

Radical Tax Changes on the Horizon For Massachusetts

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On July 3 Gov. Deval Patrick (D) signed into law the most far-reaching corporate tax changes to have been enacted in Massachusetts in the last 30 years, all embodied in Chapter 173 of the Acts of 2008, An Act Relative to Tax Fairness and Business Competitiveness.¹ Later in July, we examined how the work of the Massachusetts Study Commission on Corporate Taxation helped to break a political impasse standing in the way of enactment.² In this article, we will review the major provisions of the act, with a focus on the origin of some of those provisions in the debate leading up to enactment, and on questions of interpretation that the Department of Revenue or the courts will have to resolve.

Rate Reductions

As we noted in our earlier article, the act represents a delicate compromise between those who wanted to make the Massachusetts system less vulnerable to manipulation via “aggressive” planning, and those wishing to make the system more competitive and less burdensome. A major goal of the latter group was to use some of the revenue raised by the act to reduce corporate rates, most especially the 9.5 percent rate that applies to regular business corporations, which detractors identi-

fied as the fourth highest in the nation.³ Under the act, the rate for those corporations is reduced from 9.5 percent to 8 percent over a three-year period. The rate is scheduled to be reduced to 8.75 percent for 2010, 8.25 percent for 2011, and 8 percent for 2012 and thereafter.⁴

For financial institutions, the act reduces the rate from 10.5 percent to 9 percent over the same three-year period. The rate is scheduled to be reduced to 10 percent for 2010, 9.5 percent for 2011, and 9 percent for 2012 and thereafter.⁵

The act replaces the entity-level tax rate for S corporations with a rate determined by formula. An S corporation having \$9 million or more in total receipts is subject to tax at a rate equal to the regular business corporation rate minus the so-called Part B rate — the rate that applies to most income at the individual level.⁶ An S corporation having \$6 million or more, but less than \$9 million, of total receipts is subject to tax at two-thirds of the rate for those entities having \$9 million or more of receipts. Accordingly, if the personal income tax rate remains at 5.3 percent, the 2012 rate for large S corporations (that is, those whose receipts are \$9 million or more) will be reduced from 4.5 percent to 2.7 percent.

³The DOR anticipates that the act will generate approximately \$160 million in revenue when it is in effect for a full fiscal year. This amount is net of the benefit to taxpayers of the rate cuts, which is expected to be about \$225 million annually when they have been fully phased in.

⁴G.L. c. 63, section 39, as amended by section 84 of the act.

⁵G.L. c. 63, section 2(b), as amended by section 30 of the act. Financial institutions that are S corporations with \$6 million or more of total receipts will see rate reductions based on the reductions for S corporations generally, but taking into account the fact that financial institutions are taxed at a higher rate than regular business corporations. See G.L. c. 63, section 2B, as amended by section 32 of the act.

⁶See G.L. c. 63, section 32D, as amended by section 51 of the act. The theory behind this rate structure is that the entity-level rate taken together with the rate at which tax is paid at the individual level should equal the rate applicable to C corporations.

¹When the act was debated in the Massachusetts Senate, Republican Minority Leader Richard Tisei (R) offered an amendment to have the name of the bill changed to “An Act to Promote Economic Stimulus in New Hampshire, Rhode Island and other States in the Union.”

²See Joseph X. Donovan and Sarah D. Wellings, “Combined Reporting in Massachusetts Survives Study and Actually Comes to Pass,” *State Tax Notes*, July 21, 2008, p. 139, Doc 2008-15443, or 2008 STT 141-5.

Even though the rate changes and the other major provisions of the act have not yet taken effect, skeptics already are raising the question whether the rates will be frozen at some point in the course of the phase-in periods outlined above, particularly if the Massachusetts economy continues to falter.

Check-the-Box Provisions

Under current law, Massachusetts conforms to federal characterization-of-entity rules only for limited liability companies. For other entities, Massachusetts uses a standard that makes reference, but is not limited to, the “Kintner” tests that applied for federal purposes before the check-the-box rules of reg. section 301.7701-3 were put in place.⁷

Under the act, Massachusetts will follow the federal check-the-box rules for tax years beginning on or after January 1, 2009.⁸

In pushing for adoption of federal conformity, the Patrick administration had several goals.

