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Governor Unveils Major Tax Package

Governor Deval Patrick has introduced legislation that would make a number of significant changes to Massachusetts tax law. The Governor introduced his proposals as companion legislation to his FY08 budget. In many respects the proposed legislation mirrors the so-called "loophole closers" that Governor Romney first proposed and then deleted from the tax package that he sponsored in FY06; but there are also many unique features in the new package. Most of the proposals would not be effective until January 1, 2008, halfway through FY08, yet the so-called [Tax Fairness Act](#) would still raise about \$300 million, according to the Governor's summary of [FY08 estimated tax revenues](#). The Department of Revenue ("DOR") estimates that the Act could raise an additional \$500 million during FY09, when its provisions would be in effect for the entire year.

On Wednesday, March 28, at 3:00 p.m., our State & Local Tax Group will conduct a comprehensive briefing on the tax package. We invite you [to register](#) for attendance at the briefing. In addition, those who wish to review the language of the Governor's proposals may visit our website to [download a redline](#) that illustrates the changes that the proposals would make.

The most important provisions in the proposal are described below.

Unitary Combination

The proposal would make Massachusetts the first major industrial state in decades to adopt mandatory unitary "combined reporting" in the context of a corporate tax measured by income. (Massachusetts has long offered affiliated taxpayers doing business in the state the option to file returns that the law refers to as "combined," but these are not unitary returns. Rather, these returns permit taxpayers to net the apportioned losses of one corporation against the apportioned income of another, and they offer certain other opportunities for sharing of tax benefits as well. In normal state tax parlance, by contrast, "combined returns" are equivalent to unitary returns.)

In combined reporting states, all corporations that are part of the same unitary group – roughly, those that are economically integrated with each other – compute their income as if they were one corporation, using a single set of apportionment factors. The group can and often does include corporations over which the state does not have jurisdiction. The theory for their inclusion is that they are not taxed by the unitary state; rather, the income of the corporation or corporations that are in the state is measured by reference to the income of the overall group. In a combined return,

IF YOU WOULD LIKE ADDITIONAL INFORMATION, PLEASE CONTACT:

Joseph X. Donovan
617 338 2860
jdonovan@sandw.com

Jonathan B. Dubitzky
617 338 2936
jdubitzky@sandw.com

William E. Halmkin
617 338 2436
whalmkin@sandw.com

David J. Nagle
617 338 2873
dnagle@sandw.com

Walter Nagel
202 775 1235
wnagel@sandw.com

Richard L. Jones
617 338 2482
rjones@sandw.com

David J. McLaughlin
617 338 2833
dmclaughlin@sandw.com

John C. Paek
617 338 2818
jpaek@sandw.com

BOSTON

Sullivan & Worcester
One Post Office Square
Boston, MA 02109

NEW YORK

Sullivan & Worcester
1290 Avenue of the Americas
New York, NY 10104

WASHINGTON, DC

Sullivan & Worcester
1666 K Street, NW
Washington, DC 20006

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WORCESTER

intercompany transactions within the group are eliminated. The effect of this is to reverse out the benefits associated with any tax planning that has relied on base eroding payments by companies in high-tax states.

In broad terms, the unitary provisions in the bill follow the approach taken in classic unitary states like California, Illinois, New Hampshire and Maine. By contrast, a proposal that was dropped from Governor Romney's FY06 package would have permitted DOR to impose combination as a remedy when in DOR's view conventional separate-company computation of the tax would have "distorted" the Massachusetts income base. Under the new proposal, which would take effect for taxable years beginning on or after January 1, 2008, companies themselves will be permitted, and indeed required, to file on a unitary basis when the unitary tests are met.

DOR estimates that the adoption of unitary combined reporting will raise \$136 million in FY08. Nevertheless, it is important to remember that for particular companies combination can decrease as well as increase the amount of tax due, depending on the relative profitability and size, measured by apportionment factors, of the corporations included in the group.

Some significant features of the unitary proposal are as follows:

- The unitary group generally would stop at "the water's edge," that is, a corporation organized outside the United States generally would be excluded from the group, but only if: (1) at least 80% of the property and payroll of the corporation is outside the United States; (2) the taxpayer certifies that transactions between the foreign corporation and other members of the group are on arm's length terms; and (3) the taxpayer agrees to report to DOR any I.R.C. § 482 adjustments made by the IRS that "may have a bearing on the comparability" of intercompany transactions.
- In unitary states there has long been controversy about the appropriate treatment of sales of goods for purposes of the sales factor of the apportionment formula. Generally speaking, sales of tangible personal property are attributed to the state to which the goods are shipped. The controversy arises because corporations over which the state has no jurisdiction may be included in a unitary group. Two related questions arise: (1) If a member of the group over which the state has no jurisdiction ships goods into the state, are they included in the numerator of the sales factor, even though the state could not tax the corporation at all on a stand-alone basis? (2) How does the "throwback rule" apply in such circumstances? In Massachusetts generally, sales to a purchaser in another state may be attributed to Massachusetts rather than to the destination state if the corporation is not taxable in the destination state and the sale was not made by a salesperson based at an owned or rented office of the corporation outside Massachusetts. In a unitary context, should sales be "thrown back" to Massachusetts if the selling corporation is not taxable in the destination state, but another member of the unitary group is? Most unitary states have answered these questions by adopting the so-called "Joyce rule," which excludes sales from the numerator if the seller is not taxable in the state, and likewise throws sales back even if a corporation in the group, not the seller, is taxable in the destination state. In other words, Joyce says that separate-company jurisdiction controls for sales apportionment purposes. The opposing rule, called the "Finnigan rule," treats jurisdiction over one member as jurisdiction over all for sales apportionment purposes. The Patrick proposal adopts the Finnigan rule for purposes of inclusion of Massachusetts destination sales in the Massachusetts numerator. The bill is silent on the question whether this same rule applies for purposes of throwback, that is, whether the presence in a state of any member of the group precludes throwback.
- Combination would apply to financial institutions and utilities as well as regular business corporations, but security corporations would be excluded from the group. Where a combined group comprises corporations in more than one category, the bill leaves unclear how the tax will be computed. Further, it does not address how the rule would be applied where the group includes companies entitled to use single-sales-factor apportionment (that is, manufacturing and mutual fund service corporations) and companies not so entitled.
- The unitary rule displaces the current Massachusetts "combined return" provision referred to above. Therefore, if it is enacted, affiliated corporations that are not unitary will not be able to elect to use apportioned losses of one company against the apportioned income of

another.

Inevitably, many questions will arise between now and the effective date of the unitary proposal that will require guidance from DOR if the proposal is in fact enacted. Among the issues will be:

- How will the contours of a unitary business be drawn? The proposed definition of "unitary business" resembles that set forth in the Multistate Tax Commission's Proposed Model Statute for Combined Reporting, but its scope is in part a question of US Constitutional law. Indeed, the bill states that the unitary group will be defined as broadly as the Constitution allows. There is a significant body of Massachusetts case law dealing with the question of what constitutes a unitary business. See, for example, *W.R. Grace & Co.-Conn. v. Comm'r*, 58 Mass. App. Ct. 469 (2003). The analysis in some of the Massachusetts cases, while it purports to be grounded in the US Constitution, seems to stray from the approach taken in major unitary states such as California and Illinois.
- Will rules comparable to the federal consolidated return rules under I.R.C. § 1502 be employed in Massachusetts with respect to intercompany transactions? What transition rules will be necessary to avoid the double taxation of gains that have already been taxed pursuant to intercompany transactions?
- How will the Massachusetts net operating loss carryforward rules be affected by a switch from separate entity to combined reporting?
- Will intercompany dividends within the group be entirely eliminated or subject to the usual 95% exclusion?
- Will REITs be combined with their taxable REIT subsidiaries, even though much of the federal income taxation of these affiliated taxpayers is premised on separate company reporting?

Entity Conformity or "Check-the-Box"

Unlike the great majority of states, Massachusetts generally has not up to now conformed to the federal rules that characterize certain entities as "per se" corporations but permit others to elect to be treated either as corporations on the one hand or as partnerships or "disregarded entities" on the other. (Massachusetts does conform with respect to limited liability companies.) Rather, Massachusetts has employed tests comparable but not identical to the former "Kintner" tests for federal entity classification. Governor Patrick's

proposal would adopt broadly the federal "check-the-box" rules that govern entity classification, effective for taxable years beginning on or after January 1, 2008. The goals of adopting the federal rules are to promote simplicity and uniformity in administration, eliminate opportunities to use "hybrid" entities to create income that is not taxed, and eliminate the separate regime applicable to Massachusetts business trusts.

REITs often are organized as Massachusetts business trusts to avoid imposition of the non-income measure of the corporate excise. If the proposal is enacted, these entities will be treated going forward as corporations subject to the non-income measure.

On the other hand, entity conformity will permit DOR to simplify the rules governing the taxation of qualified subchapter S subsidiaries ("QSubs"). Under the proposal, QSubs would no longer be taxed separately on their income; rather, their income and apportionment factors would roll up into the parent entity, which would be the only entity to bear the Massachusetts "sting tax," if applicable.

DOR estimates that the adoption of conformity will raise \$99 million in FY08.

