

DOR  
HomeFor  
Individuals and FamiliesFor  
BusinessesFor  
Local OfficialsFor  
Tax Professionals

Home > Businesses > Help & Resources > Legal Library > Directives > Directives - By Decade > (2000-2009) Directives >

## Directive 03-12: Taxation of Income Earned by Non-Residents After St. 2003, c. 4, s. 7

### I. Introduction: the revised statute

For tax years beginning on or after January 1, 2003, the definition of "gross income from sources within the Commonwealth" as it applies to non-residents that are required to pay Massachusetts personal income taxes has changed. St. 2003, c. 4, § 7. See TIR 03-13, G.L. c. 62, § 5A, as amended. The definition continues to include items of gross income derived from or effectively connected with any trade or business, including any employment carried on by the taxpayer in the Commonwealth, and adds that such income is Massachusetts source income "regardless of the year in which that income is actually received by the taxpayer and regardless of the taxpayer's residence or domicile in the year it is received." G.L. c. 62, § 5A(a), as amended.

The revised G.L. c. 62, § 5A further provides that:

For purposes of this section, gross income derived from or effectively connected with any trade or business, including any employment, carried on by the taxpayer in the commonwealth shall mean the income that results from, is earned by, is credited to, accumulated for or otherwise attributable to either the taxpayer's trade or business in the commonwealth in any year or part thereof, regardless of the year in which that income is actually received by the taxpayer and regardless of the taxpayer's residence or domicile in the year it is received. It shall include, but not be limited to, gain from the sale of a business or of an interest in a business, distributive share income, separation, sick or vacation pay, deferred compensation and nonqualified pension income not prevented from state taxation by the laws of the United States and income from a covenant not to compete. The foregoing shall not be deemed to include income from qualified tax-deferred retirement plans which are exempt from taxation under any other provision of this chapter.

Income derived from or effectively connected with a lottery or wagering transaction in the Commonwealth, or derived from the ownership of any interest in real or tangible personal property in the Commonwealth, is also taxable to non-residents. The scope of these elements of income taxable under chapter 62 of the General Laws was not changed by St. 2003, c. 4, § 7, and is not treated in this Directive. See 830 CMR 62.5A.1(3).

Among other results, this legislation has the effect of altering the course taken by a line of cases, decided under the prior statutory scheme, that limited the taxation of non-residents. Those cases include *Commissioner of Revenue v. Destito*, 23 Mass. App. Ct. 977, *review denied*, 399 Mass. 1104(1987) (considering the taxation of deferred sick leave to a non-resident formerly employed in Massachusetts), *Cohen v. Commissioner of Revenue*, A.T.B. nos. 205165, 205166, 206601, 206602 (1995) (considering the taxation of the sale of a partnership interest as opposed to distributive share income), *Commissioner of Revenue v. Dupee*, 423 Mass. 617 (1996) and *Gaston v. Commissioner of Revenue*, A.T.B. nos. 163053, 170356 (1997)(both considering the taxation of the sale of assets derived from ownership in an S corporation), *Gersh v. Commissioner of Revenue*, A.T.B. nos. 204089, F205738, F217847 (1997)(considering the taxation of a non-competition agreement), and *Commissioner of Revenue v. Oliver*, 436 Mass. 467(2002)(considering whether non-qualified pension benefits attributable to Massachusetts employment are taxable to non-residents).

Employers should note that those making payments to taxpayers generally must withhold taxes on Massachusetts source income if they are also required to withhold federal taxes on that income; this

### SEARCH

Select an area to search

Search

requirement applies to any income that is newly taxed under Stat. 2003, c. 4, § 7 and that otherwise is subject to withholding. See 830 CMR 62B.2.1.

#### Issue 1

Does the current residence or domicile of a non-resident taxpayer have any effect on the taxability of Massachusetts source income?

#### Directive 1

No. All items of income that derive from the conduct of a trade or business or employment in Massachusetts, as those terms are defined in St. 2003, c. 4, § 7, are Massachusetts source income, even if the taxpayer has not been present in Massachusetts during the year of receipt.

#### Discussion 1

The revised G.L. c. 62, § 5A expands the meaning of the phrase "gross income from sources within the Commonwealth" by stating that so long as the income originated from the conduct of a trade or business or employment carried on in Massachusetts, it no longer matters when a taxpayer receives the income or where the taxpayer lives when he or she receives the income; Massachusetts source income is taxable in Massachusetts.

#### Examples of Directive 1

##### 1.a. Severance and accumulated sick leave.

Taxpayer Thomas is a resident of New Hampshire and works in Massachusetts from 1984 through 2004. Upon retirement in 2004 Thomas receives a severance compensation package that includes \$10,000 for severance pay and \$5,000 for unused sick leave. The entire \$15,000 package is derived from and attributable to Thomas's employment in Massachusetts, and is Massachusetts source income.

