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What Is the Corporate Tax Basis In Massachusetts?

by Joseph X. Donovan

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Massachusetts has imposed an income-based tax on corporations since 1920, when an income measure was added to the tax then levied on "corporate excess."[1] Eighty-seven years later, major uncertainties remain in the rules for determining the basis of assets held by corporations. Those uncertainties are greatest for chains of corporations that are members of a federal consolidated return group. Nevertheless, few businesses that anticipate significant gains from disposition of the stock of subsidiaries, or of other assets for that matter, analyze the potential effect that a difference in basis would make.

The Statutory Framework Under the Personal Income Tax

It's useful to compare the Massachusetts personal income tax and corporate excise statutes regarding basis. Section 6F of Chapter 62 of the General Laws, the chapter that governs the taxation of individuals as well as partnerships, estates, and trusts, defines Massachusetts initial basis as corresponding to federal initial basis, with some exceptions. It provides that in making adjustments to initial basis:

> (c)(2) There shall be disregarded any federal adjustment resulting from provisions of the [Internal Revenue] Code that were not applicable in determining Massachusetts gross income at the time such federal adjustments were made, and (3) adjustments shall be made for any item which was applicable in determining Massachusetts gross income but which was not so applicable in determining federal gross income and for which a federal adjustment would be allowed under the provisions of the Code if the item had been applicable in determining federal gross income.

An example of the application of that provision is the determination of gain or loss on the disposition of partnership or sole proprietorship property regarding which so-called bonus depreciation was taken under IRC section 168(k). Massachusetts decouples from the federal bonus depreciation rules for individuals and corporations.[2] When a partnership or proprietorship sells such property, because the bonus depreciation provisions "were not applicable in determining Massachusetts gross income" at the time that they reduced federal basis, they are ignored for purposes of determining Massachusetts gain or loss on disposition.[3] That is, of course, the right result. Adjustments to basis made to reflect depreciation are intended to prevent taxpayers from deriving a double benefit from the economic exhaustion of a capital asset over its useful life — once through depreciation and then again on disposition. If Massachusetts does not allow bonus depreciation, no downward adjustment to basis is justified because no Massachusetts benefit was derived from the bonus depreciation. We might characterize section 6F of Chapter 62 as a broad-brush provision intended to align Massachusetts basis for personal income tax purposes with the correct tax result.

The Corporate Excise Framework

The corporate excise statute in Massachusetts, Chapter 63 of the General Laws, does not include any provision that parallels section 6F; it is silent on the question of Massachusetts basis. One might think, then, that insofar as Massachusetts employs federal gross income and deductions as the starting

[1]*See* Philip Nichols, *Taxation in Massachusetts*, Boston Financial Publishing Co., 1938, p. 581; Jacobs, Goloboy & Politi, *Massachusetts Taxation: the Law and the Lore*, Little Brown and Co., 1982, p. 49.

[2]M.G.L. c. 62, sections 1(c), 2(d)(1)(N); M.G.L. Chapter 63, section 30(4)(iv); *see* TIR 02-11.

[3]TIR 03-25.

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point for calculating Massachusetts corporate income,[4] both taxpayers and the commonwealth should be required in all cases to equate Massachusetts and federal gain or loss on disposition.[5] But that equivalence does not hold true in every case. For example, the Massachusetts Department of Revenue permits corporate taxpayers that have taken bonus depreciation to make the same adjustments to basis on disposition as would be made by a taxpayer governed by Chapter 62, the personal income tax statute. Technical Information Release 03-25 makes that clear: "For purposes of both the corporate excise and the personal income tax, upon disposition of depreciated property, any gain or loss must be calculated using the depreciation allowed under the Massachusetts method cited above" (which method does not take into account the federal bonus depreciation rules). What we don't know after the issuance of TIR 03-25 is the legal principle that allows the department to reach that result.

One possible answer to that question is that the department has concluded that its general administrative authority is broad enough to permit it to treat questions of corporate basis as it would treat them if Chapter 63 contained a broad-brush basis provision, just as Chapter 62 does. Some support for that position can be found in a recently decided Appellate Tax Board decision, *SAHI USA, Inc. v. Commissioner of Revenue*.[6] There the corporate taxpayer was the successor-in-interest to a corporation that was a partner in a partnership — Meridien Boston Group (MBG) — that in turn held a partnership interest in Oliver Street Associates (OSA), a partnership that owned and operated a downtown Boston hotel. In 1995 MBG sold its entire interest in OSA for a substantial gain. SAHI filed a Massachusetts tax return for 1995 paying only the minimum tax, arguing that the gain that flowed through to it from MBG was attributable in large part to adjustments to basis that arose from depreciation deductions for which it had received no Massachusetts benefit in the years during which the hotel was operated, because the partnership had operated at a loss throughout its history and SAHI had had no other sources of Massachusetts income against which to use the losses currently. In rejecting that contention, the board cited section 6F of Chapter 62 for the proposition that "[b]asis adjustments determined in accordance with the Code are applicable to the Massachusetts basis of property" even though Chapter 63, not Chapter 62, technically controlled the analysis. The board also cited *Treat v. Commissioner*,[7] a personal income tax case in which the Massachusetts Appeals Court relied on section 6F as support for the proposition that a widow who had owned property by the entirety with her husband and who on his death came to own it in fee simple had a lower basis in the property for Massachusetts income tax purposes than for federal income tax purposes.

The Role of the 'Phantom Income' Concept

Suppose that the department concludes on its own, or that the courts force it to conclude, that in the absence of an express basis adjustment provision in Chapter 63, Massachusetts corporate gain or loss generally is the same as federal gain or loss. In that case, might the conclusion reached in TIR 03-25 regarding adjusting corporate basis for bonus depreciation nevertheless be correct? An alternative rationale for the conclusion is at least plausible. That rationale would be that the department must concede that taxpayers have the right to make adjustments to federal gain or loss on disposition *that favor them* when principle calls for those adjustments, but the department has no such right. That one-way street approach to nonconformity to federal basis would find its justification in the prohibition in Massachusetts, having its origins in article 44 of the Massachusetts Constitution, against the taxation of so-called phantom income; that is, of ostensible income that does not represent a real accretion in wealth.

