COMMONWEALTH OF MASSACHUSETTS

STUDY COMMISSION ON CORPORATE TAXATION

FINAL REPORT

December 28, 2007

Members of the Commission

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Senator Cynthia Stone Creem, Senate Chair, Joint Committee on Revenue

Representative Bradley H. Jones, Jr., House Minority Leader

Senator Richard R. Tisei, Senate Minority Leader

Professor Alan Clayton-Matthews, Economist, UMass Boston

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Stephen W. Kidder, Managing Partner, Hemenway & Barnes, and Former Commissioner of Revenue

Alan LeBovidge, Executive Director, Massachusetts Turnpike Authority, and Former Commissioner of Revenue

Kevin F. Long, CPA, Long & Bott, PC

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TABLE OF CONTENTS

I. Introduction – The Commission and its Mandate 4

II. The Work of the Commission 5

a. Phase 1 and Interim Report 5
b. Phase 2 and the Work of the Subcommittees 7
c. Discussion: Toward Final Report and Recommendations 20

III. Recommendations of the Commission 26

IV. Items and Forum for Further Study 31

Attachments (Index of Attachments and Appendices) 35

Separate or Dissenting Statements and Comments on Final Report 40

Appendices 65

This Study Commission on Corporate Taxation was created on April 30, 2007 at the joint direction of the Governor of Massachusetts, Deval Patrick, the Speaker of the House, Salvatore DiMasi, and the Senate President, Therese Murray.

I. Introduction -- the Commission and its Mandate

In their joint statement announcing the Commission and designating its fifteen members, the Governor, Speaker, and Senate President identified the fifteen members they were appointing to the Commission and charged them with the responsibility to "review and offer recommendations for streamlining the current tax code". See Appendix A. As described in the statement, the scope of the Commission's contemplated review and recommendations encompasses the Governor's bill, House No. 3756, An Act Improving the Fairness of the Tax Laws, as well as other subjects of business taxation in the areas of corporate excise tax, personal income tax, and sales and use taxes.

In addition, the joint statement described a broad mandate of the Commission, specifically "to study the modernization and simplification of the current business tax laws of the Commonwealth, to promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness."

The Commission was directed to file "an interim report on legislative recommendations providing revenue for Fiscal Year 2008" by June 15, 2007, and "a final report on long-term changes to corporate tax laws" by January 1, 2008.

II. The Work of the Commission

(a) Phase 1 and Interim Report. After several meetings of the Commission, the receipt of testimony and written presentations from a variety of experts, the conduct of a public hearing, and substantial discussion among its members, the Commission submitted its interim report on June 15, 2007 in the form of two documents.

A majority of eight members of the Commission joined in an Interim Report that made an initial recommendation that Massachusetts conform its business entity classification rules to the federal law that is generally followed for this purpose in other states (commonly referred to as the "check-the-box rules"). See Appendix D. Massachusetts law already adopts this uniform check-the-box classification system for classifying limited liability companies for tax purposes. In addition, the members joining this Interim Report expressed support for the purposes of the other measures proposed in the Governor's bill, after describing serious problems that have arisen under the Commonwealth's existing business tax system, including erosion of the business tax base from income-shifting and other tax planning techniques, and the lack of equity and neutrality caused by taxpayers being more or less able to engage in such tax planning. The report observed that the state's business tax laws "allow significant tax avoidance not intended by the Legislature", and that "larger multistate businesses, many of which are based outside of the Commonwealth, are the principal users of this kind of corporate structuring for tax reduction purposes", in contrast to Massachusetts-based smaller businesses that lack such opportunities. However, the report indicated that more time was needed to study the potential design and implementation of these other reform measures. As noted further below, this Interim Report also flagged certain other subjects

for further study by the Commission.

The other seven members of the Commission joined in an "Interim Report of a Minority of Members". See Appendix E. This minority report reached the judgment that as of the close of that first phase of the Commission's proceedings, it was "inappropriate, on an interim basis", for the Commission to recommend enactment of any particular proposal to raise new revenue for Fiscal Year 2008. While acknowledging "the potential usefulness of new revenue for government programs" for this fiscal year, "as well as the possible need to promote fairness by making adjustments to the tax code," the minority report expressed the view that recommendations for any increase in tax required a "full understanding of the context, consequences, and cost of those changes," and that given the "complexity of the underlying issues and the substantial nature of the proposals being discussed" it was not possible prior to the interim report due date for the Commission to do the kind of thorough review and vetting of recommendations that the minority considered necessary. The minority report further stated that "the decision of how to spend available revenue is a purely legislative function, outside the scope of the Commission's powers," and that recommendations made by the Commission should be made "solely on the basis of the principles and goals expressed in its mandate, regardless of the ultimate fiscal benefit".

In addition to the discussion of particular recommendations and issues in the two interim reports, members from across the Commission identified, in the course of the first phase of the Commission's work, various subjects that the members viewed as warranting further study, along with the specific proposals in the Governor's bill on which recommendations were still to be made. These topics included:

- potential revisions to the minimum corporate excise;
- potential simplification of the various classes of businesses and the tax rates applicable thereto;
- consideration of alternative measures of business taxation, such as taxes on gross receipts, gross margin, or “value added”; and
- consideration of whether the Commonwealth should fully participate in the Streamlined Sales Tax Project by conforming its laws to the Streamlined Sales and Use Tax Agreement.

(b) Phase 2 and the Work of the Subcommittees. In order to conduct an efficient and in-depth study of these multiple proposals and topics, six subgroups of the Commission were established, each of which would focus on one or more specific topics. These groups, which have commonly been referred to within the Commission as "subcommittees", and their respective members were comprised as follows:

- **Subcommittee on Combined Reporting** - Kidder (chair), Fryzel, Steinmetz, Tannenwald, and Widmer
- **Subcommittee on "Other Governor Proposals"** - LeBovidge (chair), Donovan, and McAnneny
- **Subcommittee on Minimum Corporate Excise** - Senator Creem (chair), LeBovidge, and Widmer
- **Subcommittee on Business Tax Rates, including Non-Income Excise and “Balance Sheet” Tax** - Senator Tisei and Representative Jones (co-chairs), Clayton-Matthews, and McAnneny

- **Subcommittee on Alternatives to the Corporate Excise, including Gross Receipts, Gross Margin, Value Added** - Donovan (chair), Clayton-Matthews, and Long
- **Subcommittee on Streamlined Sales Tax** - Fryzel (chair), Representative Binienda, and Tannenwald

Each of these subcommittees met several times, reviewed numerous proposals, articles, data, and other materials, and heard presentations from a number of experts and interested parties, both within Massachusetts and nationally, as noted below in this report and detailed in the various Subcommittee reports and other materials that are attached as Appendices.

Those subcommittees charged with considering the proposals included in the Governor's bill, in addition to the "check-the-box conformity" proposal discussed above, took separate votes on whether to recommend each of the proposed measures. The resulting recommendations of the Subcommittee on Combined Reporting and the Subcommittee on "Other Governor Proposals", respectively, are briefly summarized here and in a Preliminary Outline (Appendix Q) that was prepared for the meeting of the full Commission on December 5, 2007.

- *The Subcommittee on Combined Reporting* concluded its consideration of adopting a combined reporting system in Massachusetts by taking two votes.[1] In

[1] For purposes of both votes, the Subcommittee unanimously agreed as to certain important elements or technical underpinnings for the adoption of a combined reporting system, specifically: (i) key concepts would be reflected in the statute, and there would be a sufficient time period for implementation of a combined reporting system, including development of regulations with opportunity for significant public input into the process; (ii) a water's edge election would be offered ("worldwide unitary" would not be mandated); (iii) the *"Finnigan"*, rather than *Joyce*, method of apportionment would be utilized; (iv) details as to the scope of entities to be included in combination and the methodologies for combining them would be described; (v) there would be an appropriate sharing of credits and loss carryforwards within a combined group; and (vi) consideration would be given to providing a safe harbor election to permit inclusion of

one vote, the Subcommittee by a 3-2 margin supported adoption of a combined reporting system irrespective of whether such a proposal would be implemented on a "revenue neutral basis" (v*oting for* - Kidder, Fryzel, and Tannenwald; *voting against* - Steinmetz and Widmer). In the other vote, the Subcommittee by a 4-1 margin supported adoption of a combined reporting system if it were adopted on a "revenue neutral" basis, with revenue neutrality being achieved through a corporate tax rate cut (*voting for* - Kidder, Fryzel, Tannenwald, and Widmer; *voting against* - Steinmetz[2].)

In addition, independent of the revenue neutrality issue that was a condition to Mr. Widmer's vote in favor of combined reporting but not to the votes of Messrs. Kidder, Fryzel, and Tannenwald,[3] all members of the Subcommittee expressed their support for a meaningful corporate tax rate reduction. The members felt that such a rate cut would improve the Commonwealth's competitiveness, combat a negative perception associated with the current nominal rate, and provide a material tax benefit to all corporate taxpayers, including smaller taxpayers, taxpayers wholly in Massachusetts, and other taxpayers who cannot or do not benefit from income-shifting or other tax planning techniques that have been utilized by large multistate taxpayers.

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certain entities in the combined reporting group. With respect to item (iv), at the request of Subcommittee members, the Department of Revenue subsequently prepared two examples which the Subcommittee Chair circulated by email on December 4, 2007. As Subcommittee Chair Kidder noted in his email, the examples were designed to be "illustrative of the approach that they think makes sense", not as the only way to apportion or as the only way DOR would support. See Appendix T.

[2] In dissenting from this second vote, Ms. Steinmetz reflected her view that she could not cast a favorable vote in the absence of knowing the full details of certain technical implementation issues.

[3] Messrs. Kidder, Fryzel, and Tannenwald expressed their support for combined reporting as a "better" tax system, combating tax avoidance practices and promoting equity and neutrality among taxpayers. They viewed the question of revenue impact as a fiscal policy issue for the Legislature and fiscal policymakers.

The draft final report of this Subcommittee, issued on November 13, 2007, provides details with respect to the combined reporting proposal and the Subcommittee's consideration thereof. See Appendix K.

- *The Subcommittee on "Other Governor Proposals"* addressed the remaining proposals contained in the Governor's bill, and voted on each proposal as follows:
  - *Application of room occupancy tax to amount customer pays for hotel room that is charged and retained by internet intermediaries, etc.* (Subcommittee voted 3-0 in favor).
  - *Earned income credit – technical revision to limit the credit available to non-residents* (Subcommittee voted 3-0 in favor).
  - *Application of corporate excise tax to non-insurance flow-through entities owned by insurance companies* (Subcommittee voted 2-1 in favor).
  - *Application of deeds excise tax to transfers of controlling interests in entities whose value is attributable primarily (at least 80%) to real estate* (Subcommittee voted 2-1 in favor).
  - *Application of sales/use tax to transfers to captive leasing companies* (Subcommittee voted 2-1 against).

  Details of these proposals, and discussion of the views expressed by the Subcommittee's members with respect to the proposals, are set out in the final report of this subcommittee issued on November 12, 2007. See Appendix N.

Other subcommittees:

- *The Subcommittee on Streamlined Sales Tax* focused on a particular matter of both local and national importance, the erosion of the sales/use tax base through the growth of internet and mail order sales as to which "remote" vendors (i.e., those with no physical presence in Massachusetts) are not currently required to collect sales/use tax on sales to Massachusetts customers. This has presented a problem not only in terms of the erosion of the tax base, but also in terms of the competitive disadvantage felt by Massachusetts "main street" retailers who collect sales tax on their in-store sales.

  After hearing support from a wide variety of presenters, including officers of the Streamlined Sales Tax Governing Board, Senator Richard T. Moore, staff for Congressman William D. Delahunt, the Retailers Association of Massachusetts, and national business organizations and service providers, the Subcommittee voted unanimously (3-0) to recommend that Massachusetts enact the necessary legislation to adopt the Streamlined Sales and Use Tax Agreement (SSUTA) and to become a fully participating state in the Streamlined Sales Tax Project (SSTP).

  As detailed in its final report issued November 12, 2007, the Subcommittee found that the benefits of adopting SSTUA outweighed the potential costs. See Appendix P. The Subcommittee also concluded that a state adopting SSTUA "does not lose sovereignty because each state decides which items to tax", and that various local option taxes can still be enacted so long as they are appropriately kept distinct from the state sales and use tax

laws, including the pertinent SSUTA provisions.

In making this recommendation, the Subcommittee deferred to the full Commission regarding "recommendations for particular revenue adjustments", urged the Commission to adopt an appropriate time frame for the transition from the current system to the SSUTA system, and stated that it considered the adoption of SSUTA to be "beneficial to the Commonwealth even without the adoption of federal nexus legislation" permitting states to require remote, out-of-state vendors to collect sales/use tax on sales to Massachusetts customers, "although the enactment of such legislation would substantially enhance the benefits" of SSUTA.

- The other three subcommittees – those focused on the minimum corporate excise, on business tax rates, and on alternatives to the existing corporate excise – necessarily embarked on inquiries and analyses spanning a broad range of issues under existing law (and, in the case of the inquiry into alternative measures, the laws of a number of other states). As noted from various of the conclusions of their respective reports, some of their conclusions or recommendations called for further study and/or were dependent upon specific reforms that might first be adopted pursuant to the recommendations of other subcommittees. More specifically:

    - The *Subcommittee on Minimum Corporate Excise* focused in particular on an analysis of what types of corporations pay the current minimum

corporate excise, and why. See Appendix M (final report of the Subcommittee issued on December 5, 2007, from which Mr. Widmer dissented – see further below). The Subcommittee found it significant that many large corporations have been paying the minimum excise (without utilizing tax benefits that have been intentionally provided through legislation, such as investment or research credits), despite being part of affiliated corporate groups that reported significant net worth and revenues for the group as whole. The Subcommittee also found that corporations appearing to be in similar financial conditions paid significantly different amounts in Massachusetts taxes. In some cases, it appeared that highly-profitable corporations are paying the minimum tax, while smaller corporations with more modest profits or even losses are paying significantly more.

The analysis of these corporate filers paying the minimum tax provided further support, in the Subcommittee's view, for the conclusion that a number of large corporations were reducing their corporate excise to minimal levels through structuring techniques that shifted income to out-of-state affiliates. The Subcommittee opined that reform of the corporate excise system is needed in order to minimize the impact of such strategies, and specifically recommended the adoption of some form of combined reporting.

The Subcommittee concluded that corporations paying the minimum excise should be limited to those that are minimally

profitable and only have minimal financial resources (including those that are effectively inactive), and stated that working toward such an outcome would improve the overall fairness of the corporate tax system. The Subcommittee's report indicated that while there is an argument for increasing the minimum excise from its current rate of $456, such an increase alone, without further reform, would not achieve the Commission's goals, as it would not address the current disparity in the profiles of those corporations able under current law to pay the minimum excise.

The Subcommittee said that its view of the minimum tax itself "is colored by what, if anything is done to reform the corporate tax system. If steps are taken to make it more equitable (i.e. combined reporting), then the only remaining decision need be the absolute size of the minimum excise for very small and/or inactive corporations", whereas "if no reform of the corporate tax system is put in place . . ., consideration of changing the existing minimum excise structure to one . . . based upon a company's size (i.e. revenue, net worth …) is appropriate."

The Subcommittee also stated that a review of the current net worth measure of the excise[4] may also be warranted, under either a proposed combined reporting system or within the current corporate

[4] Under the current system that has been in place for many decades, the non-income measure of the corporate excise is based either on taxable net worth or taxable tangible property, depending on whether a corporation is classified as an intangible property corporation or a tangible property corporation, respectively. See G.L. c. 63, sections 30, 32, and 39.

tax structure.

Mr. Widmer dissented from the Subcommittee's report. He indicated that he was concerned with the tone of certain aspects of the report, and he noted that in his view "the majority reached conclusions which went well beyond the analysis that was provided by DOR for the subcommittee."[5]

- The *Subcommittee on Business Tax Rates* issued a preliminary status report on October 16, 2007 (see Appendix H) and its final report, joined in by a majority of its members,[6] on November 13, 2007 (see Appendix I). As it described its mission in the preliminary status report, the Subcommittee "was charged with analyzing the current corporate tax rate structure" and "with making recommendations as to how the tax rate structure should be amended, if at all." The Subcommittee held two meetings, heard presentations as described in its reports, and, as described in its final report, had extensive discussions of the "feasibility of instituting various corporate tax structures to replace the current structure", including discussions of a flat or more uniform tax rate.

[5] See email from Michael J. Widmer dated Dec. 18, 2007 (Attachment 6), commenting on draft final report.
[6] Professor Clayton-Matthews did not specifically join in the report. He states that he supports simplification and the goal of lowering the corporate income tax rate toward the rate applicable to individuals in order to discourage corporate tax avoidance. However, he was amenable to such changes only if other taxes, such as the personal income tax, were raised, as he believes current state revenues are inadequate to support needed services. To the extent that the source of revenues can be shifted away from the corporate income tax and toward non-corporate revenue sources, he believes competitiveness would be improved (businesses being more sensitive to tax rates than are individuals), while at the same time providing additional needed revenue.

In its final report, the Subcommittee described its focus as "investigating ways to reduce the corporate excise tax rate, or eliminate the non-income measure of the corporate excise (the so-called 'balance sheet tax'), in return for removing some intentional or unintended tax provisions ." The majority of the Subcommittee expressed the view that the increase in revenue projected in connection with proposed corporate tax revisions was a "cause for concern", as it would come at the expense of businesses and affect competitiveness. The majority members said that they "do not presume to advocate for or against the adoption of specific 'loophole closings'" proposed by the Governor, as that was a responsibility for the Commission as a whole, but concluded that the Commission should propose offsets to the revenue-enhancing changes, and to that end the Subcommittee developed a "series of options for such adjustments", generally involving one or more reductions in corporate tax rates for particular entity classes and/or removal of the "balance sheet tax" (see next paragraph), all as detailed in the Subcommittee's final report.

The Subcommittee's report also observed that the existing corporate tax structure is "a complex and confusing web of laws subject to frequent revision and constant reinterpretation" with 14 different entity classifications and a number of separate tax rates, and suggested that any changes to the tax laws, whether to offset revenue increases or otherwise, "should also be aimed at simplifying and

modernizing our state's revenue structure." The Subcommittee also stated that "the non-income measure 'balance sheet' tax should be evaluated", viewing the property measure as "archaic" in light of changes in the tax laws over the years that have altered practices that had existed contemporaneously with the institution of the property measure.

- The *Subcommittee on Alternatives to the Corporate Excise* issued its final report on November 13, 2007, reviewing a number of alternative tax regimes that might be considered for adoption in the Commonwealth, either in replacement of certain existing taxes or as a supplement thereto. See Appendix G. The Subcommittee held four meetings, and received presentations from five experts on state taxation who have been "involved intensively in major revisions to the tax structures of at least one state", and also reviewed a "briefing binder" and other materials detailing the advantages and disadvantages of various alternative methods of taxing businesses at the state and local levels.

  A majority[7] of the members of the Subcommittee concurred in several specific conclusions:

  - the present system of taxing businesses in Massachusetts is overly complex, and in some respects obsolete;

[7] Professor Clayton-Matthews separately noted his view that any reform that entails a radical departure from the current structure – e.g., a value added tax – could have a significant impact on competitiveness and on the distribution of income, and he would not favor such a change until such impacts could be estimated. See the second appendix within this Subcommittee's final report, attached as Appendix G.

- the relatively high nominal rate of income tax (9.5%) “masks a largely favorable tax environment, at least for certain industries with respect to the which the Legislature has provided tax incentives, including mutual fund service companies, manufacturers, and companies that are research intensive”; the majority generally endorsed such incentives, but questioned whether the high nominal rate may hurt competitiveness;
- Intentionally granted preferences aside, the “radical differences in tax treatment” afforded to businesses depending on industry and legal form are “difficult to justify”;
- The Commonwealth’s reliance on taxing income of corporations “on a separate-entity basis leaves the tax base vulnerable to manipulation by large multistate corporations”, which “could be cured either by combined reporting or adoption of alternative regimes”; and
- The Commonwealth’s reliance on taxing income of corporations even on a combined reporting basis would leave the tax base vulnerable to erosion during an economic downturn, which could be cured by adoption of an alternative regime imposing tax upon a different measure or base at a low rate.

However, the Subcommittee also observed that each of the alternative regimes discussed in its report carries disadvantages that

should be weighed by policymakers before shifting from reliance on the income tax or supplementing the existing tax regime.

The Subcommittee suggested that an alternative regime as described in its report might be considered not as a replacement tax but, rather, as a form of alternative minimum tax designed to reach corporations that benefit from state-provided services and infrastructure even when they have no taxable income, as well as other "flow-through" entities like partnerships and limited liability companies that currently pay no entity-level tax.

While making "no hard and fast recommendations to the Commission . . . relative to the adoption of alternative regimes", the Subcommittee expressed the view that "some of the alternative regimes examined . . . offer significant advantages over our current tax structure in simplicity, resistance to manipulation, and revenue stability". However, the Subcommittee said that if serious consideration is given to such an alternative, two threshold questions must be addressed: whether to replace or supplement the current structure; and whether to extend an alternative regime to flow-through entities that pay no corporate tax. The Subcommittee evaluated the various alternative regimes that it considered, and thought that the value added tax model "offers the most promise".

(c) Discussion -- Toward Final Report and Recommendations. Following the receipt of draft and final Subcommittee reports, the full Commission met on November 13, 2007 to receive and discuss these reports (with the Subcommittee chairs presenting a summary of their Subcommittees' deliberations), and then met again on December 5, 2007 to begin discussion of the Commission's Final Report. A Preliminary Outline of agenda items for discussion at that meeting is attached as Appendix Q.

There was extensive discussion of particular recommendations made by various of the Subcommittees:

- *Combined reporting* – There was discussion of the positives of moving to a combined reporting system from the standpoint of (a) promoting fairness and neutrality among different taxpayers, large and small, and multistate and in-state, (b) increasing economic efficiency by reducing distortions from tax-avoidance practices, (c) achieving simplification, particularly when combined with check-the-box conformity, and (d) preserving the corporate tax base from further erosion through income shifting and other practices. Ms. Steinmetz noted with respect to the combined reporting and check-the-box conformity proposals that if these changes are implemented, they should be joined with simultaneous effective dates.

  At the same time, there was recognition that the Commonwealth needed to be cognizant of the risk of creating a negative perception from the standpoint of the business community, including companies considering location or expansion in the Commonwealth. To this end, there was broad support expressed for cutting the nominal corporate income tax rate from its current 9.5%, which members

from across the Commission viewed as having a negative impact on competitiveness. In addition, it was recognized that such a rate cut would provide a substantial benefit to *all* corporations, including those small corporations, wholly in-state corporations, and other corporate taxpayers subject to the current 9.5% rate that have not been in a position to shift income under the existing separate company tax reporting system.

There was discussion of whether such rate cut should be of such a magnitude as to achieve a projected "revenue neutrality", a point on which members of the Subcommittee on Combined Reporting had divided as discussed earlier in this report. Some members expressed the view that combined reporting reflected a better and more modern system as a matter of tax policy, curbing unintended loopholes and related tax planning and a resulting erosion of the tax base, and thus should be supported irrespective of the revenue neutrality issue. They also viewed the question of revenue neutrality as part of a much broader question of fiscal policy for the Commonwealth that should be left to legislators and other policymakers. Others felt that revenue neutrality was an essential feature of a business tax reform of this magnitude, emphasizing the issues of business competitiveness and jobs creation.

Related to the subject of revenue neutrality, Representative Binienda distributed an outline of points for consideration that would encompass a combined reporting system together with check-the-box conformity, with simultaneous effective dates, along with a very substantial corporate income tax rate cut, a reduction in the rate of business tax credits made available to corporate

taxpayers, an increase in the corporate minimum tax, and adoption of the Streamlined Sales and Use Tax Agreement to become a fully participating member in SSTP. A copy of this outline is attached as Appendix R.

Commissioner of Revenue Henry Dormitzer described an analysis that the Department of Revenue conducted with respect to the erosion of the corporate tax base, and observed that the current separate company tax reporting system cannot keep pace with tax planning strategies such as those that shift income to other affiliates. See Appendix S. The DOR's study showed that over the last ten years, while corporate profits in Massachusetts had grown by more than 70%, over the same period the corresponding business tax collections had increased by only 49%.[8] The Commissioner noted that over 72% of the state's pending tax litigation receivables are attributable to income shifting, and would not exist if the separate company reporting system were replaced with a combined reporting system and check-the-box classification conformity. Commissioner Dormitzer noted that while the state's nominal 9.5% corporate income tax rate was among the highest nationally, the effective rate was substantially lower at 6.1%, and that the Council on State Taxation had determined that overall business taxes in Massachusetts were below average.

The Chair recognized that the issue of revenue neutrality was a key one to many members. Mr. Widmer urged that the Final Report present several options,

[8] DOR reports that the starting point for its analysis was domestic corporate profits as reported to the federal Internal Revenue Service. DOR allocated those profits to Massachusetts using the Massachusetts share of Gross State Product (GSP). DOR then compared those allocated profits to the corporate/business excise taxes received by the Commonwealth. DOR reports further that it found similar results when allocating domestic corporate profits to Massachusetts alternatively on the basis of Massachusetts non-farm payroll, wages and salaries, and population.

to take account of the difference of views on this revenue neutrality question. The Chair agreed and noted that there could be further outcomes as well, recognizing the broad support from Commission members generally for a meaningful rate cut.

- *Other Governor Proposals* and *Streamlined Sales Tax* proposal – There was some additional discussion of these proposals on which the Subcommittee on Other Governor Proposals and the Subcommittee on Streamlined Sales Tax, respectively, had taken specific votes. (See earlier discussions in this report.) The Chair suggested that the full Commission vote on these proposals at the next meeting.

  There was recognition that some of the proposals -- specifically relating to applying the room occupancy tax to hotel charges by intermediaries, to clarifying the earned income credit, and to adopting the Streamlined Sales and Use Tax Agreement – had received unanimous support within their respective Subcommittees. With respect to the Streamlined Sales Tax proposal, Mr. Fryzel, chair of the SST Subcommittee, summarized the favorable conclusions of the Subcommittee and noted that Massachusetts would not require major law changes in order to adopt the SSUTA, and that both state sovereignty and the ability to have certain local-option taxes would be preserved. He noted that the Subcommittee left the issue of revenue adjustments to the full Commission and ultimately the Legislature and Governor, but noted that options have been presented to the Subcommittee by DOR for making the SSUTA law changes and for offsetting the resulting revenue impact by making certain items either taxable

or non-taxable. These options are contained in appendix D of the Subcommittee's "Status Report", set out as Appendix O to this report.

By contrast, the proposal to apply the corporate excise tax to non-insurance business entities owned by insurance companies and the proposal to expand the deeds excise tax to cover certain transfers of controlling interests in companies whose assets are primarily comprised of real estate had received divided endorsements at the Subcommittee level, in each case by 2-1 votes. And the proposal to impose sales/use tax to captive leasing companies had received a negative 2-1 vote at the Subcommittee level.

As to the first of these "divided vote proposals", Mr. Donovan, a member of the Subcommittee that studied these, stated that some legitimate concerns had been raised by the insurance industry and members of the Commission as to the applicability of so-called retaliatory taxes in other states, and said that while he thought those concerns could be overcome with an appropriately-crafted provision, he would not be opposed to a longer-range, in-depth study of this issue. Ms. McAnneny, also a member of that Subcommittee, endorsed that view, agreeing that further study of proposals receiving divided support would be appropriate and suggesting that only those items receiving unanimous approval at the Subcommittee level should be presented for approval by the full Commission. Some questions had also been expressed as to whether the proposed deeds excise change was warranted at this time, given testimony by opponents citing authority of DOR under existing law to challenge tax avoidance transactions. And support was also expressed for further study of the captive leasing proposal; Mr. Fryzel

noted while captive leasing strategies had been described by those voting against it in subcommittee as simply achieving tax "deferral", such timing issues can be critically important and thus merit study.

- *Items for further study* – In addition to the items noted in the preceding paragraph, a number of additional topics were discussed that, both at the Subcommittee level and within the full Commission, were thought to be important and warranting further study. For example, Senator Creem, chair of the Subcommittee on Minimum Corporate Excise, described the Subcommittee's examination of the substantial number of corporations with corporate group revenues above $1 billion that paid the minimum tax in Massachusetts, and the conclusion that some of these corporate groups had shifted income among jurisdictions. In addition to that Subcommittee's support for combined reporting as a means of addressing income shifting, which the Subcommittee concluded would have raised an additional $29 million in revenues from 35 corporate taxpayers, Senator Creem raised issues of potential reform to the net worth measure (e.g., a tax on consolidated net worth), either in replacement of the existing measure or as an alternative minimum tax, and of a potential increase in the minimum tax amount, perhaps via a sliding scale so as not to overly burden small businesses.

  Senator Tisei, co-chair of the Subcommittee on Business Tax Rates, emphasized the goal of not simply reducing corporate income tax rates, but also simplifying and condensing those rates. His Subcommittee's work also focused attention on reducing the multitude and complexity of different tax regimes or

subregimes for different types of business entities. As reflected earlier in this report, Senator Tisei's Subcommittee examined the complex and confusing plethora of business entity categories and applicable rates under existing Massachusetts law.

The Subcommittee on Alternatives to the Corporate Excise also examined, from a different perspective, the complexity and limitations of existing Massachusetts law, including the antiquated form of "balance sheet tax", and put forward without formal recommendation particular ideas for either revising or supplementing existing law, e.g., through adoption of a different type of taxing regime or an alternative minimum tax measure.

Other areas for study that have been raised at several points have included the various specific credits and other tax incentives that have been extended to particular industries or types of businesses, and the complexity and limitations upon the existing benefits accorded by the Commonwealth to research and development activities and expenditures.

III. Recommendations of the Commission

The Commission held its final meeting on December 18, 2007, and voted on a number of potential recommendations for changes in the business tax laws, as summarized below:[9]

[9] Substantive aspects of the various proposed changes have been previously described in this report, the interim report, and subcommittee reports, and are subject to such additional points as are noted in the summary of votes reported here.

- *Combined Reporting, Check-the-box Classification, and Corporate Income Tax Rate Reduction.* The Commission's first vote was on a series of potential changes. The Chair asked that the members vote on whether they would support adoption of a system of combined reporting, together with a change in the entity classification rules to achieve conformity with the federal check-the-box rules that are generally followed in other states, and to indicate in such vote whether the recommendation should include a proposal for meaningful reduction in the corporate income tax rate[10] and whether the recommendation should be conditioned on achieving revenue neutrality. By a 9-6 vote, the Commission voted to support a recommendation of three parts: (i) adoption of a combined reporting system, (ii) revising the business entity classification rules to conform to the federal check-the-box rules, and (iii) achieving a meaningful reduction in the corporate income tax rate, but without requiring that a rate reduction achieve revenue neutrality (*voting for:* Chair Kirwan, Representative Binienda, Senator Creem, Clayton-Matthews, Donovan, Fryzel, Kidder, LeBovidge, and Tannenwald; *voting against*: Representative Jones, Senator Tisei, Long, McAnneny, Widmer, and Steinmetz[11]).

[10] Asked during the discussion preceding this vote to elaborate on what would represent a "meaningful" rate reduction, the Chair indicated that while she would not propose a specific numerical rate (as the extent of an ultimate rate cut was a matter better left to the Governor and Legislature to resolve), the reduction should not be a "token" but should be significant enough to send a positive message of business competitiveness in the Commonwealth.

[11] Ms. Steinmetz states that her support of this recommendation would require (i) simultaneous effective dates for combined reporting and check-the-box conformity, (ii) stating a "a *specified* rate cut in order to provide the Legislature with a clear recommendation as to a 'meaningful' and substantial rate reduction that is appropriate", and (iii) providing greater details as to the proposed combined reporting system, including as to the types of entities subject to combination and the methodology for including different taxpayers in a

Several members voting in the majority for these proposals indicated that they would also support combined reporting and check-the-box conformity irrespective of any rate cut, because in their view the tax policy changes represented by combined reporting and entity classification conformity would improve the current tax system; the rate cut question represented a separate fiscal policy matter for the Legislature and Governor to address. However, these members said they also supported a meaningful lowering of the corporate income tax rate as a good way to send a positive message of business competitiveness.

Several members voting against these proposals indicated that they would support combined reporting and check-the-box conformity if certain specifications were met (see footnote 11 above) or if these changes were conditioned on revenue neutrality (or at least on a very substantial corporate rate cut that would approach revenue neutrality).

After taking the vote described above, the Commission voted on a motion by Representative Jones that any corporate tax changes be conditioned on revenue neutrality.[12] This motion was defeated by a 10-5 vote (*voting for:* Representative Jones, Senator Tisei, Long, McAnneny, and Widmer; *voting against:* Chair Kirwan, Representative Binienda, Senator Creem, Clayton-Matthews, Donovan, Fryzel, Kidder, LeBovidge, Steinmetz, and Tannenwald).

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combined report, and the adoption of a "federal consolidated group election" (which Ms. Steinmetz had proposed to the combined reporting subcommittee at its final meeting and in a draft report presented at that meeting). She further states: "Considering that the final report neither addresses such specifics of the combined reporting regime nor specifies a rate reduction, Ms. Steinmetz does not support the final recommendation."

[12] See copy of proposed motion from Representative Jones circulated in advance of the Commission's meeting, attached as Appendix U.

- *Application of Room Occupancy Tax to Intermediary Resellers.* The Commission voted in favor of this proposal by a 12-3 vote (*voting for:* Chair Kirwan, Senator Creem, Clayton-Matthews, Donovan, Fryzel, Kidder, LeBovidge, Long, McAnneny, Steinmetz, Tannenwald, and Widmer; *voting against*: Representative Binienda, Representative Jones, and Senator Tisei).
- *Clarification of Earned Income Credit.* The Commission voted in favor of this proposal by a 13-2 vote (*voting for:* Chair Kirwan, Representative Binienda, Senator Creem, Clayton-Matthews, Donovan, Fryzel, Kidder, LeBovidge, Long, McAnneny, Steinmetz, Tannenwald, and Widmer; *voting against*: Representative Jones and Senator Tisei).
- *Adoption of Streamlined Sales and Use Tax Agreement, with Commonwealth Becoming Full Participant in Streamlined Sales Tax Project.* The Commission voted in favor of this proposal by a 14-1 vote (*voting for:* Chair Kirwan, Representative Binienda, Senator Creem, Senator Tisei, Clayton-Matthews, Donovan, Fryzel, Kidder, LeBovidge, Long, McAnneny, Steinmetz, Tannenwald, and Widmer; *voting against*: Representative Jones).
- *Items for Further Study:* By show of hands rather than a formal roll call vote, a majority of the Commission voted to recommend the following items for further study rather than to make a specific recommendation:
    - *Application of Corporation Excise to Non-Insurance Business Entities that Are Not Currently Subject to Income Tax on Business Income* (the draft final report had noted the views previously expressed by several members supporting further study of this proposal, including issues of

whether other states might seek to assert retaliatory insurance taxes). Ms. McAnneny voted against the proposal for further study, indicating that she would prefer to vote now.

- *Application of Deeds Excise to Certain Transfers of Controlling Interests in Companies Whose Assets Are Primarily Real Estate* (the draft final report had noted the views previously expressed by several members supporting further study of this proposal, including whether a law change of this kind is needed given current law protections against tax-avoidance transactions). Mr. Long, Ms. McAnneny, and Ms. Steinmetz voted against the proposal for further study, indicating that they would prefer to vote now.

- *Resolution Supporting Meaningful Corporate Rate Cut.* Senator Tisei proposed that in addition to the prior vote referenced in the first bulleted item of this Part III above, the full Commission express its support to the Legislature for achieving a meaningful corporate income tax rate cut. No particular rate was specified, this resolution being designed to send an "aspirational" message given the importance that Commission members placed on the objective of business competitiveness. Thirteen members voted in favor of the resolution. Senator Creem did not cast an affirmative vote but simply voted "present" and abstained, citing her view that the appropriate tax rate was a fiscal matter for Legislative deliberations. Ms. Steinmetz also abstained, indicating she could support only a rate cut that was specified.

IV. Items and Forum for Further Study

- *Items for Further Study*

    a. As indicated in the preceding section of this report, the Commission voted to support further study of the following proposed changes:

    (i) Application of Corporation Excise to Non-Insurance Business Entities that Are Not Currently Subject to Income Tax on Business Income;

    (ii) Application of Deeds Excise to Certain Transfers of Controlling Interests in Companies Whose Assets Are Primarily Real Estate.

    b. In addition, as referenced in the last bulleted section of Part II(c) above, during the course of the Commission's proceedings a number of other issues were identified as warranting study. These include, but would not be limited to:

    (i) potential reform of the net worth measure of the corporation excise (e.g., using a consolidated net worth measure), either in replacement of the existing measure or as an alternative minimum tax;

    (ii) potential increase in the minimum tax amount, perhaps via a sliding scale so as not to overly burden small businesses;

    (iii) simplifying and condensing the multiple categories of corporations subject to corporation excise and the different rates applicable thereto;

(iv) potential reform or elimination of the entire "balance sheet tax" (perhaps in conjunction with adoption of alternative tax regime or measure, see next item);

(v) revising or supplementing existing law through adoption of a different type of taxing regime or an alternative minimum tax measure;

(vi) review and potential reform of the various specific credits and other tax incentives extended to particular industries or types of businesses;

(vii) review and potential reform of the rules and limitations governing tax benefits extended to research and development activities and expenditures;

(viii) the captive leasing sales/use tax proposal which, although not receiving a positive vote in subcommittee and thus not advanced for full Commission vote, was proposed for further study.[13]

- *Forum and Participants* – As indicated, the Commission's discussions and actions have contemplated, and stressed the importance of, further study of potential reforms raised within the Commission that were not considered ripe for a specific legislative recommendation prior to issuance of the Commission's final report that would complete its work. As envisioned, such further study would involve participants from the legislative and executive branches of state government, from the business community, from public policy and academic communities, and from the tax practitioner community, who would join Department of Revenue representatives in addressing the

[13] See pages 24-25 above.

items identified by the Commission and its members, as described above, and additional items that may be proposed. DOR has offered to host such discussions and to provide appropriate research, statistical, and logistic support as participants may find helpful.

Respectfully submitted,

Leslie A. Kirwan
Alan LeBovidge
Stephen W. Kidder
Alan Clayton-Matthews
Joseph X. Donovan
Karl P. Fryzel
Robert Tannenwald
Cynthia Stone Creem
John J. Binienda, Sr.

December 28, 2007

Attachments

Separate or Dissenting Statements and Comments on Final Report

Attachment 1, "Dissenting Opinion of House Minority Leader Bradley H. Jones, Jr. to the Report of the Corporate Tax Study Commission"

Attachment 2, "Comments of Member Joseph X. Donovan of Sullivan & Worcester LLP on the Work of the Study Commission"

Attachment 3, "Comments of Member Kevin F. Long On the Deliberations and Final Report of the Special Tax Commission"

Attachment 4, "Comments of Member Eileen McAnneny, Senior Vice President, Government Affairs of Associated Industries of Massachusetts On the Work of the Special Tax Commission"

Attachment 5, "Dissenting Opinion" of Michael J. Widmer, President of the Massachusetts Taxpayers Foundation "to the Report of the Study Commission on Corporate Taxation"

Comments on Draft Final Report

Attachment 6, Comments of Member Michael J. Widmer (E-mail dated December 18, 2007)

Appendices

Appendix A, "Governor, Legislative Leaders Announce Study Commission on Corporate Taxation" (press release, dated April 30, 2007)

Appendix B, Commission Member Biographies

Appendix C, Meeting Schedule for Commission and Subcommittees

Appendix D, "Interim Report" (Majority Report, dated June 15, 2007)

Attachments:

- Public Hearing List of Attendees (dated May 22, 2007)
- "Business Tax Graphs" (prepared by DOR, dated June 1, 2007)
- "Charts Showing Business Tax Avoidance Techniques" (prepared by DOR, undated)

Appendix E, “Interim Report of a Minority of Members of the Study Commission on Corporate Taxation” (dated June 15, 2007)

Attachments:

- “Governor, Legislative Leaders Announce Study Commission on Corporate Taxation” (press release, dated April 30, 2007)
- “Proposed Tax Loophole Changes” (revenue estimate from DOR, undated)
- “DOR Handout to the Commission, May 14, 2007”
- “Sensing Changes Ahead, Corporate Tax Policy Hearing Draws Crowd” (by Michael Norton, Priscilla Yeon and Gintautas Dumcius, dated May 23, 2007)
- Letter from then Commissioner of Revenue Alan LeBovidge to Joint Committee on Taxation regarding Unitary Taxation (dated April 26, 2004)

Appendix F, List of Presenters to Commission and Subcommittees

Appendix G, Subcommittee on Alternatives to the Corporate Excise - “Report” (Final Report, dated November 13, 2007)

Attachments:

- “Briefing Binder Table of Contents” (dated November 13, 2007)
- “Comments of Prof. Alan Clayton-Matthews on Subcommittee Report” (dated November 8, 2007)

Appendix H, Subcommittee on Business Tax Rates – “Preliminary Status Report” (dated October 16, 2007)

Appendix I, Subcommittee on Business Tax Rates – “Final Report” (dated November 13, 2007)

Attachments:

- Subcommittee on Business Tax Rates – “Preliminary Status Report” (dated October 16, 2007)

Appendix J, Subcommittee on Combined Reporting – “Status Report” (dated October 16, 2007)

Appendix K, Subcommittee on Combined Reporting – “Findings and Recommendation” (Draft Final Report, distributed on November 13, 2007)

Appendix L, Subcommittee on Minimum Corporate Excise – “Status Report” (dated October 16, 2007)

Attachments:

- “Analysis TY 2004 Corporate Tax Statistics” (prepared by Senator Creem’s office, undated)
- “The Massachusetts Corporate Excise Tax: Who Pays the Minimum … and how?” (prepared by Senator Creem’s office, September 20, 2007)
- “Further Look at Filers with Gross Sales Greater than $50M” (prepared by Senator Creem’s office, undated)
- Analysis of Minimum Corporate Excise Payers (prepared by DOR, undated)

Appendix M, Subcommittee on Minimum Corporate Excise – "Final Report" (dated December 5, 2007)

Attachments:

- "Analysis TY 2004 Corporate Tax Statistics" (prepared by Senator Creem's office, undated)
- "The Massachusetts Corporate Excise Tax: Who Pays the Minimum … and how?" (prepared by Senator Creem's office, September 20, 2007)
- "Further Look at Filers with Gross Sales Greater than $50M" (prepared by Senator Creem's office, undated)
- Analysis of Minimum Corporate Excise Payers (prepared by DOR, undated)
- "Summary of DOR Findings for Minimum Excise Subcommittee" (prepared by DOR, undated)

Appendix N, Subcommittee on Other Governor Proposals – "Report" (Final Report, dated November 12, 2007)

Attachments:

- Draft Legislative Amendment (prepared by DOR, undated)

Appendix O, Subcommittee on Streamlined Sales Tax – "Status Report" (dated October 16, 2007)

Attachments:

- Index of Materials Prepared by DOR for Subcommittee Meeting on October 3, 2007
- "FY2007 Annual Report – Streamlined Sales Tax Governing Board" (undated)
- Analysis of Potential Adoption of Streamlined Sales Tax Agreement by Massachusetts (prepared by DOR, undated)
- "Annualized Revenue Impact of SSTP Items" (prepared by DOR, undated)

Appendix P, Subcommittee on Streamlined Sales Tax – "Draft Report" (Draft Final Report, dated November 12, 2007)

Attachments:

- "Summary Chart of SST Requirements" (prepared by DOR, undated)

Appendix Q, "Preliminary Outline – Points for Discussion and Recommendation by Commission" (staff outline circulated to members for discussion at Commission meeting on December 5, 2007)

Appendix R, "MA Study Commission on Corporate Taxation – Outline of Major Points for Final Report" (circulated by Representative Binienda at Commission meeting on December 5, 2007)

Appendix S, "Some facts about Massachusetts business taxation" (presented by Commissioner of Revenue Henry Dormitzer at Commission meeting on December 5, 2007)

Appendix T, Examples of Combined Reporting/Apportionment (circulated via e-mail by Mr. Kidder, Chairman of Subcommittee on Combined Reporting, on December 4, 2007)

Appendix U, Proposed Motion (circulated via e-mail by Representative Jones on December 17, 2007)

Appendix V, “Study Commission on Corporate Taxation – December 18, 2007 -- Agenda” (circulated by Chairwoman Kirwan at Commission meeting on December 18, 2007)

Appendix W, Letter to Chairwoman Kirwan from COST regarding Subcommittee Draft Reports (dated December 3, 2007)

Appendix X, Letter to Commission from NAIOP regarding Deeds Excise Tax (dated October 15, 2007)

Appendix Y, Letter to Commission from NFIB regarding Gross Receipts Tax (dated September 14, 2007)

Appendix Z, “Massachusetts Business Taxes: Unfair? Inadequate? Uncompetitive?” (by Robert Tannenwald, version dated August 20, 2004)

Appendix AA, “The Pros and Cons of Worldwide Unitary Taxation” (by Robert Tannenwald, dated July/August 1984)

Appendix BB, “Recommendations of the State and Local Fiscal Modernization Study Commission to the General Assembly” (by North Carolina State and Local Fiscal Modernization Study Commission, undated)

Appendix CC, “A Green Mountain Miracle and the Garden State Grab: Lessons from Vermont and New Jersey on State Corporate Tax Reform” (by Mark J. Cowan and Clint Kakstys, dated August 8, 2007)

Appendix DD, “Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana” (by Michael J. McIntyre, Paull Mines and Richard D. Pomp, dated 2001)

Appendix EE, “Combined Reporting Issues List for MTC Income and Franchise Tax Uniformity Subcommittee” (by Multistate Tax Commission, undated)

Appendix FF, “Report of the Hearing Officer regarding the Proposed Model Statute for Combined Reporting” (by Shirley Sicilian of Multistate Tax Commission, dated April 25, 2005)

Appendix GG, “Supplemental Report of the Hearing Officer regarding the Proposed Model Statute for Combined Reporting” (by Shirley Sicilian of Multistate Tax Commission, amended June 21, 2005)

Appendix HH, “State-Local Business Taxation and the Benefits Principle” (by William H. Oakland and William A. Testa, undated)

Appendix II, “Alternative State Business Tax Systems: A Comparison of State Income and Gross Receipts Taxes” (by Laura Wheeler and Edward Sennoga, dated August 20, 2007)

Appendix JJ, “Illinois’ Proposed Gross Receipts Tax: A Modified GRT Could Be Paired With Other Tax Changes” (by Elizabeth C. McNichol and Iris J. Lav, dated May 3, 2007)

Appendix KK, “Ohio’s Tax Reform and the Commercial Activity Tax” (presented by Thomas M. Zaino to Subcommittee on Alternatives to the Corporate Excise on August 20, 2007)

Appendix LL, “The New Texas Margin Tax: Overview, Pitfalls and Opportunities – Including 2007 Legislative Changes” (by Ira Lipstet, dated August 21, 2007)

ATTACHMENT 1

"Dissenting Opinion of House Minority Leader Bradley H. Jones, Jr.
to the Report of the Corporate Tax Study Commission"

DISSENTING OPINION OF HOUSE MINORITY LEADER BRADLEY H. JONES, JR. TO THE REPORT OF THE CORPORATE TAX STUDY COMMISSION

On December 18, 2007, a majority of the members of the Study Commission on Corporate Taxation ("the Commission") voted to recommend a business tax increase worth close to $485 million that I believe amounts to an uncalculated, unwise, unfair and untimely new burden on businesses in this state.

Raising business taxes for the fourth time in the span of four years would be a serious mistake and a devastating blow to our economy. It is troubling that recommendations to increase taxes were considered individually at our last commission meeting, and there was never any discussion about their specific cost to businesses. Although the Department of Revenue provided cost estimates dating back to the time the Governor first filed his tax increase proposals, the Commission never used these figures and did not factor them into its decision-making process.

Massachusetts' success and well-being relies on maintaining a strong economy and fostering good jobs, and we should be focusing our efforts on attracting new businesses to our state and keeping already established businesses here. The Commission's vote sends a message to businesses that does exactly the opposite.

Businesses in Massachusetts are already facing costs and expenses that are greater than ever before. These expenses are a direct limitation on the ability of corporations to locate and expand here, and they would be compounded by a further increase in business taxes. The Commission's report is one more in a series of decisions that have proved costly to businesses in recent years. They include:

- **History of Large Tax Increases.** If Massachusetts were to raise taxes on businesses, it would be the fourth substantial corporate tax increase in six years. The first "loophole closing" in 2003 [1] raised $211 million in additional revenue, according to the Department of Revenue. [2] A second "loophole closing" a year later [3] raised another $90 million, according to the Beacon Hill Institute. [4] The third such move in 2005 [5] raised revenue by an amount that has yet to be determined. The total of these increases is more than $300 million a year in new, direct costs to businesses operating in this state.

- **A Hike in Property Taxes.** In 2004, the Legislature allowed cities and towns to effectively charge businesses double on their property taxes. Subsequent decisions have allowed this situation to persist for longer than expected, and during a period when assessments increased at the same time. According to a report prepared for Associated Industries of Massachusetts (AIM) by Ernst and Young, [6] property taxes on Massachusetts businesses have grown by $1.2 billion, or approximately 27%, since 2002. This tax burden now accounts for more than 40% of the total taxes businesses face in this state.

- **Unemployment Insurance Rate Increase.** The Legislature has failed to act on legislation that would freeze unemployment insurance rates at Schedule "D" in 2008. According to data collected by AIM, a rate freeze at Schedule "D" would save Massachusetts employers approximately $153 million in costs next year. This would equal cost savings of about $40 per employee and, according to AIM, it would still permit the balance of the Unemployment Insurance Trust Fund to increase by about $245 million in 2008. [7]

- **Burden of Health Care Costs.** According to the Massachusetts Taxpayers Foundation, Massachusetts employers "will spend an estimated $175 million more a year for health insurance under the state's healthcare reform law. The increase in costs will include $150 million as more employees accept coverage and $24 million for new prescription drug benefits." [8]

Our job as members of the Commission was to "study the modernization and simplification of the current business tax laws of the Commonwealth, to promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness."

Unfortunately, many members seem to have interpreted this mandate as an opportunity to alter the tax code so as to raise more money for state coffers. While they may view business tax increases as a fix for perceived budgetary problems, the potential for long-term damage to businesses certainly outweighs any short-term gains.

Ultimately, the fate of the Governor's tax increase bill lies with the Legislature. I hope the Legislature will reject these proposals and refuse to ask the business community to balance the state's budget for us.

Respectfully submitted,

Bradley H. Jones, Jr.
House Minority Leader

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[1] *See* Chapter 143 of the Acts of 2003.

[2] MA Department of Revenue, *Fiscal Year 2004 Annual Report* at 1.

[3] *See* Chapter 262 of the Acts of 2004.

[4] Beacon Hill Institute, *New Tax Loophole Proposal Produces Less Economic Damage than the Original*, April 2005.

[5] *See* Chapter 163 of the Acts of 2005.

[6] Ernst and Young, *Massachusetts State and Local Business Taxes, 2002-2007* at 2, 4.

[7] Associated Industries of Massachusetts, *Legislative Bulletin*, December 4, 2007 at 1.

[8] Martin Finucane, "Mass. tax group sees big healthcare hit to employers," *The Boston Globe*, December 7, 2007. *See* Massachusetts Taxpayers Foundation, *An Analysis of the Essential Role of Employers in Massachusetts Health Care Reform*, December 6, 2007.

ATTACHMENT 2

"Comments of Member Joseph X. Donovan of Sullivan & Worcester LLP
on the Work of the Study Commission"

Comments of Member Joseph X. Donovan of Sullivan & Worcester LLP on the Work of the Study Commission

General Observations; the Role of the Commission

- It is important to note, I think, that the Study Commission on Corporate Taxation was formed not by legislative enactment but via agreement among Governor Patrick, Speaker DiMasi and Senate President Murray, and that the only document that can be said to *constitute* the Commission is a press release issued by the Governor, the Speaker and the Senate President on April 30, 2007. While the 15 members have been characterized as "appointees" of Governor Patrick, Speaker DiMasi, or the Senate President, because of the informality of the process the members of the Commission may not have known in advance by whom they were appointed. This member certainly did not know. Accordingly, the members generally made no commitments to support the views or perspectives of those who appointed them.

- I myself struggled with the question whether to approach my role on the Commission as an advocate and, if so, as an advocate for whom. This question may have been more difficult for me than for some others because I have been a consultant to and advocate for taxpayers for 20 years, but also an attorney for the Massachusetts Department of Revenue for eight years, during which time I played a role in designing and interpreting some of the provisions that have been characterized as "loophole closers." At the end of the day I concluded that it was most appropriate for me not to act as an advocate at all, but to attempt to determine what policy is best for the Commonwealth as if the policy were being determined in the voting booth, drawing on my experience on both sides of the divide.

Combined Reporting and Revenue Neutrality

- The judgments I have made in evaluating the combined reporting proposal have been informed in great measure by my experience as a Big Four state tax practitioner, particularly in the late 1990's. In this period, the state tax consulting practices of the Big Four accounting firms grew exponentially. At their peak, these practices employed at each firm roughly 500 to 1000 professionals. The growth of the practices was attributable in large part to the phenomenon of state tax "restructuring" for large, multistate corporations. (At KPMG, which pioneered the approach, the very large practice unit responsible for such engagements was called the "State Tax Minimization" or "STM" practice.) These projects often drew fees in the millions of dollars, and the fees were often computed on a contingent-fee or quasi-contingent-fee basis, that is, as a percentage of the state tax savings attributable to the projects. Most of the projects entailed a reconfiguration of corporate boxes, with a *de minimis* change in day-to-day operations of the business. Through transfer pricing, the reconfigured businesses could attribute most of their profits to low or no-tax jurisdictions. This is often perfectly legal, and indeed the Supreme Judicial Court in *Sherwin-Williams Co. v. Commissioner of Revenue*[1] seems to have taken the position that even when such a reconfigured structure is purely tax motivated, it will be sustained if the constituent entities are "real" and have adequate economic substance. From the point of view of the tax director or chief financial officer of such a corporation, it was legitimate to ask whether the company could afford *not* to undertake such an engagement, as long as it fell within the bounds of legitimate planning. The question before the Commission is not whether such planning is legal, but rather whether the resulting, dramatic reductions in corporate effective state tax rates are consistent with good tax policy, and whether they place smaller companies at a disadvantage relative to the companies that can afford to so restructure.

[1] 438 Mass. 71 (2002).

- For businesses whose headquarters are located in the Commonwealth, combined reporting can in fact create planning *opportunities*. These companies can via transfer pricing shift profits from separate reporting states to Massachusetts, without increasing the Massachusetts tax. This kind of planning is very commonly undertaken by companies based in California and Illinois, for example, which have long employed combined reporting. The companies most likely to be detrimentally affected by adoption of combined reporting are large multistate groups with a modest presence in the Commonwealth.

- The Commission was shown evidence that while Massachusetts corporate taxes have grown significantly, they have not come close to keeping pace with the growth in corporate profits. The restructuring phenomenon described above clearly accounts for much of this gap. In light of this, I do not view revenue neutrality for the Governor's proposal, looked at in isolation, as some kind of holy grail. It might be appropriate, rather, to move back to the point in the 1990's when taxpayer-friendly reforms were enacted in Massachusetts, including a generous research and development credit, an investment tax credit permanently fixed at 3%, and single-sales-factor sourcing of income for manufacturers and mutual fund service companies. This tax structure reflects deliberate and generally sound policy choices by the Legislature to reward industries that are major drivers of economic growth in the Commonwealth. One might identify the corporate income tax receipts of Massachusetts after these reforms were enacted but before most of the restructuring projects were completed, and ask what the receipts should be in 2007 assuming growth in proportion to the growth in corporate profits. If the Governor's proposal would push corporate taxes above this ratable amount, then perhaps it should be capped at this amount in the interest of "revenue neutrality." If it would not, then I would argue that it is simply making up ground lost to the restructuring phenomenon.

The Debate Over the Rate(s)

- Much was made in the deliberations of the Commission of the fact that we have in our tax structure a number of different tax rates potentially applicable to different forms of business. One proposed solution was to impose tax on all businesses at the personal income tax rate of 5.3%, in the interest of consistency. I believe that this would accomplish very little. As is demonstrated in the Report of the Subcommittee on Alternative Tax Structures, the complexity of our system is only incidentally a function of the rates; there are myriad rules and regimes, each with advantages and disadvantages, leaving aside the rates. It makes no sense to me to make the rates uniform without making the *systems* uniform. The argument that we should make the rates uniform without reforming the whole structure is just a disguised argument for radical rate reduction.

- On the other hand, I believe that our 9.5% corporate rate, at the fourth highest in the country, is too high, and sends a negative signal relative to economic competitiveness. A reduction in the rate coupled with adoption of combined reporting and conformity to federal entity classification is, therefore, a compelling package.

The "Check-the-Box" Proposal

- The interim report of the Commission that was filed in June was criticized by the minority for embracing the proposal to endorse federal entity classification without "adequate study." In fact, no one has offered the Commission any argument in favor of the arcane, unpredictable entity classification scheme that Massachusetts has now other than "it ain't broke, so don't fix it." In fact, the current system *is* broken. It is not unusual for businesses to have to spend tens of thousands of dollars in professional fees just to make an informed judgment as to whether a

company is taxed at the entity level or reports its income to its owners to be taxed to them. This issue arises most often in the context of entities used as investment vehicles, and the attendant uncertainty creates a disincentive for investment managers to operate in Massachusetts.

- Adoption of the check-the-box proposal would have the further advantages of greatly simplifying reporting for Subchapter S corporations that have so-called "QSub" structures, and of putting to rest all of the complexities associated with the Massachusetts business trust tax regime, which is a historical anomaly.

Alternative Regimes and the Future of Massachusetts Business Taxation

- In a world more perfect than the one we live in, the Commission would have had the time, resources and political will truly to try to reach consensus on a business tax structure well tailored to meet the fiscal challenges that Massachusetts is likely to face not in FY 09, but ten years from now and beyond. Unfortunately, those challenges are likely to include the need to deal with very daunting healthcare, public pension and infrastructure costs. I come out of the work of the Commission, and particularly of its Subcommittee on Alternative Tax Structures, convinced that part of the solution may lie in the adoption of an alternative system, such as a simplified value-added tax, that has the following characteristics:

  -- a very low rate and a very broad base

  -- resistance to both domestic and international "gaming"

  -- simplicity

  -- neutrality, that is, minimal disruption of business decision making; and

  -- resistance to revenue volatility stemming from peaks and valleys in the economic cycle

I agree, on the other hand, with my fellow Commission member Prof. Alan Clayton-Matthews that such a radical departure from our existing system should not be made without much further debate and analysis.

ATTACHMENT 3

"Comments of Member Kevin F. Long
On the Deliberations and Final Report of the Special Tax Commission"

Comments of Member Kevin F. Long
On the Deliberations and Final Report of the Special Tax Commission

The Special Tax Commission was created to study the modernization and simplification of the current business tax laws of the Commonwealth, promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness. A majority of Commission members believe that a corporate tax increase is synonymous with the term "fairness". This can clearly be seen in the Majority Report approved on June 12. The Commission then spent the last six months examining ways to extract more revenue from corporations. Unfortunately the remaining objectives, to "encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness" were studied by only one subcommittee whose report was largely ignored in the final report except for an illusory suggestion of a potential undefined rate reduction at some unspecified time in the future. It should be noted that a majority of Commission members would find a rate reduction acceptable only if it did not offset their ultimate objective – an increase in corporate tax receipts.

The Legislature and the Governor now have an opportunity to evaluate whether the Commission accomplished its stated objectives. I suggest that the Final Report of the Commission does not accomplish those objectives.

Following is a discussion of several substantive areas where I disagree with the majority of the Commission.

Purported Growth of Corporate Profits Compared to Tax Collections

Statistics purporting to compare corporate profits to business tax collections have been cited to support increasing the tax on business. What I find troubling is that the "Corporate Profits" cited as the foundation of the statistics cannot be found in a search of the Internal Revenue Code, does not appear to be based on taxable income which one would normally consider to be the basis for tax collections, and it does not appear to be based on any conventional accounting concept of profit. The resulting number does not take into account the high percentage of non-profit employers in Massachusetts. From what I can tell, the term does not take book/tax differences into account, nor does it take the repeal of General Utilities into account. This non-tax, non-accounting "Profit" is then (in simple terms) essentially allocated prorata to Massachusetts. Massachusetts is a high-cost state. Logic would dictate that businesses would earn a higher profit in low-cost states. In addition to the aforementioned problems, the methodology used to arrive at the so-called "Profit" earned in Massachusetts allocates profit earned in low-cost states to Massachusetts. The statistic is a hypothetical amount fabricated by persons whose objective is to increase corporate taxes. The result can only be called fiction rather than reality. To then pass this fiction off as if it were reality is simply fraud. Certainly the business community sees this fraud for what it is. The message sent to the business community is clear - Massachusetts is a dangerous place to do business because tax policy decisions here are based on fiction, rather than reason.

Combined Reporting

In a December 3, 2007 letter to Secretary Kirwan, the Council on State Taxation outlines many of the objections that the business community has to Combined Reporting. One of the primary objections is the considerable uncertainty that results from the implementation of Combined Reporting. In my experience, business leaders dislike uncertainty even more than they dislike taxes. We have heard that, as a result of Combined Reporting, the audit cycle can increase from five years to twenty-five years. One of the proponents of Combined Reporting claims that he has never heard this objection before. To claim to have never heard this objection before is disingenuous and speaks to the integrity of the arguments in favor of Combined Reporting. At the end of the day, the major factor cited by proponents of Combined Reporting is that it raises taxes on business.

There is another way to view Combined Reporting. Multi-state income of many businesses is apportioned to Massachusetts using three factors - sales, payroll and property. Some of the arrangements that have been viewed as reducing Massachusetts tax have had the result of reducing the profit to be allocated to Massachusetts without reducing the payroll here. Combined Reporting forces those companies to now reduce their payroll here to accomplish the same result. The proponents of Combined Reporting claim that employers are oblivious to state taxation (while at the same time citing the millions of dollars companies have spent in restructuring to avoid state taxes). We don't really know whether the proponents of Combined Reporting are right, however with the substantially below average job growth in Massachusetts in the last few years, can we afford to take the chance? Based on the strong objections voiced by the business community, Combined Reporting cannot be said to encourage business growth and innovation, or strengthen the Commonwealth's global competitiveness.

Check-the-Box

It is common knowledge that the Federal alternative minimum tax hits more taxpayers every year. That is especially true here in Massachusetts. The Massachusetts Business Trust (sometimes referred to as a Corporate Trust) gives Massachusetts taxpayers a Federal alternative minimum tax benefit with respect to business income apportioned to Massachusetts. Is this unique to Massachusetts? Probably yes. That alone is not a reason to eliminate Massachusetts Business Trust tax treatment. Why are we in a rush to take this Federal benefit away from our citizens? Have there been abuses? - apparently yes - but that indicates we need to examine reform not push for elimination.

Too Many Tax Rates

Under the current tax laws in Massachusetts, there is a different tax regime for each form of doing business. This means that the same business will be taxed differently depending on the type of legal entity chosen by its owners. The owners are free to change the type of entity at any time to take advantage of the benefits of the regime that

applies to a different type of entity. This is inherently inequitable. Adopting check-the-box will not change this inequity. That Massachusetts has too many tax rates and regimes applied to business income seems to have been accepted. Yet, the draft final report does not even attempt to address this structural problem. One member of the Commission has stated that it would take a complete reform of our system to resolve the rate inequity. Was that not one of the stated objectives of the Commission? The majority offer no explanation for this glaring omission.

To highlight this point further, even in the Final Report's illusory suggestion of a rate reduction there is no mention of a reduction of the 9.8% rate imposed on income earned by successful Subchapter S Corporations. I find it unacceptable to suggest a rate reduction for C Corporations while ignoring the 9.8% rate on S Corporation income.

Conclusion

Ultimately the work of the Commission as portrayed in the final report can be seen as a thinly veiled exercise in raising corporate taxes. Buried in the work of many of the subcommittees there are concepts that can be built on in the future. However, the final report itself should not provide a basis for further action by the Legislature.

ATTACHMENT 4

"Comments of Member Eileen McAnneny, Senior Vice President,
Government Affairs of Associated Industries of Massachusetts
On the Work of the Special Tax Commission"

Comments of Member Eileen McAnneny, Senior Vice President, Government Affairs of Associated Industries of Massachusetts On the Work of the Special Tax Commission

General Observation: The Role of the Commission

It is important to note that the Study Commission on Corporate Taxation was formed not by legislative enactment but via an agreement among Governor Patrick, Speaker DiMasi and Senate President Murray after Governor Patrick filed legislation H.3756, An Act Improving the Fairness of the Tax Laws after the bill met with resistance in the House. In fact, many of the provisions in Governor Patrick's bill, including combined reporting and entity classification conformity were originally contained in H.4163 (originally H.21) a bill filed by Governor Romney in 2005, opposed by the business community and ultimately rejected by the House of Representatives in a roll call vote of 110 to 45 (see Attachment A.).

The role of the Commission, given that background and as stated in the press release announcing its formation, was to look more broadly than just Governor Patrick's bill at the Commonwealth's overall business tax code to study the modernization and simplification of the current business tax laws of the Commonwealth, to promote fairness and equity, encourage business growth and innovation and strengthen the Commonwealth's global competitiveness. In my mind, we have failed at that mission because the Commission was overly focused on combined reporting at the expense of all other issues and ideas. The Commission has done nothing to further its stated goals.

The Subcommittee Structure

Despite the statement in the draft final report that "members across the Commission identified various subjects that the members viewed as warranting further study along with specific proposals in the Governor's bill" I recollect no such general discussion by Commission members. To the contrary, I vigorously objected to the Commission staff regarding the formation of subcommittees after the issuance of the interim report without a meeting of the full Commission to discuss our goals and objectives and to try to reach a consensus on the work of the Commission going forward. For the record, I would like to memorialize my objection. My concern was that the process would dictate the outcome and indeed it did. The final report of the Commission focuses on the work of the subcommittees and that work has largely become the work of the full Commission. The reports of the subcommittees, while informative and representative of a lot of preliminary work, do not provide an integrated plan for consideration by the legislature. As the final reports of some of the subcommittees indicated, without a more comprehensive discussion and strategy, it was difficult to make final recommendations in isolation. The subcommittees that were inconclusive have been penalized, as the focus of the report and the suggested recommendations give undue emphasis to the subcommittees that took votes. In fact, the only items included in the "Recommendations of the Commission" section are those from subcommittees that took a vote. As we were given assurances that

the full Commission would make all final decisions with respect to the various matters before the subcommittees, I view the process as flawed and think the full Commission should be given the opportunity to vote on all the issues of the various subcommittees.

Combined Reporting

The issue of combined reporting has dominated the discussion and focus of the full Commission, yet the emphasis has been misguided and overly simplified. Largely due to the rhetoric used by the Department of Revenue and the Administration, the concept of combined reporting has become synonymous with "stopping tax planning." There has been no acknowledgement and certainly no discussion that adoption of combined reporting has far greater impacts on the broader business community. While adoption of combined reporting may restrain the ability of companies to plan, it certainly will not eliminate it. Just ask the Governor of Illinois. Despite the adoption of combined reporting by Illinois twenty years ago, the Governor there is still chiding about "loopholes." I raise this issue to point out that we are talking about substituting one very complicated taxing system with another.

A unitary combined reporting system is a tax system choice that comes with advantages and disadvantages. Former Revenue Commissioner LeBovidge testified in 2004 before the then Joint Committee on Revenue and cautioned the Committee to study it further before adopting a change of this magnitude. We have barely scratched the surface of the plethora of issues that accompany a change of this magnitude. The subcommittee on combined reporting did a great job of laying out some of the issues, but by their own admission, have not addressed all of them and certainly not in any level of detail.

To address the very real concerns of the business community about the uncertainties surrounding combined reporting, I suggest that the Commission establish a working group of knowledgeable tax practitioners to collaborate with the Department of Revenue on a draft statute to which the Commission could react. Whether or not I can support combined reporting ultimately depends on the details of the specific proposal and whether or not it is combined with a sufficient rate reduction to make the entire package at least revenue neutral, perhaps even an overall reduction in business taxes. Without a full understanding of the shape and consequences of changing to a combined reporting system, I do not believe the Commission has done its due diligence in evaluating the merits of combined reporting.

