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SJC-13139

VAS HOLDINGS & INVESTMENTS LLC vs. COMMISSIONER OF REVENUE.

Suffolk. January 5, 2022. - May 16, 2022.

Present: Budd, C.J., Gaziano, Lowy, Cypher, Kafker, Wendlandt, & Georges, JJ.

Constitutional Law, Taxation, Commerce clause. Due Process of Law, Taxation. Taxation, Foreign corporation, Capital gain, Apportionment of tax burden, Corporate excise, Nonresident, Waiver.

Appeal from a decision of the Appellate Tax Board.

The Supreme Judicial Court granted an application for direct appellate review.

Michael J. Bowen for the taxpayer.
Brett M. Goldberg for Commissioner of Revenue.
The following submitted briefs for amici curiae:
Bruce Fort, of New Mexico, for Multistate Tax Commission.
Richard L. Jones, David J. Nagle, & Caroline A. Kupiec for American College of Tax Counsel.

WENDLANDT, J. This case requires us to consider the constitutional constraints on the Commonwealth's ability to tax a nondomiciliary corporation on the capital gain it reaped from

the sale of its fifty percent membership interest in an in-State limited liability company. The nondomiciliary corporation, VAS Holdings & Investments LLC (VASHI), maintains that the "unitary business principle" is the only constitutionally permissible methodology pursuant to which the Commonwealth may impose a tax on such capital gain. Under that principle, the Commonwealth may tax the capital gain only where (i) there is functional integration, centralization of management, and economies of scale between the out-of-State corporation and the in-State entity, or (ii) the investment in the in-State entity serves an operational function of the out-of-State corporation.

The Commissioner of Revenue (commissioner) concedes that, under the unitary business principle as applied to the facts of this case, the capital gain is not taxable in the Commonwealth. Nevertheless, he contends that the capital gain may be taxed because it reflects the in-State entity's growth in the Commonwealth. Because the nondomiciliary corporation reaped the benefit of that growth, the commissioner maintains, the Commonwealth may impose a tax on the nondomiciliary, consistent with the due process clause and the commerce clause of the United States Constitution. The Appellate Tax Board (board) agreed, and this appeal followed.

The constitutionality of the imposed taxes was the only issue raised before the board and before this court, and all

parties, including the board, have a significant interest in its resolution. Because we are persuaded that the constitutional limitations on the Commonwealth's authority to tax a nondomiciliary corporation may be satisfied where, as here, the nondomiciliary corporation has reaped the financial benefits (in the form of a capital gain) from its fifty percent ownership interest in an in-State entity whose growth is tied inextricably to the protections, opportunities, and benefits afforded to it by the Commonwealth, we agree that the capital gain could be subject to the Commonwealth's tax. Before the board, the parties did not dispute the statutory authority of the commissioner to deviate from the unitary business principle. Yet, any tax beyond that which is authorized by statute is invalid; accordingly, following oral argument before this court, we asked the parties to address whether the Legislature had authorized the tax asserted by the commissioner; having reviewed the parties' postargument briefs and the pertinent statutes, we conclude that the commissioner lacked the requisite statutory authority and reverse the decision of the board.[1]

[1] We acknowledge the amicus briefs submitted by the Multistate Tax Commission and the American College of Tax Counsel.

1. Background. a. Facts. Based on the parties' agreed statement of facts, exhibits, and witness testimony, the board found the following facts.

i. Pre-merger operations. VASHI was formed in 1999 as an S corporation[2] with its commercial domicil and headquarters in Illinois. VASHI's headquarters housed its administrative, sales, marketing, and financial functions; it had approximately fifteen employees. Through its wholly owned subsidiaries, Virtual-Agent Services Canada, Inc. (VAS USA), and Virtual-Agent Services Canada Corp. (VAS Canada),[3] VASHI operated call centers in Canada, which primarily served clients in the hospitality industry. VASHI, VAS USA, and VAS Canada had no clients or business connections in Massachusetts.

Thing5, LLC (Thing5), was a Massachusetts limited liability company owned by two Massachusetts residents, David Thor, who

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[2] An S corporation is a "small business corporation" that elects to pass its taxable income through to its shareholders in proportion to their "distributive shares." The distributive share is a shareholder's pro rata ownership. See G. L. c. 62, § 17A; 26 U.S.C. §§ 1361-1363, 1366. A small business corporation may not have more than one hundred shareholders, all of whom must be individuals. 26 U.S.C. § 1361(b).

[3] VASHI was the sole shareholder of VAS USA, which was an Illinois S corporation. VAS USA was a holding company with no employees and no active business activity. VAS USA was, in turn, the sole shareholder of VAS Canada, which was a Canadian C corporation that operated twenty-nine call centers throughout eastern Canada. VAS Canada had approximately 1,400 employees, all of whom were located in Canada. Substantially all of VASHI's revenues were derived from the operations of VAS Canada.

served as Thing5's chief executive officer (CEO), and his wife, Maura Thor. Thing5 had between forty and fifty employees; it was headquartered in Massachusetts and conducted all business from its offices in Springfield and Longmeadow, with its day-to-day operations managed by David Thor. Thing5 provided hosted telephone systems and voicemail, mobile applications, and support for legacy telephone systems for clients in the hotel business.

ii. 2011 merger. In August 2011, Cloud5 LLC (Cloud5), a Massachusetts limited liability company, was formed to effect the merger of VASHI and Thing5. Each business was valued separately at $17.5 million. In October 2011, in a single integrated transaction, VASHI contributed its shares of stock in VAS USA to Cloud5 in exchange for fifty percent of the membership units of Cloud5, and David and Maura Thor contributed their membership units in Thing5 to Cloud5 in exchange for fifty percent of the membership units of Cloud5. The total value of the merged business was estimated to be $35 million.