Article 44 is the provision that authorizes the imposition in Massachusetts of income taxes and excises generally. It provides:

> Full power and authority are hereby given and granted to the general court to impose and levy a tax on income in the manner hereinafter provided. . . This article shall not be construed to limit the power of the general court to impose and levy reasonable duties and excises.

[4] *See* M.G.L. Chapter 63, section 30(3), (4).

[5] It's instructive on that point to recall that Massachusetts had in effect for many years a personal income tax basis adjustment provision that was set forth in section 7 of Chapter 62, but was repealed, effective January 1, 1980. Chapter 409, Acts of 1979. The Department of Revenue ruled on the repeal of that provision that the Massachusetts basis of property held on December 31, 1979, and sold or exchanged thereafter was simply the federal adjusted basis of the property. Letter Ruling 80-63. In August 1981 Congress enacted the more generous depreciation rules of the accelerated cost recovery system as part of the Economic Recovery Tax Act of 1981, effective for property placed in service after 1980. Massachusetts picked up that new regime for personal income tax purposes only for tax years beginning on or after January 1, 1983, when the IRC reference date for those purposes was changed from November 6, 1978, to February 1, 1983. Chapter 233, section 11, Acts of 1983. Accordingly, the effect of Letter Ruling 80-63, in the case of property placed in service on or after January 1, 1981, but disposed of on or after January 1, 1983, was to require taxpayers to pay Massachusetts tax on gain derived from depreciation deductions that they were not allowed to take in Massachusetts.

[6] ATB Dkt. No. C262668 (2006).

[7] 52 Mass. App. 208 (2001).

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Article 44 has been interpreted to mean, roughly, that if a taxpayer does not have income that is real, then it can't be taxed.[8] An early and leading example of the application of this principle is *Brown v. Commissioner of Corporations & Taxation.*[9] The taxpayer in *Brown* purchased stock at various times between 1868 and 1904 for an aggregate price of $4,600. On January 1, 1916, a 3 percent Massachusetts tax on capital gains took effect. On that day the value of the stock was $1,470. The taxpayer sold the stock in 1920 for $4,996.32. Despite a provision in the new law that set the basis at the value on the effective date, the court held that the taxable gain was limited to the difference between what the taxpayer paid for the stock and the amount realized, or $396.32:

> "Income" . . . expresses a comprehensive idea. It is to be given a broad meaning [but it] must be rationally construed and not stretched to include purely theoretical as distinguished from practical conceptions. Income as a subject of taxation imports an actual gain. It must mean an increase of wealth out of which money may be taken to satisfy the pecuniary imposition laid for the support of the government.[10]

A more modern application of the same principle can be found in *Weston Marketing Corp. v. Commissioner of Revenue.*[11] There the taxpayer, a subchapter S corporation, had applied to commodity futures contracts the mark-to-market rules of IRC section 1256 for federal tax purposes. Those rules required it to pretend each year that it had sold the contracts for their fair market value on December 31. Thus, in 1981 it reported a loss for federal purposes regarding the contracts it held because they had declined in value during the applicable measurement period ending on December 31, 1981. In 1982, when it sold the contracts, the taxpayer was required under section 1256 to add to its federal income the loss that it had taken in the prior year. That rule prevented Weston Marketing from reaping a double benefit from the 1981 decline in value.

For Massachusetts purposes, the taxpayer did not apply the mark-to-market rules in computing its corporate excise for 1981, arguing that they did not apply in that year.[12] In 1982 it did not recapture the 1981 section 1256 loss, and it argued that this amount did not represent a "real gain." The board agreed, and the Massachusetts Appeals Court upheld its decision.

Another leading case in which the concept of phantom income, or at least avoidance of double taxation, was successfully invoked to justify decoupling from federal gain is *Rohrbough, Inc. v. Commissioner of Revenue.*[13] In *Rohrbough*, an individual sold real estate in exchange for a note and elected installment sale treatment under the code. By so electing, he was able to defer recognition of income on the sale to the extent that, and for so long as, the note was not paid. For Massachusetts personal income tax purposes, he elected to trigger recognition of income in the year of sale and to pay the entire tax in that year. He later contributed the note to Rohrbough Inc., a corporation, in an IRC section 351 transaction. For federal tax purposes, subsequently recognized income on the installment transaction fell to the corporation. Massachusetts law included no provision for corporate excise purposes decoupling from federal installment sale treatment. The DOR held that the gain taxed to the corporation federally should be taxed a second time in Massachusetts. The board and the Supreme Judicial Court rejected that result on the grounds that it represented an overly expansive interpretation of the concept of "income."

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[8]It might be asked whether this principle should be applied at all in a Massachusetts corporate context, because the Massachusetts corporate excise is not a direct tax on income but a franchise tax based in part on income. *See Boston Safe Deposit & Trust Co. v. Commissioner of Revenue*, ATB Dkt. No. 146956 (1988), *aff'd* 406 Mass. 195, 547 N.E. 2d 909 (1989). The Supreme Judicial Court appears to have disposed of this argument in *Parker Affiliated Cos., Inc. v. Department of Revenue*, 382 Mass. 256, 415 N.E. 2d 825 (1981), at n. 16, reasoning that the article 44 authorization to impose "reasonable" excises incorporates like constraints to those applying to a direct income tax on the boundaries of "income" for purposes of the income measure of the excise.

[9]242 Mass. 242, 136 N.E. 188 (1922).

