

# Massachusetts Governor's Tax Package — What Does It Include And Where Is It Going?

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Massachusetts Gov. Deval Patrick (D) has introduced legislation that would make many significant changes to Massachusetts tax law. The governor introduced his proposals as companion legislation to his fiscal 2008 budget. In many ways the proposed legislation mirrors so-called loophole closers that former Gov. Mitt Romney first proposed and then deleted from a tax package that he sponsored in fiscal 2006, 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 fiscal 2008, yet the so-called Tax Fairness Act (HB 3756) would still raise about \$300 million in that fiscal year, according to the governor's summary of estimated tax revenue. The Department of Revenue estimates that the bill could raise an additional \$500 million during fiscal 2009, when its provisions would be in effect for the entire year.

This article summarizes the most important provisions in the proposal and discusses the prospects for its passage.

## Unitary Combination

The proposal could make Massachusetts one of the first major industrial states in decades to adopt mandatory unitary combined reporting in the context of a corporate tax measured by income. (Pennsylvania, Michigan, and New York, among other states, are also considering adoption of a unitary approach.) Massachusetts has long offered affiliated taxpayers doing business in the state the option to file returns that the law refers to as "combined," but those are not unitary returns. Rather, these returns permit taxpayers to net the apportioned losses of one corporation with Massachusetts nexus against the

apportioned income of another, and they offer some other opportunities for sharing tax benefits as well. In contrast, the proposal would require combination of unitary corporations prior to apportionment, without regard to whether the corporations have nexus with Massachusetts.

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 Romney's fiscal 2006 package would have permitted the DOR to impose combination as a remedy when in the 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 tax years beginning on or after January 1, 2008, companies will be required to file on a unitary basis when the unitary tests are met.

The DOR estimates that the adoption of unitary combined reporting would raise \$138 million in fiscal 2008. But 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 in the group.

## Composition of the Group

The unitary group generally would stop at the water's edge. A corporation organized outside the United States ordinarily would be excluded from the group, but only if:

- at least 80 percent of the property and payroll of the corporation is outside the United States;
- the taxpayer certifies that transactions between the foreign corporation and other members of the group are on arm's-length terms; and
- the taxpayer agrees to report to DOR any IRC section 482 adjustments made by the IRS that "may have a bearing on the comparability" of intercompany transactions.

The conditions for exclusion from the group, which are borrowed in part from New Hampshire, raise several issues.<sup>1</sup> For example, would the DOR take literally the requirement for certification, so that non-U.S. companies would be included in the group if they did not certify the appropriateness of intercompany pricing, regardless of whether the pricing is actually at arm's length? Conversely, would companies that make the certification but whose pricing is flawed not be includable in the group? Would failure to certify (or failure to satisfy arm's-length standards) bring companies into the group even if their inclusion reduces the Massachusetts tax?

The requirement that excludable "80/20" corporations be organized outside the United States stands in contrast to the rules in states such as Illinois or Vermont.<sup>2</sup> The governor presumably has taken this approach. The requirement generally accomplishes that result because appreciated intangibles that are used in the United States cannot be contributed to a non-U.S. subsidiary without incurring a federal tax cost under IRC section 367.

The proposal would specifically exclude from the combined return group Massachusetts security corporations, which are required to limit their activities to investment in securities and pay tax at a greatly reduced rate of 1.32 percent of gross income. (Security corporations also are exempt from the \$2.60/\$1,000 "balance sheet tax" that applies to regular business corporations.) In contrast, competing vehicles set up under the law of other states, including

Delaware holding companies and Connecticut and Rhode Island passive investment companies, would be included in the group, assuming that they are in fact unitary with their affiliates.

Specifically included in the combined return group would be regulated investment companies and real estate investment trusts. That provision appears to have been included to give the DOR a new tool for attacking captive RICs and REITs. It would seem to authorize the DOR to impose a significant tax on a noncaptive REIT operating in Massachusetts, despite Massachusetts conformity to the federal dividends paid deduction for REITs, in cases in which the REIT owns one or more taxable REIT subsidiaries.