Additionally, I question the revenue estimated with adoption of combined reporting. The Department of Revenue has not adequately explained how it derived its most recent revenue projections and the full Commission did not sufficiently delve into the revenue projections and the underlying methodology. This kind of information is critical to our debate, yet it has been insufficient or one-sided. The most recent estimates also indicate a significant departure from past assertions by the DOR Commissioner in 2004 that it is not realistic to expect any significant revenue increases in the immediate aftermath of adoption of combined reporting because of the complexity of implementation and the inherent uncertainties in defining a unitary group.

Revenue Neutrality/Rate Cut

As the draft final report states, the issue of revenue neutrality is a key one to many Commission members. Some Commission members' support of combined reporting was contingent upon the entire tax package being revenue neutral. To recommend that the legislature should adopt combined reporting and entity classification conformity with no other significant tax changes is simply a rubberstamping of Governor Patrick's original bill. That is, in fact, what the Commission did in its final report. Although Commission members overwhelmingly supported a tax rate reduction, they did not recommend a specific corporate excise tax rate to the legislature. Many members felt it was not within the scope of our duties. To me, it was precisely what we were supposed to do and our failure to offer a concrete suggestion on rate reduction means that we are essentially proposing a tax increase on businesses – something I cannot support as it runs counter to the charge of the Commission and certainly does nothing to foster economic development or job creation.

Procedure

The Commission's procedures were flawed. Commissioner members received copies of the interim and final reports with insufficient time to thoroughly review and digest its content before having to vote on them. While I fully appreciate the demands on the Commission staff's time and the difficulty of drafting such a report, getting copies of the draft more than a day in advance would have led to more input and better discussion.

At the final meeting, a motion to require the entire set of recommendation offered by the Commission to be revenue neutral offered by House Minority Leader Brad Jones and seconded by Senate Minority Leader Richard Tisei was set aside without a vote at the Chairwoman's prerogative. Instead we were required to cast separate votes in support or against combined reporting, check the box, a tax rate cut and revenue neutrality. This process did not capture the nuanced positions of several Commission members or the conditional nature of their support for the combined reporting and check the box provisions. As a result, I think results can be misconstrued.

For the aforementioned reasons, I dissent from the Special Tax Commission's final report.

Respectfully,

Eileen McAnneny
Associate General Counsel and Senior Vice President, Government Affairs
Associated Industries of Massachusetts

ATTACHMENT 5

"Dissenting Opinion" of Michael J. Widmer, President of the Massachusetts Taxpayers Foundation "to the Report of the Study Commission on Corporate Taxation"

MICHAEL J. WIDMER
President, Massachusetts Taxpayers Foundation

DISSENTING OPINION TO THE REPORT OF THE STUDY COMMISSION ON CORPORATE TAXATION

I concur with the views expressed in the dissents and comments of Representative Brad Jones, Kevin Long and Eileen McAnneny, and wish to elaborate on the points I raised in my response to the draft final report.

I have several objections to the work of the Commission and to the final report.

1) **COMPETITIVENESS** The Commission largely ignored its mandate to "encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness." With the Commission's agenda focused on the administration's proposals to **increase** corporate taxes, the majority was forced to engage in various forms of sophistry to deny the obvious – namely, that **raising** corporate taxes for the fourth time since 2003 will of course make Massachusetts **less** competitive, and will **discourage**, not encourage, job creation.

Virtually all independent studies confirm that Massachusetts employers have close to the highest business costs in the nation. The administration recognizes this reality when, as part of its economic development strategy, it repeatedly offers tax incentives to employers to try to persuade them to expand in Massachusetts. How does this square with the majority's proposal to increase taxes on corporations that currently employ hundreds of thousands of Massachusetts citizens?

The Commission never gave serious thought or analysis to the question of competitiveness. In this vacuum, I and several other members argued for "revenue neutrality," not as a goal in itself but as a compromise to try to achieve a unanimous set of recommendations from the Commission. The alternative supported by a majority – a "meaningful" rate reduction – lacks any specificity or meaning and would clearly result in increased corporate taxes.

The argument by several members of the majority that the Legislature should determine the appropriate tax rate ignores the Commission's mandate. Of course, the Legislature will decide this issue, as it will whether to proceed with combined reporting or any other proposal. The purpose of the Commission was to make recommendations to the Legislature, and the majority's unwillingness to be specific about a rate reduction is one more example of their failure to address the issue of competitiveness.

2) **PROCESS** The Commission's process was tightly controlled from beginning to end and there was a lack of balance throughout. The final report reflects these shortcomings; it is heavy on opinions and light on analysis.

In the discussion of combined reporting, for example, there are frequent references to "income shifting," "tax planning techniques," and "erosion of the corporate tax base." Nowhere is it mentioned that combined reporting represents a major change in the way that corporations have been taxed in Massachusetts for decades. The policy change can be debated, but the superficial and one-sided portrayal of the issue is not helpful.

Another example of the lack of balance is the fact that the only numbers used in the report – after eight months of work – came from Commissioner Dormitzer's presentation at the December 3 meeting. After stating that the Department of Revenue conducted a study of the "erosion of the corporate tax base" and the current system "cannot keep pace with tax planning strategies such as those that shift income to other affiliates," he reported that corporate profits had grown 70% but business tax collections had increased only 49%. In one of the commission's early meetings, serious questions were raised about the derivation and interpretation of those numbers. The draft goes on to say that the Council on State Taxation (COST) had determined that overall business taxes in Massachusetts were below average. At an earlier meeting of the Commission and at the December 3 meeting, I pointed out that that same COST study documents that Massachusetts has the 10th highest corporate income tax burden among the 50 states – and, of course, the question of corporate income taxes has been the focus of the Commission's work. There are many other studies which likewise have concluded that the state's corporate income taxes are high. My comments and these studies are ignored in the final report.

The subcommittee process, and the heavy reliance on the subcommittee reports in the final Commission report, distort the work of the Commission. There was no serious attempt to have the Commission pull together a coordinated and coherent set of recommendations tied to the Commission's mission. Had this been done, for example, the inattention to the issue of competitiveness and job creation would have immediately become apparent.

The chairs and composition of the subcommittees was heavily skewed toward the eight members who voted in favor of the interim report. For example, the subcommittee on "other governor proposals" was chaired by the former Commissioner of Revenue who authored those very proposals. The second vote in several 2-1 subcommittee votes came from a former high-level DOR official who worked for the former commissioner. That meets no standard of balance or fairness.

Finally, as I noted at the time, when a slim majority supported the Governor's "check-the-box" proposal as part of the interim report, the Commission had devoted a scant 30 minutes to discussing this issue. There was no further discussion over the past six months. So, in the final analysis, the Commission voted to support check-the-box with absolutely no analysis and approximately a half hour of discussion. It is particularly

noteworthy that there was no effort to put check-the-box in the context of the multiple tax rates paid by different business tax entities.

3) **SUBCOMMITTEES** Regarding the two subcommittees on which I served, both of which did some good work, I have the following comments:

a. Subcommittee on Minimum Corporate Excise – I dissented from the majority because they reached conclusions which went well beyond the analysis provided by Department of Revenue. The subcommittee report contains many examples of the same one-sided language that is laced through the final Commission report which I have referenced above.

b. Subcommittee on Combined Reporting – The final Commission report does not make clear that there was an important caveat to the support for combined reporting, namely, the subcommittee unanimously agreed that the scope of the entities to be combined and the mechanics of combining them needed to be determined. The subcommittee concluded that it did not have sufficient knowledge to make a recommendation on this issue. The only mention of this issue in the final report is an ambiguous reference in a footnote. This issue, and the question of a safe harbor election, are critical details which were not resolved.

ATTACHMENT 6

Comments of Member Michael J. Widmer (E-mail dated December 18, 2007)

From: Michael Widmer
Sent: Tuesday, December 18, 2007 11:06 AM

Dear Commission members,

I have reviewed the draft report and have a number of comments:

1. I am troubled by the report's lack of balance at several points. In the discussion of combined reporting, for example, there are frequent references to "income shifting," "tax planning techniques," and "erosion of the corporate tax base." Nowhere is it mentioned that combined reporting represents a major change in the way that corporations have been taxed in Massachusetts for decades. The policy change can be debated, but the superficial and one-sided portrayal of the issue is not helpful.

   Another example of the lack of balance is the fact that the only numbers used in the report – after eight months of work – came from Commissioner Dormitzer's presentation at the December 3 meeting. After stating that the Department conducted a study of the "erosion of the corporate tax base" and the current system "cannot keep pace with tax planning strategies such as those that shift income to other affiliates," he reported that corporate profits had grown 70% but business tax collections had increased only 49%. In one of the commission's early meetings, serious questions were raised about the derivation and interpretation of those numbers. The draft goes on to say that the Council on State Taxation had determined that overall business taxes in Massachusetts were below average. At an earlier meeting of the commission and at the December 3 meeting, I pointed out that the COST study documents that Massachusetts had the 10th highest corporate income tax burden among the 50 states - and of course corporate income taxes are the very issue the commission is considering. There are many other studies which have concluded the state's corporate income taxes are high. We should either present a balanced portrayal of the numbers or none at all.

   As a member of the subcommittee on combined reporting, I was surprised to read on page 9 that the subcommittee felt a cut in the income tax rate would "provide a material tax benefit to all corporate taxpayers, including smaller taxpayers, taxpayers wholly in Massachusetts, and other taxpayers who cannot or do not benefit from income-shifting and other tax planning techniques that have been utilized by large multistate carriers." There was never any analysis by the subcommittee to support this point, which is repeated on page 20. I favor a rate cut, of course, but the point made here is seriously over simplified.

2. The description of the subcommittee on combined reporting does not make clear that there was an important caveat to the support for combined reporting, namely, that the scope and specific details of which entities should be included needed to be considered more closely. The subcommittee voted unanimously on that point, which is obscured in item IV of the footnote on page 8, and needs to be clarified. Resolution of that issue and the safe harbor election are critical to my support for combined reporting.

3. I don't believe it is appropriate or fair to have the subcommittee reports play such a major role in the final draft report. It is certainly appropriate to include the subcommittee reports as appendices but not to weave them through the final report in such a way that they carry more weight than they deserve. The subcommittees do not reflect the views of the full commission. For example, the subcommittee on "other governor proposals" is chaired by the former Commissioner of Revenue who authored those very proposals with the second vote coming from a former high-level DOR official who worked for the former commissioner. I recommend that the final report focus on the deliberations of the full commission.

4. The report correctly states that I, in dissenting, objected to the tone of the majority report of the subcommittee on the minimum corporate excise tax. I have a more concrete objection which I would like included in the final report - namely, the majority reached conclusions which went well beyond the analysis that was provided by DOR for the subcommittee.

5. The paragraph on Chairman Binienda's proposal that he circulated at the last meeting does not make clear that it was a specific revenue neutral proposal. The sentence: "Related to the subject of revenue neutrality, Representative Binienda distributed an outline of points for consideration..." does not convey that he circulated an alternative revenue neutral proposal. The language should be changed to reflect this.

Thank you.

Mike
Michael J. Widmer
President
Massachusetts Taxpayers Foundation
333 Washington St., Suite 853
Boston, MA 02108

APPENDIX A

"Governor, Legislative Leaders Announce Study Commission on Corporate Taxation"
(press release, dated April 30, 2007)

The Commonwealth of Massachusetts
Executive Department
State House • Boston, MA 02133
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DEVAL L. PATRICK
GOVERNOR

TIMOTHY P. MURRAY
LIEUTENANT GOVERNOR

FOR IMMEDIATE RELEASE:
April 30, 2007

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Governor, Legislative Leaders Announce Study Commission on Corporate Taxation

BOSTON– Monday, April 30, 2007 – Governor Deval Patrick, Senate President Therese Murray, and Speaker of the House Salvatore F. DiMasi announced today the creation of a Study Commission on Corporate Taxation, naming 15 members to review and offer recommendations for streamlining the current tax code.

The mandate of the Commission is to study the modernization and simplification of the current business tax laws of the Commonwealth, to promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness. An interim report on legislative recommendations providing revenue for Fiscal Year 2008 will be due by June 15, 2007. A final report on long-term changes to corporate tax laws will be completed by January 1, 2008.

"We have set an ambitious timeline for the initial findings and we expect the commission to meet that deadline," said Governor Patrick. "At hand is the issue of the fundamental fairness of our tax code—an issue that we must address in a swift and comprehensive fashion. What businesses are looking for more than anything is predictability and fairness, and I believe the commission members appointed today will set us on the path to determining how best to achieve that tax equality and ensure Massachusetts is an attractive place for business to expand and locate here."

"This is a positive approach towards giving the Governor's tax proposals due consideration because the commission will take a comprehensive and thorough look at the entire corporate tax code," said Senate President Therese Murray. "I hope the panel will find ways to make the code predictable and equitable to the business community and at the same time yield additional revenues for the Commonwealth."

"The work of this diverse commission is very important at a critical period in the Commonwealth's fiscal and economic future," said House Speaker Salvatore F. DiMasi. "The tax code in Massachusetts must be made more simple, equitable and predictable. We must also strike the right balance between businesses paying their fair share and limiting the financial burdens we place on employers that may stifle job growth and limit our revenues far into the future."

The mandate of the Commission specifically includes: reviewing the Governor's bill, House No. 3756, An Act Improving the Fairness of the Tax Laws; other subjects of business taxation, including (1) the preferential tax treatment of security corporations, (2) the appropriate method for calculating credits for research and development credits, (3) the scope and ongoing need for the various exemptions from the sales and use taxes, (4) appropriate taxation of digital products, (5) estimated tax payment rules for individuals, (6) the substitution of refundable credits for transferable credits, (7) use of gambling losses on personal income tax returns, (8) the imposition of the cigar excise on wholesale transactions, and (9) the calculation of the non-income measure of the corporate excise; and the Commonwealth's participation in the Streamlined Sales Tax Compact.

Commission members include:

- Leslie Kirwan, Secretary of Administration and Finance, Chair*
- Representative John Binienda, House Chair, Joint Committee on Revenue*
- Senator Cynthia Creem, Senate Chair, Joint Committee on Revenue*
- Representative Bradley Jones, House Minority Leader*
- Senator Richard Tisei, Senate Minority Leader*
- Alan LeBovidge, Commissioner of Revenue*
- Professor Alan Clayton-Matthews, UMass Boston
- Joseph Donovan, tax lawyer, Sullivan and Worcester
- Karl Fryzel, tax lawyer, Edwards Angell Palmer & Dodge
- Stephen W. Kidder, Managing Partner, Hemenway & Barnes
- Kevin Long, CPA
- Eileen McAnneny, Associated Industries of Massachusetts
- Jane Steinmetz, Partner, PricewaterhouseCoopers
- Robert Tannenwald, Economist and Director, New England Public Policy Center, Federal Reserve Bank of Boston
- Michael Widmer, President, Massachusetts Taxpayers Foundation

(* or designee)

APPENDIX B

Commission Member Biographies

Commission Member Biographies

Leslie A. Kirwan, *Secretary of Administration and Finance, Chair*

Secretary Kirwan serves as Chair of the Study Commission on Corporate Taxation. She was appointed by Governor Deval Patrick as Secretary of Administration and Finance in December of 2006. Secretary Kirwan has over 23 years of leadership and impact in state, local and transportation finance. She is recognized for partnering with cities and towns in solving difficult municipal finance problems and for her experience in a wide range of Commonwealth policy and management responsibilities. Prior to being appointed Secretary, she served as the Chief Financial Officer at the Massachusetts Port Authority, where she led the most significant financial recovery among United States airports in response to 9/11.

Secretary Kirwan received an A.B. degree from Harvard-Radcliffe and a Master of Public Policy degree from the John F. Kennedy School of Government, Harvard University.

The Honorable John J. Binienda, *House Chair, Joint Committee on Revenue*

Representative Binienda is a member of the Study Commission on Corporate Taxation and a member of the Subcommittee on Streamlined Sales Tax. Representative Binienda represents the seventeenth Worcester District, a position he has held since 1987. He also serves as House Chair of the Joint Committee on Revenue.

Representative Binienda received a B.A. degree from Worcester State College and attended graduate school at Worcester State College.

The Honorable Cynthia Stone Creem, *Senate Chair, Joint Committee on Revenue*

Senator Creem is a member of the Study Commission on Corporate Taxation and Chair of the Subcommittee on Minimum Corporate Excise. Senator Creem represents the First Middlesex and Norfolk Districts, a position she has held since 1999. She is an attorney and serves as Senate Chair of the Joint Committee on Revenue. She also serves on the following committees: Public Health (Vice-Chair); Bonding, Capital Expenditures & State Assets; Senate Ways & Means; The Judiciary; and Telecommunication, Utilities & Energy.

Senator Creem received a B.S. degree in business administration from Boston University and a J.D. degree from the Boston University School of Law.

The Honorable Bradley H. Jones, Jr., *House Minority Leader*

Representative Jones is a member of the Study Commission on Corporate Taxation and Co-chair of the Subcommittee on Business Tax Rates. He represents the Twentieth Middlesex District, a position he has held since 1994. Representative Jones currently serves as House Minority Leader.

Representative Jones attended Johns Hopkins University and Harvard University Extension.

The Honorable Richard R. Tisei, *Senate Minority Leader*

Senator Tisei is a member of the Study Commission on Corporate Taxation and Co-chair of the Subcommittee on Business Tax Rates. Senator Tisei represents the Middlesex and Essex Districts, a position he has held since 1985. He is the Senate Minority Leader and serves on the following committees: Bills in the Third Reading; Ethics & Rules; Elderly Affairs; Mental Health and Substance Abuse; Municipalities and Regional Government; State Administration and Regulatory Oversight; and Tourism, Arts and Cultural Development.

Senator Tisei received a B.A. degree from American University.

Professor Alan Clayton-Matthews, *Economist, UMass Boston*

Professor Clayton-Matthews is a member of the Study Commission on Corporate Taxation, a member of the Subcommittee on Alternatives to the Corporate Excise, and a member of the Subcommittee on Business Tax Rates. He is a Professor of Public Policy at the University of Massachusetts, Boston. He has worked at the Social Welfare Research Institute at Boston College studying the impact of federal budgetary policies on the distribution of income, at Data Resources, Inc. as a regional economist, and at the Department of Revenue, where he forecasted tax revenues and conducted tax policy analyses.

Professor Clayton-Matthews has published several articles in the *New England Economic Review* and *State Tax Notes*. He received a Ph.D. in economics from Boston College.

Joseph X. Donovan, *Counsel, Sullivan & Worcester LLP*

Mr. Donovan is a member of the Study Commission on Corporate Taxation, Chair of the Subcommittee on Alternatives to the Corporate Excise, and a member of the Subcommittee on Other Governor Proposals. At the Boston office of Sullivan & Worcester LLP, he uses his expertise in state and local tax law to consult with the firm's international and domestic clients with respect to state and local tax planning and controversies. Mr. Donovan served as Deputy General Counsel of the Department of Revenue from 2003 to 2006, where he was responsible for working with the General Counsel to manage the Department's legal division – the group responsible for developing public written statements of departmental policy, litigating tax cases in the Massachusetts Appellate Tax Board, and drafting and providing comments on proposed tax legislation.

Mr. Donovan has published several articles in *State Tax Notes* and the *Journal of State Taxation* as well as the 1989 Massachusetts Sales and Use Tax Manual. He is an Adjunct Faculty Member at Suffolk University, Northeastern University, and New York University State and Local Taxation Institute. Mr. Donovan received an A.B. degree in philosophy from Cornell University and a J.D. degree, with honors, at the University of Michigan Law School.

Karl P. Fryzel, *Partner, Edwards Angell Palmer & Dodge LLP*

Mr. Fryzel is a member of the Study Commission on Corporate Taxation, Chair of the Subcommittee on Streamlined Sales Tax, and a member of the Subcommittee on Combined Reporting. Mr. Fryzel's practice at Edwards Angell Palmer & Dodge LLP is focused on all aspects of tax and business planning for corporations, investment partnerships, limited liability companies and individuals engaged in active business and investment activities.

Mr. Fryzel received an undergraduate degree from Boston College and a law degree from Georgetown University Law Center. He also attended the London School of Economics and Political Science.

Stephen W. Kidder, *Managing Partner, Hemenway & Barnes, and Former Commissioner of Revenue*

Mr. Kidder is a member of the Study Commission on Corporate Taxation and Chair of the Subcommittee on Combined Reporting. As Managing Partner at Hemenway & Barnes, his practice is concentrated in the areas of government relations, real estate, taxation and service as a professional fiduciary. Mr. Kidder served as Commissioner of Revenue of the Commonwealth of Massachusetts from 1987 to 1991. Prior to that position, he served as General Counsel to the Secretary of Administration and Finance of the Commonwealth.

Mr. Kidder has written on the topic of state taxation of professional athletes. He is a Trustee of Wellesley College, Secretary and a Trustee of the Isabella Stewart Gardner Museum and Chair of The Overseers, and a Trustee of the Children's Hospital Trust. Mr. Kidder graduated from Harvard College (cum laude) and Boston College Law School (magna cum laude), where he was Editor-in-Chief of the *Boston College Law Review*.

Alan LeBovidge, *Executive Director, Massachusetts Turnpike Authority, and Former Commissioner of Revenue*

Mr. LeBovidge is a member of the Study Commission on Corporate Taxation, Chair of the Subcommittee on Other Governor Proposals, and a member of the Subcommittee on Minimum Corporate Excise. As Executive Director of the Massachusetts Turnpike Authority, Mr. LeBovidge is charged with formulating a comprehensive action plan for reform. Previously, Mr. LeBovidge served as Commissioner of Revenue of the Commonwealth of Massachusetts for over six years. Prior to this appointment, he had retired after a 32-year career at the firm that started as Lybrand, Ross Bros. & Montgomery, which is now PricewaterhouseCoopers, serving for 25 years as tax partner.

While Commissioner of Revenue, Mr. LeBovidge served as the Chair of the Springfield Finance Control Board, a member of the Board of Directors of the Federation of Tax Administrators, and a member of the Board of Directors of the North Eastern State Tax Officials Association. He is currently a member of the Advisory Board for the Department of Financial Planning and Taxation at Bentley College, a member of the Dean's Advisory Board for the University of Massachusetts' College of Social and Behavioral Sciences, and a member of the Board of Trustees for Beth Israel Deaconess Hospital.

Mr. LeBovidge received a bachelor's degree in economics from the University of Massachusetts at Amherst, a law degree from Boston College School of Law, and a master of laws degree from the Boston University School of Law.

Kevin F. Long, *CPA, Long & Bott, PC*

Mr. Long is a member of the Study Commission on Corporate Taxation and a member of the Subcommittee on Alternatives to the Corporate Excise. Mr. Long is a CPA and attorney at Long & Bott, PC and has expertise in areas of tax planning, estate planning, and business and succession planning. In addition to his legal experience, he has more than ten years in public accounting experience. Mr. Long serves as a member of the Board of Directors of the Massachusetts Society of Certified Public Accountants. In the past, Mr. Long has also served that organization as President, Vice President of Finance, Chair of the Massachusetts CPA Review Technical Advisory Board, and Chair of the State Tax and Legislation Committees.

Mr. Long received a B.S. degree in business administration from Boston College, where he was a member of the School of Management Honors Program. In addition, he received a J.D. degree from Boston College, where he was the Revisions Editor of the *UCC Reporter Digest*.

Eileen P. McAnneny, *Senior Vice President for Government Affairs, and Associate General Counsel, Associated Industries of Massachusetts (AIM)*

Ms. McAnneny is a member of the Study Commission on Corporate Taxation, a member of the Subcommittee on Business Tax Rates, and a member of the Subcommittee on Other Governor Proposals. Ms. McAnneny is the Senior Vice President and Associate General Counsel for Government Affairs at AIM, the state's largest nonprofit, nonpartisan association of Massachusetts' employers.

Ms. McAnneny advocates on Beacon Hill for AIM's legislative agenda and manages issues of general interest to the employer community. She is primarily responsible for health care and taxation issues, in both the legislative and regulatory arenas. She is a member of AIM's Taxation and Health Care Committees and represents the association on several health care advisory committees including the Managed Care Advisory Committee, the Medical Care Advisory Committee, the Massachusetts Healthcare Leadership Forum and the Coalition for Coverage. She also serves on the Massachusetts Bar Association's Tax Section Council.

Ms. McAnneny received a B.A. degree in political science, with honors, from Tufts University and a law degree, with honors, from Suffolk University Law School.

Jane Steinmetz, *Partner, PricewaterhouseCoopers LLP*

Ms. Steinmetz is a member of the Study Commission on Corporate Taxation and a member of the Subcommittee on Combined Reporting. She is a Partner at PricewaterhouseCoopers LLP (PwC) who specializes in the area of state and local taxation. Within PwC, she leads the Northeast state and local tax practice as well as the national state tax practices for the real estate and investment management industries.

Ms. Steinmetz works on a variety of clients across all industries including retail, manufacturing and financial services. Within the financial services sector, she is a recognized expert in the state taxation of the investment management and real estate industries and works with companies across the country in these industries. Prior to her work at PwC, she was a tax attorney in the legal division of the Connecticut Department of Revenue Services.

Ms. Steinmetz received her law degree and LL.M. in taxation from Boston University School of Law and a B.S. degree in accounting from Rhode Island College.

Robert Tannenwald, *Vice President and Economist, Federal Reserve Bank of Boston, and Director, New England Public Policy Center*

Mr. Tannenwald is a member of the Study Commission on Corporate Taxation, a member of the Subcommittee on Combined Reporting, and a member of the Subcommittee on Streamlined Sales Tax. He is a Vice President and Economist at the Boston Federal Reserve Bank and Director of the New England Public Policy Center. Prior to his career at the Bank, he served as Executive Director of the Massachusetts Special Commission on Tax Reform from 1984 to 1986. He has also served as Research Director of the Massachusetts Special Commission on Business Tax Policy and of the New Hampshire

Commission on Education Funding. Additionally, Mr. Tannenwald is the immediate past President of the National Tax Association.

Mr. Tannenwald has published extensively in the field of public finance, including topics such as devolution, unemployment insurance, the business tax climate, and the impacts of state and local tax policies. He received a bachelor's degree from Dartmouth College and a Ph.D. from Harvard University.

Michael J. Widmer, *President, Massachusetts Taxpayers Foundation*

Michael Widmer is a member of the Study Commission on Corporate Taxation, a member of the Subcommittee on Combined Reporting, and a member of the Subcommittee on Minimum Corporate Excise. Mr. Widmer has served as the President of the Massachusetts Taxpayers Foundation since 1992. He joined the Foundation in 1990 after more than 20 years of management and political experience in both the public and private sectors in Massachusetts.

A cum laude graduate of Princeton University, Mr. Widmer received M.A. and Ph.D. degrees in political science from Harvard University.

APPENDIX C

Meeting Schedule for Commission and Subcommittees

Meeting Schedule for Commission and Subcommittees

Study Commission on Corporate Taxation

The Commission held meetings on May 8, May 14, May 29, June 12, October 16, November 13, December 5 and December 18, 2007. Additionally, the Commission conducted a public hearing on May 22, 2007.

Subcommittees

- The Subcommittee on Alternatives to the Corporate Excise held meetings on August 30, September 17, September 27 and October 9, 2007.
- The Subcommittee on Business Tax Rates held meetings on September 19 and September 24, 2007.
- The Subcommittee on Combined Reporting held meetings on September 7, September 17, October 1, October 30 and November 12, 2007.
- The Subcommittee on Minimum Corporate Excise held meetings on September 20, October 15 and December 4, 2007.
- The Subcommittee on Other Governor Proposals held meetings on September 4 and September 25, 2007.
- The Subcommittee on Streamlined Sales Tax held meetings on October 3 and November 7, 2007.

APPENDIX D

"Interim Report" (Majority Report, dated June 15, 2007)

Commonwealth of Massachusetts

Study Commission on Corporate Taxation

Interim Report
June 15, 2007

Members of the Commission

Leslie Kirwan, Secretary of Administration and Finance, Chair

Representative John Binienda, House Chair, Joint Committee on Revenue

Senator Cynthia Creem, Senate Chair, Joint Committee on Revenue

Representative Bradley Jones, House Minority Leader

Senator Richard Tisei, Senate Minority Leader

Alan LeBovidge, Commissioner of Revenue

Professor Alan Clayton-Matthews, economist, UMass Boston

Joseph Donovan, Counsel, Sullivan and Worcester

Karl Fryzel, Partner, Edwards Angell Palmer & Dodge LLP

Stephen Kidder, Managing Partner, Hemenway & Barnes

Kevin Long, CPA and lawyer, Long & Bott, P.C.

Eileen McAnneny, Vice President, Government Affairs, Associated Industries of Massachusetts

Jane Steinmetz, Partner, PricewaterhouseCoopers

Robert Tannenwald, Vice President and Director, New England Public Policy Center, Federal Reserve Bank of Boston

Michael Widmer, President, Massachusetts Taxpayers Foundation

TABLE OF CONTENTS

Executive summary 4

Interim recommendations: 5

1. Introduction. 7

2. The immediate problem: business tax laws that allow avoidance 10

3. Interim recommendations 15

a. Entity classification and "check-the-box" rules: joining the mainstream of national tax policy. 15

b. Combined reporting and other issues in the Governor's bill: support for purposes; further study of design and implementation. 17

4. Other subjects for further study in Phase II. 21

APPENDIX A 23

APPENDIX B 25

APPENDIX C 26

Executive summary

Governor Deval Patrick, Speaker of the House Salvatore DiMasi, and Senate President Therese Murray announced establishment of this Commission on April 30, 2007. Assigning to the Commission the task of reviewing the Governor's "tax fairness" bill and various other matters, their joint statement required the Commission to "study the modernization and simplification of the current business tax laws of the Commonwealth, to promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness" and to file its final report by January 1, 2008. They called for this "interim report on legislative recommendations providing revenue for Fiscal Year 2008" by June 15, 2007.

In keeping with this mandate, the Commission strongly believes that productive and profitable businesses are essential to job growth and to the Commonwealth's economic prosperity. Part 4 of this report describes specific ideas that Commission members have proposed for accomplishing these long-term goals in the second phase of the Commission's work.

In the first six weeks of its work, however, the Commission has identified as the most immediate problem the fact that the Commonwealth's business tax laws allow significant avoidance not intended by the Legislature. This avoidance has helped reduce business tax receipts as a fraction of corporate profits from 11.5 percent in 1989 to an all-time low of 5.1 percent in 2005 and 5.5 percent in 2006 – all while corporate profits were doubling (see charts in Appendix B). Larger multistate businesses, many of which are based outside of the Commonwealth, are the principal users of this kind of corporate structuring for tax reduction purposes – as illustrated in Appendix C. These tax avoidance methods are especially unfair to Massachusetts-based smaller businesses, which do not have access to sophisticated tax planning techniques or the opportunity to use them.

The Commission's evidence demonstrates that insisting on greater shared responsibility for our Commonwealth's future – principally by asking a fairer share from larger, multistate businesses – will not harm competitiveness and economic growth in Massachusetts. Massachusetts is, and will remain, among the most economically competitive states in the nation. Yet, the Commonwealth and its businesses can prosper only with a highly educated workforce, ample affordable housing, healthy communities, and an otherwise robust economic infrastructure – all of which require adequate and fairly shared tax revenues to support them.

Interim recommendations:

The Commission's immediate legislative recommendation is that Massachusetts join the national tax policy mainstream by enacting the reform known as "check the box" – conforming Massachusetts entity classification rules to federal law, and thus preventing a corporation from claiming one status for Massachusetts taxes and another for federal and other-state taxes. This conformity will simplify and modernize the Commonwealth's tax structure and will limit tax avoidance opportunities currently allowed by the mismatch between the entity classification rules used in Massachusetts and those used both for federal purposes and in at least 45 other states. The Legislature has already applied these federal rules to limited liability companies in a 1995 statute, and the Senate approved applying them broadly in 2005.

The Commission supports the purposes of other measures proposed in the Governor's bill, but has been unable to study their design and implementation adequately in the short time available to date. In particular, the Commission believes that combined reporting would modernize the Commonwealth's corporate tax structure, would reduce opportunities for tax avoidance through transactions among affiliated corporations, and would promote stability and predictability by dramatically reducing the

need for further legislative changes in response to tax planning strategies. The Commission will devote significant effort to examining these remaining provisions, together with the specific ideas identified by Commission members and described in Part 4, in the second phase of its work this year.

1. Introduction.

On February 28, 2007, the same day he proposed his budget for fiscal year 2008, Governor Deval Patrick also filed a bill entitled "An Act Improving the Fairness of the Tax Laws," numbered H. 3756.[1] According to the Governor's filing letter, the bill would "close several tax loopholes that create an uneven playing field for business and cost hundreds of millions of dollars of lost revenue." The bill includes provisions for:

- combined reporting, to curb the practice of businesses' shifting income to out-of-state subsidiaries;
- "check the box," conforming Massachusetts entity classification rules to federal law, thus preventing a corporation from claiming one status for Massachusetts taxes and another for federal and other-state taxes.
- preventing income derived from non-insurance businesses owned by insurance companies from escaping taxation;
- clarifying that the deeds excise paid by sellers of real estate applies to real estate placed in a subsidiary business entity (such as a limited liability company) when the entity rather than the underlying real estate is sold;
- requiring Internet resellers to collect the hotel/motel tax on their mark-up of the room price as charged to the consumer;
- preventing certain businesses from avoiding paying sales tax by leasing equipment from an affiliate;
- clarifying that recipients of the personal earned income tax credit must live or work in Massachusetts.

[1] The bill's text, summary and supporting materials are available online at http://budget.mass.gov/budget/bills08/fair.shtml

The Department of Revenue estimated that the Governor's bill would have increased revenue by $275 million in fiscal year 2008 and approximately $500 million in later years. For fiscal year 2008, the Governor's budget used these funds to help close a gap between revenues and expenditures that exceeded $1 billion. Beginning in fiscal year 2009, the Governor also proposed to spend some of these new revenues to establish a Homeowner Circuit Breaker, expanding the present Senior Circuit Breaker income-tax credit to homeowners of all ages.

The fiscal year 2008 budgets passed by both the House of Representatives and the Senate did not include any revenue from the Governor's tax fairness bill. Instead, the Legislature closed that portion of its budget gap by increased use of reserves from the Commonwealth Stabilization Fund and the Health Care Security Trust Fund. The Governor's tax fairness bill remains before the Legislature's Joint Committee on Revenue.

In the meantime, the Governor, Speaker of the House Salvatore DiMasi and Senate President Therese Murray announced on April 30, 2007 that they were establishing this Commission. Assigning to the Commission the task of reviewing the Governor's bill and various other matters, their joint statement also said:

> The mandate of the Commission is to study the modernization and simplification of the current business tax laws of the Commonwealth, to promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness. An interim report on legislative recommendations providing revenue for Fiscal Year 2008 will be due by June 15, 2007. A final report on long- term changes to corporate tax laws will be completed by January 1, 2008.

The Commission held public meetings on May 8, 14, 29 and June 12. At its May 14 meeting, the Commission received detailed briefings by Kevin Brown, General Counsel, and Howard Merkowitz, Director, Office of Tax Policy Analysis, both of the Department of Revenue; Joseph Crosby of the Council On State Taxation; and Michael Mazerov of the Center for Budget and Policy Priorities. On May 22, the Commission conducted a public hearing in Gardner Auditorium, attended by about 300 people, including 46 who testified. (A complete list of those testifying is in Appendix A. Copies of all written testimony are available from the Commission staff in the Executive Office for Administration and Finance.)

2. The immediate problem: business tax laws that allow avoidance.

This Commission's long-range mandate is to "study the modernization and simplification of the current business tax laws of the Commonwealth, to promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness." The Commission takes seriously all these goals, and Part 4 of this report describes specific ideas that Commission members have proposed for accomplishing them in the second phase of the Commission's work. The Commission strongly believes that productive and profitable businesses of all kinds are essential to job growth and to the Commonwealth's economic prosperity.

Consistent with these long-term goals, however, the Commission first needs to carry out its interim charge to make "legislative recommendations providing revenue for Fiscal Year 2008 . . . by June 15, 2007." In turn, this requires the Commission to focus its immediate attention on a serious and growing problem: the Commonwealth's business tax laws allow significant avoidance not intended by the Legislature.

Generally, corporations doing business in Massachusetts are subject to a tax based on net income and on either tangible property or net worth. Together, these two measures of tax constitute the corporate excise. (Banks, security corporations, utility corporations, and insurance companies are taxed in a different manner.) The statutory tax rate on corporate net income is 9.5 percent. [2]

By several measures compiled by the Department of Revenue, businesses have been paying a smaller fraction of taxes to the Commonwealth for the last two decades. As a proportion of all Massachusetts tax collections, business tax receipts declined from

[2] This description of the corporate excise is taken from Executive Office of Administration and Finance, *Tax Expenditure Budget, Fiscal Year 2008*, p. 36, available online at http://www.mass.gov/Ador/docs/dor/Stats/TEB/TEB2008.pdf.

17.1 percent in 1989 to 12.9 percent in 2005. As a proportion of gross state product, they fell from 1.06 percent in 1986 to 0.70 percent in 2006.[3]

Perhaps most significantly, business tax receipts as a fraction of corporate profits fell from 11.5 percent in 1989 to an all-time low of 5.1 percent in 2005 and 5.5 percent in 2006 – substantially lower than the maximum statutory corporate excise rate of 9.5 percent. Over this same period, while Massachusetts business tax collections remained essentially flat, Massachusetts corporate profits more than doubled – mostly beginning in fiscal year 2003 -- from about $17 billion to $38.1 billion (all in inflation-adjusted 2000 dollars). The graphs in Appendix B clearly show these trends.

Examining the number of Massachusetts corporations paying the minimum excise of $456 provides another measure of this problem. For tax year 2004, DOR records show that 115,886 of 152,127, or 76.2 percent of all Massachusetts corporations, paid only this minimum amount. Lest it be argued that only "Subchapter S" and other small corporations account for this, among the 6,883 largest Massachusetts corporations – those with sales volume over $50 million -- fully 2,283, or 33.2 percent, paid the minimum $456 excise.

To be sure, intentional tax preferences conferred by the Legislature explain some of this deviation from the nominal 9.5 percent corporate excise rate. Recent statutory preferences include single-sales-factor apportionment, a lower rate for security corporations, increasing the investment tax credit to 3 percent, and expansion of research and development credits. This report does not recommend reconsidering these intentional legislative preferences.

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[3] Unless cited otherwise, all tax data were compiled for the Commission by the Massachusetts Department of Revenue. As used in these data and in the Appendix B graphs, "business tax receipts" or "corporate and business taxes" includes the corporate excise, receipts from public utilities, insurance companies and financial institutions, and an allocation of S-corporation pass-throughs.

But as DOR lawyers and others have explained to the Commission, a good deal of the substantial reduction in business tax revenues results from methodical avoidance of the tax statutes, in ways never intended by the Legislature. These sophisticated and aggressive avoidance techniques include shifting income to subsidiaries in other states with lower or no corporate tax rates, and claiming one tax status for Massachusetts tax filings and another for federal purposes. Appendix C contains DOR charts illustrating some of these avoidance practices.

In using the term "avoidance," the Commission does not mean to make a moral judgment. Present law arguably allows these tax planning techniques, and we recognize that businesses wish to maximize their owners' return on investment. Rather, we intend to call attention to the Commonwealth's duty to address this significant loss of revenue that does not result from any intentional tax preference conferred by the Legislature. We add that these changes proposed here will provide the very stability and consistency in the tax law rightly demanded by the business community.

Larger multistate businesses, many of which are based outside of the Commonwealth, are the principal users of this kind of corporate structuring for tax reduction purposes. In general, businesses with operations both inside and outside the state with high absolute profitability have the greatest opportunity and incentive to shift taxable income from the Commonwealth (and other separate-return states) to low-tax jurisdictions. These tax avoidance methods are thus especially unfair to Massachusetts-based smaller businesses, which do not have access to sophisticated tax planning techniques or the opportunity to use them.

Partly because a relatively small number of businesses is affected, even if the Governor's entire tax fairness bill were fully implemented, the present proportion of business tax receipts as a fraction of corporate profits would increase by a single

percentage point, from the present 5.8 only to 6.8 percent, still well short of the 9.5 percent statutory rate.

Insisting on greater shared responsibility for our Commonwealth's future – principally by asking a fairer share from larger, multistate businesses – will not harm competitiveness and economic growth in Massachusetts. First, several influential economists cited to the Commission have concluded that, while taxes are one factor that businesses consider in deciding where to locate or expand, the predominance of other factors usually renders business taxation a much less significant consideration.[4]

Second, even by the standard of total business taxation, Massachusetts is among the most economically competitive states in the United States. Ernst & Young's February 2007 survey for the Council on State Taxation rated the Commonwealth 40th in the nation for business taxes as a percentage of private sector gross state product.[5] Even if the Governor's bill were fully implemented and the telecommunication exemption from property taxation were also repealed (as proposed in the Governor's pending "municipal partnership" bill, H. 3749, §§ 23-27), Massachusetts total business taxes would increase by only 4.3 percent, leaving our rank in this Ernst & Young survey unchanged.[6]

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[4] E.g., Stephen T. Mark, Therese J. McGuire, and Leslie E. Papke, "What Do We Know About the Effect of Taxes on Economic Development? Lessons from the Literature for the District of Columbia," State Tax Notes magazine, August 25, 1997, pp. 508-509; George A. Plesko and Robert Tannenwald, Measuring the Incentive Effects of State Tax Policies Toward Capital Investment, Federal Reserve Bank of Boston Working Paper 01-4, December 3, 2001; Michael Mazerov, "Growing Number of States Considering a Key Corporate Tax Reform," available online, April 5, 2007, http://www.cbpp.org/4-5-07sfp.htm, last accessed June 4, 2007.

[5] Available online at http://www.ey.com/Global/download.nsf/US/Total_State_and_Local_Taxes_-_50_State_Estimates_2006/$file/TotalStateLocalTaxes2006.pdf . This survey is based on a broader measure of business taxes, including for example sales and use and property taxes.

[6] For example, Massachusetts is the leading state in the Beacon Hill Institute's *Metro Area and State Competitiveness Report 2004*, available online at http://www.beaconhill.org/Compete04/PRCompete04FINAL.pdf . It is also first in the Information Technology and Innovation Foundation's *2007 State New Economy Index*, available online at http://www.itif.org/index.php?id=30

Finally, Massachusetts business can prosper only with a highly educated workforce, ample affordable housing, healthy communities, and an otherwise robust economic infrastructure. Organized business groups have correctly recognized this. Thus, the Massachusetts Taxpayers Foundation has called for dedicating 40 percent of tax revenues to local aid, restoring and increasing the state's investment in public higher education, maintaining and expanding our capital infrastructure, and addressing state retiree health costs. The Greater Boston Chamber of Commerce has called for increased support for public higher education, implementing the new health care reform law, and securing long-term funding for smart growth housing development. All of this requires government spending, and that in turn implies that businesses that receive the benefit of public-sector activity must meet their shared responsibility for the taxes necessary to support it. Indeed, a recent paper cites persuasive economic authority that increased tax revenues expended for increased public services may accelerate economic growth more effectively than foregoing those tax revenues.[7]

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[7] R.G. Lynch, W. Schweke, N. Jenny and N. Berger, "Building a Strong Economy: the Evidence on Combined Reporting, Public Investments and Economic Growth" (June 8, 2007), available online at http://www.massbudget.org/BuildingStrongEconomyJune07.pdf .

3. Interim recommendations.

a. Entity classification and "check-the-box" rules: joining the mainstream of national tax policy.

Massachusetts is out of step with the federal government and virtually every other state in the way that it classifies businesses for tax purposes. This fact is so plain that, even in its first few weeks of work, the Commission has become convinced that the Commonwealth should promptly enact legislation to bring the state into conformity with federal entity classification rules. This conformity would simplify and modernize the Commonwealth's tax structure and would limit tax planning opportunities currently allowed by the mismatch between the entity classification rules used in Massachusetts and those used both for federal purposes and in at least 45 other states. It is a necessary first step toward the broader modernization of Massachusetts business taxes that the Commission will undertake in the second phase of its work. It will also bring clarity to the law and remove an impediment to attracting companies, particularly in the financial services industry

Entity classification is the determination of whether a legal entity will be subject to tax as a corporation, which generally pays tax on its income, or will be treated as a partnership or "disregarded entity," which generally does not pay tax on its income. Partnership income "flows through" and is generally taxable to the partners instead of to the partnership entity.

For federal tax purposes, domestic legal entities formed under formal statutes of incorporation are taxed as corporations. Other entities can elect whether to be taxed as corporations or to be treated as partnerships (or to be disregarded altogether where the entity has only one owner). The federal Internal Revenue Service adopted these elective "check-the-box" rules in 1996, replacing a system which had determined whether an entity should file as a corporation by examining certain characteristics of the

entity under applicable laws and governing documents, including whether the entity possessed limited liability, centralized management, transferable shares, and continuity of life. All other states with income taxes generally follow the federal check-the-box classification (with the exception of a few states such as New Hampshire that employ a different system by taxing partnerships as well as corporations at the entity level).

Massachusetts stands alone in having an inordinately complex set of entity classification rules that can be explained only by the Commonwealth's failure to update its tax statutes to reflect modern business structures. In general, the state classification rules for most corporations and partnerships tie to the pre-1996 federal rules. However, the Massachusetts statutes specify that for most purposes limited liability companies (LLCs) are taxed according to their current federal classification – that is, LLCs already must follow the check-the-box rules. Finally, "corporate trusts" (certain business trusts and partnerships with transferable shares) are taxed as individuals under the personal income tax, regardless of their federal treatment.

The Commission heard testimony demonstrating that business taxpayers are able to use the mismatch in classification rules between Massachusetts and other states to reduce their state taxes in Massachusetts and in other states. However, there appears to be little or no policy justification for the current system – indeed, it can be a trap for unwary and unsophisticated taxpayers. The only relevant Massachusetts legislation to be enacted after the federal check-the-box rules came into effect, the 1995 LLC law,[8] follows the federal classification system. In 2005, the Massachusetts Senate adopted a version of this "check-the-box" proposal.[9]

The Commission recommends adoption of full conformity with the federal check-the-box classification rules. This step would simplify and modernize the

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[8] St. 1995, c. 281.
[9] Senator Creem amendment to Senate, No. 2092, Senate Journal, July 14, 2005.

Commonwealth's tax structure and would raise revenue. It should have only a minor effect on competitiveness because other states already use the federal classification system. The Department of Revenue estimates that this initial step alone will increase fiscal year 2008 revenues by about $100 million.

The Commission is aware of some business tax structures that use "check-the-box planning" for purposes other than reducing tax in Massachusetts. In order to give some level of predictability to planning that is not aimed at Massachusetts tax reduction, the Commission recommends an elective grandfather rule for a five-year period. Such a grandfather rule might, for example, allow a particular taxpayer to elect to continue its current tax classification under Massachusetts law during this five-year period if it can demonstrate that the structure does not materially reduce its Massachusetts tax.

b. Combined reporting and other issues in the Governor's bill: support for purposes; further study of design and implementation.

The Commission has considered substantial testimony regarding the proposed enactment of combined reporting in Massachusetts. Currently, the Commonwealth determines the income and tax of individual corporations by considering each separate company's income and apportionment factors. As a result, affiliated corporations that are within commonly owned or controlled corporate groups are permitted to determine income and tax separately, even if there are significant transactions among these affiliated entities. Testimony heard by the Commission has demonstrated that this system allows multistate businesses to shift income out of corporations engaged in business in the Commonwealth to affiliates in low-tax jurisdictions, thus reducing Massachusetts taxes paid. The Governor has proposed that the Commonwealth eliminate this shifting of income by adopting combined reporting, under which affiliated corporations engaged in unitary business activities combine their incomes and apportionment factors and file as one entity.

The Commonwealth has previously taken steps to limit shifting of income out of the state. In particular, the "add-back" provisions enacted in 2003 disallow expenses for interest or royalty payments to affiliated entities unless the taxpayer demonstrates that the disallowance would be unreasonable. In the same year, the Legislature expanded the authority of the Department of Revenue to challenge structures adopted for tax purposes as "sham transactions." The Department has a growing litigation inventory involving disputes about the legitimacy of tax-motivated structures, both under these statutes and under prior law. And these earlier statutory changes have not resolved the problem of business tax avoidance identified in this report – combined reporting may be the best available method for addressing this problem comprehensively, without resorting to new legislation repeatedly.

Twenty other states have adopted combined reporting -- roughly the same number that employ separate reporting. States that have recently adopted combination include Vermont, New York, and West Virginia, and its adoption has been proposed in several other states this year (Maryland, Michigan, New Mexico, North Carolina, and Pennsylvania). Combination is a systemic approach to remove the opportunities for aggressive tax planning available under a separate reporting system, by contrast to the case-by-case approach employed to challenge tax-motivated structures under the add-back and sham transaction statutes.

The Commission believes that combined reporting would modernize the corporate tax structure in the Commonwealth and would reduce opportunities for tax avoidance through transactions among affiliated corporations. It would also promote stability and predictability in the Commonwealth's tax law by dramatically reducing the need for further changes in response to tax planning strategies. The Commission thus agrees with the purposes of this portion of the Governor's bill.

Adoption of combined reporting would require significant changes for both businesses and the Department of Revenue, however, and would raise design and implementation issues that warrant further consideration by the Commission before making final recommendations. These issues include:

- the appropriate transition period for adoption of combined reporting;
- the appropriate method for calculating the sales factor under a combined reporting structure (the so-called *Finnegan* and *Joyce* issue);
- the appropriate filing methodology where existing rules provide for different apportionment formulas and different tax rates for certain companies within a combined group;
- other appropriate adjustments to Massachusetts apportionment factors, in light of enacting combined reporting;
- potential repeal of the 2003 add-back provisions and codification of the "economic substance" doctrine, as no longer needed if combined reporting is enacted;
- methods to minimize disputes over the scope of a unitary business.

The Governor also proposed five other areas for tax reform, including non-insurance businesses conducted by insurance companies; the scope of the deeds excise; application of the room occupancy tax where hotel rooms are sold by Internet

and other intermediaries; sales/use taxes applicable to purchases by captive leasing companies; and earned income tax credits claimed by non-residents. Because of the short deadline for issuing this interim report, the Commission has focused its attention on the two largest revenue proposals, entity classification and combined reporting. The Commission supports the general purposes of these other proposals and believes it is appropriate to examine them, but requires further time to give adequate study to them. The Commission plans to do so in the second phase of its proceedings, together with the other subjects for further study discussed in Part 4.

4. Other subjects for further study in Phase II.

Having made these interim recommendations, the Commission now plans to attend to its long-term mission to "study the modernization and simplification of the current business tax laws of the Commonwealth, to promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness." In addition to continuing to pursue the remaining provisions of the Governor's tax fairness bill discussed in Part 3, members of the Commission have proposed detailed study of the following suggestions for accomplishing these purposes:

(a) striving for more-uniform rates of business taxation among different classes of businesses, including security and utility corporations;

(b) increasing the minimum corporate excise from its current level of $456, perhaps according to some calculation of a business's net worth;

(c) substituting a uniform low tax rate on a business's gross receipts, or on gross margin or "value added";

(d) carefully examining the Commonwealth's "tax expenditure budget" to identify statutory tax preferences that no longer serve a useful purpose consistent with the Legislature's present goals, and in particular ascertaining whether those intended to create jobs actually do so;[10]

(e) considering whether the Commonwealth should fully participate in the Streamlined Sales Tax Compact;

(f) eliminating the present "balance sheet" tax;

(g) reducing the corporate excise tax rate, or eliminating the non-income measure of the corporate excise, in return for removing some intentional or unintended tax preferences.

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[10] The fiscal year 2008 "tax expenditure budget" is available at http://www.mass.gov/Ador/docs/dor/Stats/TEB/TEB2008.pdf .

Respectfully submitted by the following members of the Study Commission on Corporate Taxation, June 15, 2007:

Cynthia Stone Creech — Alan D. Bridge

[illegible] — [illegible]

[illegible] — Allan Boyd-Matthews

Leslie A. Kuwait — Robert Tannenwald

APPENDIX A

Study Commission on Corporate Taxation
Public Hearing
Gardner Auditorium, State House
May 22, 2007
4:00 -8:30 p.m.

The commission heard testimony from the following individuals:

Senator Patricia Jehlen

Senator Stan Rosenberg

Representative Steven D'Amico

Representative James Marzilli

Representative James O'Day

Representative Matthew Patrick

Representative Cleon Turner

Rick Lord, President and CEO, Associated Industries of Massachusetts (AIM)

John Regan, Vice President, Associated Industries of Massachusetts

Paul Guzzi, President, Greater Boston Chamber of Commerce

Jim Klocke, Vice President, Greater Boston Chamber of Commerce

Alan MacDonald, Massachusetts Business Roundtable

Jeffrey Brown, Executive Vice President, Colpitts World Travel

Paul O'Connor, Millipore Corporation and Chair, AIM Taxation Committee

Kin Kwan, Biogen Idec

Scott Roberts, General Electric Company

Andy Calamare, Life Insurance Association of Massachusetts

Frank O'Brien, VP, Regional Manager & Counsel – PCI New England Region

George Ryand, Liberty Mutual

Alan Solomont, political activist, entrepreneur and philanthropist

Steve Grossman, President and CEO, Grossman Marketing Group

Arnold Hiatt, Former Chair and CEO, Stride Rite Corporation

Michael Wilcox, President and CEO, Alford Associates Inc.

Mark Kritzman, President and CEO, Windham Capital Management, LLC

Cristino Acosta, Owner, "Canon's Place", Lynn

Ceasar Santana, Co-Owner, Services Express, Lynn

Basilio Encarnacion, Owner, Rincon Macorisano, Lynn

Geoff Beckwith, Executive Director, Massachusetts Municipal Association

Ed Sullivan, Executive Director, Massachusetts Teachers Association

Noah Berger, Executive Director, Massachusetts Budget and Policy Center

Phinneus Baxandall, Senior Analyst Tax and Budget Policy, MASSPIRG

Jeff McLynch, Institute for Taxation and Economic Policy

Dr. Bruce Wallin, Professor of Political Science, Northeastern University, specializing in public finance

Shirley Kressel, Alliance of Boston Neighborhoods

Professor John Edward, Bentley College

Veronica Turner-Biggs, Vice President of 1199 SEIU

Gloria Mulcahy, Coalition for Social Justice

Diane Sullivan, Homes for Families

Milly Davilia, Worcester

Jim Monsour, Coalition against Poverty, Fall River

Bob Lund, Progressive Democrats of Massachusetts, Lexington

Gloria Mulcahy, Coalition for Social Justice

Elizabeth Toulan, Greater Boston Legal Services

Betty Morningstar, First Vice President, National Association of Social Workers, Massachusetts Chapter

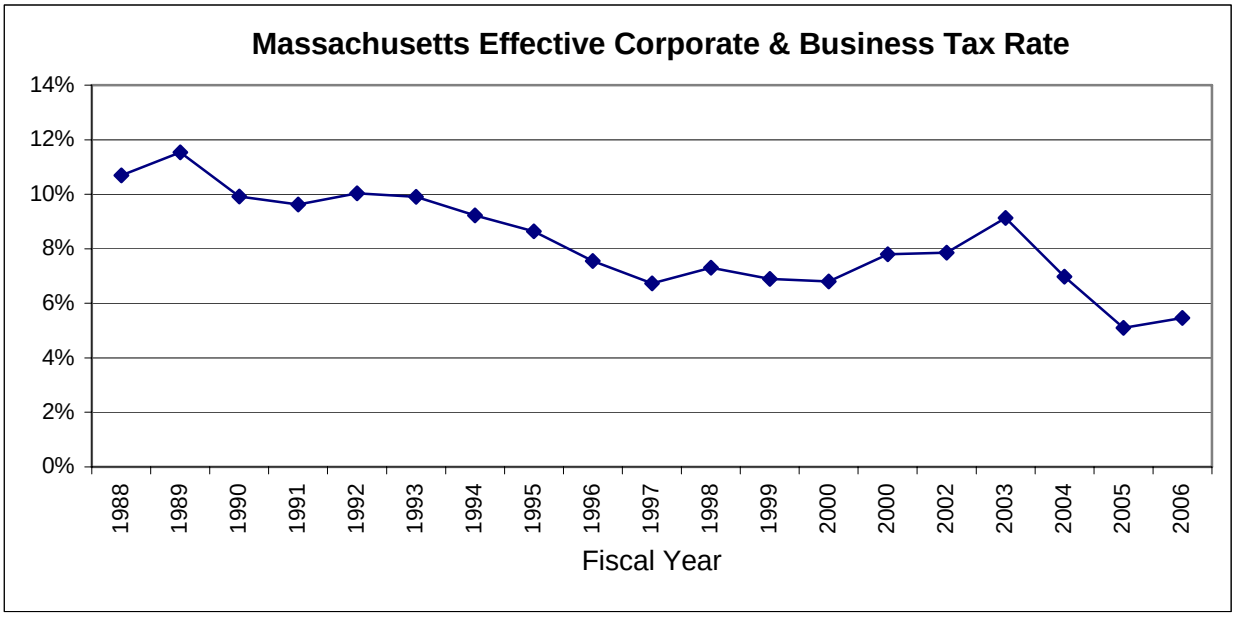
Michael Grunko, President, SEIU Local 509

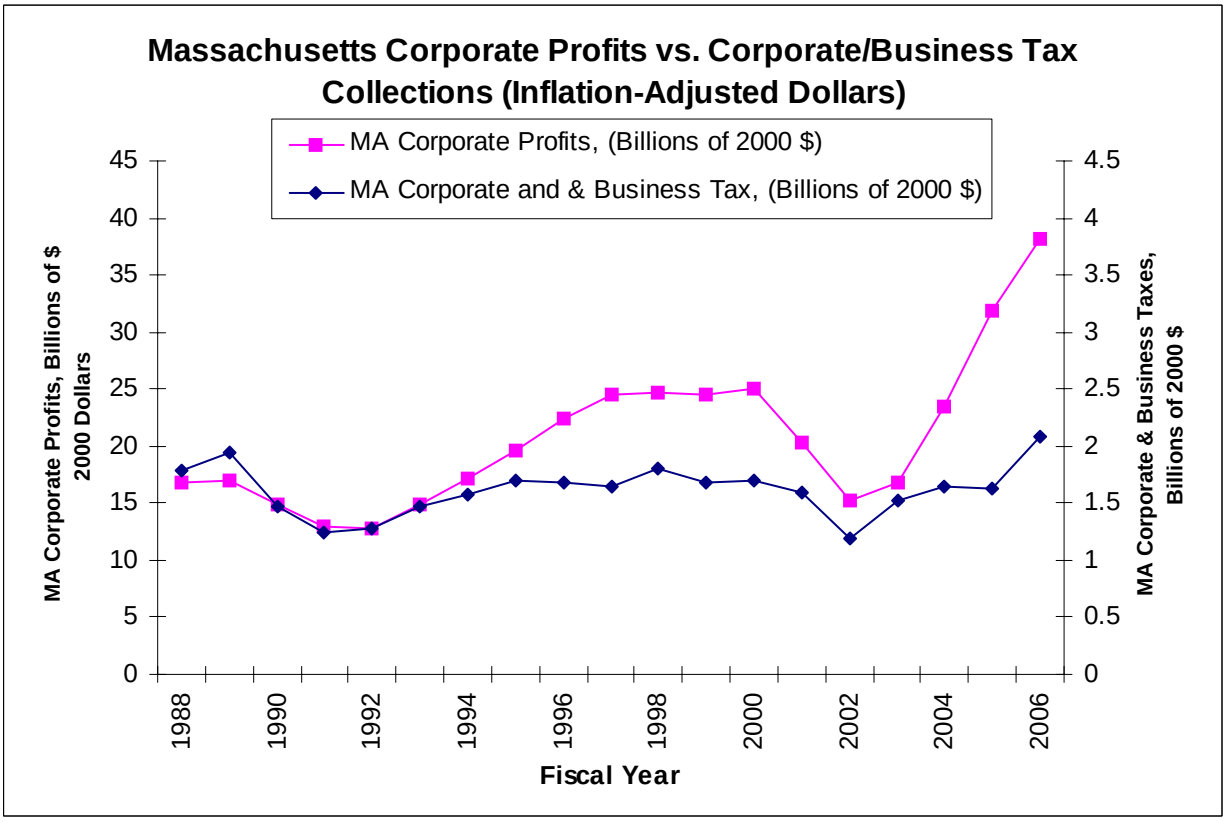
Timothy T. Collins, President, Springfield Education Association

APPENDIX B

BUSINESS TAX GRAPHS

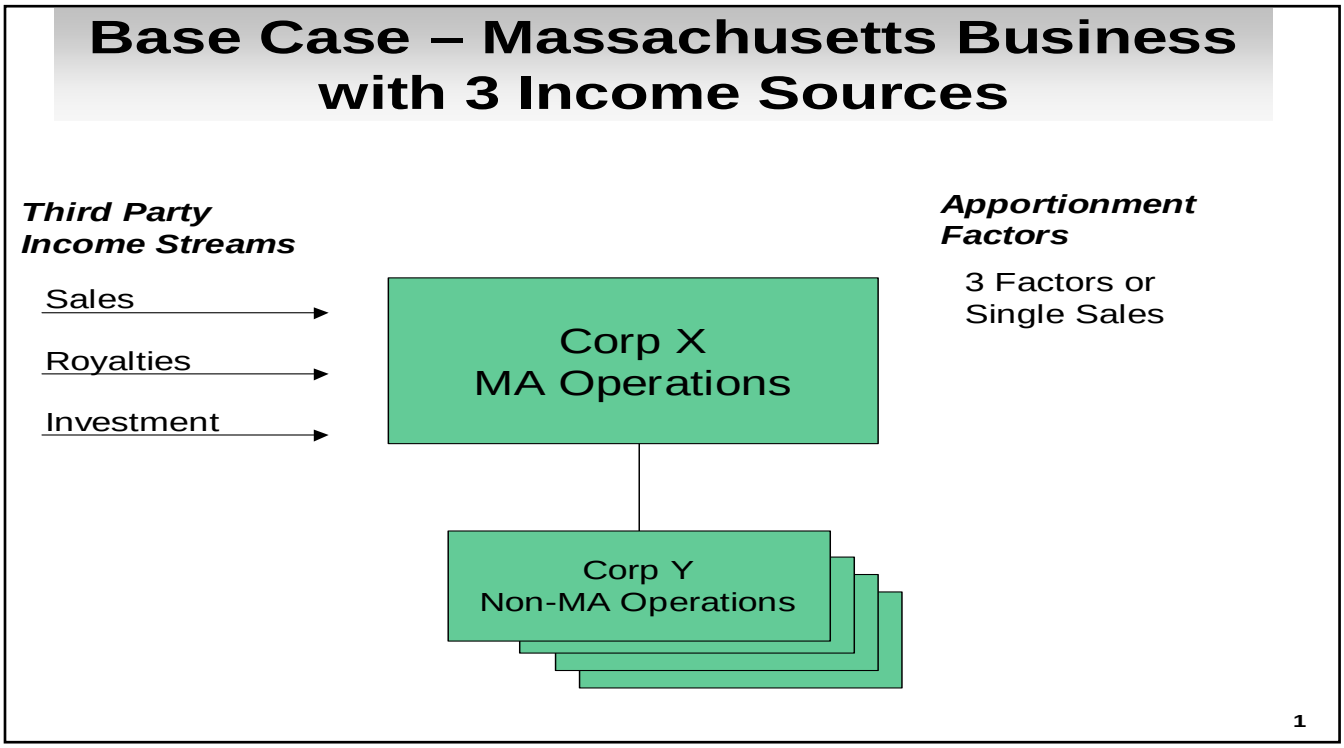
(Prepared by Office of Tax Policy Analysis, MA Department of Revenue, June 1, 2007)`

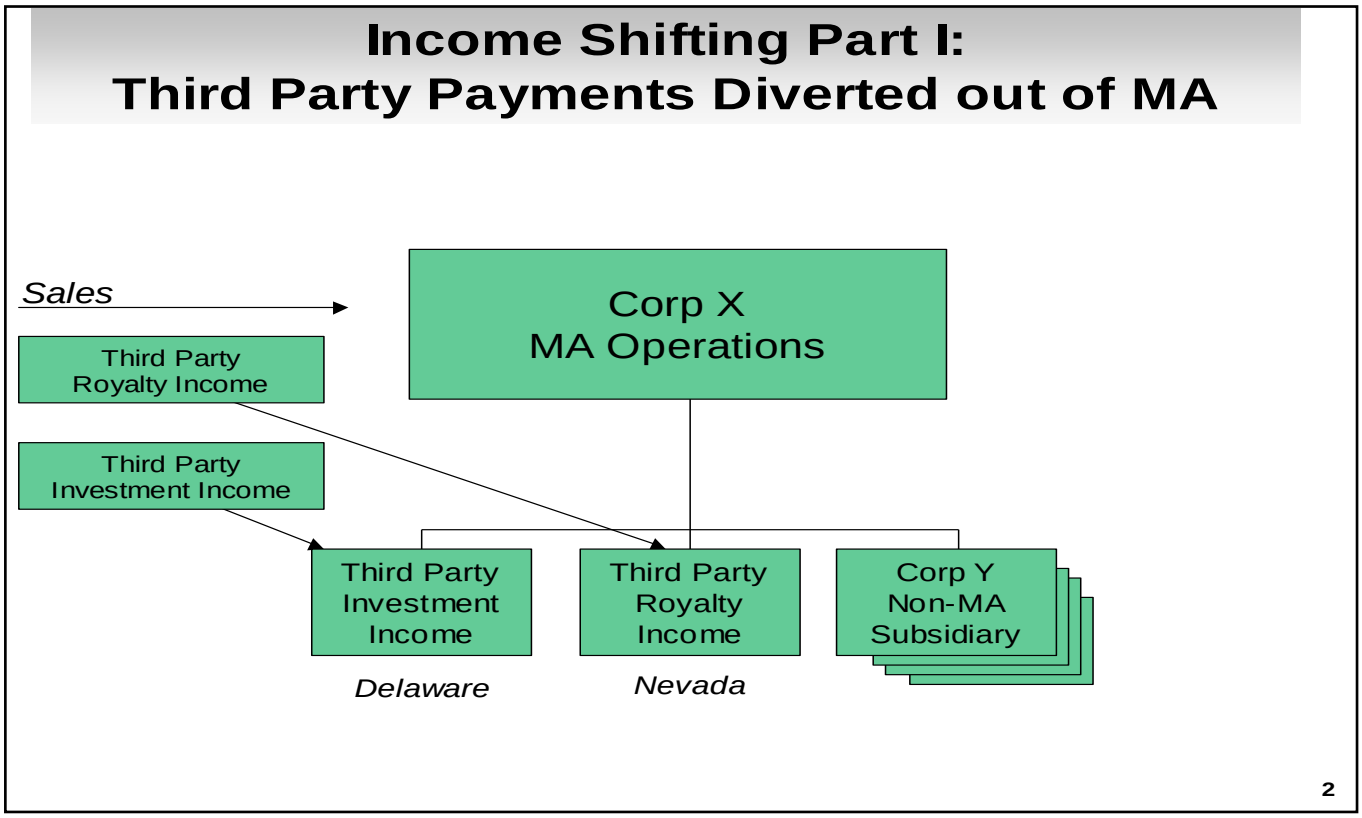




APPENDIX C

CHARTS SHOWING BUSINESS TAX AVOIDANCE TECHNIQUES





Income Shifting Part II: Remaining Taxable Income Reduced by (1) Payments to Non-MA Affiliates and (2) Check-the-Box apportionment Factor Dilution

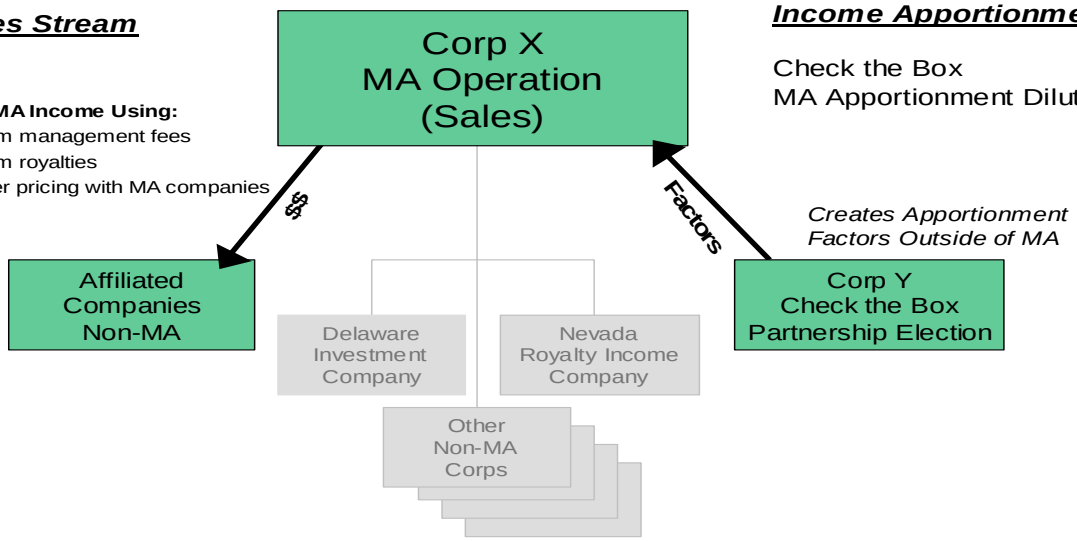
Sales Stream

Minimize MA Income Using:

- Intercom management fees
- Intercom royalties
- Transfer pricing with MA companies

Income Apportionment

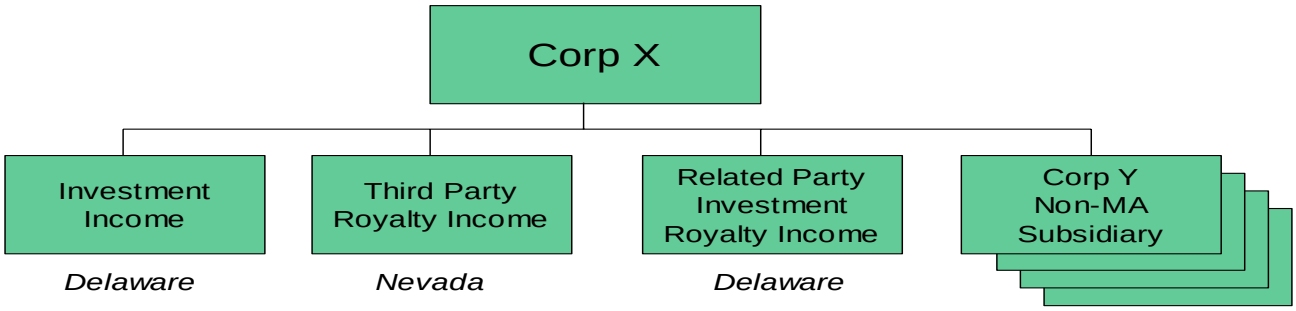
Check the Box
MA Apportionment Dilution



Creates Apportionment Factors Outside of MA

3

Unitary (Combined) Reporting State



Include income of all entities.