Simplicity

The change to conformity is viewed as a helpful simplification in the rules not only for DOR but also for taxpayers, who often have been uncertain about the Massachusetts treatment of nonmainstream entities, including entities organized outside the United States but owned by, or owning, entities doing business in Massachusetts, and offshore investment vehicles that may be at risk of Massachusetts taxation because, for example, they have a contractual relationship with an investment management service provider in Massachusetts or conduct board meetings in the state.⁹

Elimination of Hybrid Entities

Accounts in the popular press of the check-the-box legislative initiative have been somewhat misleading. They have suggested that having different rules for characterizing entities for federal tax purposes and in Massachusetts has lent itself to abuse. The real concern, of course, was that because almost all the other states conformed to the federal rules, nonconformity created opportunities to play off the rules in Massachusetts and in the other states, in a classic shell game.

In truth, taxpayers often took advantage of nonconformity to create structures designed not to reduce Massachusetts tax, but to reduce tax in the

other separate-filing jurisdictions. Thus, in Letter Ruling 99-13, a consumer products company set up a partnership that checked the box to be treated as a corporation federally and hence in most other states. The parent owned 99.9 percent of the partnership and a subsidiary owned the remaining 0.1 percent. The partnership took over the distribution function for the business. The parent developed and manufactured the company’s products and sold them to the partnership. The partnership sold them in turn to the outside world. The DOR ruled that despite the partnership’s federal character, it would be treated as a partnership for Massachusetts’s purposes. As a consequence, after the restructuring, the company’s Massachusetts tax remained almost the same, because 99.9 percent of the income and apportionment factors of the partnership rolled up to the parent.

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In the other separate-entity states following check-the-box, however, nexus over the parent presumably was cut off, because only the hybrid was doing business in those states. Because the parent held the intangibles of the business and the hybrid had only one function — distribution — that typically carries only a routine profit, the tax liability in those other states no doubt was greatly reduced.

Although that general strategy did not reduce Massachusetts taxes, it found its way into the debate over unitary combination, the other major element of the act. DOR General Counsel Kevin Brown made the point that taxpayers already had what amounted to an elective unitary system in Massachusetts, in the sense that if unitary combination would lessen the Massachusetts tax burden, they could create a hybrid structure sanctioned by Letter Ruling 99-13 so that the various entities in a group would be treated as if they were one for Massachusetts’s purposes, and yet be treated as separate corporations in other, separate-filing states.

Further, hybrid entities could be used to lower the Massachusetts tax as well. Assume, for example, a corporation with two divisions — a highly profitable one in Pennsylvania and a marginally profitable or unprofitable one in Massachusetts. The corporation might create a Delaware statutory trust subsidiary, which would be an eligible entity for purposes of the check-the-box rules, drop its Massachusetts operations into that subsidiary, and let the entity default to a disregarded entity for federal purposes and for

⁷See, e.g., Mass. Letter. Rul. 99-13 (June 24, 1999); Mass. Letter Rul. 91-2 (finding that a Delaware statutory trust was properly characterized as a foreign corporation for Massachusetts corporate excise purposes).

⁸G.L. c. 62, section 1, as amended by section 11 of the act; G.L. c. 63, section 30 as amended by section 38 of the act.

⁹See, Mass. Letter Rul. 00-5 (Mar. 20, 2000); see also, Tech. Info. Rel. 98-6 (Sept. 9, 1998).

purposes of the law in conforming states. For Massachusetts purposes, the trust probably would be treated as a corporation.¹⁰ In that case, the Massachusetts tax would be reduced or eliminated and the Pennsylvania tax would remain the same because Pennsylvania would treat the new entity as a branch of its parent.

Also, hybrid structures could be used to avoid the Massachusetts throwback rule. That could be accomplished by placing a partnership conducting business in many states below a parent corporation that, on a separate company basis, had Public Law 86-272 protection. The partnership would elect corporate status under the check-the-box rules. The parent would continue to assert protection under the federal law in other separate-filing states and hence would not file there, but for Massachusetts purposes it would claim that the partnership activities were attributed to it, and that it was therefore taxable in those states for purposes of the throwback rule.¹¹

Elimination of the Massachusetts Business Trust Regime

Massachusetts has for a long time had a special regime for Massachusetts business trusts or corporate trusts (MBTs).¹² MBTs are eligible entities for purposes of the check-the-box rules.¹³ For Massachusetts purposes, however, MBTs have been taxed under the personal income tax rather than the corporate excise statute regardless of their federal characterization, and at individual rates.¹⁴ Further, until 2003, when the “loophole” was closed, an MBT that held nothing but stock in subsidiaries and intercompany debt — commonly referred to as an “MBT HoldCo” — generally was completely exempt from tax.¹⁵ It therefore was common to have in a Massachusetts corporate group an MBT that both held operating subsidiaries and served as a finance company for the group. If the MBT sold off a subsidiary in a stock sale, it paid no Massachusetts tax, and it could lend the proceeds from the sale to operating companies in Massachusetts and elsewhere, and

take a deduction for the interest expense, but pay no tax on the interest income.