##### 1.b.1 Non-qualified pension benefits.

Taxpayer Terry worked in Massachusetts from 1985 through 2002 and retires, moving out of state. A portion of her pension package includes non-qualified benefits that non-domiciliary states are permitted to tax under federal law. Those benefits are paid in 2003 and years thereafter. Because this taxable pension income is derived from Terry's employment in Massachusetts, it is Massachusetts source income taxable to Terry in the year of receipt.

##### 1.b.2 Non-qualified pension benefits, multistate employment.

Same facts as in b.1, but Taxpayer Tessie worked for the same company in various states from 1985 through 2002. Tessie is allowed to source her non-qualified pension benefits to Massachusetts in the same proportion as her period of Massachusetts employment credited toward her pension bears to the total period of employment credited toward her pension. The apportionment rules in 830 CMR 62.5A.1(6) may be used for this purpose, or if the necessary information to apply those rules for years prior to the issuance of this Directive is not available, the taxpayer may use other reasonable methods. The apportionment calculation for this example must be based on the entire employment period from 1985 through 2002, assuming that all of those years were credited toward Tessie's pension.

##### 1.c.1 Withdrawn partners, Massachusetts LLP.

LLP is a limited liability partnership that conducts its business out of its Massachusetts headquarters. It consists of twenty partners. In 2002, ten partners withdraw, leaving ten Active Partners and ten Withdrawn Partners. Upon withdrawal, the ten Withdrawn Partners cease to be members of the partnership, and move out of state. The Withdrawn Partners receive annual payments for ten years after withdrawal, identified as undistributed profits. Because these payments are attributable to the partners' conduct of a trade or business in Massachusetts, they are taxable Massachusetts source income to the non-residents.

##### 1.c.2 Withdrawn partners, Multistate LLP

Same facts as in c.1, except that from 1998 through 2002 the partnership had one or more nonresident individual partners, had income derived from business activities in another state, and such other state had jurisdiction to levy an income tax on the partnership or partners. Five-Year Partner was a partner during the period 1998 through 2002. The partnership should apply the average apportionment percentage of the partnership during the period 1998 through 2002 and notify the Five-Year Partner of the Massachusetts source income portion of his annual payments.

#### Issue 2

What does the phrase "trade or business, including any employment" mean?

## Directive 2

All activities that are considered a "trade or business," including employment, under state and federal law are subject to taxation in Massachusetts under G.L. c. 62, § 5A. Income from a trade or business includes that gross income against which trade or business expense deductions are generally allowed under sections 62 and 162 of the Code. See G.L. c. 62, § 1(l), IRC §§ 62, 162, Treas. Reg. §§ 1.161-1 – 1.162-29. Such gross income received by non-residents is subject to Massachusetts taxation whether or not the taxpayer actually is eligible for or actually takes deductions on the federal return for the tax year during which the income is received. St. 2003, c. 4, § 7. See 830 CMR 62.5A.1(3)(a)2.

Income from a trade or business includes income that results from the sale of an interest in a business. This rule generally applies to the sale of an interest in a sole proprietorship, general partnership, limited liability partnership or limited liability company. It generally does not apply to the sale of a limited partnership interest or the sale of shares of stock in a C or S corporation. Nevertheless, gain from disposition of a limited partnership interest or shares of corporate stock may give rise to Massachusetts source income if, for example, a taxpayer changes the organizational form of a business in anticipation of its disposition for the purpose of avoiding Massachusetts tax. Depending on the facts and circumstances of the case, gain from the sale of such stock or limited partnership interest will be taxable to non-residents if it is determined that the taxpayer has engaged in a transaction or multiple transactions, the purpose of which is the avoidance of tax upon the gain (e.g. sham or step transaction, or other prohibited assignment of income).

## Discussion 2

Section 5A treats income derived from a trade or business or employment the same. The term "employment" includes personal services performed for compensation in Massachusetts, regardless of where or when paid. 830 CMR 62.5A.1(2), (3)(a)1. This definition is unchanged by the new law.

The phrase "trade or business" for purposes of section 5A has the same meaning as in section 62 of the Code. G.L. c. 62, § 1(l). The Code, however, has no precise definition of the concept for general application, and each case must be considered on its facts. *Commissioner of Internal Revenue v. Groetzing*, 480 U.S. 23, 32, 36 (1987). The Department of Revenue will rely on the judicial interpretation of the concept.

In *Groetzing*, the U.S. Supreme Court distilled the complex history of interpreting the phrase "trade or business," and stated the following requirements:

- (a) The taxpayer's primary purpose for engaging in the activity must be for income or profit;
- (b) The taxpayer must be involved in the activity with continuity and regularity.