Apportionment based on income and factors of all entities.

4

Detailed Example of Apportionment Factors Dilution (Reducing MA Tax with Partnership/Hybrid Entity)

Base Case

Apportionment Factors

X: Sales 100 – All MA
Property 10 – All MA
Payroll 90 – All MA

Y: Sales 1000 – All Non-MA
Property 490 – All Non-MA
Payroll 910 – All Non- MA

X Corp (in MA)

$1,000 Income
x 100% Apportionment
x 9.5% Tax
= $95 of MA Tax

100% Owned

Y Corp Subsidiary (Outside MA)

$100 Income
x 0% Apportionment
x 9.5% Tax
= $0 of MA Tax

Combined Apportionment

Sales	100 MA / 1100 All	= 9%
Property	10 MA / 500 All	= 2%
Payroll	90 MA / 1000 All	= 9%

Blended Percentage with double weighted Sales Factor = 7.25%

"Check-the-box Planning"

X Corp (in MA)

$1,100 Combined Income
x 7.25% Apportionment
x 9.5% Tax
= $7.58

100%

99% Ltd Partner

Holding Co. Subsidiary

1% General Partner

Y Partnership (Corp. for Fed/Other State Tax)

Effect of Planning:

- **MA tax lowered from $95.00 to $7.58**
- **No impact on tax in other states**

5

Detailed Example of Single Sales Factor Planning (Reducing MA Tax with Partnership/Hybrid Entity; Avoiding "Throwback" Sales)

Base Case

Apportionment Factors

X: Sales 100 – All MA (incl. 90 of MA-destination sales and 10 of non-MA sales "thrown back" to MA)

Y: Sales 900 – All Non-MA

X Corp (in MA)

$1,000 Income
x 100% Apportionment
x 9.5% Tax
= $95 of MA Tax

100% Owned

Y Corp Subsidiary (Outside MA)

$1,000 Income
x 0% Apportionment
x 9.5% Tax
= $0 of MA Tax

Combined Apportionment

Sales	90 MA* / 1,000 All	= 9%

***In Combined Apportionment case, X's sales of 100 are reduced by 10 of non-MA sales made in state(s) where Y present (Base Case throwback is eliminated)**

"Check-the-box Planning"

X Corp (in MA)

$2,000 Combined Income
x 9% Apportionment
x 9.5% Tax
= $17

100%

99% Ltd Partner

Holding Co. Subsidiary

1% General Partner

Y Partnership (Corp. for Fed/Other State Tax)

Effect of Planning:

- **MA tax lowered from $95.00 to $17**
- **No impact on tax in other states**

6

APPENDIX E

"Interim Report of a Minority of Members of the Study Commission on Corporate Taxation"
(dated June 15, 2007)

INTERIM REPORT OF A MINORITY OF MEMBERS OF THE STUDY COMMISSION ON CORPORATE TAXATION

JUNE 15, 2007

Governor Patrick, Senate President Murray and House Speaker DiMasi:

A minority of the members of the Study Commission on Corporate Taxation ("the Commission") respectfully submit the following as their interim report on legislative recommendations providing revenue for Fiscal Year 2008.

I. BACKGROUND AND PROCEDURAL HISTORY

On April 30, 2007, Governor Deval Patrick, Senate President Therese Murray and Speaker of the House Salvatore DiMasi issued a joint press release appointing 15 members to serve on a special commission to review and offer recommendations for streamlining the current tax code. [1] The press release further defined the mandate of the Commission. Per the joint statement, the Commission was created to study the modernization and simplification of the current business tax laws of the Commonwealth, promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness. The press release called for an interim report on legislative recommendations providing revenue for Fiscal Year 2008 by June 15, 2007. A final report on long- term changes to corporate tax laws must be completed by January 1, 2008.

The Commission held an organizational meeting on May 8, 2007. Members agreed to an accelerated work schedule to prepare to file the interim report. The schedule included a series of public meetings and a public hearing. According to the established mandate, members also agreed to confine the scope of their investigation for the interim report to the consideration of proposals to increase tax revenue payable to the Commonwealth in FY'08, including House Bill 3756, *An Act Improving the Fairness of the Tax Laws*, filed by Governor Patrick. [2] Members further agreed that, if the members of the Commission could not reach complete consensus as to proposed recommendations, then dissenting members could submit a minority report.

A subsequent meeting was held on May 14, 2007. At this meeting, members heard presentations from representatives of the Department of Revenue, the Council on State Taxation, and the Center on Budget and Policy Priorities. These presentations explained the operation of certain provisions of House Bill 3756, together with their likely costs and benefits.

In order to solicit input from citizens of the Commonwealth, members of the Commission held a four-hour public hearing on May 22, 2007 in the State House's Gardner Auditorium. Members heard testimony from several legislators, panels of business leaders, grassroots activists and others. All testimony concerned provisions of House Bill 3756 and the merit of passing them into law. This prepared members for the next meeting of the Commission on May 29, during which they discussed recommendations for submission of an interim report.

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[1] A copy of the joint press release is attached to this Interim Report as "Appendix A."

[2] At the May 8 meeting, Michael Widmer, President of the Massachusetts Taxpayers Foundation and a member of the Commission, suggested making certain changes to the state sales tax on account of the disproportionate share of that tax paid by businesses. This idea has not been pursued at subsequent meetings, and no other legislative recommendations providing revenue for Fiscal Year 2008 have been considered by the Commission. As such, it is not part of these recommendations.

A. The Governor's Legislative Proposal - House Bill 3756

Due to time and circumstance, the Commission's investigation to date has focused on House Bill 3756. This bill, which has an effective date of January 1, 2008, would raise tax revenue by preventing corporations from taking advantage of some favorable conditions in the tax code (more popularly called "corporate tax loopholes"). The most important of these provisions are as follows: [3]

- Making Massachusetts a so-called "combined reporting" state for the reporting, apportionment and taxation of corporate net income from unitary businesses.
- Adopting so-called "check the box" rules for the classification of certain entities for state tax purposes, consistent with federal law and the laws of many other states.
- Taxing the operating income of insurance companies which is realized from non-insurance businesses, instead of simply taxing insurance premiums.
- Expanding the deeds excise tax so it would cover certain transfers of substantial interests of business entities which are not now taxable.
- Requiring businesses that resell hotel rooms to collect taxes on the difference between the retail price of the room paid by the consumer and the discounted price the reseller pays to acquire the room.
- Preventing capital-intensive businesses from avoiding the payment of sales tax on large equipment purchases by leasing equipment to subsidiaries.
- Requiring recipients of the state refundable earned income credit to live or work in Massachusetts.

The bulk of the Commission's review has been centered on the combined reporting and "check the box" provisions. The earned income tax credit and capital leasing provisions have generated little discussion. Estimates by the Department of Revenue indicate that the enactment of all 7 of these proposals would result in approximately $500 million of new tax revenue for the Commonwealth on an annualized basis, and about $296.6 million for that portion of Fiscal Year 2008 for which it would be effective (January 1, 2008 to June 30, 2008).

B. Majority Report of the Commission

On June 12, 2007, 8 of the 15 members of the Commission voted to approve a set of interim recommendations drafted by the Executive Office of Administration and Finance as the Interim Report of the Commission ("the Majority Report").

The Majority Report is premised on the consensus belief that economic development in Massachusetts requires "a highly educated workforce, ample affordable housing, healthy communities and an otherwise robust economic infrastructure – all of which require adequate

[3] A chart summarizing each provision, with a revenue estimate from the Department of Revenue for Fiscal Year 2008, is attached hereto as "Appendix B."

and fairly shared tax revenues to support them." [4] The Majority Report purports to further this goal by addressing what it terms a "serious and growing problem," namely, "the fact that the Commonwealth's business tax laws allow significant avoidance not intended by the Legislature." [5] According to the report, this avoidance has resulted in a reduction of business tax receipts as a percentage of corporate profits, which has benefited primarily larger, multi-state businesses to the detriment of Massachusetts-based small businesses. [6]

On the basis of these findings, the Majority Report expresses support for the entirety of House Bill 3756, in principle. [7] It then makes detailed recommendations with regard to 2 particular proposals: combined reporting for unitary businesses and new rules for classification of business entities. Specifically, the Majority Report recommends that Massachusetts law conform to federal tax law on the classification of business entities, commonly known as "check the box." This reform is intended to bring Massachusetts into parity with 45 other states whose laws mirror federal requirements for state classification. The majority recommends that the changes be subject to an elective 5-year grandfather rule, to permit taxpayers to continue using current classification if it does not materially reduce their Massachusetts tax. The Majority Report further supports the proposal to adopt a combined unitary reporting system in Massachusetts, but acknowledges open questions regarding the design and implementation of a combined reporting system. The report states that the Commission will "devote significant effort" to the examination of combined reporting and other aspects of House Bill 3756 during the second phase of its work.

II. DISSENTING RECOMMENDATIONS OF THE MINORITY

The members of the Commission offering this Minority Report believe that it is inappropriate, on an interim basis, for the Commission to recommend the enactment of any proposal to raise new revenue for Fiscal Year 2008. We acknowledge the potential usefulness of new revenue for government programs this year, as well as the possible need to promote fairness by making adjustments to the tax code. However, we firmly believe that recommending increases in any tax for the sake of raising revenue, without a full understanding of the context, consequences and cost of those changes, is short-sighted, bad tax policy and contrary to the broad mandate of this Commission.

A. The Interim Report Conflicts With The Broad Mandate of the Commission

From the beginning, the Commission was given a broad mandate to review our state's business tax code with an eye toward several fundamental principles. Among these are the concepts of simplicity, fairness, and equity. The Commission also was charged with promoting some essential goals with its recommendations, including modernization, innovation and the competitiveness of our domestic industries.

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[4] Majority Report at 5.

[5] Majority Report at 10.

[6] *See* Majority Report at 10-13.

[7] *See* Majority Report at 5-6, 17, 19-20.

Every aspect of the Commission's work should be focused squarely on these concepts and directed toward these goals. This is essential for the explicit reason of ensuring that the Commission will fulfill its mandate, as stated uniformly by those who created it, and for the implicit reason of making sure that its recommendations are in the best interests of the citizens of the Commonwealth. We owe our state and its residents nothing less.

For the Majority Report to recommend that so-called tax loophole provisions in House Bill 3756 be closed in Fiscal Year 2008 threatens to distract the Commission from its mission and undermine the credibility and viability of its longer-term responsibility. The Commission cannot make informed judgments on any revenue proposal without placing it into proper context and evaluating it based on its broader effects on state tax laws and the economic stability of the Commonwealth. [8] Indeed, the very reason for establishing the Commission in the first place was for it to help ensure that future decisions about tax policy are not made in a vacuum.

Because of the complexity of the underlying issues and the substantial nature of the proposals being discussed, there is absolutely no way that the Commission can vet its recommendations in a credible and satisfactory manner in the course of a mere month-and-a-half. And making favorable recommendations on legislative changes on a rushed and incomplete basis is irresponsible. Even worse, it threatens to impede the ultimate goals of the Commission by creating the possibility of inconsistent recommendations when the Commission issues its final report in January, 2008. There is nothing the Commission could do to damage stability and predictability more than to recommend interim changes in tax policy for Fiscal Year 2008, only to potentially reverse its recommendations for reasons of broader fairness six months later.

B. The Process Behind The Majority Report Is Flawed [9]

The procedure behind the crafting of the Majority Report and the recommendations set forth therein also is a concern for the minority.

The draft report was released by the Executive Office of Administration and Finance on June 11, 2007. This release occurred about 2 weeks after the last meeting of the Commission and only 1 day before the meeting at which it was to be voted on by members. The Chair of the Commission had committed to having the report available to members with ample time for review; however, that did not happen. Suffice it to say, fundamental alterations to tax policy worth hundreds of millions of dollars deserve more than a few hours of consideration.

Once some members saw the report, what surprised them the most is that it contained information which was not part of the Commission's debate. This pertained both to certain recommendations that were made and the information on which they were based. For example, the Majority Report recommends a 5-year elective grandfather rule for "check the box" rules.

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[8] These same sentiments were expressed by several individuals at the May 22 public hearing. To paraphrase the testimony of Paul Guzzi of the Greater Boston Chamber of Commerce, no one change to our tax laws should be done outside the context of looking at our entire tax system. And to paraphrase the testimony of Rick Lord from the Associated Industries of Massachusetts, to issue an interim report without undertaking such an analysis would undermine the long-term mandate of the Commission.

[9] Commission member Jane Steinmetz does not concur with this section of the report.

While the minority agrees that potential grandfathering of this provision was discussed by the Commission at its May 29 meeting, the specifics of how the provision would work were not discussed or voted on by the members. In terms of information, one of the most critical conclusions of the Majority Report is that spending increased tax revenues on public services is more beneficial for economic growth than perpetuating the existence of corporate "loopholes." Without debating the merits of this conclusion, it is suspect because it is based on a report which was released by the Massachusetts Budget and Policy Center on June 8, 2007 – 2 weeks after the Commission last met to discuss recommendations and 3 days before the release of the draft report. How this could serve as the basis for the Commission's recommendations is baffling.

There is another example of this practice which is even more troubling, and which is worthy of separate mention. A major assumption underlying the Majority Report is the premise that "business tax receipts as a fraction of corporate profits has fallen from 11.5 percent in 1989 to an all-time low of 5.1 percent in 2005 and 5.5 percent in 2006." The majority finds this trend persuasive because recent figures are "substantially lower than the 9.5 percent statutory rate." The majority relies on this conclusion to indicate that Massachusetts businesses are paying taxes an artificially-low effective tax rate, and that they therefore contribute less than their fair share to the Commonwealth. [10] A chart purporting to illustrate this trend is attached to the Majority Report as "Appendix B." The data underlying this assumption were discussed at the Commission's May 14, 2007 meeting, principally during a presentation by the Office of Tax Policy Analysis for the Department of Revenue. However, the chart presented by the Department of Revenue at the Commission Meeting is substantially different from the one appended to the Majority Report. [11] Aside from the confusion occasioned by these differences, the charts themselves are potentially misleading. At the Commission meeting, the Department of Revenue explained that actual corporate profit data are not available for any of the years in question, and that the charts are based largely on estimates using federal information.

The conclusions of the Commission, on both an interim and a long-term basis, should be based on timely, accurate information which is available to all members for their consideration. More importantly, recommendations should be arrived at collectively and opinions should be detailed fully. The failure of the Majority Report to follow this process calls its conclusions into question and undermines its credibility. Hopefully, the remainder of the Commission's work will be subject to a better process.

C. Policy Concerns With The Majority Recommendations

Of course, there are more important matters at stake than the internal workings of the Commission itself. We turn our attention to these concerns for the remainder of this report.

1. Systemic Considerations – "First, do no harm."

The goal of the Commission is to reform our tax code so that simpler and more equitable laws will promote the expansion of existing businesses in Massachusetts and lure out-of-state business to the Commonwealth. This mission is fundamental to the economy of this state, and therefore the quality of life and financial success of its residents.

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[10] *See* Majority Report at 11, 13.

[11] A comparison of the charts from the meeting and in the Majority Report is attached hereto as "Appendix C."

There are many possible ways to place this responsibility into proper context and to apply it to the Commission's work. Perhaps the most solid advice is that which was given to the Governor by his Transition Working Group on Economic Development at the beginning of his administration. The Working Group was tasked with a responsibility not unlike that before the Commission now. In making its recommendations on potential business incentives for the Commonwealth, the Working Group advised that the Patrick/Murray Administration should "first, do no harm." Specifically, the administration was advised as follows:

> *The Patrick/Murray Administration should make a bold statement early on that it will not, and has no plans to, alter current business regulations or taxation in a direction other than one that is helpful to the business community. This message of predictability and stability will resonate and will in itself be an incentive for businesses to start, grow and relocate here.* [12]

The minority members of the Commission believe in this approach, and we dissent from the Majority Report because it fails to capture this important concept. In fact, we are troubled by the inclusion of strong, unnecessary, anti-business rhetoric in the Majority Report. [13] This language sends the wrong message to the business community in our state and elsewhere. This is a mistake, and it is against our mandate. We cannot expect to foster economic development with tax increases and anti-business tones. Fulfilling our duty to attract businesses to Massachusetts and encourage them to expand here might call for changes in our tax code, but if nothing else it requires an un-biased and fair state of mind. The Majority Report makes it appear that business will not be treated fairly in Massachusetts.

The minority believes that the best tax policy to help businesses in Massachusetts is one that promotes predictability and stability. Making a sudden move to combined reporting and new entity classification rules would serve neither purpose. If nothing else, taxpayers would have to adjust to these new systems; at worst, they might move elsewhere. [14]

The minority members find it troubling that the majority has adopted the belief that "asking a fairer share from larger, multi-state businesses… will not harm competitiveness and economic growth in Massachusetts," even though this conclusion was disputed at the public hearing [15] and is not shared universally by the members of the Commission.

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[12] *See* "Recommendations to the New Administration," Patrick-Murray Transition Working Group on Economic Development, December 15, 2006 at 9.

[13] *See*, *e.g.*, Majority Report at 5 (suggesting that legal tax planning techniques permit larger, multi-state businesses to avoid "shared responsibility for our Commonwealth's future"); 10 ("…businesses have been paying a smaller fraction of taxes to the Commonwealth for the last two decades."); 12 (discussion of "methodical avoidance of the tax statutes" by "larger, multi-state businesses" through "sophisticated and aggressive avoidance" techniques).

[14] Numerous witnesses testifying before the Commission agreed that, while corporate taxes might not always be the most important factor for businesses locating in Massachusetts, they are undoubtedly at least a factor.

[15] For example, Rick Lord, President and CEO of the Associated Industries of Massachusetts, testified at the public hearing that, "I can assure you, our members tell us tax matters when making decisions here in the Commonwealth…. Predictability and stability are positive aspects for the business climate."." *See* Appendix D.

2. "Check the Box"

Aside from general concerns regarding any recommendation for policy changes for FY'08, the minority has specific problems with support for "check the box" entity classification.

At the May 29 meeting, commission members discussed the fact that new entity classification rules could effect the collection of local property taxes in Massachusetts. After consulting the Department of Revenue, it appeared that these concerns were well-founded but further questions developed. For example, the Department of Revenue was unsure how much of an effect would occur. Additionally, the department advised that some communities likely would have increased collections while others would realize a loss, though the amount and location of such changes was unknown. This uncertainty spotlights exactly the reason why making interim recommendations to raise revenue without complete information of consequences is misguided. It did not stop the majority from supporting "check the box" in its report, however. In fact, there is not any reference to the potential property tax effects of this provision in the report, even though this collateral question could substantially impact the ability of Massachusetts cities and towns to deliver the very services the majority deems essential to competitiveness in Massachusetts. The minority can not support such an interim recommendation.

Likewise, the Majority Report does not mention that "piggy-backing" on federal entity classification rules could leave Massachusetts vulnerable to the vicissitudes of changes to the Internal Revenue Code. Massachusetts lawmakers do not control these federal changes, but these changes could directly affect the taxability of corporate excise revenue in the Commonwealth. Again, the Commission should not make sweeping recommendations in favor of tax policy changes without understanding the consequences of its actions fully.

Another significant concern with "check the box," from a fairness standpoint, is that it does nothing to change the inequity of the 5 different tax rates that Massachusetts imposes on business income. Even if the rules are adopted, the Massachusetts tax on partnership income will remain at 5.3%. However, an identical business that is classified as a corporation will pay tax at rates ranging from 5.3% to 9.5%. Further, when the financial institution tax was restructured several years ago, mortgage brokers that conducted business in an S-Corporation inadvertently found themselves paying tax at 15.8% (5.3% plus 10.5%). In Letter Ruling 01-9, the DOR sanctioned the use of a Massachusetts Business Trust to avoid this inequitable result. Under Letter Ruling 01-9 the entity's income is taxed at 5.3%. But as a result of check-the-box, it appears that the mortgage broker's income will be tax at 10.5%. This inequity is not removed by the Majority Report; in fact, one could say it is exacerbated by it.

Finally, regarding the last-hour recommendation for grandfathering rules [16] on this proposal, there has been no information presented to the Commission regarding how many entities might be subject to grandfathering and how much added revenue would be foregone. Thus, the majority is making a recommendation to increase tax revenue without knowing how many people it would affect and how much it would cost. Even if the recommendation ultimately proves to be appropriate, pending further investigation, making the recommendation on an interim basis is irresponsible tax policy.

[16] It remains open to discussion whether the proposed 5-year election actually is a "grandfathering" provision or if it is simply a gradual phase-in.

3. Combined Reporting

The majority's expression of support for combined reporting is another good example of why it is inappropriate to make interim recommendations for legislative changes.

The Majority Report admits that there are many unanswered questions regarding how combined reporting would work in Massachusetts. These questions are not trivial; they are fundamental to the basic operation and effects of a combined reporting system in this state. Until these questions are answered, it is impossible to know how much combined reporting would cost, how many businesses it would effect, and how complicated it would be to implement. Whereas the majority is content to support this "loophole closing" on the assumption that these questions will be answered later, the minority finds it impossible to recommend support for a legislative proposal – even in principle – without knowing exactly what the proposal is.

Specifically, testimony from the Council on State Taxation at the May 14 meeting indicated that combined reporting enactments in other states (1) generally requires a phase-in period of 18-24 months to allow for the promulgation of regulations and transition of business finances, and (2) is usually accompanied by other, off-setting tax provisions. House Bill 3756 would take effect on January 1, 2008, only 6 months in the future, and it does not include any off-setting revenue provisions. The Majority Report fails to address these questions, other than to state that they will be subject to further investigation. This failure undermines the worth of the majority's recommendations for the very policymakers relying on them. The minority believes that recommendations on combined reporting should not be made until these questions are answered.

The minority members also take notice of a letter which then Commissioner of Revenue Alan LeBovidge sent to the Joint Committee on Taxation on April 26, 2004, which expressed concerns with combined reporting. [17] The Department of Revenue advised that a significant rise in corporate tax revenue "will not materialize in the near term" upon the adoption of a unitary approach. In fact, the letter suggests that revenues might actually *decrease*. The Commissioner also acknowledged that the definition of a "unitary business" (the foundation of a combined reporting system) is "inherently grey," and that protracted audits and litigation would ensue. Finally, the Commissioner advised that policymakers weigh the perceived benefits of combined reporting against the perception that it is harmful to business.

The Commissioner's letter ends with the following information:

> *Largely for such reasons, no state has implemented combined reporting for 20 years. Last year, the Connecticut legislature passed a bill that would have authorized a unitary approach, but it was repealed almost immediately when its unitary consequences became clear, and the state instead modified its treatment of intercompany deductions to follow the model of the Massachusetts addback law adopted in March 2003.*

[17] A copy of the letter is attached hereto as "Appendix E."

The minority simply cannot endorse a recommendation of support for combined reporting, on an interim basis, knowing that questions that go the very essence of such a plan remain unanswered and unaddressed by the Commission.

4. General Administrative Concerns

Regardless of the nomenclature that is used or the intent involved, all can agree that closing the "loopholes" addressed by the Governor's bill would result in substantial changes in state tax policy. The minority of the Commission is worried that the Department of Revenue would be ill-prepared to implement these provisions administratively – particularly the combined reporting requirement – with only a few months' notice. It is unfair for the Commission to recommend significant structural tax changes in the face of such a concern.

Our state already has experienced the unpredictability and instability of three separate business "tax loophole" closings since 2003.[18] Indeed, due to these retroactive and ambiguous changes to the tax code, the Department of Revenue already has experienced a large number of business tax cases filed with the Appellate Tax Board, involving close to $1 billion in taxes and interest. This litigation is acknowledged by the Majority Report. [19] Now is not the time for the Commission to recommend further unpredictable results. Resolving these appeals will take a great deal of time and resources on the part of both the state and the businesses involved.

Making additional small changes would only further complicate an already confusing system; the minority disagrees with the majority's conclusion that "combined reporting may be the best available method for addressing this problem comprehensively, without resorting to new litigation repeatedly." [20] And more basically, the minority believes that if the Commission's concern is with closing loopholes, then we should take this opportunity to carefully consider the overall tax structure and analyze the fair and comprehensive changes that may be made to ensure that the result is not further complexity and obfuscation.

Forward planning is imperative to the success of any business within the Commonwealth, whether large or small. In order to plan properly, businesses must be reasonably able to foresee and account for any impending costs. Constant changes of this type indicate a tendency toward instability, which inhibits business growth - a condition contrary to the Commission's established mandate. The minority is especially unwilling to recommend changes of this type on an interim basis.

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[18] *See* Chapter 143 of the Acts of 2003, Chapter 262 of the Acts of 2004 and Chapter 163 of the Acts of 2005.

[19] *See* Majority Report at 18.

[20] In fact, the Commission heard testimony that closing "loopholes" could actually have an adverse effect on litigation. During the public hearing, Scott Roberti, Director of State Tax Policy for General Electric Company, testified that the normal audit cycle for his company in combined reporting states is over 20 years. In California, the company is now just settling its tax returns from the early 1980's. Business witnesses also testified that combined reporting is a disincentive for investment in such states.

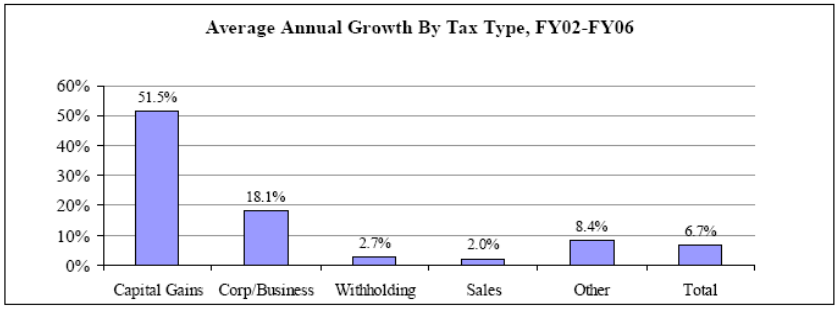
5. Budgetary Concerns

Perhaps most concerning to the majority of the Commission is the appearance of a rush to judgment regarding tax change proposals and the need for operating revenue in Fiscal Year 2008. Numerous witnesses at the public hearing testified regarding the need to fund important government programs and the benefits of revenue from House Bill 3756. Aside from humanitarian concerns, there is undoubtedly a potent political component to such arguments.

The minority does not necessarily disagree with the need for such revenue, nor does it necessarily refute the merit of such programs for those who need them. However, the minority does believe that raising revenue for the support of operational programs is not one of the mandates of the Commission; in fact, it might ultimately prove to be contrary to the Commission's mandate, which would be wrong.

The decision of how to spend available revenue is a purely legislative function, outside the scope of the Commission's powers. As much as the Commission cannot earmark or dictate how corporate tax revenue might be spent in Fiscal Year 2008, it also should not base its recommendations on speculation about how revenue might be spent once it is raised. Any recommendations made by the Commission should be made solely on the basis of the principles and goals expressed in its mandate, regardless of the ultimate fiscal benefit of those decisions.

Moreover, it is important to remember the recent testimony of the Department of Revenue during the Fiscal Year 2008 Consensus Revenue Estimate hearing, where mention was made of the volatility of corporate tax and capital gains tax collections. Fiscal Year 2006 witnessed 31% growth in corporate tax collections, while FY07 is presently seeing only 4.3% growth. While there has been much talk regarding $500 million in new revenue from the closure of corporate tax "loopholes," the reliance on a volatile revenue source every fiscal year for such a large amount may prove to be too risky.



Source: Massachusetts Department of Revenue

III. CONCLUSION

It is imperative that any altering of the structure of the Commonwealth's corporate tax code be approached broadly, comprehensively, and include a reasonable timeframe for implementation. Employing a methodical strategy will avert the erratic practice of making changes to the tax code on an annual basis which is the method the Commonwealth has recently adopted. A thorough review of the lengthy corporate tax law, with particular attention paid to simplification and fairness, will require a great deal more time than is allowed by the June 15th deadline. Moreover, it is against the charge of the Commission to implement long-term corporate tax changes by January 1, 2008. It is impractical for not only businesses but also the Department

of Revenue to effectively prepare for the advent of new tax policy in such a short period of time. The charge of the Commission is far too important to be rushed.

It is for these reasons that the undersigned members of the Commission dissent from the Majority Report and offer this Minority Report to explain their views.

Regardless of the Commission's recommendations, we remain committed to fulfilling its mandate through the remainder of this year. We look forward to the ongoing exploration of all pending issues, and perhaps many more, as we continue to discharge our responsibilities between now and January 1.

Respectfully submitted by the following members of the Commission on June 15, 2007:

BRADLEY H. JONES, JR.
Minority Leader, Massachusetts House of Representatives

RICHARD R. TISEI
Minority Leader, Massachusetts Senate

JOHN J. BINIENDA
House Chairman, Joint Committee on Revenue, Massachusetts House of Representatives

EILEEN MCANNENY, ESQ.
Vice President for Government Affairs, Associated Industries of Massachusetts (AIM)

MICHAEL J. WIDMER
President, Massachusetts Taxpayers Foundation

JANE STEINMETZ
Partner, PricewaterhouseCoopers

KEVIN LONG, ESQ., CPA
Long & Bott, P.C.

APPENDIX A

The **C**ommonwealth of **M**assachusetts
Executive **D**epartment
State House • Boston, MA 02133
(617) 725-4000

DEVAL L. PATRICK
GOVERNOR

TIMOTHY P. MURRAY
LIEUTENANT GOVERNOR

FOR IMMEDIATE RELEASE:
April 30, 2007

CONTACT: Cyndi Roy 617-725-4025
Dave Guarino 617-725-2500
Ann Dufresne 617-725-1500

Governor, Legislative Leaders Announce Study Commission on Corporate Taxation

BOSTON– Monday, April 30, 2007 – Governor Deval Patrick, Senate President Therese Murray, and Speaker of the House Salvatore F. DiMasi announced today the creation of a Study Commission on Corporate Taxation, naming 15 members to review and offer recommendations for streamlining the current tax code.

The mandate of the Commission is to study the modernization and simplification of the current business tax laws of the Commonwealth, to promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness. An interim report on legislative recommendations providing revenue for Fiscal Year 2008 will be due by June 15, 2007. A final report on long-term changes to corporate tax laws will be completed by January 1, 2008.

"We have set an ambitious timeline for the initial findings and we expect the commission to meet that deadline," said Governor Patrick. "At hand is the issue of the fundamental fairness of our tax code—an issue that we must address in a swift and comprehensive fashion. What businesses are looking for more than anything is predictability and fairness, and I believe the commission members appointed today will set us on the path to determining how best to achieve that tax equality and ensure Massachusetts is an attractive place for business to expand and locate here."

"This is a positive approach towards giving the Governor's tax proposals due consideration because the commission will take a comprehensive and thorough look at the entire corporate tax code," said Senate President Therese Murray. "I hope the panel will find ways to make the code predictable and equitable to the business community and at the same time yield additional revenues for the Commonwealth."

"The work of this diverse commission is very important at a critical period in the Commonwealth's fiscal and economic future," said House Speaker Salvatore F. DiMasi.

"The tax code in Massachusetts must be made more simple, equitable and predictable. We must also strike the right balance between businesses paying their fair share and limiting the financial burdens we place on employers that may stifle job growth and limit our revenues far into the future."

The mandate of the Commission specifically includes: reviewing the Governor's bill, House No. 3756, An Act Improving the Fairness of the Tax Laws; other subjects of business taxation, including (1) the preferential tax treatment of security corporations, (2) the appropriate method for calculating credits for research and development credits, (3) the scope and ongoing need for the various exemptions from the sales and use taxes, (4) appropriate taxation of digital products, (5) estimated tax payment rules for individuals, (6) the substitution of refundable credits for transferable credits, (7) use of gambling losses on personal income tax returns, (8) the imposition of the cigar excise on wholesale transactions, and (9) the calculation of the non-income measure of the corporate excise; and the Commonwealth's participation in the Streamlined Sales Tax Compact.

Commission members include:

- **Leslie Kirwan**, Secretary of Administration and Finance, Chair*
- **Representative John Binienda**, House Chair, Joint Committee on Revenue*
- **Senator Cynthia Creem**, Senate Chair, Joint Committee on Revenue*
- **Representative Bradley Jones**, House Minority Leader*
- **Senator Richard Tisei**, Senate Minority Leader*
- **Alan LeBovidge**, Commissioner of Revenue*
- **Professor Alan Clayton-Matthews**, UMass Boston
- **Joseph Donovan**, tax lawyer, Sullivan and Worcester
- **Karl Fryzel**, tax lawyer, Edwards Angell Palmer & Dodge
- **Stephen W. Kidder**, Managing Partner, Hemenway & Barnes
- **Kevin Long**, CPA
- **Eileen McAnneny**, Associated Industries of Massachusetts
- **Jane Steinmetz**, Partner, PricewaterhouseCoopers
- **Robert Tannenwald**, Economist and Director, New England Public Policy Center, Federal Reserve Bank of Boston
- **Michael Widmer**, President, Massachusetts Taxpayers Foundation

(* or designee)

APPENDIX B

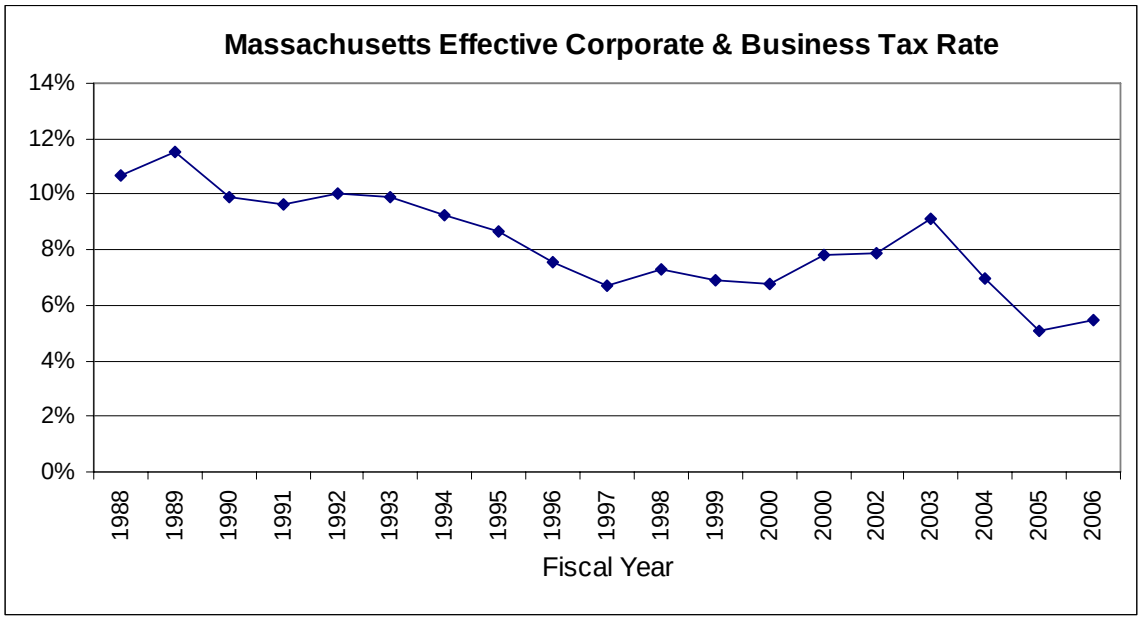
PROPOSED TAX LOOPHOLE CHANGES

	Short Title	Description	FY08 Estimated Tax Revenue
1.	Combined Reporting	This provision curbs the practice of businesses shifting income to out-of-state subsidiaries and avoiding Massachusetts taxes.	$136 million
2.	"Check the Box:" Conform Entity Classification Rules to Federal Laws; Tax Business Trusts as Corporations	"Check the Box" prevents a corporation from claiming one status for state taxes and another for federal. This change would require businesses to conform their corporate identity between their state and federal tax returns (e.g., a company that files as a corporation on its federal return must then file as a corporation for its state return).	$99 million
3.	Insurance Companies Operating Non-Insurance Business	Currently, an insurance company is only taxed on premiums and not subject to tax on non-insurance revenue. Under this provision, non-insurance businesses run by insurance companies would be subject to the standard corporate tax.	$14 million
4.	Deeds Excise Avoidance	Massachusetts currently imposes a real estate transfer tax when property is sold. This initiative will prevent corporate taxpayers from placing the real estate in a subsidiary business entity (such as a limited liability corporation) and selling the interest in that entity rather than the underlying real estate.	$12 million
5.	Room Occupancy Tax – Internet Resellers	Hotel and motel rooms are subject to a state, and in some cases, a local option tax. Internet retail agents avoid paying the hotel/motel tax on the full price of the room as charged to the consumer. Although the consumer pays tax on the higher, retail price, the state only receives the amount on the lower, wholesale price.	$5.6 million for state $4.0 million for municipalities
6.	Sales Tax – Captive Leasing Companies	Large, capital-intensive businesses can avoid paying full, upfront sales tax by leasing equipment from a subsidiary affiliate.	$28 million
7.	Income Tax – Earned Income Credit for Non-Residents	Massachusetts has a refundable earned income credit that is a percentage of the available federal credit. This provision would require the credit recipient to live or work in Massachusetts.	$2 million

APPENDIX C

DOR Handout to the Commission, May 14, 2007

Chart in "Appendix B" of the Majority Commission Report, June 15, 2007



APPENDIX D

STATE HOUSE NEWS SERVICE

SENSING CHANGES AHEAD, CORPORATE TAX POLICY HEARING DRAWS CROWD

By Michael Norton,
Priscilla Yeon and Gintautas Dumcius
STATE HOUSE NEWS SERVICE

STATE HOUSE, MAY 23, 2007…..Organizations representing teachers, consumers and low-income individuals on Tuesday urged a special commission to support so-called loophole closings, saying the state needs the money for schools, health care and housing, while business leaders urged a broader look at the state tax code with an eye towards generating money by building the state's jobs base.

Representatives of the Massachusetts Teachers Association, Neighbor-to-Neighbor Massachusetts, and the Massachusetts Public Interest Research Group called on the state's Special Commission on Business Taxes to support Gov. Deval Patrick's proposal to close loopholes that the governor says allow businesses to avoid taxes that other companies are paying. The plan, if approved, would generate $500 million per year, the administration says.

The state's largest business group, Associated Industries of Massachusetts (AIM), which opposes Patrick's proposal, called on the panel to take its time – the panel faces a self-imposed interim reporting deadline of June 15 - and develop a strategic plan for the business tax code, noting businesses care deeply about tax rates and the state should modernize and simplify its tax structure with an eye toward fostering economic growth.

Rick Lord, AIM president and CEO, highlighted the importance of stability to a healthy business environment and called for a "stable fiscal policy" that would bring steady sources of revenues to the state and businesses. "I can assure you, our members tell us tax matters when making decisions here in the Commonwealth," said Lord. "Predictability and stability are positive aspects for the business climate."

Bay State businesses have been hit with hundreds of millions of dollars in new taxes in recent years and business leaders, who have pushed for government investments in many areas, say a tax policy that improves the business climate is the best way to boost slow-growing state revenues to finance public investments. Travel industry executives said a proposed levy on hotel rooms would be "double taxation" and discourage small business travel.

Batting leadoff at a well-attended late afternoon hearing that focused on Patrick's proposal while occasionally veering into a broader economic discussion, a quintet of current Democratic lawmakers called for the "loopholes" to be closed, with Rep. James Marzilli (D-Arlington) labeling them "creations of accountants and lawyers."

Asked by AIM's Eileen McAnneny, a commission member, whether it was appropriate to broadly look at the tax code, Marzilli said the Legislature can enact Patrick's combined reporting proposal, aimed at forcing businesses to claim the same structure on state and federal returns, and continue to look to streamlining the tax code as a whole.

"This is a matter of equity," said Rep. Jim O'Day (D-West Boylston), speaking in front of a crowd largely made up of supporters of Patrick's proposals, many of them T-shirt wearing SEIU union members.

Several executives of Massachusetts-based firms also voiced support for the proposals and dismissed contentions that changing the tax code would send a “bad signal” to the business community as the economy struggles to gain momentum. “I think the opposite is true,” said Mark Kritzman, president of Windham Capital Management.

Added Steve Grossman, head of Grossman Marketing Group and a Democratic Party high-roller: “I believe strongly that there are things state government can and should do to improve the business climate in our state – but tolerating tax avoidance isn’t one of them.”

Noting Massachusetts loses one of every two college graduates, Paul Guzzi, president of the Greater Boston Chamber of Commerce, urged the commission not to rush to its conclusion. “Obviously talent makes a major difference but the cost of doing business makes a major difference as well,” he said.

Sen. Cynthia Creem (D-Newton) challenged Guzzi to return with recommendations for fairer business taxes. “We’re in an equity situation,” Creem said. “I find it hard to believe that we should do nothing but bury our heads.”

“Fairness is one of our principle goals here,” said commission member Stephen Kidder, a Dukakis administration revenue commissioner, who pressed Guzzi to say whether any of Patrick’s proposals introduced fairness.

“We’re supportive of the concept of fairness,” Guzzi said, adding, “We would like to see the totality of what the recommendations are.”

Lord said he found it “disturbing” to hear people calling combined reporting a “tax loophole.”

“We believe combined reporting is not the solution,” said Lord. “I think it sends a very negative message to the business climate here.”

Commission member Karl Fryzel said California has had the “combined reporting” form of tax reporting on its books for decades and the state is “killing us” based on several indicators of economic progress. Guzzi replied: “I just don’t see that as a fair comparison.”

Massachusetts Teachers Association Executive Director Edward Sullivan said public education is woefully underfunded and businesses should share more responsibility for taxes. “We’re going backwards on the funding that we need,” said Edward Sullivan, MTA director, noting remediation funding aimed at helping students pass the MCAS has been reduced from $50 million to $12 million. Students now pay to park cars and play sports, he added.

“If you don’t close the loopholes, the money is simply not going to be there,” Sullivan said.

Sen. Stanley Rosenberg (D-Amherst) said closing the loopholes could offset some of the costs that will be necessary to maintain the state’s public higher education system, which has faced repeated budget cuts and the languishing of proposals calling for major investments.

Similarly, the Massachusetts chapter of the National Association of Social Workers, urged the commission to endorse Patrick’s proposal to address funding needs in the mental health arena and in other health care services.

Alan Macdonald, executive director of the Massachusetts Business Roundtable, said fairness is “in the eye of the beholder” and emphasized that high employment numbers will deliver tax revenues sufficient to pay for many public investments pushed by the business community. Massachusetts businesses collectively pay about $1 billion more, due to tax policy changes at several levels, than they did four years ago, he said.

“You have a difficult task and it’s a complicated issue,” MacDonald told the panel.

“Different businesses operate differently and they are treated differently under the tax code,” MacDonald said, who added that Patrick’s proposal was put forth to solve budget problems but deserves closer inspection. Commission chair Leslie Kirwan, Patrick’s budget chief, reminded MacDonald that administration officials, when crafting their budget, had been visited by business leaders who put forth numerous spending requests.

Geoffrey Beckwith, president of the Massachusetts Municipal Association, said lawmakers need to ask whether they should preserve “outdated, obsolete or abused” tax exemptions when public spending needs are going unmet. He said “strong and effective cities and towns,” which depend on local aid increases that he said have been insufficient, are keys to the state’s economic competitiveness

Noah Berger, executive director of the Massachusetts Budget and Policy Center, concurred with the business claim that “tax policy matters” but urged commission members to weigh “better uses,” calling on decision makers to judge whether investments in tax policies that benefit a few companies are worth foregoing public investments in education, local aid and public infrastructure.

John Regan, AIM executive vice president of government affairs, said that based on his experience working at the state Office of Business Development, taxes have an impact on business decisions. He said the relocation of a major distribution company, which operated in Roxbury and New Bedford, to Kentucky showed him that “tax policy matters.” He said Kentucky offered the company better tax incentives than Massachusetts.

Commission members asked Regan several questions about the company’s decision to relocate. Creem said she believed the company Regan was referring to moved because it was bought out by another. Other commission members cited studies that have said companies make decisions to relocate based on labor force and cost of living data and not necessarily on taxes.

Commission member Michael Widmer, who is president of the Massachusetts Taxpayers Foundation, asked Regan whether Massachusetts had to pass “special legislation” relative to tax credits to convince Bristol-Myers Squibb to move to the state. Regan said “Absolutely.” “Thank you,” Widmer quickly replied.

-- END

APPENDIX E

The Commonwealth of Massachusetts

Department of Revenue
Office of the Commissioner
P.O. Box 9550
Boston, MA 02114-9550

ALAN LEBOVIDGE
COMMISSIONER

April 26, 2004

Representative Paul Casey
Chairperson, Joint Committee on Taxation
State House, Room 236
Boston, MA 02133

Dear Chairman Casey:

I am writing to outline for you some of the concerns I have about the current adoption of a unitary system of taxation in Massachusetts, and to suggest that it would be appropriate for the General Court to give further study to the advantages and disadvantages of such a system before making a fundamental change in the Commonwealth's approach to corporate taxation.

Advocates for combined reporting assume that, because a unitary approach eliminates the tax effect of intercompany transactions that are undertaken for planning purposes, corporate tax revenues would significantly rise immediately upon the adoption of such a system. Such a revenue increase will not materialize in the near term.

As you know, in principle, a unitary approach can either increase or decrease a corporation's state tax liability. Under either our existing "separate company" approach to taxation or a unitary approach, an apportionment formula is applied to the appropriate US income base to determine Massachusetts income. Under current law, this approach is taken separately with respect to the income of each corporation doing business in the Commonwealth. Under a unitary system, the income base would be the income of the entire unitary group, including the income of members that are beyond the jurisdiction of the state. At the same time, the apportionment factors of the entire group would be used to determine the Massachusetts income. *For groups that have operations outside the state that are either unprofitable, or less profitable relative to their apportionment factors than Massachusetts operations, a unitary system will reduce the tax.*

Further, the definition of a "unitary business" that can be required to file a combined report is inherently grey. Because the definition arises out of US Constitutional principles, it is not within the power of the General Court to create a bright-line definition.

Accordingly, I would expect that most companies that would benefit from a unitary approach will file on that basis immediately upon its adoption, whereas many, if not all of those for which it would be detrimental, will take the position that they are not unitary. If this is true, the positive fiscal impact of the change would be deferred until corporations whose tax is increased work their way through the audit and appeals cycle. This process will take several years or more.

Even if we were to assume that corporations would file their returns more conservatively than I have predicted, it is not realistic to expect a positive fiscal impact from adoption of combined reporting in FY 05. For calendar-year corporations, combined reporting cannot be required until calendar 2005. Returns for this period will not be due until FY 2006 if they are filed on extension, as is customary, and it is unlikely that companies will substantially increase their FY 2005 estimated tax payments to take into account the impact of the change. *These existing rules almost guarantee a zero revenue growth in fiscal 05 at best.*

Finally, it should be noted that much of the corporate tax planning at which a unitary system is aimed focuses on the creation of intercompany interest and royalty payments. As you know, we now have in place rules that reverse out the tax benefit of such intercompany payments when they are predominantly tax motivated. Not only will a unitary system fail to generate incremental revenue with respect to these transactions; it will *reduce* revenue in some cases, because the positive impact of eliminating the deductions will be "diluted" by the reduction of the Massachusetts apportionment factor that takes place under a unitary approach.

Taking all of these considerations together, I do not believe that it is realistic to expect any significant increase in revenues in the immediate aftermath of adoption of combined reporting.

My staff has, also, undertaken a preliminary review of the proposed House Budget amendment that would require combined reporting in the Commonwealth. We see some technical problems with the bill, including, for example, its reference to Domestic International Sales Corporations and Foreign Sales Corporations, which no longer exist because our foreign trading partners deemed them to create illegal export subsidies. While these sorts of technical issues can be readily addressed, I believe that further analysis needs to be given to issues that can be said to lie on the border between policy and technical considerations. For example (moving along the spectrum from policy to technical issues):

- The proposal by its terms would exclude banks, utilities and insurance companies from its reach. If combined reporting makes sense for other companies, is it wise to exclude these major categories? If not, what rules should be adopted to determine how a unitary approach will work when the group includes corporations that are subject to very different taxing regimes?
- Massachusetts business trusts are also outside the scope of the proposal. The perceived abuses that combined reporting is intended to cure will still be a problem to the extent that the MBT form of business is used.
- When one member of a group is entitled to use a single-sales-factor approach to apportionment because it is a manufacturing corporation or a mutual fund service corporation, but others are not, how should the tax be determined?
- How will net operating losses and credits be computed in a combined return?
- The US Treasury Regulations include extremely complicated provisions that explain how intercompany transactions are to be treated in a federal consolidated tax return under Section 1502 of the Internal Revenue Code. Should Massachusetts adopt these provisions wholesale for combined reporting purposes? If not, what rules should apply?
- What transitional rules should be put in place to rationalize tax results after movement to a unitary system? For example, if an intercompany sale triggered a Massachusetts gain under prior law, should the basis of the asset that was sold reflect the gain even after combined reporting is adopted, so that the same appreciation will not be taxed again when the asset leaves the group? Does DOR need statutory authorization to reach this result?

Given all of the above issues and recent changes in the law related to the addback of royalties and interest payments, it is impossible for us to give you any meaningful revenue estimate at this time.

Finally, it is important, I believe, for the Commonwealth's policymakers to weigh against the perceived benefits of combined reporting the perception that it is harmful to business. The perception arises in part because of the very vagueness of the definition of a unitary business to which I referred earlier in this letter. Rightly or wrongly, companies often accuse states that use a unitary approach of "having it both ways," that is, arguing that a business is unitary when that position gives rise to a tax increase, but resisting taxpayer arguments for unitary treatment on burden of proof or other grounds. They perceive the regime as lowering the predictability of their state tax costs because a unitary inquiry is so fact intensive.

Beyond the problem of vagueness, companies often truly resent the consequences of unitary treatment where the consequences are counterintuitive as, for example, when a California corporation shows no profit both for tax and operational purposes, but it pays California tax nonetheless because it has unitary affiliates beyond the jurisdiction of the state that are profitable. While the US Supreme Court has made it quite clear that the states have the power to take a unitary approach in such circumstances, companies still see the unitary states as taxing "extraterritorial income."

Largely for such reasons, no state has implemented combined reporting for more than 20 years. Last year, the Connecticut legislature passed a bill that would have authorized a unitary approach, but it was repealed almost immediately when its unitary consequences became clear, and the state instead modified its treatment of intercompany deductions to follow the model of the Massachusetts addback law adopted in March of 2003.

I hope that the above is helpful to you in your deliberations. As always, my staff and I would be happy to discuss this area with you if you so wish.

Sincerely,

Alan LeBovidge
Commissioner of Revenue

AL:jd:mr

cc Representative John Rogers, Chairman, House Ways & Means Committee
Representative Bradley Jones, House Minority Leader
Eric Kriss, Secretary, Administration & Finance
Kelt Kindick, Chief Financial Officer
Charles Chieppo, Policy Director

APPENDIX F

List of Presenters to Commission and Subcommittees

List of Presenters to Commission and Subcommittees

Study Commission on Corporate Taxation

The Study Commission on Corporate Taxation heard presentations from the following individuals, who are listed in alphabetical order, at the Commission's meeting on May 14, 2007:

- Kevin Brown, General Counsel, Massachusetts Department of Revenue (MA DOR)
- Joseph R. Crosby, Legislative Director, Council on State Taxation (COST)
- Michael Mazerov, Senior Policy Analyst, Center on Budget and Policy Priorities
- Howard Merkowitz, Director, Office of Tax Policy Analysis, MA DOR

Additionally, a public hearing was held on May 22, 2007 at 4:00 PM in Gardner Auditorium at the State House in Boston. Members heard testimony from the following individuals:

- The Honorable Patricia D. Jehlen, State Senator
- The Honorable Stanley Rosenberg, State Senator
- The Honorable Steven D'Amico, State Representative
- The Honorable J. James Marzilli, Jr., State Representative
- The Honorable James J. O'Day, State Representative
- The Honorable Matthew Patrick, State Representative
- The Honorable Cleon H. Turner, State Representative
- Rick Lord, President and CEO, Associated Industries of Massachusetts (AIM)
- John Regan, Vice President, AIM
- Paul Guzzi, President, Greater Boston Chamber of Commerce
- Jim Klocke, Vice President, Greater Boston Chamber of Commerce
- Alan MacDonald, Massachusetts Business Roundtable
- Jeffrey Brown, Executive Vice President, Colpitts World Travel
- Paul O'Connor, Millipore Corporation and Chair, AIM Taxation Committee
- Kin Kwan, Biogen Idec
- Scott Roberts, General Electric Company
- Andy Calamare, Life Insurance Association of Massachusetts
- Frank O'Brien, Vice President, Regional Manager and Counsel, PCI New England Region
- George Ryan, Liberty Mutual
- Alan Solomont, political activist, entrepreneur and philanthropist
- Steve Grossman, President and CEO, Grossman Marketing Group
- Arnold Hiatt, Former Chair and CEO, Stride Rite Corporation
- Michael Wilcox, President and CEO, Alford Associates Inc.
- Mark Kritzman, President and CEO, Windham Capital Management, LLC
- Cristino Acosta, Owner, Canon's Place, Lynn
- Ceasar Santana, Co-Owner, Services Express, Lynn
- Basilio Encarnacion, Owner, Rincon Macorisano, Lynn
- Geoffrey Beckwith, Executive Director, Massachusetts Municipal Association
- Edward Sullivan, Executive Director, Massachusetts Teachers Association
- Noah Berger, Executive Director, Massachusetts Budget and Policy Center
- Phinneus Baxandall, Senior Analyst Tax and Budget Analyst, MASSPIRG (Massachusetts Public Interest Research Group)

- Jeff McLynch, Institute for Taxation and Economic Policy
- Bruce Wallin, Professor of Political Science, Northeastern University
- Shirley Kressel, Alliance of Boston Neighborhoods
- John Edward, Professor, Bentley College
- Veronica Turner-Biggs, Vice President of 1199 SEIU (Service Employees International Union)
- Gloria Mulcahy, Coalition for Social Justice
- Diane Sullivan, Homes for Families
- Milly Davilia, Worcester
- Jim Monsour, Coalition against Poverty, Fall River
- Bob Lund, Progressive Democrats of Massachusetts, Lexington
- Elizabeth Toulan, Greater Boston Legal Services
- Betty Morningstar, First Vice President, National Association of Social Workers, Massachusetts Chapter
- Michael Grunko, President, SEIU Local 509
- Timothy T. Collins, President, Springfield Education Association

Subcommittee on Alternatives to the Corporate Excise

The Subcommittee on Alternatives to the Corporate Excise heard presentations from the following individuals, who are listed in alphabetical order:

- William F. J. Ardinger, Partner, Rath, Young and Pignatelli, Concord, New Hampshire
- Stanley R. Arnold, Advisor, Rath, Young and Pignatelli, Concord, New Hampshire, and former Commissioner of New Hampshire Department of Revenue Administration
- Karey Barton, Senior Manager, Ryan & Company, Austin, Texas, and formerly the Tax Director of the Texas Tax Reform Commission
- Richard D. Pomp, Professor of Law, University of Connecticut
- Thomas Zaino, Partner, McDonald & Hopkins, Columbus, Ohio, and former Commissioner of the Ohio Department of Taxation

Subcommittee on Business Tax Rates

The Subcommittee on Business Tax Rates heard presentations from the following individuals, who are listed in alphabetical order:

- Stephen P. Trenholm, Rucci, Bardaro & Barrett PC, and member of the Massachusetts Society of Certified Public Accountants (MSCPA)
- R. David Wheeler, Rucci, Bardaro & Barrett PC, and member of the MSCPA

Subcommittee on Combined Reporting

The Subcommittee on Combined Reporting heard presentations from the following individuals, who are listed in alphabetical order:

- William F. J. Ardinger, Partner, Rath, Young and Pignatelli, Concord, New Hampshire
- Stanley R. Arnold, Advisor, Rath, Young and Pignatelli, Concord, New Hampshire, and former Commissioner of New Hampshire Department of Revenue Administration
- Keith Davis, Executive Director, North Carolina State and Local Fiscal Modernization Study Commission

- Todd Lard, Tax Counsel, COST
- Benjamin Miller, Counsel, Multistate Tax Bureau, California Franchise Tax Board
- Richard D. Pomp, Professor of Law, University of Connecticut
- Shirley Sicilian, General Counsel, Multistate Tax Commission

Subcommittee on Other Governor Proposals

The Subcommittee on Other Governor Proposals heard presentations from the following individuals, who are listed in alphabetical order:

- Katharine Bachman, Vice Chair, Real Estate Development, Wilmer Hale, Boston
- David I. Begelfer, CEO, National Association of Industrial and Office Properties
- George Ryan, Liberty Mutual
- James R. Shea, Jr., Partner, Edwards Angell Palmer & Dodge LLP, Boston
- James J. Williams, Jr., President and CEO, Massachusetts Mutual Life Insurance Company

Subcommittee on Streamlined Sales Tax

The Subcommittee on Streamlined Sales Tax heard presentations from the following individuals, who are listed in alphabetical order:

- Deborah R. Bierbaum, Executive Director of External Tax Policy, AT&T
- Charles Collins, Vice President, Government Affairs, ADP Taxware
- Stephen P. Kranz, General Counsel, COST
- Edward Lauper, Deputy Chief, Rulings & Regulations Bureau, MA DOR
- The Honorable Richard T. Moore, State Senator
- Matthew N. Murray, Professor of Economics and Associate Director, Center for Business & Economic Research, University of Tennessee
- Scott C. Peterson, Executive Director, Streamlined Sales Tax Governing Board, Inc.
- William C. Rennie, Vice President, Retailers Association of Massachusetts
- Joan Wagnon, Secretary, Kansas DOR, and First Vice President, Streamlined Sales Tax Governing Board
- Davida Walsh, Legislative Assistant, Office of Congressman William D. Delahunt

APPENDIX G

Subcommittee on Alternatives to the Corporate Excise - “Report”
(Final Report, dated November 13, 2007)

Commonwealth of Massachusetts

Study Commission on Corporate Taxation

Report of Subcommittee on Alternative Tax Structures

November 13, 2007

Executive summary [1]

The Study Commission on Corporate Taxation that was formed on April 30, 2007 by Governor Deval Patrick, Speaker of the House Salvatore DiMasi, and Senate President Therese Murray has been charged with studying the modernization and simplification of the current business tax laws of the Commonwealth, with a particular emphasis on advancing proposals that promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness. On August 9, 2007, a Subcommittee of the Commission was convened specifically to consider possible alternatives to the business tax structure now in place in Massachusetts. The members of the Subcommittee are as follows:

- Joseph X. Donovan, Counsel, Sullivan & Worcester LLP, Chair
- Kevin F. Long, of the law firm of Long & Bott
- Professor Alan Clayton-Matthews, Ph.D, economist, UMass Boston

The Subcommittee met on August 30, September 17, September 27 and October 9, 2007. It invited and received presentations from the following experts on the state taxation of business enterprises, all of whom have been involved intensively in major revisions to the tax structures of at least one state:

- Stan Arnold, former Commissioner of the New Hampshire Division of Revenue Services, and William F. Ardinger, partner, both of Rath, Young and Pignatelli, Concord, New Hampshire (the New Hampshire Business Enterprise Tax)

[1] The Subcommittee wishes to thank Erin Gossett of Boston University School of Law and Rasna Mehta and Lysandra Ferentinos of Sullivan and Worcester LLP for their assistance in the preparation of this report.

- Karey Barton, Senior Manager, Ryan & Company, Austin, Texas, and formerly the Tax Director of the Texas Tax Reform Commission (the Texas Margin Tax)

- Professor Richard D. Pomp of the University of Connecticut (involved in tax reform efforts in many states, including New York, but commenting specifically on gross receipts tax regimes)

- Thomas Zaino, partner, McDonald & Hopkins, Columbus, Ohio, and former Commissioner of the Ohio Department of Revenue (the Ohio Commercial Activity Tax or "CAT")

The Subcommittee reviewed a "briefing binder" that included papers and other written materials addressing the advantages and disadvantages of alternative methods of taxing businesses at the state and local level. The materials included in the briefing binder are listed in Appendix A of this report.[2]

A majority of the members of the Subcommittee concur with the following conclusions:

- The present system of taxing businesses in Massachusetts is overly complex, and in some respects it is obsolete.

- The relatively high nominal rate of tax on the income of public companies – 9.5% -- masks a largely favorable tax environment, at least for certain industries with respect to which the Legislature has provided tax incentives, including mutual fund service companies, manufacturers, and companies that are research intensive. The Subcommittee generally endorses those tax incentives, but raises the question whether the high rate itself may hurt Massachusetts tax competitiveness.

- Intentional tax preferences aside, the radical differences in tax treatment that are afforded to businesses in Massachusetts depending upon industry and legal form are difficult to justify.

[2] A number of the sources cited in footnotes throughout this report are included in the binder and therefore referenced in Appendix A.

- The Commonwealth's reliance on the taxation of the income of corporations on a separate-entity basis leaves the tax base vulnerable to manipulation by large multistate corporations. This vulnerability could be cured either by combined reporting or adoption of alternative regimes (see further discussion below).

- The Commonwealth's reliance on the taxation of the income of corporations, even on a combined or unitary basis, leaves the tax base vulnerable to erosion during downturns in the economy. This vulnerability could be cured by the adoption of alternative regimes based not on income but on gross receipts, gross margin, value added or net worth. If such a regime were applied to all businesses regardless of form of organization, it is expected that it could be imposed at a very low rate.

Each of the alternative regimes to which reference is made above carries disadvantages that should be weighed by policymakers before shifting from reliance upon a tax on income or supplementing the existing regime with a new, alternative tax. These disadvantages are noted in the body of this report.

The alternative regimes might be considered not as a replacement for the current tax on income, but, in the case of corporations now subject to an entity-level tax, as alternative minimum taxes designed to exact some tax from corporations that benefit from state-provided services and infrastructure even when they have no taxable income. Such an alternative minimum tax could be structured so as to apply to companies for which the Legislature has provided preferential treatment or not, as the Legislature sees fit. The alternative regimes might also be extended to businesses in flow-through form – partnerships and limited liability companies – that currently pay no entity-level tax.

Salient Features of the Commonwealth's System for Taxing Businesses

-- Taxation of Regular Business Corporations

Regular business corporations doing business in the Commonwealth are taxed on income that is apportioned to Massachusetts at a 9.5% rate, and they also bear a tax at $2.60/$1000 on their apportioned net worth or their tangible property that is not taxed

locally,[3] depending on whether they are classified as "intangible property" or "tangible property" corporations. A minimum tax of $456 applies if it exceeds the tax computed under the former measures.[4] Income and net worth generally are apportioned based on a formula that takes into account relative property, payroll and sales in Massachusetts, but double weights the sales in the computation.[5] Thus, a corporation that has 50% of its property and payroll in the state but only 25% of its sales would apportion 37.5% of its income to Massachusetts (50% plus 50% plus 25% plus 25% divided by four). Corporations that are classified as manufacturers or as mutual fund service providers are permitted to apportion their income and net worth based on sales only. [6] Accordingly, a manufacturing corporation that has 10% of its sales in Massachusetts pays tax to Massachusetts on only 10% of its income, even if most of its property and payroll is in the Commonwealth.

Manufacturing corporations and corporations that derive 2/3 or more of their receipts from research and development are entitled to a credit against the tax measured by 3% of the cost of depreciable property, including buildings, that they place in service in Massachusetts.[7]

Corporations that conduct research and development activities in Massachusetts and that qualify for the federal research and experimentation tax credit generally are entitled to a credit against the Massachusetts tax measured by 10% of their qualifying expenditures.[8]

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[3] Mass. Gen. L. ch. 63, §§ 31B, 32 and 39; St. 1969 c. 546 §§ 18 and 21. Tangible property that is taxed locally includes real estate, motor vehicles, machinery (except in the case of manufacturing corporations), as well as poles, underground conduits, wires and pipes, but since locally taxable machinery does not include machinery used in an air conditioning, purchasing, selling or accounting function, such machinery is subject to tax at the state level even to non-manufacturing corporations. See Mass. Gen. L. ch. 59, § 5, clause 16.

[4] Mass. Gen. L. ch. 63, §§ 32 and 39.

[5] Mass. Gen. L. ch. 63, § 38.

[6] Mass. Gen. L. ch. 63, §§ 38(l) (manufacturing corporations) and (m) (mutual fund service providers); Mass. Regs. Code. tit. 830, §§ 63.38.1(10) (manufacturing corporations) and 63.38.7 (mutual fund service providers). Mutual fund service corporations also enjoy the benefit of a special rule that sources their sales according to the distribution of the places of residence of fund shareholders, rather than to the place where the services are performed. See Mass. Gen. L. ch. 63, § 38(f); Mass. Regs. Code tit. 830, § 63.38.7(4)(c).

[7] Mass. Gen. L. ch. 63, § 31A.

[8] Mass. Gen. L. ch. 63, § 38M.

Both the investment credit and the R&D credit are subject to ceilings on the percentage of the tax they can absorb,[9] but the ceilings are applied independently. Accordingly, a corporation that has both investment and R&D credits may be permitted to use them to reduce the tax to the $456 minimum.[10]

-- Taxation of Corporations in Special Industries

Financial institutions do not pay the tax on regular business corporations, but rather pay a special excise measured by 10.5% of apportioned income, and no tax on net worth or tangible property.[11] For purposes of this tax income is apportioned differently than for regular business corporations.[12]

Insurance companies generally do not pay tax on their income or their tangible property or net worth, but rather pay tax on their premiums attributable to Massachusetts customers.[13]

Utilities pay an income tax at a 6.5% rate on income apportioned to Massachusetts.[14] The apportionment formula for utilities does not assign a double weight to the sales factor.[15]

The dividing lines between regular business corporations and corporations in special industries are often very unclear. For example, a company that would otherwise be treated as a regular business corporation is taxed as a financial institution if it (1) derives more than 50% of its revenue from lending or credit card activities "in substantial competition with banks;" (2) is treated as a bank holding company for regulatory purposes; or (3) is a corporate subsidiary of a bank holding company.[16]

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[9] See Mass. Gen. L. ch. 63, §§ 32C (corporation may not use certain credits to reduce excise below the greater of the minimum tax or 50 percent of the excise before credits) and 38M(d) (research and development credit limited to first $25,000 of excise determined before application of any credits, plus 75 percent of corporation's excise over $75,000).

[10] See Mass. Regs. Code tit. 830, § 63.38M.1(9).

[11] Mass. Gen. L. ch. 63, § 2.