[10]*Id.* at 244 (citation omitted).

[11]ATB Dkt. No. 161893 (1994), *aff'd*, 40 Mass. App. 1108, 662 N.E. 2d 249 (1996).

[12]The board accepted that premise. It stated the question before it as follows: "Whether a Subchapter S corporation which has taken capital losses on its federal return under the mark-to-market rules of IRC section 1256, but did not and could not take them on its Massachusetts corporation excise return, must recapture them on its Massachusetts return in a later year merely because it recaptures them on its federal return for the later year." The board went on to say that "[t]he Code in effect in Massachusetts for 1982 was as amended on November 6, 1978, before the enactment of IRC §1256." In fact, the premise is incorrect, and indeed *Weston Marketing* was wrongly decided because of the faulty premise. As the board acknowledged, subchapter S corporations were taxed for the years in question as C corporations under Chapter 63 of the General Laws. *See* TIR 84-4. The governing cross-references to the Internal Revenue Code for purposes of Chapter 63 were then, as they are now, to the code "as amended and in effect for the taxable year." G.L. c. 63, s. 30 (3), (4). Accordingly, the taxpayer should have applied the section 1256 rules in computing its Massachusetts excise for 1981. *Compare Tobins v. Commissioner of Revenue*, ATB Dkt. No. 159730 (1994), involving the mark-to-market rules as applied to the owner of Weston Marketing in his individual capacity.

[13]385 Mass. 830, 434 N.E. 2d 211 (1982).

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When the board and the courts have retreated from application of the phantom income doctrine, they have sometimes done so out of concern that the doctrine not circumvent restrictions on the reach of net operating loss carryforward and tax benefit rules in Massachusetts.

For example, in *Insoft v. Commissioner of Revenue*,[14] the taxpayer was a Florida resident who invested in a partnership that owned a number of Massachusetts apartments. The initial basis of the partnership in the properties was about $7.775 million. Over time it took depreciation deductions of about $6.4 million. (The properties were subject to generous depreciation rules because they comprised low- and moderate-income housing.) At sale in 1988, the properties had a basis of $1.375 million. The consideration paid for them was, but for one dollar, entirely in the form of assumed liabilities of about $6.2 million. Accordingly, the partnership realized a gain of about $4.825 million on sale.

For federal tax purposes, the taxpayer used his share of the losses flowing out of the partnership to offset income from his medical practice. Because he had no Massachusetts-source income until the properties were sold, he received no benefit from the depreciation deductions in Massachusetts. (Because Florida has no income tax, presumably he received no state tax benefit for them anywhere.) He argued that in the absence of such a benefit he should not be taxed by Massachusetts on the gain that he reported federally. The board rejected that argument. It said first that it appeared that Massachusetts adopted all of the federal depreciation provisions that had applied to the partnership federally. It then parsed subsection (c)(2) of section 6F, calling for the disregard of any federal adjustment resulting from provisions of the IRC that were "not applicable in determining Massachusetts gross income," and it concluded that the depreciation provisions were "applicable," even though they did not give rise to a Massachusetts tax benefit.[15] The board said that, for federal tax purposes, basis must be reduced in the amount of allowable depreciation, regardless of whether the depreciation is ever used to reduce income, citing *Virginian Hotel Co. v. Helvering*, 319 U.S. 523 (1943) and *United States v. Hill*, 506 U.S. 546 (1993). The board implied that basis reduction in such circumstances is the correct economic result:

> Appellant's position misapprehends the purpose for adjustments to basis to take account of depreciation. Reductions in the cost basis of depreciable property over time in accordance with prescribed depreciation schedules reflect the loss of value that comes from "exhaustion, wear and tear, [and] obsolescence" of an asset with a finite useful life. See I.R.C §1016 (a)(2)(A). Deductions are extended because some erosion of fair market value is deemed to occur over the life of the asset.

(Footnote omitted.[16])

Finally, the board found a way to distinguish Insoft's complaint from that raised and cured by invocation of the phantom income doctrine in *Weston Marketing*. There, the board said,[17] federal and Massachusetts law diverged in years before the disposition event; as a consequence, the items of federal income in that year were "patently artificial considered apart from the purpose of 'recapturing' past tax benefits." In *Insoft*, by contrast, "there was congruence in the applicability of relevant federal and state tax provisions in prior years."

Although the board did not articulate its reasoning in those terms, the *Insoft* result perhaps can be explained in part as motivated by a reluctance to create a de facto NOL carryforward in Massachusetts for nonresidents who invest in Massachusetts businesses. Since Massachusetts does not allow NOL carryforward deductions for individuals generally, a retired Massachusetts resident, for example, who invested in the same partnership as Insoft and had no sources of income other than the partnership, would have been subject to the same result. It is difficult to argue that a nonresident like Insoft should be better postured than that person. Further, although Insoft reaped no state benefit at all from the partnership losses, he likely would have done so

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[14]ATB Dkt. No. 215079 (1998).

[15]It's not clear why subsection (c)(2) even came into play on the facts presented. Subsection (d) of section 6F then provided, as it does now, that "[t]he rules prescribed in this section shall apply to non-residents; except that if any nonresident has owned any items of property during a period when the income or gains from such items were not subject to taxation under this chapter, and if the income or gains from such items subsequently became or become subject to taxation under this chapter, then the special limitations of subparagraphs (2) to (4), inclusive, of paragraph (c) of this section shall not apply as to such period."

[16]While it's often said, as noted above, that basis reductions for depreciation are justified by the need to preclude a double tax benefit from arising from exhaustion of a capital asset, and the taxpayer in *Insoft* reaped no such double benefit, the board's analysis makes some sense. After all, financial accounting principles, which have nothing per se to do with tax benefits or detriments, require the depreciation of capital assets and concomitant basis reductions so as to give an accurate picture of the earnings of a business. If, for example, a publisher's printing press is purchased for $100,000, depreciated for financial accounting purposes down to $20,000, and sold for its adjusted basis, generating no financial accounting gain or loss, this accounting convention appropriately matches the erosion in value of the machine over time to the period during which it generated income for the business, rather than showing that erosion as a loss at the time of disposition of the asset.

