Massachusetts Enacts Sweeping Changes in Taxation of Businesses

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Legislation signed into law by Governor Deval Patrick on July 3, 2008, made the following major changes in the Massachusetts taxation of business entities:

Adoption of Combined Reporting. Effective for tax years beginning on or after January 1, 2009, Massachusetts adopts a combined reporting method and abandons the separate reporting method. Under current law, a corporation doing business in Massachusetts is permitted to file a separate return, and the determination of the corporation's income subject to Massachusetts taxation takes into account only its income and its apportionment factors and does not include the income and apportionment factors of any affiliates, whether or not the affiliates are doing business in the Commonwealth.

- Corporations doing business in Massachusetts now will be required to file tax returns using the income and apportionment factors of all members of a combined group, consisting of all affiliates engaged in a unitary business, whether or not the affiliates are doing business in the Commonwealth. Corporations that are subject to combined group reporting include financial institutions, business corporations, S corporations and utility corporations, as well as certain insurance companies that are not taxed as insurance companies for federal tax purposes.
- The combined taxable income of all members of a unitary group of businesses is used for purposes of apportionment to Massachusetts and is defined as the income derived from the unitary business.
- A "unitary business" is defined to mean the activities of a group of two or more corporations under common ownership 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. The term is to be construed to the broadest extent permitted under the United States Constitution.
- Taxpayers may elect, without the consent of the Commissioner, to have their Massachusetts combined group consist of the members of their affiliated group. For this purpose, "affiliated group" generally has the same meaning as "federal affiliated group," as defined in Section 1504 of the Internal Revenue Code, except that if members of the group

own more than 50 percent voting control of a corporation, such corporation will be included in the group, and certain other commonly owned corporations will also be included in the group. Therefore, the affiliated group, for Massachusetts tax purposes, may include more members than the federal affiliated group, which has an 80 percent vote and value test.

- Taxpayers may also elect to determine their apportioned share of income pursuant to a worldwide election under which each member, wherever located, takes into account the income and apportionment factors of all members includible in the combined group. In the absence of such an election, the combined group shall determine its share of the taxable income on a water's edge basis, in which case the group generally includes foreign corporations only to the extent the average of the foreign corporation's property, payroll, and sales factors within the United States is 20 percent or more. Both this election and the affiliated group election are binding and applicable for 10 taxable years.

- **Adoption of Federal Rules for Entity Classification.** Massachusetts will follow the federal rules for tax classification of an entity. Accordingly, an entity classified as a corporation, partnership or disregarded entity for federal tax purposes will be so classified for Massachusetts tax purposes. For years, Massachusetts has taxed business entities according to its own classification criteria. For example, corporate trusts (including entities also known as "business trusts") that were taxed as corporations federally were taxed under the individual income tax provisions of Massachusetts law at a rate lower than the corporate rate and were not subject to the property tax measure of the corporate excise. Moreover, after the Internal Revenue Service adopted the so-called "check-the-box rules" for federal income tax classification purposes, Massachusetts continued to use its own classification system, resulting in a different Massachusetts tax classification for even more entities. Some entities that were classified as corporations for federal tax purposes could be classified for Massachusetts tax purposes as corporate trusts or partnerships depending on certain criteria established under Massachusetts statutory and case law. This provision, like most of the other provisions in the bill, is effective January 1, 2009. The Department of Revenue has been charged with the responsibility of preparing transition rules for entities whose classification will be changed as a result of the legislation.

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- With the changes in classification of entities and the adoption of the federal classification rules, Massachusetts will no longer treat qualified Subchapter S subsidiaries as separate entities. The change will eliminate a number of complex questions involving qualified Subchapter S subsidiaries that are owned by a corporate trust that has elected to be taxed as an S corporation for federal purposes but taxed under the personal income tax provisions of the prior tax law.
- The statute includes provisions intended to preserve the tax treatment of distributions of tax-free and previously taxed earnings and profits of corporate trusts as of December 31, 2008.

- Reduction in Corporate Tax Rates:

  - The income tax rate on business corporations is scheduled to be reduced from the present rate of 9.5% to 8.75% in 2010, 8.25% in 2011, and 8% in 2012 and thereafter. The income tax rate on financial institutions is scheduled to be reduced from the current rate of 10.5% to 10% in 2010, 9.5% in 2011, and 9% in 2012 and thereafter. These rate reductions are intended to relieve the burden of some of the estimated $400 million tax increase anticipated as a result of the change to a combined reporting method. No change is made to the tax rate on the property measure of the corporate excise.
  - While the decrease in corporate rates was intended to soften the impact of an increase in taxation as a result of the law, a number of minority members of the Legislature expressed doubt that the Legislature would allow the lower rates to go into effect, particularly if the Commonwealth continued to face deficits in subsequent years.
  - The statute retains the imposition of a tax on large S corporations but revises the applicable rates to reflect any future changes in the difference between corporate and individual income tax rates. For S corporations with total receipts in excess of $9 million, the applicable tax rate is the difference between the applicable corporate rate and the applicable individual income tax rate. For S corporations with total receipts between $6 million and $9 million, the rate is two-thirds of the rate described in the preceding sentence. As a result, for a large S corporation with total receipts in excess of $9 million, the total income tax, consisting of the individual income tax on stockholders on their distributive shares of corporate income and the additional tax on the corporation, will equal the tax that would have been imposed on the corporation if it had been a C corporation.

- **Reporting Relief.** As another concession to businesses, the legislation includes provisions intended to alleviate the financial reporting impact under FAS 109 as a result of

the enactment of combined reporting requirements for unitary businesses. Under these provisions a combined group is entitled to claim an annual deduction for the seven-year period beginning with the combined group's taxable year beginning in 2012 for an amount equal to 1/7 of the lesser of (i) the difference between the book and tax bases of certain assets held by members of the combined group not subject to Massachusetts taxation, and (ii) the amount necessary to offset the increase in the net deferred tax liability that would result from the imposition of combined reporting. To claim the deduction, a taxpayer must file a statement with the Commissioner of Revenue on or before July 1, 2009, specifying the total amount of the deduction claimed by the taxpayer. Only publicly traded companies, including affiliated corporations participating in the filing of the publicly traded company's financial statements, are eligible for the deduction.

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- **Department of Revenue Discretion.** Although, as a concession to business taxpayers, the final legislation does not include some of the proposed revisions granting the Commissioner of Revenue broad discretion in certain areas, it retains a number of provisions permitting the Commissioner to adopt regulations that deal with a number of important areas, such as transition rules for entities reclassified by the legislation, the elimination of inter-company transactions, including the payment of dividends between or among group members, sharing credits among the combined group, the application of any carry-forwards and the sharing of net operating loss or tax credit carry-forwards and the relationship of the new unitary provisions to the so-called "add-back" provisions under which a taxpayer is required to add-back to income deductions for payments of interest or the use of certain intangibles if such payments are made to an affiliate operating outside of the Commonwealth. With the adoption of the unitary approach, one might have thought that the add-back provisions would be repealed. However, the legislation allows the Commissioner, through regulation, to utilize these Sections to the extent the Department deems necessary.

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