October 28, 2015

[Taxpayer Representative]
[Address]
[Address]
[Address]
[Address]

Re: Formal Ruling 15-04

Dear [Taxpayer Representative]:

This is a formal ruling for your client, [Taxpayer], regarding the applicability of Vermont income tax to the flow-through of a capital gain from [Taxpayer's] S Corporation. This ruling is based upon representations in your letter dated [Date], the attached materials, and our telephone conversation of [Date].

RULING

Based upon the facts presented, Taxpayer will be subject to Vermont income tax on the capital gain realized from the sale by [S corp] of its [C corp] stock.

FACTS

You have submitted a Special Power of Attorney from your client, [Taxpayer], to you as [Taxpayer's] agent for purposes of this ruling request.

1. [Taxpayer] (Taxpayer) is domiciled in [State]. [Taxpayer] has not been domiciled in Vermont since [Year], when [Taxpayer] graduated from college. Taxpayer files annual Vermont nonresident

income tax returns to report all of the income realized by [S corp] that is properly allocated and apportioned to Vermont.

2. Taxpayer is the sole shareholder of [S corp], a Subchapter S corporation operating primarily in Vermont.

3. [S corp] was incorporated in 1989 in [State] as [S corp]. It was re-incorporated in Delaware in 2007 as [S corp].

4. [S corp] provides "business process outsourcing, business consulting, and managed business assurance offerings to the telecommunications industry."

5. In 2000, [S corp] transferred assets, contracts and liabilities related to the "application service provider" (ASP) portion of its business to the newly-formed [C corp] in exchange for 8 million shares common stock and two million share preferred stock in [C corp]. This was accounted for as a tax-free exchange for Federal tax purposes. The assets transferred to [C corp] included a data center in [State], computer equipment and hosted software located there, a contract with a major telecommunications provider and associated software. [C corp]'s initial management and employees were 13 former [S corp] employees who had worked in [S corp]'s [State] and [State] offices. None of the assets transferred to [C corp] were located in Vermont, no [S corp] Vermont employees were employed by [C corp], and the intellectual property transferred to [C corp] was not developed in Vermont, but was developed by [S corp]'s employees at its [State] and [State] locations.

6. At the time [C corp] was created, [S corp]'s business was conducted 43 percent in Vermont, 44 percent in [State] and 13 percent in [State].

7. The book value of the transferred assets was $[Dollar value]. Nine percent of the value was allocated to the common stock, which was then distributed to [S corp]. Ninety-one percent was allocated to the preferred stock, which [S corp] retained.

8. From 2000, when [C corp] was created, through 2004, [S corp] and [C corp] continued to have business interactions, including [S corp]'s billing its former customer for contract work now performed by [C corp] and remitting the receipts to [C corp]; [S corp]'s purchasing, at arm's length prices, application hosting from [C corp] and [S corp]'s sales to [C corp] at arm's length prices of certain services; and [S corp]'s continued payment of certain [C corp] business expenses, such as rent, voice and data communication, personnel and miscellaneous expenses, all of which were reimbursed by [C corp].

9. In 2006, [C corp] became a publicly-traded company. As part of its initial public offering, [S corp] received 2 million shares of [C corp] common stock in exchange for its 2 million preferred shares.

10. Due to the transfer of the ASP business to [C corp], and to a decline in [S corp]'s remaining telecommunications business, [S corp]'s gross sales in 2014 totaled $[Dollar value], with approximately 97 percent Vermont sales [see Fact # 11, below], 2 percent [State], 0 in [State], and 1 percent in other states. [C corp] has 43 million outstanding shares, a current market capitalization of $[Dollar value] and net income of $[Dollar value]. Of [S corp]'s original 2 million shares of [C corp], it owns directly 870,000 shares; 1 million are owned by a private foundation controlled by Taxpayer and [Taxpayer's] immediate family; and the remaining 130,000 were "donated for charitable purposes," but it is not stated whether that donee is a related entity. Taxpayer owns directly an additional 5 percent of [C corp]'s 43 million outstanding shares. There is no evidence which establishes that [S corp] owns any other portion of [C corp] stock, directly or by attribution.

11. In our telephone conversation of [Date], you indicated that [S corp]'s Vermont apportionment factors in [Year 1] were 100 percent sales, 94 percent property, and 91 percent payroll, and that these factors would remain essentially the same for [Year 2].