[17]Incorrectly, as it turns out; *see* note 12.

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had he lived in a state with a personal income tax, where the losses normally would have offset his professional income as they did federally. It would be asking a lot of Massachusetts to expect it to tailor its treatment of the gain on disposition of the properties to the treatment of the depreciation-related losses in the taxpayer's state of residence.

The most recent pronouncement of the Massachusetts Supreme Judicial Court on the subject of phantom income was in 2000, in *Bill DeLuca Enterprises, Inc. v. Commissioner of Revenue*.[18] The corporate taxpayer in *DeLuca* had purchased and depreciated a number of vehicles in years before 1989. The depreciation deductions, as well as others, put the corporation in a loss position for those years. When the corporation sold the vehicles in 1989, it had taxable income and was able for federal tax purposes to absorb some of the income with NOL carryforwards from the earlier years. Because there was no general NOL carryforward provision in Massachusetts in 1989, DeLuca could not do the same for state purposes. However, the corporation argued that the tax benefit rule of IRC section 111 and article 44 itself permitted it to reduce its gain on disposition of the vehicles by the amount of the depreciation for which it had received no Massachusetts benefit. The court disagreed.

The court said that the statutory benefit rule had been "consistently interpreted to exclude from its scope deductions taken for depreciation."[19] On the question why such deductions are excluded, the court stated:

> Excluding depreciation deductions from tax benefit treatment under Section 111(a) provides a sensible interpretation of the statute in light of the fact that Congress intended accelerated depreciation to serve as a tax benefit in and of itself. . . . Taking into account the time value of money, accelerated deductions reduce the present value of tax to be paid by deferring payment to later years. . . . That the taxpayer later may have to pay taxes on part of this amount does not negate the initial tax benefit. . . . Thus, DeLuca has received a tax benefit from the use of its depreciation deductions.[20]

(Citations omitted.)

The court's reasoning here is not persuasive. There is no question that accelerated depreciation generally constitutes a tax benefit because of the time value of money even though it reverses over time. But on the facts presented, DeLuca derived no Massachusetts tax benefit from the accelerated depreciation deductions it took, except to the extent that they brought the income of DeLuca down to zero. Once they created a loss that could not be carried forward, they gave rise to no tax benefit at all. Still, principles of conformity may justify the court's conclusion that section 111 did not provide good ground for adjusting the gain for Massachusetts purposes.

Regarding the constitutional argument, *DeLuca*, like *Insoft*, distinguished *Weston Marketing*, and on grounds similar to those invoked by the board in that case. The court focused on a distinction between "inequities that arise out of the necessity of imposing an annual tax" on the one hand and "the taxation of fictional gain" on the other.[21] Only the latter, according to the court, brings article 44 into play.

Why was the gain in *Weston Marketing* "fictional gain"?

> First, it involved an imaginary transaction that was deemed to have taken place for the sole purpose of assessing taxes. Second, the adjustment compensated for a loss that the taxpayer was required to report under the Federal Code, but which could not be reported under Massachusetts law.[22] In the instant case, on the other hand, taxes were assessed on an actual transaction which increased DeLuca's wealth by some $8 million.[23] The State Legislature chose to align itself with Federal tax law insofar as adjustments to the basis of the vehicles and the computation of recaptured income, both of which align the State's tax system more closely with a transactional accounting system. . . . Because of this legislative choice, DeLuca was able to reduce the amount of its 1989 gains subject to the excise tax by approximately $5 million. The remaining portion of those gains was "an increase of wealth

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[18]431 Mass. 314, 727 N.E. 2d 508.

[19]*Id.* at 320.

[20]*Id.* at 320-321.

[21]*Id.* at 323.

[22]This part of the rationale for distinguishing *Weston Marketing* seems to mirror the focus in *Insoft* on whether the federal and Massachusetts regimes were "congruent" during the years before disposition, when basis was adjusted. But why should incongruity between federal and state schemes be a condition for application of the phantom income theory? After all, *Brown*, the seminal case on the subject, involved no such incongruity, but rather an inequity created by a Massachusetts statutory transition rule regarding a new tax.

[23]Here the court is referring to the gross sales price of the vehicles — $8,282,105. DeLuca had purchased them for $15,694,885, and its basis after depreciation deductions was $5,023,001 at the time of sale. The gain subject to Massachusetts tax was $3,259,104. Does the amount realized by the taxpayer always represent an increase in wealth for purposes of the phantom income doctrine? (Certainly the *Brown* court would not say so.) If a person buys land, which is not depreciable, for $4 million in January and, having made a bad bargain, sells it for $2 million in October, does the person reap a $2 million increase in wealth?

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> out of which money may be taken to satisfy the pecuniary imposition laid for the support of the government."[24]

(Citations omitted.)

What Can Be Distilled From the Cases?

Where do the cases discussed thus far leave the question of Massachusetts corporate basis? They strongly suggest that a corporate taxpayer may, when it works to its advantage, make adjustments to federal basis in the circumstances enumerated in subsections (c)(2) and (3) of Chapter 62, section 6F; that is, it may disregard federal adjustments resulting from IRC provisions that were not applicable in determining Massachusetts gross income at the time the federal adjustments were made.[25] And the taxpayer may also make adjustments for any item that was applicable in determining Massachusetts gross income but was not so applicable in determining federal gross income, and for which a federal adjustment would be allowed if the item had been applicable federally.[26] These departures from the federal treatment may be grounded in the idea that taxpayers and the department have the right on general principle to treat Chapter 63 as if it contained a provision identical to section 6F or, alternatively, they may be grounded in the phantom income doctrine, because, as we have noted, that doctrine has been interpreted as being triggered if there was a lack of congruence between federal and Massachusetts provisions in years before disposition, and that lack of congruence resulted in an income item that from a Massachusetts point of view is fictional in some sense.[27] This lack of congruence is precisely what section 6F of Chapter 62 addresses.