[12] See Mass. Gen. L. ch. 63, § 2A(b). For example, certain intangible property is included in the property factor for financial institutions but not for regular business corporations. See Mass. Gen. L. ch. 63, § 2A(e).

[13] Mass. Gen. L. ch. 63, § 20. Note that Governor Patrick's tax proposal, H.B. 3756, would impose a tax on certain non-insurance income of insurance companies.

[14] Mass. Gen. L. ch. 63, § 52A(2).

[15] Mass. Gen. L. ch. 63, § 52A(3).

[16] Mass. Gen. L. ch. 63, § 1.

Likewise, a corporation that is regulated as a utility generally will be so taxed, but it is not clear what level of regulation triggers such treatment. [17] The phenomenon of "convergence" -- the blurring of the lines between, for example, insurance and other financial services, banking and other financial services, telephony and telecommunication via less conventional means such as internet access, and even electrical distribution and trading in commodities – driven in part by de-regulation, has made the problems of classification in the Massachusetts tax system much more acute.

-- Taxation of Flow-through Entities

In practice, the excise on regular business corporations generally is paid by larger, public companies. This is because closely-held businesses usually are organized in a form designed to limit the federal tax and the tax in most states to one level – the individual level. The forms that may be chosen for this purpose are Subchapter S corporation,[18] limited liability corporation ("LLC"), general or limited partnership, or limited liability partnership ("LLP"). These entities either "flow through" their income and losses to shareholders automatically (S corporations) or may choose under the "check-the-box" rules to do so for federal and most state tax purposes (the others). [19] Generally speaking there is no federal income tax imposed at the entity level in the case of these forms of doing business, unless the entity is an entity eligible to check the box and it elects corporate status. Which of the flow-through entities is chosen depends upon tax, other legal and business considerations.

In Massachusetts, the income or loss of S corporations flows through to shareholders as it does federally.[20] For S corporations whose gross receipts exceed $3 million, an entity-level tax is also imposed, at a rate of 3% for corporations whose gross receipts exceed $6 million but do not exceed $9 million, and at a rate of 4.5% for corporations

[17] Mass. Gen. L. ch. 63, § 52A. *See* Tenneco Inc. v. Comm'r, 401 Mass. 380, 516 N.E.2d 1164 (1987).

[18] S corporations are permitted to own subsidiary corporations that are called Qualified Subchapter S Subsidiaries, or "QSubs." QSubs are treated as branches of their parent S corporation for federal and most state tax purposes.

[19] I.R.C. §§ 1363 and 1366. Treas. Reg. § 301.7701-1 et seq.

[20] Mass. Gen. L. ch. 62, § 17A.

whose gross receipts exceed $9 million. [21] S corporations also pay the tax on net worth or tangible property not taxed locally, and are subject to the minimum tax.[22]

LLCs are taxed in Massachusetts as they are federally. [23] If an LLC chooses to be taxed as a flow-through entity for federal purposes under the check-the-box rules, it will be so treated for Massachusetts purposes. If it chooses to be taxed at the entity level for federal purposes, it will be treated as a regular business corporation for Massachusetts purposes.

General and limited partnerships and LLPs generally are treated as flow-through entities in Massachusetts, even if they choose to be treated as corporations for federal and most other state purposes under the check-the-box rules.[24] This discrepancy in treatment is one anomaly that Governor Patrick's proposal seeks to eliminate via the check-the-box provisions of House 3756.

Also, in certain cases it can be very difficult to determine whether an entity should be treated as a corporation, a flow-through entity or a trust for Massachusetts purposes. This is because the failure to adopt current federal classification principles leaves Massachusetts with classification rules that are idiosyncratic, even though they overlap with the so-called "Kintner tests"[25] that governed federal classification before the check-the-box rules were adopted.[26]

-- Taxation of Corporate Trusts

Corporate trusts or "Massachusetts business trusts" are common-law trusts created to operate a business.[27] For federal purposes they are entities eligible to check the box,

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[21] Mass. Gen. L. ch. 63, § 32D.

[22] Mass. Gen. L. ch. 63, § 32 and 39.

[23] Mass. Gen. L. ch. 62 § 17 and ch. 63 § 30.1 & 30.2.

[24] Partnerships with transferable shares fall within the definition of "corporate trust" and are taxed as such in Massachusetts (see footnote 27, below).

[25] Prior to the adoption of the check-the-box rules, Treas. Reg. § 301.7701-1 et seq. classified an unincorporated organization as a corporation if the organization displayed three or more of four identified corporate characteristics: limited liability, continuity of life, free transferability of ownership interests, and centralization of management.

[26] See, for example, the complex analysis in Massachusetts Letter Ruling 91-2 (July 1, 1991), taking the position that a Delaware statutory trust was taxable for Massachusetts purposes as a (foreign) regular business corporation.

[27] "Corporate trust" is defined as "any partnership, association or trust, the beneficial interest of which is represented by transferable shares." Mass. Gen. L. ch. 62, § 1.

so they may be treated either as corporations or as flow-through entities. A corporate trust that elects corporate status for federal purposes may also elect federally to be treated as an S corporation.

For Massachusetts purposes corporate trusts are taxed at the individual rate – generally 5.3% -- on income apportioned to Massachusetts.[28] Their distributions to Massachusetts resident shareholders generally are not taxed except to the extent that the distributions are made out of earnings that were apportioned outside the state by the trust.[29] Distributions to non-residents of Massachusetts are not taxed.[30]

With few exceptions, corporate trusts offer no particular (non-tax) *legal* advantages over other forms. Accordingly, businesses generally choose to operate in corporate trust form for the sake of the tax advantages that accrue.[31]

-- Local Taxation of Business Personalty

A hodgepodge of rules determines whether business personal property is subject to local tax. For example, machinery used in the conduct of the business generally is subject to tax,[32] but not in the case of machinery owned by a manufacturing corporation,[33] and not if the machinery is leased.[34] In the case of a utility corporation, the only machinery that *is* taxed is machinery used in manufacture.[35] Poles, underground conduits, wires and pipes generally are taxable.[36]

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[28] Mass. Gen. L. ch. 62 § 4, 8 and 830 CMR 62.8.2.

[29] Mass. Gen. L. ch. 62 § 8(c) and 830 CMR 62.8.2.

[30] Mass. Gen. L. ch. 62 § 8(c) and 830 CMR 62.8.2.

[31] While the corporate trust form offers a relatively low rate of tax on business earnings, there are significant detriments to the form that more often than not make it inappropriate. For example, no net operating loss carryforwards are permitted, inventory and other tangible personal property is subject to local tax, and no investment credits or R&D credits are allowed. Also, dividends from a corporate trust to a parent corporation are fully taxable, unlike distributions from a corporate subsidiary to its parent, which are entitled to the benefit of a 95% dividends-received deduction. Mass Gen. L. ch. 63, § 38(a).

[32] Mass. Gen. L. ch. 59, § 5, cl. 16(2).

[33] Mass. Gen. L. ch. 59, § 5, cl. 16(3).

[34] Mass. Gen. L. ch. 59, § 5, cl. 16(2).

[35] Mass. Gen. L. ch. 59, § 5, cl. 16(1).

[36] Mass. Gen. L. ch. 59, § 5, cl. 16.

Inventory generally is not taxed, but if a business is operated in the form of a partnership or a corporate trust, for example, its tangible personal property including machinery and inventory is subject to tax. [37]

Enforcement of these complex rules is left to the assessors in each of the 352 municipal jurisdictions of the Commonwealth. Businesses that own taxable personalty are required to report it and its value to the locality each year on a "Form of List" that is used for assessment purposes.[38] The members of the Subcommittee consider compliance with the rules and their enforcement to be spotty, relying as they do on the efforts of local assessors whose expertise and ability to devote resources to enforcement vary greatly from locality to locality.

Summary Description of Alternative Regimes

-- The Trend Toward Adoption of Alternative Regimes

The predominant system for taxing corporations at the state level clearly is the corporate net income tax, as it has been for decades.[39] All states impose a general corporate tax of some kind, except for Nevada, South Dakota and Wyoming. Until recently, there were only a few exceptional regimes. For example, Washington State has long imposed a gross receipts tax called the Business and Occupation Tax ("B&O Tax") in lieu of a corporate income tax,[40] and Michigan has relied upon a "Single Business Tax" ("SBT") that is a form of value-added tax ("VAT").[41]

VAT Regimes in New Hampshire and Michigan

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[37] Mass. Gen. L. ch. 59, § 2.

[38] Mass. Gen. L. ch. 59, § 29. See http://www.mass.gov/Ador/docs/dls/ptb/pdfs/statetax2.pdf for the actual Form of List and the accompanying instructions, which include in Section 3 a summary of the rules for taxation of business property.

[39] Having said that, sales and use taxes contribute much more to state revenues than do corporate income taxes. According to the Tax Foundation (taxfoundation.org), corporate income tax collected in 2006 totaled $47.4 billion, as compared to sales and use taxes collected of $226.5 billion, and corporations and other businesses bear a significant portion of the sales and use tax burden.

[40] Wash. Rev. Code § 82.04.220.

[41] The SBT has been repealed, and it will be replaced, effective for taxable years beginning on or after January 1, 2008, by a regime that taxes both gross receipts and gross income. See Mich. Comp. Laws § 10.020; P.A. 2007, No. 36; Mich. Comp. Laws Ann. § 208.1201 and Mich. Comp. Laws Ann. § 208.1203. On August 9, 2006, the Michigan legislature approved a voter initiative to repeal the Single Business Tax, which "encouraged" the Legislature to adopt a tax "that [was] less burdensome and less costly to employers, more equitable, and more conducive to job creation and investment." Mich. Comp. Laws Ann. § 208.151.

In 1993, New Hampshire, which imposes a unitary tax regime on businesses regardless of the form in which they are conducted – the "Business Profits Tax" or "BPT" -- added what is effectively an alternative minimum measure -- the Business Enterprise Tax ("BET") -- to its regime. The BET, like the SBT, is a form of VAT. New Hampshire found it necessary to add this new, alternative minimum measure to its tax system largely for the following reasons:

- The revenue collected from the BPT, which was the primary business tax prior to adoption of the BET, was decreasing because a shift to a service economy was eroding the tax base.

- Many businesses were avoiding the tax altogether through a so-called "reasonable compensation" deduction, as a result of which only 1% of the 70,000 business filers paid over 70% of the BPT.[42]

New Hampshire's BET is assessed on the "enterprise value base," which is the sum of compensation and interest and dividends paid. It is paid by all businesses with more than $150,000 of gross business receipts, at a rate of .075%.[43] The BET is allowed as a credit against the BPT, and thus acts as a sort of alternative minimum tax.[44] In adopting the BET, the overarching policy goals of the state were "soundness, incidence and compliance."[45] The BET was considered politically viable because revenue-neutral, and it avoided an "all-at-once" approach to tax reform. Reasons for choosing the BET model over alternative means of tax reform, according to Messrs. Ardinger and Arnold, included the following:

- As a multi-stage or comprehensive consumption tax, it is economically neutral and thus minimally alters consumer choices.

- It is simple to compute and administer – the BET is based on three components that rely on accounting information commonly used by most businesses, thus minimizing the costs of additional record-keeping.

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[42] William Ardinger and Stan Arnold, Rath, Young and Pignatelli, Presentation to the Alternatives Subcommittee: New Hampshire's Experience with the Business Enterprise Tax (Sept. 17, 2007).

[43] N.H. REV. STAT. ANN. §77-E (2007).

[44] N.H. Rev. Stat. Ann. § 77-E:13.

[45] William Ardinger and Stan Arnold, Rath, Young and Pignatelli, Presentation to the Alternatives Subcommittee: New Hampshire's Experience with the Business Enterprise Tax (Sept. 17, 2007).

- It broadens the tax base by taxing all types of business entities, and applying to all types of economic activity. This renders it more stable and less sensitive to fluctuations in the business cycle and the economy.

- It applies well-established apportionment principles, and prevents the income-shifting transactions that have reduced corporate income taxes.[46]

Michigan also has imposed a form of VAT. The Michigan SBT was first enacted in 1975 to replace the corporate income tax and several other taxes. It was adopted largely due to the belief that the corporate income tax was harming the state's budget and the business climate, and that the SBT would raise revenue.[47] It was designed as a "broad-based, low-rate tax that placed a nearly-equal burden on all industries."[48]

However, many believe that the SBT has become encumbered with special provisions, and now is complicated to apply and results in a disproportionate burden on certain industries.[49] Thus, in 2006, voters adopted an initiative to repeal the SBT, effective for tax years beginning in 2008, and encouraged the legislature to adopt a new tax that is less burdensome, more equitable, and more conducive to job creation and investment. [50]

Recently, the legislature passed, and the Governor signed into law, the Michigan Business Tax (MBT) to replace the SBT. The MBT is partially a gross receipts tax and partially a corporate income tax.[51] Two-thirds of the MBT is based on modified gross receipts, taxed at a rate of 0.8%, while one-third is based on apportioned income, which is taxed at a rate of 4.95%.[52] Any business that has less than $350,000 of Michigan apportioned gross receipts is exempt from the gross receipts portion of the MBT.[53]

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[46] Stan Arnold and William F.J. Ardinger, Top Ten Reasons Why New Hampshire's BET May Provide An Answer to State Tax Reform, State Tax Notes, Nov. 2004.

[47] JAY WORTLEY, SENATE FISCAL AGENCY, STATE NOTES: THE SINGLE BUSINESS TAX – LOOKING BACK 30 YEARS (Mar./Apr. 2006), *available at* http://www.senate.michigan.gov/sfa/Publications/Notes/notes.html.

[48] PATRICK L. ANDERSON & ILHAN K. GECKIL, TAX BURDENS OF MICHIGAN'S SINGLE BUSINESS TAX, Report commissioned by the Michigan Manufacturers Assoc. 3 (2005).

[49] Id.

[50] MICH. COMP. LAWS ANN. §208.151 (2007).

[51] MICH. COMP. LAWS ANN. §208.1101 (2007).

[52] MICH COMP. LAWS ANN. §208.1201 (2007).

[53] MICH COMP. LAWS ANN. §208.1200 (2007).

The adoption of the MBT in place of the SBT is intended to be essentially revenue neutral. [54] However, it would change the distribution of tax liabilities, shifting some tax liability from manufacturing firms to non-manufacturing firms.[55] The tax liability will likely decrease for Michigan-based multi-state firms.[56] The MBT retains many of the credits from the SBT, and implements several new credits as well.[57]

Ohio – the Commercial Activity Tax or "CAT"

Ohio moved in 2005 to radically restructure its scheme for the taxation of businesses. The major components of Ohio's tax reform are the elimination of the tangible personal property tax and the corporate franchise tax, and the adoption of a commercial activity tax.[58] At the same time that Ohio reduced the tax imposed on business property, which was widely viewed as onerous, it adopted a phased-in replacement of its corporate income tax with a tax on gross receipts (the "CAT").[59] Unlike the corporate income tax that it replaces, the Ohio receipts tax applies to all forms of business, and in the case of flow-through entities, it is incremental to the tax that has applied at the individual level to income flowing through to an owner. [60] According to former Ohio Commissioner of Revenue Tom Zaino,[61] the shift in Ohio to a gross receipts measure from a property and net income tax was justified on the following grounds:

- The tangible personal property tax was a disincentive to capital investment. By contrast, the CAT will encourage business investment and relocation to Ohio. Because the CAT is based on gross receipts in Ohio, and not on property or payroll, Ohio hopes to encourage businesses to relocate to Ohio. By relocating, a business could potentially eliminate the taxes it pays based

[54] Press Release, Office of Governor Jennifer M. Granholm (June 13, 2007).

[55] Jay Wortley, The Single Business Tax – Looking Back 30 Years, March-April 2006.

[56] STATE OF MICH. S. FISCAL AGENCY, S.B. 94 & H.B. 4369-4372: ENROLLED SUMMARY, 94/0708, at 6 (2007).

[57] *Id*. at 2-5.

[58] Thomas M. Zaino, McDonald Hopkins LLC, Presentation to the Alternatives Subcommittee: Ohio's Tax Reform and the Commercial Activity Tax (Aug. 30, 2007).

[59] Thomas M. Zaino, McDonald Hopkins LLC, Presentation to the Alternatives Subcommittee: Ohio's Tax Reform and the Commercial Activity Tax (Aug. 30, 2007).

[60] See Presentation, David A. Tumen and Mark A. Snider, "Navigating Ohio Tax Reform" (March 14, 2006).

[61] Thomas M. Zaino, McDonald Hopkins LLC, Presentation to the Alternatives Subcommittee: Ohio's Tax Reform and the Commercial Activity Tax (Aug. 30, 2007).

on physical presence in other states, without increasing the Ohio CAT that it pays.

- The corporate franchise tax had a high top marginal tax rate, a low rate of revenue collection, and numerous loopholes, and thus was viewed as inequitable and ineffective.[62] The CAT does away with many of these special privileges, thus broadening the tax base.

- Furthermore, the CAT is seen as more equitable because lawmakers believe that the amount of commercial activity more accurately reflects the extent to which businesses utilize government services.

- The CAT will be imposed at a low rate of 0.26% when fully phased in.[63]

- The CAT has a broad base: it applies to any Ohio-based taxpayer with Ohio gross receipts of more than $150,000 per year, and applies regardless of physical presence.[64] Ohio adopted a "bright-line" presence requirement for out of state businesses doing business in Ohio, which will capture more non-Ohio businesses than did the old regime.

New Jersey "Reforms"

In 2002, the New Jersey legislature passed the "Business Tax Reform Act" in an attempt to close a significant budget deficit and close loopholes.[65] The major change made by the legislation was the establishment of an alternative minimum assessment ("AMA").[66] Corporations were required to pay the greater of the Corporation Business Tax (the "CBT") or the AMA. The AMA was based on either gross profits or gross receipts, at the election of the taxpayer. [67]

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[62] Ohio Dept. of Development, Tax Reform in Ohio (2007), http://www.odod.state.oh.us/taxreform.htm .

[63] OHIO REV. CODE ANN. §§5751.02 et seq. (2007).

[64] *Id.*

[65] GEN. ASSEMBLY, 210-A2501, at 1 (N.J. 2002), *available at* http://www.njleg.state.nj.us/2002/Bills/A3000/2501_E1.PDF .

[66] 2002 N.J. Sess. Law Serv. Ch. 40 (West).

[67] N.J. Rev. Stat. §54:10A-5a(b) ; N.J. Admin. Code §18:7-18.2(a).

The new law also raised the minimum tax and imposed new taxes on partnerships and professional corporations in the form of an annual "filing fee."[68]

Aside from simply raising revenue,[69] a principal argument in favor of adoption of a gross receipts tax was ease of administrability.[70]

Ultimately, the New Jersey gross receipts tax regime proved to be very unpopular, and Governor Corzine allowed the tax to expire in 2006.[71]

Texas – the Margin Tax

Finally, in 2006, Texas adopted a "margin tax," effective for reports due beginning in 2008.[72] Like the Ohio tax, the Texas tax is applicable to partnerships and other flow-through entities. [73] (The issue of double taxation does not arise in Texas as it does in Ohio with respect to flow-through entities, because Texas does not impose a personal income tax.) Unlike the Ohio tax, the Texas tax permits a deduction for "cost of goods sold" or "COGS." [74] This helps to put retailers and other businesses whose profit relative to receipts tends to be small on a more level playing field with businesses that have similar profits but lower receipts. In lieu of deducting COGS, taxpayers may choose to be taxed on 70% of their gross receipts.[75]

The impetus for reform in Texas was a decision by that state's supreme court holding that the state's method of financing public schools violated a constitutional prohibition against a state property tax.[76] The court gave the state legislature approximately seven

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[68] 2002 N.J. Sess. Law Serv. Ch. 40 (West).

[69] Press Release, Office of the Governor for the State of New Jersey, Governor Corzine Signs FY 08 Appropriations Act (June 28, 2007), *available at* http://www.state.nj.us/governor/news/news/approved/20070628b.html .

[70] James A. Arnold, Jay R. Brown, John D'Errico, Gerald M. Dowgin, Sidney Glaser, Harold Gold, Richard Guhl, Peter H. Larkin, J. Robert Murphy, and Anne Wysocki, New Jersey State Tax News Vol. 11, No. 5.

[71] N.J. Rev. Stat. §54:10A-5a(e) ; N.J. Admin. Code §18:7-18.2(b), (c).

[72] Tex. L. 2006, H3 (3rd S.S.).

[73] Tex. Rev. Civ. Stat. Ann. § 6132b-3.08.

[74] Tex. Tax Code Ann. § 171.1012.

[75] Tex. Tax Code Ann. § 171.101(a)(1).

[76] Neely v. West Orange-Cove Consol. Indep. School Dist., 176 S.W.3d. 746, 754 (2005).

months to find a solution.[77] It was under this pressure that Texas adopted the new regime.

In adopting a margin tax, Texas lawmakers sought to broaden the base of taxpayers, and lower the rate, while raising revenue.[78] The rate is 1% for most entities, but 0.5% for taxable entities engaged "primarily" in the retail or wholesale trade.[79] Additionally, the margin tax spreads the tax burden across more sectors of the economy to establish a more reliable source of income.[80] Furthermore, the tax is said to be relatively simple for businesses to calculate because it is based on federal income tax returns.[81] Finally, the new tax exempts small business to encourage growth in the economy while closing loopholes to make the imposition of the tax more equitable.[82]

Perceived Advantages and Disadvantages of Our Current System and of the Various Alternative Regimes

Ranking Regimes Generally

In the joint statement by which the Commission was created, the Commission was expressly charged with considering the modernization and simplification of our current business tax structure, so as to promote tax fairness and equity, to encourage business growth and innovation, and to strengthen the global competitiveness of the Commonwealth. Certainly, then, the alternative regimes should be evaluated on the basis of these express goals.

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[77] *Id.* at 799.

[78] TEXAS TAX REFORM COMM'N, TAX FAIRNESS: PROPERTY TAX RELIEF FOR TEXANS (Mar. 29, 2006), *available at* *http://www.cbh.com/pdf/newsinfo/newsreleases/TX_report_small.pdf* .

[79] TEX. TAX CODE ANN. §171.002 (2007).

[80] TEXAS TAX REFORM COMM'N, *supra* note 47.

[81] *Id.*

[82] *Id.* Under the old regime, virtually any multistate corporation could reduce its Texas tax by 99% by setting up a limited partnership structure.

"Fairness and equity," of course, can be said to be in the eye of the beholder, but economists and others have often measured them by reference to the following sub-criteria:

- Is the tax burden proportional to ability to pay?
- Is the tax burden proportional to the use of local services and infrastructure supplied by the state?
- How easy is it to "game" the tax? In other words, will two similarly-situated businesses pay radically different taxes depending on their access to sophisticated advice and sophisticated planning techniques?
- Is there equivalent treatment of businesses regardless of their form of organization? (Some would say that this issue cannot be reviewed without taking into account the fact that so-called "flow-through" entities, which typically pay no entity-level tax, do pass through income to shareholders, who therefore pay tax on it as it is earned whether or not it is distributed.)

"Competitiveness" is also in the eye of the beholder. It can be argued that the most competitive tax regime is one that imposes no entity-level tax on businesses at all, and indeed, Prof. Clayton-Matthews asked that this "no tax" option be considered by the Subcommittee, with the caveat that its adoption does not necessarily imply a tax cut, because lost revenues could be made up from other sources.

One might also say that a competitive regime is one that is marked by (1) a mainstream rate structure; (2) enough simplicity that businesses can predict tax outcomes with some certainty and without expending inordinate resources on the services of tax professionals; and (3) specific incentives aimed at the protection and growth of particular industry segments (in Massachusetts, these might include the life sciences and investment management, for example).

Beyond the goals that were set when the Commission was created, there are two others that have often found their way into the debate over reform in other states, and that therefore perhaps should be addressed by our Commission as well. These are "revenue volatility" and "neutrality."

"Revenue volatility" means the sensitivity of revenue streams from a particular regime to swings associated with ups and downs in the economy. This is important, of course, because demands for government services tend to rise just as the health of the economy, and hence the revenues associated with corporate income taxes, is declining.

"Neutrality" is harder to define in terms that all economists would agree upon, but in rough terms a "neutral" tax is one that is least likely to impact economic behavior. Classically, therefore, a broad-based tax that is imposed at a low rate is considered to be more "neutral" than one imposed at a high rate on only a certain sub-class of businesses.

The question should be asked whether the preference expressed by economists for tax neutrality is a preference that Massachusetts policymakers do or should share. Massachusetts tax laws now include, either directly or via incorporation of federal concepts, many provisions designed to reward or punish particular behavior. [83] Perhaps "neutral" taxes are economically more efficient, but state policymakers are not likely to stop using the tax law to influence behavior simply to satisfy economic purists.

Evaluating Various Specific Regimes

-- The Status Quo

- Because the tax under our current system is measured principally by income[84], it scores well on "ability to pay." It scores less well in terms of proportionality to use of services. A very large business with a significant Massachusetts footprint can draw on the resources of the Commonwealth in a material way and yet pay little or no tax because it has no income, or because it absorbs its potential liability with credits.

- While various recent changes in the law, including the interest and royalty addback rules that were adopted in 2003, have made it harder to manipulate the tax liability of businesses via planning, our current regime still is

[83] See, for example, Mass. Gen. L. ch. 63, § 31A (investment tax credit); Mass. Gen. L. ch. 63, § 38M (research and development credit); Mass. Gen. L. ch. 63, §§ 31I-31K (intercompany royalty and interest addbacks); Mass. Gen. L. ch. 62, § 6(l), ch. 63, §38T (film credits); Mass. Gen. L. ch. 62, § 2(d)(i), ch. 63, § 30.4 (incorporating by reference federal accelerated depreciation rules).

[84] But note non-income measure of the excise. *See* Mass. Gen. L. ch. 63, §§ 32 and 39.

susceptible to base erosion through domestic and international transfer pricing and other strategies. Relative to alternatives, it scores poorly on this scale.

- It arguably scores poorly as well by the measure of equal treatment of similarly-situated businesses, because of susceptibility to planning and because of the many different regimes that apply depending upon industry and form of organization.

- Generally speaking, our current regime is relatively competitive. For biotech and other high technology companies, and for investment management companies and manufacturers, credits and sourcing rules can give rise to a low effective rate. The members of the Subcommittee generally endorse these incentives because they reward industries that are major drivers of growth in the Commonwealth.

- Our regime is also competitive precisely to the extent that it is susceptible to planning; that is, sophisticated companies often have confidence that they can reduce the effective tax rate by resort to planning.

- On the negative side, the high nominal rate that applies to the income of public companies – 9.5% -- may itself be viewed by many companies as anti-competitive. Also, Massachusetts has long had a reputation as being a relatively difficult state to deal with in tax controversies; this has been reflected in very low rankings in surveys periodically conducted by *CFO Magazine* of financial and tax executives at large companies. [85]

- As is noted above, our current system is highly complex, and the complexity operates to the detriment of predictability. Further, the current system scores poorly in terms of revenue volatility because it is principally based on income. Finally, the neutrality of our system is low compared to that of alternatives that offer a lower rate and a broader base.

-- Unitary/Check-the-box

[85] See surveys published in Aug. 1996, June 1998, Sept. 2000, Jan. 2004 and Jan. 2007 editions of *CFO Magazine*.

In evaluating regimes that have been adopted in other states, we should consider not only the status quo, but also the status quo as it might be changed by adoption of combined reporting ("unitary taxation") and conformity to the federal characterization-of-entity rules, because these major changes proposed by Governor Patrick and endorsed, narrowly, by the Commission in its Interim Report filed in June of 2007 would, if adopted, alter the "baseline" against which those alternatives should be measured.

Relative to our current system, unitary/check-the-box arguably:

- Scores somewhat higher on ability to pay, use of government services, and equal treatment of similarly situated companies, insofar as it is less susceptible to manipulation.

- Scores about the same with respect to overall revenue volatility and neutrality.

- Scores about the same with respect to complexity. While defining the boundaries of a unitary business can be a very complex, fact-intensive and time-consuming task in close cases, it is often clear that businesses are unitary because, for example, of the synergies that exist among them, and because of common centralized management. Moreover, once it is established that businesses are unitary, it becomes unnecessary to take on the equally complex, fact-intensive and time-consuming task of determining appropriate arms-length pricing between constituent corporations of the group.

- Scores somewhat lower on competitiveness just because it is less easy to manipulate, and because, rightly or wrongly, many large multistate businesses remain hostile to the unitary concept.

-- Gross receipts taxes

Taking the Ohio CAT as a model, the Subcommittee concludes that it arguably:

- Scores somewhat lower on ability to pay because even low-margin businesses with little or no profits can bear significant taxes under the regime.

- Scores somewhat higher on use of government services because large companies with little or no profit that draw on government services will still bear a tax.

- Scores much better with respect to volatility because revenues will not dry up during downturns in the economy.

- Scores better on neutrality because of its broad base and low rate.

- Scores less well on equal treatment of similarly-situated companies because of the differential treatment of businesses with different margins and because of the "pyramiding" effect that applies when there are multiple, unrelated corporations involved in the value chain.

- Scores better on complexity and resistance to manipulation; the tax is much simpler to compute and it is difficult to manipulate one's gross receipts. (Having said that, in one important area – sourcing – gross receipts tax regimes often do present difficult hurdles that can lead to complexity. Where, for example, should receipts received for services performed in multiple states for a large multistate business be sourced?)

- Probably scores lower on competitiveness. While the low rate and broad base make it not burdensome for most companies on an absolute basis, many businesses are opposed to gross receipts taxes in principle, largely because of the differential treatment of businesses with different margins and because of the "pyramiding" effect that applies when there are multiple, unrelated corporations involved in the value chain.

The members of the Subcommittee are unanimous in their opposition to adoption of a gross receipts tax regime in Massachusetts. Notwithstanding its advantages over the status quo, the Subcommittee believes that pyramiding and the differential treatment of businesses with different margins are serious flaws that are not shared by other models that offer many or all of the advantages of the gross receipts tax model.

-- Margin Taxes

Here it is natural to take the Texas margin tax as a model, because it is the only such regime in force, and margin taxes can be structured in myriad ways.

Arguably, the Texas tax shares the advantages and disadvantages of the Ohio CAT, except that:

- It is better aligned with ability to pay.
- It applies more equally to similarly-situated businesses;
- There is significantly less "pyramiding."
- It is more complex than the Ohio tax, but still far less complex than our own existing system.
- It is probably more competitive because there is significantly less pyramiding.

-- Net Worth Taxes

Massachusetts of course already has a net worth tax regime that is one of two alternative "balance sheet" taxes that may apply to corporations, depending on the mix of their asset base.[86] The members of the Subcommittee agree that the entire current balance sheet tax regime functions poorly, because:

- It is overly complex, especially relative to the amount of revenue for which it accounts. The complexity arises in part because of the integration into the formula for computing it of the local property tax regime that applies to corporations, which itself is very complicated and often arbitrary.
- The exclusions for investment in subsidiaries as well as real estate and other locally-taxed property leave a relatively small number of corporations that pay a significant amount of tax, and the amount paid does not seem to correlate well with either ability to pay or use of government services.

These criticisms could be met by replacing the balance sheet tax with a net worth tax tied to the consolidated net worth of a group of controlled companies, as determined under Generally Accepted Accounting Principles ("GAAP"), and apportioned to Massachusetts on a group-wide basis so as to avoid double taxation of the same value.

[86] Mass. Gen. L. ch. 63, §§ 30.10 and 30.11; Mass. Gen. L. ch. 63, §§ 32 and 39.

Measuring this sort of reformed net worth tax against our current regime, perhaps it should be said first that it would more naturally serve as a secondary tax, as the balance sheet tax does now, or as an alternative minimum tax, than as a complete replacement for our income-based tax. With that in mind:

- Such a tax would score about as well as the current regime on ability to pay and use of government services, as well as neutrality.
- It would score better on volatility (that is, volatility would be lower), level of complexity and resistance to manipulation.
- It would not score much better on equal treatment of similarly-situated businesses, assuming that it could not be extended to businesses in non-corporate form. Also, one particular anomaly that would arise under a GAAP-net-worth-based system is that more acquisitive businesses that are otherwise similarly situated would bear a much higher tax, because the value of assets would be set at a recent purchase price (less a modest amount of depreciation or amortization) rather than at older historical cost, reduced by a greater amount of accumulated depreciation or amortization. (Some would say, however, that this is a defect in the GAAP rules rather than in any net worth tax based thereon.)
- It is difficult to know how such a tax would score on competitiveness, without knowing the details of its structure and the applicable rate.

The members of the Subcommittee are in agreement that if such a tax is put in place, it should include exclusions for regulated investment companies ("RICs") and real estate investment trusts ("REITs"), because the members believe that the states should broadly follow the federal, *de facto* flow-through treatment of these entities, both in principle and so as not to create a disincentive for creating, operating and managing such entities in the Commonwealth.

-- Value-added Taxes ("VATs")

As is noted above, there are two principal models for VATs that the Subcommittee reviewed. One is the Michigan SBT, which was Michigan's main business tax regime until its recent repeal. The other is the New Hampshire Business Enterprise Tax, which supplements that state's unitary business income tax, the BPT, at a low rate. An

important feature of both of these regimes that is not inherent in a VAT but that the Subcommittee regards as critical to their workability at the state level is the use of a conventional apportionment formula, applied against the value added of a business everywhere, to determine the in-state base. This is a much simpler model than attempting to determine where value is added on a transaction-by-transaction basis, analogously to the sourcing rules that are used in a sales and use or gross receipts tax.

Relative to the status quo, these sorts of VAT regimes arguably:

- Score somewhat lower on ability to pay insofar as a company without profits can bear a significant VAT liability. Against this, in the context of companies that have depressed their liabilities via aggressive planning, a VAT may more accurately correlate to ability to pay because it is harder to manipulate.

- Score better on use of government services.

- Are much less volatile, and significantly less complex.

- Score more favorably on neutrality, whether that is measured by broad base/low rate, or treatment of similarly-situated companies equally, assuming that the VAT, like those imposed in Michigan and New Hampshire, applies to all businesses without regard to the form in which organized.

- Score less well on perceived competitiveness, because the best-known VAT regime, the SBT, became quite unpopular by the time of its repeal. Labor is of course a very important component of value added, and critics accordingly often said that the SBT was a "tax on labor" or a "tax on jobs." This is at best a distortion of what VATs measure. Further, many of the elements of the SBT that made it unpopular – like the complexity that crept into the computation over the years – were not necessary features of a VAT but merely features that were added to the Michigan tax as it evolved.

Which Alternative Regime Is the Best?

The Subcommittee concludes that among the alternatives considered, some form of VAT regime is the best. It can be structured so as to be much simpler than our current

regime, it is less subject to manipulation, it is far less volatile in revenue production, and it can be spread across a much broader base of businesses at a low rate. It does not share with gross receipts or margin taxes a tendency to multiply arbitrarily depending on the number of companies involved in the stages of production and distribution.

A VAT could be enacted as a replacement for the current tax on income, but such a radical change could be disruptive and lead to uncertainty in revenues in the short term. Further, it could be perceived to be anti-competitive because of the poor reputation of the Michigan Single Business Tax. Accordingly, the model adopted in New Hampshire, where a supplemental VAT at a very low rate was enacted as a form of alternative minimum tax, may be more palatable. Such a supplemental VAT could be used as a replacement for the current balance-sheet tax, which the Subcommittee concludes does not function well.

Conclusion

The Subcommittee makes no hard and fast recommendations to the Commission as a whole relative to the adoption of alternative regimes in Massachusetts, but it expresses the following views to be considered by the Commission as it works towards its January, 2008 reporting deadline:

- Some of the alternative regimes examined by the Subcommittee offer significant advantages over our current tax structure in simplicity, resistance to manipulation, and revenue stability in times of economic distress.

- Of the alternative regimes, the VAT model offers the most promise.

- If serious consideration is given to any alternative regime, two threshold questions must be addressed – (1) whether the regime will displace our current structure or be enacted as a supplement to it; and (2) whether it will be extended to businesses in flow-through form that currently pay no entity-level tax.

Finally, the Subcommittee Chair wishes to note the following: Prof. Clayton-Matthews believes that any reform that entails a radical departure from the current structure, for example, going to a VAT – even if the tax rate is low – could have real impacts on competitiveness and on the distribution of income. For this reason, he

would not be in favor of such a change until these impacts were estimated (see Appendix B -- Comments of Prof. Alan Clayton-Matthews on Subcommittee Report).

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Joseph X. Donovan, Chair

Appendix A – Briefing Binder Table of Contents

No. ***Topic***

1. ***General Materials***

A. Robert Cline et al., "Total State and Local Business Taxes: 50-State Estimates for Fiscal Year 2006," Council on State Taxation (Feb. 2007).

B. Chris Atkins, "A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems," Tax Foundation, Background Paper No. 49 (Sept. 2005).

C. Presentation, Kenneth Reichel, "The 'Un-Income' Tax: How Will States' Alternative Tax Approaches Impact Your Business," Multistate Tax Institute, University of Wisconsin at Milwaukee (June 22, 2006).

D. William F. Fox et al., "Emerging State Business Tax Policy: More of the Same or Fundamental Change?" Center for Business and Economic Research, University of Tennessee, National Tax Conference (Mar. 2007).

2. ***Gross Receipts Tax***

E. John L. Mikesell, "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance," Tax Foundation, Background Paper No. 53 (Jan. 31, 2007).

• ***Illinois Proposal***

F. Center for Tax and Budget Accountability, *Fact Sheet: Gross Receipts Tax* (2007), *available at* http://www.ctbaonline.org.

G. Illinois Chamber of Commerce, *Gross Receipts Tax Policy Position* (adopted Dec. 8, 2006), *available at* http://charlestonchamber.com/GRT_Discussion_Paper.pdf.

• ***Ohio CAT***

H. Chris Atkins & Curtis Dubay, "Ohio's Changing Fortunes: Can the State's Economy Overcome the Tax Burden?" Tax Foundation, Special Report No. 143 (June 2006).

I. Presentation, David A. Tumen & Mark A. Snider, "Navigating Ohio Tax Reform" (Mar. 14, 2006).

Candace Pollock, "New Ohio Tax Good for Economy, Economists Say," Ohio State University Extension (Aug. 24, 2005), *available at* http://www.ag.ohio-state.edu/~news/story.php?id=3273.

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3. ***Margin Tax***

• ***Texas Margin Tax***

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L. Presentation, Henry Serrano, "Texas Margin Tax" (Nov. 2006).

M. Gardere Wynne Sewell LLP, "Margin Tax Update: Consider Restructuring Your LP Immediately," Client Alert (June 2007).

4. ***(i) Value Added Tax***

N. Institute on Taxation and Economic Policy, *Value Added Taxes: An Option for States?*, Policy Brief No. 5 (2005), *available at* http://www.itepnet.org/pb5vat.pdf.

Washington State Tax Structure Study Committee, "Calculating the Base for a Value-Added Tax (VAT)," in *Tax Alternatives for Washington State: A Report to the Legislature* (Nov. 2002) *available at* http://dor.wa.gov/Content/AboutUs/StatisticsAndReports/WAtaxstudy/Report_Highlights.htm.

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Jay Wortley, "The Single Business Tax – Looking Back 30 Years," State Fiscal Agency, Michigan State Senate, *State Notes* (Mar.–Apr. 2006), *available at* http://www.senate.michigan.gov/sfa/Publications/Notes/notes.html.

Curtis S. Dubay, "GM and Michigan," Tax Foundation, Tax Policy Blog (May 26, 2005), *available at* http://taxfoundation.org/blog/show/506.html

O. Presentation, Douglas B. Roberts, "Michigan's Single Business Tax: A Personal Journey" (undated).

Kyle I. Jen, *Background and History: Michigan's Single Business Tax*, House Fiscal Agency, State of Michigan House of Representatives, at 11 (Nov. 2003).

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P. *Trinova Corp. v. Michigan Department of Treasury*, 498 U.S. 358 (1991).

Q. Patrick L. Anderson & Ilhan K. Geckil, "The Tax Burdens of Michigan's Single Business Tax," Anderson Economic Group LLC, *commissioned by* Michigan Manufacturers Association (May 24, 2005).

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S. Memorandum from Joseph C. Bright, member of the Pennsylvania Business Tax Reform Commission ("PABTRC"), to the Commissioners of the PABTRC, regarding the Business Benefits Tax (Oct. 14, 2004).

(ii) Federal Level VAT

T. James M. Bickley, "Value-Added Tax: A New U.S. Revenue Source?" The Library of Congress, *Congressional Research Service Report for Congress* (Aug. 22, 2006).

5. ***Other Alternatives***

U. Edward D. Kleinbard, "Rehabilitating the Business Income Tax," The Brookings Institution, The Hamilton Project, Discussion Paper 2007-09 (Aug. 22, 2006).

6. ***Materials Added at Suggestion of Bob Tannenwald***

William H. Oakland & William A. Testa, "State-Local Business Taxation and the Benefits Principle," Federal Reserve Bank of Chicago, *Economic Perspectives* (1996).

Elizabeth C. McNichol & Iris J. Lav, "Illinois' Proposed Gross Receipts Tax: A Modified GRT Could Be Paired with Other Tax Changes," Center on Budget and Policy Priorities (May 3, 2007).

Robert Tannenwald, "Massachusetts Business Taxes: Unfair? Inadequate? Uncompetitive?" Federal Reserve Bank of Boston, Public Policy Discussion Paper No. 04-4 (Aug. 20, 2004).

Appendix B -- Comments of Prof. Alan Clayton-Matthews on Subcommittee Report

The principle of taxation according to services used is of relatively low priority to me compared to issues of competitiveness vs. other states and countries, and to the distributional characteristics of the tax (i.e., who pays the burden of the tax). Business' real estate tax payments (directly if they own the real estate, or indirectly through rents if they do not own it) roughly correspond to services used, so the issue is not critical here with respect to corporate taxes.

Competition, on the other hand, is a critical issue if business location is sensitive to costs. For businesses that sell in national and international markets, I believe that business costs *are* an important factor in location decisions. Because these businesses can't pass on the tax in higher prices, it is paid directly out of profits, and that gives an incentive for these firms to move or expand elsewhere. There may be some ability for these businesses to shift some of the tax back toward their employees through lower wages and salaries, but the ability to do this is limited to the extent that employees – particularly highly-educated professionals – can find jobs in other states that pay higher wages and salaries.

For businesses that sell almost exclusively in-state, for example, restaurants, retail stores, and personal-service establishments, the tax can be passed onto the consumer in higher prices, and competition is not an important issue. These types of businesses are also able to shift some of the tax onto their employees through lower wages, since labor markets for many of these jobs are more local than for professional occupations in large national and international corporations, and because these workers also tend to be less geographically mobile than highly educated professionals.

For these businesses that sell almost exclusively in-state, issues of the incidence of the tax should be considered. The burden of the business tax will fall some on owners through lower profits, some on consumers through higher prices, and some on workers through lower wages. We should be aware that changes in business taxes, be they higher or lower, will have consequences on the distribution of income.

The upshot of all this is that any reform that entails a big change, for example, going to a VAT – even if the tax rate is low – could have big impacts on competitiveness and on the distribution of income, and I would not be in favor of such a change until these impacts were estimated, so that choices could be made in a rational manner.

Alan Clayton-Matthews 11/8/07

APPENDIX H

Subcommittee on Business Tax Rates – "Preliminary Status Report"
(dated October 16, 2007)

Subcommittee on Business Tax Rates

Preliminary Status Report

Presented to the Study Commission on Corporate Taxation

October 16, 2007

The Subcommittee on Business Tax Rates ("the Subcommittee") respectfully submits the following as a status report to the Study Commission on Corporate Taxation.

On August 9, 2007, Secretary Leslie Kirwan, chair of the Study Commission on Corporate Taxation, announced the creation of six subcommittees of the Commission for the purpose of studying specific corporate tax-related issues. These subcommittees were organized on August 13, 2007. The Subcommittee on Business Tax Rates was charged with analyzing the current corporate tax rate structure, as codified in chapter 63 of the General Laws, as well as other Acts & Resolves of the Commonwealth. The Subcommittee was further charged with making recommendations as to how the tax rate structure should be amended, if at all.

The Subcommittee held an organizational meeting on September 19, 2007. All four members were in attendance: Sen. Richard R. Tisei & Rep. Bradley H. Jones, Jr. (Co-Chairs), Alan Clayton-Matthews, and Eileen McAnneny. They agreed to meet several times within a short period of time in order to prepare a status report to the full Commission in October. The first meeting also included a presentation on the corporate tax structure by R. David Wheeler and Stephen P. Trenholm of Rucci, Bardaro and Barrett, members of the Massachusetts Society of Certified Public Accountants.

A subsequent meeting was held by all members on September 24, 2007. At this meeting, the Subcommittee held an extensive discussion regarding the feasibility of instituting various corporate tax structures to replace the current structure. Among other notions, the consideration of a corporate flat tax was explored. The members agreed more data would have to be provided by the Department of Revenue (DOR) in order to proceed. In addition to various requests for data made to DOR (which have been fulfilled), the Subcommittee has most recently requested, and received, four revenue impact analyses for different tax models the Subcommittee has designed. The Subcommittee is currently studying these analyses. In taking into account the many economic variables which businesses face, the Subcommittee believes it necessary that any possible, new corporate tax structure must meet certain requirements. These requirements are imperative not only for the proper growth and success of business but also for the credibility and solidity of the Commonwealth:

1. Fair
2. Simple
3. Predictable
4. Stable
5. Substantially Revenue Neutral

The Subcommittee intends to continue with its study, analysis, and modeling of the corporate tax structure in order to present a viable list of recommendations to the Study Commission on Corporate Taxation in the near future.

APPENDIX I

Subcommittee on Business Tax Rates – "Final Report"
(dated November 13, 2007)

Final Report of the

Subcommittee on Business Tax Rates

Massachusetts Study Commission on Corporate Taxation

November 13, 2007

Hon. Richard R. Tisei, Co-chair
Hon. Bradley H. Jones, Jr., Co-chair
Alan Clayton-Matthews
Eileen McAnneny

A majority of members of the Subcommittee on Business Tax Rates ("the Subcommittee") respectfully submits the following as its Report of Recommendations to the Study Commission on Corporate Taxation (the "Commission").

I. BACKGROUND

A. The Study Commission on Corporate Taxation

On April 30, 2007, Governor Deval Patrick, Senate President Therese Murray and Speaker of the House Salvatore DiMasi issued a joint press release appointing 15 members to serve on a special commission to review and offer recommendations for streamlining the current tax code. Per the joint statement, the mandate of the Commission is to study the modernization and simplification of the current business tax laws of the Commonwealth, promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness. The press release called for an interim report on legislative recommendations providing revenue for Fiscal Year 2008 by June 15, 2007. A final report on long- term changes to corporate tax laws must be completed by January 1, 2008.

On June 15, 2007, a majority of the members of the Commission filed an Interim Report with Leslie Kirwan, Secretary of Administration and Finance and Chair of the Commission. The Interim Report "identified as the most immediate problem the fact that the Commonwealth's business tax laws allow significant avoidance not intended by the Legislature." [1] To address this problem and to start "insisting on greater shared responsibility for our Commonwealth's future – principally by asking a fairer share from larger, multistate businesses," the Interim Report recommended that "Massachusetts join the national tax policy mainstream by enacting the reform known as "check the box" – conforming Massachusetts entity classification rules to federal law, and thus preventing a corporation from claiming one status for Massachusetts taxes and another for federal and other-state taxes." [2] The Interim Report also recommended that the Commission devote its remaining work to investigating the design and implementation of other measures proposed in House Bill 3756, *An Act Improving the Fairness of the Tax Laws* filed by Governor Patrick, as well as other areas identified by members of the Commission. [3]

B. The Subcommittee on Business Tax Rates

On August 9, 2007, Secretary Kirwan announced the creation of six subcommittees. Each subcommittee was formed to study one or more specific corporate tax-related issues identified in the Interim Report. These subcommittees were organized on August 13, 2007.

The Subcommittee on Business Tax Rates was charged with analyzing the current corporate tax rate structure, as codified in Chapter 63 of the General Laws and other Acts & Resolves. In particular, the Subcommittee was charged with investigating ways to reduce the corporate excise tax rate, or eliminate the non-income measure of the corporate excise (the so-called "balance sheet tax"), in return for removing some intentional or unintended tax provisions.

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[1] Interim Report of the Majority of the Study Commission on Corporate Taxation at 4.
[2] Id. at 5.
[3] See id. at 5, 6.

Secretary Kirwan appointed four members of the Commission to serve on the Subcommittee, as follows:

- **Hon. Richard R. Tisei**, Minority Leader of the Senate (co-chair)
- **Hon. Bradley H. Jones, Jr.**, Minority Leader of the House of Representatives (co-chair)
- **Professor Alan Clayton-Matthews**, Economist, UMass Boston
- **Eileen McAnneny**, Senior Vice President for Government Affairs and Associate General Counsel, Associated Industries of Massachusetts (AIM)

The Subcommittee held an organizational meeting on September 19, 2007. All four members were in attendance. Members agreed to meet several times within a short period of weeks to prepare a status report to the full Commission in October. The first meeting also included a presentation on corporate tax structure by R. David Wheeler and Stephen P. Trenholm of *Rucci, Bardaro and Barrett*, members of the Massachusetts Society of Certified Public Accountants.

A subsequent meeting was held on September 24, 2007. At this meeting, members engaged in an extensive discussion regarding the feasibility of instituting one unified corporate tax structure to replace the current structure of multiple tax rates. Among other ideas, the concept of a more uniform corporate tax rate was explored. The members agreed that more data would have to be provided by the Department of Revenue (DOR) in order to make a sound decision.

The Subcommittee issued its preliminary status report on October 16, 2007. [4]

II. FINDINGS

A. Offsetting Impacts of Potential Tax Policy Shifts is a Paramount Goal

Since the beginning, the role of the Commission has been to evaluate a series of multi-million dollar corporate tax revisions proposed by Governor Patrick in House Bill 3756. These changes, if enacted, would result in substantially-increased revenue for the Commonwealth. However, this increase in revenue – whether or not it is fair and equitable – would come at the direct expense of those businesses expected to fund the excise.

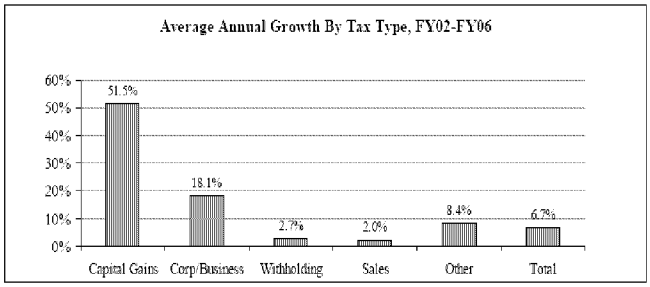
The increase in revenue itself is cause for potential concern. Businesses already located in Massachusetts would see their tax liability increase abruptly, and they would have to adjust to these added costs within the current economic climate. This would have an adverse effect on the competitiveness of our domestic industries within the national and international economy. Beyond this, businesses considering whether to relocate to the Commonwealth would see these changes as deterrents to moving here, which is not in the best interest of Massachusetts.

[4] A copy of this report is attached to this Recommendations Report as "Appendix A."

Massachusetts corporate tax rates also suffer from frequent readjustment and revision. The best and most recent example of this trend is the series of three major business "tax loophole" closings that began in 2003.[5] Each of these laws resulted in major overhauls of the corporate tax code for Massachusetts businesses, as well as significant increases in business taxes by $378 million per year.

Constant readjustment of business tax rates sends a harmful message to the business community in the Commonwealth that taxes here are unstable and unpredictable costs. This is the equivalent of corporate anathema. Forward planning is imperative to the success of any business, whether large or small. In order to plan properly, businesses must be reasonably able to foresee and account for any impending costs. Constant changes of this type indicate a tendency in the Commonwealth toward instability, which stymies capital investment and is then reflected in our economic climate.

Indeed, testimony by the Department of Revenue during the Fiscal Year 2008 Consensus Revenue Estimate hearing showed how repeated changes in our business tax code have led to highly volatile corporate tax and capital gains tax collections. Fiscal Year 2006 witnessed 31% growth in corporate tax collections, while FY07 saw only 4.3% growth. Without a doubt, this volatility is a sign that the profitability and competitiveness of Massachusetts businesses is harmed when there is instability in the corporate tax structure statewide.



Source: Massachusetts Department of Revenue

The members of the Subcommittee do not presume to advocate for or against the adoption of specific "loophole closings" proposed by Governor Patrick. This is a responsibility for the Commission to consider as a whole during the remainder of its term. However, the members of the Subcommittee do feel strongly that it is the responsibility of the Commission to offset revenue-enhancing changes that it might make with corresponding reductions in revenue. These offsets might involve adjustments of the statutory excise rates or the elimination of certain inappropriate provisions of the existing tax code, or both. The Subcommittee has developed a series of options for such adjustments for the consideration of the full Commission. These proposals are set forth in more detail in Section III of this report.

B. Simplification of the Tax Code Should Also Be Considered

As part of the Subcommittee's broad examination of the corporate tax code, it would be an oversight to propose structural reforms without acknowledging that the corporate tax structure of the Commonwealth is a complex and confusing web of laws subject to frequent revision and constant reinterpretation. We believe that any changes to the tax code, whether for the purpose of offsetting corresponding increases in revenue or otherwise, should also be aimed at simplifying and modernizing our state's tax structure. This is an important consideration to ensure that our

[5] *See* Chapter 143 of the Acts of 2003, Chapter 262 of the Acts of 2004, and Chapter 163 of the Acts of 2005.

tax laws foster appropriate compliance and also further the economic development and public policy objectives of this state and its citizens.

The existing statutory framework for calculating an entity's tax liability is nearly unworkable because of its complexity. Massachusetts law sets forth 14 different classifications of business entities which are subject to corporate excise taxation, most of which have their own separate tax rate. The following chart illustrates the complexity and non-uniform nature of this system:

Massachusetts Business Tax Rates and Entity Classifications			
Entity	**Tax Rate**	**Non-income Measure**	**14% Surtax**
Sole Proprietor	5.3%	None	No
Corporate Trust	5.3%	None	No
S Corporation (Shareholders)	5.3%	None	No
S Corporation (<$6M receipts)	-	Yes	Yes
S Corporation ($6M-9M receipts)	3%	Yes	Yes
S Corporation (>$9M receipts)	4.5%	Yes	Yes
Utility Corporation	6.5%	None	Yes
Business Corporation	9.5%	Yes	Yes
Manufacturing Corporation	9.5%	Yes	Yes
R&D Corporation	9.5%	Yes	Yes
Financial Institution	10.5%	None	No
Life Insurance Company[6]	2%	None	No
Bank Security Corporation	0.33%	None	Yes
Regular Security Corporation	1.32%	None	Yes

Source: Massachusetts Department of Revenue & Office of the House Minority Leader

This system of entity classification is inherently complicated on its face. Furthermore, due to the wide disparity of tax rates, this framework actually provides an unfair incentive for capable businesses to assume a corporate form that minimizes the applicable tax rate.

Adding to the confusion behind the tax rate system is the labyrinth of session acts passed into law over time, which alter statutory tax rates without being codified in general law. A prime example is Chapter 546 of the Acts of 1969, which imposes a 14% surtax on business corporations. Sections 32 and 39 of Chapter 63 of the General Laws (2006 Official Edition) set the corporate tax rate for such entities at 8.33%. However, factoring in the 14% surtax brings the total tax liability to 9.5%, as reported in the chart above. Aside from cloaking effective tax increases in obscure laws, setting tax policy by way of session laws also adds layers of complexity to an already complicated tax code.

C. <u>The Non-Income Measure "Balance Sheet" Tax Should Be Evaluated</u>

Another confusing aspect of the Massachusetts corporate tax code is the non-income (property) measure tax, otherwise known as the "balance sheet" tax. This tax requires a business to use statutory formulae [7] to evaluate whether to subject its tangible property or net worth to

[6] Casualty insurance companies and PPOs are taxed at 2.28% (includes surtax); Ocean marine companies are taxed at 5.7% (includes surtax).

[7] Clause 10 (tangible property) and Clause 11 (net worth) of §30 of Chapter 63 of the MGL, 2006 Official Edition.

taxation. Once a choice is made, the appropriate figure is multiplied by the statutory rate, and the result is then added to the company's income tax to yield the total tax due.

The property measure of the excise hails from the Commonwealth's earliest form of taxation, long before the uniform income tax that appeared in 1916.[8] Prior to this time, the Commonwealth's cities and towns levied a personal property tax on both tangible (jewelry and furniture) and intangible (stocks and bonds) personal property. The rates of tax varied, and it was common for major cities to have higher tax rates than the smaller cities and towns. For example, the tax rates for the city of Boston on such tangible and intangible property were higher than the tax rates in some of the surrounding suburbs. However, this situation led to the practice of individuals declaring their domiciles in municipalities with a lower tax rate, or refraining from reporting assets to the local assessors.

Modernization of our tax laws has made such practices archaic. However, the property measure remains on the books. In fact, the excise itself has been altered several times within less than ten years, albeit the sequence of changes occurred roughly 30 years ago.[9] The current rate of .228% (.26% with 14% surtax) has been in effect since 1975.

III. RECOMMENDATIONS

A. Methodology

In formulating recommendations for the Commission, the Subcommittee has followed a set of important guidelines to ensure the substantive quality of the options it has prepared and the relevance of those options to the broader mandate of the commission.

First, the Subcommittee has sought the assistance of qualified tax professionals and practitioners to identify areas in need of review and to evaluate proposed recommendations. The members of the Subcommittee would like to express their sincere appreciation and gratitude to these individuals, including the staff of the Department of Revenue, for their assistance in the preparation of this report. Without these individuals' expertise and the empirical data and cost impact estimates they provided, these recommendations would not have been possible.

Second, all meetings of the Subcommittee were held with prior notice and were open to the members of the public. Subjecting the workings of the Subcommittee and the Commission as a whole to public scrutiny enhances the credibility of recommendations that might result.

Third, the Subcommittee has remained true to the charge given to the Commission in its formation. Specifically, the members have chosen to evaluate the business tax code and any recommendations made to improve it through the prism of the mandate expressed in the joint statement on April 30, 2007. This methodology has led the Subcommittee to focus on the following concepts in developing its recommendations:

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[8] Article 44 of the Massachusetts Constitution was ratified in 1915. After its imposition, the new rates of taxation were instituted in 1916. Included among the various rates was the 4% tax on income from wages and business.

[9] Including the 14% surtax, the non-income measure rate was .798% from 1969 to 1973, .576% in 1974, and .26 beginning in 1975.

1. **Offsetting the Removal of Tax Preferences.** One of the most important duties of the Subcommittee is to develop ways to offset the Commission's potential recommendation to remove "some intentional or unintended tax preferences." The members of the Subcommittee take this responsibility very seriously. Some of these changes the Commission is reviewing would impose substantial added costs to businesses if adopted. For example, the Governor estimated that the FY08 tax revenue generated from the adoption of combined reporting would be $271.2 million, with another $198.4 million generated from the adoption of "check the box." Without necessarily advocating for or against these changes, the Subcommittee has worked diligently to develop proposals to offset revenue increases which would result from their adoption. It would be unfair, inequitable and extremely hazardous economically for the Commission to recommend the "removal of tax preferences" in a vacuum without also proposing ways to hold the business community harmless.

2. **Modernization.** If we are to expect Massachusetts businesses to compete and thrive in the modern economy, then we should subject them to a tax code which relates in a reasonable way to the way business is conducted in the 21st Century. With this in mind, the full Commission should consider amending the tax code to reward behavior, such as capital investment, regardless of a business entity's classification.

3. **Simplification.** Massachusetts will benefit from a tax law that is codified in one unitary system and which is easy to understand and to enforce. This will encourage compliance and help to attract businesses to locate here.

4. **Fairness and Equity.** The Massachusetts corporate excise tax rate system should exhibit properties of horizontal and vertical equity, and it should produce consistent results for corporate entities of different classifications and means.

5. **Encouragement of growth, innovation and competitiveness.** The success of our economy depends on a backbone of strong, robust corporate activity. This business is encouraged by the development of a tax system that exhibits the principles above.

B. Options for the Consideration of the Commission

1. *"Sting Taxes" for S-Corporations Should Be Removed*

Massachusetts law effectively taxes S-Corporation income twice: once at the corporate-entity level and another time at the shareholder (personal) level (which is presently 5.3%). This system of double taxation, known as a "sting tax," though perhaps not as harsh as the tax liability imposed on a regular corporation, is inherently unfair.

The policy also has been inherently unstable. Massachusetts first recognized the federal income tax treatment of S-Corporations in 1986. [10] Similar to the federal law, income was considered to "flow through" the S-Corporation to the shareholders and was slated to be taxed as personal income at the shareholder level. Two years later, S-Corporation treatment was repealed

[10] Chapter 488 of the Acts of 1986

for businesses with total receipts of $6 million or more. [11] This later change was short-lived, as the law was altered again in 1989. This latest change, subjects S-Corporations to varying tax rates according to their total receipts:[12]

Masachusetts S-Corporation Tax	
Total Receipts	**Tax Rate ("Sting Tax")**
<$6,000,000	-
$6,000,000 to <$9,000,000	3%
$9,000,000 or more	4.5%

For the sake of simplicity, and in keeping with the true intention and benefit of the federal S-Corporation designation, the Subcommittee recommends the removal of the 3% and 4.5% "sting tax." Therefore, the only business classes subject to rate changes in the Subcommittee's other recommendations are utility corporations, business corporations, manufacturing corporations, R&D corporations, and financial institutions. Certain business classifications are taxed at the personal level (sole proprietor, corporate trust, and S-Corporations with less than $6 million in receipts). Only those classifications whose tax rates are applied at the entity level will be subject to alteration.

2. *The Subcommittee Has Developed A Series of Offsetting Options for the Consideration of the Commission*

Pursuant to its mandate, the Subcommittee has developed the following set of options for the Commission to consider for the purpose of offsetting corresponding increases in revenue which might be proposed in the Commission's final report; in the Subcommittee's estimation, the final recommendation should be revenue neutral. While not an exhaustive list, these options focus on adjusting statutory tax rates for subject business entities, with the goal of simplifying and consolidating the existing rate structure. They also are designed to achieve an overall framework that is as fair and equitable as possible. Following each option is the estimate from the Department of Revenue of the reduction in revenue payable to the Commonwealth, which would offset corresponding increases in revenue from potential "loophole closings."

1. **Establish a Flat Tax of 5.3%**
   The imposition of an across-the-board uniform tax rate for all business classifications is the simplest form of taxation. Similar to the Commonwealth's personal income tax, the new business rate of 5.3% is a lower rate than the current tax rates of 6.5%, 9.5%, and 10.5%.
   DOR Offset Estimate: $621,201,781

2. **Establish a Flat Tax Rate of 6%**
   As with Option 1, the 6% tax rate is lower than the current rates applied to the entity.
   DOR Offset Estimate: $542,940,992

[11] Chapter 202 of the Acts of 1988
[12] Chapter 287 of the Acts of 1989

3. **Create a Flat Tax of 5.3% and Eliminate the Three Ancillary Tax Forms**
   A flat rate of 5.3% is applied to all corporate entities, as in Option 1. However, the following ancillary tax forms are removed from the code: minimum corporate tax, "balance sheet" tax, and 14% surtax.
   DOR Offset Estimate: $917,836,695

4. **Create a Flat Tax of 6% and Eliminate Two Ancillary Tax Forms**
   A flat tax rate of 6% is applied to all corporate entities, as in Option 2. However, the following ancillary tax forms are removed from the code: "balance sheet" tax and 14% surtax.
   DOR Offset Estimate: $749,815,750

5. **Establish Two Tax Rates and Eliminate Three Ancillary Tax Forms**
   The multiple tax rates are replaced with only two rates: 5.3% for utility corporations, and 10.5% for business corporations, manufacturing corporations, R&D corporations, and financial institutions. In addition, the following ancillary tax forms are removed from the code: minimum corporate tax, "balance sheet" tax, and 14% surtax.
   DOR Offset Estimate: $384,237,085

6. **Create Two Tax Rates and Eliminate Two Ancillary Tax Forms**
   The multiple tax rates are replaced with only two rates: 6% for utility corporations, and 10% for business corporations, manufacturing corporations, R&D corporations, and financial institutions. In addition, the following ancillary tax forms are removed from the code: "balance sheet" tax and 14% surtax.
   DOR Offset Estimate: $340,316,836

Summary of Current System vs. Subcommittee Options							
Entity	**Rates**						
	Current	**Option 1**	**Option 2**	**Option 3**	**Option 4**	**Option 5**	**Option 6**
Sole Proprietor	5.3%	5.3%	5.3%	5.3%	5.3%	5.3%	5.3%
Corporate Trust	5.3%	5.3%	5.3%	5.3%	5.3%	5.3%	5.3%
S Corporation (Shareholders)	5.3%	5.3%	5.3%	5.3%	5.3%	5.3%	5.3%
S Corporation (<$6M receipts)	-	-	-	-	-	-	-
S Corporation ($6M-9M receipts)	3%	-	-	-	-	-	-
S Corporation (>$9M receipts)	4.5%	-	-	-	-	-	-
Utility Corporation	6.5%	5.3%	6%	5.3%	6%	5.3%	6%
Business Corporation	9.5%	5.3%	6%	5.3%	6%	10.5%	10%
Manufacturing Corporation	9.5%	5.3%	6%	5.3%	6%	10.5%	10%
R&D Corporation	9.5%	5.3%	6%	5.3%	6%	10.5%	10%
Financial Institution	10.5%	5.3%	6%	5.3%	6%	10.5%	10%
Life Insurance Company	2%	2%	2%	2%	2%	2%	2%
Bank Security Corporation	0.33%	0.33%	0.33%	0.33%	0.33%	0.33%	0.33%
Regular Security Corporation	1.32%	1.32%	1.32%	1.32%	1.32%	1.32%	1.32%
Minimum Corporate Tax	*Yes*	*Yes*	*Yes*	*No*	*Yes*	*No*	*Yes*
"Balance Sheet" Tax	*Yes*	*Yes*	*Yes*	*No*	*No*	*No*	*No*
14% Surtax	*Yes*	*Yes*	*Yes*	*No*	*No*	*No*	*No*

Conclusion

All business entities doing business in the Commonwealth are required to financially contribute to the support of government for use of its services, and for the privilege of conducting business within its borders. The Subcommittee believes the Commonwealth is equally liable in its duty to present a fair and simple vehicle by which business conveys its support. Government and business must work hand-in-hand. Otherwise, the consequences will result in less tax revenue due to profitable companies leaving Massachusetts for more business-friendly states. The Subcommittee contends that a reversal of how the Commonwealth administers its corporate tax system, to a fairer and simpler mode, could be manifested with the adoption of one of the several options presented in this report.

Respectfully submitted,

Hon. Richard R. Tisei, Co-chair

Hon. Bradley H. Jones, Jr., Co-chair

Alan Clayton-Matthews

Eileen McAnneny

Appendix A

Subcommittee on Business Tax Rates

Preliminary Status Report

Presented to the Study Commission on Corporate Taxation

October 16, 2007

The Subcommittee on Business Tax Rates ("the Subcommittee") respectfully submits the following as a status report to the Study Commission on Corporate Taxation.

On August 9, 2007, Secretary Leslie Kirwan, chair of the Study Commission on Corporate Taxation, announced the creation of six subcommittees of the Commission for the purpose of studying specific corporate tax-related issues. These subcommittees were organized on August 13, 2007. The Subcommittee on Business Tax Rates was charged with analyzing the current corporate tax rate structure, as codified in chapter 63 of the General Laws, as well as other Acts & Resolves of the Commonwealth. The Subcommittee was further charged with making recommendations as to how the tax rate structure should be amended, if at all.

The Subcommittee held an organizational meeting on September 19, 2007. All four members were in attendance: Sen. Richard R. Tisei & Rep. Bradley H. Jones, Jr. (Co-Chairs), Alan Clayton-Matthews, and Eileen McAnneny. They agreed to meet several times within a short period of time in order to prepare a status report to the full Commission in October. The first meeting also included a presentation on the corporate tax structure by R. David Wheeler and Stephen P. Trenholm of Rucci, Bardaro and Barrett, members of the Massachusetts Society of Certified Public Accountants.

A subsequent meeting was held by all members on September 24, 2007. At this meeting, the Subcommittee held an extensive discussion regarding the feasibility of instituting various corporate tax structures to replace the current structure. Among other notions, the consideration of a corporate flat tax was explored. The members agreed more data would have to be provided by the Department of Revenue (DOR) in order to proceed. In addition to various requests for data made to DOR (which have been fulfilled), the Subcommittee has most recently requested, and received, four revenue impact analyses for different tax models the Subcommittee has designed. The Subcommittee is currently studying these analyses. In taking into account the many economic variables which businesses face, the Subcommittee believes it necessary that any possible, new corporate tax structure must meet certain requirements. These requirements are imperative not only for the proper growth and success of business but also for the credibility and solidity of the Commonwealth:

1. Fair
2. Simple
3. Predictable
4. Stable
5. Substantially Revenue Neutral

The Subcommittee intends to continue with its study, analysis, and modeling of the corporate tax structure in order to present a viable list of recommendations to the Study Commission on Corporate Taxation in the near future.