As a result of the merger, Thing5 became a wholly owned subsidiary of Cloud5, operating essentially as a division of Cloud5 for tax purposes. VAS USA also became a wholly owned subsidiary of Cloud5; VAS USA was restructured as a C corporation, and thus a separate taxable entity such that its property, activities, and income did not pass through to Cloud5

for either Federal or Massachusetts tax purposes. VAS Canada remained a wholly owned subsidiary of VAS USA.

iii. Post-merger operations. Following the merger, the business operations of VAS Canada and Thing5 were integrated. David Thor, who remained at all relevant times a Massachusetts resident, became the CEO of both Cloud5 and VAS Canada, assuming responsibility for the call center operations of VAS Canada in addition to his prior responsibilities at Thing5.[4] Employees of Thing5 in Massachusetts performed the functions previously conducted by VASHI employees. The operations of Cloud5's subsidiaries consisted of the Thing5 headquarters and offices in Springfield and Longmeadow; a newly established Thing5 call center in Springfield that served as a satellite to the VAS Canada call centers; the VAS Canada call center operations in Canada; and one employee, Thing5's chief financial officer, who was located in Illinois.

Following the merger, VASHI had no employees or operations, did not own or lease any real or tangible property, and was not involved in the operations of Cloud5; other than bank accounts,

[4] Cloud5 was nominally managed under the direction of a board of managers, which initially consisted of five individuals, including David and Maura Thor. The board was neither functional nor active and met only twice during Cloud5's existence -- once immediately after the merger, and again to approve the sale of the interests in Cloud5 to a third party, which is at the center of the present dispute.

its only material asset was its fifty percent membership interest in Cloud5. In December 2012, VASHI reincorporated in Florida after closing its Illinois offices.

iv. Growth of Cloud5. Between 2011 and 2013, under David Thor's management, the value of Cloud5 increased, which the parties attribute to business activities that took place primarily in Massachusetts. Cloud5 consolidated the business operations of VAS Canada and increased its over-all profitability. The staffing model of VAS Canada was changed based on data and tools available to Thing5, and the number of VAS Canada's employees was reduced from 1,400 to approximately 800. Unprofitable client contracts were not renewed, and the total number of VAS Canada's clients was reduced.

Meanwhile, Thing5's operations grew significantly. Thing5 established a call center in Springfield, leasing approximately 10,000 square feet of office space. Thing5's product offerings expanded, and its number of customers increased.

Cloud5 filed State tax returns in Massachusetts in 2011, 2012, and 2013. For tax purposes, Cloud5 was a partnership. Accordingly, VASHI's distributive share of Cloud5's business income -- that is, its income derived from Cloud5's regular business operations -- was apportioned or allocated to Massachusetts under G. L. c. 63, § 38; VASHI's distributive share was subject to (i) State personal income tax under G. L.

c. 62, § 5A, as if realized directly by VASHI's shareholders under G. L. c. 62, § 17A, and (ii) corporate excise tax under G. L. c. 63, § 32D.[5]

v. Sale of Cloud5 and capital gain. In October 2013, VASHI sold its fifty percent membership interest in Cloud5 to an unrelated third party, realizing a capital gain of $37,280,849 (Cloud5 gain). The board found that "the increase in value, and likewise the [Cloud5] [g]ain, were inextricably connected to and in large measure derived from property and business activities in Massachusetts."

VASHI, being a pass-through entity for Federal tax reporting purposes,[6] was not required to and did not pay tax to the Federal government on the Cloud5 gain; instead, VASHI's shareholders each paid personal income tax to the Federal government on the gain, and those shareholders who were required to report and pay tax on the Cloud5 gain to their State of

[5] This case does not concern the taxes VASHI's shareholders paid on VASHI's distributive share of Cloud5's income from Cloud5's regular business operations; instead, the present dispute centers on the tax owed by VASHI on the capital gain it received when it sold its fifty percent membership interest in Cloud5, as described infra.

[6] "Pass-through taxation" is "[t]he taxation of an entity's owners for the entity's income without taxing the entity itself." Black's Law Dictionary 1762 (11th ed. 2019). S corporations, such as VASHI, are typically taxed under this method. Id.

residence did so. None of the shareholders of VASHI was a resident of Massachusetts.

b. Massachusetts taxation of the capital gain. For the 2013 tax year, VASHI made estimated payments of Massachusetts corporate excise taxes and nonresident composite taxes, which included the Cloud5 gain. VASHI later reported that no tax was due on the Cloud5 gain, and the commissioner issued refunds to VASHI.

The commissioner audited VASHI for the 2013 tax year and timely issued notices of assessment, reflecting the position that the Cloud5 gain was taxable. VASHI timely filed for an abatement, which the commissioner denied. VASHI filed petitions with the board pursuant to G. L. c. 58A, § 7, and G. L. c. 62C, § 39, appealing from the assessment of the tax on its Cloud5 gain.

Following a hearing, the board upheld the assessments. Specifically, the board rejected VASHI's contention that the only permissible methodology pursuant to which the Commonwealth could tax its Cloud5 gain was the "unitary business principle." Instead, the board held that the Commonwealth could, consistent with the due process and commerce clauses, tax the Cloud5 gain. The board concluded that because Cloud5 had grown in value as a result of its business activities in the Commonwealth, VASHI's Cloud5 gain was taxable even though VASHI had no other

Massachusetts presence. VASHI appealed, and we granted its application for direct appellate review.