What about the right of the department to force a departure from federal corporate basis? Clearly, if it has administrative authority to import into Chapter 63 a rule identical to the rule set forth in section 6F of Chapter 62, the department and taxpayers occupy a level playing field in this respect. If the department does not have this administrative authority, then departure from federal basis for corporations is a one-way street. There is, in other words, no concept of phantom deductions or exclusions grounded in article 44 that can be invoked by the department against taxpayers to increase federal gain or reduce federal loss on disposition.

Basis in Subsidiaries

So far in this article we have left aside an especially complex but critical setting for discussing Massachusetts corporate basis — the rules for determining basis in the stock of corporate subsidiaries. Let's turn to them now.

> ***There is no concept of phantom deductions or exclusions grounded in article 44 that can be invoked by the department against taxpayers to increase federal gain or reduce federal loss on disposition.***

Suppose (Scenario One) that on December 31, 2007, Corporation A, which does business solely in Massachusetts, purchases Corporation B, which does business solely in Connecticut, for $20 million. The two corporations make up a group that files a federal consolidated tax return. In 2008 Corporation A earns $10 million and Corporation B loses $5 million. On January 1, 2009, Corporation A sells Corporation B for $22 million. Corporation A recognizes a federal gain on disposition of $7 million. Its basis has been reduced under the federal consolidated return rules of section 1502 by the $5 million loss that the group used to offset Corporation A's income in 2008. Therefore, its basis at the time of sale is $15 million.

Suppose instead (Scenario Two) that the facts are the same except that in 2008 Corporation B *earns* $5 million. In that case the basis is increased by the income of Corporation B and Corporation A therefore has a federal loss on disposition equal to the

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[24] *Id.* at 324-325.

[25] As, for example, by disregarding federal downward basis adjustments attributable to bonus depreciation.

[26] This principle might be invoked in the following circumstances, for example. Corporations A and B are members of a federal consolidated return group. In 2006 Corporation A sells a building with a basis of $1 million to Corporation B for $2 million. In 2007 Corporation B sells the building to an unrelated party for $2.5 million. (Assume that Corporation B is not permitted to take any depreciation for the building in 2007.) For federal purposes, the 2006 intercompany gain was deferred under the rules of IRC section 1502. In 2007 the total federal gain triggered by the sale to an unrelated party is $1.5 million. For Massachusetts purposes, the 2006 intercompany sale was taxed, because the 1502 rules do not apply. (*See* discussion post.) The intercompany gain therefore can be considered to be an "item that was applicable in determining Massachusetts gross income but was not so applicable in determining federal gross income." Accordingly, it is appropriate in 2007 for Corporation A to recognize no gain for Massachusetts purposes and for Corporation B to recognize a gain limited to the difference between what it paid for the building and the amount realized, or $500,000.

[27] *But see* note 23. If the Supreme Judicial Court is prepared to consider all amounts realized as an increase of wealth, then the application of the phantom income doctrine to gains from disposition of capital assets has been sharply curtailed by *DeLuca*.

(Footnote continued in next column.)

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difference between the adjusted basis of $25 million and the amount realized of $22 million, or $3 million.

The reason generally given for adjusting the basis of stock in subsidiaries under the consolidated return rules is, in the case of losses, to prevent taxpayers from taking two deductions on the same losses and, in the case of profitable subsidiaries, to prevent the earnings of the subsidiary from in effect being taxed twice in corporate solution.[28] The result is informed, at least, by the general philosophy behind the federal consolidated return rules of treating commonly owned and controlled corporations as if they were one corporation for tax purposes.

Should that same logic hold true in principle for Massachusetts purposes? What does the governing law say specifically about the appropriateness of Massachusetts conformity to section 1502 basis adjustments?

Taking these questions in reverse order, we can first reiterate that a "strict constructionist" reading of the Massachusetts statutory framework might lead one to say that Massachusetts gain or loss on disposition of stock in a controlled subsidiary should be the same as federal, because Chapter 63 does not contain a section 6F equivalent. Three points, though, may cut against conformity here. First, the phantom income doctrine may create exceptions to that result in some circumstances. Second, as we have also said, the department's general administrative authority may be broad enough to permit the department to adopt section 6F-type principles in the corporate arena. Third, even in the absence of such authority, the department and taxpayers may be authorized to decouple from the federal result in this context on the grounds that Massachusetts, even though it permits the filing of corporate "combined" returns,[29] is a separate-entity state in which the consolidation rules of IRC section 1502 generally are inapplicable.

On two occasions the effect of the phantom income doctrine on Massachusetts basis in the stock of subsidiaries has, in fact, been litigated.

In *Parker Affiliated Cos., Inc. v. Department of Revenue*,[30] parent and subsidiary corporations filed consolidated federal and state returns. During the years at issue, Massachusetts had no general NOL carryforward provision. In 1972 Parker used a loss carryforward of the subsidiary federally to offset the income of the parent by about $490,000. The parent sold its interest in the subsidiary in the same year and, as required by the IRC section 1502 rules, reduced its basis in the subsidiary by the amount of the loss that was used in consolidation. It then reported a federal gain of $1.5 million on the sale. For Massachusetts purposes, it did not so reduce its basis, on the grounds that it was not able to use the carryforward for state purposes. The department argued that Parker was bound by the amount of gain reported for federal purposes, and the board and the Supreme Judicial Court agreed. In its opinion, the court relied in the first instance on the plain language of the statute. Then, in rejecting the assertion that piggybacking on federal gain resulted in a tax on fictional income in violation of article 44, the court noted that, in the year of disposition, Massachusetts allowed a 50 percent deduction for capital gains. It also noted that, leaving aside basis adjustments, the simple difference between the amount realized by the parent and what it had invested in the subsidiary was about $1.2 million. The court's opinion implies that Massachusetts could tax this entire amount without violating article 44. Because the amount of the gain that Massachusetts taxed after the allowance of the 50 percent deduction was well below that amount, the phantom income doctrine did not come into play to override federal conformity.