DISCUSSION

You have asked for a ruling on the Vermont income tax treatment of gain from the sale by [S corp] of its shares of stock in [C corp]. Since [S corp] owns the shares, any gain will be realized by [S corp]. [S corp], in turn, is an S corporation owned 100 percent by Taxpayer. Taxpayer is a nonresident.

Vermont taxation of shareholder's S corporation income

An S corporation is a pass-through entity under both Federal and Vermont tax law. Vermont does not generally tax S corporation income at the corporate level. 32 V.S.A. § 5911(a). Instead, Vermont imposes income tax on each shareholder's "pro rata share of the S corporation's income attributable to Vermont." 32 V.S.A. § 5911(b). The tax character of the shareholder's pass-through income is "determined as if the item were received or incurred by the S corporation and not its shareholder." 32 V.S.A. § 5912.

The first question, then, is whether [S corp]'s sale of the [C corp] stock will produce "income attributable to Vermont." If so, it will be passed through to Taxpayer "as if it were received by [S corp], and not its shareholder."

"Income attributable to Vermont"

Vermont's corporate income tax is imposed on the corporation's "Vermont net income." 32 V.S.A. § 5832. If a corporation is doing business in Vermont and in other states, only the income which has sufficient nexus with Vermont is attributed to Vermont for tax purposes. 32 V.S.A. § 5833. The Vermont net income of an affiliated group of corporations engaged in a unitary business will be based on the combined net income of the group. 32 V.S.A. § 5811(18)(C). An "affiliated group" is a "group of two or more corporations in which more than 50 percent of the voting stock of each member corporation is directly or indirectly owned by a common owner or

owners . . . ." 32 V.S.A. § 5811(22). On the facts presented, [S corp] and [C corp] are not corporations that constitute an "affiliated group."

Under the general rule, corporate income is attributed to Vermont in two ways. First, business income is *apportioned* to Vermont, based on the portion of the corporation's business activity in Vermont, as measured by its Vermont property, payroll and sales receipts. 32 V.S.A. § 5833(a). Second, nonbusiness income is *allocated*, in accordance with the "Allocation and Apportionment of Income" regulations. Department of Taxes Regulations ("Reg.") § 1.5833.

"Nonbusiness" income is defined in the Regulations as "passive or portfolio income . . . from dividends, interest and capital gains," unless the asset underlying the intangible "constitute[s] an integral part" of the corporation's "regular business operations":

> (6) Nonbusiness Receipts Nonbusiness receipts are all receipts other than business receipts resulting from operations unrelated to its regular business operations. Typically nonbusiness receipts are comprised of passive or portfolio income. Income from dividends, interest and capital gains will be considered nonbusiness income unless the acquisition, management, and disposition of the underlying property generating the income constitute an integral part of the taxpayer's regular business operations.

Reg. § 1.5833(d)(6).

Gain from sale of the [C corp] stock will be capital gain and nonbusiness income

In your case, the "property generating the income" is the [C corp] stock which will be sold. Assuming [S corp] realizes a gain on the sale, it will be recognized as capital gain and nonbusiness income, first because the "acquisition, management, and disposition of the stock" would not constitute "an integral part" of [S corp]'s "regular business operations." That is, [S corp]'s "regular business" is not the acquiring and selling of equities or companies, and the stock does not appear to be a working asset of any sort. In addition, the gain would be capital gain because the stock does not qualify under the exceptions to the definition of "capital asset," and the proceeds would not fall

within the doctrine of "substitute for ordinary income." 26 U.S.C. § 1221; *see, e.g.*, Temple v. Commissioner of Internal Revenue, 136 T.C. 341 (U.S.T.C. April 5, 2011).

Nonbusiness income is allocated to the state of commercial domicile

You state that "because the Stock is an intangible, the situs of the Stock is determined by the Taxpayer's domicile - as if the Taxpayer held and then sold the Stock." You conclude that, since Taxpayer's domicile is [State], the income from the sale of the stock will be taxable in [State], and not Vermont. Application of Vermont's tax laws, however, produces a different result, as follows:

The owner of the stock is [S corp]; [S corp] will sell the stock and realize any gain from the sale. As noted, [S corp]'s gain from sale of the stock will constitute nonbusiness income. Nonbusiness income is allocated to the state of situs in which the income-producing asset is located or, if the asset has no situs, then to the state of commercial domicile of the income recipient:

> (e) Nonbusiness income will be allocated to the state in which the income producing assets are located. If the income producing asset has no situs, the income will be allocated to the state of commercial domicile, the principle [*sic*] place from which the business is directed or managed.