2. Discussion. a. Standard of review. We defer to the board's expertise with respect to the interpretation of tax laws in the Commonwealth. See WB&T Mtge. Co. v. Assessors of Boston, 451 Mass. 716, 721 (2008); French v. Assessors of Boston, 383 Mass. 481, 482 (1981) (respecting "expertise of the board in tax matters involving interpretation of the laws of the Commonwealth"). We apply our "independent judgment," however, as to both law and facts on constitutional issues. WB&T Mtge. Co., supra. Board decisions will be set aside for an error of law. See General Mills, Inc. v. Commissioner of Revenue, 440 Mass. 154, 161 (2003), cert. denied, 541 U.S. 973 (2004). When challenging a tax assessed by a State, "[t]he burden is on the taxpayer to show by clear and cogent evidence that [the State tax] results in extraterritorial values being taxed" (quotation omitted). Id. at 162, quoting Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 164 (1983) (Container Corp.).

b. Constitutional limitations on State taxing authority. Under the due process[7] and dormant commerce[8] clauses of the

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[7] The due process clause prohibits the taking of property without due process of law. Fourteenth Amendment to the United States Constitution, § 1.

[8] The commerce clause expressly authorizes Congress to "regulate Commerce with foreign Nations, and among the several

United States Constitution, a State may not "tax value[s] earned outside its borders." Container Corp., 463 U.S. at 164, quoting ASARCO Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 315 (1982) (ASARCO). This principle "rests on the fundamental requirement of both the Due Process and Commerce Clauses that there be 'some definite link, some minimum connection, between a [S]tate and the person, property or transaction it seeks to tax.'" Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 777 (1992) (Allied-Signal), quoting Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-345 (1954). It ensures that the State has "a connection with the corporation's activities that produce the income that the [S]tate seeks to tax," and permits taxation on "only the portion of the corporation's income that is fairly attributable to the corporation's income producing activities in the [S]tate," Hellerstein, State Taxation of Corporate Income from Intangibles: Allied-Signal and Beyond, 48 Tax L. Rev. 739, 744 (1993), by requiring "a connection to the activity itself, rather than a connection only to the actor the State seeks to tax," Allied-Signal, supra at 778.

"The 'broad inquiry' subsumed in both constitutional

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States." Art. I, § 8, United States Constitution. It has been construed as having a negative sweep, referred to as the "dormant" commerce clause, which prohibits States from levying "taxes that discriminate against interstate commerce or that burden it by subjecting activities to multiple or unfairly apportioned taxation." MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep't of Revenue, 553 U.S. 16, 24 (2008).

> requirements[9] is 'whether the taxing power exerted by the [S]tate bears fiscal relation to the protection, opportunities and benefits given by the [S]tate' -- that is, 'whether the [S]tate has given anything for which it can ask return.'"

MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep't of Revenue, 553 U.S. 16, 24-25 (2008) (MeadWestvaco), quoting ASARCO Inc., supra.

i. Protections, opportunities, and benefits provided by the Commonwealth to VASHI's investment in Cloud5. The commissioner contends that the protections, opportunities, and benefits provided by the Commonwealth to Cloud5, VASHI's investee, suffice to meet the constitutional requirement of a nexus between the Commonwealth and VASHI; and, because the tax imposed by the Commonwealth reflects the apportionment formula of Cloud5, the tax is circumscribed to capture the value of those protections and benefits. The commissioner asserts that Cloud5 flourished within the Commonwealth and that nexus satisfies the due process and the dormant commerce clauses, permitting the Commonwealth to extend its taxing authority to the fiscal measure of Cloud5's growth -- the Cloud5 gain realized by VASHI, Cloud5's fifty percent owner. We agree.

[9] VASHI does not suggest that the analyses under the due process and the dormant commerce clauses differ as they pertain to the tax imposed on the Cloud5 gain.

The question presented in this case is similar to one answered by the United States Supreme Court in a pair of cases decided in the first half of the Twentieth Century. See International Harvester Co. v. Wisconsin Dep't of Taxation, 322 U.S. 435, 437 (1944) (International Harvester); Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940) (J.C. Penney). These cases concerned Wisconsin's "privilege tax," which required a nondomiciliary corporation conducting business in Wisconsin to deduct a tax from the dividends it paid to its investors, regardless of whether those investors were domiciled in Wisconsin.[10] The Court twice upheld the tax against constitutional challenge, concluding that the nondomiciliary corporation benefited from "[t]he substantial privilege of carrying on business in Wisconsin." J.C. Penney, supra at 444-445.[11] Because the tax was apportioned to reflect the nondomiciliary corporation's Wisconsin activities, "the

[10] The nondomiciliary corporation already was required to pay corporate income tax to Wisconsin based on the portion of its income attributable to its Wisconsin activities. J.C. Penney, 311 U.S. at 441. The additional privilege tax was collected directly from the nondomiciliary corporation. Id. at 441-442.

[11] In J.C. Penney, 311 U.S. at 443, the nondomiciliary corporation challenged the tax on the ground that the events triggering the privilege tax occurred outside the State. Specifically, the decision to declare a dividend happened at corporate meetings in New York, and the dividend was paid from New York bank accounts. Id.

incidence of the tax as well as its measure is tied to the earnings which the State of Wisconsin has made possible, insofar as government is the prerequisite for the fruits of civilization for which, as Mr. Justice Holmes was fond of saying, we pay taxes." Id. at 446, citing Compañía Gen. de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting) ("Taxes are what we pay for civilized society . . .").

For the same reason, the Court later upheld the same tax even though it acknowledged that, in effect, the tax was levied against the nondomiciliary corporation's nonresident investors, whose sole connection with the State was their investment in the corporation, which did some of its business in Wisconsin. See International Harvester, 322 U.S. at 437, 445; id. at 440 (recognizing that dividend tax, although ostensibly paid by nondomiciliary corporation based on its in-State activities, is "in point of substance, laid upon and paid by the stockholders"). The Court explained that the nonresident shareholders, through their investment in the nondomiciliary corporation, which in turn was doing business in Wisconsin, had nevertheless availed themselves of the privileges, protections, and benefits of conducting business in Wisconsin.