In 1986 the Appellate Tax Board addressed conformity to federal basis adjustments again, in *T.H.E. Investment Corp. v. Commissioner of Revenue.*[31] In *T.H.E.*, a parent company owned a corporation that operated solely in Maine. The Massachusetts rules for filing a combined or consolidated return then precluded (as they now preclude) the inclusion in the return of any corporation not doing business in the commonwealth. The Maine subsidiary, which operated a ski resort, incurred losses in excess of the parent's basis in its stock that had been used to offset income of the parent in a federal consolidated return. Under the 1502 rules, those generated an "excess loss account" — effectively, negative basis in the stock. On audit, the IRS later concluded that the subsidiary had become insolvent in 1977. The insolvency triggered recapture of the excess loss account, just as if the subsidiary had been sold. When the audit was concluded, T.H.E. filed a federal change report with Massachusetts, but it did not include the excess loss account recapture in its income, arguing in effect that it represented phantom income. The board ruled for the taxpayer, focusing on the disconnect between federal and Massachusetts law that gave rise to the recapture: "Since the appellant never filed consolidated Massachusetts returns with its subsidiary, the subsidiary's losses were never

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[28]*See* Kevin Hennessey, Richard Yates, James Banks, and Patricia Pellervo, *The Consolidated Tax Return*, Warren, Gorham & Lamont, 6th Ed. (2006), at section 13.02[1], *citing Ilfeld v. Hernandez*, 292 U.S. 62 (1934).

[29]*See* G.L. Chapter 63, section 32B.

[30]382 Mass. 256, 415 N.E. 2d 825 (1981).

[31]ATB Dkt. No. 132408.

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deducted against the taxpayer's Massachusetts income, and no Massachusetts tax was ever deferred." The board went on to distinguish *Parker*, but its discussion on the point suggests a misunderstanding of the facts in *Parker*:

> That case differed from the present appeal in that the taxpayer had filed both federal and Massachusetts consolidated returns in the immediately preceding years, deducting the allowable share of the subsidiary's operating losses and adjusting the basis of its stock to reflect the deducted losses. It may be inferred, therefore, that the taxpayer had already enjoyed the benefit of the subsidiary's operating losses on its Massachusetts returns for prior years.

(Citations omitted.)

In fact, as noted above, the difference in income reported by Parker federally and in Massachusetts represented a loss that the taxpayer carried over from a prior year and then used in consolidation; since Massachusetts permitted no carryforward of NOLs, Parker did *not* enjoy the benefit of the subsidiary's losses to that extent.

Turning back to the two scenarios above, we might infer from *Parker* and *T.H.E.* that in Scenario One the taxpayer should be able to ignore the downward basis adjustment made to compensate for the 2008 loss that was used in the federal consolidation but not in Massachusetts. The facts, after all, are the same as those in *T.H.E.*, except that there is an actual sale rather than an insolvency and the downward federal adjustments do not exceed the parent's basis in the stock of the subsidiary. Neither of those differences should "make a difference." *Parker* does not call for a different result because Massachusetts no longer has a corporate capital gains deduction, and the "real gain" as *Parker* would seem to define it — that is, the difference between the amount paid and the amount realized — is only $2 million, not $7 million.[32]

What about Scenario Two? Does the department in that case have the right to ignore the upward basis adjustment for the income of the subsidiary in 2008, and hence to treat the sale as triggering a $2 million gain, on the grounds that Massachusetts has never taxed the subsidiary's earnings and therefore it need not raise the basis to avoid imposing two taxes? Certainly the department has no article 44 or phantom income argument for doing so; however, as we have said, it may argue that it has administrative authority to reach this result. Furthermore, it has an independent rationale for reaching the same result; that is, that Massachusetts corporate conformity does not extend to incorporation of the section 1502 rules, because Massachusetts is a separate-entity state. That may seem inconsistent with the approach taken by the Supreme Judicial Court in *Parker*, but *Parker* predated an important change in the Massachusetts combined return statute, section 32B of Chapter 63. That change, adopted in 1988, added language for the first time expressly calling for separate computation of the income of each constituent corporation that participates in a Massachusetts combined return:

> Where [a combined return] election is made, . . . [t]he combined net income shall be determined as follows: (a) the taxable net income of each such corporation apportioned to this commonwealth . . . shall first be separately determined; and (b) the taxable net income of each such corporation, as so determined, shall then be added together and shall constitute their combined net income taxable under this chapter.

The department's regulation on combined returns seems to imply that Massachusetts does not follow the federal investment adjustments set forth in U.S. Treas. reg. section 1.1502-32 — that is, the subsidiary basis adjustments. The regulation states:

> Each member of the combined group shall first separately determine its "taxable net income" . . . as if it were filing a separate return. . . . Modifications to the separate taxable incomes of federal consolidated return group members under Treas. Reg. §1.1502-12, which generally include deferrals and eliminations for intercompany transactions, are not used when determining the Massachusetts net income of combined group members, even for transactions exclusively involving members of a Massachusetts group. The net income of each corporation should, if necessary, be adjusted to compensate for any such federal modifications.

Reg. 830 CMR 63.32B.1(7)(a).

