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On July 3, 2008, Governor Deval Patrick signed into law An Act Improving Tax Fairness and Business Competitiveness (the “Tax Fairness Bill” or the “Bill”). The Bill makes a number of substantial changes to the Massachusetts tax system including the adoption of a unitary taxation regime and federal entity classification conformity. In general, these changes will take effect for tax years beginning on or after January 1, 2009.

The following are the major highlights of the Tax Fairness Bill.

Unitary Taxation

The most sweeping change under the Bill is the adoption of unitary taxation in Massachusetts. Since the inception of the corporate excise, Massachusetts has been a separate return state in which each corporation doing business in the state determined its corporate excise tax separately. Although combined returns were permitted, these returns included only corporations doing business in Massachusetts and merely permitted participating corporations to aggregate their separately determined and separately apportioned net income. Under the Bill, this current combined reporting regime is repealed.

The Tax Fairness Bill changes the current regime by adopting a unitary tax system starting with tax years beginning on or after January 1, 2009. Under the new unitary system, one or more affiliated corporations conducting related business activities are generally required to determine their corporate income tax by taking into account the income and activities of the entire group of affiliates. In this system, the income of all corporations in the group (including those not doing business in the state) is aggregated and intercompany transactions are eliminated. Aggregated income is then apportioned to the state based on the property, payroll and sales of all of the group members. The following are some of the important features of the unitary provisions of the Bill.

Unitary Group Composition: The unitary group includes all corporations under common ownership that are engaged in a unitary business. Corporations are considered under common ownership if more than 50% of their voting stock is controlled by the same beneficial owners. A unitary business is defined broadly to include two or more corporations whose business activities are interrelated and result in mutual benefit or a sharing of value between the corporations. The
Bill specifies the Legislature’s intent that the term be construed to the broadest extent permissible under the U.S. Constitution.

The group includes financial institutions, S corporations, utility corporations, real estate investment trusts (REITs) and regulated investment companies (RICs) if the companies otherwise meet the definition of a unitary group. Captive insurance companies are also included. Security corporations and tax exempt organizations with UBIT will not be included in a unitary group.

**Water’s Edge Rule:** Under the unitary system, tax will be imposed on a water’s edge basis, unless a worldwide election is made. A waters edge report will include:

(i) any member incorporated in the United States or formed under the laws of the United States, any state, or any territory or possession of the United States;

(ii) any member, regardless of the place incorporated or formed, if the average property, payroll, and sales factors within the United States is 20% or more; and

(iii) any member that derives more than 20% of its income from intangible property or service activity where that income is received from a group member that deducts the expenses related to the activity for federal income tax purposes.

In the case of members that are included in the group under the third prong of the definition, only the income and apportionment factors relating to their transactions with other group members are included in the unitary computation.

**Worldwide Election:** The worldwide election permits every member of the unitary group, wherever located, to be included in the report. The election needs to be made on a timely filed, original return and, once made, is binding for a period of 10 years.

**Unitary Computation:** The unitary group will determine its income on an aggregate basis, eliminating intercompany transactions. The share of the aggregated income or loss attributable to the Commonwealth will be based on the apportionment percentages of each “taxable member” of the group. A taxable member is defined as a member of the unitary group that is independently subject to tax in Massachusetts.

Each taxable member will compute the numerator of its apportionment factor based on its separate activities and its share of Massachusetts sales of non-taxable members. Each taxable member’s share of Massachusetts non-taxable member’s sales will be determined based on a ratio, the numerator of which will be the taxable member’s Massachusetts sales and the denominator will be the
aggregate amount of all Massachusetts sales of all the taxable members. In addition, each taxable member will compute the denominator of its apportionment factor by aggregating the apportionment factor denominators of every member of the group. Further, a taxable member’s apportionment factor denominator will include the property and payroll factors attributable to members that are subject to single sales factor apportionment.

By attributing the sales of non-taxable members to taxable members, the Bill adopts the Finnegan approach to unitary apportionment. As such, the Massachusetts sales of all group members will be considered in apportioning income, regardless of whether or not any particular member of the group has Massachusetts nexus.