APPENDIX J

Subcommittee on Combined Reporting – "Status Report"
(dated October 16, 2007)

M E M O R A N D U M

TO: Tax Commission

FROM: Subcommittee on Combined Reporting

RE: Status Report

DATE: October 16, 2007

The Subcommittee on Combined Reporting has met three times and has a fourth meeting scheduled for October 30.

At the first meeting, the Subcommittee held a general discussion about Combined Reporting and decided to set up several meetings for briefings from experts and review of background materials. Subsequent meetings have included presentations from: (1) Richard Pomp, Professor of Law at the University of Connecticut and an expert on state taxation; (2) Stanley Arnold, a former Commissioner of New Hampshire's Department of Revenue Administration, and Bill Ardinger, from the New Hampshire law firm, Roth, Young and Pignatelli**,** who spoke about unitary taxation in New Hampshire; (3) Shirley Sicilian, General Counsel of the Multistate Tax Commission; and (4) Todd Lard, Tax Counsel to COST. We also have a meeting scheduled for October 30 where we will hear from Keith Davis, Executive Director of the North Carolina Tax Commission, and Ben Miller, who heads the California Franchise Tax Board's Legal Department's Multistate Tax Bureau.

In addition to the above presentations, the following written materials have been provided to the Subcommittee: (1) The Pros and Cons of Worldwide Unitary Taxation, a 1984 article by Robert Tannenwald from the New England Economic Review; (2) North

Carolina Tax Commission Report; (3) Proposed Model Statute for Combined Reporting approved by the Multistate Tax Commission on August 17, 2006; (4) April 25, 2005 Report of the Multistate Tax Commission Hearing Officer regarding the proposed Model Statute for Combined Reporting; (5) June 3, 2005 Supplemental Report of the Hearing Officer Regarding the proposed Model Statute for Combined Reporting [Amended June 21, 2005]; (6) Combined Reporting Issues List for MTC Income and Franchise Tax Uniformity Subcommittee; and (7) A 2001 Law Review article published in the Louisiana Law Review entitled: Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana.

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APPENDIX K

Subcommittee on Combined Reporting – "Findings and Recommendation"
(Draft Final Report, distributed on November 13, 2007)

Massachusetts Tax Commission

Subcommittee on Combined Reporting

Findings and Recommendation

The following provides an overview of the findings and recommendation of the subcommittee established by the Massachusetts Tax Commission to examine combined reporting (hereinafter, the "Subcommittee").

The first section explains the principles of unitary taxation, some of the pros and cons of adopting such a regime, as well as the Subcommittee's recommendation to the Massachusetts Tax Commission to [approve / oppose] it as part of our final report due on January 8, 2008 ("Final Report").

Should the Massachusetts Tax Commission recommend combined reporting as part of its Final Report, there are subsidiary issues that should be understood and addressed. This report explains six of these subsidiary issues, which are explained in the second section of this report. To allow the Commission to better understand each issue and its attendant considerations, the report also outlines the positions relative to these issues presented by certain organizations, including the Multistate Tax Commission ("MTC"),[1] Council on State Taxation ("COST")[2] and Massachusetts Department of Revenue ("Department").

I. Combined Reporting

A. Brief Overview of Unitary Taxation and Combined Reporting

The fundamental manner in which states seek to tax a portion of income of a multijurisdictional enterprise has its roots in the unitary method of taxation. The unitary method of taxation evolved in response to difficulties inherent in attributing income of a multistate business to the states in which it operated. Over time, the unitary method of taxation, often referred to as formulary apportionment, has become the widely accepted approach for dividing income among states. Under formulary apportionment, the business income of a multijurisdictional taxpayer is apportioned to a state using one or more apportionment factors that typically measure the percentage of a taxpayer's property, payroll and/or sales in a state.[3]

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[1] The Multistate Tax Commission is an intergovernmental state tax agency that works on behalf of states and taxpayers to facilitate the administration of tax laws that apply to multistate and multinational enterprises.

[2] COST is a nonprofit trade association formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of 570 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

[3] Business income is generally defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible or intangible property, if the acquisition, management or disposition of the property constitutes integral parts of the taxpayer's regular

In general, formulary apportionment is applied against the income from the unitary operations of a business. Suppose, however, that a taxpayer segregated its business operations into separately incorporated subsidiaries. Should a state tax each subsidiary separately based on its own income and apportionment factors, or should the state continue to tax its share of income from the entire unitary business enterprise, essentially as if the division of the business into separate corporations did not occur? In addressing this question, states either take a "separate entity" approach or a unitary "combined reporting" approach.

Massachusetts currently adopts a separate entity method of taxation. Under separate entity reporting, the taxable income of each legal entity that is subject to Massachusetts tax is reported separately, without regard to the combined income of the multistate enterprise of which the entity may be a member.[4]

On the other hand, approximately twenty states have adopted a combined reporting method of taxation which seeks to determine the portion of the combined unitary business income of a group of affiliated corporations that share a unitary relationship based on the overall apportionment factors of the group.[5] Unitary affiliates of a taxpayer may be included in the combined report, irrespective of whether they are subject to the state's taxing jurisdiction. In determining whether a group of corporations share a unitary relationship, these states generally rely on one of the three judicial tests or some variation of them. Although each test is slightly different, all of the tests essentially examine the same objective and subjective characteristics, and thus the tests are somewhat interchangeable.

1. Three Unities Test

The three unities test, as first espoused in *Butler Brothers v. McColgan*[6], describes three hallmarks of a unitary business as (1) unity of ownership, which is generally evidenced by more than 50% common ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting, and management; and (3) unity of use in the centralized executive force and general system of operation.

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trade or business." UDIPTA §1(a). Nonbusiness income, which is allocated rather than apportioned to states, is generally defined as "all other income than business income." UDIPTA § 1(e).

[4] Massachusetts allows corporate taxpayers to file a so-called "combined report," which more accurately should be referred to as a nexus consolidated return, as the return is limited to corporations that file on a federal consolidated basis, provided that each corporation in the report is separately subject to Massachusetts taxing jurisdiction. Moreover, unlike a unitary combined reporting regime, the members of the Massachusetts combined report must separately calculate their Massachusetts apportioned taxable income and then combine the results.

[5] Unitary combined reporting is adopted by Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Michigan (effective for business activity occurring on or after December 31, 2007), Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, Texas, Utah, Vermont and West Virginia (effective January 1, 2009).

[6] 17 Cal.2d 664, *aff'd*, 315 U.S. 501 (1942).

2. Contribution or Dependency Test

The California Supreme Court, in *Edison California Stores v. McColgan*, applied the "contribution or dependency test."[7] There, the court stated:

> [i]f the operation of a portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate.

3. Other Tests of Unity

The United States Supreme Court has referred to other tests for unitary business relationships, which may be no more than variations on the two standard tests referenced above. Specifically, the Court has referred to a unitary business as one that exhibits "contributions to income resulting from functional integration, centralization of management and economies of scale."[8] In addition, the Court suggested another *indicium* of a unitary business, noting, "[t]he prerequisite to a constitutionally acceptable finding of a unitary business is a flow of **value**, not a flow of goods."[9] In an alternative approach, the Court has stated that for commonly controlled activities to be nonunitary, they must be part of "unrelated business activity which constitutes a "discrete business enterprise."[10]

B. Merits of Unitary Taxation

In formulating its recommendation regarding combined reporting, the Subcommittee solicited the opinions of various individuals and groups. The following summarizes the sentiments of the MTC, COST and the Department regarding the merits of combined reporting.

1. MTC

The MTC is a proponent of combined reporting. In addressing the merits of combined reporting, the MTC has noted that combined reporting appropriately reports and assigns income of jointly owned and operated companies. Notably, it curbs the ability of multistate enterprises to shift income away from states where the income was earned to no-tax or low-tax states.[11]

The MTC recognizes, however, the uncertainties inherent in determining the manner in which combined reporting will impact tax revenues for any particular taxpayer. With

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[7] 183 P.2d 16 (Cal. 1947).
[8] *Mobil Oil Corp.; F. W. Woolworth Co. v. Taxation and Revenue Dept. of the State of N.M.*, 458 U.S. 354, 366 (1982).
[9] *Container Corp. of America v. Franchise Tax Bd.* 463 U.S. 159 (1983).
[10] *Mobil Oil Corp., ASARCO Inc. v. Idaho State Tax Comm'n*, 455 U.S. 307 (1982).
[11] *See Federalism at Risk, A Report by the Multistate Tax Commission*; p. 63 (June 2005).

respect to tax revenues, the MTC candidly noted that it is difficult to predict whether corporate tax revenues will increase as a result of combined reporting in the short run. The MTC believes, however, that combined reporting eliminates current incentives for companies to attempt to shift income out of state and therefore will likely increase tax revenues over the long term.

Specific to controversies, the MTC indicated combined reporting should ultimately reduce the time and effort expended by a state and taxpayers on state tax controversy matters. According to the MTC, determining a unitary group is dependent on the particular facts and circumstances at issue, which can be the subject of audits. The MTC, however, believes that combined reporting eliminates the majority of disputes over whether a taxpayer properly generated intercompany expenses or shifted income to another state. Although, the MTC recognized that where combination is limited to the water's edge (discussed below), then combined reporting will not address income shifting to overseas entities. Finally, the MTC believes it is yet to be seen whether the courts will uphold recently-enacted add back statutes. Combined reporting, by comparison, has been upheld by the U.S. Supreme Court.

2. COST

COST is opposed to the unitary method of taxation. In COST's opinion, taxpayers generally feel strongly against combined reporting and therefore the business community may negatively view the adoption of combined reporting by Massachusetts. COST members, for example, have voiced concern over whether combined reporting unfairly taxes income earned outside of the state in certain situations, add levels of complexity to return preparation and audits and increases the length of disputes.

COST explained that unitary taxation is largely a facts and circumstance test that is fraught with uncertainties, which increases the complexity and costs associated with the preparation of combined reports and results in long and expensive audits for taxpayers and the taxing authorities. According to COST, it is hard to determine the parameters of a unitary business enterprise given the vague criteria established by statutes and regulations for defining a unitary group coupled with the vague synergies or unitary ties that may exist within an organization. For example, if an organization manufactures different products (e.g., shoes and medical devices), it is unclear whether a state would view manufacturing activities of any kind as related business activities or separately view the different lines of manufacturing operations as separate businesses. In particular, COST cited to a number of California cases which dragged on over many years (e.g., 20 years) as indicative of the burden that combined reporting imposes on businesses and tax authorities.

Moreover, as a result of the inherent difficulties in defining a unitary business, statutes and regulations do not provide clear definitions or bright-line standards rendering it necessary to conclude on the unitary business operations of affiliates as part of an audit or litigation. Consequently, according to COST, concepts of unitary taxation are generally drawn from case law at the expense of taxpayers and state taxing authorities.

Finally, COST cautioned that it is difficult to predict the revenue impact of combined reporting and warned that some states have predicted that moving from separate entity reporting to combined reporting could decrease tax revenues. For example, depending on the facts of the particular combined group, a combined report may decrease tax revenues if the combination of entities (i) reduces the income generated by one member by losses suffered by another member; (ii) dilutes a state's apportionment percentage; or (iii) allows gains from intercompany transactions to be deferred.

3. Department

The Department supports adopting a unitary combined reporting approach. In the Department's opinion, the current separate entity reporting regime is far too susceptible to tax planning which in turn decreases tax revenues, increases tax controversies and has led to the enactment of certain anti-abuse tax provisions that introduce their own complexities for taxpayers to administer and the Department to police.

Under the current regime, taxpayers have the ability to exploit the weaknesses of separate entity reporting through the use of intercompany transactions that source income outside the state to low-tax or no-tax jurisdictions. To combat these planning techniques, Massachusetts has enacted various statutes, such as discretionary authority to challenge sham transactions, provisions that require taxpayers to add back to taxable income certain intercompany charges and captive REIT legislation. The Department views some of these anti-abuse provisions as piece-meal attempts to curb specific planning trends and recognizes that certain of such provisions may require taxpayers and the state to perform a fact intensive analysis that presents its own set of complexities. While the determination of a unitary combined reporting group may also require a fact intensive analysis, the Department believes that the combined reporting method provides a simpler and comprehensive approach to address the income shifting and transfer pricing issues currently faced by the Commonwealth with its separate entity reporting system.

In the Department's opinion, unitary combined reporting would eliminate most of the income shifting opportunities found under the current regime and thereby increase tax revenues and decrease tax controversies. The Department noted that approximately three quarters of outstanding Massachusetts tax assessments facing litigation would have been resolved through a unitary combined reporting regime.

C. Recommendation of the Subcommittee [TBD]

II. Subsidiary Issues Attendant with Adoption of a Unitary Method of Taxation

In considering the adoption of a unitary method of taxation, there are numerous technical issues that must be considered. The following subsidiary issues were specifically considered by the Subcommittee, as they engender policy issues important to the business community and taxing authorities. These selected subsidiary issues are explained below, along with a summary of the views of certain organizations relative to each.

- Statutory versus regulatory interpretation of unitary provisions
- Worldwide versus water's edge combination
- Inclusion of entities subject to different tax regimes
- "*Joyce*" Versus "*Finnigan*" approach to determining the sales factor numerator
- Application of net operating loss (NOL) carryforwards and credits
- Federal consolidated group election or Massachusetts combined group election

A. Statutory versus Regulatory Rulemaking

In analyzing the unitary method of taxation, the Subcommittee heard differing views expressed concerning whether specific rules relative to a unitary combined reporting regime should be clearly addressed in the statute or left for interpretation by taxing authorities in regulations or administrative pronouncements. The following summarizes the MTC's views on this matter as well as the approach taken in Governor Patrick's 2007 tax proposal, *An Act Improving the Fairness of Tax Laws* ("Governor's Proposal").

1. MTC

According to the MTC, it purposely drafted its unitary combined reporting proposal in a detailed fashion to provide model language states can use for either statutes or regulations. The MTC acknowledges certain issues can be the subject of regulations, such as inclusion of certain non-corporate taxpayers in the combined group (discussed below).

2. Department

The Governor's proposal set forth the framework of a unitary combined reporting regime, but largely deferred to the Department to clarify the details and mechanics of its provisions. Specifically, the proposal authorized the Commissioner of Revenue to adopt regulations to implement and coordinate the unitary reporting provisions with the other corporate tax provisions, including rules to address

(i) the elimination of intercompany transactions,
(ii) the application of any carry forwards of tax attributes attributable to the combined group's unitary business (including a preclusion as to the carry forward of losses or other tax benefits that were attributable to entities not subject to tax in Massachusetts),
(iii) the relationship of the combined reporting provisions to the statutory addback rules for certain payments of interest, royalties, etc. to related parties, and
(iv) all other matters related to the interpretation and administration of the unitary provisions.

See An Act Improving the Fairness of Tax Laws, § 45.

The Department agrees with the above approach because the Governor's proposal specifies the underpinnings of the proposed combined reporting regime (e.g., *Finnigan*, water's edge filing, etc.) but left the specifics and mechanics of the proposal to regulations. In the Department's view, the Governor's Proposal provides more detail regarding the underpinnings of the proposed combined reporting regime than most other states.

B. Worldwide versus Water's Edge Combination

One of the more significant policy issues in devising a unitary tax regime is the extent to which foreign affiliates are included in the combined group. Under a worldwide unitary combined reporting regime, all affiliates sharing a unitary relationship are included in the combined report, whether domestic or foreign. Although such a worldwide combination is constitutionally permissible, it is regarded as fraught with complexity and resistance from taxpayers. As a result, the majority of unitary combined reporting states allow taxpayers to limit the combined group generally to eligible domestic corporations and foreign corporations with U.S. source income, a regime referred to as a water's edge combination. If a water's edge approach is taken, then the scope of entities included in the water's edge combined group must be considered.

1. MTC

While the MTC appreciates the merits of worldwide combined reporting, it advocates an approach that permits a water's edge election. According to the MTC,

> If combination includes only domestic corporations, then the apportionment of income associated with foreign activity of a multinational unitary business can be manipulated through changes in the corporate structure. The income (or loss) and apportionment factors associated with the foreign activity could be excluded by conducting the activity in a foreign affiliate, or it could be included by conducting the activity as a foreign division of the domestic corporation….Despite its conceptual superiority, the world-wide approach is extremely unpopular with multinational corporations and much of the international tax community. As a practical matter, a water's edge combination is likely to be administratively simpler, for both the taxpayer and the state, and far less contentious.[12]

As a result, the MTC's model for unitary combined reporting adopts a worldwide combination approach, with a water's edge election (10 year rolling election). Under the MTC's water's edge election, the combined group would include (i) entities incorporated in the United States or formed under the laws of any state, the District of Columbia, or any territory or possession of the United States, (ii) corporations whose average property,

[12] MTC, *Report of the Hearing Officer regarding the proposed Model Statute for Combined Reporting*, April 25, 2005, p. 11.

payroll and sales factors within the United States is 20% or more, regardless of their place of incorporation (iii) corporations that qualify as DISCs, FSCs, or export trade companies under the Internal Revenue Service; (iv) corporations that earn more than 20% of their income, directly or indirectly, from intangible property or service-related activities that are deductible against the business income of the other members of the combined group; (v) members doing business in foreign tax haven jurisdictions; and (vi) all other corporate affiliates to the extent of their United States source income.[1]

2. Department

The Governor's Proposal adopted a water's edge approach under which affiliates incorporated under the laws of a foreign country are not included in the combined report if the foreign affiliate ordinarily has 80% or more of its payroll and property outside the United States and conducts business with other members on an arm's length basis. The Department understands that most multinational companies would be reluctant to attempt a worldwide combination and, as a result, the Department supported a water's edge approach in the Governor's Proposal. However, the Department is amenable to adopting worldwide combined reporting with a water's edge election, similar to the approach adopted by California and other states.

C. Entities Subject to Combination

Massachusetts has enacted specialized tax regimes or apportionment formulas for certain business entities, such as financial institutions, insurance companies, S Corporations, mutual fund service providers and manufacturers. It is possible that a unitary business may be conducted by different types of business entities that are subject to varying tax rules. In enacting a combined reporting regime, the Commission should consider the extent to which entities subject to different tax provisions, but engaged in one unitary business, should be included in the same combined report and mechanically how such a combination should be accomplished.

1. MTC

The MTC proposal authorizes combination of unitary business entities subject to different tax regimes by regulation, in order to allow the state taxing authorities to develop appropriate rules to address each type of situation, rather than statutorily requiring combination in all situations. The model statute also allows for combination to be required by the director on a case-by-case basis, but only in situations involving tax avoidance or evasion.

2. Department

Under the Governor's Proposal, corporations subject to combination would include financial institutions, general business corporations, S corporations, utility corporations, certain captive insurance companies, certain insurance companies owning "flow through"

[1] *MTC Proposed Model Statute for Combined Reporting*, Section 5A.

entities with non-insurance trade or business activities, real estate investment trusts, and regulated investment companies (although regulated investment companies are exempt from the general corporate excise). Corporations not subject to combination would include Massachusetts security corporations, most insurance companies, tax-exempt organizations, and certain foreign entities with 80 percent or more of their payroll and property outside of the United States. Similar to the MTC proposal, the 2007 proposal permitted the Commissioner to include any person (corporate or non-corporate) in the combined group to prevent the avoidance or evasion of Massachusetts taxes.

Regarding the mechanics for accomplishing a combination of different taxpayers, the Governor's Proposal would have required each member of the combined group to determine their tax base by applying the apportionment provisions applicable to such member to the apportionable income of the group.

The Department supports the inclusion of taxpayers subject to different tax regimes in the combined report, but recognized that it would create complexities. If the Governor's Proposal was enacted, the Department intended to address the specifics of such a combination by regulation.

D. *Joyce* versus *Finnegan*

Another combined reporting issue which sparks policy concerns is the methodology for determining the sales factor numerator of a unitary combined group.

Most state apportionment formulas use a receipts factor, the numerator of which is receipts from in-state sales and the denominator of which is total receipts. In a combined group setting, questions arise as to whether the combined group should compute the receipts factor numerator by considering the combined group as one taxpayer (the so-called "*Finnigan*" approach) or separately considering each member (the so-called "*Joyce*" approach).[13]

The issue is best exemplified by an example. Suppose a combined group consists of Corporation A and Corporation B. Corporation A has a taxable presence in state X, whereas Corporation B is not subject to tax in state X. Both Corporation A and B sell products that are delivered to customers in state X. In computing the state X apportionment percentage under a *Joyce* approach, the receipts factor numerator would not include receipts from sales made by Corporation B into state X because Corporation B is not subject to tax in state X. However, under a *Finnigan* approach, such receipts would be included in the numerator of the combined group's sales factor because a member of the group, Corporation A, is subject to tax in state X.

The decision to use the *Joyce* or *Finnigan* approach has implications in states, like Massachusetts, that have a throw back rule. Under a general throw back rule, sales of

[13] The *Joyce* and *Finnigan* methodologies were developed through California case law. *See Appeal of Joyce Inc*, Cal. St. Bd. of Equal., 66-SBE-069, Nov. 23, 1966 *and Appeal of Finnigan Corporation*, Cal. St. Bd. of Equal., 88-SBE-022-A, 88-SBE-022-A, January 24, 1990.

tangible personal property delivered into the taxing state are included in the numerator of that state's sales factor unless the taxpayer is not taxable in that taxing state. In that event, the sales are thrown back to the state from which the goods were shipped. The key is whether the term "taxpayer" means the individual selling corporation (the *Joyce* method) or the selling corporation's unitary group (the *Finnigan* method).

In a combined group setting, if all the members are treated as one taxpayer (i.e., *Finnigan*), then throw back would not apply if a member sells products into a state in which any one of its affiliates is subject to tax. Thus, in the above example, sales by Corporation B into state X would not be thrown back because its affiliate, Corporation A, is subject to tax in state X. However, under a *Joyce* theory, sales by Corporation B into state X would be subject to throw back because Corporation B is not itself subject to tax in state X.

Based on the above, as a generalization, combined groups with members that ship goods from Massachusetts will generally benefit from a *Finnigan* approach, as their affiliates' nexus in states to which the goods are shipped may reduce the instances in which Massachusetts throw back applies. Conversely, the *Finnigan* approach may increase the Massachusetts apportionment percentage of a combined group with a significant presence outside of Massachusetts because the group must take into account the Massachusetts sales of an affiliate that is not itself subject to Massachusetts taxing jurisdiction in the computation of its Massachusetts apportionment percentage.

1. MTC

The MTC combined reporting proposal adopted a *Joyce* theory for computing the sales factor of a combined group. The MTC advocated an approach in its combined reporting regime that would ultimately reduce instances where taxpayers could source income to a state in which it is not subject to tax (so-called "nowhere income"). The MTC views the *Finnigan* approach as a methodology aimed at avoiding “nowhere income,” as it requires the combined group to include in its state's receipts factor the receipts of all members, irrespective of whether a particular member is not independently subject to tax in such state. An alternative approach that achieves the same objective is the *Joyce* approach plus a throwback rule. Given that the majority of combined reporting states adopt a *Joyce* approach, the MTC adopted the *Joyce* approach coupled with a throw back rule to foster uniformity among the states..

2. Department

The Governor's Proposal, on the other hand, employed the *Finnigan* approach for computing the sales factor of a combined group. The Department supported the *Finnigan* approach for three reasons.

First, the *Finnigan* approach generally benefits Massachusetts based businesses subject to the Massachusetts throw back rule as an affiliate's nexus in other states may curtail the instances in which throw back would otherwise apply. Second, the *Joyce* approach

allows taxpayers to manipulate their Massachusetts apportionment by having members that are not subject to Massachusetts tax sell products into Massachusetts (or perform services that would be sourced to Massachusetts). Under the *Joyce* approach, these sales would not be included in the numerator of the Massachusetts receipts factor; whereas, under the *Finnigan* approach, the sales would be included in the Massachusetts receipts factor numerator, thus eliminating this planning opportunity.

Third, the Department noted that although the *Joyce* theory has been prevalent among combined reporting states, the more recent trend is the adoption of the *Finnigan* approach. For example, Michigan recently adopted a unitary combined reporting regime with a *Finnigan* approach, recent New York case law condoned the application of *Finnigan*, and California adopted a *Finnigan* approach in recently promulgated apportionment regulations for mutual fund service providers. With respect to California, it should be noted that California is the original state in which the *Joyce* and *Finnegan* approaches arose through case law.[2] With the exception of this specialized industry regulation, California decided to adopt to the *Joyce* approach, irrespective of the fact that a subsequent California decision upheld the *Finnegan* approach.

E. NOLs and Credits

In a combined report setting, an issue arises as to whether tax attributes, such as NOL carryforwards and credits, generated by a member of the group can be taken into account by the entire group.

1. MTC and COST

The MTC proposal allows credits to be claimed by the entity that generated the credit (unless the credit statute specifically directs otherwise) and restricts NOL carryforward deductions to the individual taxpayer to which the loss was originally apportioned. COST challenged the application of MTC's treatment of NOLs as inconsistent with the combined reporting concept. According to COST, if a group of corporations are required to combine their income in order to produce an accurate reflection of income attributable to any one state, then the same logic ought to extend to losses generated by the same group of corporations.[14] Similarly, COST believes credits should be applied to offset the income of the entire combined group.

2. Department

The Governor's proposal did not address the application of credits in a combined return. Similarly, the proposal instructed the Commissioner of Revenue to promulgate regulations to address the manner in which net operating loss carryforwards would be taken into account in a combined report.

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[2] *See Appeal of Joyce Inc*, Cal. St. Bd. of Equal., 66-SBE-069, Nov. 23, 1966 *and Appeal of Finnigan Corporation*, Cal. St. Bd. of Equal., 88-SBE-022-A, 88-SBE-022-A, January 24, 1990.

[14] MTC, *Report of the Hearing Officer regarding the proposed Model Statute for Combined Reporting*, April 25, 2005, p. 23.

In the Department's opinion, however, credits should only be utilized by the member that generated the credits, unless the credit provision specifically authorizes the utilization of credits among affiliates. Regarding NOL carryforwards, the Department recognized that the treatment of NOLs warranted further examination as part of the regulations process. The Department noted its understanding that in many states the deduction has been limited to the member that generated the loss rather than shared among the group. Subcommittee members expressed the view that such an approach appears to contradict the overall notion of a combined report in which income, and therefore presumably losses, are pooled.

F. Combined Group Elections

1. Federal consolidated group election

An overriding concern regarding combined reporting is the degree of uncertainty inherent in determining the members of a unitary group. State combined reporting statutes and regulations generally are too vague to provide appropriate guidance and direction relative to the unitary relationship of, for example, affiliates within a conglomeration or recently acquired affiliates that continue to operate autonomously. This uncertainty sheds doubt as to whether the tax liability reported on a combined basis will ultimately be sustained on audit.

The uncertainty inherent in a combined reporting regime can have a significant negative impact on financial statements. Financial accounting standards require corporations to record reserves for uncertain tax positions. Effective for fiscal years beginning after December 15, 2006, FASB Interpretation No. 48 ("FIN 48") provides guidance as to the accounting for uncertain tax positions. Under FIN 48, a tax benefit from an UTP may only be recognized, in whole or in part, if it is more-likely-than-not that the position is sustainable based solely on technical merits and any relevant administrative practices; otherwise, a full reserve of the tax benefit associated with the UTP is necessary.[3] As compared to its predecessor (i.e., FAS 109), FIN 48 has a much broader focus on the identification and measurement of uncertain tax positions.

Given the vague definitions of a unitary business, there could be several plausible conclusions regarding the composition of affiliates that form a unitary business, any one of which may be advocated by the state or the taxpayer. As a result, corporations have been forced to record sizeable tax reserves to address these uncertainties, particularly given the recent adoption of FIN 48. These reserves will impact financial statements until the tax years at issue are closed for assessment which, given the audit history in combined reporting states, may not be for approximately eight to twenty years.

The inherent uncertainty in combined reporting could be eliminated if taxpayers were provided with an election to use their federal consolidated group as their combined group

[3] FASB Interpretation No. 48 ("FIN 48") replaced FAS 5 as the guidance in accounting for uncertain tax positions recognized in accordance with FAS 109.

(hereinafter, "federal consolidated group election"). The election would provide taxpayers with an option that would reduce the instances of long and expensive audits between taxpayers and the taxing authorities regarding the appropriate composition of entities to include in the combined group. Of most importance, the election would provide taxpayers with a level of assurance that would eliminate material financial statement consequences that could otherwise exist under a combined reporting regime.

From the state's perspective, the election generally should not disturb the advantageous of a combined reporting regime that the Department seeks to obtain. The election would require a federal consolidated group of taxpayers to compute their Massachusetts taxable income on a combined basis in accordance with the fundamental rules and principles of a combined reporting regime. The election, therefore, should eliminate most of the income shifting opportunities among affiliates that the Department noted as an inherent weakness of the current separate entity approach.[4] At the same time, the election could significantly decrease tax controversies and provide taxpayers with a level of certainty regarding their Massachusetts tax liability calculated under a combined reporting regime.

2. Massachusetts combined group election

The Subcommittee was also asked to consider recommending that the existing Massachusetts combined reporting option be preserved to the extent of permitting federal consolidated return groups to file in such a way that the apportioned losses of non-unitary members of the group doing business in the Commonwealth could be used against the apportioned income of the unitary group.

As mentioned above, under the current separate reporting regime in Massachusetts, members of a federal consolidated group that are separately subject to Massachusetts tax can elect to file a "combined return." A Massachusetts combined return requires each member to separately determine its Massachusetts taxable income or loss and then the results are "combined. " The main advantage of filing a Massachusetts combined return is the ability to offset current year losses against current year income of the members.

It has been suggested that this type of election could reduce controversies that would otherwise arise regarding whether certain Massachusetts affiliates share a unitary relationship and, therefore, eliminate some of the audit risks that opponents associate with combined reporting.

3. Commentary

The federal consolidated group election and Massachusetts combined group election were recently brought to the attention of the Subcommittee. The Subcommittee, therefore, recommends that the Commission solicit comments and opinions from industry, organizations and the Department regarding the merits of the alternative elections.

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[4] The election could be irrevocable for an extended period (e.g., ten years) to ameliorate, over time, any short-term tax advantages associated with the election.

APPENDIX L

Subcommittee on Minimum Corporate Excise – "Status Report"
(dated October 16, 2007)

Status Report of the Study Commission on Corporate Taxation's Subcommittee on Corporate Minimum Tax

October 16, 2007

Introduction:

The Subcommittee was established by the Study Commission on Corporate Taxation to provide additional focus and review on the efficacy of the Massachusetts corporate minimum excise tax.

The members appointed to the subcommittee, all of whom serve on the full Commission, are Senator Cynthia Stone Creem (Chair), Alan Lebovidge and Michael Widmer.

The Subcommittee held two public meetings at the State House on September 20, 2007 and October 15, 2007.

Prior to the first meeting a request for information and statistics relating to the taxation of corporations was made to the Department of Revenue. An analysis of this information was prepared by Senator Creem's office and presented to the subcommittee for discussion at the September 20th meeting (see attached exhibits A & B). During the course of the discussion it was determined that additional information would be helpful and a second request for information was made to DOR. The information received from DOR relative to the second request for information was again analyzed and presented to the subcommittee for discussion at the October 15th meeting (see exhibits C & D).

Background:

In 2005, Senator Creem conducted a detailed analysis and issued a report on the corporate minimum excise tax. The report found (using tax year 2000 statistics) that 74% of all corporate filers paid the minimum corporate excise of $456. The report then went on to identify factors that may cause this result by identifying dormant corporations, separating out S.Corps, and gauging the effect of corporations using statutorily authorized policies and incentives to reduce their tax burden (i.e. use of credits or single sales factor apportionment.) However, after considering these possible explanations for the high percentage of minimum filers, the report still found that:

- More than 50% of "active" corporations paid the minimum excise.
- 37% of corporations reporting more than $10 million in gross receipts paid the minimum excise.
- 20% of the State's largest 50 employers paid the minimum excise.
- Only 8% of minimum filers with sales of more than $10 million used tax credits or single sales factor apportionment.

Current Subcommittee Findings:

In seeking more updated information from DOR, the subcommittee first wanted to test the assumptions and findings of the aforementioned analysis to determine if they remained valid. The information provided by DOR to the subcommittee utilizing tax year 2004 statistics was consistent with the findings of the previous report including the following:

- Out of 152,127 total corporate filers, 115,886 or 76% of all filers pay the minimum excise.

- Minimum filers pay only 6% of the total corporate excise tax collected. Therefore….94% of the annual corporate excise collected is paid by only 24% of all corporate filers. As demonstrated below, however, this is not because larger corporations are universally carrying a larger tax burden than their small counterparts.

- There were 2,283 filers with gross sales of more than $50M that paid the minimum corporate excise.

    - This represents 33% of all filers with sales of more than $50M.

    - The average net worth of these companies was $355.4 million.

    - Total corporate tax paid by these companies was: $1,041,048.

    - 1,657 or 72% of these companies paid the minimum ***without*** the benefit of credits, carry over losses, or single sales factor apportionment.

    - There were 221 minimum filers (out of 864 total corporations) with sales of more than ***$1B***. The average net worth of these companies was almost $2 billion. The total tax paid by these companies was $100,776.

    - Of minimum filing companies with sales over $1 billion – 131 or 59% ***did not*** utilize credits, carry over losses, or single sales factor apportionment

Conclusion and Recommendations:

The subcommittee found it significant that many large corporations were paying the minimum corporate excise, despite reporting significant net worth and sales. In keeping with one of the Commission's original stated goals, "to promote [business] tax fairness and equity," the subcommittee agreed that additional information and analysis was needed to enhance the full Commission's understanding of the application and use of the

minimum corporate excise tax. In this regard, the subcommittee is seeking the following additional information from the Department of Revenue:

1. Information relative to minimum tax filers in 2005.
2. With regard to the 131 filers paying the minimum with sales greater than $1B, and not using credits, carryover losses, or single sales factor apportionment, and for the largest 50 companies by sales (Boston Globe 100 article) doing business in the state:
    (a) Is the filer part of a consolidated entity which has taxable profit in the United States?
    (b) What can be determined or gleaned from the filers' Massachusetts returns as to why they are paying the minimum?
    (c) Considering all the facts, and allowing for deductive reasoning, what additional reasons are there as to why these companies are paying the minimum excise in Massachusetts which are not directly set forth on the return?

The Department of Revenues has indicated that it will provide information to the subcommittee by Friday October 19th or it will provide an estimate as to when the information will be made available.

EXHIBIT A

Analysis TY 2004 Corporate Tax Statistics

GENERALLY:

- 115,886 filers, or 76% of all filers pay the minimum.
- Minimum filers pay about 6% of total corporate tax. Therefore….24% of filers pay 94% of Corporate Tax.

- There were 2283 minimum filers with sales of more than $50 million.
- There were 6883 filers in total who had sales of more than $50 million. Therefore…One-third of all filers with sales of more than $50 million pay the minimum.

- Total corporate excise paid by corporations with sales of more than $50 million was $428,957,934 representing 46% of total corporate excise paid.
- Total corporate excise paid by minimum tax paying corporations with sales of more than $50 million was $1,041,048. Therefore…these large corporations that pay less than one-quarter of one percent the amount paid by similar large corporations pay one tenth of one percent of total corporate excise paid.

TAX CREDITS:

- 3,671 filers, or 2.4% of total filers, utilize available tax credits.
- 1,364 filers, or .8% of total filers, utilize available tax credits *and* pay the minimum.
- 37% of all filers *who use credits* pay the minimum excise.

- There were 575 filers who used credits and had sales of more than $50 million.
- Of these, 153 or 26% paid the minimum excise.

CARRY FORWARD LOSSES (CFL):

- 13,088 filers, or 8.6% of total filers, utilize CFL's.
- 8,418 filers, or 5.5% of total filers, utilize CFL's *and* pay the minimum excise.
- 64% of all filers *who use CFL's* pay the minimum excise.

- There were 1,222 filers who used CFL's and had sales of more than $50 million.
- Of these, 429 or 35% paid the minimum excise.

SINGLE SALES FACTOR (SSF):

- 1,135 filers, or .7% of total filers, utilize SSF.
- 412 filers, or .2% of total filers uses SSF *and* pay the minimum excise.
- 36% of all filers *who use SSF* pay the minimum excise.

- There were 626 filers who used SSF and had sales of more than $50 million.
- Of these, 166 or 26% paid the minimum excise.

S CORPORATIONS GENERALLY:

- 84,462 filers, or 55% of total filers are S Corporations.
- 72,079 filers, or 47% of total filers are S Corporations and pay the minimum excise.
- 85% of all S Corporations pay the minimum excise.

- There were 1,463 filers that were S Corporations with sales of more than $50 million.
- Of these, 493 or 33% paid the minimum.

S CORPORATIONS USING CREDITS:

- 1,231 S CORP filers, or 1.5% of total S CORP filers, utilize available tax credits.
- 379 S CORP filers, or .4% of total S CORP filers, utilize available tax credits *and* pay the minimum.
- 37% of all S CORP filers *who use credits* pay the minimum excise.

- There were 90 S CORP filers who used credits and had sales of more than $50 million.
- Of these, 10 S CORP filers or 11% paid the minimum excise.

S CORPORATIONS WITH CARRY FORWARD LOSSES (CFL'S):

- 779 S CORP filers, or .9% of total S CORP filers, utilize CFL's.
- 328 S CORP filers, or .3% of total S CORP filers, utilize CFL's *and* pay the minimum excise.
- 42% of all S CORP filers *who use CFL's* pay the minimum excise.

- There were 104 S CORP filers who used CFL's and had sales of more than $50 million.
- Of these, 39 S CORP filers or 38% paid the minimum excise.

S CORPORATIONS USING SINGLE SALES FACTOR:

- 89 S Corp filers utilize SSF.
- 26 S Corp filers use SSF *and* pay the minimum excise.
- 29% of all S Corp filers *who use SSF* pay the minimum excise.

- There were 33 S Corp filers who used SSF and had sales of more than $50 million.
- Of these, 8 or 24% paid the minimum excise.

NON-S CORPORATIONS GENERALLY:

- 67,655 filers, or 44% of total filers are Non-S Corporations.
- 43,807 filers, or 28% of total filers are Non-S Corporations and pay the minimum excise.
- 65% of all Non-S Corporations pay the minimum excise.

- There were 5,420 filers that were Non-S Corporations with sales of more than $50 million.
- Of these, 1,790 or 33% paid the minimum.

NON-S CORPORATIONS USING CREDITS:

- 2,438 Non-S CORP filers, or 3.6% of total Non-S CORP filers, utilize available tax credits.
- 985 Non-S CORP filers, or 1.4% of total Non-S CORP filers, utilize available tax credits *and* pay the minimum.
- 40% of all Non-S CORP filers *who use credits* pay the minimum excise.

- There were 485 Non-S CORP filers who used credits and had sales of more than $50 million.
- Of these, 143 Non-S CORP filers or 29% paid the minimum excise.

NON-S CORPORATIONS WITH CARRY FORWARD LOSSES (CFL'S):

- 12,309 Non- S CORP filers, or .18% of total Non-S CORP filers, utilize CFL's.

- 8,090 Non-S CORP filers, or 12% of total Non-S CORP filers, utilize CFL's *and* pay the minimum excise.
- 65% of all Non-S CORP filers *who use CFL's* pay the minimum excise.

- There were 1118 Non-S CORP filers who used CFL's and had sales of more than $50 million.
- Of these, 390 Non-S CORP filers or 34% paid the minimum excise.

NON-S CORPORATIONS USING SINGLE SALES FACTOR:

- 1,046 Non-S Corp filers utilize SSF.
- 386 Non-S Corp filers use SSF *and* pay the minimum excise.
- 37% of all Non-S Corp filers *who use SSF* pay the minimum excise.

- There were 593 Non-S Corp filers who used SSF and had sales of more than $50 million.
- Of these, 158 or 26% paid the minimum excise.

EXHIBIT B

THE MASSACHUSETTS CORPORATE EXCISE TAX:

WHO PAYS THE MINIMUM … AND HOW?

Massachusetts Study Commission on Corporate Taxation
Subcommittee on the Corporate Minimum Tax
September 20, 2007

Corporations by Sales Level and Minimum-Filing Status in Tax Year 2004[1]

	Paid Minimum Tax	Paid More than the Minimum	Total
All Filers	115,886 (76%)	36,241 (24%)	152,127
Sales > $50M	2283 (33%)	4600 (67%)	6883
Sales > $500M	379 (25%)	1109 (75%)	1488

Among all corporations in Massachusetts, 76% paid only the minimum in TY04. Many of these ha d only modest sales, but among those with sales above $50M, 33% still paid only the minimum tax. Furthermore, **25% of corporations with sales exceeding $500M claimed only the minimum $456 tax bill**.

For S-corporations, which make up 55% of Massachusetts filers, taxes are applied to income differently from non-S-corporations. And indeed, 85% of these firms paid the minimum. But what about the non-S-corporations that paid the minimum?

[1] All original data in this presentation comes from the Massachusetts Department of Revenue, with additional analysis by Senator Cynthia Stone Creem.

Non-S-Corporations by Sales Level and Minimum-Filing Status in Tax Year 2004

	Paid Minimum Tax	Paid More than the Minimum	Total
All Filers	43,807 (65%)	23,858 (35%)	67,665
Sales > $50M	1790 (33%)	3630 (67%)	5420
Sales > $500M	333 (24%)	1028 (76%)	1361

When S-corporations are removed from the picture, the results are strikingly similar for the largest corporations: **33% of those with sales in excess of $50M and 24% of those with more than $500M in sales paid the minimum for TY04**.

The next question is: How are these large corporations able to pay only the minimum tax? There are certain legislated tax incentives that, in some cases, corporations may avail themselves of in filing their taxes. The next two charts look specifically at the corporations that use these incentives – and what role they may play in allowing the corporations to pay only the minimum.

Use of Legislated Tax Incentives by Corporations with Sales Above $50M in Tax Year 2004

	Paid Minimum Tax	Paid More than Minimum	Total Filers
Total Filers	2283	4600	6883
Use Credits	153	422	575
Use CFL[2]	429	793	1222
Use SSF[3]	166	460	626
Use at least one of the above[4]	748	1675	2423
Percentage that use one of the above[5]	**33% or less**		
Percentage that do not	**67% or more**		

In other words, among **the largest corporations, no more than 33% of the minimum-tax filers availed themselves of one of these legislatively-sanctioned methods** of reducing their tax burdens in TY04. **How did the other two-thirds-plus get to the minimum?**

In the case of S-corporations, the answer could again lie in their allocation of income. So what about non-S-corporations?

[2] CFL: carried-forward net operating losses from previous years
[3] SSF: single-sales-factor apportionment (rather than using the three-part apportionment factor)
[4] There is some overlap caused by some companies using more than one of these methods to reduce their tax. Therefore, these figures may actually be lower.
[5] See note 4 above.

Use of Legislated Tax Incentives by
Non-S-Corporations with Sales Above $50M in Tax Year 2004

	Paid Minimum Tax	Paid More than Minimum	Total Filers
Total Filers	1790	3630	5420
Use Credits	143	342	485
Use CFL	390	728	1118
Use SSF	158	435	593
Use at least one of the above	691	1505	2196
Percentage that use one of the above	**39% or less**		
Percentage that do not	**61% or more**		

So, if 61% of the largest non-S-corporations that paid only the minimum are not using credits, carried-forward losses, or single-sales-factor apportionment to reduce their tax to the minimum, the question remains:

How are those 1000+ large corporations doing it?

EXHIBIT C

Further Look at Filers with Gross Sales Greater than $50M

All Filers:

- There are 6,883 filers with sales of more than $50M.
    - 1,463 S Corps – of these 127 have sales of more than $500M
    - 5,420 Non S Corps
    - Total Net Worth - $2.4 trillion
    - Total Corporate Tax Paid - $428,957,934

Minimum Filers with Gross Sales Greater than $50M:

- There were 2,283 filers with sales of more than $50M that paid the minimum corporate excise.
    - This represents 33% of all filers with sales of more than $50M.
    - Total net worth of these companies is: $486.9 billion (represents only the 1,370 companies that provided Schedule A's)
    - Total Corporate Tax Paid: $1,041,048
    - 1,657 or 72% paid the minimum without the benefit of credits, carry over losses, or single sales factor apportionment.
    - There were 221 minimum filers having sales of more than $1B. The net worth of these companies totaled almost $272 billion. The total tax paid by these companies was a little over $100,000.
    - Of minimum filing companies with sales over $1 billion – 131 or 59% ***did not*** utilize credits, carry over losses, or single sales factor apportionment

S Corp Minimum Filers with Gross Sales Greater than $50M:

- There were 493 S Corp filers with sales of more than $50M that paid the minimum corporate excise.
    - This represents 21% of all minimum filers with sales of more than $50M.

- Total net worth of these companies is: $9.9 billion (represents only the 292 companies that provided Schedule A's)
- Total Corporate Tax Paid: $224,808
- 440 or 89% paid the minimum without the benefit of credits, carry over losses, or single sales factor apportionment.
- There were 29 S Corp minimum filers having sales of more than $1B. The net worth of these companies was $3.1 billion. Total tax paid by these companies was $13,224
- 27 out of 29 of S Corp minimum filers having sales of more than $1B paid the minimum **without** the benefit of credits, carry over losses, or single sales factor apportionment.

Non S Corp Minimum Filers with Gross Sales Greater than $50M:

- There were 1,790 Non S Corp filers with sales of more than $50M that paid the minimum corporate excise.
  - This represents 79% of all minimum filers with sales of more than $50M.
  - Total net worth of these companies is: $476.9 billion (represents only the 1,078 companies that provided Schedule A's)
  - Total Corporate Tax Paid: $816,240
  - 1,217 or 68% paid the minimum without the benefit of credits, carry over losses, or single sales factor apportionment.
  - There were 192 Non S Corp minimum filers having sales of more than $1B. The net worth of these companies was $268.7 billion. Total tax paid by these companies was $87,552.
  - 104 out of the 192 Non S Corp minimum filers having sales of more than $1B paid the minimum **without** the benefit of credits, carry over losses, or single sales factor apportionment.

EXHIBIT D

		Minimum Payers with Gross Sales > $50 Million					Million credits, No Loss Carryovers, Non-single sales fa					
		Tax Paid		Computed Net Worth (from Schedule A's, if figues were available)		Average Net Worth (where available)	Tax Paid		Computed Net Worth (from Schedule A's, if figues were available)		Average Net Worth (where available)	$1 in Tax Paid per $__ of Net Worth (where figures available)
	Sales Range	Count	Amount	Count	(Total Assets - Total Liability)		Count	Amount	Count	(Total Assets - Total Liability)		
All	>1B	221	$100,776	136	$271,964,560,367	$1,999,739,414	131	$59,736	79	$132,161,739,902	$1,672,933,416	$3,668,714
	500M to 1B	158	$72,048	96	$46,752,594,189	$487,006,189	101	$46,056	61	$24,108,784,206	$395,225,971	$866,724
	100M to 500M	965	$440,040	568	$143,141,927,888	$252,010,436	700	$319,200	412	$113,241,777,279	$274,858,683	$602,760
	50M to 100M	939	$428,184	570	$25,049,815,291	$43,947,044	725	$330,600	426	$15,340,668,610	$36,010,959	$78,971
	Total	2,283	$1,041,048	1,370	$486,908,897,735	$355,407,955	1,657	$755,592	978	$284,852,969,997	$291,260,706	$638,730
		-	-	-	-		-	-	-	-		
S Corp	>1B	29	$13,224	20	$3,171,794,212	$158,589,711	27	$12,312	18	$2,698,579,033	$149,921,057	$328,774
	500M to 1B	17	$7,752	12	$297,052,974	$24,754,415	16	$7,296	12	$297,052,974	$24,754,415	$54,286
	100M to 500M	162	$73,872	99	$4,212,633,664	$42,551,855	146	$66,576	94	$3,078,641,660	$32,751,507	$71,823
	50M to 100M	285	$129,960	161	$2,305,721,513	$14,321,252	251	$114,456	140	$2,111,953,623	$15,085,383	$33,082
	Total	493	$224,808	292	$9,987,202,363	$34,202,748	440	$200,640	264	$8,186,227,290	$31,008,437	$68,001
		-	-	-	-		-	-	-	-		
Non-S Corp	>1B	192	$87,552	116	$268,792,766,155	$2,317,179,019	104	$47,424	61	$129,463,160,869	$2,122,346,899	$4,654,270
	500M to 1B	141	$64,296	84	$46,455,541,215	$553,042,157	85	$38,760	49	$23,811,731,232	$485,953,699	$1,065,688
	100M to 500M	803	$366,168	469	$138,929,294,224	$296,224,508	554	$252,624	318	$110,163,135,619	$346,424,955	$759,704
	50M to 100M	654	$298,224	409	$22,744,093,778	$55,609,031	474	$216,144	286	$13,228,714,987	$46,254,248	$101,435
	Total	1,790	$816,240	1,078	$476,921,695,372	$442,413,447	1,217	$554,952	714	$276,666,742,707	$387,488,435	$849,755

		More Than Minimum Payers with Gross Sales > $50 Million					More Than Minimum Payers with Gross Sales > $50 Million No credits, No Loss Carryovers, Non-single sales factor				
		Tax Paid		Computed Net Worth (from Schedule A's, if figues were available)		Average Net Worth (where available)	Tax Paid		Computed Net Worth (from Schedule A's, if figues were available)		Average Net Worth (where available)
	Sales Range	Count	Amount	Count	(Total Assets - Total Liability)		Count	Amount	Count	(Total Assets - Total Liability)	
All	>1B	643	$222,719,800	576	$1,324,180,200,000	$2,298,923,958	404	$139,741,799	371	$525,226,131,192	$1,415,703,858
	500M to 1B	466	$42,716,278	421	$208,387,430,511	$494,982,020	315	$26,640,174	286	$105,439,461,541	$368,669,446
	100M to 500M	2,052	$114,226,894	1,847	$323,370,285,350	$175,078,660	1,420	$67,629,570	1,269	$227,699,272,909	$179,432,051
	50M to 100M	1,439	$48,253,914	1,280	$64,084,358,690	$50,065,905	1,066	$29,201,171	942	$39,566,614,524	$42,002,776
	Total	4,600	$427,916,886	4,124	$1,920,022,274,551	$465,572,811	3,205	$263,212,714	2,868	$897,931,480,166	$313,086,290
		-	-	-	-		-	-	-	-	
S Corp	>1B	27	$8,476,454	24	$4,301,372,060	$179,223,836	24	$2,632,629	21	$3,393,476,199	$161,594,105
	500M to 1B	54	$6,103,011	51	$7,918,099,767	$155,256,858	44	$5,068,683	42	$5,814,598,674	$138,442,826
	100M to 500M	402	$18,718,070	356	$19,326,859,868	$54,288,932	348	$13,031,866	308	$15,828,955,984	$51,392,714
	50M to 100M	487	$15,699,935	416	$6,148,207,567	$14,779,345	406	$12,236,847	343	$4,482,289,400	$13,067,899
	Total	970	$48,997,470	847	$37,694,539,262	$44,503,588	822	$32,970,025	714	$29,519,320,257	$41,343,586
		-	-	-	-		-	-	-	-	
Non-S Corp	>1B	616	$214,243,346	552	$1,319,878,827,940	$2,391,084,833	380	$137,109,170	350	$521,832,654,993	$1,490,950,443
	500M to 1B	412	$36,613,267	370	$200,469,330,744	$541,809,002	271	$21,571,491	244	$99,624,862,867	$408,298,618
	100M to 500M	1,650	$95,508,824	1,491	$304,043,425,482	$203,919,132	1,072	$54,597,704	961	$211,870,316,925	$220,468,592
	50M to 100M	952	$32,553,979	864	$57,936,151,123	$67,055,730	660	$16,964,324	599	$35,084,325,124	$58,571,494
	Total	3,630	$378,919,416	3,277	$1,882,327,735,289	$574,405,778	2,383	$230,242,689	2,154	$868,412,159,909	$403,162,563

APPENDIX M

Subcommittee on Minimum Corporate Excise – "Final Report"
(dated December 5, 2007)

Final Report of the Study Commission on Corporate Taxation's Subcommittee on Corporate Minimum Tax

December 5, 2007

A majority of the members of the Subcommittee (Senator Creem and Mr. Lebovidge – with Mr. Widmer dissenting) respectfully submits the following as its Final Report to the Study Commission.

INTRODUCTION

The Subcommittee was established by the Study Commission on Corporate Taxation to provide additional focus and review on the efficacy of the Massachusetts corporate minimum excise tax.

The members appointed to the subcommittee, all of whom serve on the full Commission, are Senator Cynthia Stone Creem (Chair), Alan Lebovidge and Michael Widmer.

The Subcommittee held three public meetings at the State House on September 20, 2007, October 15, 2007, and December 4, 2007.

Prior to the first meeting a request for information and statistics relating to the taxation of corporations was made to the Department of Revenue. An analysis of this information was prepared by Senator Creem's office and presented to the subcommittee for discussion at the September 20th meeting (see attached exhibits A & B). During the course of the discussion it was determined that additional information would be helpful and a second request for information was made to DOR. The information received from DOR relative to the second request for information was again analyzed and presented to the subcommittee for discussion at the October 15th meeting (see exhibits C & D). Subsequent to the presentation of the subcommittee's interim status report to the full Commission on October 16, 2007, further requests for information were made to DOR and its responses were analyzed and are incorporated in this report.

CONCLUSIONS AND RECOMMENDATIONS

Based on the information derived from an analysis of corporate filers paying the minimum excise, the subcommittee finds that the State's corporate excise system does not promote, nor is it reflective of, a fair and equitable corporate tax structure. The subcommittee finds it significant that many large corporations were paying the minimum corporate excise, despite reporting significant net worth and sales. In terms of equity – which was one of the goals of the Commission from the outset, the current system falls short.

The subcommittee finds that corporations that appear to be in similar financial condition pay significantly different amounts in taxes. In some cases, it appears that highly-profitable corporations are paying the minimum, while smaller, less well-off corporations are paying significantly more. This promotes neither "vertical" nor "horizontal" tax equity.

Further, an analysis of certain corporate entities that pay only the minimum excise leads the subcommittee to conclude that a number of large corporations are structured to shift income to out-of-state affiliates in order to reduce the excise owed to Massachusetts. Companies using such strategies appear to be going beyond the tax incentives intended by the Legislature. The subcommittee believes that any reform to the corporate excise system should be structured to minimize such strategies.

The subcommittee believes that corporations paying the minimum excise should be limited to those that are both minimally profitable and with minimal financial resources – these would include those that are effectively inactive. The subcommittee believes that working towards such an outcome would improve the overall fairness of the State's corporate tax system. While there is an argument for simply increasing the minimum excise from its current rate of $456, the subcommittee does not believe that this alone would achieve the Commission's goals. The subcommittee therefore finds that a reform of the corporate tax system is needed, and recommends the adoption of some form of combined reporting.

The subcommittee also believes that a review of the net worth calculation may also be warranted under either a proposed combined reporting system or within the current structure.

The subcommittee's view of the minimum itself is colored by what, if anything is done to reform the corporate tax system. If steps are taken to make it more equitable (i.e. combined reporting), then the only remaining decision need be the absolute size of the minimum excise for very small and/or inactive corporations (we make no suggestion here). On the other hand, if no reform of the corporate tax system is put in place, the subcommittee believes that consideration of changing the existing minimum excise structure to one that is based upon a company's size (i.e. revenue, net worth …) is appropriate.

ANALYSIS

Background:

In 2005, Senator Creem conducted a detailed analysis and issued a report on the corporate minimum excise tax. The report found (using tax year 2000 statistics) that 74% of all corporate filers paid the minimum corporate excise of $456. The report then went on to identify factors that may cause this result by identifying dormant corporations, separating out S-Corps, and gauging the effect of corporations using statutorily

authorized policies and incentives to reduce their tax burden (i.e., use of credits or single-sales-factor apportionment.) However, after taking into consideration these possible explanations for the high percentage of minimum filers, the report still found that:

- More than 50% of corporations with positive gross receipts paid the minimum excise.
- 37% of corporations reporting more than $10 million in gross receipts paid the minimum excise.
- 20% of the State's largest 50 employers paid the minimum excise.
- Only 8% of minimum filers with sales of more than $10 million used tax credits or single-sales-factor apportionment.

Subcommittee Findings:

In seeking more updated information from DOR, the subcommittee first wanted to test the assumptions and findings of the aforementioned analysis to determine if they remained valid. The information provided by DOR to the subcommittee utilizing tax year 2004 statistics was consistent with the findings of the previous report, including the following:

- Out of 152,127 total corporate filers, 115,886 or 76% of all filers pay the minimum excise.

- Minimum filers pay only 6% of the total corporate excise tax collected. Therefore….94% of the annual corporate excise collected is paid by only 24% of all corporate filers. As demonstrated below, however, this is not because larger corporations are universally carrying a larger tax burden than their small counterparts.

- There were 2,283 filers with gross sales of more than $50M that paid the minimum corporate excise.

    - This represents 33% of all filers with sales of more than $50M.

    - The average net worth of these companies was $355.4 million.

    - Total corporate tax paid by these companies was: $1,041,048.

    - 1,657 or 73% of these companies paid the minimum ***without*** the benefit of credits, carry over losses, or single-sales-factor apportionment.

    - There were 207 minimum filers (out of 864 total corporations) with sales of ***more than $1B***. For the 60% of corporate filers in this category for which the information was available, t he average net worth of the 207

companies was almost $2 billion. The total tax paid by these companies was $100,776.

- Of minimum-filing companies with sales over $1 billion – 117 or 53% ***did not*** utilize credits, carry over losses, or single sales factor apportionment.

The subcommittee also received some "rough" numbers from DOR relative to tax year 2005 corporate taxpayer statistics. This information was sufficient to conclude that there would be no significant change in findings if a full analysis of TY 2005 statistics were conducted if such information was fully compiled.

Additionally, as reported in its status report to the full Commission, the subcommittee found it significant that so many large corporations were paying the minimum corporate excise, despite reporting significant net worth and sales, and agreed that additional information and analysis was needed to explain this dichotomy. Specifically, the subcommittee chose to focus on the 117 Massachusetts corporations with sales of more than $1 billion that did not utilize credits carry over losses, or single sales factor apportionment. The following findings were made relative to this group.

Findings on Minimum Taxpayers Among the Largest Corporations:

DOR responded to the subcommittee's further requests by subjecting the tax year 2004 returns of the aforementioned 131 corporate taxpayers to closer scrutiny. It was then discovered that 14 of these 131 had been inadvertently included in the original count, leaving a total of 117 corporations that paid the minimum tax despite having gross receipts above $1 billion that year, and despite not using any of the previously-discussed sanctioned incentives to reduce their tax burdens.

Most prominently, DOR found that 35 of these filers had "reduced their tax payments due to some form of income shifting". These firms filed as separate entities yet exist as part of larger multi-state groups of affiliated corporations. In each case, while the minimum-paying entity was reporting little or no income (or a loss), the larger group reported substantial profit.

DOR believes – and the subcommittee agrees -- that this generally results from income being "shifted away from the Massachusetts filer … to out-of-state affiliates through various types of transactions with those out-of-state affiliates, such as inter-company interest or royalties, or through the transfer price of sales of goods or services." As a consequence of such actions, these groups were able to attribute less income to Massachusetts and more to other states – presumably states with lower corporate tax rates.

Crucially, DOR noted that such income-shifting "is not limited to corporations paying the minimum excise". Rather, these 35 corporations "represent a small subset of a larger income-shifting problem which is best addressed through combined reporting." That is,

many more taxpayers are reducing their taxes through similar means. But because the reduction does not, in these instances, reduce their tax burdens to $456 or below, these corporations were not captured in the sample the subcommittee referred to DOR for special review.

Also not captured were the many companies with receipts totaling less than $1 billion in tax year 2004. DOR previously reported to the subcommittee that in the $50 million to $1 billion range, there were an additional 1,526 taxpayers that did not take advantage of any of the state's tax incentives yet paid the minimum. Even if a smaller proportion of these "second-tier" businesses used income-shifting to reach the minimum, and even if they reduced their tax burdens to a lesser extent, on average, than the 35 largest did, the subcommittee believes it is still safe to assume that this, too, expands the amount of lost revenue significantly.

EXHIBIT A

Analysis TY 2004 Corporate Tax Statistics

GENERALLY:

- 115,886 filers, or 76% of all filers pay the minimum.
- Minimum filers pay about 6% of total corporate tax. Therefore….24% of filers pay 94% of Corporate Tax.

- There were 2283 minimum filers with sales of more than $50 million.
- There were 6883 filers in total who had sales of more than $50 million. Therefore…One-third of all filers with sales of more than $50 million pay the minimum.

- Total corporate excise paid by corporations with sales of more than $50 million was $428,957,934 representing 46% of total corporate excise paid.
- Total corporate excise paid by minimum tax paying corporations with sales of more than $50 million was $1,041,048. Therefore…these large corporations that pay less than one-quarter of one percent the amount paid by similar large corporations pay one tenth of one percent of total corporate excise paid.

TAX CREDITS:

- 3,671 filers, or 2.4% of total filers, utilize available tax credits.
- 1,364 filers, or .8% of total filers, utilize available tax credits *and* pay the minimum.
- 37% of all filers *who use credits* pay the minimum excise.

- There were 575 filers who used credits and had sales of more than $50 million.
- Of these, 153 or 26% paid the minimum excise.

CARRY FORWARD LOSSES (CFL):

- 13,088 filers, or 8.6% of total filers, utilize CFL's.
- 8,418 filers, or 5.5% of total filers, utilize CFL's *and* pay the minimum excise.
- 64% of all filers *who use CFL's* pay the minimum excise.

- There were 1,222 filers who used CFL's and had sales of more than $50 million.
- Of these, 429 or 35% paid the minimum excise.

SINGLE SALES FACTOR (SSF):

- 1,135 filers, or .7% of total filers, utilize SSF.
- 412 filers, or .2% of total filers uses SSF *and* pay the minimum excise.
- 36% of all filers *who use SSF* pay the minimum excise.

- There were 626 filers who used SSF and had sales of more than $50 million.
- Of these, 166 or 26% paid the minimum excise.

S CORPORATIONS GENERALLY:

- 84,462 filers, or 55% of total filers are S Corporations.
- 72,079 filers, or 47% of total filers are S Corporations and pay the minimum excise.
- 85% of all S Corporations pay the minimum excise.

- There were 1,463 filers that were S Corporations with sales of more than $50 million.
- Of these, 493 or 33% paid the minimum.

S CORPORATIONS USING CREDITS:

- 1,231 S CORP filers, or 1.5% of total S CORP filers, utilize available tax credits.
- 379 S CORP filers, or .4% of total S CORP filers, utilize available tax credits *and* pay the minimum.
- 37% of all S CORP filers *who use credits* pay the minimum excise.

- There were 90 S CORP filers who used credits and had sales of more than $50 million.
- Of these, 10 S CORP filers or 11% paid the minimum excise.

S CORPORATIONS WITH CARRY FORWARD LOSSES (CFL'S):

- 779 S CORP filers, or .9% of total S CORP filers, utilize CFL's.
- 328 S CORP filers, or .3% of total S CORP filers, utilize CFL's *and* pay the minimum excise.
- 42% of all S CORP filers *who use CFL's* pay the minimum excise.

- There were 104 S CORP filers who used CFL's and had sales of more than $50 million.
- Of these, 39 S CORP filers or 38% paid the minimum excise.

S CORPORATIONS USING SINGLE SALES FACTOR:

- 89 S Corp filers utilize SSF.
- 26 S Corp filers use SSF *and* pay the minimum excise.
- 29% of all S Corp filers *who use SSF* pay the minimum excise.

- There were 33 S Corp filers who used SSF and had sales of more than $50 million.
- Of these, 8 or 24% paid the minimum excise.

NON-S CORPORATIONS GENERALLY:

- 67,655 filers, or 44% of total filers are Non-S Corporations.
- 43,807 filers, or 28% of total filers are Non-S Corporations and pay the minimum excise.
- 65% of all Non-S Corporations pay the minimum excise.

- There were 5,420 filers that were Non-S Corporations with sales of more than $50 million.
- Of these, 1,790 or 33% paid the minimum.

NON-S CORPORATIONS USING CREDITS:

- 2,438 Non-S CORP filers, or 3.6% of total Non-S CORP filers, utilize available tax credits.
- 985 Non-S CORP filers, or 1.4% of total Non-S CORP filers, utilize available tax credits *and* pay the minimum.
- 40% of all Non-S CORP filers *who use credits* pay the minimum excise.

- There were 485 Non-S CORP filers who used credits and had sales of more than $50 million.
- Of these, 143 Non-S CORP filers or 29% paid the minimum excise.

NON-S CORPORATIONS WITH CARRY FORWARD LOSSES (CFL'S):

- 12,309 Non- S CORP filers, or .18% of total Non-S CORP filers, utilize CFL's.

- 8,090 Non-S CORP filers, or 12% of total Non-S CORP filers, utilize CFL's *and* pay the minimum excise.
- 65% of all Non-S CORP filers *who use CFL's* pay the minimum excise.

- There were 1118 Non-S CORP filers who used CFL's and had sales of more than $50 million.
- Of these, 390 Non-S CORP filers or 34% paid the minimum excise.

NON-S CORPORATIONS USING SINGLE SALES FACTOR:

- 1,046 Non-S Corp filers utilize SSF.
- 386 Non-S Corp filers use SSF *and* pay the minimum excise.
- 37% of all Non-S Corp filers *who use SSF* pay the minimum excise.

- There were 593 Non-S Corp filers who used SSF and had sales of more than $50 million.
- Of these, 158 or 26% paid the minimum excise.

EXHIBIT B

THE MASSACHUSETTS CORPORATE EXCISE TAX:

WHO PAYS THE MINIMUM … AND HOW?

Massachusetts Study Commission on Corporate Taxation
Subcommittee on the Corporate Minimum Tax
September 20, 2007

Corporations by Sales Level and Minimum-Filing Status in Tax Year 2004[1]

	Paid Minimum Tax	Paid More than the Minimum	Total
All Filers	115,886 (76%)	36,241 (24%)	152,127
Sales > $50M	2283 (33%)	4600 (67%)	6883
Sales > $500M	379 (25%)	1109 (75%)	1488

Among all corporations in Massachusetts, 76% paid only the minimum in TY04. Many of these ha d only modest sales, but among those with sales above $50M, 33% still paid only the minimum tax. Furthermore, **25% of corporations with sales exceeding $500M claimed only the minimum $456 tax bill**.

For S-corporations, which make up 55% of Massachusetts filers, taxes are applied to income differently from non-S-corporations. And indeed, 85% of these firms paid the minimum. But what about the non-S-corporations that paid the minimum?

[1] All original data in this presentation comes from the Massachusetts Department of Revenue, with additional analysis by Senator Cynthia Stone Creem.

Non-S-Corporations by Sales Level and Minimum-Filing Status in Tax Year 2004

	Paid Minimum Tax	Paid More than the Minimum	Total
All Filers	43,807 (65%)	23,858 (35%)	67,665
Sales > $50M	1790 (33%)	3630 (67%)	5420
Sales > $500M	333 (24%)	1028 (76%)	1361

When S-corporations are removed from the picture, the results are strikingly similar for the largest corporations: **33% of those with sales in excess of $50M and 24% of those with more than $500M in sales paid the minimum for TY04**.

The next question is: How are these large corporations able to pay only the minimum tax? There are certain legislated tax incentives that, in some cases, corporations may avail themselves of in filing their taxes. The next two charts look specifically at the corporations that use these incentives – and what role they may play in allowing the corporations to pay only the minimum.

Use of Legislated Tax Incentives by Corporations with Sales Above $50M in Tax Year 2004

	Paid Minimum Tax	Paid More than Minimum	Total Filers
Total Filers	2283	4600	6883
Use Credits	153	422	575
Use CFL[2]	429	793	1222
Use SSF[3]	166	460	626
Use at least one of the above[4]	748	1675	2423
Percentage that use one of the above[5]	**33% or less**		
Percentage that do not	**67% or more**		

In other words, among **the largest corporations, no more than 33% of the minimum-tax filers availed themselves of one of these legislatively-sanctioned methods** of reducing their tax burdens in TY04. **How did the other two-thirds-plus get to the minimum?**

In the case of S-corporations, the answer could again lie in their allocation of income. So what about non-S-corporations?