*Groetzing*, 480 U.S. 23, 35 (1987). See also *Rosse v. Commissioner of Revenue*, 430 Mass. 431, 435 (1999).

In addition to the federal standard for determining whether a taxpayer is conducting a trade or business, St. 2003, c. 4, § 7 expands the definition of gross income derived from or effectively connected with a trade or business to include the gain from the sale of a business or an interest in a business. This provision in effect departs from court interpretations of the prior statutory scheme, notably *Dupee v. Commissioner of Revenue*, 423 Mass. 617 (1996) and *Cohen v. Commissioner of Revenue*, A.T.B. nos. 205165, 205166, 206601, 206602 (1995). In *Dupee*, an S corporation conducting business in Massachusetts liquidated, distributing its assets to non-resident shareholders, who then sold a portion of their interest in the assets for cash. Under the new law, the taxpayers would be taxable on this Massachusetts source income even if they were not active participants in the S corporation's activities. In *Cohen*, general partners sold their interest in a partnership that owned Massachusetts based income-producing assets. Under current law the non-resident general partner would be taxable on the income derived from selling the interest in this Massachusetts business. Similarly, non-resident partners in limited liability partnerships and non-resident members in limited liability companies are taxable on the sale of their interest in the business. If the business was taxable in Massachusetts and in another state, the amount of the gain attributable to Massachusetts is generally based on the average apportionment percentage of the business during the years the non-resident owned the business interest. If this apportionment method is unreasonable based on the facts and circumstances of the case, the taxpayer may apply to the Department of Revenue to use an alternate method of apportionment.

The sale of a limited partner's interest in a limited partnership, or of shares of stock in a C or S corporation, generally is not taxable to non-residents. There may be circumstances, however, 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. See G.L. c. 62C, § 3A. *Cf. Koch v. Commissioner of Revenue*, 416 Mass. 540 (1993). In such cases the Commissioner will disallow the asserted tax consequences of the transaction and will impose the tax on the non-resident on the gain from the sale of the interest in the business. See G.L. c. 62C, § 3A. Applying the standards in G.L. c. 62C, § 3A, the taxpayer will have the opportunity and burden of proving that the transaction was not a sham and that the gain should not be Massachusetts source income.

## Examples of Directive 2

### 2.a.1 Sale of a Massachusetts-based limited liability partnership interest

Limited Liability Partner Peter, a non-resident, owns a 25% partnership interest in a Massachusetts limited liability partnership that operates a computer consulting business in Massachusetts. Peter contributed funds to the limited liability partnership upon its creation, but took no part in its management or operations. Peter sells his interest in the partnership and recognizes a capital gain for federal tax purposes. Peter is taxable in Massachusetts on the gain.

### 2.a.2 Sale of a multi-state limited liability partnership interest

Same facts as 2.a.1, but the partnership had one or more nonresident individual partners, had income derived from business activities in another state, and such other state had the jurisdiction to levy an income tax on the partnership or partners. Non-resident Limited Liability Partner Pauline may apportion the gain on the sale of the partnership interest. In this case, Pauline has available the apportionment percentages from each partnership Form 3 during the period she owned the partnership interest. The proper method for determining apportionment in these circumstances is to use the average of those percentages.

### 2.b. Sale of a limited partnership interest

Limited Partner Laura, a non-resident, purchased a share in a limited partnership during a period that she was an office manager for the firm. The privilege of purchasing a limited partnership interest was restricted to firm employees. On November 10, 1999, Laura resigns from the firm, continuing to own her limited partnership interest, in accordance with the policies of the partnership. On March 8, 2004, Laura sells her interest. Laura, as a limited partner, is not taxable in Massachusetts on the gain.

### 2.c Sale of shares of a C corporation

Investor Ivan is an out-of-state employee of NationalCorp, a C corporation doing business in Massachusetts. Ivan works in NationalCorp's Massachusetts offices. Ivan purchases stock of NationalCorp as an ordinary investment unrelated in any way to his compensation package. The gain on Ivan's sale of the stock is not Massachusetts source income.

## Issue 3

Under what circumstances will shares of stock issued by a corporation as compensation be taxable to non-residents?

## Directive 3

If a taxpayer obtains an ownership interest in a trade or business as part of the taxpayer's compensation attributable to the period the taxpayer is employed or conducting the trade or business in Massachusetts, the income that the taxpayer recognizes from this element of compensation for federal tax purposes is Massachusetts source income in the year of federal recognition whether or not the taxpayer is a resident of Massachusetts at that time and whether or not the taxpayer continues to conduct a trade or business or be employed in Massachusetts. This rule applies to an ownership interest in any business entity, including a C corporation, S corporation, partnership, limited liability partnership, limited partnership, or limited liability company.