Reg. § 1.5833(e).

This allocation of the situs of intangibles to the commercial domicile of the owner-corporation has its root in the original common law doctrine of a state having jurisdiction over a tangible *res*. Where the tangible *res* was mobile, the courts developed the rule that jurisdiction over the mobile item followed the *in personam* jurisdiction over its owner: *mobilia sequuntur personam*. Intangibles were similarly considered to be "mobile" and to follow the owner for purposes of jurisdiction. In the case of a corporate entity, jurisdiction over its intangibles is considered to be the principal jurisdiction from which the entity is directed or managed.

Vermont's regulation regarding allocation of intangibles to the commercial domicile is in accord with the generally-accepted rule that a corporation is taxable upon its nonbusiness intangibles in the state of the corporation's "commercial domicile":

> [W]here a foreign corporation acquires a commercial domicile in a state, that state acquires jurisdiction of the corporation analogous to the jurisdiction of the state of its legal domicile. This is an independent ground of jurisdiction separate from that where jurisdiction is acquired over a res by reason of its localization within the state. The former reaches the owner of the res and through the owner, the res also. For instance, where a corporation organized under the laws of one state transacts no business there and establishes its principal office in another where it manages and directs its business, it acquires a commercial domicile there, by virtue of which it is subject to taxation there upon its intangibles even though its business may extend into other states. For purposes of taxation, intangibles generally have a situs at the taxpayer's commercial domicile.

18A Fletcher Cyc. Corp. § 8821, "Taxation of Foreign Corporations; Property taxes - Situs for tax purposes" (updated September 2015).

Use of the commercial domicile for nonbusiness intangibles is also the rule under the Uniform Division of Income for Tax Purposes Act (UDITPA), and Vermont's regulation is based on the UDITPA language.[1]

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[1] Section 6(c) of UDITPA reads:

> (c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

Sections 1(a) and (b) and the related comment provide:

> **Section 1.** As used in this Act, unless the context otherwise requires:
>
> (a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.
>
> (b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.
>
> **Comment**
> The phrase "directed or managed" is not intended to permit both the state where the board of directors meets and the state where the company is managed to claim the commercial domicile. The phrase "directed or managed" is intended as two words serving the same end; not as two separate concepts.

[S corp]'s commercial domicile is Vermont

As noted in the Fletcher Cyclopedia excerpt above, the state of "commercial domicile, the principal place from which the business is directed or managed" may be different from the state in which the entity was incorporated. Kevin Associates, LLC v. Crawford, 865 So.2d 34 (La. 2004). The Court in *Kevin* found that a business which was incorporated in Delaware, but which had its principal business office in Louisiana, and used its Louisiana address as its corporate headquarters address, and which "functioned in and was managed from" Louisiana, had its "commercial domicile" in Louisiana.

[S corp] was first incorporated in [State], and later re-incorporated in Delaware. The bulk of [S corp]'s business, however, is in Vermont. In [Year 2], as calculated under the corporate apportionment statute, 100 percent of [S corp]'s sales were Vermont sales, 91 percent of its payroll was Vermont payroll, and 94 percent of its property was Vermont property. These Vermont factors are projected to remain unchanged in [Year 3]. This indicates that [S corp]'s "commercial domicile" is Vermont.

As a result, [S corp]'s nonbusiness income from sale of its intangible asset, the [C corp] stock, will be allocated to [S corp]'s commercial domicile, Vermont.

Taxpayer's pass-through income from [S corp]'s stock sale will be Vermont capital gain income

Section 5823 of Title 32 defines the items of "Vermont income" of a nonresident individual for purposes of applying the Vermont personal income tax. Section 5911(b) provides that "For the purposes of section 5823 of this title, each shareholder's pro rata share of the S corporation's income attributable to Vermont shall be taken into account by the shareholder in the manner provided in Section 1366 of the Code."