### **Would the bill's language give the DOR carte blanche to include in the group whatever non-U.S. entities it chooses to include?**

The bill contains provisions permitting the DOR to include in the combined return group any entities that would ordinarily be excluded if, in the view of the DOR, inclusion is necessary to prevent tax avoidance or evasion or to reflect "a proper apportionment of income of the unitary business." The breadth of that language is troubling. A unitary purist would argue that combined reporting is *always* necessary to reflect a proper sourcing of income. Would the language give the DOR carte blanche to include in the group whatever non-U.S. entities it chooses to include?

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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: If a member of the group over which the state has no jurisdiction ships goods into the state, are the goods included in the numerator of the sales factor, even though the state could not tax the corporation at all on a stand-alone basis? How does the "throwback rule" apply in those 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. (That is in contrast to the more conventional throwback rule of the Uniform Division of Income for Tax Purposes Act, which

<sup>1</sup>In New Hampshire, a water's-edge combined group is a group of business organizations operating as a unitary business, except for overseas business organizations, which are those with 80 percent or more of their average payroll and property assignable to a jurisdiction outside the 50 states and the District of Columbia. Generally, an overseas business organization would not be treated as a member of a water's-edge group if the group can certify that transactions conducted between the overseas business and members of a water's-edge group are similar to transactions conducted between other businesses owned by the overseas business and any other member of the water's-edge group and if the overseas business agrees to report any adjustments made by the IRS regarding transactions between related business organizations that bear on the comparability of transactions between the members. N.H. Rev. Stat. Ann. section 77-A:1, XV, XIX.

<sup>2</sup>Under Illinois law, a member is excluded from the unitary group if its business activity outside the United States is 80 percent or more of its total business activity. ILCS chapter 35 section 5/1501(a)(27). The Vermont corporate income tax is a water's-edge unitary tax because an "affiliated group" excludes overseas business organizations. Vt. Stat. Ann. 32 section 5811(18)(C); Vt. Stat. Ann. 32 section 5811(22). An "overseas business organization" means an organization that ordinarily has 80 percent or more of its payroll and property outside the 50 states and the District of Columbia. Vt. Stat. Ann. 32 section 5811(24).

attributes sales to the origin-of-shipment state if the seller is not taxable in the destination state.) 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, 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 whether the same rule applies for purposes of throwback, that is, whether the presence in a state of any member of the group precludes throwback. One would hope that Massachusetts will follow the lead of other unitary states in applying the rules consistently in both contexts.

### Application Across Different Corporate Tax Regimes

Massachusetts maintains corporate tax regimes that differ in rates and in apportionment rules for regular business corporations, financial institutions, and utilities. The rates applicable to the three categories, for example, are 9.5 percent, 10.5 percent, and 6.5 percent, respectively, and whereas the sales factor generally is double-weighted for regular business corporations, it is single-weighted for utilities. Further, the financial institution apportionment rules differ radically from those that apply to other corporations. Even within the category of regular business corporations, special single-sales-factor rules apply to both manufacturing corporations and mutual fund service providers, that is, corporations whose predominant business is investment management, distribution, and administration under contracts with mutual funds.

Under the proposal, combination would apply to financial institutions and utilities as well as to regular business corporations. Moreover, the proposal contemplates that otherwise unitary corporations in the three categories could and would be included in the same combined return group. In those cases, the bill seems to suggest that each corporation in the group would separately compute its income or loss, starting with the aggregate income or loss of the entire group, and multiplying it by an apportionment factor derived from the denominators of the entire group but the numerators of the single company only. It remains to be seen how

the *Finnigan* approach to sales factor inclusion would be reconciled with that computational method.

### Combined Returns but No ‘Combined Returns’?

The unitary rule in the proposal would displace the current Massachusetts combined return provisions referred to above. Therefore, if it is enacted, affiliated corporations that are not unitary would not be able as they are now to elect to use apportioned losses of one company against the apportioned income of another, nor would they be able as they are now to share research and development credits, for example.