Another common use for an MBT has been as the parent holding company for a qualified subchapter S subsidiary (QSUB). Massachusetts imposes an entity-level tax on S corporations that have \$6 million or more in gross receipts, commonly referred to as the “sting tax.”¹⁶ It also treats S corporations as flow-throughs for purposes of shareholder taxation, as they are treated federally.¹⁷ In 1999 the DOR ruled that if the owners of an S corporation (OpCo) formed an MBT and contributed the shares of OpCo to it, electing to have the MBT treated as an S corporation and OpCo as a QSUB, OpCo generally would be disregarded as it would be for federal purposes, and its activities would be treated as activities of its parent MBT.¹⁸ Although the MBT would be taxed at individual rates on its own income and on the income of the QSUB, no sting tax would be due. Further, if the business operated solely in Massachusetts, the shareholders would pay no tax on distributions from the MBT.¹⁹ Accordingly, the tax on the MBT could be viewed as a substitute for the tax that was paid on a flow-through basis by the shareholders before the reorganization, and the change in structure effectively meant that the business went from two levels of tax to one. Most “large” S corporations based in Massachusetts reorganized to take advantage of the opportunity presented by the DOR’s acquiescence in this result.

That perceived loophole also was eliminated in 2003, when the law was changed to impose the sting tax on QSUBs.²⁰

The act will in effect convert all MBTs to the status that they hold federally, effective for tax years beginning on or after January 1, 2009.

With the elimination of the MBT HoldCo regime and the MBT/QSUB loophole, the DOR questioned whether there was any longer a need for retaining the special tax treatment of MBTs. The conventional wisdom, however, was that the DOR could not simply adopt check-the-box with respect to MBTs,

¹⁰See Mass. Letter Rul. 91-2.

¹¹It’s a nice question whether the other states should treat such a partnership as a flow-through rather than a separate entity for nexus purposes, notwithstanding their conformity to the federal tax fiction that it is a corporation.

¹²A corporate trust is defined as “any partnership, association or trust, the beneficial interest of which is represented by transferable shares.” G.L. c. 62, section 1(j).

¹³See Treas. reg. section 301.7701-3.

¹⁴See G.L. c. 62, section 8. For most income, the individual rate is 5.3 percent. G.L. c. 62, section 4.

¹⁵See G.L. c. 62, section 8(b), before amendment by Chapter 4, section 8 of the acts of 2003.

¹⁶See G.L. c. 63, section 32D.

¹⁷See G.L. c. 62, section 17A.

¹⁸Mass. Letter Rul. 99-17.

¹⁹See G.L. c. 62, section 8(c).

²⁰See G.L. c. 63, section 32D, as amended by Chapter 4, section 18 of the acts of 2003.

because the Massachusetts Supreme Judicial Court ruled in 1883 that it would violate the provision of the Massachusetts Constitution authorizing the legislature to impose taxes to subject a common-law entity such as an MBT to the corporate excise.²¹

The DOR's current view is that the constitutional barrier to conformity for MBTs has been overcome, in part because rights and privileges, including the right to readily convert to a corporation, have been extended by statute to MBTs,²² and because the Supreme Judicial Court has suggested that almost any entity engaged in a trade or business *ipso facto* holds a "commodity" that can be subjected to the excise under the constitution.²³

The act will in effect convert all MBTs to the status that they hold federally, effective for tax years beginning on or after January 1, 2009.²⁴ The act provides the DOR with authority to determine reasonable transition rules in case of a conversion resulting from the act, providing for the nonrecognition of gain or loss and corresponding basis adjustments as they may be appropriate.²⁵

Combined Reporting

The act makes Massachusetts the first major industrial state in recent decades to replace a separate reporting system with mandatory unitary combined reporting for a corporate tax measured by income.