[2] CFL: carried-forward net operating losses from previous years
[3] SSF: single-sales-factor apportionment (rather than using the three-part apportionment factor)
[4] There is some overlap caused by some companies using more than one of these methods to reduce their tax. Therefore, these figures may actually be lower.
[5] See note 4 above.

Use of Legislated Tax Incentives by
Non-S-Corporations with Sales Above $50M in Tax Year 2004

	Paid Minimum Tax	Paid More than Minimum	Total Filers
Total Filers	1790	3630	5420
Use Credits	143	342	485
Use CFL	390	728	1118
Use SSF	158	435	593
Use at least one of the above	691	1505	2196
Percentage that use one of the above	**39% or less**		
Percentage that do not	**61% or more**		

So, if 61% of the largest non-S-corporations that paid only the minimum are not using credits, carried-forward losses, or single-sales-factor apportionment to reduce their tax to the minimum, the question remains:

How are those 1000+ large corporations doing it?

EXHIBIT C

Further Look at Filers with Gross Sales Greater than $50M

All Filers:

- There are 6,883 filers with sales of more than $50M.
    - 1,463 S Corps – of these 127 have sales of more than $500M
    - 5,420 Non S Corps
    - Total Net Worth - $2.4 trillion
    - Total Corporate Tax Paid - $428,957,934

Minimum Filers with Gross Sales Greater than $50M:

- There were 2,283 filers with sales of more than $50M that paid the minimum corporate excise.
    - This represents 33% of all filers with sales of more than $50M.
    - Total net worth of these companies is: $486.9 billion (represents only the 1,370 companies that provided Schedule A's)
    - Total Corporate Tax Paid: $1,041,048
    - 1,657 or 72% paid the minimum without the benefit of credits, carry over losses, or single sales factor apportionment.
    - There were 221 minimum filers having sales of more than $1B. The net worth of these companies totaled almost $272 billion. The total tax paid by these companies was a little over $100,000.
    - Of minimum filing companies with sales over $1 billion – 131 or 59% ***did not*** utilize credits, carry over losses, or single sales factor apportionment

S Corp Minimum Filers with Gross Sales Greater than $50M:

- There were 493 S Corp filers with sales of more than $50M that paid the minimum corporate excise.
    - This represents 21% of all minimum filers with sales of more than $50M.

- Total net worth of these companies is: $9.9 billion (represents only the 292 companies that provided Schedule A's)
- Total Corporate Tax Paid: $224,808
- 440 or 89% paid the minimum without the benefit of credits, carry over losses, or single sales factor apportionment.
- There were 29 S Corp minimum filers having sales of more than $1B. The net worth of these companies was $3.1 billion. Total tax paid by these companies was $13,224
- 27 out of 29 of S Corp minimum filers having sales of more than $1B paid the minimum **without** the benefit of credits, carry over losses, or single sales factor apportionment.

Non S Corp Minimum Filers with Gross Sales Greater than $50M:

- There were 1,790 Non S Corp filers with sales of more than $50M that paid the minimum corporate excise.
  - This represents 79% of all minimum filers with sales of more than $50M.
  - Total net worth of these companies is: $476.9 billion (represents only the 1,078 companies that provided Schedule A's)
  - Total Corporate Tax Paid: $816,240
  - 1,217 or 68% paid the minimum without the benefit of credits, carry over losses, or single sales factor apportionment.
  - There were 192 Non S Corp minimum filers having sales of more than $1B. The net worth of these companies was $268.7 billion. Total tax paid by these companies was $87,552.
  - 104 out of the 192 Non S Corp minimum filers having sales of more than $1B paid the minimum **without** the benefit of credits, carry over losses, or single sales factor apportionment.

EXHIBIT D

		Minimum Payers with Gross Sales > $50 Million					Million credits, No Loss Carryovers, Non-single sales fa					
		Tax Paid		Computed Net Worth (from Schedule A's, if figues were available)		Average Net Worth (where available)	Tax Paid		Computed Net Worth (from Schedule A's, if figues were available)		Average Net Worth (where available)	$1 in Tax Paid per $__ of Net Worth (where figures available)
	Sales Range	Count	Amount	Count	(Total Assets - Total Liability)		Count	Amount	Count	(Total Assets - Total Liability)		
All	>1B	221	$100,776	136	$271,964,560,367	$1,999,739,414	131	$59,736	79	$132,161,739,902	$1,672,933,416	$3,668,714
	500M to 1B	158	$72,048	96	$46,752,594,189	$487,006,189	101	$46,056	61	$24,108,784,206	$395,225,971	$866,724
	100M to 500M	965	$440,040	568	$143,141,927,888	$252,010,436	700	$319,200	412	$113,241,777,279	$274,858,683	$602,760
	50M to 100M	939	$428,184	570	$25,049,815,291	$43,947,044	725	$330,600	426	$15,340,668,610	$36,010,959	$78,971
	Total	2,283	$1,041,048	1,370	$486,908,897,735	$355,407,955	1,657	$755,592	978	$284,852,969,997	$291,260,706	$638,730
		-	-	-	-		-	-	-	-		
S Corp	>1B	29	$13,224	20	$3,171,794,212	$158,589,711	27	$12,312	18	$2,698,579,033	$149,921,057	$328,774
	500M to 1B	17	$7,752	12	$297,052,974	$24,754,415	16	$7,296	12	$297,052,974	$24,754,415	$54,286
	100M to 500M	162	$73,872	99	$4,212,633,664	$42,551,855	146	$66,576	94	$3,078,641,660	$32,751,507	$71,823
	50M to 100M	285	$129,960	161	$2,305,721,513	$14,321,252	251	$114,456	140	$2,111,953,623	$15,085,383	$33,082
	Total	493	$224,808	292	$9,987,202,363	$34,202,748	440	$200,640	264	$8,186,227,290	$31,008,437	$68,001
		-	-	-	-		-	-	-	-		
Non-S Corp	>1B	192	$87,552	116	$268,792,766,155	$2,317,179,019	104	$47,424	61	$129,463,160,869	$2,122,346,899	$4,654,270
	500M to 1B	141	$64,296	84	$46,455,541,215	$553,042,157	85	$38,760	49	$23,811,731,232	$485,953,699	$1,065,688
	100M to 500M	803	$366,168	469	$138,929,294,224	$296,224,508	554	$252,624	318	$110,163,135,619	$346,424,955	$759,704
	50M to 100M	654	$298,224	409	$22,744,093,778	$55,609,031	474	$216,144	286	$13,228,714,987	$46,254,248	$101,435
	Total	1,790	$816,240	1,078	$476,921,695,372	$442,413,447	1,217	$554,952	714	$276,666,742,707	$387,488,435	$849,755

		More Than Minimum Payers with Gross Sales > $50 Million					More Than Minimum Payers with Gross Sales > $50 Million No credits, No Loss Carryovers, Non-single sales factor				
		Tax Paid		Computed Net Worth (from Schedule A's, if figues were available)		Average Net Worth (where available)	Tax Paid		Computed Net Worth (from Schedule A's, if figues were available)		Average Net Worth (where available)
	Sales Range	Count	Amount	Count	(Total Assets - Total Liability)		Count	Amount	Count	(Total Assets - Total Liability)	
All	>1B	643	$222,719,800	576	$1,324,180,200,000	$2,298,923,958	404	$139,741,799	371	$525,226,131,192	$1,415,703,858
	500M to 1B	466	$42,716,278	421	$208,387,430,511	$494,982,020	315	$26,640,174	286	$105,439,461,541	$368,669,446
	100M to 500M	2,052	$114,226,894	1,847	$323,370,285,350	$175,078,660	1,420	$67,629,570	1,269	$227,699,272,909	$179,432,051
	50M to 100M	1,439	$48,253,914	1,280	$64,084,358,690	$50,065,905	1,066	$29,201,171	942	$39,566,614,524	$42,002,776
	Total	4,600	$427,916,886	4,124	$1,920,022,274,551	$465,572,811	3,205	$263,212,714	2,868	$897,931,480,166	$313,086,290
		-	-	-	-		-	-	-	-	
S Corp	>1B	27	$8,476,454	24	$4,301,372,060	$179,223,836	24	$2,632,629	21	$3,393,476,199	$161,594,105
	500M to 1B	54	$6,103,011	51	$7,918,099,767	$155,256,858	44	$5,068,683	42	$5,814,598,674	$138,442,826
	100M to 500M	402	$18,718,070	356	$19,326,859,868	$54,288,932	348	$13,031,866	308	$15,828,955,984	$51,392,714
	50M to 100M	487	$15,699,935	416	$6,148,207,567	$14,779,345	406	$12,236,847	343	$4,482,289,400	$13,067,899
	Total	970	$48,997,470	847	$37,694,539,262	$44,503,588	822	$32,970,025	714	$29,519,320,257	$41,343,586
		-	-	-	-		-	-	-	-	
Non-S Corp	>1B	616	$214,243,346	552	$1,319,878,827,940	$2,391,084,833	380	$137,109,170	350	$521,832,654,993	$1,490,950,443
	500M to 1B	412	$36,613,267	370	$200,469,330,744	$541,809,002	271	$21,571,491	244	$99,624,862,867	$408,298,618
	100M to 500M	1,650	$95,508,824	1,491	$304,043,425,482	$203,919,132	1,072	$54,597,704	961	$211,870,316,925	$220,468,592
	50M to 100M	952	$32,553,979	864	$57,936,151,123	$67,055,730	660	$16,964,324	599	$35,084,325,124	$58,571,494
	Total	3,630	$378,919,416	3,277	$1,882,327,735,289	$574,405,778	2,383	$230,242,689	2,154	$868,412,159,909	$403,162,563

Summary of DOR Findings for Minimum Excise Subcommittee

The minimum corporate excise subcommittee asked the Department of Revenue (DOR) to review a subset of 2004 corporate excise tax returns. The tax returns reviewed by DOR involved a profile in which: (1) the corporation paid the minimum excise of $456; (2) the individual corporation had high (*i.e.*, greater than $1 billion) gross receipts; (3) the corporation was not taking advantage of specified tax incentives, including single sales factor apportionment or various credits. A group of 131 returns initially met this profile, though after further analysis, 14 corporate returns were judged to have not met the $1 billion gross receipts criterion (due to incorrectly filled out returns), leaving 117 corporate filers with more than $1 billion in gross receipts that paid the minimum tax in 2004.

Some of these 117 corporations were minimum excise payers because they had current year losses and a low non-income measure. Other corporations that reported profits in tax year 2004, yet still paid the minimum excise, did so due to low Massachusetts apportionment. A corporation may have high total receipts, but very few receipts sourced [attributed] to Massachusetts. In these cases, the income apportioned to Massachusetts multiplied by the 9.5% corporation rate could be less than $456, and the filer would pay the minimum tax. The low apportionment percentage would also typically reduce any taxable net worth to a minimal level, since net worth is also apportioned to Massachusetts before the non-income measure tax rate of 0.26% is applied. The Department of Revenue estimates that there were 82 corporate filers that paid the minimum tax because they either had losses or low Massachusetts apportionment.

There remain 35 corporate filers that appear to have reduced their tax payments due to some form of income shifting[1]. In these situations, corporations that either had a current year loss or relatively low income, *when that income was calculated on a separate company basis*, were part of larger multistate groups of affiliated corporations that showed proportionately greater profit than the Massachusetts filers. In other words, although the larger affiliated groups reported substantial profit, the individual members of those groups (or the groups as currently constituted for Massachusetts filing purposes) showed reduced profit, and in many cases the profit was reduced to the point where only the minimum excise was due. These are generally cases where income is shifted away from the Massachusetts filer or filers to out-of-state affiliates through various types of transactions with those out-of-state affiliates, such as inter-company interest or royalties, or through the transfer price of sales of goods or services. In this sample, the result of the income shifting was to lower the income of the Massachusetts filers. If unitary combined returns had been filed in these 35 cases, we estimate that an additional $29 million in Massachusetts tax would have been due.

The Department observes that income-shifting is not limited to corporations paying the minimum excise. It is a common tax planning practice used to reduce taxable income of Massachusetts filers with out-of-state affiliates, but in most cases the income of the Massachusetts filer would not be reduced to such a low level that only minimum excise is paid. The Department's interpretation of these 35 returns is that they represent a small subset of a larger income-shifting problem which is best addressed through combined reporting.

The attached table summarizes the findings described above.

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[1] It should be noted that 8 of these corporations were members of groups that filed a Massachusetts combined return where one or more members of the group paid more than the minimum excise. However, in each case, the group as a whole reduced its tax liability below what would have been calculated on a unitary combined basis.

Summary of DOR Analysis of Tax Year 2004 Massachusetts Minimum Corporate Excise Payers With $1 Billion or More in Gross Receipts

1.	# of Corporate Filers in Original Group	131
2.	# of Corporate Filers Removed from Original Group After Data Cleaning (<$1B in Gross Receipts)	-14
		===
3.	# of Remaining Corporate Filers with $1 Billion or More in Gross Receipts That Paid Minimum Tax	117*
4.	# of Corporate Filers That Did Not Show Increased Tax Liability Under Unitary Combined Reporting	82
		===
5.	# of Corporate Filers That Showed Increased Tax Liability Under Unitary Combined Reporting (Probable Income Shifting)	35
6.	**Estimated $ Amount of Additional Taxes That Would Have Been Paid Under Unitary Combined Reporting**	**$29 million**

*Of these 117 remaining corporate filers, 45 were members of groups that filed Massachusetts combined returns, and 24 of these were members of groups that as a whole paid more than the minimum excise.

APPENDIX N

Subcommittee on Other Governor Proposals – "Report"
(Final Report, dated November 12, 2007)

Commonwealth of Massachusetts

Study Commission on Corporate Taxation

Report of "Subcommittee on Other Governor Proposals"

November 12, 2007

Executive Summary

The Study Commission on Corporate Taxation that was formed on April 30, 2007 by Governor Deval Patrick, Speaker of the House Salvatore DiMasi, and Senate President Therese Murray has been charged with studying the modernization and simplification of the current business tax laws of the Commonwealth. On August 9, 2007, a series of subcommittees of the Commission were convened to address certain issues that lent themselves to "working groups," with a request to report their findings back to the Commission as a whole by mid-November. One such subcommittee (the "Subcommittee on Other Governor Proposals") was asked to examine proposals included in House Bill No. 3756 – the Governor's corporate tax initiative – other than (1) combined reporting or "unitary" taxation; and (2) conformity to the federal characterization-of-entity rules (commonly referred to as the "check-the-box" proposal). These secondary proposals would change the law to do the following:

- Impose a tax on the non-insurance income of partnerships and limited liability companies owned by insurance companies ("the Insurance Proposal" --Section 35 of House 3756)

- Expand the deeds excise to cover transfers of ownership of certain entities that principally hold real estate ("the Deeds Excise Proposal" -- Sections 87-96 of House 3756)

- Expand the room occupancy tax to cover, in the case of sales of hotel and motel rooms by "intermediaries" such as internet suppliers of occupancy, the mark-up representing the difference between what the intermediary paid for the room and what it charges the retail customer ("the Room Occupancy Proposal" --Sections 97-107 of House 3756)

- Impose the sales tax on the purchase by "captive leasing companies" of tangible personal property to be leased to affiliates, rather than permitting such companies to purchase the property tax free and collect a tax on the lease payments over the life of the lease ("the Captive Leasing Proposal" -- Sections 108-110 of House 3756)

- Restrict the Massachusetts "earned income tax credit" to people who live or work in Massachusetts ("the Earned Income Credit Proposal" – Section 16 of House 3756)

The three members of this Subcommittee are as follows:

- Former Commissioner of Revenue Alan LeBovidge, Chair
- Eileen McAnneny, Senior Vice President, Government Affairs, Associated Industries of Massachusetts
- Joseph X. Donovan, Counsel, Sullivan & Worcester LLP

The Subcommittee met on September 4 and September 25, 2007. Ms. McAnneny suggested early in the discussions of the Subcommittee that industry representatives be invited to give input with respect to their objections to two proposals in particular – the Insurance Proposal and the Deeds Excise Proposal. The other members agreed, and at its meeting of September 25, the Subcommittee heard presentations by representatives of the insurance industry, the commercial real estate industry (specifically including the National Association of Industrial and Office Properties ("NAIOP")), and the real estate bar.[1] Having heard the presentations, the Subcommittee decided to conduct advisory

[1] The insurance industry representatives who presented were Jim Williams, from MassMutual, and George Ryan, from Liberty Mutual. Also in attendance for the insurance industry were Andrew Calamare and Jenny Erickson, Life Insurance Association of Massachusetts, and Kristine Vardo from Liberty Mutual.

Presenting on behalf of the commercial real estate community were David Begelfer, Chief Executive Officer of NAIOP, as well as Jim Shea, an attorney from Edwards, Angell, Palmer & Dodge, and Katharine Bachman, an attorney from Wilmer Hale.

votes on the various proposals to be communicated to the Commission as a whole. Those votes were as follows:

- 2 – 1 in favor of the Insurance Proposal, with Messrs. LeBovidge and Donovan voting in favor and Ms. McAnneny against. The votes in favor by Messrs. LeBovidge and Donovan were contingent on amending the proposal to make it clear that it should not trigger any "retaliatory tax" impact, as is further explained below.
- 2 -1 in favor of the Deeds Excise Proposal, with Messrs. LeBovidge and Donovan voting in favor and Ms. McAnneny against.
- 3 – 0 in favor of the Room Occupancy Proposal.
- 2 – 1 against the Captive Leasing Proposal, with Mr. LeBovidge voting in favor and Ms. McAnneny and Mr. Donovan voting against.
- 3 – 0 in favor of the Earned Income Credit Proposal.

Summaries of and Arguments with Respect to Each Proposal

-- The Insurance Proposal

In Massachusetts, insurance companies that are regulated as such generally are not taxed on their income but are subject to tax based on the premiums they receive with respect to Massachusetts policies. Insurance business affiliated groups may and often do include corporations or other entities that conduct non-insurance businesses. In an era of "convergence" among insurance, banking, money management and other financial services, and other businesses, such groups are more likely than in the past to include entities that conduct non-insurance financial service businesses in particular. Under present law, if these businesses are conducted in corporate form, they will be taxed on their income as regular

business corporations.[2] If, instead, they are conducted by partnerships or limited liability companies that are owned by insurance companies and treated as "flow-through entities" for tax purposes, their income will not be subject to Massachusetts tax at all, regardless of how material their operations may be to the overall financial performance of the group.[3] The proposal would impose an income tax on the income generated by such non-insurance LLCs and partnerships, to the extent that the income flows through to an insurance company which owns, directly or indirectly, 50% or more of the interests in such flow-through entities. The proposal would impose such tax at the level of the parent insurance company.

The insurance industry representatives who appeared before the Subcommittee argued first that the premiums taxes already paid by insurance companies are quite high. The 2.28% premiums tax paid by casualty companies is said by the industry to translate into the equivalent of an income tax paid at a rate of 14%, which is significantly higher than the rate paid by regular business corporations or by utilities or banks. Counterarguments to this objection might be:

- This statistic represents an average across a group of companies. There may be individual companies where the relative size of the insurance and non-insurance businesses is such that the effective income tax rate is very low. In fact, the larger the relative size of the non-income business, the larger is the incentive to operate it

[2] G.L. c. 63, sections 32, 39.

[3] By contrast, if an LLC elected to be treated as a corporation for federal income tax purposes, it would similarly be treated as a corporation for Massachusetts corporation excise purposes. See G.L. c. 63, sec. 30(1), (2).

in the form of a flow-through entity such as a partnership or limited liability company to insulate the profits from tax.

- If the effective rate on insurers is too high, that problem should be dealt with by reducing the premiums tax rate, not by letting the profits of non-insurance businesses go untaxed.

The representatives also argued that the proposal would trigger very large tax increases *outside Massachusetts* for Massachusetts-organized insurance companies, via the effect of *retaliatory tax regimes*.

Under retaliatory tax regimes, states impose taxes on insurers doing business in the state but organized elsewhere that are the higher of two measures: (1) the tax computed according to the rules that apply to domestic insurers in that state; or (2) a tax computed by applying to the out-of-state insurer the rules that apply in its home state, that is, its state of legal domicile. Such retaliatory regimes are quite common; Massachusetts law itself provides a readily available example.[4]

It is a well-established principle of state tax law that the Commerce Clause of the United States Constitution prohibits tax discrimination based solely on the state of

[4] See G.L. c. 63, s. 21, which provides that "[e]very foreign life insurance company shall annually pay with respect to business taxable under the preceding section, in addition to the excise hereby imposed, a sum equal to the excess over such excise of the amount of tax which would be imposed in the same year by the laws of the state or country under which such company is organized, upon a life insurance company incorporated in this commonwealth, or upon its agents, if doing business to the same extent in such state or country."

organization of a corporation. Thus, for example, in *Perini Corporation v. Commissioner*,[5] the Supreme Judicial Court held that insofar as the Massachusetts net worth tax permitted domestic (that is, Massachusetts-organized) corporations to deduct from their net worth investment in controlled domestic subsidiaries, but did not permit corporations organized elsewhere to deduct such an investment, the regime violated the Commerce Clause and could not be enforced as written.[6]

On their face, retaliatory regimes would seem to violate this constitutional principle, because they impose higher taxes on foreign than on domestic insurers. It is settled law, however, that the regimes are constitutional if properly structured because, under old case-law reasoning that has long been codified at the federal level in the McCarran-Ferguson Act,[7] the business of insurance is considered not to constitute "commerce."

Accordingly, consider an insurance company domiciled in Massachusetts that owns a single-member limited liability company that conducts an investment management business in Massachusetts and in three other states, all of which impose retaliatory insurance tax regimes similar in their statutory language to the Massachusetts retaliatory tax cited at footnote 4, with the investment management business having a 25% apportionment factor in each of the four states in which it operates. If such retaliatory insurance tax regimes could be applied so as to tax income of this investment management business, adoption of the Insurance Proposal in Massachusetts would not only impose a 9.5% tax on 25% of the

[5] 419 Mass. 763 (1995).

[6] The statutory provisions defining taxable net worth have since been revised. See G.L. c. 63, sec. 30(8), (9).

[7] 15 U.S.C. secs. 1011-15.

income of the investment management business, but also trigger a tax in the other three states on the other 75% of the income of that business.

The Legal Division of the Department of Revenue has indicated that it does not believe that retaliatory taxes could properly be imposed if the Insurance Proposal were adopted in its present form. Its rationale is that the proposed law by its terms applies only to income generated by non-insurance businesses, and hence the Commerce Clause would in fact render imposition of a retaliatory tax on such income unconstitutional. The insurance industry representatives disagreed, however, believing that the Governor's insurance tax proposal as drafted would have significant retaliatory consequences.

Noting these objections of the insurance industry representatives, Mr. Donovan expressed concerns that with respect to the proposal as drafted, the law on this point is insufficiently clear to protect Massachusetts-domiciled insurers from at least the threat of imposition of retaliatory taxes in other states. He and Mr. LeBovidge were of the view, however, that if the proposal were changed so as to extend the excise on regular business corporations to limited liability companies and partnerships conducting non-insurance businesses[8], rather than imposing the tax at the level of the parent insurer, the retaliatory tax regimes of other states generally would not be imposed as a matter of statutory interpretation, and that in the event they were so imposed such imposition would be unconstitutional in any case. The Department of Revenue has agreed to provide proposed

[8] This extension of the excise to limited liability companies and partnerships would of course be limited in that it would not apply to the extent that the income of such entities is otherwise taxed under G.L. c. 62 or 63, either to the entities or to their owners.

legislative text that would reflect this recommended change in the proposal. See attached Exhibit A.

Ms. McAnneny remained concerned that if the proposal were so changed, the imposition of retaliatory taxes would remain an issue. In her view, although this tax would apply to the partnership or the limited liability company as an entity, it would be considered a tax levied on the parent insurance company. She believes that states have ample authority to apply their retaliatory tax to any burden directly or indirectly incurred by an insurer, and notes that existing federal and Massachusetts tax rules, as well as those of most other states, impute the activities of a partnership to its owners for certain purposes. Thus, in Ms. McAnneny's view any tax burden imposed upon the partnership will be construed by states to be a tax burden imposed on the insurer and thus subject to retaliation.

Ms. McAnneny further noted that, more importantly in her view, the imposition of the retaliatory tax on domestic insurers would be determined by each individual state and could not be controlled by Massachusetts. She suggests that there is nothing Massachusetts could do to prevent retaliation, other than by declining to levy the tax in the first place. She envisions that should this new tax be enacted, many states would move immediately to retaliate against Massachusetts insurers, leaving Massachusetts-based insurers little recourse other than complex constitutional litigation in courts outside of Massachusetts, adding huge additional costs to Massachusetts insurers over and above the burden of the taxes themselves.

Ms. McAnneny further disagreed with the assertion by Messrs. LeBovidge and Donovan that if the proposal were changed so as to extend the excise on regular business corporations to limited liability companies and partnerships conducting non-insurance businesses, rather than imposing the tax at the level of the parent insurer, the retaliatory tax regimes of other states generally would not be imposed as a matter of statutory interpretation, and that in the event they were so imposed their imposition would be unconstitutional in any case. In her view, it is well-settled law that states may impose retaliatory taxes triggered by other states' taxes on insurers, as in the case at hand, without violating the Commerce Clause. Ms. McAnneny stated that the McCarran-Ferguson Act leaves the taxation of insurance companies to the states and, further, that the United States Supreme Court in *Western & Southern Life Ins. Co. v. State Board of Equalization of California* made it clear that the Commerce Clause does not restrict any state powers to tax insurers, including the power to levy retaliatory taxes on them.

In Ms. McAnneny's view, enactment of the proposed tax on non-insurance income, even in its revised form, would be a new and additional tax on insurers that would be exactly what the retaliatory tax is designed to prevent. She asserted that a tax on "non-insurance" income of an insurer would be a unique tax, unlike any other in the country, and thus it would be highly likely that states would immediately seek to impose their retaliatory tax on Massachusetts-domiciled insurers.

Lastly, Ms. McAnneny is opposed to the insurance tax change at issue because in her view it is counter to the goals of the commission – to makes the tax code simple, equitable and more competitive**.** Ms. McAnneny believes that the new tax on insurers would create unprecedented federal/state tax non-conformity, which has been cited as a major problem with the current Massachusetts tax system. Several proposals currently being evaluated by the Study Commission on Corporate Taxation seek greater federal/state conformity, including proposed "check the box" rules. Taxing partnerships and disregarded entities

owned by insurers would, in Ms. McAnneny's view, create new and unprecedented federal/state tax non-conformity and significant new tax complexities for insurers, and also would create an inequity by treating insurance-owned partnerships and disregarded entities differently than other partnerships and disregarded entities. Ms. McAnneny believes that this new tax -- multiplied through the retaliatory taxation she anticipates -- would be particularly unfair for insurers whose home base is in Massachusetts. In an increasingly competitive environment, Ms. McAnneny states that raising taxes on insurance companies would curb domestic industry growth and hamper the Commonwealth's ability to attract out of state insurance companies to invest here – again, an outcome that she believes is contrary to the goals of the Commission.

Messrs. LeBovidge and Donovan disagree with the objections raised by Ms. McAnneny. For the reasons they expressed, they believe the proposal as revised would not provide grounds for retaliatory taxes in other states and that, if any such taxes were asserted, they would be unconstitutional. However broad the powers of the state may be to impose retaliatory taxes on insurance companies, they note that the revised proposal would not impose any tax on insurance companies, but only on partnerships and limited liability companies owned by them. In their view, this proposal is no more likely to trigger retaliatory taxation than current Massachusetts taxes on the non-insurance corporate (and corporate trust) subsidiaries of insurance companies. Messrs. LeBovidge and Donovan further note that if any retaliatory tax were imposed by another state and survived constitutional challenge, it would have to be limited and imposed on the non-insurance business income on a fairly apportioned basis, which is the system for taxing all business income generated by any business entity. They share Ms. McAnneny's support for equity among different taxpayers, and believe that principle supports including in the Massachusetts business income tax base all non-insurance business income earned by any type of business entity, irrespective of the nature of the ultimate owner of the entity

(whether individuals, regular business corporations, financial institutions, or insurance companies).

-- The Deeds Excise Proposal

The Deeds Excise Proposal would extend the deeds excise to cover cases in which interests in an entity are transferred where more than 80% of the value of the assets of the entity is comprised of real estate. The proposal is based on the controlling interest transfer tax that has long been in place in New York State. It is intended to prevent owners of real estate from avoiding the excise by transferring real estate to be sold to, for example, a newly-organized, wholly-owned limited liability company (which transaction would not itself trigger the excise) and then selling the intangible interest in the LLC rather than the real estate in kind.

The panel led by NAIOP that spoke before the Subcommittee on September 25 made several arguments against the Deeds Excise Proposal. Those arguments are set out in the following paragraphs, in each case coupled with (a) some concerns expressed by Messrs. LeBovidge and Donovan as to their force and effect, and then (b) responses to Messrs. LeBovidge and Donovan from Ms. McAnneny:

- *There is no "loophole" to be closed. It almost never happens that a real estate owner in fact transfers an interest in real estate rather than the real estate in kind to avoid the tax. One reason why it almost never happens is that a buyer would not*

want to buy an interest in an LLC or partnership because it would be taking on whatever liabilities are associated with the entity. On this point, Messrs. LeBovidge and Donovan are of the view that, from their personal knowledge and experience in both government and private tax practice, indeed it has been a common planning tool to use LLCs and partnerships to avoid the tax. They state that in the classic case in which a new entity is formed immediately prior to the sale, buyers generally are comfortable that they are not purchasing hidden liabilities along with the real estate. Ms. McAnneny responds that the assertion that it is a common planning tool to use LLCS and partnerships to avoid the deeds excise tax was vehemently disputed by the real estate bar as simply untrue; that commercial buyers of real estate do not invest significant sums of money for real estate assets without proper risk underwriting; and that the liabilities associated with an interest in an entity cannot be determined by a public records search, nor is title insurance available to protect the purchaser of such an interest

- *DOR can track the cases in which the strategy has been used and attack them on "sham transaction" grounds by following reports in the weekly Banker and Tradesman of instances in which real estate was contributed to an LLC or a partnership.* Messrs. LeBovidge and Donovan are not convinced that it would be in the interests of sound tax administration, or a good use of DOR resources, for DOR to have to find all such cases and bring them through administrative appeals and potentially to litigation under a doctrine such as the sham transaction doctrine that is very fact intensive. Ms. McAnneny responds that the real estate bar suggested, and Ms. McAnneny agrees, that DOR already had a tool to go after taxpayers avoiding the deeds excise tax – the sham transaction doctrine. While Messrs LeBovidge and Donovan indicated they are not convinced this would be the best use

of DOR resources, Ms. McAnneny believes that if the real issue is use of administrative resources, this proposal would create a need for increased state bureaucracy to administer and enforce the new tax, given the much more complex task of understanding the complex levels of entity structure now common in the commercial real estate market. In her view, the case that was cited as an example by Messrs. LeBovidge and Donovan in the meeting discussion does not justify what would be a material increase in real estate transaction costs, and a discouragement to business investment occasioned by a material new level of disclosure of ownership structures.

- *The real estate industry will be "paralyzed" while DOR sorts through the regulations that would be needed to fill statutory gaps in the law.* Messrs. LeBovidge and Donovan believe that the proposal is sufficiently similar to the New York law that the regulatory guidance in that state could be used as a starting point for development of Massachusetts regulations, and they are not aware that any similar paralysis of the real estate market took place in New York upon enactment of that state's controlling interest transfer tax. Ms. McAnneny agrees with the real estate bar on this point, given the complexity of real estate transactions and the speed with which they now occur in the marketplace, and believes that reliance upon another state's regulatory scheme is unrealistic and unhelpful.

- *Significant legal and accounting costs will be incurred to determine the value of real estate so that companies can assess whether the 80% threshold is met.* Messrs. LeBovidge and Donovan believe that most cases of controlling interest transfers will clearly fall on one side of the 80% line or the other, and they note that when LLCs

and partnerships holding real estate are sold, the purchasers generally need to determine the value of the underlying real estate in any event so that they will be able to take the appropriate amount of depreciation for federal and state income tax purposes. Ms. McAnneny does not agree with the assertion that most cases of controlling interest transfers will "clearly fall" on one side or the other of 80%. She believes that importantly, given the movement of capital in and out of entities at the upper tier of ownership, the proposal to tax at the indirect level of ownership will at minimum create additional transaction and legal compliance costs, and create the risk of unintended regulatory non-compliance that discourages business investment. In her view, this proposal is simply not consistent with the administration's goal of streamlined real estate process and encouragement of economic development.

- The incremental revenues will go to Registrars of Deeds, not to the General Fund. Messrs. LeBovidge and Donovan note that with the abolition of most counties, most of the revenue from this proposal would go directly to the General Fund.[9] Further, they state that even with respect to the portion that would go to the special Deeds Excise Fund, it seems that the incremental revenues would reduce pressure on the state budget. They also note that if the Legislature concludes that certain political subdivisions or agencies are "over-funded" because of this incremental revenue, it could reallocate revenues so that the practical effect of the proposal would be to enhance the General Fund dollar-for-dollar.

[9] G.L. c. 64D, sec. 11.

Messrs. LeBovidge and Donovan supported the deeds excise proposal, and had reservations as to the force of the arguments against the proposal, as noted above. Ms. McAnneny found the arguments against the proposal to be persuasive, and voted against it.

-- The Room Occupancy Proposal

The Room Occupancy Proposal would expand the room occupancy tax to cover, in the case of sales of hotel and motel rooms by “intermediaries” such as internet suppliers of occupancy, the mark-up representing the difference between what the intermediary paid for the room and what it charges the retail customer.

All three members of the Subcommittee voted in favor of this proposal. The three members agree that, in substance, the amount paid for rooms to intermediaries such as internet suppliers represents a payment for occupancy of the rooms, and they believe that there should be a level playing field between cases in which such an intermediary is used and those involving more conventional transfers of occupancy. They noted as well that the proposal would not change at all the responsibilities of a Massachusetts proprietor of a hotel or motel, who would continue to collect the tax only on the amount it charges to an intermediary where such intermediaries are used.

-- The Captive Leasing Proposal

Under the existing sales and use tax law, sales at retail are taxed, but sales to a "wholesaler" are not; rather, they are considered to be "sales for resale" that are exempt.[10] Further, when property is rented or leased, each rental or lease period is treated as a separate sale that is subject to tax if the transaction is at the retail level.[11] Accordingly, if a company purchases tangible personal property that it will lease, it is entitled to purchase the property free of tax.

The premise of the Captive Leasing Proposal is that many large companies have set up special-purpose captive leasing corporations, with a view towards purchasing property tax free and collecting tax on the intercompany lease or rental charges only. This treatment would spread payment of the tax over the period of the rental or lease, rather than triggering it up front, and thus give rise to a deferral of the liability. In some cases it could also create a permanent tax savings. Assume, for example, that Corporation X expects to purchase 100 fork-lift trucks for $3500 each. It will pay a tax on the acquisition of $17,500, that is, 5% of the purchase price. If the Corporation sets up a captive leasing subsidiary, Corporation Y, and has it buy the fork-lifts tax-free for lease to Corporation X, and if it sells them after two years for $1000 each to DispoCo, which will sell them in turn as used equipment, then no tax will be paid by Corporation X on $1000 of the purchase price. (Note, however, that if the intercompany lease charge is computed at arm's length, the total of the lease payments in this instance will be more than $3500 less $1000 or $2500,

[10] See G.L. c. 64H, secs. 1 (definitions of "sale" and "sale at retail"), 2.

[11] *Id.*

because the lease charge will include an amount that represents interest or the time value of money, and also a profit element for Corporation Y.)

The proposal would in effect reverse out the savings associated with the captive leasing strategy by imposing the sales or use tax up front on the purchase by Corporation Y of property for rental or lease to its affiliate, Corporation X.

Mr. LeBovidge endorses the proposal because he believes it necessary to preclude a result not intended under the statute, and to put companies that have used the captive leasing strategy on a level playing field with those that have not. Ms. McAnneny and Mr. Donovan oppose the proposal because (1) they do not believe that the captive leasing strategy has been widely implemented; and (2) in most instances it would give rise to a mere deferral rather than a permanent savings in any case. They are not confident that further complicating the sales and use tax law is justified in these circumstances.

-- The Earned Income Tax Proposal

The Earned Income Tax Proposal would restrict access to the refundable Massachusetts earned income tax credit to taxpayers who live or work in the Commonwealth.

All three members of the Subcommittee voted in favor of the proposal. They agree with representatives of DOR who have characterized this initiative as simply a clarifying "fix", consistent with current administrative practice, for a statutory provision that should have been so limited when it was first enacted, and they share the concern of DOR that the existing statute invites fraud and abuse.

Alan LeBovidge, Chair

EXHIBIT A

Chapter 63 of the General Laws is further amended by inserting after section 39A the following section:

Section 39B: When 50 per cent or more of the interests in an entity that is engaged in a non-insurance trade or business and would otherwise be treated as a partnership or disregarded entity for purposes of chapter 63 are owned, directly or indirectly, by an insurance company or other ownership entity that is not of a type subject to tax on net income under chapter 63, the net income that would otherwise pass through to such insurance company or other ownership entity shall be taxed to the partnership or disregarded entity at the entity level as if the partnership or disregarded entity were a corporation subject to tax under chapter 63, in accordance with such rules or regulations as may be promulgated by the commissioner of revenue. Income that is taxable to the partnership or disregarded entity pursuant to this section, and any related tax attributes, shall not pass through to the insurance company or other ownership entity. To the extent applicable, income that is taxable to the partnership or disregarded entity pursuant to this section, and any related tax attributes and activities, shall be included and taken into account in a combined report filed under section 32B, and a partnership or disregarded entity that is subject to tax under this section shall be considered to be a corporation subject to tax under chapter 63 for purposes of section 32B.

APPENDIX O

Subcommittee on Streamlined Sales Tax – "Status Report"
(dated October 16, 2007)

TO: Study Commission on Corporate Taxation

FROM: Karl P. Fryzel
Chair, Subcommittee on Streamlined Sales Tax

DATE: October 16, 2007

RE: Status Report

Meetings

The Subcommittee met on October 3, 2007. The guests at the meeting were Ted Lauper, Deputy Chief, Rulings and Regulations Bureau, and Joan Wagnon, Secretary, Kansas Department of Revenue, 1st Vice President, Streamlined Sales Tax Governing Board. Mr. Lamper briefed the Subcommittee on the materials assembled by the Department (a copy of the index is attached to this Report as Attachment A). Ms. Wagnon briefed the Subcommittee on the history, current status and future prospects of the Streamlined Sales Tax Project.

Summary of October 3rd Subcommittee Meeting

The remarks by Joan Wagnon may be summarized as follows:

- a healthy state revenue base needs a mix of revenue sources, including sales tax revenues
- sales tax revenues are flattening out
- a factor behind this trend is "multichanneling" in retailing, in particular, internet sales
- U.S. Supreme Court precedent, the Quill case, prohibits states from taxing remote sellers without physical presence in a state
- at the same time, the Supreme Court made it clear that Congress could change this result in a manner that is permissible under the Constitution
- therefore, state governments and business retail organizations got together to produce the Streamlined Sales Tax Agreement ("SSTA")
- the core principles of the SSTA are:
    1. uniform definitions of taxable items, e.g. taxable candy, clothing, medical products the same in every state, and
    2. the same tax rate must apply to each taxable item in each taxing jurisdiction within a state
- currently, there are 19 full members, and 3 associate members of the SSTA representing 30% of the population of the 46 states with a sales tax (see Attachment B)
- the goal is to increase the population of SSTA sates to 50% so that Congress is more likely to adopt universal streamline sales tax legislation
- approximately 1300 remote retailers have voluntarily participated in SSTA and they voluntarily paid approximately $89M in sales taxes in 2007
- even without Congressional legislation, adoption of SSTA makes sense for two reasons:

Memo

1. fairness between Main Street retailers and internet retailers, and
2. prevent further erosion of the sales tax base which will force higher sales tax rates.

The remarks of Ted Lauper may be summarized as follows:

- adoption of SSTA by Massachusetts would not be too difficult except for clothing and medical products (see Attachment C for details)
- the DOR has prepared a matrix of revenues gains and losses by adopting SSTA (see Attachment D)
- an emerging potential problem is legislation on Beacon Hill adopting local option sales taxes which are not allowed under the SSTA

Future Agenda

The Subcommittee intends to meet with the following individuals before preparing its official report:

- Professor Matthew Murray of the University of Tennessee who has done extensive research on potential consumer impact if internet sales are subject to sales tax
- representatives of COST and Retailers Association of Massachusetts
- Senator Moore, the sponsor of the Massachusetts SSTA legislation
- Congressman Delahunt, the sponsor of federal legislation adopting SSTA
- representatives of the SSTP that specialize in legal issues
- a representative of TaxWare, a Certified Service Provider, a software provider for administering tax collections under the SSTA.

KPF/efb

ATTACHMENT A

Contents

		Pages
I.	Introduction	3 - 5
II.	Historical Background	6 - 7
III.	State Requirements for SST Conformity	8 - 16
	A. Tax Base Simplification	
	B. Tax Rate Simplification	
	C. Sourcing Rules	
	D. Administrative Simplifications	
	E. Summary Chart	
IV.	Revenue Issues	17 - 19A
V.	Costs and Technological Changes	20 - 21
VI.	Conclusion	22

Attachments

A. The Streamlined Sales Tax Agreement as Amended June 23, 2007.

B. Federal Legislation – Senate and House

C. 2003 Massachusetts SSTP Legislation

D. 2007 Massachusetts Legislation – Senator Moore's Bill

E. Massachusetts Sales Tax Revenues 2003 – 2007

F. Tax Expenditure Budget

G. State Status Chart

H. Letter of Support from Retailers Association of Massachusetts and Equipment Leasing and Finance Association

I. Report on August, 2007 Meeting on Local Sourcing issues

ATTACHMENT B

Message from President Dwight Cook:

As I sign off on this annual report I would be remiss if I didn't thank all of you who worked so hard to make our efforts such a success. The commitment, dedication and professionalism shown by all of you is absolutely amazing. You have addressed our challenges in this public policy arena in no less a manor than the American public would expect. I believe this annual report shows a level of accomplishments that none of us dared to think possible after just two years. We still have many challenges yet to address yet I am confident that they too will be put to rest. I look forward to the passing of the Federal legislation and the continued growth in state membership. The road to perfection is still under construction but the ride should soon start becoming a lot smoother.

Introduction:

On October 1, 2005, thirteen states representing 20.3 percent of the population of all the states with a sales tax joined together to activate the Streamlined Sales and Use Tax Agreement. Five associate states joined with those thirteen full member states.

Four states have joined the Streamlined Sales Tax Governing Board since its founding. In the 2007 fiscal year Rhode Island, Vermont and Washington became members. Over 28 percent of the country's population lives in a member state.

There have been several successes in this fiscal year. One of the greatest is the amount of tax collected by the sellers who have registered on the Streamline registration system. The sellers registered on the Governing Board's registration system collect sales taxes for the member states. The member states report that those sellers who were not already registered to conduct business in their states collected $88,958,093 in sales tax for the 2007 fiscal year. This represents tax that was owed but would otherwise not have been collected or paid to those states.

Member States:

Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, North Carolina, North Dakota, Nebraska, New Jersey, Oklahoma, Rhode Island, South Dakota, Vermont, West Virginia

Associate Member States:

Arkansas, Nevada, Ohio, Tennessee, Utah, Washington, Wyoming

Changes to the Streamlined Sales and Use Tax Agreement:

The Governing Board approved the following changes:

- Required state to provide boundary databases at least 30 days in advance of a calendar quarter.
- Delayed when florists must transition to destination sourcing.
- Repealed the multiple points of use provisions.
- Provided additional liability relief for purchasers who rely on state provided data.
- Imposed additional requirements on states to review and certify accuracy of CSP systems.
- Conferred advisor states status on those states that were implementing states.

ATTACHMENT C

I. Introduction:

The Streamlined Sales Tax Project is a joint effort involving most states that impose a sales tax and representatives from the business community. The purpose of the Project is to develop simplified standards for imposition and collection of state sales and use taxes. The long range goal is to induce Congress to enact federal legislation that would require large remote vendors selling taxable goods at retail and shipping them by common carrier to collect sales/use tax based on the destination state. At the present time, vendor participation is purely voluntary. Under current federal case law, and until Congress acts, vendors are not required to collect tax on items shipped to states where they do not have a physical presence, such as a store or warehouse. Collection by such non-nexus vendors for states that have adopted SST is voluntary, although a number of such vendors have registered through the SST Central Registration System and are currently collecting for states that have adopted conforming legislation.

States that have fully conformed their laws to the SST Agreement are full members of the Governing Board, and currently include: Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, New Jersey, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Vermont and West Virginia. States that have passed legislation with a future effective date, or have passed some legislation but are not fully conforming are considered Associate Members, and these currently include: Arkansas, Nevada, Ohio, Tennessee, Utah, Washington and Wyoming. Associate member status is due to expire on January 1, 2008, unless further extended.

Massachusetts DOR has been participating in and observing the Streamlined meetings as directed by the Legislature in St. 2003, c. 4, s. 82. Insofar as Massachusetts has not adopted legislation that would conform the state sales and use tax statutes to the Streamlined Sales Tax Agreement, we currently are part of the State and Local Advisory Council (SLAC) and act as an "Advisor State" to the Governing Board.

Clearly states are losing substantial revenues due to failure of remote Internet sellers to collect sales/use tax on items shipped to retail customers in those states, and

Internet commerce is growing. As a policy matter, most tax state administrators and many businesses, including the Retailers Association of Massachusetts, support SST both from a revenue enhancement perspective and from the perspective that it would tend to level the playing field between Internet retailers and in-state brick and mortar stores. *See* Attachment H.

In the absence of federal legislation, the additional revenue that Massachusetts would collect from the current voluntary registrants would be relatively small (most recently estimated at $ 3 - $ 6 million annually). Although SST is theoretically designed in a way that states can adopt conforming changes in a revenue neutral way, because of changes in the tax base it hasn't worked out that way for some of the states that have done so. At the June, 2007 meeting, for example, Ohio reported that it had a $50 million a year revenue loss that it attributed to SST conforming changes, some of which was attributable to adoption of the uniform product definitions. Although Massachusetts does not face the specific issues that Ohio did, we are aware of some required changes that are potential revenue losers, including the loss of the clothing taxability threshold of $175 (under SST, "clothing" must either be subject to tax or exempt), loss of the drop shipment provisions, and potential broadening of exemptions for medical products. The Department's Office of Tax Policy Analysis has studied the fiscal effect of those changes and prepared estimates which are discussed in Section IV. To make the change to SST revenue neutral, in the short term and prior to the passage of federal legislation, some offsetting changes to the sales/use tax base would need to be made.

While most everyone agrees that SST is conceptually a good idea, the issue for Massachusetts is whether to adopt conforming legislation now (with a future effective date) or wait until Congress acts. Arguments in favor of passing legislation now include generation of additional support for the project at the national level and being ready to receive the benefit of the federal legislation, when and if passed by Congress. *See* Attachment B for pending federal legislation. *Also see* Attachment D for Senator Moore's Massachusetts SSTP bill. Arguments in favor of waiting include possible revenue loss, the time and expense for both DOR and taxpayers in making the transition to a new system (in some instances, the uniform rules are more complex that those currently in place), and unresolved issues within the project itself, such as the application

of destination sourcing to intrastate sales, which may preclude some other states from joining.

Additional current information on the Streamlined Sales Tax project is available from the Project's website at: www.streamlinedsalestax.org.

ATTACHMENT D

SSTP ITEMS:	Annualized Revenue Impact	
	Revenue Loss	Revenue Gain
Loss of drop shipment provisions	-$4 to -$10 Million	
Exemption of all clothing except furs, protective, or sport items	$-50 to $-100 Million	
Exemption of all durable medical equipment on prescription for home use	$-4 to $-6 Million	
Inclusion of delivery charges in the sales price subject to tax		+$15 to +$25 Million
Taxation of candy		+$20 to +$28 Million
Taxation of soft drinks		+$40 to +$60 Million
Taxation of Digital Audio-Visual Works, Digital Audio Works, and Digital Books		+$6 to +$13 Million
Revenue that would be raised from voluntary registrants		+$3 to +$6 Million
Total	-$68 to -$116 Million	+$84 to +$132 Million

APPENDIX P

Subcommittee on Streamlined Sales Tax – "Draft Report"
(Draft Final Report, dated November 12, 2007)

Draft Report of Streamlined Sales Tax Subcommittee
November 12, 2007

The Subcommittee held its last meeting on November 7, 2007, to gather information from several guests and vote on a recommendation to the Commission regarding adoption of the Streamlined Sales Tax Agreements (SSTA) in Massachusetts. The guests included:

(1) Scott C. Peterson, Executive Director, Streamlined Sales Tax Governing Board, Inc.
(2) Stephen P. Kranz, General Counsel, Council on State Taxation
(3) Charles Collins, Vice President, Government Affairs, ADP Taxware
(4) Senator Richard T. Moore, Massachusetts Senate
(5) Deborah R. Bierbaum, Executive Director, External Tax Policy, AT&T
(6) Davida Walsh, Legislative Assistant, Congressman William D. Delahunt
(7) William C. Rennie, Vice President, Retailers Association of Massachusetts

After hearing from the guests listed above, and those appearing at the Subcommittee's meeting on October 3, 2007 (see status report of October 16, 2007), and the materials prepared for the Subcommittee by the Department of Revenue, the Subcommittee members voted unanimously to recommend to the Commission the adoption of SSTA. In making this recommendation, the Subcommittee found that the benefits of adopting SSTA outweighed the potential costs.

The following benefits were identified:

- tax fairness between bricks and mortar and internet businesses
- tax neutrality between consumers purchasing products in stores and over the internet
- prevention of erosion of sales tax revenue base as more sales take place over the internet, including digital products
- simplicity for multistate businesses thereby reducing administrative costs
- reduction of risk of audits for multistate businesses

- reduction of risk of class action suits against multistate businesses from consumers alleging erroneous sales tax charges
- adoption of SSTA does not require substantial changes to the existing Massachusetts sales/use tax laws (see attached DOR chart)

The Subcommittee weighed the following objections:

- loss of state sovereignty
- loss of local option taxes

A state adopting SSTA does not lose sovereignty because each state decides which items to tax. If an item is taxed, then the item is defined in accordance with the SSTA. Local option taxes can still be enacted so long as the provisions imposing such taxes are enacted in a chapter of the General Laws separate from the chapter of the General Laws incorporating the SSTA.

Finally, in making this recommendation the Subcommittee: (1) defers to the Commission regarding revenue adjustments; (2) urges the Commission to adopt an appropriate time frame for the transition from the current system to the SSTA (the DOR estimates that at least one year will be necessary); and (3) considers the adoption of SSTA beneficial to the Commonwealth even without the adoption of federal nexus legislation, although the enactment of such legislation would substantially enhance the benefits of the SSTA.

Respectfully submitted:

Karl Fryzel, Chair
Rep. John Binienda
Robert Tannenwald

III. Requirements that Must be Adopted for SST Conformity

E. Summary Chart of SST Requirements

SSTP Feature	SSTP Model Agreement	Change required for MA
State Tax Administration	State and local sales/use taxes must be administered at the state rather than local level.	None
Uniform Definitions with Tax Bases	The Agreement contains uniform definitions from which a state must define its tax base. The states can determine what is taxable or exempt but must use the uniform definitions. For example, a state can exempt "food," but must follow the uniform definition as to what constitutes food.	Substantial revisions to G.L. 64H and 64I, to include the model definitions and revising the exemptions in G.L. c. 64H, § 6 to fit with the new definitions as closely as possible. The current sales tax law has been amended in a piecemeal fashion over the past 30 years, often in response to a particular constituency or a particular case. The simplification required by the model act may eliminate some exemptions or require the Legislature to exempt a larger category of items than current law provides. Revisions will be needed to many DOR regulations.
Tax Rate Simplification	The Agreement provides states may have only one state tax rate. Rate changes must be made on the first day of a calendar quarter. Local jurisdictions may not have more than 1 rate per local taxing jurisdiction. States and local jurisdictions may not have caps or thresholds on the application of rates or exemptions based on the value of a transaction.	Generally not an issue for MA as we currently only have one statewide rate of 5% and no local sales/use taxes. However, the current treatment of clothing (exempt if less than $175 per item) would not be permissible after 12/31/05.
Uniform Sourcing Rules	The Agreement sources sales of property and services on a destination basis.	Generally, sourcing sales on a destination basis seems like a good approach and is consistent with current MA practice.
Simplified Exemption Administration	The Agreement recognizes 3 types of exemptions (1) product exemptions based on uniform definitions, (2) entity-based exemptions, and (3) use based exemptions. The Agreement requires uniform exemption certificates and elimination of any requirement on sellers other than obtaining the required certificate.	The 3 types of exemptions in the model Agreement are generally consistent with current MA law. We would have to adopt the uniform certificates and eliminate the statutory "good faith" requirement for a seller accepting a resale certificate contained in G.L. c. 64H, § 8. Note that most use and entity based exemptions could remain unchanged.

SSTP Feature	SSTP Model Agreement	Change required for MA
Caps and Thresholds	The Agreement eliminates caps and thresholds, *e.g.*, an exemption for clothing with a sales price of less than $175, because these are difficult for multistate sellers to administer.	The only change required would be to the clothing exemption. MA would have to either exempt or tax all clothing according to the uniform definition, although separate treatment is allowed for furs, protective clothing and sporting items.
Sales Tax Holidays	The model Agreement places restrictions on sales tax holidays.	Our holidays have been passed on a "one-time" basis and future ones would be permitted, but would need to conform to the SST requirements.
Centralized Registration and Amnesty	The Agreement provides for an online registration system that would permit a seller to register with all participating states. The Agreement provides for amnesty for past taxes for sellers voluntarily registering under the Agreement.	Some systems changes will be needed at DOR to participate in the central online registration system. The authority for an amnesty needs to be incorporated into legislation.
Uniform Rules for Recovery of Bad Debts	The Agreement provides that sellers will be allowed to claim a deduction on the sales/use tax return for the period when the bad debt is written off for federal income tax purposes rather than filing a separate refund claim.	MA currently requires sellers to file a separate refund claim. *See* TIR 00-3. G.L. c. 64H, § 33 and G.L. c. 64I, § 34 will require amendment.
Technology Models for Sellers to Collect Tax	Participating sellers can choose 3 new models for collecting and remitting tax or continue to file under each state's existing system. Briefly, Model 1 is a Certified Service Provider (CSP), an agent that performs all of the seller's tax functions (calculating, collecting, remitting tax and filing returns). The CSP's transaction fees may be paid by the states or the seller. Model 2 is a Certified Automated System (CAS). A seller selects a CAS (purchases tax collection software). Seller remits tax and files returns. Model 3 is a variation on Model 2 for large nationwide sellers that already have in place tax collection software. That system can be certified and operate as a CAS. Once the system is certified, no audits on tax calculation would be conducted (as in Model 2). States would verify tax remission and filing requirements.	Massachusetts statutes do not currently permit the use of state tax revenues to compensate entities providing tax functions for vendors. This would require a statutory change. Models 2 and 3 generally require audit of software systems in place of an audit of a seller's books and records. Purchaser use tax audits are also permitted.

SSTP Feature	SSTP Model Agreement	Change required for MA
Direct Pay Permits	A holder of a direct pay permit may purchase taxable goods and services without payment of tax at the time of purchase. The Agreement provides for direct pay permits with a uniform application and certificate, however each state may set its own limits and requirements.	After being discontinued in 1994, statutory authority for direct pay permits was reinstated by an amendment to G.L. c. 64H, § 3(b) effective 1/1/01. *See* TIR 00-9, Section III A, and 830 CMR 64H.3.1. Other than administratively adopting uniform application and certificate, no further change required.
Seller Compensation for Cost of Collection of Sales/Use Taxes	27 states currently permit sellers to keep a small portion of the tax collected to offset a portion of the economic burden of tax compliance. The appropriate amount of such seller compensation is the subject of the "Joint Collection Cost Study."	Massachusetts does not currently provide for seller compensation from tax revenues except insofar as sales tax "breakage" (the difference between 5% of a vendor's gross receipts and additional amounts collected due to the formula in G.L. c. 64H, § 4, for tax on fractional amounts of a dollar). *See* TIR 87-11. SST currently limits seller compensation to payment of CSP charges for new voluntary (non-nexus) sellers registering under the Central Registration System.
Uniform Rounding Rule	The SSTP has proposed the following rounding rules (1) eliminate bracket systems (2) compute tax to 3 decimal places (3) allow sellers to elect to collect tax on individual items or aggregate purchase (4) agree upon 1 rounding algorithm, *e.g.*, round up for any calculation of ½ cent or more, round down for any tax of less than ½ cent.	Massachusetts currently uses a bracket system. *See* G.L. c. 64H, § 4. This section will require revision. Elimination of the bracket system will reduce "breakage" (see discussion above). The SSTP does not contemplate a difference between a seller's tax collection and tax remission obligation. A revision in 64H will be required to define a vendor's tax remission obligation in terms of "tax collected in accordance with the provisions of this chapter" rather than "gross receipts."
Uniform Tax Return	The SSTP provides a seller would electronically file a single return with each state for each reporting period.	DOR will need to adopt the uniform return.

APPENDIX Q

"Preliminary Outline – Points for Discussion and Recommendation by Commission"
(staff outline circulated to members for discussion at Commission meeting
on December 5, 2007)

<u>Preliminary Outline</u> –- <u>Points for Discussion and Recommendation by Commission</u>

(Based on Committee reports)

- **Combined Reporting**
    - Committee took two votes, both in favor of combined reporting (one vote was 4-1 in favor, with condition of a corporate income tax rate cut designed to achieve revenue neutrality; the other vote was 3-2 in favor, without any condition related to revenue or rate – see staff recommendation #2 at end)
    - Technical underpinnings of Committee votes in favor of combined reporting:
        - Key concepts are to be reflected in the statute; also, allow sufficient time period for implementation of combined reporting, including development of regulations with opportunity for with significant public input into process
        - Water's edge election (not mandatory worldwide)
        - *Finnigan*, rather than *Joyce*, method of apportionment
        - Scope of entities to be included in combination and mechanics of combining them
        - Sharing of credits and loss carryforwards within combined group (Committee indicated general support for this principle)
        - Consideration of a possible safe harbor election to permit inclusion of certain entities in combined reporting group

- **"Check the Box" Conformity:** see Commission's interim report

- **Other Governor Proposals**
    - Application of room occupancy tax to amount customer pays for hotel room that is charged and retained by internet intermediaries, etc. (Committee voted 3-0 in favor)
    - Earned income credit – technical revision to limit credit available to non-residents (Committee voted 3-0 in favor)

- Application of corporate excise tax to non-insurance flow-through entities owned by insurance companies (Committee voted 2-1 in favor)

- Application of deeds excise tax to transfers of controlling interests in entities comprised of >80% real estate (Committee voted 2-1 in favor)

- Application of sales/use tax to transfers to captive leasing companies (Committee voted 2-1 against)

- **Streamlined Sales and Use Tax Agreement** -- Committee voted 3-0 to recommend that Massachusetts adopt conforming legislation to become a fully participating member state

  - Committee's recommendation did not extend to question of SSTP's revenue impact or to particular changes that would reduce revenue or raise offsetting revenue – deferred to full Commission and Legislature

  - Commission may wish to recommend that Legislature consider implementing any necessary sales/use tax revisions in a manner that will avoid any revenue loss

- **Reforms and Simplification --** Several Committees were focused on broader issues of potential reform and simplification:

  - **Business Tax Rates, Including Non-income Excise and "Balance Sheet Tax"**
  - **Minimum Corporate Excise**
  - **Alternatives to the Corporate Excise, Including Gross receipts, Gross Margin, Value Added Taxes**

Additional staff recommendations:

1. Consider recommendation for further study of reforms in the above areas of "reforms and simplification," specifically including, among other items:

- Reform of non-income measure/alternative minimum
- Simplification of multitude of rates/rules for different business entities
- More effective R&D incentives

Participants in study could include DOR and interested persons in Executive branch and Legislature, the business community, tax practitioners, and others in academia or public policy

2. Consistent with Combined Reporting Committee's recommendation, consider recommendation for some reduction in corporate excise rate, to encourage business competitiveness, while not requiring revenue neutrality continuing a public and transparent discussion of the reduction's amount and timing.

APPENDIX R

"MA Study Commission on Corporate Taxation – Outline of Major Points for Final Report"
(circulated by Representative Binienda at Commission meeting on December 5, 2007)

MA Study Commission on Corporate Taxation
Outline of Major Points for Final Report

The MA Study Commission on Corporate Taxation was created to study the modernization and simplification of the current business tax laws of the Commonwealth, promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness. Consolidation of business tax rates and a reduction in the tax rate on corporate income is critical to creating a tax reform package that promotes tax fairness and equity, encourages business growth and innovation, and strengthens the Commonwealth's global competitiveness. We prefer and recommend a rate reduction to the tax rate on personal income, 5.3%. However, we recognize that some members of the Commission may not favor a reduction of that magnitude and some do not favor a corporate tax cut standing alone. In the spirit of compromise and with the objective of preparing a final report that can be supported by a majority of the Commission, we offer the following outline of a comprehensive tax reform package that modernizes and simplifies the current business tax laws promotes tax fairness and equity, encourages business growth and innovation, and strengthens the Commonwealth's global competitiveness, <u>and is revenue neutral</u>. Overall revenue neutrality is a pre-condition for the consideration of any component of this proposal. All revenue estimates need to be evaluated by DOR and confirmed by an independent third party.

A. <u>Tax Rate</u>: **6.0%** for all income that is taxed at the corporate level, except Financial Institutions, Insurance Companies and Securities Corporations.

Fiscal Note: Loss - approx. $700M.

B. <u>Filing Requirements</u>: **Check the Box** and **Combined Reporting**:

1. same effective date for both provisions
2. a working group of tax practitioners will draft the statutory language and present the version to the Special Commission for approval. The version of combined reporting must include a safe harbor that permits businesses to elect to combine the entities included in their Federal consolidated group (which would be deemed to include 80% or more owned domestic flow-through entities) and allow for water's edge election.

Fiscal Note: Gain - approx. $500M.

C. Business Credits: Reduce the rate of the remaining business credits by the same percentage that the 9.5% tax rate is reduced.

Example: 3% ITC would be reduced to 1.8945% (reflecting a reduction of 36.85% - same as reduction from 9.5% down to 6.0%).

Fiscal Note: Gain - approx. $100M.

D. Minimum Corporate Rate: Adjust the amount of the minimum corporate rate to make this entire proposal revenue neutral.

Fiscal Note: Gain - approx. $100M.

E. Other:

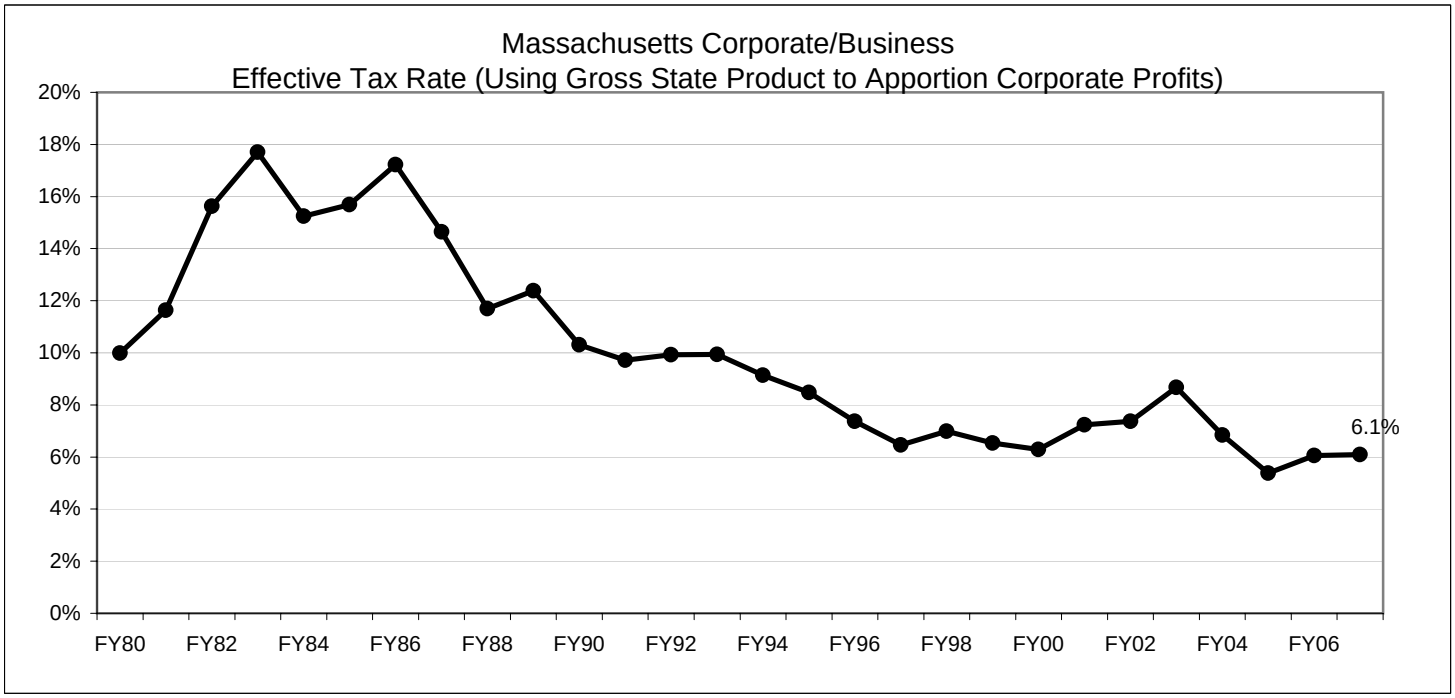
- Streamlined Sales & Use Tax Agreement: Implement necessary legislation to make Massachusetts a fully participating member
- Other Governor proposals to be studied further:
    - Non-Income Measure: assess reporting rules
    - Earned Income Credit: non-resident restrictions
    - Insurance Companies: treatment of certain subsidiaries
    - Deeds Excise: application to certain transfers of interests
    - Room Occupancy Excise: end-consumer purchase price basis

APPENDIX S

"Some facts about Massachusetts business taxation"
(presented by Commissioner of Revenue Henry Dormitzer
at Commission meeting on December 5, 2007)

Some facts about Massachusetts business taxation

- **The actual business impact of prior loopholes was approximately $200 million.**
  - It has been said that "Loopholes 1 through 3" raised taxes on business by $400 million.
    - In fact, DOR estimated the total fiscal impact of "Loopholes 1 through 3" to be $377 million. However, many of those loophole fixes were not specific to businesses (for instance, intercepting lottery winnings for tax obligations or sales tax on software in "intangible form"). In total, the impact of prior loophole bills on business was approximately $250 million.
    - Note that $50 million of the $250 million business impact is attributable to the captive REIT tax-planning strategy. DOR has been winning litigation relating to the captive REIT strategy under prior law. The courts and the Appellate Tax Board have found that even under prior law (i.e., without the captive REIT loophole closing law), various captive REIT structures were an invalid tax planning device. The loophole closing law was clarifying but itself did not "raise the business tax burden". These tax shelters were already illegitimate under old law. This leaves $200 million of loophole closings affecting businesses.
- **Our tax system cannot keep pace with tax planning strategies.** Massachusetts' business tax system has become less effective: over the last ten years corporate profits in Massachusetts have grown over 70% - a good thing. Over the same period, business tax collections have increased only 49%.
- **Over 72%, or approximately $700 million, of the state's pending tax litigation receivable is attributable to income shifting** and would not exist if Massachusetts had a combined reporting tax system.
- **Combined reporting and check-the-box reform are important reforms to the business tax regime, and they go hand-in-hand and must be adopted together.** Together they are a comprehensive response to prevalent tax planning strategies available to multi-state businesses. Michael Mazerov of the Centers on Budget and Policy Priorities recently wrote, "Combined reporting nullifies most of these shelters in one fell swoop. Attacking them one by one, as some states are doing, is inefficient and costly. Moreover, some of the strategies simply cannot be shut down effectively by any policy other than combined reporting."
- Massachusetts' corporate tax rate is among the highest nationally (we rank 4th with a nominal rate of 9.5%) although our effective tax rate is substantially lower at 6.1%. **A study by the national Council on State Taxation determined that Massachusetts business taxation is below average:** business taxes in Massachusetts represent 4.4% of Massachusetts Gross State Product (compared to 5.1% national average). (For purposes of its study, COST included sales and property taxes in its calculations.)
- **Massachusetts' personal income tax rate ranks 29th in the country.** The personal income tax is paid by employees and also by partnerships and other pass through entities.