Imposition of Corporate Income Tax on Non-Insurance Business of Insurance Companies

Most insurance companies in Massachusetts are subject to a premiums tax but no income tax on operating income. Under current law insurance companies may, however, include in their operations activities that are not insurance-related. For example, an insurance company may be a member of a limited liability company or a partner in a partnership that conducts regular business operations. In such a case the income of the LLC or partnership that flows up to the insurance company is not taxed at all. The Patrick proposal would subject such income to tax if it flows up from a partnership, limited liability company or disregarded entity and the insurance company owns 50% or more of the entity. DOR estimates that taxing such non-insurance businesses will raise \$14 million in FY08.

Nexus for Purposes of the Non-Income Measure of the Tax

The proposal would eliminate so-called Public Law 86-272 protection with respect to the non-income measure of the corporate excise. Accordingly, mere regular solicitation of sales of tangible personal property will require companies to file and pay the non-income measure. As a practical matter, companies whose Public Law 86-272 posture is aggressive may become Massachusetts tax return filers for the first time, thus alerting DOR to their presence. Also, companies for which the non-income measure of the excise is significant may wish to consider whether the financial accounting treatment of the non-income measure will change if the proposal is adopted.

Corporate Basis

The proposal includes a provision that would authorize departures from federal tax basis for corporations, to take into account differences between Massachusetts and federal tax provisions that can have an effect on basis. DOR already permits and requires such departures for corporations in certain circumstances via administrative pronouncement, and the personal income tax law includes a provision calling for such basis adjustments.

Controlling Interest Transfer Tax

Governor Patrick's proposal would revive provisions in the first FY06 Romney package that would extend the Massachusetts deeds excise to cases in which more than 50% of an entity owning real estate is sold, but only if the value of real estate represents 80% or more of the value of the entity whose interests are sold. Transfers of interests in publicly-traded entities would not be taxed under the proposal. DOR estimates that these provisions will raise \$12 million in FY08.

Hotel Reseller Tax

The proposal would require so-called "resellers" of hotel rooms – largely companies that sell rooms over the internet – to collect tax on the difference between what they pay for the rooms and what they are paid by their retail customers. Hotels would continue to collect the tax on the amount that they charge the resellers.

Elimination of Sales Tax Benefits Associated with Captive Procurement Companies

Certain corporate groups have set up special-purpose subsidiaries for the purpose of registering

as a sales tax vendor and buying goods tax free under a resale certificate for later resale or for lease or rental to affiliates in the group. Use of such companies defers the application of the sales tax for so long as the goods are held by the procurement company in inventory, and for longer if the procurement company leases or rents the property to the affiliate. Such companies also facilitate better monitoring of available exemptions within the group. Governor Patrick's proposal would impose tax on purchases by such companies for resale or for lease or rental to an affiliate. DOR estimates that the Patrick proposal will raise \$28 million in FY08.

Credit for Real Estate Taxes

The proposal would extend the Senior Circuit Breaker program by providing a credit to any homeowner, regardless of age, equal to the amount by which the real estate tax payment exceeds 10% of the taxpayer's total income, but the credit may not exceed \$750.

Tax Study Commission

The Patrick proposal would create a special commission to study the "modernization and simplification" of Massachusetts tax law, and require it to report its findings to the Legislature by December 31, 2008. The commission would have authority to address all Massachusetts tax matters, but it would be required to provide recommendations specifically with respect to:

- Utility corporations
- Security corporations
- Research and development credits
- Sales and use tax exemptions
- The taxation of "digital products"
- Individual estimated tax payment rules
- The substitution of refundable credits for credits that may be sold to another taxpayer
- The treatment of gambling losses
- Imposition of the cigar excise at the wholesale level
- Calculation of the non-income measure of the corporate excise and
- The Commonwealth's participation in the Streamlined Sales Tax Compact.

The commission would have 17 members:

- The Secretary of Administration and Finance as Chair
- The House and Senate Chairs of the Committee on Revenue
- The Commissioner of Revenue
- The Secretary of Housing and Economic Development
- Three gubernatorial appointees who are experts in economics or corporate tax

and, in addition, appointees of:

- The Federal Reserve Bank of Boston
- The Massachusetts Taxpayers Foundation
- The Greater Boston Chamber of Commerce
- Associated Industries of Massachusetts
- The Massachusetts Budget and Policy Center
- The Massachusetts AFL-CIO
- Neighbor to Neighbor Massachusetts
- The Massachusetts Teachers Association and
- The Massachusetts Municipal Association

If you have questions about the impact of the proposal on your business, please contact Joe Donovan or any other member of our State and Local Tax Group.