Existing Combined Return Election Repealed

Under current law, when a federal consolidated return group includes multiple members over which Massachusetts has jurisdiction, those corporations subject to Massachusetts tax can elect to file a so-called combined return,²⁶ but that return is not a combined return as usually understood in state tax parlance. Rather, it calls for separate-company apportionment of income and loss, and permits apportioned current-year losses of group members to be used against apportioned income of other members.²⁷ The rules for use within the group of credits and net operating loss carryforwards are complex, and they reveal no clear underlying policy regarding

the treatment of member companies as separate or as if they were a single corporation.²⁸

When the act takes effect, for tax years beginning on or after January 1, 2009, the existing combined return provisions will be repealed in their entirety and replaced with a true unitary system.²⁹

What Is a Unitary Business?

The act defines a unitary business conventionally:

The activities of a group of 2 or more corporations under common ownership³⁰ that are sufficiently interdependent, integrated or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them or a significant flow of value between the separate parts.³¹

The definition above, though, is of limited significance, because the act goes on to state that "the term unitary business shall be construed to the broadest extent permitted under the United States Constitution."³²

Even though Massachusetts has been a separate-company state up to now, there is a considerable body of Massachusetts tax law that addresses the confines of a unitary business.³³ As controversies arise under the new law, it will be interesting to see the extent to which the Massachusetts Appellate Tax Board and the appellate courts look in their analysis to the developed law of longtime combined reporting states such as California, in addition to

²⁸See Joseph X. Donovan, "What Is Massachusetts Corporate Tax Basis?" *State Tax Notes*, Apr. 9, 2007, p. 97, *Doc 2007-5955*, or *2007 STT 69-1* (discussing basis in subsidiaries).

²⁹See section 48 of the act, substituting a new section 32B of Chapter 63 of the General Laws for the old. One consequence of adoption of the act, then, is prospectively to preclude members of a federal consolidated return group doing business in Massachusetts from netting losses against income if they are not unitary and do not choose to be so treated under the so-called federal consolidated return election discussed later in this article.

³⁰"Common ownership" exists when there is more than 50 percent direct or indirect voting control. G.L. c. 63, section 32B(b)(2).

³¹G.L. c. 63, section 32B(b)(1). That definition borrows from the model unitary business regulations adopted by the Multistate Tax Commission. See MTC Reg. IV.1.(b).

³²G.L. c. 63, section 32B(b)(1).

³³See, e.g., *W.R. Grace & Co. v. Comm'r of Revenue*, 378 Mass. 577 (1979), abrogation recognized by *W.R. Grace & Co. — Conn. v. Comm'r of Revenue*, Mass. App. Tax. Bd. Docket No. F23986 (Nov. 19, 1999); *W.R. Grace & Co. — Conn. v. Comm'r of Revenue*, 790 N.E.2d 1110 (Mass. App. Ct. July 2, 2003); *General Mills, Inc. v. Comm'r of Revenue*, Mass. App. Tax. Bd. Docket No. F223398 (June 29, 2001); *Central-National Gottesman, Inc. v. Comm'r of Revenue*, Mass. App. Tax. Bd. Docket No. F232651 (Sept. 4, 1998); 830 CMR. 63.38.1; 830 CMR 62.17A.1; Tech. Info. Rel. 04-22; Tech. Info. Rel. 92-5.

²¹See *Gleason v. McKay*, 134 Mass. 419 (1883).

²²See G.L. c. 156D section 9.50, added by Chapter 127, section 17 of the acts of 2003. See also, section 1.40 of Chapter 156D.

²³See Opinion of the Justices, 408 Mass. 1201 (1990).

²⁴G.L. c. 62, section 1, as amended by section 11 of the act; G.L. c. 63, section 30, as amended by section 38 of the act. Note that "savings provisions" in sections 86 and 87 of the act will, in the event that the imposition of the excise is found to be unconstitutional, reinstate the preact regime.

²⁵See section 96 of the act.

²⁶See G.L. c. 63, section 32B.

²⁷*Id.*

the more familiar unitary cases that have been decided in the U.S. Supreme Court.