### Defining the Unitary Business

How would the contours of a unitary business be drawn? The proposed definition of unitary business resembles that in the Multistate Tax Commission’s proposed model statute for combined reporting, focusing as it does on “mutual benefit” and “sharing or exchange of value,” but its scope is in part a question of U.S. constitutional law.<sup>3</sup> Indeed, the bill says that the unitary group would be defined as broadly as the U.S. Constitution allows, which arguably makes any statutory constraints on the scope of the business moot.

There is a significant body of Massachusetts case law dealing with what constitutes a unitary business. The analysis in some of the Massachusetts cases, although it purports to be grounded in the U.S. Constitution, seems to stray from the approach taken in major unitary states. For example, in *W.R. Grace & Co. — Conn. v. Comm’r*, 58 Mass. App. Ct. 469 (2003), the Court of Appeals seemed to equate “flow of value,” for purposes of determining whether a unitary business exists, with distortive, that is, non-arm’s-length, intercompany pricing. In conventional unitary thinking (as contrasted with the approach taken in New York), distortive pricing certainly is not a prerequisite to imposition of combined reporting.

<sup>3</sup>The model statute defines unitary business in part as “a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.” A drafter’s note indicates that that portion of the definition is drafted to follow MTC Reg. IV(b), defining a unitary business. See [http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Uniformity\\_Projects/A\\_-\\_Z/CombinedReporting-FINALversion.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/CombinedReporting-FINALversion.pdf).

## Other Issues

If the combined reporting proposal is enacted, the DOR will face a formidable challenge to get regulations in place before the January 1, 2008, effective date to clarify the many issues that inevitably come with enactment of a unitary regime. For example, would Massachusetts adopt rules that parallel those that apply under IRC section 1502 for purposes of determining the treatment of transactions within the unitary return group? How would net operating losses and credits be shared, if at all, within the group? How would the “income-producing activity/cost of performance” test for the sourcing of receipts from sales of services be applied in cases in which multiple corporations in the group contribute to the activity or incur the costs associated with the sale? What rules would be needed to rationalize results in transition from separate-company to unitary treatment?

### *Entity Conformity or ‘Check the Box’*

Unlike most states, Massachusetts generally has not up to now conformed to the federal rules that characterize some 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 regarding limited liability companies.) Rather, Massachusetts has used tests comparable but not identical to the former *Kintner* tests for federal entity classification. Patrick’s proposal would adopt broadly the federal check-the-box rules that govern entity classification, effective for tax years beginning on or after January 1, 2008. The goals of adopting the federal rules are to promote simplicity and uniformity in administration and to eliminate opportunities to use “hybrid” entities, sometimes to reduce the tax burden in Massachusetts, and sometimes to reduce taxes elsewhere. In those structures, for example, there may be partnerships that are treated as such for Massachusetts tax purposes, but that check the box to be treated as corporations federally and hence in all of the states that conform to federal entity classification. Conversely, there may be Delaware statutory trusts or other entities that Massachusetts will characterize as corporations, but that can be treated as partnerships or disregarded entities under the check-the-box rules.

The conformity proposal would eliminate the long-standing separate tax regime in Massachusetts applicable to Massachusetts business trusts or corporate trusts. Those trusts under current law pay tax at 5.3 percent rather than the usual corporate rate of 9.5 percent, and they pay no balance sheet tax. Further, distributions to individual shareholders are not taxed except to the extent that they are paid out of earnings that were apportioned outside the state. Under the proposal, those trusts

would be taxed as corporations, partnerships, or disregarded entities, in conformity with their federal classification.

REITs doing business in the state often are organized as Massachusetts business trusts to avoid imposition of the nonincome measure of the corporate excise. If the proposal is enacted, those entities would be treated going forward as corporations subject to the nonincome measure.

