

Massachusetts Combined Reporting Proposal Survives Study And Becomes Law

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It's a truth almost universally acknowledged that when a legislative body commits a subject to "study," the statutory status quo will be preserved, at least in the short term. Massachusetts has defied that rule, however, with its adoption on July 3 of combined reporting, effective for tax years beginning on or after January 1, 2009.¹

The Massachusetts combined reporting proposal had its origin in 2006 as part of a "loophole-closing" package sponsored by then-Gov. Mitt Romney, who was faced with fiscal pressures that led to an open-ended search for alternatives to a broad tax increase of any kind. Business community opposition soon reached a high decibel level, however, and at the same time the state's revenue outlook became rosier. Romney then submitted to the General Court, the state's legislature, a revised proposal that did not include combination.

In November 2006 relative political newcomer Deval Patrick (D) was swept into office as Romney's successor by more than a 20-point margin, giving Democrats control over both the executive and legislative branches for the first time in 16 years. In the legislature, the Democratic Party has long enjoyed overwhelming majorities.² It was assumed, therefore, that all of Patrick's early core initiatives would find a friendly audience in the legislature.

Chief among those core initiatives was the governor's first budget proposal, and as a companion to that proposal he introduced a loophole-closing pack-

age of his own, designed to help close a budgetary gap of over \$1 billion. The two most significant elements of that package — combined reporting and conformity to federal entity classification, or the check-the-box rules, were borrowed, with some major revisions, from Romney's package.

In March 2007 combined reporting appeared to run into an immovable object. Rep. Sal DiMasi (D), the powerful speaker of the House of Representatives, announced in a speech to the Greater Boston Chamber of Commerce that he was unequivocally opposed because of concerns about the effect of its adoption on business competitiveness. In Massachusetts almost no bill is passed without the support, or at least the indifference, of the speaker and the Senate president. Therefore, many observers at that point considered unitary to be dead, and indeed it was dead as a component of the fiscal 2008 budget.

Patrick did not fold his hand, however. Rather, he secured agreement from the speaker and the Senate president to establish the Study Commission on Corporate Taxation, which was charged with making recommendations on the appropriateness of his own tax proposals. Significantly, the commission had no formal standing whatsoever; it was created not by legislative act but by a joint press release issued on April 30.³ It was made up of 15 members (including the lead author of this viewpoint), presumably chosen in part based on perceived bias in favor of or against adoption of the business tax changes. The commission included Secretary of Administration and Finance Leslie Kirwan as chair; the House and Senate chairs of the Joint Committee on Revenue; the House and Senate minority leaders; former commissioner of revenue Alan LeBovidge, under whose leadership the tax package was crafted; executives of two major business advocacy

¹See Chapter 173 of the Acts of 2008.

²As of this writing, the Democrat/Republican split in the House is 141/19; in the Senate it is 35/5.

³See the 686-page report of the commission at <http://www.mass.gov/Ador/docs/dor/Publ/PDFS/Study%20Commission%20on%20Corporate%20Taxation%20-%20Final%20Report.pdf>.

organizations — Associated Industries of Massachusetts and the Massachusetts Taxpayers Foundation; two prominent economists; three tax lawyers, including former commissioner of revenue Stephen Kidder; and two accountants specializing in state taxation.

The commission was given two reporting dates — June 15, 2007, for an “interim report on legislative recommendations providing revenue for Fiscal Year 2008,” and January 1, 2008, for a “final report on long-term changes to corporate tax laws.”⁴

From the outset, the commission’s deliberations reflected deep divisions about where it should head in its recommendations. Nevertheless, on June 15 it did submit a majority report, endorsed by eight members, and a minority report of the other seven, to the legislature. The majority report recommended adoption of conformity to the check-the-box rules, and “expressed support for the purposes” of the governor’s other proposals, including combined reporting, but said that more time was needed to consider the design and implementation of combination and the remaining proposals.⁵ The minority report made no recommendations, but expressed serious concerns about whether it was possible to make informed decisions by the interim due date. Given the narrow majority expressing support in principle for the governor’s package, and the speaker’s continuing opposition, at that point prospects for passage remained dim.