Definition of the Water's-Edge Group; Election to File on a Worldwide Basis

Corporations subject to combination include financial institutions, so-called regular business corporations, S corporations, and utility corporations.³⁴ Real estate investment trusts and regulated investment companies are specifically included,³⁵ and insurance companies generally are excluded.³⁶ Massachusetts security corporations and not-for-profit corporations likewise are excluded from the group.³⁷ A few of the issues raised by that list of combinable and noncombinable entities include the following:

- Inclusion in the same group of entities that are subject to differing apportionment regimes³⁸ complicates the mechanics of the unitary tax computation. That issue is explored further below.
- It seems clear that C corporations and S corporations that are tied together only via common individual ownership will be combined, but the statute gives no guidance on how that will be accomplished or on whether it may have an effect on the amount of income that will be taxed to a nonresident shareholder of an S corporation.
- Some have questioned the fairness of excluding Massachusetts security corporations — the passive investment vehicle favored under Massachusetts law — but including those, such as Rhode Island passive investment companies, favored by sister states.
- The inclusion of REITs and RICs seems intended as a tool to attack so-called captive REITs and RICs, but in the case of REITs, at least, it raises a risk of unintended consequences for noncaptive structures. For example, a public REIT in Massachusetts might own a taxable REIT subsidiary in another state. If the REIT is included with the subsidiary in a combined return, then the activities of the public REIT, which generally pays no tax itself because it is entitled to a dividends-paid deduction,³⁹ will draw the income of the taxable REIT subsidiary into Massachusetts.

³⁴G.L. c. 63, section 32B(c)(1).

³⁵*Id.*

³⁶G.L. c. 63, section 32B(c)(2).

³⁷*Id.*

³⁸Regular business corporations, financial institutions, and utilities use different apportionment formulas. G.L. c. 63, sections 2A, 38, and 52A(3). Also, within the category of regular business corporations, manufacturers and mutual fund service corporations are entitled to use single sales factor apportionment. G.L. c. 63, section 38 (l), (m).

³⁹See IRC sections 561, 857(b)(2)(B); G.L. 63, section 30(4).

The Massachusetts combined return group generally is defined on a water's-edge basis. Among those corporations that are "combinable" in accordance with the rules above, it includes:

- any member incorporated in the United States or formed under the laws of the United States, any state, the District of Columbia, or any territory or possession of the United States;⁴⁰
- any member, regardless of its place of organization, if the average of its property, payroll, and sales factors in the United States is 20 percent or more ("foreign 80/20 corporations"); and
- any member that earns more than 20 percent of its income, directly or indirectly, from intangible property or service-related activities the costs of which generally are deductible for federal income tax purposes against the business income of the other members of the group, but only to the extent of that income and the apportionment factors related to it.⁴¹

The definition of the water's-edge group represents a compromise between more expansive and more restrictive definitions embodied in the Senate and House versions of the proposal that led to the act, respectively. The Senate version would have given the DOR discretion to add some other foreign corporations to the group; the House version would have excluded from the group domestic 80/20 corporations, that is, U.S. corporations whose average of property, payroll, and sales factors within the United States were less than 20 percent.

Although the default in the Massachusetts unitary system will be a water's-edge group, taxpayers will be permitted to elect to be taxed on a worldwide basis.⁴² The election must be made on a timely filed, original return, and is binding for 10 years.⁴³

Federal Consolidated Return Group Election

One of the objections to combined reporting voiced early and often in the debate over the proposal was the inherent softness of the definition of a unitary business, a softness that cannot be cured by statute

⁴⁰Thus, corporations organized in Puerto Rico, for example, are part of the water's-edge group.

⁴¹G.L. c. 63, section 32B(c)(3). It is not clear what it means, in the case of corporations includable because of the last bulleted rule, to include them "only to the extent of that income and the apportionment factors related thereto." In a combined return, intercompany transactions are eliminated both for purposes of computing income and for purposes of determining apportionment factors. The income and factors referenced are by definition intercompany, so it would appear that they would not be included. Query whether the real impact of that provision is merely to disallow a deduction in Massachusetts for payments made to the foreign corporation for intangibles or services.

⁴²G.L. c. 63, section 32B(c)(3).

⁴³*Id.*

because the commerce clause of the U.S. Constitution constrains the definition. Critics of the proposal pointed out that public companies in particular would struggle with determining financial statement exposure in undertaking the analysis required under FIN 48. Largely in response to that criticism, a special election was added to the proposal, permitting taxpayers to have the group correspond generally to the federal consolidated return group, but with important exceptions. First, all corporations are included if they are organized in the United States or under the law of any state, the District of Columbia, or any territory or possession of the United States, that are commonly owned, directly or indirectly, by any member of the federal affiliated group.⁴⁴ For that purpose, a more than 50 percent voting control test is substituted for the 80 percent test for determining membership in a federal consolidated return group.⁴⁵ Further, foreign 80/20 corporations, and corporations earning more than 20 percent of their income from intercompany payments for intangibles or services as identified in the third bullet above, are included in the group as well.⁴⁶

One of the objections to combined reporting was the inherent softness of the definition of a unitary business, a softness that cannot be cured by statute.