> "We think that Wisconsin may constitutionally tax the Wisconsin earnings distributed as dividends to the stockholders. It has afforded protection and benefits to

> appellants' corporate activities and transactions within the [S]tate. These activities have given rise to the dividend income of appellants' stockholders and this income fairly measures the benefits they have derived from these Wisconsin activities."

Id. at 442. See id. at 444 ("the incidence of the tax as well as its measure is tied to the earnings which the State of Wisconsin has made possible" [citation omitted]).[12]

These cases provide strong support for the commissioner's position that the tax imposed by the Commonwealth on VASHI, a nondomiciliary shareholder of Cloud5, passes constitutional muster. The profit realized by VASHI in the Commonwealth (in the form of the Cloud5 gain from the sale of VASHI's fifty percent interest in Cloud5) reflects the benefits,

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[12] In an earlier case, Curry v. McCanless, 307 U.S. 357, 360, 367-368 (1939), the Court addressed the issue whether Tennessee and Alabama could both assert an inheritance tax on intangible assets -- shares of corporate stock held in trust by an Alabama trustee for the benefit of the decedent, a Tennessee domiciliary who bequeathed the trust assets to her family in her will. Relevant to the present case, the Court concluded that "[s]hares of corporate stock may be taxed at the domicil[] of the shareholder and also at that of the corporation which the taxing [S]tate has created and controls; and income may be taxed both by the [S]tate where it is earned and by the [S]tate of the recipient's domicil[]. Protection, benefit, and power over the subject matter are not confined to either [S]tate. The taxpayer who is domiciled in one [S]tate but carries on business in another is subject to a tax there measured by the value of the intangibles used in his [or her] business" (emphasis added). (Footnote omitted.) Id. (rejecting rigid application of rule that only domiciliary State could impose tax on intangibles where "the taxpayer extends his activities with respect to his [or her] intangibles, so as to avail himself [or herself] of the protection and benefit of the laws of another [S]tate").

opportunities, and protections afforded to Cloud5 and in turn to VASHI, its fifty percent owner, by the Commonwealth.[13] Taxing VASHI on the Cloud5 gain it realized when it sold its significant interest in Cloud5 is permissible under the rationale of these cases because VASHI, through its substantial investment in Cloud5, reaped the benefits afforded to Cloud5 by the Commonwealth.

The fact that the present case involves profit in the form of capital gains rather than dividends is of no constitutional significance. The Supreme Court has concluded that "for constitutional purposes capital gains should be treated as no different from dividends." Allied-Signal, 504 U.S. at 780. Reliance on these cases supports the commissioner's position that the Commonwealth's taxing power as applied to the Cloud5 gain "bears fiscal relation to protection, opportunities and benefits given by" the Commonwealth to VASHI. MeadWestvaco, 553 U.S. at 25.

ii. Unitary business principle. A taxpayer who contends that a taxing jurisdiction has transgressed constitutional limitations on its taxing authority bears the "distinct burden of showing by 'clear and cogent evidence' that [the challenged

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[13] Specifically, the benefits, opportunities, and protections granted by Massachusetts allowed Thing5's operations, and thus Cloud5's operations, to grow significantly following the merger, as discussed supra.

tax] result[ed] in extraterritorial values being taxed." Container Corp., 463 U.S. at 164, quoting Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207, 221 (1980) (Exxon). In this case, VASHI purports to meet this heavy burden in reliance on the unitary business principle, which the Supreme Court has identified as the "linchpin of apportionability in the field of [S]tate income taxation." Mobil Oil Corp. v. Commissioner of Taxes of Vt., 445 U.S. 425, 439 (1980) (Mobil Oil). VASHI contends that the Court effectively has repudiated its jurisprudence embodied in J.C. Penney and International Harvester, and that the unitary business principle constitutes the only constitutionally permissible methodology when it comes to a State's authority to tax a nondomiciliary corporation's income from capital gains.

A. Development of unitary business principle. The unitary business principle is based on the proposition that for a business whose activities extend to multiple States, often the value of the business cannot be compartmentalized neatly into its State-by-State activities. The principle permits each State to tax its proportionate share of the annual income of the enterprise as a whole. Pursuant to the principle, a State first calculates the tax base of a multistate corporation by defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form one

part;[14] then, the State may tax its fair share of the tax base on the basis of an apportionment formula,[15] which comprises an objective measure of the corporation's in-State activities. Container Corp., 463 U.S. at 165.

The principle developed initially as a way to value the activities of railroad or telegraph companies for property tax purposes, recognizing that the value of such a business was "the enterprise as a whole, rather than the track or wires that happen to be located within a State's borders." Allied-Signal, 504 U.S. at 778. See, e.g., Massachusetts v. Western Union Tel. Co., 141 U.S. 40, 45 (1891). The Court has held that, consistent with constitutional constraints, a State could tax "the proportionate part of the value resulting from the combination of the means by which the business was carried on, a value existing to an appreciable extent throughout the entire

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[14] Briefly, to determine the scope of a unitary business, courts look to whether the contributions to income result from (1) functional integration, (2) centralization of management, and (3) economies of scale. General Mills, Inc., 440 Mass. at 162. See MeadWestvaco, 553 U.S. at 30 (recognizing these factors as "hallmarks" of unitary business relationship). In addition, income can be included where it serves an operational function in that business. Id. at 28-29, citing Allied-Signal, 504 U.S. at 787.

[15] This formula often constitutes a ratio of the taxpayer's in-State payroll, property, and sales divided by the taxpayer's total payroll, property, and sales. See Container Corp., 463 U.S. at 170.

domain of operation." Adams Express Co. v. Ohio State Auditor, 165 U.S. 194, 220-221 (1897).

