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CAPITAL GAIN FROM SALE OF STOCK BY NONRESIDENT IS SUBJECT TO MASSACHUSETTS INCOME TAX

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On April 3, the Massachusetts Appeals Court ruled in *Welch vs. Commissioner of Revenue* that the taxpayer was liable for Massachusetts income tax on his sale of stock in a Massachusetts-based company even though the taxpayer was a nonresident of Massachusetts at the time of the sale.

The *Welch* Case

The taxpayer in *Welch*, Craig Welch, founded AcadiaSoft, Inc. ("AcadiaSoft") in 2003 when he was a Massachusetts resident. From 2003-2015, Welch worked exclusively for the company in Massachusetts, first focusing on sales and then transitioning to the Chief Executive Officer in 2010. AcadiaSoft consistently apportioned 100% of its income to Massachusetts and Welch filed Massachusetts resident income tax returns for the years 2003 - 2014.

In April 2015, Welch and his wife established residency in New Hampshire and Welch sold his stock in AcadiaSoft in June 2015 for $4,744,760. For the year 2015, Welch filed a Massachusetts nonresident/part-year resident tax return on which he did not include the capital gain from the sale as Massachusetts-source income. The Massachusetts Department of Revenue considered the stock to be compensation for Welch's services at the company and assessed approximately $335,000 in tax, interest and penalties against Welch based on its treatment of the gain as Massachusetts source income.

The Massachusetts Appeals Court upheld a prior ruling by the Appellate Tax Board that Welch was liable for Massachusetts income tax on the capital gain. The Appeals Court began its analysis with Massachusetts law G.L. c. 62, § 5A which provides that Massachusetts source income includes "income derived from or effectively connected with . . . any trade or business, including any employment carried on by the taxpayer in the commonwealth, *whether or not the nonresident is actively engaged in a trade or business or employment in the commonwealth in the year the income is received*." The Appeals Court also considered Massachusetts tax regulation 830 Code Mass. Regs. § 62.5A.1(3)(c)(8) which in the court's view made it clear that the gain from the sale of stock in a C corporation may constitute Massachusetts source income if the stock is related to the taxpayer's compensation for services in Massachusetts. Based on the relevant Massachusetts law and regulation, the Appeals Court affirmed the Appellate Tax Board's conclusion that Welch's gain from the sale of his AcadiaSoft stock was "derived from and was effectively connected with his trade or business or employment, and therefore it was taxable as Massachusetts source income."

Implications of *Welch*

The Appeals Court mentions the unique facts of the case but the *Welch* decision could have wide-ranging implications for business owners who relocate from Massachusetts but retain equity in companies they helped build. The ruling (i) establishes clearer authority for Massachusetts to tax nonresidents on gains from equity awards that are inextricably linked to Massachusetts work, (ii) underscores the state's ability to recharacterize investment income as compensation, and (iii) highlights the importance of considering the underlying relationship between stock ownership and employment or business activities when determining Massachusetts source income for nonresidents. In essence, the decision reinforces the broad reach of Massachusetts sourcing rules for income derived from Massachusetts activities, even when the income is realized after the taxpayer has left the state, and puts taxpayers on notice that Massachusetts emphasizes that where you *earn* the value outweighs where you *recognize* it in determining Massachusetts source income.

If you have any questions regarding this alert, please contact your Cummings & Lockwood private clients attorney.