The federal consolidated return election, like the worldwide election, must be made on an original, timely filed return, and it is also binding for 10 years.⁴⁷ After the election has been in effect for 10 years, a taxpayer may revoke it or extend it for another 10 years without the consent of the DOR, but if it is revoked, a taxpayer may not make a new election in any of the three years immediately following.⁴⁸ Any corporation that comes into the group while the election is in effect is deemed to have elected to be combined.⁴⁹

If a corporation makes the federal consolidated return election, it must apportion all of its income, even if otherwise it would have a constitutional right to treat the income as nonapportionable.⁵⁰

⁴⁴G.L. c. 63, section 32B(g).

⁴⁵*Id.*

⁴⁶*Id.*

⁴⁷*Id.*

⁴⁸*Id.*

⁴⁹*Id.*

⁵⁰*Id.*

The Mechanics of the Unitary Computation

In the controversy over the unitary proposal, critics attempted to derail it on the grounds that before blessing combination, it was necessary to understand in great detail how it would be implemented by the DOR, and that the proposal did not contain enough specificity regarding the mechanics of apportionment to support an informed vote. Some of the complaints either were disingenuous or reflected a naïve view of the respective roles of the legislature and the agency charged with administration of a tax. For example, business lobbying groups and their legislative allies suggested it was dangerous per se to have tax laws interpreted by “unelected officials,” as if the tens of thousands of pages of regulations and other pronouncements of the Internal Revenue Service were somehow all *ultra vires*.⁵¹

As we noted in our earlier article, complaints of that sort were voiced throughout the deliberations of the Tax Study Commission. Late in those deliberations, the DOR sought to blunt the criticism by circulating examples intended to show how unitary apportionment might work in Massachusetts, in light of the multiple apportionment regimes in effect for various categories of corporations.⁵² In a nutshell, the examples used a common base of combined income, and each constituent company computed its numerator(s) in accordance with the rules applicable to it. Accordingly, a financial institution would include intangibles in the numerator of its property factor, for example, but a regular business corporation would not.⁵³ To ensure consistency between numerators and denominators, each corporation determined its denominator(s) by pretending that all other companies in the group were subject to the regime that applied to it. Therefore, the financial institution would include in the denominator of its property factor loans held by all members of the group, for example, regardless of whether they were themselves financial institutions.

⁵¹In fairness to the critics, the DOR, compared with other states’ taxing agencies, has a not entirely undeserved reputation for the adoption of harsh administrative positions. *See*, most notably among public written statements issued in the recent past, Tech. Info. Rel. 08-4 — Limitations Period for Certain Corporations and Financial Institutions Failing to File Tax Returns.

⁵²*See* footnote 38. The examples are reproduced in Appendix T of the Report of the Tax Study Commission, available at <http://www.mass.gov/Ador/docs/dor/Publ/PDFS/Study%20Commission%20on%20Corporate%20Taxation%20-%20Final%20Report.pdf>. The DOR emphasized that the examples were intended to generate discussion, and were not to be viewed as necessarily reflecting how the agency ultimately would approach the mechanics of the computation.

⁵³Report of the Tax Study Commission, Appendix T, Example 1.

In the debate that followed in the legislature, some lobbyists for business interests pressed a different view — that all of the constituent companies should use a common denominator representing the sum of the denominators of all of the companies, each computed according to the rules applicable to it, but the numerators should include only the amounts required under the regime applicable to the particular company. Thus, if a group included both regular business corporations and financial institutions, the regular business corporations would include only tangible property in the numerator of the property factor, but would be permitted to include the loans of the financial institution in their property factor denominators.

The legislators charged with sorting out the merits of the apportionment approaches that were set before them of course were helpless to do so, and ended up doing what legislators often do when faced with theoretically irreconcilable methods — writing a little bit of both methods into the law in the spirit of political compromise.