The principle was expanded beyond property as a way for a State to determine taxes on its fair share of corporate income for multistate corporations. See Mobil Oil, 445 U.S. at 436 ("[T]he entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs" [citation omitted]). Thus, in Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 120 (1920), the Supreme Court considered application of the principle to the profits of a large manufacturing corporation, which "were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States." In these cases, the "physical unity existing in" the railroad and telegraph cases "is lacking . . . but there is the same unity in the use of the entire property for the specific purpose, and there are the same elements of value arising from such use." Allied-Signal, 504 U.S. at 779, quoting Adams Express, 165 U.S. at 221.

In cases where the business is unitary, the Court has instructed that "a State need not 'isolate the intrastate income-producing activities from the rest of the business' but 'may tax an apportioned sum of the corporation's multistate

business'" based on its activities within the taxing State. MeadWestvaco, 553 U.S. at 25, quoting Allied-Signal, 504 U.S. at 772. See, e.g., Container Corp., 463 U.S. at 175-179 (taxpayer and overseas subsidiaries constituted unitary business, and California's apportionment scheme did not result in taxation of extraterritorial values). See also Exxon, 447 U.S. at 210, 221, 229 (unitary business principle permits State to include in apportionable tax base income from vertically integrated operations of corporation, which benefited from centralized management and controlled interactions, so long as apportionment formula of that total tax base was grounded in corporation's in-State marketing and sales activities).

Relevant to the present case, the Court has also approved the use of the unitary business principle to determine the tax base of a parent corporation whose business income included dividends it received from legally separate entities structured as subsidiaries and affiliated companies of the parent. See Mobil Oil, 445 U.S. at 435. "So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability." Id. at 440. Thus, even though the subsidiaries and affiliates

were legally separate entities, the State could include the dividends received by the parent in the apportionable tax base so long as, as a matter of economic reality, the subsidiaries and affiliates were part of a unitary business with the taxpayer. Id. at 440-441.

By the same token, the Court cautioned that a State may not include all dividend payments received by a corporation conducting interstate business in the corporation's tax base and subject to apportionment based on the corporation's in-State activities. "Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business." Mobil Oil, 445 U.S. at 442.

Thus, in ASARCO, the Court struck down Idaho's application of the unitary business principle to justify inclusion of dividends and capital gains received from foreign corporations in calculating ASARCO's apportionable tax base. ASARCO's business and the foreign corporations' businesses did not include any hallmarks of centralized management or control, and thus were "insufficiently connected to permit the two companies to be classified as a unitary business." ASARCO, 458 U.S. at 322. The Court rejected Idaho's plea to capture income in the form of dividends and capital gains whenever the income served a

broadly defined corporate purpose, stating that such an expansion

> "would destroy the concept [underlying the unitary business principle]. The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently all of its operations, including any investment made, in some sense can be said to be 'for purposes related to or contributing to the [corporation's] business."

Id. at 326. See F.W. Woolworth Co. v. Taxation & Revenue Dep't of N.M., 458 U.S. 354, 372 (1982) (holding New Mexico could not employ unitary business principle to justify tax of dividends received from nondomiciliary corporate taxpayer's foreign subsidiaries, absent unitary relationship). In these cases, there was no nexus between the taxing State and the entity that was the source of the dividend or capital gain; instead, the taxing State exclusively relied on the unitary business principle to defend the asserted tax.

More recently, however, the Court has considered the tax treatment of dividends and capital gains where there is a nexus between the source of that income and the taxing State in that the source of the income is domiciled or headquartered in the taxing State. For example, in Allied-Signal, 504 U.S. at 773-774, the Court examined a New Jersey tax on the capital gain realized by a Delaware corporation doing business in New Jersey from the sale of stock in an unrelated entity, which was incorporated in New Jersey and did business there. New Jersey

relied on the unitary business principle to justify the tax; however, the Court concluded that, because the Delaware corporation and the New Jersey entity were "unrelated business enterprises each of whose activities had nothing to do with the other," and thus were not engaged in a unitary business, New Jersey could not tax the gain. Id. at 788.

Similarly, in MeadWestvaco, 553 U.S. at 19-20, 30, Illinois relied on the unitary business principle to justify its tax on capital gains reaped by Mead, an Ohio corporation, from its sale of Lexis, which was headquartered in Illinois; the Court remanded for determination whether the unitary business factors were satisfied. Significantly, in each of these cases, the taxing State relied on the unitary business principle to reach the dividend or capital gains; in addition, the State sought to apply the apportionment percentage of the nondomiciliary corporate taxpayer rather than the percentage of the entity that was the source of the income. See MeadWestvaco, supra at 23; Allied-Signal, 504 U.S. at 776.

VASHI contends that these more recent cases concerning the treatment of dividend and capital gains income prohibit the Commonwealth's tax in the present case because, according to VASHI, they stand for the proposition that the unitary business principle is the only apportionment methodology that may be used by taxing States. For the reasons discussed infra, we disagree.

B. Unitary business principle is not the only apportionment methodology. To begin, the Supreme Court has not held that the unitary business principle is the exclusive methodology permissible under the Constitution to determine the limits of a State's taxing power. To the contrary, the Court has declined repeatedly to prescribe a particular formula for State taxation, admonishing that

> "[n]othing can be less helpful than for courts to go beyond the extremely limited restrictions that the Constitution places upon the [S]tates and to inject themselves in a merely negative way into the delicate processes of fiscal policy-making. We must be on guard against imprisoning the taxing power of the [S]tates within formulas that are not compelled by the Constitution but merely represent judicial generalizations exceeding the concrete circumstances which they profess to summarize."

J.C. Penney, 311 U.S. at 445. See id. at 444 ("The Constitution is not a formulary. It does not demand of [S]tates strict observance of rigid categories nor precision of technical phrasing in their exercise of the most basic power of government, that of taxation").