Massachusetts Corporate/Business
Effective Tax Rate (Using Gross State Product to Apportion Corporate Profits)
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
FY80
FY82
FY84
FY86
FY88
FY90
FY92
FY94
FY96
FY98
FY00
FY02
FY04
FY06
6.1%

APPENDIX T

Examples of Combined Reporting/Apportionment
(circulated via e-mail by Mr. Kidder, Chairman of Subcommittee on Combined Reporting, on December 4, 2007)

From: Kidder, Stephen W.
Sent: Tuesday, December 04, 2007 12:47 PM

One of the issues that was left open in the Combined Reporting Subcommittee Report was the issue of what entities would be included in a combined group and how the combination would work with different entities. The DOR has put together the two examples set forth below as illustrative of the approach that they think makes sense. Our subcommittee has not had an opportunity to meet to discuss the examples and will not have the opportunity before tomorrow's meeting. I am forwarding the examples to everyone.

Illustrative Draft: Here are two combined reporting/apportionment examples reflecting a general methodology under a MA combined reporting system, and addressing the MA statutory structure of different apportionment formulas for different types of taxpayers. Note that under this methodology, members of a combined group that are manufacturers, utilities, financial institutions, etc. would maintain their existing classifications, apportionment formulas, tax rates, etc. Also, the examples include *Finnigan* adjustments. Both examples should be considered as illustrative draft proposals for discussion purposes -- not as the only way to apportion or as the only way DOR would support.

The 1st example includes two business corporations, one treated as a manufacturing corporation and thus subject to single sales factor apportionment, and the other treated as a general business corporation subject to traditional 3-factor apportionment. The 2d example includes a financial institution (FI) in the unitary group, illustrating a combination among FIs and non-FIs (which, under MA statutes, utilize differing sales and property factors).

Example 1: Use of Single Sales Factor and Three Factor Apportionment with

***Finnigan* adjustment**
Comment: This is a fact pattern where there are four corporations in the combined unitary group, A, B, C, and D -- where Corporation A is a MA-nexus manufacturing corporation using single sales factor apportionment and Corporation B is a MA-nexus general business corporation using three factor apportionment (with double weighted sales). Corporations C and D, the non-nexus corporations, are corporations engaged in manufacturing and in general business activity, respectively (although, as demonstrated by the example, the status of the non-nexus corporations as manufacturing or business corporations does not affect the calculation). In the case of MA sales by a non-MA nexus member (in this case, by C), which are to be reattributed to MA nexus members under *Finnigan*, the reattributed sales would be distributed among MA nexus members (in this case, A and B) based on the ratios of MA sales among the MA nexus companies.

Company A. (MA Nexus; Manufacturing Corporation)
Property, MA/Everywhere: 1000/1100
Payroll, MA/Everywhere: 500/600
Sales, MA/Everywhere: 100/5000

Company B. (MA Nexus; Non-manufacturing Business Corporation)
Property, MA/Everywhere: 500/550
Payroll, MA/Everywhere: 200/250
Sales, MA/Everywhere: 400/500

Company C (No MA nexus; Manufacturing)
Property, MA/Everywhere: 0/900
Payroll, MA/Everywhere: 0/600
Sales, MA/Everywhere: 500/4000

Company D (No MA nexus; Non-manufacturing)
Property, MA/Everywhere: 0/300
Payroll, MA/Everywhere: 0/400
Sales, MA/Everywhere: 0/2000

Combined Group Denominators (totals of separate company numbers above).
Sales 11500
Property 2850
Payroll 1850

Combined Group Income in this example will be $5,000.

<u>Company A Calculation</u> (Manufacturer single sales factor formula)
(100 + 100*/11500) x $5000
= .0174 x $5000
= $87 of income apportioned to MA
*Reattributed 1/5 of $500 MA sales from Company C, using Company A:Company B MA sales ratio of 1:4

Company B Calculation (Standard 3 factor formula; double weighted sales)
[(400+400**/11500 x 2) + 500/2850 + 200/1850]/4 x $5000
= [(0696 x 2) + .175 + .108]/4 x $5000
= .1056) x 5000
= $528
**Reattributed 4/5 of $500 MA sales from Company C, using Company A:Company B MA sales ratio of 1:4

Example 2. Combined Apportionment Example including Financial Institution (FI) and Non-Financial Institution (Non-FI) Group Members; *Finnigan* Adjustment

Comment: The amounts included in the sales and property factors of FIs are broader than those of non-FI entities, generally including interest and certain intangibles that are excluded by statute from the non-FI factors. Therefore, if a combined group contains both FI and non-FI members, the group as a whole would compute two sales and property factor denominators (i.e. “everywhere” sales and property), one calculated using FI rules and one calculated using non-FI rules. Each FI group member would determine an apportionment percentage with the FI denominator; each non-FI group member would determine an apportionment percentage with the non-FI denominator. In the case of MA sales by a non-MA nexus member, which are to be reattributed to MA nexus members under *Finnigan*, the reattributed sales would be distributed among MA nexus members based on the ratios of MA sales among the MA nexus companies. In this example, the ratio would be based on FI or non-FI sales, depending on whether the particular MA nexus member to whom sales are reattributed is an FI or a non-FI.

Company A. (MA Nexus; Financial Institution)

Sales (FI rules)	100/1000;	Sales (non-FI rules)	10/50;
Property (FI rules)	800/10000;	Property (non-FI rules)	50/200;
Payroll	25/200		

Company B. (MA Nexus; non-FI Business Corporation)

Sales (FI rules)	20/300	Sales (non-FI rules)	15/250
Property (FI rules)	50/100	Sales (non-FI rules)	45/75
Payroll	10/100		

Company C. (No MA nexus; non-FI Business Corporation)

Sales (FI rules)	36/5000	Sales (non-FI rules)	25/4000
Property (FI rules)	0/300	Property (non-FI rules)	0/200
Payroll	0/200		

Combined Group Denominators (totals of separate company numbers above).

Sales (FI rules)	6300	Sales (non-FI rules)	4300
Property (FI rules)	10400	Property (non-FI rules)	475
Payroll	500		

Combined Group Income in this example will be $1,000.

Company A Calculation (FI 3 factor formula)

[(100 + 30*)/6300 + 800/10400 + 25/500]/3 x $1000
= [0.02063 + 0.07692 + 0.05]/3 x $1000
= .04918 x $1000
= $49.18 of income apportioned to MA
*Reattributed 5/6 of $ 36 MA sales (FI) from Company C, using Company A:Company B FI MA sales ratio of 5:1

Company B Calculation (Standard 3 factor formula; double-weighted sales)

[2(15 + 15**)/4300 + 45/475 + 10/500]/4 x $1000
= [0.01395 + 0.0947 + 0.0200]/4 x $1000
= 0.03216 x $1000
= $32.16 of income apportioned to MA
**Reattributed 3/5 of $25 MA sales (non-FI) from Company C, using Company A:Company B non-FI MA sales ratio of 2:3

APPENDIX U

Proposed Motion
(circulated via e-mail by Representative Jones on December 17, 2007)

From: Jones, Bradley - Rep. (HOU)
Sent: Monday, December 17, 2007 11:10 AM

December 17, 2007

Dear Members of the Corporate Tax Study Commission:

I enclose for your review a copy of a motion I intend to offer for consideration at the beginning of our next commission meeting on Tuesday, December 18, 2007, that will ensure a discussion and decision on revenue neutrality.

Based on the draft report, one of the most important decisions the commission will be forced to make is whether it should recommend increasing business taxes. I believe, and I think other members agree, that it will be impossible for the commission to reach consensus on a set of recommendations unless there are also accommodations made so that our state does not end up profiting off of our business community as a whole. I also think it is important to make this decision about revenue neutrality up-front, before we make decisions on the more specific tax policies that are before us.

The purpose of our commission is to promote the predictability and simplicity of our business tax code, to make it fairer and more equitable and to increase the competitive advantage for businesses in this state. I believe recommendations primarily intended to raise new revenue do not fulfill the role of the commission.

As it prepares its budget for Fiscal Year 2008, the administration claims that we are facing a substantial budget deficit. It proposes to close the gap by raising new revenues, including corporate taxes. While this quick fix for our budgetary problems has certain appeal, I believe the potential for long-term damage to businesses outweighs any short-term benefits. Our commission should not be responsible for making such recommendations.

The concept of revenue neutrality is important for the economic wellbeing of our commonwealth. Over the past few years we have increased taxes on our businesses by $378 million per year. In addition, recent passage of property tax classification legislation will stall a promised reduction in business property taxes. Massachusetts has still not regained the 220,000 jobs lost from the recession which began in March 2001, with recent unemployment estimates hovering at 150,300 individuals. Employers will spend an estimated $175 million a year for additional employee coverage under the new health care reform law, and our failure to enact changes to unemployment insurance laws could cost businesses up to $153 million more next year. Now is not the time to think of placing even greater burdens on our business community.

With this in mind, I hope that you will review the attached motion favorably and that we can have a lively and productive discussion about this issue at the start of our next meeting. Thank you for your consideration.

Sincerely,

Bradley H. Jones, Jr.
House Minority Leader

Mr. Jones moves that the study commission on corporate taxation hereby resolve that its final report on long-term changes to the corporate tax laws be revenue-neutral, in that any recommendations that would have the purpose or effect of increasing business taxes shall be offset by corresponding recommendations to decrease business taxes, such that the net increase or decrease in revenue payable to the commonwealth by business corporations as a result of such recommendations shall be as close to zero as possible.

APPENDIX V

"Study Commission on Corporate Taxation – December 18, 2007 -- Agenda"
(circulated by Chairwoman Kirwan at Commission meeting on December 18, 2007)

STUDY COMMISSION ON CORPORATE TAXATION
December 18, 2007

AGENDA

Consideration of draft final report:
(see pages 26-27 of draft report for list of decision items, as follows:)

1. Combined reporting (based on discussion to date, commission members should indicate whether this recommendation should be joined with meaningful corporate income tax rate cut, and whether achieving revenue neutrality is a critical component)

2. Apply room occupancy tax to charges of intermediary resellers

3. Clarify earned income credit

4. Adopt streamlined sales and use tax agreement, with commonwealth becoming full participant in streamlined sales tax project

5. Apply corporation excise to non-insurance business entities that are not currently subject to income tax on business income (also, per discussion above, members may wish to consider further study of this, e.g., issues of potential retaliatory tax efforts in other states)

6. Apply deeds excise to certain transfers of controlling interests in companies whose assets are primarily real estate (also, per discussion above, members may wish to consider further study of this, e.g., degree to which a law change is needed given current law protections against tax-avoidance transactions)

7. Encourage further study by working group hosted by DOR

APPENDIX W

Letter to Chairwoman Kirwan from COST regarding Subcommittee Draft Reports
(dated December 3, 2007)

COST
COUNCIL ON STATE TAXATION

Officers, 2007-2008

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J. Hugh McKinnon
Covidien

Richard Prem
Amazon.Com

Bruce J. Reid
Microsoft Corporation

Frances B. Sewell
Tyco International (US), Inc.

John H. Stagmeier
Georgia-Pacific LLC

Amy Thomas Laub
Tempur-Pedic International Inc.

Warren D. Townsend
Wal-Mart Stores, Inc.

R. Paul Weatherford
Sears Holdings Management Corporation

James Williams
Massachusetts Mutual Life

Joseph R. Crosby
Legislative Director
(202) 484-5225
jcrosby@statetax.org

December 3, 2007

Study Commission on Corporate Taxation
Secretary Leslie A. Kirwan
Executive Office for Administration & Finance
State House, Room 373
Boston, Massachusetts 02133

Re: Draft Reports of the Subcommittees of the Study Commission on Corporate Taxation

Dear Secretary Kirwan:

The Council On State Taxation (COST) appreciates the diligent work of the members of the Study Commission on Corporate Taxation ("the Commission") and the opportunity to testify before the full Commission as well as its subcommittees. In response to the draft reports recently released by the subcommittees, COST submits the following comments.

About COST

COST is a nonprofit trade association based in Washington, D.C. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Report of Subcommittee on Combined Reporting

Moving from a separate entity reporting regime to a mandatory unitary combined reporting regime would be a radical change for Massachusetts. COST is opposed to mandatory unitary combined reporting due to the costly administrative burdens it imposes on taxpayers and the considerable uncertainty that results from its use. For these reasons, further discussed below, COST urges the Commission not to recommend combined reporting as part of its final report.

In testimony before the Commission on this issue in early May, COST was "neutral" with regard to the concept of mandatory unitary combined reporting. Later that same month, the COST Board of Directors voted to change COST's position on mandatory unitary combined reporting to "oppose". This change in COST's position came as a result of extensive consultations with COST members that shed further light on the substantial and unnecessary administrative burdens that mandatory unitary combined reporting imposes on taxpayers. COST's opposition to mandatory unitary combined reporting is also based on the fact that many states considering this issue are utilizing the significantly flawed model legislation developed by the Multistate Tax Commission.

The negative consequences to the Commonwealth if it were to enact such a change must be carefully considered. Mandatory unitary combined reporting is complicated, costly to administer, and it creates significant uncertainty for both taxpayers and states. It may also depress economic development in the Commonwealth.[1] Only one state, Vermont, has moved to a mandatory unitary combined reporting regime in the past two decades, and that change was made as part of an overall corporate tax reduction.[2] COST urges the Commission to consider the following:

- Unitary combined reporting is a tax system choice, not a means of increasing tax revenue. Especially in the short term, a state converting to combined reporting may experience revenue loss as taxpayers file returns under the most favorable interpretation of the new law (and potentially file refund claims).

- The effect of combined reporting on a corporation's state tax liability is dependent upon the profit level of each member of the combined group relative to the location of the members' apportionment factors. The result is that some corporations will experience—either temporarily or on an ongoing basis—a reduction in their state income tax liability while other corporations will experience an increase in tax. According to a study completed by Pennsylvania, if mandatory combined reporting were enacted in that state, 2,100 firms would experience a tax reduction and 2,730 firms would experience a tax increase. Minnesota adopted mandatory unitary combined reporting in 1981. At the time, the state projected increased revenues of $63 million (the mid-point of an estimate with a range of $23-103 million). By 1983, after mandatory unitary combined reporting was implemented, the estimate of the actual change in revenue was zero ($0.0).

- Although many states have considered such a change, most have rejected moving to mandatory unitary combined reporting. Just this year, such legislation has been rejected in Iowa, Maryland, New Mexico, North Carolina and Wisconsin.

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[1] Williams, Michael G., Charles W. Swenson and Terry L. Lease, "Effects of Unitary vs. Nonunitary State Income Taxes on Interstate Resource Allocation: Some Analytical and Simulation Results," Journal of the American Taxation Association, Vol. 23, No. 1, Spring 2001, pp. 39-60.

[2] New York changed its laws regarding corporate tax reporting in 2007, but the New York law is unique and is premised on "substantial intercorporate transactions" between related entities rather than on a unitary relationship, per se. West Virginia passed legislation adopting mandatory unitary combined reporting this year, but the law is not effective until 2009. Michigan, Ohio and Texas have also adopted some form of mandatory unitary combined reporting recently, but all are in the context of gross receipts or other alternative base (non-income) business taxes and thus have dramatically different motivations and effects.

- The concept of a "unitary business" is uniquely factual and universally poorly defined. It is a constitutional (Due Process) concept that looks at the business as a whole rather than individual separate entities or separate geographic locations. The criteria used to determine whether a group of business entities or divisions are "unitary" are derived from state statutes and regulations and state and federal case law and are often based upon a "flow of value" among the entities or divisions at issue. Due to differing state definitions and case law, the entities included in a business' "unitary group" are likely to vary significantly from state to state. Due to the factual nature of the inquiry into which entities are members of the unitary group, unitary combined return audits take much longer than separate company return audits and often require more corporate and state personnel to effectively complete the audit.

- Specific industries, such as insurance, are subject to other taxes in lieu of corporate income taxes. Including entities subject to non-income tax regimes within the combined group raises particular and serious policy concerns.

COST urges the Commission to reject a recommendation for the adoption of mandatory unitary combined reporting.

Report of Subcommittee on Alternative Tax Structures

The Subcommittee on Alternative Tax Structures thoroughly reviewed Massachusetts' existing corporate tax structure and potential alternative tax structures that have been adopted or considered recently in other states. COST offers the following two comments on the subcommittee's report:

- The subcommittee report expresses opposition to gross receipts taxes; COST shares that opposition. Gross receipts taxes are widely understood to represent poor tax policy, as they violate the tax policy principles of transparency, fairness, economic neutrality and competitiveness. For a full treatment of such taxes, COST encourages the Commission to review a recent study prepared for COST and the Tax Foundation by Professor John Mikesell of Indiana University (enclosed).

- The subcommittee report says: "The alternative regimes might be considered…as alternative minimum taxes designed to exact some tax from corporations that benefit from state-provided services and infrastructure even when they have no taxable income." This comment is out-of-place in an otherwise balanced report and reflects a fundamental misunderstanding of the Commonwealth's business tax system. As the subcommittee's report notes elsewhere, businesses are already subject to an alternative tax regime in Massachusetts (the net worth tax) and businesses pay a substantial portion of the state sales tax. Businesses pay numerous other taxes and fees to support state services and infrastructure. None of these other taxes rely on profitability. At the local level, businesses pay a disproportionate share of property taxes due to the fact that taxes are levied on business property in the Commonwealth at nearly twice the rate of residential property. Finally, if the proper justification for business taxes is the "benefits received" principle, the economic research in this area suggests that businesses are currently "overpaying" taxes.[3]

[3] William H. Oakland & William A. Testa, "State-Local Business Taxation and the Benefits Principle," Federal Reserve Bank of Chicago, *Economic Perspectives* (1996).

Report of Subcommittee on Streamlined Sales Tax

COST supports the recommendation of the Streamlined Sales Tax Subcommittee to adopt the Streamlined Sales and Use Tax Agreement (SSUTA). A sales and use tax must be easily administered, easily understood by consumers, and nondiscriminatory between similarly situated vendors, purchasers, and goods. As the subcommittee aptly points out, the existing state and local sales and use tax system creates burdensome and unnecessary complexity, which imposes substantial costs on vendors, states, and consumers.

Conclusion

Thank you for the opportunity to comment on the draft reports of the Massachusetts Study Commission on Corporate Taxation. We appreciate the Commission's interest in COST's views and look forward to the final report of the Commission. If you have any questions regarding our comments, please contact me.

Sincerely,

Joseph R. Crosby

Cc: Richard C. Lord, President & Chief Executive Officer, Associated Industries of Massachusetts
Doug Lindholm, President & Executive Director, Council On State Taxation
COST Board of Directors

APPENDIX X

Letter to Commission from NAIOP regarding Deeds Excise Tax
(dated October 15, 2007)

October 15, 2007

Special Commission on Corporate Taxation
c/o David Sullivan
Executive Office of Administration & Finance
State House, Room 373
Boston, MA 02133

Dear Member:

On September 25, 2007, NAIOP made a presentation to the Special Tax Commission's Subcommittee on the Governor's Tax Bill (House No. 3756) Section 87 of which (the "Bill') would amend Chapter 64D of the General Laws to dramatically expand the collection of deed excise tax to transactions never contemplated at the time the deed excise tax was originated and never to date taxed by this state. What follows is a summary and a follow-up to our testimony.

I. Background – Functions of the Bill

The Bill broadens the reach of Section 1 of Chapter 64D as follows:

- by expanding the definition of "conveyance" of real property or interest in real property to include any ***"transfer or acquisition of a controlling interest in any entity with an interest in real property."***

- by expanding the definition of "interest in real property" to include ***"a life estate, a perpetual easement, or a leasehold or subleasehold interest … [with a term exceeding 49 years]."***

  by providing that an excise tax is payable ***"regardless of whether the conveyance is evidenced by a deed, instrument, or other writing or whether such deed, instrument or writing is recorded."***

- by defining a "transfer or acquisition of controlling interest" very broadly and to include transfers by persons "***acting in concert,"*** concepts which are to be defined in the future in accordance with new regulations to be promulgated by the commissioner.

II. There is no "Loophole" in the Deed Excise Tax Law in Massachusetts

The Governor submitted the Bill to the Legislature on February 28, 2007 to close a perceived loophole in Chapter 64D. NAIOP believes that the Bill is premised upon a well intentioned but misinformed position held by the Department of Revenue ("DOR").

DOR has stated its rationale for expanding the deed excise tax to include the transfer of a controlling interest in any entity that holds real estate as follows:

144 Gould Street, Needham, Massachusetts 02494 781-453-6900 fax: 781-292-1089 www.naiopma.org

Companies have often attempted to avoid the Massachusetts deeds excise by placing real estate in a partnership, limited liability company, or other entity and selling the interests in the entity rather than selling the real estate itself. The proposal would extend the deeds excise to transfers of a controlling interest in an entity holding real estate. This proposal would follow a model adopted a number of years ago by New York State. Sales of shares in a publicly-traded company would not be taxed under the proposal. (emphasis added)

NAIOP emphasized to the subcommittee that Limited Liability Companies ("LLC's") and similar entities categorically are not used to avoid paying deed excise taxes. The liability concerns associated with acquiring a controlling interest in an entity far outweigh the savings associated with tax of $4.58 per $1,000 dollars of consideration. Such entity interests are interests in personal property which do not have any of the record title benefits afforded to interests in real estate. Would any purchaser of a $500,000 home accept the risk of unlimited unknown liabilities in order to share in a seller's avoidance of $2,290 in deed stamps? The subcommittee seemed to agree that the answer is obvious but expressed concern that more sophisticated tax avoiders may be at work in the Commonwealth.

The subcommittee, which includes the former commissioner of DOR, know of **only one example** of sophisticated tax avoidance. Apparently, a major downtown real estate acquisition had been announced in the news but no deed excise stamps were purchased in connection with the transaction. DOR only needed to review the Official Records section of the weekly Banker and Tradesman to discover an obvious sham transaction to avoid taxes. The seller recorded a deed transferring the property to a new LLC for nominal consideration immediately prior to the transfer of the membership interests to the buyer. DOR notified the seller who wisely paid the deed excise tax. In other words, the system worked in that case and the Bill is absolutely unnecessary to deal with such a case.

The subcommittee expressed concern that there may be other such sham transactions that DOR does not know about because transfers of entity interests are not recorded. This misses the point that, because of the liability concerns the subcommittees conceded are legitimate, such a sham transaction will **always** be immediately preceded by the recording of deed transferring the property to a newly formed entity which is easily detected.

Since the Bill does not close any loopholes in Chapter 64D, it should be considered on its merits as a new tax.

III. Regulations and Bureaucracy

There are significant uncertainties created by the Bill which can only be addressed by the promulgation of comprehensive, detailed regulations. Since the Bill does not provide much guidance as to its intended scope, the regulatory process is likely to be protracted. The real estate industry will effectively be paralyzed during this interim period.

The many issues requiring regulatory clarification include:

a. Valuation of life estates, easements and leaseholds;

b. Determination of controlling interests;

c. Determination of whether an entity owns "directly or indirectly" real estate "wherever situated" exceeding 80% of the fair market value of all the assets of the entity;

d. Treatment of tax credit transactions, family partnerships used for estate planning, joint venture agreements, and mezzanine debt financings, to name only a few.

IV. The Bill would add unnecessary legal, accounting and appraisal costs to transactions.

Appraisals will be required to determine if more than 80% of the value of an entity's assets consists of real estate. Although the Bill appears to require valuation of an entity's real estate assets in and outside of Massachusetts, some members of the subcommittee suggested that the intention was that the 80% test would apply only to Massachusetts real estate. In either event, this requirement will cause significant delays and increased costs to transactions without any benefit that would not be achieved if the test were simply that all or substantially all of the entity's assets consist of Massachusetts real estate.

Additional accounting and legal costs will be incurred to properly allocate the consideration for the transfer of the entity interest to the entity's Massachusetts real estate. Similarly, determining whether a controlling interest in the entity has been transferred and when will be extremely complex in certain cases. Consider, for example, the case of real estate joint venture where, because of the performance of the asset, control of the partnership shifts among the partners without any transaction of any kind.

V. The New York model should not necessarily be adopted in Massachusetts.

If the intention of the Bill is to create a new tax in Massachusetts similar to the New York Real Estate Transfer Tax, the merits of the Bill should be evaluated as a new tax and not as a device to close a "loophole" that does not exist.

VI. The revenue generated will be directed to the Registry of Deeds.

If enacted, the money generated from this proposed language would be directed to the Registry of Deeds, not the General Fund. There is no obvious need for further funding of the Registry at this time. If the goal of this proposal is to generate additional revenue for cities and towns in Massachusetts, it will not be achieved.

Thank you for the opportunity to provide comments on this proposal. Please contact me if you have any questions or would like to further discuss this matter.

Sincerely,

NAIOP, MASSACHUSETTS
National Association of Industrial and Office Properties

David I. Begelfer
Chief Executive Officer

APPENDIX Y

Letter to Commission from NFIB regarding Gross Receipts Tax
(dated September 14, 2007)

SEP 17 2007

MASSACHUSETTS

September 14, 2007

Leslie Kirwan, Secretary of Administration and Finance
Chair of Study Commission on Corporate Taxation
State House – Room 373
Boston, MA 02133

Re: Proposed Gross Receipts Tax

Dear Secretary Kirwan and Members of the Commission:

In my first written testimony to the Commission dated May 22, 2007, I made several proposals to alter corporate tax policy to make Massachusetts a more hospitable environment for job growth and economic opportunity. Representing the state's largest small and independent business organization, I emphasized small business owners' support for an equitable and fair corporate tax structure as an essential element to the creation of the more favorable business climate for the small business sector that creates most new jobs.

After reading press coverage of your deliberations, I wanted to make clear small business' opposition to a gross receipts tax (GRT) or variation thereof. Although its supporters claim simplicity and ease of collection of substantial revenue (broad base and low rates) as attributes of a GRT, its application is usually more complicated than expected and its broad-based impact often produces unanticipated consequences.

A GRT creates negative economic consequences and encourages poor economic decision-making. The GRT assessed consistently at each level of production will increase costs to consumers. Since the tax is assessed at each level of production, larger companies are encouraged to vertically integrate to eliminate some taxable levels of production, while small companies that are less able to integrate continue to pay the tax at every level. Larger businesses with greater mobility are also better able to seek a neighboring jurisdiction that does not impose a GRT so that they can produce a lower cost product, leaving the jurisdiction with the GRT, and the small businesses remaining there, less competitive.

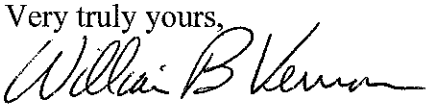
Finally, and most importantly, the GRT fails to satisfy the fairness test because it does not reflect a business' ability to pay. Again, small businesses with generally less liquidity are disadvantaged as the tax is assessed on gross receipts rather than net

National Federation of Independent Business - MASSACHUSETTS
10 High Street, Suite 401 • Boston, MA 02110 • 617-482-1327 • Fax 617-482-5286 • www.NFIB.com

receipts. Capital intensive industries, often small businesses and start-ups, are also disadvantaged. Many retailers as well are especially unfairly impacted.

In summary, adoption of a gross receipts tax (GRT) is not a change that will create a healthier and more favorable climate for business in Massachusetts. The National Federation of Independent Business (NFIB), the state's largest small business advocacy organization, opposes the adoption of a GRT in Massachusetts.

Very truly yours,



William B. Vernon

WVB:ec
cc: Members of the Study Commission on Corporate Taxation

APPENDIX Z

"Massachusetts Business Taxes: Unfair? Inadequate? Uncompetitive?"
(by Robert Tannenwald, version dated August 20, 2004)

Public Policy
Discussion Papers
Federal Reserve Bank of Boston

No. 04-4

Massachusetts Business Taxes: Unfair? Inadequate? Uncompetitive?

Robert Tannenwald

Abstract:
In debating Massachusetts business tax policy, protagonists have cited many different indicators purporting to assess the fairness, adequacy, and competitiveness of the Commonwealth's business taxes. These statistics actually reveal very little about the degree to which Massachusetts business taxes achieve these widely accepted tax policy goals. The author explains why these indicators are misleading and presents new indicators of business tax competitiveness that, although imperfect, are more accurate than those most widely quoted. The article concludes that the fairness of Massachusetts business taxes is unclear and that the Commonwealth's corporate income taxes are inadequate. The clearest conclusion drawn is that Massachusetts business taxes do not harm its competitive standing.

JEL Classification: H25, H71, O10

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This paper, which may be revised, is available on the web site of the Federal Reserve Bank of Boston at http://www.bos.frb.org/economic/ppdp/index.htm.

The views expressed in this paper are solely those of the author and do not reflect official positions of the Federal Reserve Bank of Boston or the Federal Reserve System.

This version: August 20, 2004

Massachusetts policymakers have vigorously debated the optimal level of state and local business taxes since the founding of the Commonwealth. Lately, they have focused on three concerns about these taxes: Are they "fair"? Are they "adequate"? and Are they "competitive"? Tax reformers have argued that businesses are not paying their fair share and that the Commonwealth could tax firms more heavily without damaging its competitive standing. Reformers have also contended that long-term competitive pressures to keep taxes low and increasingly aggressive tax avoidance efforts have diminished the yield of the corporate excise tax so much that the ensuing revenue squeeze is seriously impeding state and local governments from meeting the demands of constituents for public services. By contrast, business groups contend that many employers would shrink their operations or would relocate if their taxes were increased. Some such groups also contend that state and local governments have sufficient revenues to meet the demands of their constituents. To them, the chief fiscal problem is wasteful spending, not inadequate revenue.

For those who have struggled to give policymakers lucid, impartial insights into these issues, recent developments have been discouraging. Sparring interest groups have spawned a thicket of statistics whose derivation is not always clearly explained and whose significance and relevance are sometimes difficult to fathom. Consequently, many policymakers have trouble making sense of the jumble of testimony, reports, tables, and charts that are presented to them by lobbyists across the political spectrum.

This paper aims to clarify recent debate about the fairness, adequacy, and competitiveness of state and local business taxation in Massachusetts. It evaluates the validity of indicators prominently cited in this debate and offers two new indicators of business tax competitiveness. Section I defines a business tax and briefly explains the concepts of fairness, adequacy, and competitiveness in the context of business taxation. Section II presents and assesses indicators recently used in Massachusetts to evaluate the Commonwealth's business taxes in general, and its corporate excise tax in particular, according to these three normative tax policy goals. Section III presents two new

indicators of tax competitiveness and and applies them to business taxation in the 50 states in order to assess the competitiveness of Massachusetts business taxes. Section IV summarizes and offers suggestions for further research.

The article finds evidence that the adequacy of the Massachusetts corporate excise tax has diminished in recent years. Evidence concerning the fairness of this tax, as well as the fairness and adequacy of the Commonwealth's business taxes in general, is inconclusive. The clearest conclusion drawn is that, taken as a whole, Massachusetts business taxes do not diminish the Commonwealth's competitive standing.

I. Background

A "business" tax is one that a private firm, as opposed to a household, is legally obliged to pay. A clear example is the corporate income tax. By contrast, a property tax on owner-occupied housing is a "household" tax.[1]

What are the principal attributes of an equitable, adequate, competitive business tax?

Equity

Standards of tax fairness are inherently subjective. Nevertheless, two abstract norms of equity enjoy widespread acceptance: the "ability to pay" principle and the "benefit" principle (Musgrave and Musgrave 1984). According to the former, tax burdens should be distributed among households according to their ability to bear

[1]Distinguishing and measuring business taxes is especially difficult when taxpayers are both households and business owners. Consider, for example, the income tax liability of a household owning an unincorporated family business. The business's profits are a component of the household's total taxable income, which includes wages and salaries, interest income from savings accounts, dividends, and other sources of income. Since many state income tax rates are graduated, the amount of income tax paid on the profits would depend on whether the profits are considered to be the "first dollars" earned by the household or the "last dollars" earned. If the last dollars earned, the tax on the profits would be higher. As discussed in Section III, this measurement issue has become increasingly serious in recent years because the percentage of businesses choosing not to incorporate, at least for the purposes of taxation, has risen dramatically.

them.[2] According to the latter, the distribution of tax burdens should reflect the distribution of benefits conferred by governmental services.

Economists have difficulty applying principles of equity to business taxes because, in reality, people, not businesses, bear tax burdens. Businesses are groups of people organized to produce goods, to distribute goods, or to provide services. Consequently, while the financial officer of a business might write checks to the taxing authorities, the burden of a business tax is actually borne by business owners, business employees, business customers, or business suppliers in the short run. In the long run, these people will attempt to shift the burden of the tax to others by changing their behavior. Consequently, one can determine the ultimate incidence of the tax only after analyzing (or, in the absence of evidence, assuming) how everyone adjusts to it and how prices change as a result.[3]

Some have argued that the benefit principle is easier to apply to business taxes than is the ability-to-pay principle because one can think of many public services as inputs to the production process. (For example, see Oakland 1992.) Just as firms must purchase labor and capital from factor markets, arguably they should also pay for those public services that enhance their capacity to produce and, therefore, to generate profits. Granted, to the extent that public services augment profit, their benefits also ultimately redound to people—businesses owners, business customers (if businesses elect to pass

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[2] The manner in which this ability should be measured is very controversial. Some feel that ability to pay should be measured by income, others by consumption. Another controversial issue is the period of time over which ability to pay should be measured. Should income or consumption be measured on an annual basis? A lifetime basis? Some interval in between? There are no "right" answers to these questions.

[3] Although difficult, such analysis has been done. The Institute on Taxation and Economic Policy (ITEP) (2003) has evaluated the distribution of state and local tax burdens across annual income classes in all 50 states, taking into account tax shifting and the exporting of tax burdens to residents of other states. ITEP has evaluated the incidence of three state and local business taxes: corporate income taxes, taxes on nonresidential property, and general sales taxes on business inputs. In general, ITEP has found that the former two are progressive (their burden rises as income rises), while the latter is regressive (its burden falls as income rises). See also the Minnesota Department of Revenue (2003) for a similar analysis of taxes in the state of Minnesota. The appropriate definition of a "household" for the purpose of evaluating tax equity is also contentious.

on public benefits in the form of lower prices), or workers (if employers pass on public benefits in the form of higher labor compensation).[4] Consequently, as is the case for the ability-to-pay principle, tax shifting complicates the application of the benefit principle. Nevertheless, one can reasonably assume that public benefits initially conferred on business are shifted in a manner similar to the manner in which business taxes are shifted. Consequently, if public benefits and the business taxes of a particular jurisdiction match up well at the firm level, one can reasonably assume that they match up well at the individual level as well and, therefore, are equitable according to the benefit principle.

Adequacy

An adequate tax produces revenues that over the long run grow at roughly the same rate as the cost of meeting the public's demand for public services. Since what constitutes an optimal level of public services is a subjective issue, applying the adequacy principle is also difficult and contentious. According to the Cato Institute, the fact that aggregate per capita state spending has grown more rapidly than inflation during the past three decades is evidence that state governments have spent excessively (Stansel and Moore 1999; Edwards et al. 2003). Other groups, such as the Center for Budget and Policy Priorities (CBPP), have argued that constant inflation-adjusted per capita growth is too stringent a standard of adequacy. Rather, state spending "naturally" grows with the economy. Moreover, argues CBPP, new federal mandates, the soaring cost of health care, and increasing demand for public education have compelled state and local governments to increase the share of the nation's economic resources that they command (McNichol and Carey 2002). As with fairness, adequacy is largely in the eye of the beholder.

It is difficult for a tax to remain adequate over the long run unless its base keeps pace with the demand for public services, however defined. If tax policymakers must

[4]For attempts to evaluate the incidence of the benefits of public services among households, see Musgrave, Case, and Leonard (1974) and Reynolds and Smolensky (1977).

continually increase the tax's statutory rate to satisfy this demand, then eventually the tax will create undesirable economic distortions, forcing policymakers to scale back the tax rate or narrow the tax base. The adequacy of a tax is usually questioned when long-run economic, social, and political forces erode its base or compel policymakers to cut its statutory rate extensively. For example, some have argued that the adequacy of the general sales tax has diminished over the past two decades because households have substituted services, which are generally not taxed, for goods, which are usually taxed, in their mix of consumption (Bruce and Fox 2000). As another example, discussed more extensively below, some have alleged that mounting interjurisdictional competitive pressures, among other factors, have compelled many states to narrow the base and/or to reduce the rate of their corporate income tax to the point where the revenues produced by the tax have become inadequate.

Competitiveness

A competitive tax promotes a jurisdiction's economic growth by enhancing its ability to attract and retain geographically mobile capital, labor, and consumption. In recent decades, concern about business tax competitiveness has intensified as technological and regulatory changes have increased the mobility and geographic range of employers. The resulting pressure on state and local governments to compete more aggressively is partially responsible for renewed interest in indicators of state and local business tax burdens. Reports of intensified efforts to avoid corporate income taxes (for example, Pomp 1998, Fox and Luna 2002, Mazerov 2000, and the Multistate Tax Commission 2003) have also stimulated this interest. The severe fiscal crisis that has confronted several states over the past three fiscal years has led policymakers to consider increasing taxes on business as a means of raising additional revenue. Business groups have mounted a vigorous opposing campaign in most states, stressing potential damage to their state's competitive standing.

The shifting of tax burdens complicates the evaluation of tax competitiveness, just as it does the evaluation of tax fairness. Other things being equal, firms will upgrade

their evaluation of a location's business tax climate if they believe that economic conditions prevailing at that location facilitate tax shifting. For example, suppose that a nationwide chain of restaurants specializing in Indian cuisine is seeking sites for new facilities. At site A, although business taxes are relatively high, unions are relatively weak and labor regulations are relatively lax. Furthermore, the restaurant chain believes that the demand for Indian food at this site is relatively price inelastic, perhaps because the population surrounding the site has a high concentration of people of Indian descent. Consequently, the restaurant chain believes that if it were to locate there, it would be able to shift a significant portion of its business taxes backward onto its workers or forward onto its customers. By contrast, at site B, although business taxes are slightly lower, unions are strong, labor regulations are strict, and perceived demand for Indian food is more price elastic. As a result, the restaurant chain perceives tax shifting options to be more limited. Under these conditions, the chain might rate the business tax climate of site A higher than that of site B even though business taxes are higher at site A than at site B.

Nevertheless, every indicator of business tax competitiveness assessed in this article is predicated on the assumption that state and local business taxes are not shifted; that is, their burden is borne solely by business owners. Indicators based on this assumption are useful for several reasons. First, in making their tax systems more competitive, state and local governments are especially interested in attracting and retaining a subset of firms whose ability to shift their taxes forward is relatively limited. These businesses—those selling their products in multistate markets—are highly valued because they "import" income into the states in which they are located, thereby driving the growth of secondary and tertiary industries (such as suppliers, wholesalers, and retail and service establishments). Firms selling into such geographically broad markets are wary of shifting their taxes forward because they fear that their customers might switch their patronage to competitor producers who could gain market share by offering lower

prices.[5] Second, while conditions in some states may be more conducive to tax shifting than conditions in others, evidence quantifying interstate differences in such conditions is not available and, indeed, may be impossible to obtain.[6] In the absence of such evidence, the assumption of no interstate differences in tax shifting potential is as good as any. Third, when comparing states in terms of business tax competitiveness, business groups assume, explicitly or implicitly, that business owners bear the entire burden of state and local business taxes. By embracing this assumption, therefore, one can evaluate the implications of these groups' analyses for the tax competitiveness of particular states. Although such groups often contend that their state's business taxes are not competitive, sometimes their own data, when carefully analyzed, suggest otherwise. If such discrepancies exist, policymakers should be aware of them.

II. An Assessment of Indicators of State and Local Business Tax Levels Frequently Cited in Recent Policy Debate in Massachusetts

Protagonists in the recent debate about tax policy in Massachusetts have cited several indicators purporting to evaluate the fairness, adequacy, and competitiveness of the Commonwealth's business taxes in general and its corporate excise tax in particular. The same indicators have been cited in similar debates at statehouses throughout the nation. This article evaluates four of them.

Two indicators, featured in the writing and public testimony of the Massachusetts Budget and Policy Center (MBPC) (St. George and McLynch 2003, Massachusetts Budget

[5] However, in theory, such firms are not limited in their relative ability to shift business taxes backward onto labor.

[6] The task of analyzing interstate differences in conditions for tax shifting is further complicated by the fact that in theory when businesses relocate they affect their ability to shift taxes at their new location in ways that they do not anticipate initially. If a state attracts firms by lowering its business taxes, the influx of employers will augment the demand for labor within the state, driving up wages. In other words, the ability of firms to shift their tax burden back to labor is diminished as the ratio of capital to labor rises. This effect may be viewed as a desirable sharing of the benefits of greater tax competitiveness between capital and labor. However, because the magnitude of this effect is difficult to determine in advance of relocation, it greatly complicates the relationship between business tax shifting and business tax competitiveness.

and Policy Center 2003), focus solely on the corporate excise tax.[7] These indicators are as follows: (1) the share of total state tax revenues accounted for by the corporate excise tax (corporate excise share, Figure 1) and (2) corporate excise tax receipts per $1,000 of personal income (corporate excise burden, Figure 2). MBPC has cited declining trends in both statistics as evidence that the tax has become increasingly unfair and inadequate.[8] Another statistic, figuring prominently in publications and testimony of the Massachusetts Taxpayers Foundation (MTF), is total receipts from all corporate income taxes (not just the corporate excise tax) per $1,000 of personal income (corporate income tax burden, Figure 3).[9] According to MTF, the relatively high ranking of Massachusetts by this statistic in fiscal year 2000 shows that heavy corporate income tax burdens are a competitive liability to the Commonwealth (Massachusetts Taxpayers Foundation et al. 2003).

The fourth indicator, often cited by the Associated Industries of Massachusetts

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[7] This tax, which applies to most corporations doing business within the Commonwealth, has two components. The larger component is a tax on profits, levied at a statutory rate of 9.5 percent. The smaller component is a tax on either personal property or net worth, levied at a rate of $2.60 per $1,000. Personal property is essentially machinery and equipment, as opposed to real property, which consists primarily of land and structures. Under current laws and regulations, corporate taxpayers can choose either base of this component. In FY1999, the latest year for which data are available, the profits component accounted for approximately 80 percent of total corporate excise tax collections. Corporate excise taxpayers are also subject to a minimum tax of $456 (Massachusetts Department of Revenue 2003). Because the bulk of corporate excise tax revenues are collected from the profits tax component, the U.S. Census Bureau classifies the tax as a corporate income tax.

The tax is called an "excise" tax because it was originally conceived of as a price that corporations should pay for the privilege of doing business within the Commonwealth under the special protections afforded by incorporation. One of the meanings of the word "excise" is a tax on privileges.

[8] The glossary on page 44 presents shortened names for the indicators analyzed in this article.

[9] In addition to the corporate excise tax, Massachusetts imposes the following other three corporate income taxes: a tax on the net income of most financial institutions (the "bank excise"); a constellation of taxes applying to selected public utilities and urban development organizations (the "public service excises"); and a constellation of taxes on the investment income of certain insurance companies (the investment privilege component of the "insurance excises"). See Commonwealth of Massachusetts, Department of Revenue (2002), pp. 54-67.

(AIM), is all business taxes (not just corporate income taxes) as a share of total state and local tax receipts (business share or BSH, Figure 4). AIM emphasizes that corporate income taxes are only a small fraction of all taxes that Massachusetts businesses are legally obliged to pay. AIM has not clarified what this finding implies about the fairness, adequacy, or competitiveness of Massachusetts business taxes. However, as discussed below, in one of its reports, the organization implied that BSH is primarily an indicator of business tax competitiveness and that, since BSH in Massachusetts is "substantial," the Commonwealth's business taxes are a competitive liability (Saviano and Cline 2003).

Adequacy and Fairness

Consider the two indicators of adequacy and fairness cited by MBPC. The organization noted that between FY1968 and FY2002 the corporate excise share fell from over 16 percent to just over 4 percent (Figure 1), and the corporate excise burden fell from $7.43 per $1,000 of personal income to $2.36 per $1,000 (Figure 2). The fall in corporate excise tax burden took place primarily after FY1986, when corporate tax incentives proliferated and efforts by corporations to avoid the obligation to pay state and local corporate taxes reportedly intensified. (See Fox and Luna 2002.) After tracing these declining trends, MBPC stated that "one of the principal causes of Massachusetts'…inability to maintain existing service levels with current revenue streams…is the state's vanishing corporate income tax ," (p. 1). In this statement, the organization implied that public service provision below "existing levels" is inadequate. MBPC interpreted the sharp decrease in the corporate excise burden as evidence that "a large amount of economic activity in Massachusetts was not subject to the state corporate income tax" (and, presumably, a smaller amount is now taxed than used to be taxed when the burden was much higher). Such base erosion is the hallmark of an inadequate tax. Finally, MBPC exhorted tax policymakers and officials to rescind business tax incentives and to adopt stricter enforcement policies "to ensure that

profitable businesses pay their fair share of taxes," implying that this share is unfairly low.

Both MBPC indicators are potentially biased by their failure to take into account *all* state and local corporate income taxes (as does MTF), not just the corporate excise tax. As noted in footnote 9, one of these taxes is the bank excise tax. During the 1990s, the Commonwealth took some financial institutions off the rolls of the corporate excise tax and put them on the rolls of the bank excise tax.[10] Furthermore, banks' share of the Massachusetts economy has grown considerably over the past 35 years. Thus, in theory, the declining corporate excise share and burden could have been offset by an increasing bank tax share and burden.

As AIM has pointed out, MBPC also does not take into account the possibility that some disappearing corporate taxable income has reappeared in the base of the Commonwealth's personal income tax as "pass-through" income. Such income consists of profits earned by a corporation or by an unincorporated enterprise and allocated to the enterprise's owners for tax purposes. Although these profits are not subject to the corporate excise tax, the owners report them on their personal income tax returns. In this respect, the income of these enterprises is taxed in the same manner as that of general partnerships. Examples of such enterprises include Subchapter S corporations, limited liability corporations (LLCs), and limited liability partnerships (LLPs). LLCs and LLPs were not recognized in Massachusetts for state tax purposes until 1996. Changes in federal income tax law induced a large wave of conversions from regular corporate to Subchapter S status during the last half of the 1980s.

The denominator of corporate excise share, total *state* taxes, is also a potential source of bias because it is narrowly defined. One should analyze trends in business income taxes as a share of *all state and local* taxes, not just of *state* taxes. During the past 25 to 30 years, Massachusetts state government has assumed a larger share of the Commonwealth's total state and local fiscal responsibilities—in part because Proposition

[10] See Commonwealth of Massachusetts, *The General Laws of Massachusetts*, Chapter 81 of the Acts of 1995.

2-1/2, a property tax limitation, has compelled state government to take more fiscal responsibility for public schooling. While in FY1968 state government collected 48 percent of state and local taxes in the Commonwealth, by FY2000 this percentage had risen to 67 percent. Thus, while taxes on business income may have declined as a fraction of total state taxes, state taxes may have increased as a fraction of all state and local taxes. As result, the fraction of the total state and local fiscal pie accounted for by taxes on business income may be unchanged or have even grown.

Furthermore, one should not exclude *fees and charges* from the denominator of the share variable. These sources of revenue accounted for over 25 percent of the Commonwealth's state and local "own-source" revenues in FY2000.[11] By comparison, they accounted for only 13 percent in FY1968. Therefore, failure to consider fees and charges could lead one to underestimate the decline in the role of business income taxes in financing the Commonwealth's state and local governments.

Finally, it is misleading to compare values of corporate excise burden and corporate excise share in FY1968, a year of economic expansion in the Commonwealth, with values in FY2002, a year of economic contraction. During periods of economic weakness, profits, a relatively volatile flow, usually shrink far more than the bases of other major taxes, such as the personal income tax or retail sales tax. Conversely, when the economy is growing rapidly, growth in corporate profits usually outpaces growth in other tax bases. Thus, some of the declines in corporate excise burden and corporate excise share between FY1968 and FY2002 can be attributed to cyclical influences. However, the business cycle cannot explain the low values of these indicators (by historical standards) over the past two fiscal years, nor their declines between the mid 1980s and mid 1990s, two expansionary periods.

Figures 5 and 6 attempt to correct for these various potential sources of bias in corporate excise burden and corporate excise share. Figure 5 displays indexes of corporate excise burden and corporate income tax burden from FY1968 to FY2004, with

[11] State and local "own-source" revenues are revenues that state and local governments raise on their own authority. They exclude federal aid.

values for FY1982 set equal to one. The figure also displays a comparable index for the ratio of all business income taxes to personal income (business income tax burden). The numerator of this ratio includes not only corporate income taxes but estimated personal income taxes on income earned by Subchapter S corporations, LLCs, LLPs, other types of partnerships, and sole proprietorships. Because of data limitations, the index of business income tax burden is reported only for selected years between FY1982 and FY2003. Figure 6 plots comparable historical trends for indexes of corporate excise share, corporate income tax share, and business income tax share. The denominator in the share variables is state and local own-source receipts, not state tax receipts.

These burden and share variables, modified along the lines suggested above, do, in fact, trace different historical patterns than those of unmodified corporate excise burden and corporate excise share between FY1968 and FY1986. During this period, while corporate excise burden held steady and corporate excise share trended downward, the four other expanded indicators trended upward. However, all six measures plummeted between FY1987 and FY1992, reversed only a fraction of their decline over the ensuing nine years, and plummeted again in FY2002.[12] While these measures have risen since FY2002, all except business income tax share and corporate excise tax share are currently below their FY1992 levels. Among the series with data back through the late 1960s, all four are well below their values in FY1968, the year chosen by the MPBC as its benchmark. (Business income tax burden and share are below their FY1982 values.)

Thus, the trends of the expanded measures are consistent with MPBC's analysis. Yet, in order for arguments concerning the adequacy and fairness of the corporate excise tax to be valid—or in order to apply MBPC's arguments to all business income taxes—MBPC should justify its choice of FY1968 as its benchmark year. With respect to adequacy, is the demand for state and local public services the same now as it was 36 years ago? Or did state and local government become so bloated during the 1970s and 1980s that slowing growth in business income taxes over the past 15 to 20 years has

[12]The sharp decline in the six indicators from FY1987 to FY1992 partially reflects cyclical influences.

helped to eliminate unwanted and unnecessary government programs? As for fairness, has the match between benefits received by business and income taxes paid by business deteriorated since FY1968? Perhaps 36 years ago business income taxes paid were higher than the business benefits received. If so, then the declines depicted in Figures 1 through 3, 5, and 6 may indicate that benefits and business income taxes have become more closely aligned, rendering these taxes more equitable, not less.

While adequacy may be subjective, few would argue that Massachusetts residents would have wanted to shrink the percentage of their personal income that they devote to state and local public services as sharply as the corporate income tax burden has fallen over the past 36 years. In FY2004, this burden was estimated to be only 60 percent of its FY1968 level. Yet, during this period, the public demand for many state and local public services, such as education, health care, corrections, and public safety, has grown considerably. Trends in the burden of total own-source revenues do not indicate a broad-based movement to take a large chunk of economic resources out of state and local government. The burden of own-source revenues other than corporate income taxes was about the same in FY2004 as in FY1968, while in FY2004 the burden of own-source revenues other than business income taxes was only slightly below its FY1982 level. (Again, recall that FY1982 is the earliest year for which the author has estimates of business income taxes.) Thus, the steep declines in the corporate income tax burden and the business income tax burden in recent decades imply that these taxes are inadequate.

Evidence from other states within New England lends support to MPBC's claim that nationwide influences are eroding the bases of Massachusetts corporate income taxes. If MBPC's diagnosis of the sources of this erosion is accurate, patterns displayed in the Commonwealth's historical corporate income tax statistics should be evident in those of other states. In three of the other five states within the region, both the corporate income tax burden and the corporate income tax share were considerably lower on average during the 1990s than they had been over the course of the late 1960s, 1970s, and 1980s (Figures 7 and 8). The declines in these two indicators were especially sharp in

Connecticut, which enacted a personal income tax during the early 1990s to deal with a serious fiscal crisis. The state has cut its statutory corporate income tax rate, once the second highest in the nation, significantly over the past 15 years. The two exceptions are New Hampshire and Maine. New Hampshire has raised its corporate taxes, largely in response to a series of State Supreme Court decisions invalidating local property taxes as a means of financing public primary and secondary education. These decisions, which in effect direct the state to fund a larger share of public schooling, have forced the state to consider implementing a broad-based income tax or sales tax. (See Swaine 2000.) Rather than reform its tax system so drastically, New Hampshire has chosen to raise its existing state taxes, including business taxes. Maine has been reluctant to reduce its reliance on the corporate income tax because, according to U.S. Census data, its combined personal income and property tax burden (total receipts from these two taxes as percentage of residents' personal income) was the second highest in the nation in FY2000.[13]

In the nation as a whole, the corporate income tax burden and corporate income tax share were about the same in FY2000 as they were in FY1968 (Figures 3, 7, and 8). However, since many fewer states had corporate income taxes 34 years ago than today, comparisons between the two years do not accurately gauge the strength of trends in base erosion. Between FY1987 and FY2002, a period during which interstate competition and corporate tax avoidance allegedly intensified but the number of states imposing corporate income taxes did not change, the nation's corporate income tax burden declined, albeit not as sharply as in Massachusetts. This decline suggests that erosion of state and local corporate income tax bases has been a nationwide phenomenon.

While strong circumstantial evidence suggests that Massachusetts corporate income taxes have become less adequate, one cannot so readily infer that these taxes have

[13]The corporate income tax burden and corporate income tax share of all the New England states except New Hampshire fell sharply from FY2000 to FY2002, largely because this period encompassed the latest recession.

become less fair according to the benefit principle. Whether they have is hard to evaluate in large part because dividing the benefits of state and local public services between businesses and households is extremely difficult.[14] However, a comparison of the Massachusetts corporate income tax share with that of the nation since FY1968 suggests that this share may have been unfairly high in the Commonwealth back then. As shown in Figure 8, in FY1968 the corporate income tax share in the Commonwealth was more than twice as high as in the nation as a whole. It is unlikely that the proportion of public benefits enjoyed by Massachusetts corporations in FY1968 was more than twice the proportion enjoyed by corporations nationwide. Thus, the dramatic narrowing of the gap between the corporate income tax shares of Massachusetts and the nation could indicate improvement over time in the aggregate match between benefits received and taxes paid. If so, then perhaps the Commonwealth's corporate income taxes have become more equitable, not less.

While this match may have improved in the aggregate, it may have deteriorated for individual corporations. The income taxes that some corporations pay may still be higher than the public benefits they receive, while other corporations may pay little or no income tax while still receiving substantial public benefits. This may be the case because, as MBPC has pointed out, all corporations do not have equal access to the tax benefits that the Commonwealth has enacted in recent years. For example, single factor apportionment based on sales is most beneficial to corporations that produce their

[14] See Oakland and Testa (1998) for state-by-state estimates of the split between the value of services benefiting businesses and the value of services benefiting households.

products primarily in Massachusetts but sell them to customers located elsewhere.[15] Corporations whose operations and customers are located solely within the Commonwealth do not benefit from this new tax feature at all. In addition, large multistate corporations are able take advantage of tax avoidance techniques that involve the "shifting" of taxable income from affiliates located in high-tax states to those located in low-tax states. Corporations whose entire operations and clientele are located within a single state cannot reduce their taxes in this manner. Consequently, an improved match between taxes paid and benefits received in the aggregate could be masking an unfair redistribution of the tax burden away from multistate firms toward small in-state firms. However, since firm-specific data on taxes paid and benefits received are not available, it is unclear whether corporate income taxes or business income taxes have become more or less fair.

Moreover, in evaluating the extent to which businesses pay taxes in proportion to governmental benefits received, why limit oneself to corporate income taxes or even business income taxes? As a report commissioned by the Council on State Taxation (COST) has emphasized, these taxes account for only about 8 percent of U.S. state and local business tax liabilities (Cline et al. 2003a). Businesses also pay property taxes, sales taxes on inputs, license taxes, excise taxes, unemployment insurance taxes, workers compensation premiums, and a host of additional smaller taxes to state and local governments. According to the COST study, the property tax accounted for the largest

[15] Single factor apportionment based on sales (SFAS) is a formula used by states to determine for the purposes of corporate income taxation their share of the taxable profits of a multistate corporation, that is, one that operates or sells or produces in more than one state. In Massachusetts, manufacturers and mutual fund managers use this formula. According to it, the Commonwealth's share of a corporation's taxable income is equal to the share of the corporation's total receipts earned from transactions taking place within the Commonwealth's borders. Consequently, a manufacturer with all of its production facilities located in Massachusetts that sells all of its products to customers located outside of the Commonwealth would have no taxable profits in the Commonwealth. Under alternative apportionment formulas, which give some weight to the fraction of the corporation's payroll or property located within the taxing state, the manufacturer would have some taxable profits in Massachusetts. Under all apportionment formulas, including SFAS, a manufacturer with all of its production facilities and sales located in Massachusetts must pay the Commonwealth's corporate income tax on all of its taxable income.

percentage of state and local business taxes nationwide (38 percent) in FY2003. Perhaps the historical trends in these other business taxes have differed significantly from those of corporate and business income taxes. If so, then the share of state and local own-source revenues accounted for by *all* business taxes might be smaller in Massachusetts than in the rest of the nation, calling into question the assertion that the Commonwealth's businesses as a whole have borne more than their "fair share" of taxes.

Data needed to test this hypothesis are scarce. In 2003, AIM commissioned a study to analyze state and local taxes paid by Massachusetts businesses (Saviano and Cline 2003). Although the authors of the AIM study never fully describe their methodology, it appears to be similar to that used in their comparable nationwide COST study. According to AIM, corporate income taxes accounted for 11 percent of all Massachusetts business taxes in FY2001, while property taxes accounted for 44 percent.

AIM's historical series for Massachusetts business taxes goes back only to FY1991. In that year, and over the ensuing 10 years, the share of the Commonwealth's total state and local taxes that was paid by businesses, excluding personal income taxes paid on business profits (business share, or BSH), was consistently lower than the nation's (Figure 4). This gap exhibited an erratic trend, sometimes narrowing and sometimes widening, and ranged from 2.5 to 6 percentage points. The historical pattern of expanded business share (EBSH), including personal income taxes paid on business profits, exhibited similar results (Figure 9). Thus, if the nationwide BSH or EBSH is the benchmark for Massachusetts business tax fairness according to the benefit principle, then Massachusetts businesses as a whole did not pay their fair share during the FY1991-FY2001 period. However, one cannot draw clear conclusions without firm-specific estimates of tax burdens borne relative to state and local public benefits received and an analysis of the historical trends in these firm-specific relationships.

Competitiveness, Corporate Income Tax Burden, Business Share, and Expanded Business Share

As alluded to earlier in this section, MTF gauged the competitiveness of Massachusetts business taxes by computing the relative corporate income tax burden. It pointed out that in FY2000 (the latest year for which state-specific data are available) this burden stood 26 percent higher than the national average and ranked 11th among the 50 states and the District of Columbia.[16] Against the 20 states identified by MTF as the Commonwealth's principal economic competitors, Massachusetts' corporate burden ranked 7th. Largely based on these statistics, MTF concluded that "preserving the single sales factor and other business tax reforms is critical to maintaining the Commonwealth's competitive position" (Massachusetts Taxpayers Foundation et al. 2003, p. 28).

MTF admitted that corporate income tax burden is a crude indicator of business tax competitiveness. It acknowledged that dividing a state's corporate income tax revenues by corporate profits earned within its borders would produce a better indicator, since, in deciding where to locate and to expand, firms care most about how taxes affect their bottom line. MTF used personal income instead of profits as its denominator—a common practice—because state-specific measures of corporate profits are not readily available, and a state's personal income is thought to be a valid indicator of the size of its business profits. A large percentage of the nation's corporate profits are earned by large multistate or multinational conglomerates. Their operations are so well integrated that no analyst can objectively allocate corporate profits by state. MTF also explicitly cautioned that, as discussed above, corporate income tax burden is an especially inaccurate indicator of business tax competitiveness at peaks and troughs of business cycles. As a result, MTF cautioned policymakers not to conclude that the

[16]The Commonwealth's corporate burden was actually 39 percent above the national average in FY2000, based on dividing corporate income tax receipts for fiscal year 2000 by personal income for *fiscal year* 2000. MTF divides corporate income tax receipts for fiscal year 2000 by personal income for *calendar year* 2000. Many analysts use calendar year personal income data in tax burden comparisons because such data are more readily available. However, the mixing of calendar year and fiscal year data can distort results significantly.

competitiveness of Massachusetts business taxes deteriorated between FY1992, a recession year, and FY2000, a boom year, even though the gap between the Commonwealth's corporate income tax burden and the nation's widened during this period.

Regardless of the strengths and weaknesses of MTF's indicator, by FY2002 the gap between the corporate income tax burden in Massachusetts and the nation as a whole had all but disappeared and did not re-emerge in FY2003 (Figure 3). Thus, according to MTF's indicator of choice, it appears that, taken as a whole, the Commonwealth's corporate income taxes have become reasonably competitive.

As noted earlier in this section, AIM portrayed BSH and EBSH as indicators of business tax competitiveness. After showing that businesses pay a significant *share* of the Commonwealth's taxes, the study concluded as follows:

> The combined Massachusetts state business tax *burden* is significant. From an economic development perspective, Massachusetts policymakers should carefully evaluate the *competitiveness* of the state and local business tax structure, including all of the business taxes identified in this study (italics added). . . .The disincentive effects of Massachusetts business taxes depends (sic) on the cumulative effect of all business taxes.

In these quotes, AIM implies (erroneously, as argued below) that BSH and EBSH are valid indicators of the effects of business taxes on firms' behavior, presumably including their decisions about where to invest.

The author has already noted that, according to the COST and the AIM studies, the EBSH of the Commonwealth is considerably lower than that of the nation as a whole. In a study released in March of 2004, Ernst and Young, LLP (E&Y), the consulting firm that performed both the COST and AIM studies, reported estimates of BSH for all 50 states for FY2003 (Cline et al. 2004). (Data limitations precluded estimation of EBSH for all the states.) In that year, the Commonwealth's BSH ranked 42nd among the 50 states (Table 1, column 1). In an earlier study (Cline et al. 2003a), E&Y reported comparable estimates for FY2000 (Table 1, column 2). The author developed his own BSH for FY2000 (the

methodology is set forth in the Appendix), which produced results similar to E&Y's.[17] These estimates show the BSH in the Commonwealth at 36.1 percent, 7.5 percentage points below the national share. Excluding the District of Columbia (as did E&Y), Massachusetts ranked 48th, according to BSH (Table 1, column 3).[18]

Given that the BSH in Massachusetts ranks among the lowest in the nation—even according to analysis provided by business groups—and that its EBSH is below the national average, one is tempted to conclude that, taken as a whole, Massachusetts business taxes are quite competitive. Indeed, MBPC concludes from E&Y's analysis, "efforts to protect the corporate income tax base in Massachusetts from further erosion…likely would not cause tax burdens to rise above national levels (Massachusetts Budget and Policy Center 2003)."

However, BSH and EBSH are no better indicators of business tax competitiveness than corporate income tax burden because both reflect the capital intensity of a state's economy more than the burden of state and local businesses taxes. (See Tannenwald 1994.) Massachusetts BSH and EBSH are low in large part because labor-intensive industries—professional business services, health care, education, info-tech, financial services—account for a relatively large share of the Commonwealth's economy. Moreover, these industries pay their workers relatively high wages because they are highly skilled. Because the Commonwealth's economy is intensive in highly skilled labor, the bases of taxes paid by households are large relative to the bases of taxes paid by businesses. Its low BSH has little to do with how intensively it taxes one set of tax bases or the other. The late John Gould captured this point in testimony before the Massachusetts Legislature's Joint Committee on Taxation. He asked:

> Why is Massachusetts so dependent on personal taxes? Not because business fails to pay its share, but because Massachusetts pays so much of its income to its employees…the proportion of our state

[17] Ideally, the business share of all state and local own-source revenues, not merely taxes, should be measured. However, neither the author nor E&Y has devised a methodology for dividing user fees and charges into business and household components.

[18] E&Y's 50-state report was released well after this study was begun, and E&Y has described its methodology in only sketchy terms.

> revenues derived from business taxes, though low by national standards, results from the structure of our economy, not from low business tax burdens. (Gould 1995).

At the time he gave this testimony, Mr. Gould was president of Associated Industries of Massachusetts.

Box 1 provides a further explanation and empirical evidence of the relationship between capital intensity and business share.

BOX 1

Explanation and Empirical Evidence of the Relationship Between Capital Intensity and Business Share

Consider two hypothetical states with only one for-profit business in each. In one state the firm is a chemical manufacturer; in the other, a consulting firm. Assume that each firm earns the same rate of return on assets. The consulting firm would have the higher ratio of payroll to profit. A large percentage of its expenses consists of wages and salaries to its employees. By contrast, the chemical company has few employees relative to the extensive and expensive plant and equipment that it uses—pumps, pipes, meters, towers, distillers, precipitators, trucks, pollution control devices, etc. Profits are a large part of the return to capital. So the *aggregate* profits (not necessarily the *rate* of profit) of the chemical plant are high relative to the firm's aggregate wage bill (not necessarily its average wage *rate*), while the opposite is true for the consulting firm. Profit is the base of an important business tax. Wages are the most important component of the personal income tax base. In addition, the chemical plant owns a lot of taxable nonresidential property (the base of a business tax). By contrast, the state with the consulting firm has a lot of owner-occupied residential property (the base of a large household tax) since its workers need places to live and many of them own rather than rent (property taxes on rental housing are considered to be business taxes).

The following equation, estimated using ordinary least squares from observations on the 50 states, provides empirical evidence supporting the argument that BSH rises with the capital/labor ratio:

$$\mathbf{BSH = \underset{(6.57)^{**}}{0.0026(K/P)} + \underset{(5.23)^{**}}{11.71(NPYT)} + \underset{(29.28)^{**}}{38.16},} \qquad R^2 = 0.70$$

where:

BSH = business taxes as a percentage of total taxes, FY2000,
K/P = capital labor payroll ratio of state's private sector economy [imputed physical capital ($millions), payroll ($millions) estimated for FY2000 with methodology developed by Munnell and Cook 1990],[19] and
NPYT = a dummy variable, equal to 1 if a state has no broad-based personal income tax as of January 1, 2000.

Numbers in parentheses are t-statistics.
** significant at the 0.001 level, two-tailed test

[19] Ideally the K/P variable should be rK/P where r is the average return to a unit of physical capital. The author implicitly assumes in this equation that r is uniform across the states.

III. Toward Better Indicators of State Business Tax Competitiveness

As has been argued elsewhere (Pomp 1998; Tannenwald 1994, 1996), an accurate comparison of states' business tax competitiveness requires insight into how business taxes interact to affect differences across states in the marginal after-tax return to business investment. No simple ratio can capture these differences. One can best gain such insight through the "representative firm" approach. In implementing this strategy, the tax analyst attempts to view a state's business taxes and those of its economic competitors through the eyes of rational, well-informed, profit-maximizing firms in the process of choosing a site for a new facility.[20]

Such an approach is difficult and time-consuming. When applied to local jurisdictions, it reveals intra-state differences across counties, cities, and towns in business tax competitiveness, attributable primarily to differences in local property taxes. It also shows how a state's business tax competitiveness varies by industry, since the impact of business taxes on after-tax rates of return often depends on the capital intensity of a firm and its mix of depreciable assets. Consequently, it is difficult to extract a single indicator of state business tax competitiveness using this approach. For all these reasons, the approach has been employed only occasionally and has almost never been used to evaluate the business tax competitiveness of all 50 states. An alternative, simpler solution would be to compare states in terms of the ratio of their

[20]In order to determine how such firms would evaluate the "tax climate" at alternative locations, one would follow these steps: 1) "locate" hypothetical representative firms at various sites within each state and at sites within competitor states, 2) assume that the gross pre-tax rates of return of these firms and their costs other than taxes are the same at each site, 3) compute the firms' total local, state, and federal tax liabilities and their net after-tax cash flows 20 to 50 years into the future, a range of time that encompasses the useful lifetimes of most facilities, 4) assume that each firm builds a new facility at each site, 5) calculate the long-run after-tax rate of return to the new facility at each site for each representative firm (by assumption, differences across sites in rates of return reflect only differences in state and local tax burdens), and 6) compare states in terms of the average after-tax rate of return at the sites located within their borders. The higher a state's average rate of return, the more competitive is its system of business taxation.

business tax collections to business profits earned within their borders. Such a measure would capture differences in the impact of business taxes on the *average* rate of return on investment, not the marginal rate of return. However, no readily available statistical series allocates business profits by state. On the whole, multistate and multinational corporations and partnerships are so tightly integrated that statisticians have shied away from trying to divide their profits geographically.