However, entity conformity would permit the DOR to simplify the rules governing the taxation of qualified subchapter S subsidiaries (QSUBs). At present, if they reach a specified size threshold measured by gross receipts, those entities, like stand-alone subchapter S corporations, bear a tax at the corporate level at a rate of 3 percent or 4.5 percent, depending on their size. That tax is commonly referred to as the “sting tax.” Under the proposal, QSUBs would no longer be taxed separately; rather, their income and apportionment factors would roll up into the parent entity, which would be the only one to bear the sting tax, if applicable.

The DOR estimates that the adoption of conformity would raise \$99 million in fiscal 2008.

### **Imposition of Corporate Income Tax on Noninsurance 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 an LLC or a partner in a partnership that conducts regular business operations. In that 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 that income to tax if it flows up from a partnership, LLC, or disregarded entity and the insurance company owns 50 percent or more of the entity. The DOR estimates that taxing those noninsurance businesses would raise \$14 million in fiscal 2008.

This proposal has drawn fire from the insurance industry on the grounds that it might subject insurance companies to significant retaliatory taxes. Under most retaliatory tax regimes, the states impose on foreign (nondomestic) insurance companies a tax that is the higher of the tax imposed on similarly situated domestic corporations or the tax that would be due if the regime in place in the foreign company’s home state were in force. Therefore, if the proposal is enacted, a Massachusetts-organized insurance company holding an interest in an LLC conducting a noninsurance business both in Massachusetts and elsewhere might be treated as if the

other states where the LLC does business had also enacted this Patrick proposal.

### **Nexus for Purposes of the Nonincome Measure of the Tax**

The proposal would eliminate protection under the federal Interstate Income Tax Law, commonly referred to as Public Law 86-272, for the nonincome measure of the corporate excise. Therefore, mere regular solicitation of sales of tangible personal property would require companies to file and pay the nonincome measure. As a practical matter, companies whose posture under that federal law is aggressive might become Massachusetts tax return filers for the first time, thus alerting the DOR to their presence.

### **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. The DOR already permits and requires those departures for corporations in some circumstances via administrative pronouncement, and the personal income tax law in Massachusetts includes a provision calling for those basis adjustments. In the corporate context, however, the implications of broad nonconformity to federal basis might be difficult to predict. For example, how would basis in corporate subsidiaries be computed if the proposal is enacted? See Joseph X. Donovan, "What Is Corporate Tax Basis in Massachusetts?" *State Tax Notes*, Apr. 9, 2007, p. 97, *Doc 2007-6955*, or *2007 STT 69-1*.

### **Controlling Interest Transfer Tax**

Patrick's proposal would revive provisions in the first 2006 Romney package that would extend the Massachusetts deeds excise to cases in which more than 50 percent of an entity owning real estate is sold, but only if the value of real estate represents 80 percent 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. In broad terms, that proposal follows the approach taken under New York state's controlling interest transfer tax.

The DOR estimates that those provisions would raise \$12 million in fiscal 2008.

### **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. The proposal would define the

nexus rules applicable to resellers very broadly. It includes a provision focusing on exploitation of the in-state market, and also a provision stating that the inspection of rooms in Massachusetts would give rise to nexus. Indeed, the nexus provision by its terms extends the jurisdiction of Massachusetts as far as the U.S. Constitution permits.

The treatment of hotel resellers is an issue that has attracted the attention of states other than Massachusetts. It will be interesting to see whether the Massachusetts model for capturing within the tax base the spread between the price paid by the reseller and the price paid by the retail consumer would be followed in other jurisdictions.

### **Elimination of Sales Tax Benefits Associated With Captive Procurement Companies**

Some 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 those captive procurement companies defers the application of the sales tax for as 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. Those companies also facilitate better monitoring of available exemptions within the group. Patrick's proposal would impose tax on purchases by captive procurement companies for resale or for lease or rental to an affiliate. The DOR estimates that this proposal would raise \$28 million in fiscal 2008.