Apportionable income will be determined by each taxable member applying its apportionment percentage to the unitary business income received by the group members. Every member of the unitary group will be jointly and severally liable for the tax due from any member.

**Special Rules Applicable Where a Unitary Group Includes Financial Institutions and Other Corporations:** Where a unitary group includes both financial institutions and other corporations, the following adjustments to the apportionment rules apply:

(i) Prior to combination, the value of intangible property included in the property factors of the financial institution members (e.g., loans) are reduced to 20% of the otherwise applicable value;

(ii) Receipts that are includable in the sales factors of the financial institutions but not the other corporations (e.g., interest on loans) are taken into account in the denominators of the other corporations; and

(iii) Goodwill from the sale of a business is excluded from the sales factor of all members.

**Election to Use the Federal Affiliated Group as the Reporting Group:** A taxpayer may elect, without consent of the Department of Revenue (DOR), to include in its Massachusetts group all corporations that are members of its affiliated group, as defined under IRC §1504, to the extent that such corporations are not otherwise included. This methodology will permit non-unitary companies to be included in the tax computation. The election is binding for 10 years.

**Election Update:** On September 5, 2008, the DOR issued its first “Statement of Anticipated Regulatory Positions relating to Implementation of Combined Reporting.” The Statement sets out the DOR’s position that the election will not result in the exclusion of any corporation that would otherwise be included in the unitary group under the generally applicable rules. Rather, the election permits additional non-unitary corporations that are at least fifty percent owned to be
included in the group if they would qualify as members of the federal affiliated group. The definition of the federal affiliated group would be applied to include fifty percent owned affiliates.

**DOR Regulations:** The DOR is required to promulgate other regulations necessary to implement the unitary tax system. These regulations will be required to provide for: (i) the elimination or deferral of intercompany transactions, (ii) the sharing and carryover of credits by group members, (iii) the sharing and carryover of NOLs, and (iv) the appropriate application of the intercompany interest and royalty addback provisions (which will remain in effect).

**NOL Update:** The DOR Statement sets forth the Department’s position that pre-unitary NOL will be available as a deduction only to the company that generated it. The deduction will apply after the computation of combined unitary income – which is the aggregate of current income and losses of all companies in the unitary group net of intercompany eliminations. Combined unitary income is the starting point for each unitary group member’s tax computation. The DOR statement does not provide specific guidance as to the actual computation of the NOL deduction that will be allowed for pre-unitary losses. What is clear is that any NOL remaining after the deduction by the corporation that generated the loss may not be shared with other group members.

**New FAS 109 Deduction for Financial Accounting Effect of Converting to the Unitary System**

The Tax Fairness Bill will allow publicly traded corporations a special deduction to address an increase in a deferred tax liability on the company’s GAAP financial statements resulting from the shift to unitary taxation. The deduction will be available for seven years starting with taxable years beginning during calendar year 2012.

The amount of the deduction for each tax year is one-seventh of the lesser of (i) the net increase in deferred tax liability that results from the switch to unitary taxation or (ii) the difference between the book basis and tax basis of the group’s non-taxable members’ depreciable or amortizable assets before the taxpayer becomes subject to the unitary tax regime. For computational purposes, the increase in the deferred tax liability caused by the switch to unitary taxation must be offset by any increase in the deferred tax asset caused by any and all provisions of the law.

To claim the deduction a taxpayer must file a report with the DOR showing the computation of the deduction. The report is due by July 1, 2009 and must be submitted using forms and procedures to be developed by the DOR.

**FAS 109 Deduction Update:** The DOR Statement of Anticipated Regulatory Positions referenced above clarifies several aspects of the deduction. First, a company need not be in a net deferred tax liability position in order to claim the deduction. All that is required is that deferred tax liability is increased. A company that has such an increase may claim the deduction even if it is in a net deferred tax asset position. Second, the valuation date for determining the difference between book and tax basis is July 3, 2008.
– the effective date of the Tax Fairness Bill. Third, the Statement makes clear that the deduction will be a grossed-up amount. That is, the application of the statutory formula will determine the after-tax financial reporting effect of the switch to unitary taxation for which relied will be available. To convert this amount to a pre-tax deduction from net income, the after-tax amount must be grossed up by dividing it by the applicable statutory rate.