## Discussion 3

Massachusetts source income includes income in any form, and paid at any time, provided that it is attributable either to the taxpayer's employment or conduct of a trade or business in Massachusetts, as that phrase has been amended. St. 2003, c. 4, § 7. The issuance of shares of stock or other ownership interest as part of an employee's compensation is part of such income. This income is treated as gross income to be recognized for state purposes in the same year it is recognized for federal purposes.

## Example of Directive 3

Executive Emma works for C Corporation in Massachusetts in 2003 and is promised one thousand shares of stock as a bonus in 2003, but the stock is not actually issued until 2004, after Emma has been transferred to C Corporation's Boise, Idaho headquarters. The receipt of this stock is attributable to Emma's employment in Massachusetts and is taxable as Massachusetts source income to a non-resident in 2004, the year of federal recognition.

#### Issue 4

How are stock options received by non-residents to be treated for Massachusetts tax purposes?

#### Directive 4

A taxpayer must recognize income derived from nonqualified stock options that are granted or exercised in connection with employment, or with the conduct of a trade of business in Massachusetts in the year the income is recognized for federal purposes whether or not the taxpayer is a resident of Massachusetts during the year in which the income is reported and whether or not the taxpayer remains employed by the issuer of the option in the year of recognition of the income. A non-resident will generally not be taxable on income that derives from a qualified stock option, namely an incentive stock option under IRC § 422, or an employee stock purchase plan under IRC § 423.

#### Discussion 4

The taxation of stock options is governed by the Code. For stock options designated by the Code as "nonqualified," the option is taxed upon its grant if the option has a readily ascertainable fair market value at that time. Treas. Reg. 1.83-1(a) and Treas. Reg. 1.83-7(a). If the option does not have a readily ascertainable fair market value upon its grant, it is taxable when the taxpayer exercises the option. Treas. Reg. 1.83-7(a). In either case the income is Massachusetts source income if the option is granted or exercised in connection with employment or the conduct of a trade or business in Massachusetts, whether or not the taxpayer is a resident of Massachusetts at the time the income is recognized and whether or not the taxpayer remains employed by the issuer of the option in the year the income is recognized. For nonqualified stock options, subsequent gain or loss when the employee sells the stock generally will not be taxable to non-residents.

For stock options designated as "qualified" under IRC §§ 421 – 424, namely incentive stock options (ISOs) under IRC § 422 and employee stock purchase plans under IRC § 423, income is generally not recognized at the grant of the option, nor at the exercise of the option. Rather, a taxpayer generally recognizes the income at the time the taxpayer sells the stock. IRC § 421(a). Income qualifying under IRC §§ 421 – 424 is generally not taxable to non-residents.

#### Example of Directive 4

Employee Edward works for NationalCorp, a Delaware Corporation. In 2001 Edward worked at NationalCorp's office in Northampton, Massachusetts, and was granted a nonqualified stock option that could be exercised in 2003, as compensation for services performed in 2001. In 2002 Edward was transferred to NationalCorp's offices in Albuquerque, New Mexico. Edward exercised the option in July 2003. Edward recognizes income from the exercise of the option federally in 2003. The income is Massachusetts source income in 2003 because the option from which the income derives is attributable to Edward's employment in Massachusetts.

#### Issue 5

When are payments from a covenant not to compete to nonresidents treated as Massachusetts source income?

#### Directive 5

Income derived from a covenant not to compete is Massachusetts source income to the extent that it is derived from or effectively connected with any trade or business, including any employment carried on by the taxpayer in the Massachusetts.

#### Discussion 5

The new legislation includes as one type of income taxable to non-residents income derived from a covenant not to compete. St. 2003, c. 4, § 7. Recognizing that such covenants often provide for payments over a number of years, this Directive affirms that each year's payments are Massachusetts source income to the extent that the original covenant was based on the taxpayer's Massachusetts based activity.

#### Example of Directive 5

Franchise owner Freida owns several franchises of a fast food chain in Massachusetts, each of which is a separate corporation. Freida sells her interest in the corporations and executes an agreement with the purchaser not to open any competing fast food restaurant near the existing stores. The covenant not to compete provides for payments over a period of three years. Freida moves to another state and never returns to Massachusetts. Since all the income from the covenant not to compete derives both from the Freida's former conduct of and her sale of a trade or business in Massachusetts, it is Massachusetts source income for the duration of the covenant, notwithstanding Freida's change in domicile or lack of business activity in Massachusetts for the years in question.

/s/ Alan LeBovidge

Alan LeBovidge

Commissioner of Revenue

AL:LEM:dt

167967

January 16, 2004

DD 03-12