MASSBUDGET BRIEF

JULY 1, 2008

Legislature Enacts Corporate Tax Reform

On July 1st, 2008 the Massachusetts Legislature enacted corporate tax reform legislation that will significantly reduce opportunities for corporate tax avoidance, improving the fairness and efficiency of the state tax system. The legislation also cuts corporate income tax rates, but by less than the amount saved by reducing tax avoidance. As a result, the legislation generates revenue that will be available to strengthen the fiscal condition of the Commonwealth and fund investments in public infrastructure, education, and other essential building blocks for a strong state economy.

This Budget Brief describes the legislation, explaining the major provisions and detailing the revenue implications in each of the next several years. A more complete discussion of the economic policy research on the effects of tax avoidance and public investments is available in a previous MassBudget paper, available at this link:
http://www.massbudget.org/BuildingStrongEconomyJune07.pdf

Major Provisions:

Combined Reporting

The legislation adopts a corporate tax reporting system known as combined reporting. This system, already adopted in twenty-one other states, makes it more difficult for multi-state companies with numerous subsidiaries to reduce their taxes by shifting income between subsidiaries. It restricts these tax avoidance opportunities by requiring businesses with numerous subsidiaries to file a combined return with the income and losses of all of the subsidiaries. Therefore strategies to shift income between subsidiaries for tax avoidance purposes become ineffective.

Check the Box Conformity

The legislation brings Massachusetts in line with the rest of the country by requiring that companies be classified as the same type of legal entity for state and federal tax purposes. Under federal laws, some companies can choose what type of entity they will be considered for tax purposes (as a corporation or a partnership, for example). They do this by checking a box on federal forms indicating their choice. Other states automatically treat those companies the same way for state tax purposes as they are treated for federal tax purposes; Massachusetts did not. As a result, companies were able to reduce their taxes by being treated as one type of entity in Massachusetts and as another in other states and federally. This legislation will require conformity between federal and state treatments of these companies.

Resolutions of House and Senate Differences

While both the House and Senate bills contained these two major provisions, there were significant differences, primarily in how combined reporting would be implemented (for a description of these differences, see: http://www.massbudget.org/CorpTaxConference.pdf)

The legislation recommended by the conference committee, and enacted by the legislature, eliminates a potentially expensive new loophole and adopts compromise language on several other issues. While the legislation will make tax avoidance significantly more difficult, it does not provide the state department of revenue with all of the regulatory authority that the Governor's bill recommended to allow the department to prohibit new tax avoidance strategies as they are developed. As a result, future legislation may be needed to address those issues as they arise.

The 80/20 Loophole

The 80/20 loophole was the most fiscally dangerous provision in conference. It was a provision that had been contained in a House floor amendment that would have allowed companies with subsidiaries that do most of their business overseas to shift profits into those subsidiaries as a means of eliminating their state taxes on those profits. This provision could have cost the state over $100 million a year, but it was eliminated by the conference committee.

FAS 109

The House bill contained a provision creating a new tax deduction for companies "if book-tax differences for the fiscal period ending during the year of enactment of this section result in an increase to a net deferred tax liability or decrease to a net deferred tax asset for any taxpayer affected by this section." While there was no clear explanation of the need for this new deduction, businesses expressed a concern that accounting standards (FAS 109) would require them to disclose adverse financial implications resulting from the adoption of combined reporting in Massachusetts. The conference report keeps this deduction, but limits it to situations where there would be an increase in tax liabilities and does not make it available to offset decreases in tax assets. The compromise also requires disclosures and makes companies spread these benefits over seven years starting in 2012, rather than allowing the benefits to be taken immediately. It remains unclear how costly this provision will be.

Apportionment for Companies with Financial and Non-Financial Subsidiaries

Because financial and non-financial businesses are taxed in different ways, a combined reporting state needs to set rules for how to combine the income of companies that have both types of subsidiaries. The Governor had recommended that this be done by regulation after adoption of the legislation. The House would have combined different types of subsidiaries without adjustments. The Senate put specific adjustments into statute. This was the strategy adopted by the conference committee as well.

Federal Consolidated Return

In general combined reporting requires a unified business to have all of its subsidiaries file together. But if two totally separate lines of business are owned by one parent, they are not required to file together. Thus a car company might have to file one return including its various manufacturing subsidiaries, sales subsidiaries, management, etc. But if it is owned by a company that also runs a dairy farm that separate business can file separately. Both the House and the Senate created an option for these parent companies to combine together not just the subsidiaries in each line of business, but all of the businesses they own. For constitutional reasons, states can not require this type of combination, but they can allow it. The advantage of allowing it is that it can help to avoid conflicts over which subsidiaries are part of a unified business. The problem is that because it has to be an option, it will likely be chosen only by those companies that will see a reduction in their taxes as a result. It is not known how much this could cost the state. The Senate had recommended language limiting the tax reduction as a result of this option to twenty percent for any company. The conference committee did not adopt this provision, but did include language making sure that certain types of income wouldn't be able to be excluded from the full consolidated return.

Other Provisions

The Senate version of the legislation had included two other provisions. One, which was not included in the final bill, would have required Internet resellers of hotel rooms to charge the sales tax on the full retail cost of the room rather than the wholesale price they pay. This provision was not included in the final bill.

The Senate also included a provision that clarifies that non-residents with income earned in Massachusetts can receive the state earned income tax credit only on income earned in the state. The final legislation includes this provision.

Rate Reductions

The final legislation includes three sets of corporate tax rate cuts: reductions for publicly traded C-Corporations; reductions for S-Corporations, which are generally smaller companies and are not publicly traded; and reductions for financial institutions.

The rate for C-Corporations, which is currently 9.5%, is reduced over three years according to the following schedule:

Tax Year 2010: 8.75%
Tax Year 2011: 8.25%
Tax Year 2012: 8.00%

The taxation of S-corporations is somewhat more complicated (because owners of these companies are taxed on the income directly), but the bill provides rate cuts that essentially mirror the cuts for C-Corporations.

The tax rate for financial institutions, now 10.5% is reduced over three years as well, on the following schedule:

Tax Year 2010: 10.00%
Tax Year 2011: 9.5%
Tax Year 2012: 9.00%

Revenue Estimates

The legislation is estimated to generate $291 million in FY 2009 and $163 million when fully implemented in FY 2013.[1] These estimates could be high, however, as it is unclear what the cost will be of the federal consolidated return provision, the FAS 109 provision, and the limitations on the department of revenue's authority to prohibit new tax avoidance strategies. Because the costs of those provisions are not known, they are not included in these estimates.

The amount generated by the legislation will increase in FY 2010 because the major reforms become effective January 1st, 2009 and therefore will not generate a full year of revenue in FY 2009 (which goes from July 1, 2008 to June 30, 2009). After that the revenue generated each year declines as the tax cuts are phased in.

The year-by-year revenue estimates are as follows:

FY 2009: $291 million
FY 2010: $390 million
FY 2011: $269 million
FY 2012: $190 million
FY 2013: $163 million

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[1] This estimate assumes that none of the rate cuts would be effective until January 1, 2010, which is what documents prepared by the legislature suggest is the intent. It appears, however, that for technical drafting reasons, part of one of the cuts would take effect in 2009. That would reduce the FY 2009 revenue to $285 million. If, however, this technical issue is resolved, the corporate tax provisions would be expected to generate $289 million in FY 2009 and the EITC provisions would generate an addition $2 million.