**Phased-In Rate Reduction for Business Corporations**

The Tax Fairness Bill reduces corporate excise tax rates on net income applicable to general business corporations. The general corporate excise tax rate applicable to C corporations will drop from the current rate of 9.5% to the following rates:

- 8.75% for tax years beginning on or after January 1, 2010;
- 8.25% for tax years beginning on or after January 1, 2011;
- 8% for tax years beginning on or after January 1, 2012 and thereafter.

S corporations will also be taxed at lower rates. The entity level tax rate will be reduced for S corporations with total receipts of $9 million or more to a rate determined by subtracting the personal income tax rate (currently 5.3%) from the applicable general business corporation tax rate applicable to C corporations. S corporations with total receipts in excess of $6 million and less than $9 million will be subject to tax at a rate equal to two-thirds of the rate specified for S corporations with total receipts of $9 million or more.

**Phased-In Rate Reduction for Financial Institutions**

The Tax Fairness Bill reduces corporate excise tax rates on net income applicable to financial institutions. The rate drops from the current rate of 10.5% to the following rates:

- 10% for tax years beginning on or after January 1, 2010;
- 9.5% for tax years beginning on or after January 1, 2011;
- 9% for tax years beginning on or after January 1, 2012 and thereafter.

S corporations that are financial institutions will also be taxed at lower rates. The entity level tax rate will be reduced for such S corporations with total receipts of $9 million or more to a rate determined by subtracting the personal income tax rate (currently 5.3%) from the applicable financial initiation tax rate applicable to non S corporations. S corporations that are financial institutions and have total receipts in excess of $6 million and less than $9 million will be subject to tax at a rate equal to two-thirds of the rate specified for such S corporations with total receipts of $9 million or more.
Repeal of Public Law 86-272 Protection under the Net Worth / Property Measure of the Corporate Excise

The Tax Fairness Bill amends the prior law to impose the net worth / property measure of the corporate excise on corporations whose activities in Massachusetts are limited to the solicitation of sales of tangible personal property. Such companies will remain protected from the net income tax by Public Law 86-272. This measure will take effect for the 2009 tax years. Under prior law, Massachusetts afforded Public Law 86-272 protection to both the net income and net worth / property measures of the corporate excise even though the Public Law applies only to net income taxes.

Massachusetts Entity Classification Conformity

The Tax Fairness Bill adopts the federal tax classification rules for unincorporated entities starting with tax years beginning on or after January 1, 2009. Prior law adopted the federal entity classification rules for Limited Liability Companies (LLCs), but not for other unincorporated entities. Under the Bill, partnerships, business trusts, and LLCs will generally be classified for Massachusetts purposes in the same manner as the entity is classified for federal income tax purposes.

Under the Bill, business trusts that are taxed as corporations for federal income tax purposes will be fully subject to the corporate excise, including the corporate income tax and a .26% net worth / property tax. Under prior law, business trust income was taxed at a 5.3% rate and there was no net worth or property tax imposed at the state level. Dividends from former business trusts now taxed as corporations will be eligible for the corporate excise dividends received deduction to the same extent as dividends paid by corporations. Transition rules with respect to pre-existing business trusts require resident shareholders to pay tax on distributions of previously untaxed business trust income earned before the business trust became subject to taxation as a corporation.

In addition, under the Bill, partnerships will no longer be permitted to be taxed as corporations for federal purposes while retaining partnership treatment in Massachusetts (so called “99-13 partnerships” under prior law). Rather, partnerships will now be taxed according to their federal income tax classification.

The federal entity classification rules will also be applied for purposes of the local property tax. The local property tax treatment of certain items of property depends upon whether the property is owned by a “corporation.” Thus, the new entity classification rules will affect the local property tax burden of certain taxpayers.