Section 1366 of the Federal Internal Revenue Code (IRC) reads:

> The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

26 U.S.C. § 1366(b). As a result of Section 5911(b) and IRC Section 1366, Taxpayer's pro rata share of [S corp]'s income attributable to Vermont is taken into account as "Vermont income" of Taxpayer, with the same tax character as if Taxpayer were the selling corporation.

Section 5912 elaborates on the Vermont tax character of the gain in the shareholder's hands. That section provides that an S corporation shareholder's pass-through income is "determined ***as if the item were received or incurred by the S corporation and not its shareholder***." 32 V.S.A. § 5912 (emphasis added). Taxpayer's pass-through of the proceeds from the [C corp] stock sale will thus have the same character as they would have if taxed directly to [S corp] and not to Taxpayer.

Any gain received by [S corp] from the stock sale will be capital gain, because the stock does not qualify for exception to the definition of "capital asset," and the sale proceeds would not fall within the doctrine of "substitute for ordinary income." 26 U.S.C. § 1221; *see, e.g.*, Temple v. Commissioner of Internal Revenue, 136 T.C. 341 (U.S.T.C. 2011). The capital gain will be nonbusiness income, and, as described earlier, will be allocated to [S corp]'s commercial domicile, Vermont.

When the capital gain is passed through to the shareholder (Taxpayer), it will have this same character, that is, Vermont-situs capital gain income ("as if the item were received by [S corp], and not its shareholder"). [S corp] will be liable for its nonresident shareholder's (that is, Taxpayer's) Vermont income tax. 32 V.S.A. § 5914(c).

TB-06 is not relevant to this case

You cited Technical Bulletin TB-06 as support for the position that [S corp]'s nonresident shareholder will owe no Vermont tax. Item 1 in that Bulletin provides:

(1) A Vermont partnership or limited liability company with nonresident owners or partners has as its only assets interest bearing accounts or stock brokerage accounts earning dividends. The sole purpose of the entity is the management of these assets. Is the entity required to make estimated tax payments pursuant to 32 V.S.A. § 5914 or § 5920 on behalf of its nonresident members or partners?

The pro rata share of the dividends, interest, and gains on marketable securities passed through to nonresident owners or partners does not constitute Vermont income in the hands of these individuals and is not subject to Vermont individual income tax. See 32 V.S.A. § 5823(b). The partnership or limited liability company is not required to make estimated payments on behalf of its nonresident members or partners. The partnership or limited liability company will be subject to the minimum tax of $250 imposed by 32 V.S.A. § 5921.

This advice, however, covers partnerships and limited liability companies, but not S corporations. S corporations with nonresident shareholders are governed by separate statutes, Sections 5911, 5912 and 5915, which, as discussed earlier, require allocation of nonbusiness investment income to the commercial domicile (under Section 5833 and the regulations), and Vermont taxation of the nonresident shareholder on the pro-rata share of all income "attributable to Vermont."

Moreover, the TB-06 Bulletin describes entities which have only interest-bearing accounts and brokerage accounts, with a sole purpose of asset management, unlike [S corp], which is an active business operating in Vermont. The Bulletin does not describe in detail the legal premise for its conclusion, but in any case, as noted, it does not apply to S corporations.

On the other hand, Department Formal Ruling 2007-01 is specific to S corporations. That Ruling provides that a nonresident shareholder of an S corporation operating in Vermont is taxable in Vermont on his pro rata share of the S corporation's capital gain income. The Ruling notes that the shareholder's Vermont income tax will be calculated taking into account the limit on taxation of capital gain under 32 V.S.A. § 5811(21).

GENERAL PROVISIONS

This ruling will be made public after deletion of the parties' names and any information which may identify the parties. A copy of this ruling showing the proposed deletions is attached, and you

may request within 30 days that the Commissioner delete any further information that might identify the parties. The final discretion as to deletions rests with the Commissioner.

This ruling is issued solely to the taxpayer and is limited to the facts presented, as affected by current statutes and regulations. Other taxpayers may refer to this ruling, when redacted to protect confidentiality, to determine the department's general approach, but the Department will not be bound by this ruling in the case of any other taxpayer or in the case of any change in the relevant statutes or regulations.

You have the right to appeal this ruling within 30 days. 3 V.S.A. §§ 808, 815.

______________________________ ______________________

Emily Bergquist Date

Approved:

______________________________ ______________________

Mary N. Peterson Date
Commissioner of Taxes