### **Tax Study Commission**

The Patrick proposal would create a special commission<sup>4</sup> to study the modernization and simplification of Massachusetts tax law and would 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 regarding:

- utility corporations;
- security corporations;
- research and development credits;
- sales and use tax exemptions;
- the taxation of digital products;
- the rules on individual estimated tax payments;
- 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;

<sup>4</sup>For coverage of the commission on corporate taxation, see *State Tax Notes*, May 7, 2007, p. 384, *Doc 2007-10874*, or *2007 STT 86-16*.

- calculation of the nonincome measure of the corporate excise; and
- participation in the Streamlined Sales and Use Tax Agreement.

The commission would have 17 members:

- the secretary of administration and finance as chair;
- the House and Senate chairs of the Joint Committee on Revenue;
- the commissioner of revenue;
- the secretary of housing and economic development; and
- three gubernatorial appointees who are experts in economics or corporate tax.

It would also include 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.

### Prospects for Passage

Patrick, whose previous governmental experience was limited to the Clinton administration's Justice Department Civil Rights Division in Washington, defied expectations in 2006 by taking the Democratic gubernatorial nomination with ease and defeating Republican Lt. Gov. Kerry Healey in the general election by over 20 points. With a heavily Democratic legislature in place and a strong public mandate behind him, the governor appeared to be well positioned to push through his early legislative priorities.

Key among them was his first budget bill. The state has an overall proposed budget of about \$26 billion, but a deficit of over \$1 billion in fiscal 2008 was predicted, absent new revenue streams. And in his campaign, Patrick had promised to hire 1,000 new police personnel and to provide broad-based property tax relief. He later scaled back both proposals. Prospects for bridging the gap via spending cuts in other areas seemed bleak; over half of state spending is devoted to two categories not amenable to cuts — Medicaid payments and state aid for local public education. Therefore, when the governor resurrected and revised Romney's loophole closers as companion proposals to the budget bill, it seemed reasonable to assume that they would get a sympathetic reception in the legislature.

They did not, at least not from the leadership. With the Senate in transition from the leadership of veteran President Robert Travaglini, who recently left his post to become a lobbyist, to that of incoming President Therese Murray (D), the center of power now seems to lie with Speaker of the House Salva-

tore DiMasi (D). DiMasi announced in a speech to the Greater Boston Chamber of Commerce on March 20 that he will oppose all increases in business taxes, specifically including the Patrick proposals. The Senate president, on the other hand, who is generally regarded as left of center even by Massachusetts standards, promised to give the proposals a fair hearing, but signaled her ambivalence about them by saying that she would not include the associated revenue in the Senate version of the budget.

At this writing, a proposal has surfaced to create a Special Commission on Taxes that would review Patrick's revenue proposals and report to the legislature by June on the advisability of adopting them. That commission, if created, could meld into and succeed to the longer-term responsibilities of the commission originally proposed by the governor and described above. According to an April 3 article in *The Boston Globe*, membership on the commission would include the chairs of the Joint Ways and Means and Joint Revenue committees, Republican lawmakers, and representatives from the DOR and the business community. The article suggested that Secretary of Administration and Finance Leslie Kirwan; Michael Widmer, president of the Massachusetts Taxpayers Foundation; and one or more academics might also be appointed. It remains unclear whether, if the commission recommends enactment of any of the significant parts of the package, the speaker's strong initial opposition can be overcome.

Even if the governor's initiative fails this year, major pieces of it, including combined reporting and check-the-box conformity, might resurface later in the Patrick administration, if, as expected, revenue pressures continue to mount. Certainly if other major industrial states adopt a unitary approach, that may ease the path forward in Massachusetts. However, the longer-term study commission could settle on recommendations for more fundamental changes in the Massachusetts system for taxing businesses, perhaps following in the footsteps of Ohio and Texas, which over the last several years have moved away from income-based taxes in favor of gross receipts and margin taxes. ☆