New S Corporation / QSUB Rules

Consistent with the change to conform to the federal entity classification rules, the Bill revises the entity level income tax with respect to S corporations with QSUBs. Under prior law, QSUBs and disregarded LLCs owned by S corporations were treated as taxable entities separate from the S corporation. Under the Bill, QSUBs and LLCs owned by S corporations will be disregarded under the corporate excise. Effective for tax years beginning on or after January 1, 2009, the income, property and
apportionment factors of a QSUB or disregarded LLC owned by an S corporation will be included in the income and non-income measures of its parent S corporation.

In addition, under the Bill, it appears that S corporations could qualify for security corporation status. Under current DOR regulations, S corporations are not permitted to apply for security corporation classification. The change results from the fact that an S corporation will be included in the definition of a business corporation and all business corporations would be eligible for security corporation classification. In particular, section 65 of the Bill amends the security corporation provisions to specifically reference business corporations taxable as S corporations and states that those corporations are not subject to the S corporation tax if they qualify as security corporations.
New Massachusetts Basis Rules

The Bill adds a new provision (M.G.L. c. 63, §31M) that will require an adjustment for gain and loss to reflect the disparities between federal tax basis and Massachusetts tax basis. Effective for tax years beginning on or after January 1, 2009, this adjustment to the calculation of Massachusetts gross income would occur if federal taxable income contained any items of gain or loss related to disposals of property. Federal gross income would be increased by the excess of federal adjusted basis over the Massachusetts adjusted basis. Likewise, federal gross income would be decreased by the excess of Massachusetts adjusted basis over federal adjusted basis.

Such variances between state and federal tax basis may result from items such as bonus depreciation and differences in filing methodologies (i.e., separate return vs. consolidated return). Prior law did not explicitly provide for an adjustment to federal taxable income for disparities in federal tax basis and Massachusetts tax basis. Thus, from a practical perspective, the new rule will require companies to keep closer track of the state basis of assets.

Sales Factor Treatment of Goodwill

For apportionment purposes, the sales factor generally takes into account the full amount of net gain from sales of business assets. Under prior law, no specific provision was made for goodwill. Thus, the portion of net gain attributable to goodwill was taken into account in the sales factor. In addition, the DOR has changed its position over the years regarding the “sourcing” of such receipts for purposes of the sales factor. Current DOR regulations provide that receipts from the sale of goodwill are included in the numerator of the Massachusetts sales factor if the taxpayer is domiciled in the state.

Effective for tax years beginning on or after January 1, 2009, the Bill will eliminate the sale of goodwill from the computation of the sales factor. The exclusion applies to receipts attributable to goodwill “or similar intangible value, including, without limitation, ‘going concern value’ and ‘workforce in place.”

Streamlining of the Local Property Tax and Corporate Excise Tax Statutes

Effective for tax years beginning on or after January 1, 2009, references to domestic corporations and foreign corporations will be deleted from the tax statutes and will be replaced by general references to business corporations. All of the separate provisions for domestic corporations and foreign corporations are consolidated into a single set of provisions applicable to both. This will streamline the statutes.

In addition, the Bill simplifies the tax law by repealing certain surtax provisions that had previously comprised a portion of the various corporate excise tax rates. The Bill incorporates the surtax into the new statutory tax rates.

Commission to Review Corporate Tax Laws
The Tax Fairness Bill creates a new commission to review the corporate tax laws of the Commonwealth for purposes of (i) simplification and modernization and (ii) the effectiveness of rate structures, apportionment, and reporting mechanisms. Significantly, the commission is charged with reviewing the effect of the single sales factor (currently applicable to manufacturers and mutual fund service corporations) and making recommendations for its expansion or termination.

**Disallowance of the Massachusetts Earned Income Credit to Nonresidents and Part-Year Residents**

The Bill provides that non-residents and part year residents of Massachusetts who qualify for the earned income credit must pro rate the earned income credit based on the portion of their income that is received from Massachusetts sources.

**Streamlined Sales and Use Tax Agreement Study**

Section 98 of the Bill directs the DOR to prepare a study on the feasibility of adopting the Streamlined Sales and Use Tax Agreement (SSTP). The DOR is also charged with drafting the legislation necessary for Massachusetts to implement the SSTP. The study and draft legislation are due by December 1, 2008.