The federal modifications to separate taxable incomes under Treas. reg. section 1.1502-12 include the adjustments that are made to subsidiary basis under Treas. reg. section 1.1502-32. See Treas. reg. section 1.1502-12(o).

The general principle that Massachusetts does not follow the federal consolidated return rules, even in the case of a Massachusetts combined return group, was tested in *FMR Corp. v. Commissioner of Revenue*.[33] There a corporation participating in a federal consolidated return group made a charitable contribution. Under IRC section 170**,** the deduction for such contributions is limited to 10 percent of the

[32]*But see* notes 23 and 27.

[33]441 Mass. 810, 809 N.E. 2d 498 (2004).

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corporation's taxable income. Under the consolidated return rules, that limitation effectively is applied on a groupwide basis, so that if the aggregate contributions are less than 10 percent of the aggregate income, the limitation does not come into play. In FMR's case, the contribution made by the contributing corporation exceeded 10 percent of its income, but the aggregate contributions did not exceed 10 percent of the aggregate income. The department argued successfully that in those circumstances the limitation applied, just as it would if the contributing corporation had not participated in a federal consolidated return group. The Supreme Judicial Court said, in summary:

> We agree with the board that the method proposed by FMR for calculating the charitable contributions deduction is inconsistent with the plain language of G.L. c. 63, s. 32B, *which requires net income to be calculated on an individual-entity basis*.[34]

If, as the Massachusetts combined return regulation and *FMR* suggest, corporations must compute their income as if they were filing a separate return, then it seems clear that the basis adjustment rules that require basis in subsidiaries to "float" with the profits and losses of a subsidiary that participates in a consolidated return should not apply in Massachusetts, subject only to an override when the phantom income doctrine comes into play, grounded as it is in the Massachusetts Constitution.

> ***It is difficult to discern any clear picture of the policy that determines the Massachusetts treatment of related or controlled corporations.***

But is this the right result? Stepping outside the authorities directly addressing conformity with the federal consolidated return rules in Massachusetts, it is difficult to discern any clear picture of the policy that determines the Massachusetts treatment of related or controlled corporations. Those who prefer to think of Massachusetts as a strict separate-entity state will cite, in addition to the combined return regulation and *FMR*:

- *Macy's East*;[35]
- the intercompany pricing rules set forth in sections 33 and 39A of Chapter 63;
- the general inability of a Massachusetts combined return group to apply losses carried forward by one company against the income of another member;[36] and
- the general inability in a Massachusetts combined return group to share corporate credits.[37]

Those who see Massachusetts tax policy in this area as more nuanced will focus instead on:

- the ability in a Massachusetts combined return to offset apportioned current losses of one company against the apportioned income of others in the group;[38]
- the use of aggregate amounts to compute incremental research and development expenditures for purposes of the Massachusetts research and development credit[39] and the ability to share the credit within a group;[40]
- the 95 percent dividends received deduction that applies whenever a corporation owns at least 15 percent of the voting stock of the payer corporation;[41]
- the ability to exclude from net worth, for purposes of the tax on net worth set forth at sections 32 and 39 of Chapter 63, investment in subsidiaries that are at least 80 percent owned;[42] and
- Massachusetts's conformity to the nonrecognition provisions that apply to corporate mergers, reorganizations, and liquidations.[43]

Taking all of these rules together, it is clear that for some purposes Massachusetts treats related corporations as if they were stand-alone entities, while for other purposes it aggregates their activities or applies special rules to prevent or ameliorate multiple taxation of income or assets. For the right *economic* result, perhaps we should turn not to these difficult-to-reconcile provisions, but rather to the rules that govern financial accounting for groups

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[34]*Id*. at 820 (emphasis supplied). *See also Macy's East, Inc. v. Commissioner of Revenue*, 441 Mass. 797, 808 N.E. 2d 1244 (2004), upholding the department's position to the effect that IRC section 381 does not apply in Massachusetts so as to preserve NOLs of a nonsurviving corporation in a code section 368(a)(1)(A) merger. *Compare R.J. Reynolds Tobacco Co. v. Commissioner of Revenue*, ATB Dkt. No. 206404 (1997), holding that for Massachusetts purposes, gain was not triggered under section 311(b) of the code when a subsidiary distributed appreciated property to its parent, and both corporations were members of a federal consolidated return group.

[35]*Macy's East, Inc. v. Commissioner of Revenue*, 441 Mass. 797, 808 N.E. 2d 1244 (2004). (For the decision, see *Doc 2004-11452* or *2004 STT 106-13*.)

[36]*See* G.L. Chapter 63, section 30(5)(b); reg. 830 CMR 63.32B.1(9); *Farrell Enterprises, Inc. v. Commissioner of Revenue*, 46 Mass. App. 564, 707 N.E. 2d 1088 (1999).

[37]*See* reg. 830 CMR 63.32B.1(8)(a).

[38]*See* reg. 830 CMR 63.32B.1(7)(d).

[39]G.L. Chapter 63, section 38M(a); reg. 830 CMR 63.38 M(7).

[40]G.L. Chapter 63, section 38M(e); reg. 830 CMR 63.38 M(12)(c).

[41]G.L. Chapter 63, section 38(a)(1).

[42]G.L. Chapter 63, section 30(8).

[43]*See, for example,* Letter Rulings 83-77, 85-3.

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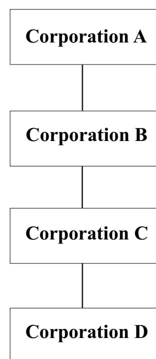
that are both commonly owned and controlled, because they are intended to ensure that shareholders see an undistorted picture of the financial performance of a corporate group. Under those rules,[44] if specific thresholds of ownership and control are met, the corporate group either is consolidated — meaning that it is treated as one entity that owns all of the assets and has all of the liabilities of the constituent companies — or it is required to use the *equity method* of accounting, under which investment in subsidiaries floats in much the same way that it does under the federal consolidated return rules.