Instead, the Court has stated that a "[S]tate is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the [S]tate has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society." Id. See Mobil Oil, 445 U.S. at 436 (noting that

"traditional rule" that dividend income is attributable to corporate recipient's State of incorporation is not rule "of constitutional dimension"); Curry v. McCanless, 307 U.S. 357, 367-368 (1939) (cautioning against "substitut[ing] a rule for a reason" when determining constitutional constraints on States' taxing authority).

Indeed, the Court has acknowledged that the existence of a unitary relationship between the taxpayer and the investee "is one justification for apportionment, but not the only one." Allied-Signal, 504 U.S. at 787. See generally Hellerstein, Substance and Form in Jurisdictional Analysis: Corrigan v. Testa, 80 State Tax Notes 849, 852-853 (2016) ("Given the geographically indeterminate 'location' of intangible property and the existence of various competing rules for determining the deemed location of such property and the income it generates, it would be difficult as a matter of principle to maintain that the due process clause prescribes a single location [or theory of location] to which intangibles and the income they generate must be assigned").

Next, the cases applying the unitary business principle to dividends and capital gains income to the nondomiciliary corporate taxpayer differ from the present case in two significant ways: either the taxing State had no connection to the entity, which was the source of the dividend or capital

gain, and thus the State chose to rely on the unitary business principle to reach the out-of-State income;[16] or where the taxing State had such a connection, the taxing State did not rely on that nexus and instead chose to rely on the unitary business principle and to use the apportionment percentage applicable to

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[16] See, e.g., F.W. Woolworth Co., 458 U.S. at 372 (applying unitary business principle to conclude New Mexico lacked authority to assert tax on dividends from foreign subsidiaries where subsidiaries had had no connection to New Mexico and, although owned by nondomiciliary corporate taxpayer, were not part of taxpayer's unitary business); ASARCO, 458 U.S. at 328-329 (applying unitary business principle to conclude Idaho lacked authority to tax dividends and capital gains from foreign entities where entities had no connection to Idaho and, although owned or partially owned by nondomiciliary corporate taxpayer, were not part of taxpayer's unitary business); Mobil Oil, 445 U.S. at 442 (applying unitary business principle to conclude Vermont could assert tax on dividends from foreign subsidiaries and affiliates where subsidiaries and affiliates had no connection to Vermont, but were part of unitary business with nondomiciliary corporate taxpayer).

The Supreme Court also framed the issue in these cases narrowly, suggesting that the Court did not intend for the unitary business principle to be the exclusive test in all interstate taxation cases. See, e.g., F.W. Woolworth Co., 458 U.S. at 356 ("The question is whether the Due Process Clause permits New Mexico to tax a portion of dividends that appellant F.W. Woolworth Co.[, a New York corporation doing some business in New Mexico,] received from foreign subsidiaries that do no business in New Mexico" [emphasis added]); ASARCO, 458 U.S. at 308-309 ("The question is whether the State of Idaho constitutionally may include within the taxable income of a nondomiciliary parent corporation doing some business in Idaho a portion of intangible income -- such as dividend and interest payments, as well as capital gains from the sale of stock -- that the parent receives from subsidiary corporations having no other connection with the State" [emphasis added]). See also Matter of Allied-Signal Inc. v. Commissioner of Fin., 79 N.Y.2d 73, 80 n.9 (1991).

the recipient of the income, the nondomiciliary corporate taxpayer, rather than the entity that was the source of the income at issue.[17] Here, the commissioner has not chosen to rely on the unitary business principle. Instead, the commissioner relied on the Commonwealth's connection to Cloud5 -- the entity that is the source of the capital gain; Cloud5 is domiciled and headquartered in the Commonwealth, and its growth, the board found, is attributable to the benefits, opportunities, and privileges afforded to it by the Commonwealth. Accordingly, unlike in the cases cited by VASHI, the commissioner has chosen to rely on this connection to Cloud5 to satisfy the constitutional requirement of a nexus between the Commonwealth and the activities that produced the income that the State seeks to tax. See Allied-Signal, 504 U.S. at 777; Hellerstein, 48 Tax L. Rev. at 744.

Furthermore, unlike in the cases where the taxing State relied on the unitary business principle and used the apportionment percentage of the recipient of the dividend or

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[17] See, e.g., MeadWestvaco, 553 U.S. at 30 (applying unitary business principle to conclude Illinois lacked authority to tax capital gains from nondomiciliary corporate taxpayer's sale of Illinois headquartered entity based on nondomiciliary's apportionment formula); Allied-Signal, 504 U.S. at 776 (applying unitary business principle to conclude New Jersey lacked authority to assert tax on capital gain from nondomiciliary corporate taxpayer's sale of New Jersey entity based on nondomiciliary's apportionment formula).

capital gain, the tax asserted by the Commonwealth in this case is based on Cloud5's apportionment percentage, not VASHI's. The use of Cloud5's apportionment percentage satisfies the constitutional requirement that there be a rational relationship between the tax and the activities of the entity that is the source of the value. See MeadWestvaco, 553 U.S. at 31 n.4 (recognizing that where constitutionally sufficient link between taxing State and value it wishes to tax is founded on State's contacts with source of value, "apportioned tax base should be determined by applying the State's . . . apportionment formula" to entity that is source of value). See also Moorman Mfg. Co. v. Bair, 437 U.S. 267, 273 (1978) ("income attributed to the State for tax purposes must be rationally related to values connected with the taxing State" [quotation and citation omitted]).[18]