In the end, the act specified the following approach to apportionment:

- each member of the group over which Massachusetts has jurisdiction generally uses the formula applicable to it; accordingly, a corporation entitled to use single-sales-factor apportionment will so compute its income in the combined return;
- each member of the group over which Massachusetts has jurisdiction generally computes its numerator according to the regime separately applicable to it;
- each member of the group also generally computes its separate denominators according to the rules applicable to it, and the total denominator used by each member generally is the sum of all such separate denominators (including, of course, the denominators of members that are not subject to Massachusetts tax jurisdiction);
- the property and payroll denominators of companies that are subject to single-sales-factor apportionment are included in the denominators of companies that use three-factor apportionment; and
- if a combined group includes financial institutions and other corporations, (1) only 20 percent of the intangible property of the financial institutions is included in the total property factor denominator used by the group; (2) interest on loans and other receipts that are includible for financial institutions but not for other corporations are nevertheless counted for all corporations before the individual denominators are added to create the overall denominators; and

(3) the numerators of constituent companies are adjusted in accordance with the rules in (1) and (2).⁵⁴

These rules can lead to some anomalous results. Aside from the distortion that can be a consequence of inclusion of large financial institution factors in the denominators, but not the numerators, of regular business corporations, consider the following scenario:

Unitary Group includes two corporations — Corp A and Corp B — with apportionment factors that are limited to Massachusetts but each of which has a right to apportion its income. Corp A is a manufacturing corporation entitled to use a single-sales-factor approach. Corp B is a service company that uses the usual Massachusetts three-factor formula, with the sales factor double-weighted. The income of the group is \$1,000.

The property, payroll, and sales factors of Corp A are all 20/20. The property, payroll and sales factors of Corp B are 100/100, 100/100 and 1,000/1,000, respectively. Of the \$1,000 of total income, 20/1020 or 2 percent will be attributed to Corp A, and 90.66 percent (100/120 plus 100/120 plus 1,000/1,020 plus 1,000/1,020 divided by 4) will be attributed to Corp B. Accordingly, \$73 of the \$1,000 will be sourced nowhere, even though all of the group's activity takes place in Massachusetts!⁵⁵

Finnigan, Not Joyce

The act adopts a *Finnigan* approach to sales factor inclusion, as opposed to the more common *Joyce* rule. That is, Massachusetts-destination sales of nontaxable members of the unitary group are included in the Massachusetts numerator or numerators of the member or members that *are* subject to tax, and sales made into a state where a member is not subject to tax will not be thrown back to Massachusetts if another member of the group *is* subject to tax in that state.⁵⁶ Based on the deliberations of the Tax Study Commission, it appears that this approach was taken because it tends to reduce the tax of Massachusetts-based corporations at the expense of out-of-state corporations.

The act specifies that sales into Massachusetts of nontaxable members are included in the numerators of taxable members in proportion to the relative Massachusetts separate-company sales of those taxable members.⁵⁷

⁵⁴G.L. c. 63, section 32B(d)(2).

⁵⁵On other facts, more than 100 percent of the group's income could be sourced to Massachusetts.

⁵⁶See G.L. c. 63, section 32B(d)(2)(ii), (iv).

⁵⁷G.L. c. 63, section 32B(d)(2)(iv).

Deferred Tax Liability Deduction

When the proposal was pending, some public companies and business lobbying groups supporting them argued that the adoption of combined reporting could adversely affect their market value because financial statement reserves for deferred tax liabilities would have to be adjusted upward in the quarter after its adoption.⁵⁸ To accommodate them, the legislature included in the act a highly unusual deduction, designed to exactly offset any such financial statement detriment, so that it won't have to be booked at all.⁵⁹

The deduction will be taken over a seven-year period, beginning with the tax year of the combined group that begins in 2012.⁶⁰ The deduction will be limited by its terms to public companies,⁶¹ which may raise issues of constitutionality under the equal protection clause of the U.S. Constitution and its Massachusetts constitutional equivalent. Companies expecting to take the deduction will be required to report to the DOR by July 1, 2009, the amount of the deduction they intend to take.

