Revenue**, 88 N.M. 411, 413, 540 P.2d 1300, 1302 (1975)(company's usual and customary business practice to invest, whenever there was enough business income that was not immediately needed in the business, in short-term investments; Court found that the interest earned was needed for company's future business activity and therefore was "business income").

A person who claims to be aggrieved by the refusal of the Commissioner to abate a tax in whole or in part has the burden of establishing the right to abatement. **Staples v. Commissioner of Corp. & Tax.**, 305 Mass. 20, 26 (1940). See also **Commissioner of Corp. & Tax. v. Filoon**, 310 Mass. 374, 376 (1941); **Stone v. State Tax Commission**, 363 Mass. 64, 65-66 (1973). In the present appeal, the burden of proof was with the taxpayers to prove that the interest and dividend income was true "investment" income not subject to tax. The Board found that the HRPT dividends received by Advisors was investment income not derived from or effectively connected with a trade or business carried on within the Commonwealth. The Board further found that the interest and dividend income earned on Advisors' short-term investments was derived from and effectively connected with its trade or business and therefore was taxable as pass-through income to Mr. Portnoy. Lastly, the Board found

that the taxpayers failed to prove that the interest generated by Quiet Woman Properties' bank account was not derived from or effectively connected with a trade or business carried on within the Commonwealth and therefore was subject to tax.

Based on the foregoing, the Board issued a decision for the appellants which abated the tax assessed on Mr. Portnoy's distributive share of the HRPT dividends paid to Advisors.

APPELLATE TAX BOARD

By: \_\_\_\_\_  
Abigail A. Burns, Chairman

A true copy,

Attest: \_\_\_\_\_  
Clerk of the Board