There is another political maxim that became apt at this juncture: Process often dictates results. Kirwan as chair wanted to establish momentum toward consensus over the summer, but was concerned that summer schedules would make it difficult to gather all 15 members on multiple occasions for long and substantive discussions. Instead, she broke the membership into subcommittees, each charged with examining in depth one or more major subtopics. One was the Subcommittee on Combined Reporting, chaired by Kidder, and also including attorney Karl Fryzel from Edwards Angell Palmer & Dodge; accountant Jane Steinmetz from PricewaterhouseCoopers; Federal Reserve Bank economist Robert Tannenwald, who has long studied the economic effects of state tax policy decision making; and Michael Widmer, the president of the Massachusetts Taxpayers Foundation and a vocal opponent of the governor’s package.

⁴*Id.*

⁵*Id.* The majority report said that “the Commission believes that combined reporting would modernize the Commonwealth’s corporate tax structure, would reduce opportunities for tax avoidance through transactions among affiliated corporations, and would promote stability and predictability by dramatically reducing the need for further legislative changes in response to tax planning strategies.”

The subcommittee met on several occasions during the summer and fall of 2007, and called on various experts to help inform its judgment, including:

- Prof. Richard Pomp of the University of Connecticut;
- former New Hampshire Revenue Commissioner Stan Arnold and Bill Ardinger, both of Rath, Young & Pignatelli, Concord, N.H.;
- Shirley Sicilian, general counsel of the Multi-state Tax Commission;
- Todd Lard, tax counsel to the Council On State Taxation;⁶
- Keith Davis of Bank of America, in his capacity as executive director of the North Carolina Tax Commission; and
- Ben Miller of the California Franchise Tax Board.

The subcommittee also reviewed various papers addressing the advantages and disadvantages of combined reporting.⁷

Although the subcommittee, unlike some others, prepared no final report documenting the results of its deliberations, it issued a draft report on November 13, 2007, in which it called attention to various subsidiary issues that later formed the heart of the debate over the specific contours of unitary in Massachusetts. Those were:

- the extent to which detailed unitary rules should be specified statutorily or left to regulation;
- whether Massachusetts should take a water’s-edge or worldwide approach to combination, and if the former, how the water’s-edge group should be defined;
- whether and how groups comprising corporations subject to differing apportionment regimes⁸ should be combined;
- whether the *Joyce* or the *Finnigan* rule should be adopted;
- whether net operating losses and credits should be computed and used on a combined basis;
- whether, to reduce financial statement uncertainty, taxpayers should be allowed to elect to have their federal consolidated return group constitute the unitary group; and
- whether the existing Massachusetts combined return election should be preserved for nonunitary affiliates.

⁶In the course of the work of the commission, COST moved from a position of neutrality on the merits of combined reporting to opposition to it.

⁷See the report, *supra* note 3.

⁸Regular business corporations, financial institutions, and manufacturing and mutual fund service corporations apportion their income differently in Massachusetts.

While those deliberations were taking place, the remaining subcommittees focused on the following topics:

- the proposals in the governor's package other than unitary and check-the-box;
- whether the \$456 minimum corporate excise should be changed;
- whether the overall Massachusetts business tax rate structure was in need of revision;⁹
- whether Massachusetts should consider adopting an alternative model such as a gross receipts or margins tax or a value added tax such as the old Michigan single business tax or the New Hampshire business enterprise tax; and
- whether Massachusetts should fully embrace the Streamlined Sales Tax initiative.

The commission was charged with recommending tax changes that would encourage business growth and strengthen the state's global competitiveness.¹⁰ As the various subcommittees met independently over the summer, it became clear that an informal consensus was developing on the commission that the rate of tax on the income of regular business corporations — at 9.5 percent the fourth highest in the nation — was an impediment to tax competitiveness. (From the point of view of the Patrick administration, perhaps it can be said that that insight was fortuitous on two grounds — it offered an opportunity to break the logjam posed by the speaker's opposition, and in broad terms it presented an opportunity to shift some tax benefits from large multistate corporations whose effective rate was low despite the high nominal rate because of aggressive planning, to companies that had not adjusted their structures to reduce the Massachusetts tax burden.) Some of those on the commission who were unfavorably disposed toward combined reporting signaled that perhaps they could support it if there were a rate reduction sufficient to make the overall proposal revenue neutral.