Consider how counterintuitive the economic results can become if those rules, or rules similar to them, are *not* applied. Suppose that we have a chain of corporations as follows:



Corporation A capitalizes Corporation B with $100 in cash. Corporation B uses the cash to capitalize Corporation C, and Corporation C likewise uses it to capitalize Corporation D. Corporation D operates for two years and earns $200 during that period. Nothing else happens within the group, and at the beginning of year three Corporation D holds $300 in cash and has no liabilities. Corporation C then sells Corporation D for its net worth, namely, $300. Corporation B then sells Corporation C for its net worth, which is also equal to the cash it now holds, or $300. Finally, Corporation A sells Corporation B, once again for $300.

If this entire chain of corporations operates in Massachusetts, and each corporation's investment in its subsidiary is determined as if it were filing a separate federal return, without application of the section 1502 rules, the basis of each corporation in the stock of its subsidiary will be equal to $100, the initial capital contribution. Massachusetts will tax the $200 of operating profits of Corporation D. It will also tax $200 of gain on disposition of directly owned subsidiaries by corporations C, B, and A in turn. Therefore, in a case in which the actual economic profit of the group was $200, the state will tax $800, because the business was operated in a tiered structure.[45] Is this result so clearly wrong that it may itself trigger application of the phantom income doctrine?[46] If so, we could face the odd result that decoupling from the 1502 investment adjustment rules is necessary to avoid the taxation of phantom income (in circumstances like those presented in *T.H.E.* and in Scenario One, above), but conformity to those same rules is required in other circumstances so as not to tax fictional income.

Let's look once again at this tiered example, but adjust the facts so that each of the corporations in the chain operates in a different state. Let's assume further that each state has the same tax rate and that they all decouple from the investment adjustment rules of IRC section 1502. Is the tax result in those circumstances any more defensible? Conversely, let's examine Scenario One again, but assume that the parent company in Massachusetts has two subsidiaries in Connecticut. The second subsidiary — Corporation C — earns $6 million in 2008. Accordingly, corporations B and C are permitted in that year to file a combined return in Connecticut in which the $5 million loss of Corporation B is used to offset the $6 million in profit of Corporation C.[47] If, in the subsequent year, Corporation A is permitted because of the phantom income rule to decouple from the investment adjustment rules of section 1502, it arguably reaps a windfall, when taxation in both states is taken into account. It took the loss once in Connecticut in the loss year, and in effect it gets to take it again in Massachusetts in the subsequent year when it sells the stock of Corporation B.

These examples highlight a fundamental problem with attempting to analyze conformity with the

[44] *See* APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock"; FASB Statement of Financial Accounting Standards No. 94, "Consolidation of All Majority-Owned Subsidiaries."

[45] Of course, if Corporation D were unprofitable, losses could be duplicated in this structure just as easily.

[46] Note that the appeals court in *BankBoston Corporation v. Commissioner of Revenue*, Dkt. No. 05-P-1545, Feb. 2, 2007, looked with favor, albeit in a different context, on the principle that the income generated in a corporate group should be taxed once, but only once, before distribution to shareholders: "The thrust of the dividends-received deduction in the Massachusetts corporate excise has been to impose a unified tax on a corporate enterprise, recognizing that affiliates and subsidiaries should not create additional liability by transferring revenues within the family." In *BankBoston*, the court upheld a decision by the Appellate Tax Board that dividends received by a corporation from a captive real estate investment trust subsidiary did not qualify for the Massachusetts dividends received deduction.

[47] *See* C.G.S. section 12-223a.

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federal investment adjustment rules from the narrow perspective of the tax results that obtain in a particular state, as was done in both *Parker* and *T.H.E*. The subsidiary whose income or loss gives rise to basis adjustments federally may be in one state, while its parent, whose tax on disposition is determined in part by reference to those adjustments, is in another. As a policy matter, a narrow focus in this context on whether the results give rise to a double benefit or to phantom income in one state is dubious. Although focusing on a single state's results does not raise any obvious federal constitutional problems by itself, it can lead to the sort of tax Balkanization that offends the spirit, if not the letter, of the U.S. Constitution's Commerce Clause.

It is not at all clear that a strict conformity approach to basis in subsidiaries can be reconciled with the phantom income doctrine as the courts and the board have applied it.

However, broadening the focus to take into account multistate tax effects in detail does not much recommend itself as a policy, either. For Massachusetts, for example, to adopt basis rules for stock in subsidiaries that vary with the tax regime in effect in the state where a subsidiary does business would simply be too complex to be feasible.[48]

What Road to Take?

What rules should Massachusetts adopt regarding basis in the stock of subsidiaries?

There is much to be said in principle for general conformity to federal basis. Although the federal rules for determining the basis of subsidiary stock are by no means simple, conformity at least avoids adding an additional layer of complexity to the federal rules. Further, when all state impacts are taken into account, it may be as likely to give rise to fair results as any other approach. It may be that incident to such a system circumstances will arise in which less than or more than 100 percent of corporate earnings is taxed before distribution of the earnings to shareholders, but it is doubtful in any case whether any reasonably administrable system can be created that does more than rough justice by such a standard of avoidance of overinclusion and underinclusion of income.

It is not at all clear, however, that a strict conformity approach to basis in subsidiaries can be reconciled with the phantom income doctrine as the courts and the board have applied it. Perhaps it is time to revisit the doctrine and consider anew how it should be applied in the context of multistate corporate taxation, in which principles of federalism and comity cut against a narrow focus on what has happened in Massachusetts in determining what should happen when corporate assets are sold. ✰

[48]It would be even more complex than the examples suggest because in the real world large corporations rarely do business in one state only.

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