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[18] We find persuasive the Court of Appeals of New York's decision in Matter of Allied-Signal Inc., 79 N.Y.2d at 80-83, rejecting an argument similar to the one pressed here by VASHI that the only constitutionally permissible method of taxing capital gains and dividend income was the unitary business principle. Instead, the court upheld New York City's taxing methodology, which applied a tax that reflected the nexus between New York City and the entities that generated the taxpayer's investment income. See id. at 82. See also Matter of Allied-Signal, Inc. v. Tax Appeals Tribunal, 229 A.D.2d 759, 762-763 (N.Y. 1996) (adopting reasoning of Court of Appeals of New York to conclude that New York State could impose tax based on investee apportionment approach). By contrast, the Ohio Supreme Court's decision in Corrigan v. Testa, 2016-Ohio-2805, which rejected application of any methodology other than the unitary business principle, is based on a misreading of

We see nothing in the Court's jurisprudence that would preclude the Commonwealth from asserting its taxing authority based on the nexus to Cloud5 and to determine the tax using Cloud5's apportionment percentage. See generally Hellerstein, 80 State Tax Notes at 854 (discussing State's authority to tax capital gains reaped by nonresident from in-State entity based on in-State entity's apportionment formula). Whether such an assertion is good fiscal policy is a different question, as to which we must defer to the Legislature -- a subject to which we turn now.

c. Statutory limitations on State taxing authority. "No method of determining tax liability is valid unless authorized by statute and assessed in conformity to its terms." Gillette Co. v. Commissioner of Revenue, 425 Mass. 670, 675 (1997) (Gillette). Both the commissioner and VASHI did not dispute before the board or before this court that the Legislature authorized, by statute, the taxes imposed. We asked for postargument briefing on the subject sua sponte. These statutes establish that the Legislature has chosen to adhere to the unitary business principle in formulating its taxing policy. See, e.g., G. L. c. 63, § 32B (discussing taxation of corporation "engaged in a unitary business"); G. L. c. 63, § 32D

International Harvester. See Hellerstein, 80 State Tax Notes at 855-858 (discussing errors in Ohio Supreme Court's reasoning).

(discussing taxation of S corporations, and directing commissioner to apply limits set forth therein "on an aggregate basis to S corporations engaged in a unitary business"); G. L. c. 63, § 38 (discussing net income of business carried on within Commonwealth, and dividing same into apportionable income and allocatable income); id. (defining apportionment formula for corporations doing business in multiple States). Regulations promulgated in conformity with these statutes similarly reflect an adherence to the unitary business principle. See, e.g., 830 Code Mass. Regs. § 63.38.1 (2015) (explaining apportionment and allocation of income, and discussing income subject to apportionment based on unitary business principle); 830 Code Mass. Regs. § 62.5A.1 (2008). Thus, although the Constitution does not prevent the taxes asserted by the commissioner, see supra, the taxes -- a corporate excise tax in the amount of $914,489, and a nonresident composite tax in the amount of $1,717,406[19] -- are invalid because there is no statutory authority for the taxes so asserted.[20]

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[19] VASHI was also assessed a penalty of $182,898 and interest of $106,578.27 on the corporate excise tax and a penalty of $349,481 and interest of $161,432 on the nonresident composite tax, which VASHI does not separately dispute.

[20] Jurisdictions that have authorized the approach adopted by the commissioner, such as New York City, New York, and Ohio, have passed specific legislation expressly authorizing the approach. See N.Y. Tax Law § 210.3, repealed by N.Y. St. 2014, c. 59, pt. A, § 15; Ohio Rev. Code Ann. § 5747.212; N.Y. City

i. Corporate excise tax. Under G. L. c. 63, § 39, "every business corporation . . . actually doing business in the commonwealth, or owning or using any part or all of its capital, plant or any other property in the commonwealth, shall pay" annual taxes on "its net income determined to be taxable in accordance with [c. 63]." G. L. c. 63, § 39 (a) (2) (iv). General Laws c. 63, § 38, in turn, directs the commissioner to distinguish between income that is subject to apportionment and income that is subject to allocation. Apportionable income is defined by reference to the unitary business principle. See 830 Code Mass. Regs. § 63.38.1(3) ("a taxpayer's income subject to apportionment is its entire income derived from its related business activities within and outside of Massachusetts not including any allocable items of income that either are or are not subject to the tax jurisdiction of Massachusetts"); 830 Code Mass. Regs. § 63.38.1(4)(a) (defining related business activities as those activities that "are mutually beneficial, interdependent, integrated or such that they otherwise contribute to one another," and include two activities of taxpayer "unless the two segments or activities are not unitary"). Allocable income also is defined by reference to the

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Admin. Code § 11-604.3(a). Here, there is no such statute; rather, the commissioner claims authorization for the investee apportionment methodology from statutes and regulations that are based on the unitary business principle.

unitary business principle; it includes, inter alia, an "item of income [that] was not derived from a unitary business or from transactions that serve an operational function." 830 Code Mass. Regs. § 63.38.1(2). An "allocable item of income" is not allocated to Massachusetts if the taxpayer's commercial domicil is outside the Commonwealth. 830 Code Mass. Regs. § 63.38.1(3)(c). Because there is no unitary business between VASHI and Cloud5,[21] and because VASHI's commercial domicil is Florida, the asserted corporate excise tax is not authorized by statute either as apportionable or allocable income.

ii. Nonresident composite tax. A similar fate attaches to the asserted nonresident composite tax pursuant to G. L. c. 62, § 5A, which authorizes taxation of nonresidents on income "derived from or effectively connected with . . . any trade or business . . . carried on by the taxpayer in the commonwealth, whether or not the nonresident is actively engaged in a trade or

[21] VASHI and Cloud5 lacked the functional integration, centralization of management, and economies of scale that are the "hallmarks" of a unitary business relationship. MeadWestvaco, 553 U.S. at 30. Following the merger, VASHI had "zero" involvement with the operations of Cloud5, did not participate in its management or activities, and did not provide services or loan money to Cloud5. Although some shareholders of VASHI were members of Cloud5's board, the board was neither functional nor active, and met only twice during the existence of Cloud5 -- once immediately after the merger, and again to approve the sale of VASHI's interest in Cloud5 to a third party. Indeed, the parties agreed before the board and on appeal that none of the unitary business factors was present between VASHI and Cloud5.