At its final meeting, the Subcommittee on Combined Reporting took two votes. In the first, it voted 3 to 2 to endorse combined reporting without condition. In the other, it voted 4 to 1 to support adoption of a combined reporting system if it came in tandem with a rate cut sufficient to achieve revenue neutrality.

As the makings of a compromise were falling into place, another development moved toward legislative center stage and arguably gave the unitary

proposal a backhanded push without which it never would have been enacted. That development was casino gambling. Patrick in September 2007 floated a plan to authorize the development of three resort casinos in the state, arguing that they would generate \$400 million in tax revenue and 20,000 permanent jobs.¹¹ DiMasi later announced his strong opposition to the plan, and when the plan finally came to a vote in the House of Representatives in March 2008, it was defeated 108 to 46.¹²

The casino proposal and the tax proposal were not tied together in the public mind, but they may have been in private debates. Having inflicted political damage on a popular governor of his own party by stopping casino gambling, DiMasi, cognizant of the unitary/check-the-box for rate cuts compromise brewing at the commission, may have concluded that it was prudent from both a fiscal and a political point of view to facilitate a victory for the governor on the tax front.

In November and December 2007 the full commission met to consider the work of the subcommittees and to settle on recommendations to the legislature. At its final meeting on December 18, it voted 9 to 6 to support combined reporting and check-the-box conformity if accompanied by a "meaningful reduction in the corporate income tax rate," but without requiring revenue neutrality.¹³ Among those voting in favor was Rep. John J. Binienda (D), the House chair of the Committee on Revenue. That sent a signal that the speaker's unconditional opposition to combined reporting had been overcome.

Ultimately, the commission's compromise found its way into law with the enactment of a water's-edge unitary approach, accompanied by check-the-box conformity and rate reductions scheduled to leave the rate at 8 percent for 2012 and thereafter.

On the path to the final bill, there was heated debate — reflected in significantly different House and Senate tax packages that had to be reconciled in conference committee — around issues such as those identified by the Subcommittee on Combined Reporting. The conference committee had to resolve:

- whether to grant the Department of Revenue discretion to add some foreign corporations to the water's-edge group;¹⁴
- whether to include so-called 80/20 domestic corporations in the group;¹⁵

⁹Financial institutions pay tax in Massachusetts at a higher rate than regular business corporations; utilities pay tax at a lower rate; small subchapter S corporations pay no entity-level tax but large ones do; and Massachusetts business trusts pay tax at the same rates as those to which individuals are subject.

¹⁰See the report, *supra* note 3.

¹¹See *The Christian Science Monitor*, Mar. 22, 2008, available at <http://www.csmonitor.com/2008/0321/p25s09-uspo.html>.

¹²*Id.*

¹³See the report, *supra* note 3.

¹⁴The DOR was not granted that discretion.

¹⁵Those corporations are included in the group.

- whether to permit corporations to elect to have the federal consolidated return group constitute the unitary group;¹⁶
- how to compute apportionment factors when there are corporations subject to different regimes in the group;¹⁷ and
- whether to create a special deduction to blunt the impact of adopting combined reporting on the earnings of public companies.¹⁸

Finally, it's of interest that the very law that one can say represents the culmination of the work of the study commission in 2007 creates a new special

¹⁶There is such an election in the law as enacted.

¹⁷The law adopts an eccentric approach to that issue.

¹⁸There is such a deduction in the law as enacted.

commission, composed only of legislators and their designees, that must report by March 31, 2009, on "the modernization and simplification of the current business tax laws, as well as rate structure, reporting mechanisms of corporations, and the use and effectiveness of the single-sales tax formula."¹⁹ Lawmakers have concluded that some of the business of studying was left undone.

Next month the authors of this viewpoint will outline in *State Tax Notes* the technical details of the new combined reporting law, and will also address the implications of adopting entity conformity and the other important provisions of the new Massachusetts law. ☆

¹⁹See section 100 of Chapter 173 of the Acts of 2008.