Other Provisions

The act states that, as is customary, intercompany eliminations will be made in computing income and apportionment factors, "under rules analogous to those under section 1502 of the Code."⁶² It also calls for the adoption of regulations that will explain the application of credits and net operating losses in a unitary context.⁶³

Expanded Nexus for Purposes of the Massachusetts 'Balance-Sheet Tax'

P.L. 86-272 provides that a corporation need not file a corporate income tax return in a state where the corporation merely solicits sales of tangible personal property in that state and where orders are approved outside the state, and when the goods are shipped into the state from an out-of-state location. The Massachusetts tax on regular business corporations includes both an income measure and a non-income or "balance-sheet" measure.⁶⁴ The DOR has historically held that P.L. 86-272 protection extends to the balance-sheet tax. The new act provides, however, that corporations protected from the income measure of the corporate excise by P.L. 86-272 may nevertheless be subject to the greater of the

nonincome measure or the minimum tax of \$456 if they merely solicit sales of tangible personal property in Massachusetts.

Corporate Basis

The act permits and requires a corporation to depart from the federal tax basis of its assets when necessary to adjust for differences between the federal and Massachusetts treatment of the asset.⁶⁵ For example, the bonus depreciation allowed under IRC section 168 is not allowed under Massachusetts law.⁶⁶ Accordingly, when an asset for which bonus depreciation was taken is sold, typically the asset will have a higher Massachusetts than federal basis and the Massachusetts gain will be less than the federal gain.⁶⁷

The basis adjustment provision seems intended in part to permit the DOR ultimately to capture untaxed earnings of former MBT HoldCos via a reduced basis in the stock of those HoldCos or their successor entities.⁶⁸ It is far from clear how that recapture regime will work in practice.

Exclusion of Sales of Goodwill From the Sales Factor

The act amends the definition of sales for purposes of determining the sales factor of the apportionment formula to exclude dispositions of "goodwill," "going concern value," "workforce in place," and similar intangible values on the sale or deemed sale of a business.⁶⁹ Depending on where the goodwill component is sourced, that exclusion could significantly increase or decrease the Massachusetts tax liability, because goodwill value often constitutes the largest component of the sale of a business. Currently, sales of intangible property such as goodwill are sourced to the state of the seller's commercial domicile.⁷⁰ For multistate companies based in Massachusetts, this new rule will generally reduce the amount of gain on disposition of a business that is sourced to Massachusetts, compared with the result under previous law.

Commissions and Studies

As our earlier article noted, the act creates a special commission, made up entirely of state legislators and their designees, to review the corporate

⁵⁸Companies with large book/tax differences in the value of their intangibles were especially concerned about that effect.

⁵⁹See section 95 of the act.

⁶⁰*Id.*

⁶¹*Id.*

⁶²G.L. c. 63, section 32B(d)(2)(v), (f).

⁶³*Id.*

⁶⁴G.L. c. 63, sections 32 and 29.

⁶⁵G.L. c. 63, section 31M.

⁶⁶G.L. c. 63, section 30(4)(iv).

⁶⁷That specific result already was authorized by the DOR. See Tech. Info. Rel. 02-11; Tech. Info. Rel. 03-25. See the general discussion of this issue in Donovan, *supra* note 28, at p. 97.

⁶⁸See G.L. c. 63, section 31M.

⁶⁹G.L. c. 63, section 38(f), as amended by section 60 of the act; see also G.L. c. 63, section 32B, as amended by section 48 of the act.

⁷⁰830 CMR section 63.38.1(9)(d)(3)(d).

tax laws of the state and report back to the legislature with recommendations by March 31, 2009.⁷¹ The new commission is charged with reviewing the appropriateness of the use in the state of a single-sales-factor formula for apportioning the income of manufacturing corporations and mutual fund service corporations.⁷²

The act also requires that the DOR investigate bringing the state into full compliance with the Streamlined Sales and Use Tax Agreement. Currently, Massachusetts is not a full member of SSUTA and therefore is not required to adopt SSUTA's sales and use tax provisions. In contemplation of the state becoming a full member and adopting SSUTA's provisions, the DOR is required to prepare a feasibility

study and a draft of legislation amending the state's current laws as necessary to bring Massachusetts into compliance with SSUTA. The study and draft legislation must be sent to the legislature by December 1, 2008.

What Lies Ahead?

The DOR and its constituent taxpayers face a daunting task in adjusting to the new tax world created by the act in the few months remaining before its implementation at the turn of the year. We can expect that there will be a series of draft releases issued by the DOR between now and then that attempt to clarify its interpretation of the act. It behooves the community of businesses and practitioners who are wrestling with the new rules to make their concerns known as soon as possible, and to make comments on the draft releases as they are issued, so that they can be heard in the rush to be ready for myriad changes on January 1, 2009. ☆

⁷¹Section 100 of the act.

⁷²*Id.*