business . . . in the commonwealth in the year in which the income is received" (emphasis added). As we held in Commissioner of Revenue v. Dupee, 423 Mass. 617 (1996), the emphasized language precludes the Commonwealth from taxing the capital gain realized by a nonresident shareholder on the sale of his or her interest in a Massachusetts entity where the shareholder himself or herself did not actively participate in the activities of the entity. Id. at 621-623.[22,23]

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[22] The commissioner contends that Dupee is distinguishable from the present case because it concerned a shareholder of an S corporation, whereas here, VASHI was effectively a partner of Cloud5, a limited liability company that was treated as a partnership for tax purposes. However, nothing in Dupee suggests that its construction of G. L. c. 62, § 5A, turned on the form of the shareholder's investee. See generally Hellerstein, 80 State Tax Notes at 849 ("when a nonresident realizes gain from the disposition of an interest in a flow-through entity [whether a partnership, an S corporation, or an LLC], the [S]tates typically attribute the source of the gain under the rules governing income from the sale of intangibles" regardless of type of flow-through entity).

[23] Section 5A was amended in 2003, after the Dupee decision, to state that the income of a nonresident doing business in the Commonwealth may be taxed "whether or not the nonresident is actively engaged in a trade or business or employment in the commonwealth in the year in which the income is received." St. 2003, c. 4, § 7. See G. L. c. 62, § 5A. Prior to the amendment, Massachusetts courts had interpreted § 5A to prohibit "taxation of nonresident income 'derived from or effectively connected with' past Massachusetts employment where the taxpayer has not 'carried on' any business in the Commonwealth during the taxable year of receipt" (emphasis added). Commissioner of Revenue v. Oliver, 436 Mass. 467, 474 (2002) (holding that § 5A did not permit taxation of pension benefits earned through taxpayer's employment in Massachusetts but received after he became nonresident because he did not carry on business in Massachusetts in relevant year). As amended, the statute now

Although the statute was amended to state that income "shall include, but not be limited to, gain from the sale of a business or of an interest in a business . . . [or] distributive share income," G. L. c. 62, § 5A (a), the regulations clarify that such income "may" include capital gains and further set forth rules for the treatment of the apportionment and allocation of income for nonresident members of a pass-through entity. See 830 Code Mass. Regs. § 62.5A.1(6). These regulations clearly limit the income subject to tax to that falling within the unitary business principle. See, e.g., 830 Code Mass. Regs. § 62.5A.1(6)(a) (defining income subject to apportionment as entire net income of pass-through entity derived from "related business activities"); 830 Code Mass. Regs. § 62.5A.1(2) (defining "related business activities" as those that would fall under unitary business principle); 830 Code Mass. Regs. § 62.5A.1(6)(d) (defining "related business activities" by reference to unitary business principle as discussed in Allied-Signal, 504 U.S. 768); id. ("In general, any two segments or activities of a single pass-through entity are

permits a tax on a nonresident who did business in the Commonwealth regardless of whether the business was conducted in that particular year. Indeed, in a Technical Information Release following the amendment, the commissioner explained that the effect of the added language was to alter only the requisite timing of the taxpayer's business activities in Massachusetts. TIR 03-13 (July 28, 2003). The amendment did not affect the language construed in Dupee.

related business activities unless the two segments or activities are not unitary").

The commissioner argues that the tax is allowable under the regulations, relying on 830 Code Mass. Regs. § 62.5A.1(3)(c)(8) and example (3)(c)(8.1), which state that "[i]f a non-resident has a trade or business . . . carried on in Massachusetts, Massachusetts source income includes, among other things: . . . income that results from the sale of a business," which includes capital gains from the sale of an interest in a partnership or limited liability company, even where the partner "took no part in its management or operations." Here, however, VASHI does not carry on a trade or business in Massachusetts.

iii. Waiver. In general, "[a] party is not entitled to raise arguments on appeal that he [or she] could have raised, but did not raise, before the administrative agency." Albert v. Municipal Court of Boston, 388 Mass. 491, 493 (1983), citing Shamrock Liquors, Inc. v. Alcoholic Beverages Control Comm'n, 7 Mass. App. Ct. 333, 335 (1979). Here, VASHI did not raise before the board its contention that the imposed taxes were not authorized by statute. As the Supreme Court has recognized, however,

> "[t]here may always be exceptional cases or particular circumstances which will prompt a reviewing or appellate court, where injustice might otherwise result, to consider questions of law which were neither pressed nor passed upon by the court or administrative agency below."

Hormel v. Helvering, 312 U.S. 552, 557 (1941). See, e.g., Hoffer v. Commissioner of Correction, 412 Mass. 450, 457 (1992); Cruz v. Commissioner of Pub. Welfare, 395 Mass. 107, 111 (1985); McLeod's (Dependents') Case, 389 Mass. 431, 434 (1983).[24] Because the commissioner lacked statutory authority to tax the capital gain realized by VASHI based on Cloud5's connection to Massachusetts, the decision of the board must be reversed. See Gillette, 425 Mass. at 675 (tax liability invalid unless authorized by statute).[25] The decision of the board is reversed.

So ordered.

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[24] In addition, courts are not bound by stipulations when such stipulations are based on incorrect applications of the law. See, e.g., Goddard v. Goucher, 89 Mass. App. Ct. 41, 45 (2016), quoting Texas Instruments Fed. Credit Union v. DelBonis, 72 F.3d 921, 928 (1st Cir. 1995) ("Parties may not stipulate to the legal conclusions to be reached by the court").

[25] Having concluded on this basis that the taxes cannot be sustained, we need not consider VASHI's challenge to the apportionment percentage applied by the commissioner.