An easier, albeit second-best, approach is to compare states in terms of the ratio of business taxes to personal income ("business tax burden"). This approach combines the best feature of E&Y's ratio, its numerator, with the best feature of MTF's indicator, its denominator. In Table 2, states are compared in terms of business tax burden (with personal income taxes on business income not included in the numerator) for FY2000 and FY2003. Massachusetts ranks between 43rd and 47th according to this statistic, depending on the estimate of business taxes used (E&Y's or the author's) and the year in question. Thus, the Commonwealth's rank according to BSH is similar to its rank according to business tax burden. However, as discussed further in Box 2, the ranks of some states differ significantly between the two indicators. (Compare Table 1 with Table 2.)

Box 2
States Differing Significantly in BSH Rank and Business Tax Burden Rank

In general, states with high total tax burden rank higher according to business tax burden than to according to BSH, and vice versa. Within New England, Connecticut, Maine, and New Hampshire are cases in point. Maine's total tax burden was the second highest in the nation in FY2000. According to the author's estimates, in that year the state's BSH ranked 21st in the nation, 0.5 percentage point above the national median. In contrast, the state's business tax burden ranked 10th, 31 percent above the national median. Similarly, Connecticut had a high total tax burden (ranked 11th), a low BSH (ranked 40th), and an average business tax burden (ranked 28th). By contrast, New Hampshire's BSH ranked 6th in terms of business share and stood 34 percent above the national median. The state's business tax burden ranked 20th and stood only slightly above the national median. In FY2000, New Hampshire had the lowest total tax burden in the nation.

Yet, while business tax burden may be a better indicator of business tax competitiveness than business share, it is still a crude measure. Consequently, despite severe data limitations and the inherently arbitrary nature of the endeavor, the author estimated business profits by state for FY2000. He then created a new indicator of state business tax competitiveness by dividing state and local business taxes (excluding personal income taxes on business income) by business profits.[21] The methodology used is based on the premise that the traditional three-factor formula for apportioning the income of multistate corporations for tax purposes is the most accurate way to gauge the true geographic allocation of corporate and partnership income. According to this formula, a state should tax a fraction of a corporation's total income, Y_s/Y_n, equal to the sum of the corporation's state shares of three factors—payroll, property value, and sales revenue—divided by three:

$$Y_s/Y_n = \frac{\dfrac{(\text{Payroll}_s)}{(\text{Payroll}_n)} + \dfrac{(\text{Property}_s)}{(\text{Property}_n)} + \dfrac{(\text{Sales}_s)}{(\text{Sales}_n)}}{3},$$

where s stands for state totals and n stands for nationwide totals.

Underlying this formula (called the "Massachusetts formula") is the theory that business income is generated where the two principal factors of production, labor and capital, are applied and where demand for the product manifests itself. Payroll is a proxy for labor, property is a proxy for capital, and sales is a proxy for demand (Francis and McGavin 1992). More details on the author's methodology for estimating business profits earned within a state are provided in Box 3.

[21]The measure of business profits used includes profits taxed under the personal income tax, creating an inconsistency between numerator and denominator. However, since the numerator includes other taxes paid by Subchapter S corporations, LLPs, LLCs, partnerships, and sole proprietorships, the author decided that the "least worst" choice was to include these profits in the denominator.

Box 3

Methodology for Estimating Business Profits Earned Within a State

In order to estimate the profits earned by corporations within each state for FY2000, the author first used nationwide corporate profit data by 45 two-digit industrial classifications, as reported in the Internal Revenue Service's *Statistics of Income—Corporations.* Calendar year 1999 and 2000 data were averaged to obtain estimates for state FY2000. For each industry, the percentage of nationwide payroll and receipts in each state was determined. The latest available data for receipts are for 1997, reported in the U.S. Economic Census. Monthly payroll data from the Bureau of Labor Statistics were used to estimate FY2000 payroll totals by industry by state. For each industry in each state, the ratio of payroll to receipts in FY2000 was assumed to be the same as it had been in calendar year 1997.[22] Industry-specific data on property by state are not available.

The fraction of the nationwide profits earned within a given state by the corporations in each industry was estimated according to the following formula:

$$P^{i}_{s} = P^{i}_{n} \times \left\{ \frac{(\text{sales})^{i}_{s}/(\text{sales})^{i}_{n} + 2 \times (\text{payroll})^{i}_{s}/(\text{payroll})^{i}_{n}}{3} \right\},$$

where: P = profit

i = industry

s = state

n = nation.

Payroll was double-weighted in the absence of any state-specific data on property. This is tantamount to making the strong simplifying assumption that the property/payroll ratio of each two-digit industry is the same across states. Total corporate profits for each state, s, are the sum of all the industry corporate profits for that state:

$$P_{s} = \sum^{i} P^{i}_{s}.$$

The income of partnerships was allocated by state according to the same method as was the profits of corporations. National industry-specific data on the pre-tax income of partnerships from the Internal Revenue Service's *Statistics of Income—Partnerships 1999* and *2000* were used. State-specific measures of income earned by sole proprietorships were obtained from the Internal Revenue Service's *Individual Income Tax Returns 1999* and *2000.*

Further methodological details are available from the author on request.

[22] The use of such estimating techniques introduces a potential source of error that can be eliminated when more data become available.

Table 3, column 1 reports each state's value and rank for business taxes as a percent of business profits in FY2000, using E&Y's estimates of business taxes. (Comparable estimates using the author's estimates are reported in Table 3, column 2.) At first blush, the high ratio of business taxes to profits in some states may seem implausible. For example, in Alaska, it was 82 percent, while in New Mexico it was 63 percent (author's estimates). How can businesses in these states pay such a high percentage of their profits in state and local taxes (not counting their federal taxes), and still survive? They can, by shifting the burden of most of these taxes. Both states rely heavily on severance taxes and property taxes levied on industries engaged in mineral extraction. Demand for these products is relatively price inelastic, and the mineral deposits being extracted do not move to a lower-tax state. Under such conditions, these firms are usually able to shift most of their tax burden to customers located throughout the world. Moreover, since firms outside of these industries do not face such taxes, the statewide average is not indicative of the tax burden on the "prototypical" business, even before shifting. The high ranks of these two states bring into sharp relief the importance of considering tax shifting when evaluating business taxes, as well as the advantages of using the representative firm approach.

Massachusetts ranks low according to business tax burden and business taxes as a percent of profits, no matter whose data are used (Table 3). According to the author's estimates, the Commonwealth ranked 49th according to the tax-to-profit ratio (column 2) and 47th according to business burden (column 4). According to figures relying on E&Y's estimates of business taxes, the Commonwealth ranked slightly higher, but was still among the 10 lowest in the nation. (See Box 4 for a discussion of comparisons of business tax burden and business taxes as a percent of profits in other states.)

Box 4
How Ranks According to Business Tax Burden and Business Taxes-To-Profits Differ in States Other Than Massachusetts

Most other states within New England rank similarly across the measures of business tax burden and business taxes as a percent of profits. Maine, Rhode Island, and Vermont rank within the top third according to both statistics, while New Hampshire ranks roughly in the middle. Connecticut is the only New England state whose rank differs substantially between business tax burden and business taxes as a percent of profits. The state ranked 40th in terms of taxes as a percent of profits and 28th in terms tax burden in FY2000. This discrepancy reflects primarily two factors. First, incomes of sole proprietorships and partnerships were high relative to personal income in the state. Second, and a related factor, the state had a high concentration of payroll and receipts in financial service industries that were highly profitable. Examples include security and commodity brokers, holding and other investment offices, and insurance brokers.

Some states in other regions also ranked very differently according to taxes as a percent of profits and business tax burden in FY2000. Delaware ranked much lower according to taxes as a percent of profits because depository financial institutions, which were very profitable, accounted for a large proportion of Delaware's payroll and receipts. Florida ranked much higher according to taxes relative to profits because its industries were not especially profitable and because, given that a large percentage of its population consists of retirees, the link between the profits earned within the state's borders and personal income earned by residents is especially weak. Compared with other residents, retirees rely relatively heavily on dividends and interest for their income. Much of this income is paid on shares in funds invested in businesses throughout the world, not just in Florida.

Maryland ranked much higher on business taxes as a percent of business profits than on business taxes as a percent of personal income because such a large fraction of the personal income of its residents reflects compensation from the federal government. Oklahoma ranked much higher on taxes as a percent of profits because its principal sector, mining, was so unprofitable. While the reasons for the discrepancies may differ, they all imply that the personal income of a state's residents is not necessarily a good proxy for the profits earned within the state's borders.

IV. Findings and Next Steps

This paper presents analysis whose purpose is to help policymakers make more sense of the recent debate about the fairness, adequacy, and competitiveness of state and local business taxes in Massachusetts, and, by extension, in general. Several indicators that have been used to evaluate business taxes according to these three criteria are assessed. Two new indicators of business tax competitiveness are developed, and their values are estimated for all 50 states. One is a measure of business taxes as a percent of in-state profits. This indicator has theoretical appeal to economists, who posit that firms, as profit-maximizers, are influenced by taxes to the extent that they affect their bottom lines.

The author finds abundant evidence that Massachusetts business taxes are competitive, even from data supplied by business interest groups. In the aggregate, the bases of the Commonwealth's corporate income taxes have been eroding, especially during the last decade. No conclusions are drawn about the overall fairness of business taxes in the Commonwealth, although modifications to the corporate excise tax introduced in recent years clearly favor some types of firms over others.

Policymakers should not rely solely on the indicators presented in this article. Indeed, the author hopes that reading this article will induce a healthy skepticism concerning the validity and unbiasedness of such indicators and will cultivate an interest in superior evaluation tools. For example, policymakers should use the representative firm approach to analyze the marginal incentives and disincentives to invest provided by Massachusetts business taxes to different types of firms. They should also use this approach to gain insights into differences in tax competitiveness across cities and towns within the Commonwealth.

Policymakers and policy analysts could better evaluate the fairness of the Commonwealth's business taxes if they had more data on how the ratio of taxes to pre-tax profits differs on average across industries and business size. If they possessed such data, they could evaluate disparities in the ratio and changes over time. If such disparities have widened dramatically, and if there is no reason to believe that the

incidence of the benefits of state and local public services has changed in a similar fashion, then policymakers would have reason to be concerned about the fairness of state and local business taxes. The Commonwealth could ask the Massachusetts Department of Revenue to provide such data, at a sufficiently aggregated level to avoid disclosing confidential or sensitive information.[23]

[23] See Kodrzycki (1993) for an analysis, based on actual tax return data, of differences across industries within Massachusetts in tax-to-profit ratios. The Massachusetts Department of Revenue publishes an annual report of corporate tax characteristics across industries and firm size categories (Commonwealth of Massachusetts Department of Revenue 2002). However, the data that it reports shed little light on dispersion in tax-to-profit ratios. Data are broken down into only 11 broad industrial categories. For each of these categories, the Department reports totals for gross profits, income subject to apportionment (that is, the nationwide income of corporate entities to which the apportionment formula is applied), Massachusetts taxable income, excise tax owed, and selected other variables. In order to evaluate average effective tax burden for each industrial category, one would need information concerning the percentage of nationwide payroll, property, and sales located in the Commonwealth for corporate excise tax filers, that is, the income that would actually be apportioned to Massachusetts if the unweighted three-factor apportionment formula were in place.

APPENDIX

I. Estimating Corporate Income Taxes and Business Income Taxes

Corporate income taxes. The U.S. Census Bureau reports total state and local corporate income taxes collected by each state and the District of Columbia by state fiscal year. (See http://www.census.gov/govs/www/estimate00.html.) When research for this article was completed, the latest set of published statistics for these taxes for the nation as a whole was for FY2002. The latest state-specific observations were for FY2002. Consequently, values for later years for Massachusetts and the nation as a whole had to be estimated.

For the nation as a whole, a measure very similar to the Census Bureau's state and local corporate income tax receipts—"state and local taxes on corporate income"—was available through calendar year 2003:Q4 from the National Income and Product Accounts (NIPA), published by the U.S. Bureau of Economic Analysis (BEA)(http://www.bea.gov, Table 3.3). Thus, on a state fiscal year basis, the author was able to estimate state and local taxes on corporate income nationwide through FY2003. In so doing, he assumed that the Census measure grew over the course of FY2002 and FY2003 at the same rate as the BEA measure.

For Massachusetts, one can obtain a very close approximation of the Census Bureau's figure for total corporate income tax receipts from statistics reported by the Massachusetts Department of Revenue (DOR) (http://www.dor.state.ma.us/stats/stats.htm). Specifically, the author added up receipts from all of the various Massachusetts taxes on corporate income cited above. Since this sum was not exactly equal to the Census figure for FY2002, the growth rates of corporate income taxes measured from DOR statistics over the course of FY2003 were applied to FY2002 receipts measured from Census statistics. Based on this assumption, the author extrapolated the Census measure of corporate income tax receipts to FY2003.

All business income taxes. As noted in the text, a comprehensive measure of business income taxes should include, in addition to corporate income taxes, personal income taxes paid on the profits of sole proprietorships, partnerships, limited liability corporations, and Subchapter S corporations (business-related personal income taxes). Data needed to measure business-related personal income taxes for Massachusetts and the nation as a whole are available for only a limited number of years. However, sufficient data are available to estimate business income tax receipts for the Commonwealth and for the nation for several years going back to the early 1980s.

For certain years, the author relied on estimates provided for both the United States and Massachusetts by Ernst and Young LLP (E&Y)(Cline et al. 2003a, 2003b, 2004; Saviano and Cline 2003). On a nationwide basis, E&Y provided estimates for the years FY1980, FY1990, FY1999, and FY2001. For Massachusetts, E&Y provided estimates for every fiscal year between FY1992 and FY2002. The author estimated these taxes for Massachusetts (used in Figures 4 through 6) for FY1982, FY1987, and FY2003. For the first two of these three fiscal years, the assumption was made that the ratio of personal taxes on business-related income to *total taxes as estimated by E&Y* was the same in Massachusetts as in the United States as a whole. (The ratios were almost identical in FY1999, the only year for which E&Y provided an estimate for both Massachusetts and the U.S.) It was then assumed that between FY1980 and FY1990 the nationwide ratio grew at a constant rate and that the Massachusetts ratio grew at the same rate. Based on these assumptions, linear interpolation was used to develop estimates for personal taxes on business-related income in Massachusetts in FY1982 and FY1987, the two years used as observations during the FY1980s in Figures 4 through 6. To obtain an estimate for FY2003, it was assumed that the rate of growth in personal income taxes on business-related income in Massachusetts from FY2002 to FY2003 was the same as the annualized rate of growth from FY1992 to FY2002 (9.9 percent).

The author's estimates are reported in the following table:

Appendix Table 1
Estimated Massachusetts Personal Income Taxes on Business-Related Income, FY1982 though FY2003

	FY1982	*FY1987*	*FY1992*	*FY1999*	*FY2000*	*FY2001*	*FY2002*	*FY2003*
($ millions)	214	371	405	933	1,049	1,149	1,042	1,046

II. Estimating General Own-Source Revenue: FY2001-FY2003

Unfortunately, state-specific Census data are not available for fiscal years 2001 through 2003 for state and local government general own-source revenues. The author used the following technique to estimate total general own-source revenues for state and local governments in both Massachusetts and the entire United States.

Massachusetts: DOR data were used. An estimate of *state* taxes, fees, and charges was obtained from the residual of "total revenues" less "Federal reimbursements" as stated in the official financial statements broadcast on the Commonwealth's official web site (http://budget.mass.gov/budget). To estimate the *local* taxes, fees, and charges, "State Aid" was removed from "Total Receipts" as measured in the Massachusetts Department of Revenue Municipal Databank (http://www.dls.state.ma.us/mdm.htm.)

Combining these estimates provides an approximation for total *state and local* general own-source revenues for Massachusetts, measured with Massachusetts data. The author assumed that state and local own-source revenues, as reported by the Census Bureau, grew at the same rates in order to estimate Massachusetts general own-source revenues for FY2001 through FY2003. (Results appear in Appendix Table 2, below.) This technique is certainly not problem-free, although it does create estimates based on actual state and local data that are in some ways sensitive to Census standardizations.

United States: A parallel technique was used in estimating total state and local general own-source revenue for the United States. Bureau of Economic Analysis data from the National Income and Product Accounts were used to construct the scaling factor. Total general own-source revenue was estimated from "total state and local current receipts" less "total state and local transfer receipts." Mirroring the technique employed for the DOR data above, growth rates were constructed and applied to standardized Census data to approximate total state and local general own-source revenues for fiscal years 2001-2003. Results appear in Appendix Table 3 below.

Appendix Table 2
Estimates for Massachusetts General Own-Source Revenues, FY2001-FY2003
($ millions)

FY	Total Revenues	Federal Reimbur sements	State Taxes, fees and charges (1-2)	Municipal Taxes, Fees and Charges	Estimated GOSR (3+4)	Percentage Growth from Prior FY	Census Data General Own-Source Revenue	Estimated General Own-Source Revenue
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
2000	22,587.00	3,645.50	18,941.50	10,314.88	29,256.38		31,855.85	
2001	22,809.10	3,974.00	18,835.10	10,985.33	29,820.43	1.93		32,470.02
2002	21,756.40	4,346.70	17,409.70	11,654.04	29,063.74	-2.54		31,646.09
2003	22,561.80	4,652.50	17,909.30	12,193.66	30,102.96	3.58		32,777.64

Appendix Table 3
Estimates for United States General Own-Source Revenues, FY2001-FY2003
($ millions)

Fiscal Year	*Total receipts*	*Current transfer receipts*	*Total Own-Source Revenue (1-2)*	Percentage Growth from Prior FY	Census Data General Own-Source Revenue	Estimated General Own-Source Revenue
	(1)	(2)	(3)	(4)	(5)	(6)
2000	1,326,925	303,525	1,023,400		1,249,373	
2001	1,403,775	334,025	1,069,750	4.52		1,305,957
2002	1,441,625	366,350	1,075,275	0.51		1,312,702
2003	1,504,750	401,175	1,103,575	2.63		1,347,250

III. Further Methodological Details for Figures

Corporate Excise Tax and Total State Tax Collections FY2004: *Figures 1, 2, 5, 6*

The values for 2004 are estimated. It was assumed that the year-over-year growth rates in corporate excise tax receipts and total tax receipts for all of FY2004 equaled the year-over-year growth rates for these two taxes through February of FY2004.

Massachusetts Personal Income FY2004: *Figures 2, 5*

Massachusetts personal income for FY2004 is estimated. The Bureau of Economic Analysis supplied sufficient data to calculate a year-over-year growth rate of personal income for the first quarter of FY2004. This growth rate was compared with the year-over-year growth rate of the first quarter from FY2002 to FY2003. The change from this observable growth rate in the first quarter of FY2004 was assumed to hold for the remaining quarters, providing an estimate of Massachusetts personal income in FY2004.

Corporate Excise Tax Receipts FY2002-FY2003: *Figures 5, 6*

U.S. Census data for state tax collections for individual states are available only through FY2002. Therefore, Census data for corporate excise tax collections were extended through FY2003 by using annual growth rates and through FY2004 by using the observed year-over-year growth rates through February 2004 from Massachusetts Department of Revenue data on corporate excise tax collections.

Corporate Income Tax Receipts FY2001-FY2002 and FY2002-2004: *Figures 3, 5*

See Appendix section I. *Corporate income taxes.*

Expanded Business Share FY2003: *Figure 9*

See Appendix section I. *All business income taxes.*

IV. State-Specific Estimates of Business Share of Total Taxes, FY2000

Total taxes were set equal to total general taxes, as defined by the U.S. Census, plus unemployment insurance taxes and workers compensation premiums, both considered to be business taxes by E&Y.

Taxes assumed to be nominally borne in whole or in part by businesses, as opposed to households, include the following:

property tax
general sales/gross receipts tax
selective sales tax
insurance premium tax
motor fuels tax
public utilities tax
amusement license
corporate license
alcoholic beverages license
public utilities license
occupation/business license, NEC
other license taxes
corporate net income taxes
severance
workers compensation
unemployment insurance taxes

Allocation of Taxes to Businesses: Some of these taxes, such as corporate net income, are clearly paid entirely by businesses. In contrast, some taxes, like property taxes, are shared by businesses and households. The following methodology was used to assess the share of each tax borne by businesses in each state. Those taxes not explicitly listed were assumed to be entirely business taxes.

Property Tax:

The business share of property taxes was calculated as the residual of total property taxes in the state for FY2000 (reported in the U.S. Census State and Local Government Finances) less the aggregate property taxes paid on owner-occupied units in the state (obtained from the U.S. Census of Housing, 2000). The Census of Housing provides state-specific data on the total number of owner-occupied units and the average property tax bill per unit. Multiplying the two together yields an estimate of statewide property taxes paid on owner-occupied units. In interviews by phone, Census officials have indicated that these totals include the value of farm homesteads, vacation homes, and vacant homes, all residential units whose taxes should be treated as "household" taxes rather than "business" taxes. Taxes on rental housing are considered business taxes, since the provision of such housing is an enterprise as much as manufacturing cars or cutting hair.

General Sales and Gross Receipts Tax:

In order to determine the business share of this tax, the author used E&Y estimates graciously provided by the consulting firm.

Selective Sales Taxes:

Tobacco and liquor taxes were assumed to be paid by households. Absent any detailed data on these taxes, *selective sales taxes not elsewhere classified* were assumed to be split 50-50 between businesses and households.

To allocate *motor fuel taxes* between households and businesses, the author assumed that diesel fuel sales were made primarily to businesses (trucking, shipping, etc.) whereas gasoline sales were made primarily to households. Therefore, the business share of fuel taxes was allocated by multiplying total state fuel tax revenues by the ratio of diesel sales to total *fuel sales* (defined here as the sum of gasoline and diesel sales). Data on fuel sales were obtained from U.S. Energy Information Administration,

Petroleum Marketing Annual *2002* (U.S. Energy Information Administration 2003), which lists sales volumes on a state-by-state basis.

This allocation technique is not problem-free. In particular, it is clear that diesel fuel sales include some made to households, and gasoline fuel sales include some made to businesses. However, a lack of detailed data on fuel sales necessitated an estimation technique, and insofar as diesel fuel sales are primarily made to business, and gasoline sales are primarily made to households, this estimation yields a better approximation than arbitrarily assigning a value.

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Glossary
Names of Indicators Used in This Article

Corporate excise burden—Massachusetts corporate excise tax receipts per $1,000 of Massachusetts personal income.

Corporate excise share—Massachusetts corporate excise tax receipts as a percent of Massachusetts state taxes.

Corporate income tax burden—State and local corporate income tax receipts, as measured by the U.S. Census Bureau, per $1,000 of personal income. In Massachusetts, all of corporate excise tax receipts are included in the Census corporate income tax figures.

Corporate income tax share—State and local corporate income tax receipts, as measured by the U.S. Census Bureau, as a percent of total state and local general own-source revenues.

Business income tax burden—State and local corporate income tax receipts plus state and local personal income taxes on business income, per $1,000 of personal income.

Business income tax share—State and local corporate income tax receipts plus state and local personal income taxes on business income as a percent of all state and local own-source revenues.

Business share (BSH)—State and local taxes on business (including business income taxes except for personal income taxes on business income) as a percent of total state and local taxes, as defined by Ernst & Young LLP in Cline et al. 2003a.

Expanded business share (EBSH)—State and local taxes on business, including personal income taxes on business incomes, as a percent of total state and local taxes, as defined by Ernst & Young LLP in Cline et al. 2003a.

Business tax burden—State and local taxes on business (including business income taxes except for personal income taxes on business income and including other taxes paid by business, such as licenses, workers compensation premiums, unemployment insurance taxes, and parts of property and sales taxes—see Appendix, section IV) per $1,000 of personal income.

Table 1
Business Share of State and Local Taxes (BSH), by State
FY2000 and FY2003
(percent)

(1)			(2)			(3)		
Estimates based on Ernst and Young figures for Business Taxes, FY2003			**Estimates based on Ernst and Young figures for Business Taxes, FY2000**			**Author's Estimate FY2000**		
		Rank			**Rank**			**Rank**
US	42.7		**US**	41.6		**US**	43.6	
AL	41.1	28	**AL**	41.6	26	**AL**	42.5	28
AK	77.2	1	**AK**	81.0	1	**AK**	79.8	1
AZ	47.2	17	**AZ**	46.2	16	**AZ**	51.7	12
AR	39.2	37	**AR**	39.9	29	**AR**	37.4	43
CA	40.4	32	**CA**	37.3	40	**CA**	39.9	38
CO	40.7	31	**CO**	39.4	30	**CO**	42.6	27
CT	37.2	43	**CT**	37.0	42	**CT**	39.1	40
DE	55.7	7	**DE**	53.6	10	**DE**	53.9	10
FL	47.9	13	**FL**	47.5	13	**FL**	48.0	16
GA	39.0	38	**GA**	37.9	38	**GA**	40.6	35
HI	38.0	40	**HI**	38.4	35	**HI**	37.1	45
ID	39.6	35	**ID**	37.6	39	**ID**	39.4	39
IL	47.8	14	**IL**	46.3	15	**IL**	45.2	19
IN	36.8	44	**IN**	35.8	44	**IN**	42.8	26
IA	43.3	25	**IA**	42.0	25	**IA**	40.4	36
KS	43.3	24	**KS**	42.8	24	**KS**	43.3	25
KY	40.9	30	**KY**	39.2	32	**KY**	40.7	31
LA	57.2	5	**LA**	56.5	5	**LA**	58.5	5
ME	46.3	19	**ME**	45.0	19	**ME**	44.1	21
MD	31.8	50	**MD**	30.7	50	**MD**	32.7	50
MA	*37.5*	*42*	***MA***	*35.5*	*45*	***MA***	*36.1*	*48*
MI	41.2	27	**MI**	39.2	33	**MI**	38.8	41
MN	37.6	41	**MN**	37.1	41	**MN**	37.1	46
MS	45.5	21	**MS**	44.0	22	**MS**	45.8	18
MO	38.7	39	**MO**	38.0	37	**MO**	40.6	33
MT	54.9	8	**MT**	54.4	8	**MT**	53.4	11
NE	44.8	22	**NE**	43.6	23	**NE**	43.8	23
NV	47.3	16	**NV**	46.0	17	**NV**	49.8	13
NH	63.6	3	**NH**	62.7	3	**NH**	58.3	6
NJ	41.1	29	**NJ**	39.0	34	**NJ**	40.6	34
NM	49.7	12	**NM**	50.2	12	**NM**	49.6	14
NY	40.0	34	**NY**	40.4	28	**NY**	44.4	20
NC	36.4	47	**NC**	34.9	46	**NC**	36.9	47
ND	54.4	9	**ND**	54.6	7	**ND**	58.3	7
OH	39.5	36	**OH**	38.4	36	**OH**	42.5	29
OK	44.5	23	**OK**	44.1	21	**OK**	41.8	30
OR	35.0	48	**OR**	33.8	48	**OR**	40.2	37
PA	40.2	33	**PA**	41.1	27	**PA**	40.7	32
RI	46.1	20	**RI**	45.7	18	**RI**	43.8	22
SC	42.8	26	**SC**	39.3	31	**SC**	43.4	24
SD	57.7	4	**SD**	57.4	4	**SD**	57.5	8
TN	50.2	11	**TN**	50.6	11	**TN**	48.9	15
TX	56.1	6	**TX**	56.3	6	**TX**	59.1	4
UT	34.1	49	**UT**	32.9	49	**UT**	37.4	44
VT	46.6	18	**VT**	44.3	20	**VT**	45.9	17
VA	36.6	46	**VA**	35.9	43	**VA**	38.4	42
WA	53.9	10	**WA**	54.2	9	**WA**	59.6	3
WV	47.6	15	**WV**	47.3	14	**WV**	55.2	9
WI	36.7	45	**WI**	33.8	47	**WI**	34.5	49
WY	69.2	2	**WY**	66.4	2	**WY**	70.1	2

Note: see appendix for methodological details.
Sources: Author's calculations, Census Bureau, and Cline et al. (2004).

Table 2
Business Taxes as a Percent of Statewide Personal Income by State, FY2000 and FY2003

(1)			(2)			(3)		
Estimates based on Ernst and Young figures for Business Taxes, FY2003			**Estimates based on Ernst and Young figures for Business Taxes, FY2000**			**Author's Estimate FY2000**		
		Rank			**Rank**			**Rank**
US	4.5		**US**	4.4		**US**	4.7	
AL	3.8	42	**AL**	3.8	41	**AL**	3.9	45
AK	8.6	1	**AK**	10.6	1	**AK**	10.4	1
AZ	4.9	18	**AZ**	4.8	19	**AZ**	5.5	12
AR	4.0	37	**AR**	4.2	36	**AR**	3.9	44
CA	4.3	32	**CA**	4.2	37	**CA**	4.5	25
CO	3.8	41	**CO**	3.7	44	**CO**	4.0	43
CT	4.1	36	**CT**	4.3	31	**CT**	4.5	28
DE	6.1	4	**DE**	5.9	7	**DE**	6.0	9
FL	4.3	28	**FL**	4.4	24	**FL**	4.5	27
GA	4.0	39	**GA**	3.9	40	**GA**	4.1	42
HI	4.5	23	**HI**	4.8	18	**HI**	4.6	23
ID	4.0	38	**ID**	4.1	38	**ID**	4.4	29
IL	5.0	17	**IL**	4.8	17	**IL**	4.7	21
IN	3.7	46	**IN**	3.6	46	**IN**	4.4	35
IA	4.4	26	**IA**	4.5	23	**IA**	4.3	38
KS	4.4	27	**KS**	4.4	25	**KS**	4.5	24
KY	4.3	33	**KY**	4.2	35	**KY**	4.4	32
LA	6.3	3	**LA**	6.1	5	**LA**	6.3	6
ME	5.9	5	**ME**	6.1	6	**ME**	5.9	10
MD	3.2	50	**MD**	3.2	50	**MD**	3.4	50
MA	*3.8*	*43*	***MA***	*3.7*	*43*	***MA***	*3.7*	*47*
MI	4.5	21	**MI**	4.4	27	**MI**	4.3	36
MN	4.2	34	**MN**	4.4	28	**MN**	4.4	34
MS	4.7	19	**MS**	4.8	20	**MS**	5.0	19
MO	3.7	45	**MO**	3.7	45	**MO**	3.9	46
MT	5.6	8	**MT**	5.8	8	**MT**	5.9	11
NE	4.5	22	**NE**	4.6	22	**NE**	4.6	22
NV	4.7	20	**NV**	4.7	21	**NV**	5.0	18
NH	5.5	11	**NH**	5.0	16	**NH**	4.7	20
NJ	4.5	24	**NJ**	4.2	33	**NJ**	4.4	30
NM	5.5	10	**NM**	6.3	3	**NM**	6.1	7
NY	5.6	9	**NY**	5.4	12	**NY**	6.0	8
NC	3.6	47	**NC**	3.5	48	**NC**	3.7	48
ND	5.8	6	**ND**	6.2	4	**ND**	7.1	4
OH	4.3	30	**OH**	4.2	34	**OH**	5.1	17
OK	4.5	25	**OK**	4.4	26	**OK**	4.3	39
OR	3.3	49	**OR**	3.6	47	**OR**	4.5	26
PA	4.1	35	**PA**	4.3	29	**PA**	4.2	40
RI	5.4	13	**RI**	5.5	10	**RI**	5.1	16
SC	3.9	40	**SC**	3.9	39	**SC**	4.4	31
SD	5.3	14	**SD**	5.2	13	**SD**	5.2	15
TN	4.3	29	**TN**	4.3	30	**TN**	4.2	41
TX	5.3	15	**TX**	5.1	15	**TX**	5.4	13
UT	3.8	44	**UT**	3.8	42	**UT**	4.4	33
VT	5.2	16	**VT**	5.1	14	**VT**	5.3	14
VA	3.4	48	**VA**	3.4	49	**VA**	3.7	49
WA	5.7	7	**WA**	5.8	9	**WA**	6.8	5
WV	5.5	12	**WV**	5.5	11	**WV**	7.2	3
WI	4.3	31	**WI**	4.2	32	**WI**	4.3	37
WY	7.9	2	**WY**	7.4	2	**WY**	7.9	2

Note: see appendix for methodological details.

Sources: Author's calculations, Census Bureau, Bureau of Economic Analysis, and Cline et al. (2003).

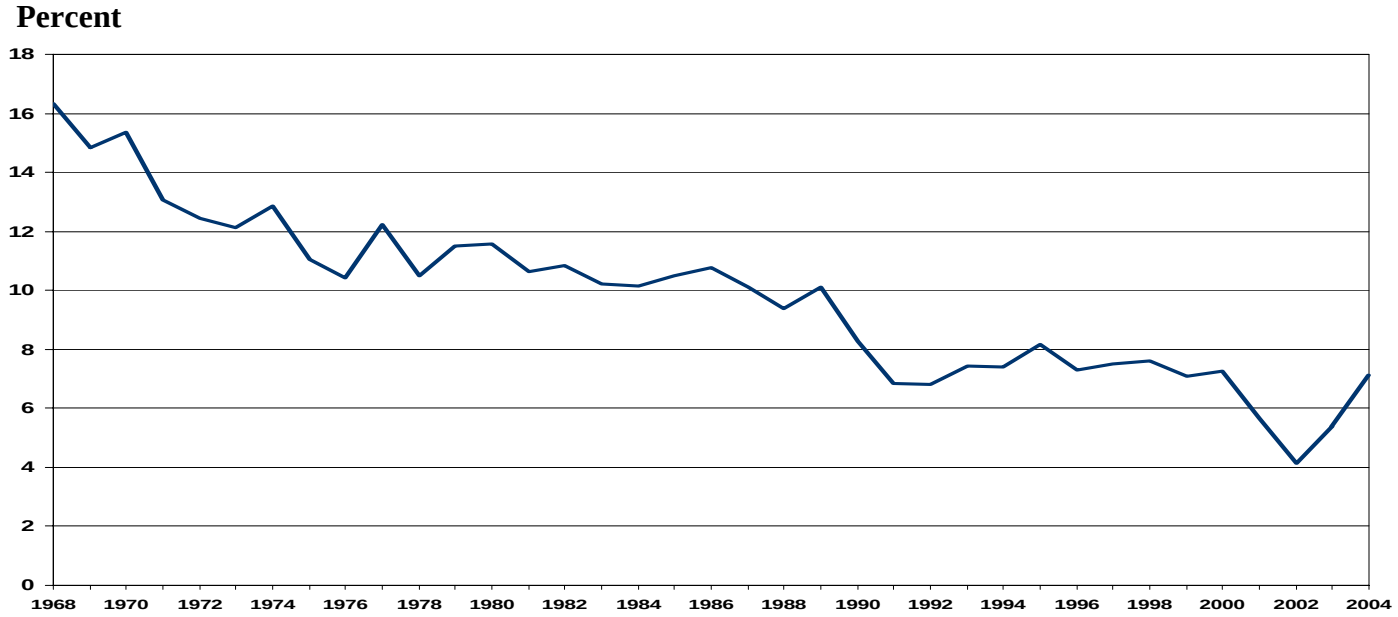
Table 3
Business Taxes as a Percent of Business Profits and Personal Income, FY2000

Business Taxes as a Percent of Business Profits						Business Taxes as a Percent of Personal Income					
(1)			(2)			(3)			(4)		
Estimates based on Ernst and Young figures for Business Taxes			Author's Estimate			Estimates based on Ernst and Young figures for Business Taxes			Author's Estimate		
		Rank			Rank			Rank			Rank
US	33.7		US	35.8		US	4.4		US	4.7	
AL	32.3	32	AL	32.8	37	AL	3.8	41	AL	3.9	45
AK	84.4	1	AK	82.3	1	AK	10.6	1	AK	10.4	1
AZ	39.6	14	AZ	45.3	9	AZ	4.8	19	AZ	5.5	12
AR	32.1	34	AR	29.9	45	AR	4.2	36	AR	3.9	44
CA	31.3	40	CA	33.7	33	CA	4.2	37	CA	4.5	25
CO	26.0	49	CO	28.0	47	CO	3.7	44	CO	4.0	43
CT	31.5	39	CT	32.5	40	CT	4.3	31	CT	4.5	28
DE	27.7	46	DE	27.9	48	DE	5.9	7	DE	6.0	9
FL	39.8	13	FL	40.1	14	FL	4.4	24	FL	4.5	27
GA	28.8	42	GA	30.7	43	GA	3.9	40	GA	4.1	42
HI	40.5	12	HI	38.7	16	HI	4.8	18	HI	4.6	23
ID	35.4	22	ID	38.5	18	ID	4.1	38	ID	4.4	29
IL	35.6	21	IL	34.5	30	IL	4.8	17	IL	4.7	21
IN	27.8	45	IN	33.3	35	IN	3.6	46	IN	4.4	35
IA	33.7	28	IA	32.5	39	IA	4.5	23	IA	4.3	38
KS	34.3	26	KS	35.0	29	KS	4.4	25	KS	4.5	24
KY	32.9	30	KY	34.2	32	KY	4.2	35	KY	4.4	32
LA	45.7	9	LA	47.3	8	LA	6.1	5	LA	6.3	6
ME	41.7	10	ME	40.5	13	ME	6.1	6	ME	5.9	10
MD	32.8	31	MD	35.1	28	MD	3.2	50	MD	3.4	50
MA	*27.6*	*47*	*MA*	*27.5*	*49*	*MA*	*3.7*	*43*	*MA*	*3.7*	*47*
MI	35.0	24	MI	34.4	31	MI	4.4	27	MI	4.3	36
MN	31.6	36	MN	31.5	41	MN	4.4	28	MN	4.4	34
MS	39.1	16	MS	40.9	12	MS	4.8	20	MS	5.0	19
MO	27.0	48	MO	28.6	46	MO	3.7	45	MO	3.9	46
MT	51.3	4	MT	52.1	7	MT	5.8	8	MT	5.9	11
NE	36.4	19	NE	36.7	22	NE	4.6	22	NE	4.6	22
NV	33.9	27	NV	36.5	24	NV	4.7	21	NV	5.0	18
NH	38.5	17	NH	35.9	25	NH	5.0	16	NH	4.7	20
NJ	35.3	23	NJ	36.6	23	NJ	4.2	33	NJ	4.4	30
NM	64.3	2	NM	63.1	3	NM	6.3	3	NM	6.1	7
NY	34.8	25	NY	38.8	15	NY	5.4	12	NY	6.0	8
NC	25.5	50	NC	26.9	50	NC	3.5	48	NC	3.7	48
ND	50.9	5	ND	58.6	5	ND	6.2	4	ND	7.1	4
OH	31.9	35	OH	38.5	17	OH	4.2	34	OH	5.1	17
OK	39.2	15	OK	37.7	21	OK	4.4	26	OK	4.3	39
OR	28.1	44	OR	35.3	26	OR	3.6	47	OR	4.5	26
PA	33.2	29	PA	32.5	38	PA	4.3	29	PA	4.2	40
RI	46.0	8	RI	43.2	10	RI	5.5	10	RI	5.1	16
SC	31.6	38	SC	35.1	27	SC	3.9	39	SC	4.4	31
SD	38.2	18	SD	38.4	19	SD	5.2	13	SD	5.2	15
TN	31.6	37	TN	30.4	44	TN	4.3	30	TN	4.2	41
TX	36.3	20	TX	38.1	20	TX	5.1	15	TX	5.4	13
UT	28.8	43	UT	33.4	34	UT	3.8	42	UT	4.4	33
VT	41.1	11	VT	42.5	11	VT	5.1	14	VT	5.3	14
VA	29.0	41	VA	31.0	42	VA	3.4	49	VA	3.7	49
WA	47.5	7	WA	56.1	6	WA	5.8	9	WA	6.8	5
WV	47.5	6	WV	63.1	4	WV	5.5	11	WV	7.2	3
WI	32.3	33	WI	32.9	36	WI	4.2	32	WI	4.3	37
WY	62.1	3	WY	66.5	2	WY	7.4	2	WY	7.9	2

Note: see appendix for methodological details.

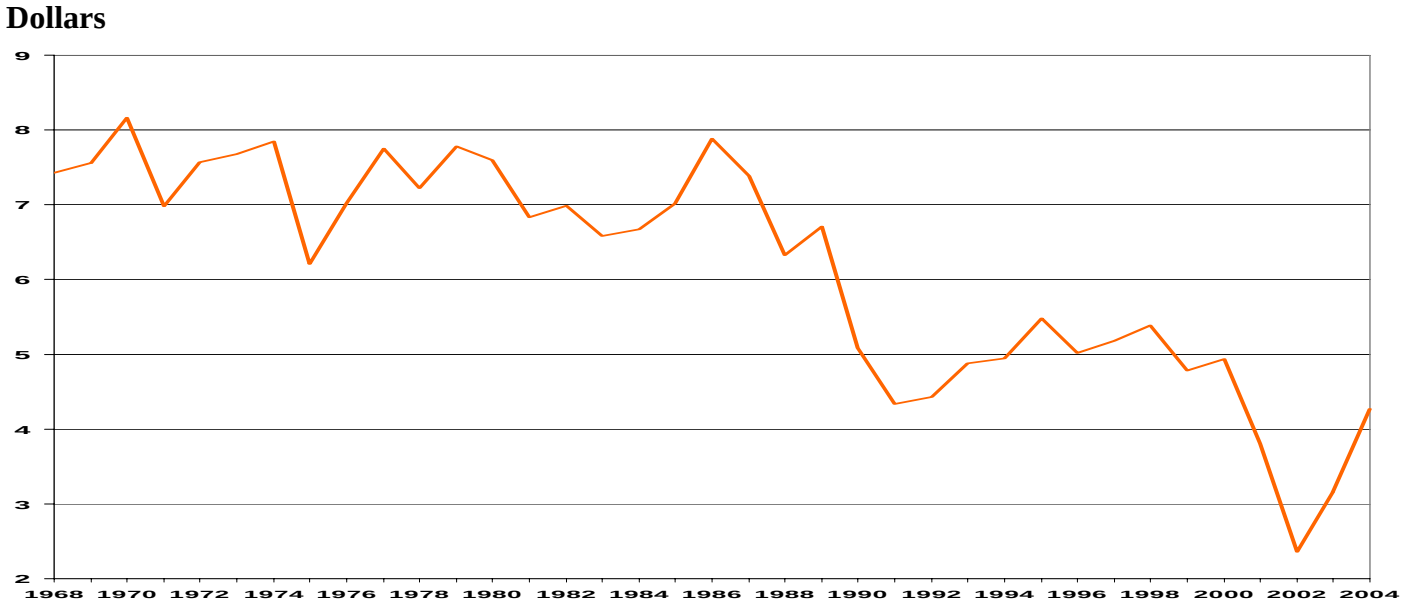
Sources: Author's calculations, Census Bureau, Cline et al. (2004), and Bureau of Economic Analysis.

Figure 1
Corporate Excise Share, Massachusetts, FY1968-FY2004*



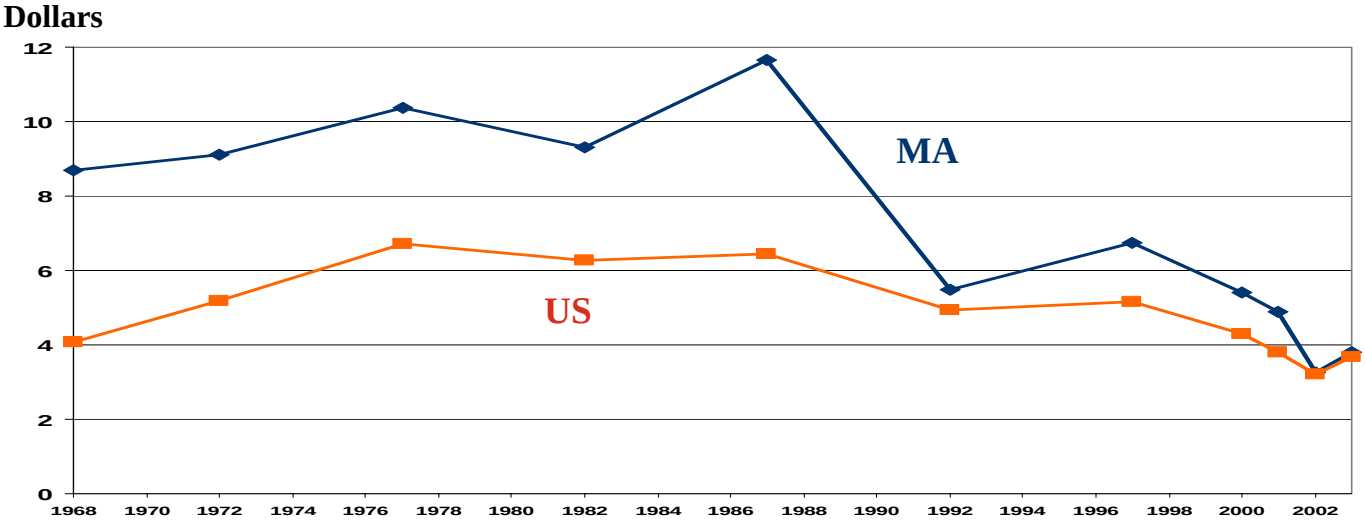
*Value for FY2004 is estimated. The rate of growth for corporate excise tax collections through the first eight months of FY2004 was assumed to be equal to the rate of growth for the whole fiscal year.
Source: Massachusetts Department of Revenue.

Figure 2
Corporate Excise Burden, Massachusetts, FY1968-FY2004*



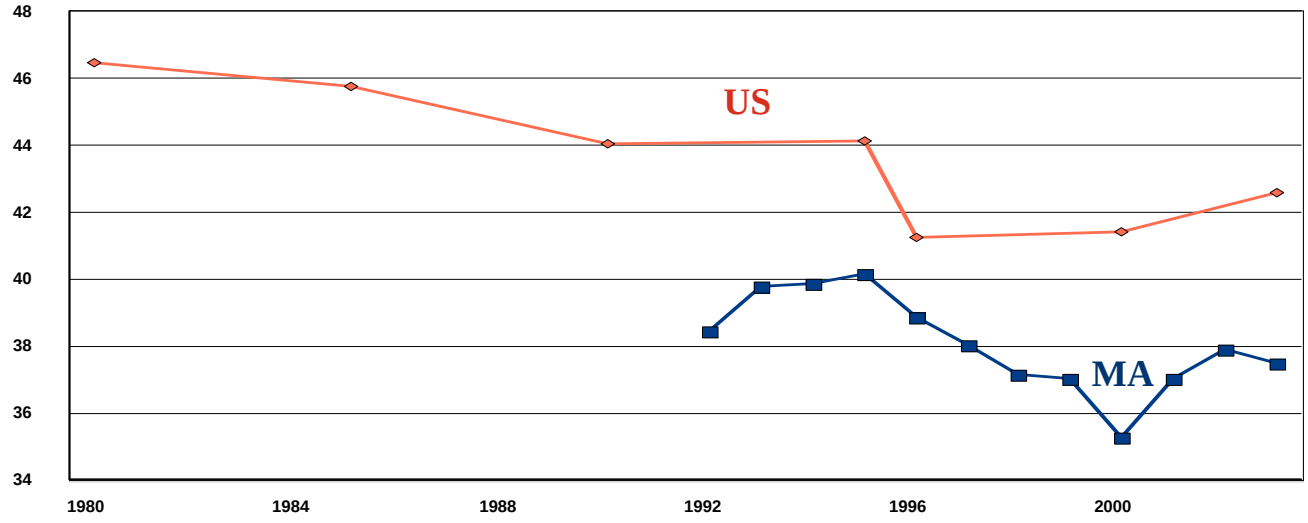
*Value for FY2004 is estimated. See notes to Figure 1 for method used to estimate FY2004 corporate excise tax receipts. See appendix for methodology used to estimate Massachusetts personal income.
Sources: Census Bureau, Bureau of Economic Analysis, and Massachusetts Department of Revenue.

Figure 3
Corporate Income Tax Burden, Massachusetts and the United States, FY1968-FY2003,* selected years



*Values for FY2001are estimated. See methodological appendix for details. See text for definition of corporate income tax burden.
Sources: Census Bureau, Bureau of Economic Analysis, and Massachusetts Department of Revenue.

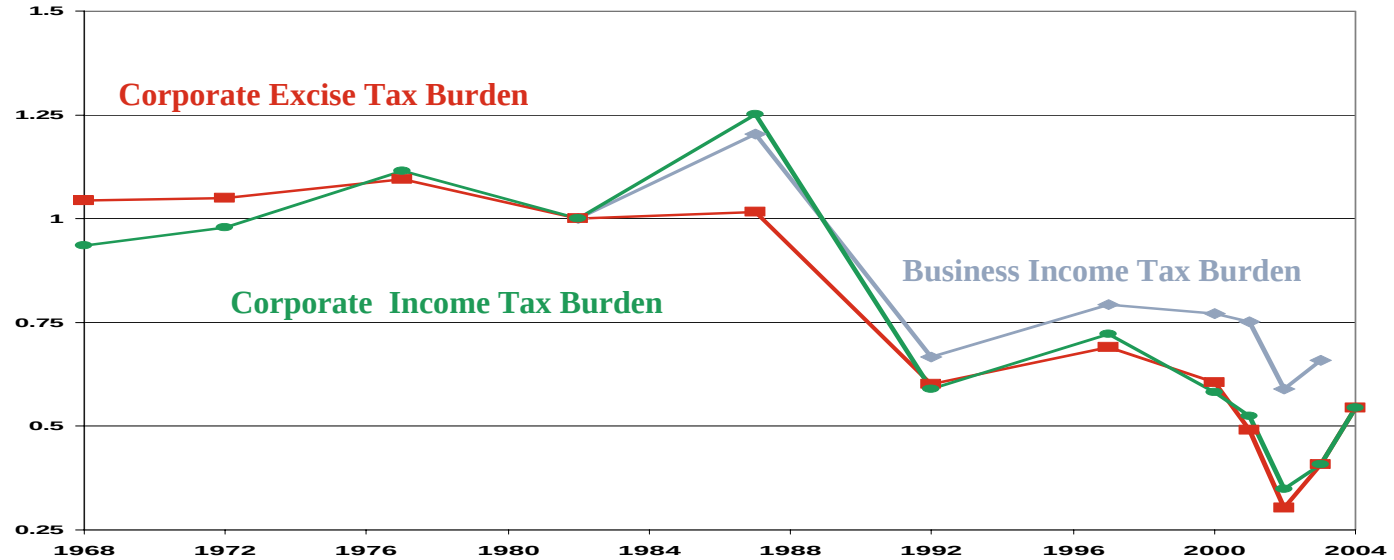
Figure 4
Business Share of State and Local Taxes (BSH), Massachusetts and the United States, FY1980-2003, selected years



Note: see text for definition of business share.
Sources: Census Bureau, Bureau of Economic Analysis, Massachusetts Department of Revenue, Cline et al. (2003), and Savino and Cline (2003).

Figure 5
Indexes of Tax Burdens, Massachusetts, FY1968-FY2004,* selected years

1982=1

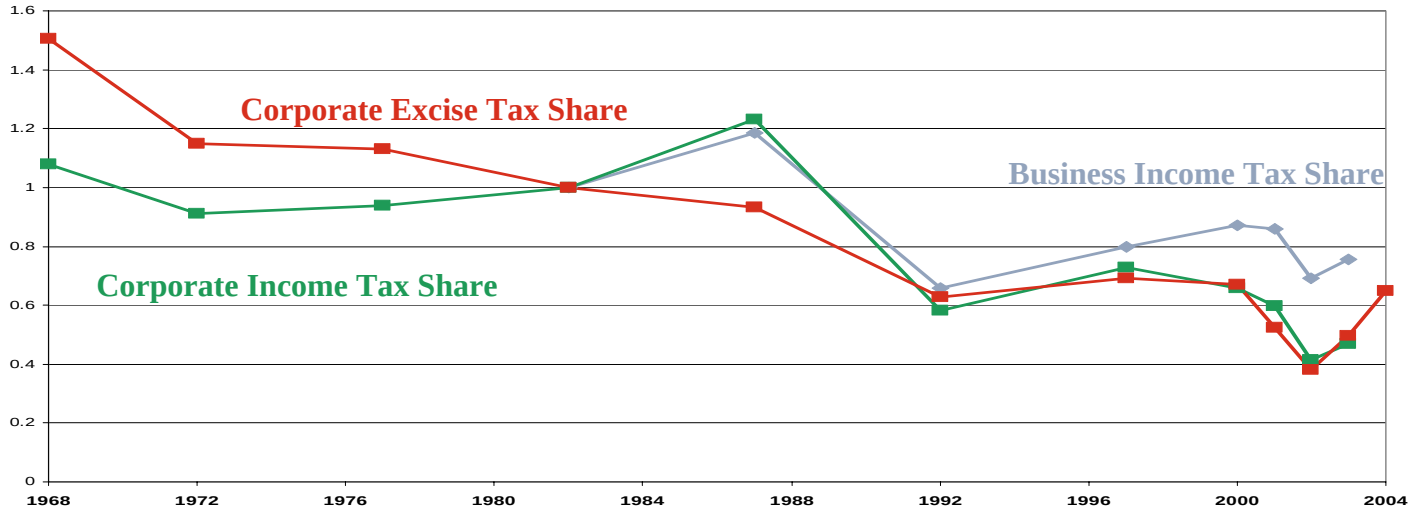


Fiscal Years

*Values for FY2002-FY2004 are estimated. See methodological appendix for details.
Sources: Massachusetts Department of Revenue, Census Bureau, Bureau of Economic Analysis, and Savino and Cline (2003).

Figure 6
Indexes of Tax Shares, Massachusetts, FY1968-FY2004,* selected years

1982=1

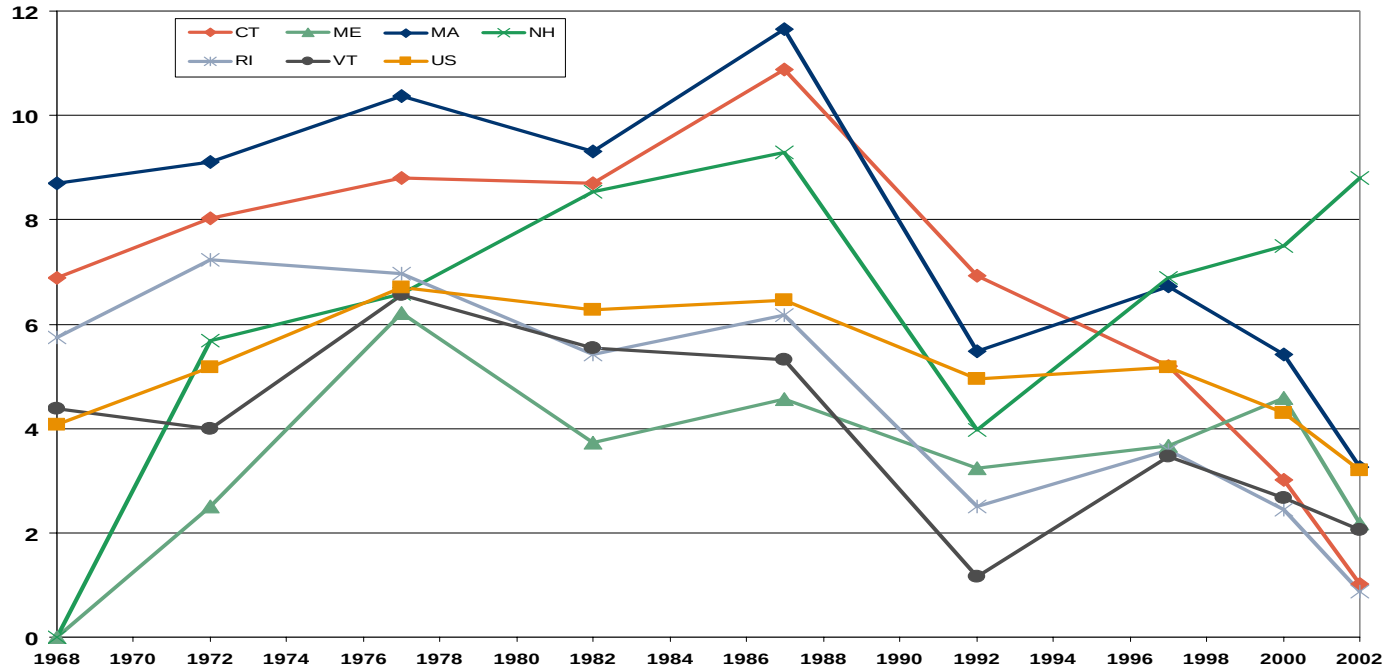


Fiscal Years

*Values for FY2003-FY2004 are estimated. See methodological appendix for details. See text for definition of corporate income tax share and business income tax share.
Sources: Census Bureau, Bureau of Economic Analysis, and Massachusetts Department of Revenue.

Figure 7
Corporate Income Tax Burden, the New England States and the United States, FY1968-FY2002, selected years

Dollars

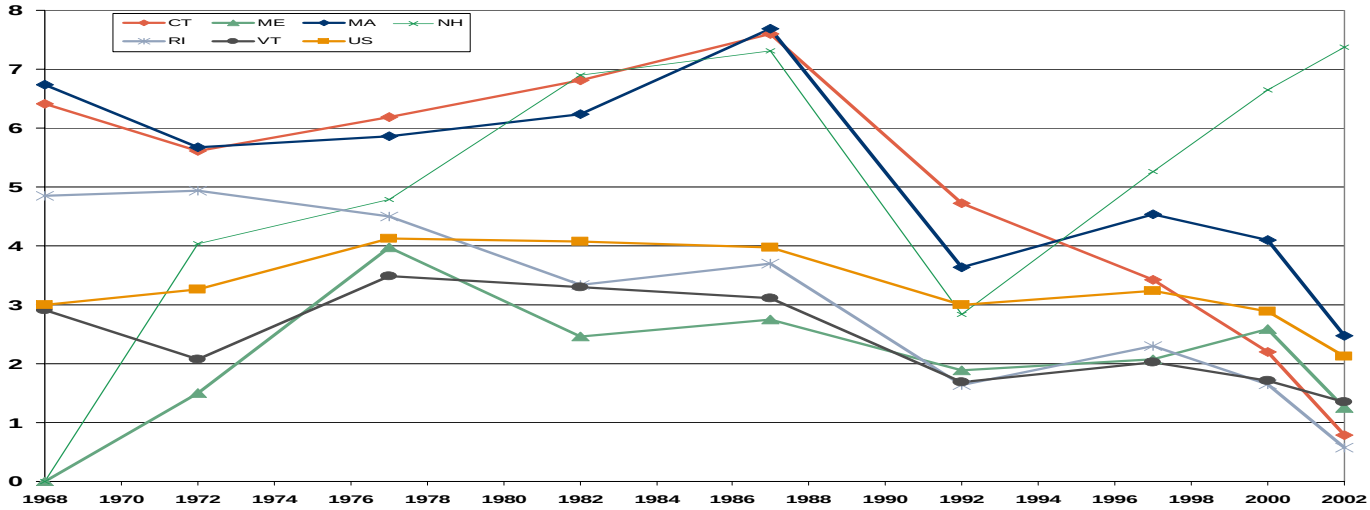


Fiscal Years

Note: see text for definition of corporate income tax burden.
Sources: Census Bureau and Bureau of Economic Analysis.

Figure 8
Corporate Income Tax Share, the New England States and the United States, FY1968-FY2002, selected years

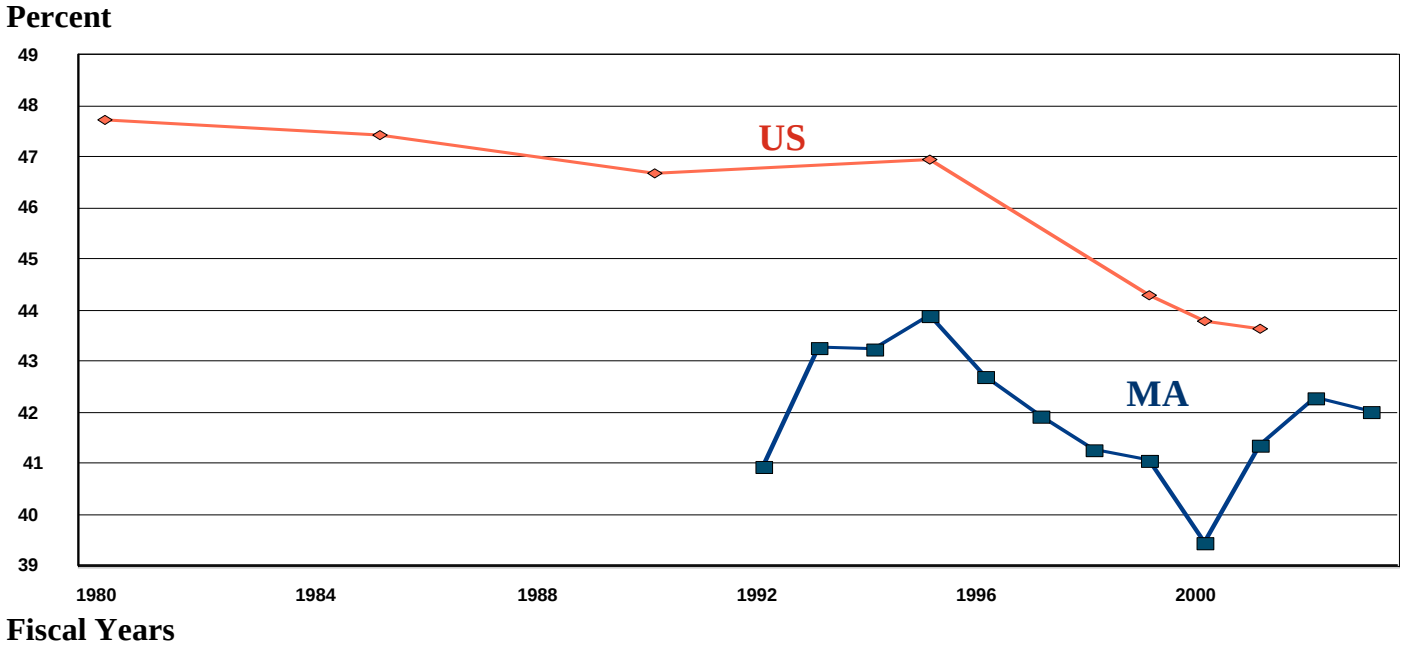
Percent



Fiscal Years

Note: see text for definition of corporate income tax share.
Source: Census Bureau.

Figure 9
Expanded Business Share (EBSH), Massachusetts and the United States, FY1980-FY2003,* selected years



Value for Massachusetts, FY2003, is estimated. See methodological appendix for details. See text for definition of expanded business share.
Sources: Census Bureau, Bureau of Economic Analysis, Massachusetts Department of Revenue, Cline et al. (2003), and Saviano and Cline (2003).

APPENDIX AA

"The Pros and Cons of Worldwide Unitary Taxation"
(by Robert Tannenwald, dated July/August 1984)

The Pros and Cons of Worldwide Unitary Taxation

Robert Tannenwald

Robert Tannenwald is an Economist at the Federal Reserve Bank of Boston. He has written several articles on tax policy and national business conditions. *The author would like to thank the Honorable Theodore Tannenwald, Jr. for his helpful comments and suggestions and R. Edward Ferguson for his able research assistance. Any errors or omissions are the author's responsibility only.*

How should a state determine its fair share of a multistate or multinational corporation's taxable income? Few issues in the field of state taxation have proven more troublesome. Multijurisdictional companies are usually so thoroughly integrated that methods of dividing their income geographically are necessarily arbitrary and therefore often controversial. For well over a hundred years, such methods have been the subject of frequent disputes in the courts, state legislatures, Congress, and negotiations of international tax treaties.

Of all methods of dividing income, none has been debated more vigorously than combined worldwide unitary accounting. This method requires a state to determine whether a corporate taxpayer is so closely linked with other establishments that it is in fact a component of a larger multiestablishment enterprise. If so, the taxpayer is deemed "unitary" with that enterprise and must report the enterprise's worldwide income, even if some of its branches, subsidiaries, or affiliates are located out of state. The state taxes a fraction of that worldwide income, usually determined by its shares of the enterprise's worldwide payroll, sales, and property.

Several states have adopted this method over the last 10 years, much to the displeasure of multinational corporations. With considerable support from foreign governments and the U.S. Department of the Treasury, multinationals have attacked the method on the grounds that it exposes them to international double taxation; burdens them with excessive bookkeeping requirements; distorts international flows of trade and investment; upsets long-standing agreements among nations designed to achieve international tax harmony; limits the federal government's ability to conduct coherent, consistent international economic policy; invites retaliation by the nation's trading partners; and violates the Constitution. State tax officials maintain that opponents of combined worldwide unitary accounting exaggerate its deleterious effects and that it is the only method by which they can effectively prevent corporations

from evading taxes by misrepresenting the geographic allocation of their income. The dispute has become so contentious that the Secretary of the Treasury recently formed a working group composed of representatives of the federal government, state governments, and the business community to try to resolve it.

For all the controversy it has aroused, combined worldwide unitary accounting is not widely understood. This article describes its evolution, explains its mechanics, and analyzes its merits and drawbacks.

I. Separate Accounting: the Originally Preferred Method of Allocating Income

In the 1910s and 1920s, the early years of state corporate income taxation, most states preferred to allocate income by separate accounting. This method requires each corporate taxpayer to compute its income on the basis of those receipts and costs related to its in-state activities only. In other words, in-state firms are treated as separable, independent businesses whose taxable income can be determined without reference to their out-of-state branches, subsidiaries, or affiliates. For example, suppose a steel company had a steel factory in Minnesota and a coal mining operation in North Dakota. Under separate accounting, Minnesota would tax only the income reflected in the accounts of the factory.

For several reasons, separate accounting has proven difficult to administer. First, multistate corporations have an incentive to misrepresent prices of intracompany transfers in order to understate profits in high-tax states. For example, suppose that in the above illustration Minnesota, where the factory is located, imposes a higher corporate income tax rate than North Dakota, where the coal mining branch is located. The steel company might quote an artificially high price for the coal, an ingredient of steel, in order to overstate the costs, and therefore understate the income, of the factory. The income of the mine would be overstated by the same amount. In this manner, the company could reallocate taxable income from high-tax Minnesota to low-tax North Dakota, reducing its overall state income tax liabilities. (See the Appendix for a numerical example.)

Because of the potential for misrepresentation, states practicing separate accounting must price intracompany transactions themselves. As guidelines, most states use the prices of "arm's length" transactions—comparable transactions occurring between independent firms. The Internal Revenue Service uses this standard in evaluating the reported prices of transfers between domestic corporations and their overseas branches and affiliates.

The usefulness of the arm's length standard is limited because in many situations comparable transactions among independents are difficult to find. How often, for example, do independent manufacturers sell television sets to independent wholesalers in the same quantities, on the same credit terms, and on the same delivery dates as General Electric, Sears, or Zenith ships television sets to its sales divisions? Where in the marketplace can a tax auditor find transactions among independent firms comparable to the transfers of formulas, patents, managerial services, technological information, and other intangibles that take place so frequently among the branches of a multistate or multinational corporation? According to a recent study by the General Accounting Office, such incomparability has limited the effectiveness of arm's length pricing at the federal level.[1]

Even when reported transfer prices are reasonable or comparable market prices are easily identifiable, separate accounting often fails because it attempts to separate the inseparable. For example, the very fact that an enterprise is vertically integrated reduces its costs, so that its profits are significantly greater than the sum of the profits its components would earn if they were unaffiliated. In the above illustration, the coal mining concern might be able to mine coal more cheaply than its independent counterparts because it would have no selling costs. Having a guaranteed customer (the steel factory), it would have no need to advertise for business or negotiate contracts with potential buyers. It could keep less inventory than an independent firm because the market for its coal would be more certain. It could buy some inputs more cheaply by entering into joint procurement arrangements with the steel factory. How should the income permitted by such savings be allocated between the mine and the steel factory? The problem has no clearcut theoretical solution.

These and other difficulties have led states to abandon separate accounting as their preferred method of allocating income. Today most states permit its use only in exceptional cases where the taxpayer demonstrates its particular suitability. The currently preferred method of dividing income among the

[1] See U.S. General Accounting Office, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations* (Washington, D.C.: U.S. General Accounting Office, 1981).

states is apportionment by formula,[2] of which combined worldwide unitary accounting is a particular type.

II. Apportionment by Formula

Under this method, currently used by all 45 states that tax corporate income, a state determines its share of a multijurisdictional business's taxable income by a formula, usually based on the state's shares of the business's total property, payroll, and sales. Most states give equal weight to each factor, although five states—Connecticut, Florida, Massachusetts, Ohio, and Wisconsin—double-weight sales. Thus, most states calculate the taxable income of multijurisdictional enterprises according to the following rule:

$$\text{state taxable income} = \left[\text{Total apportionable income}\right]\left[\text{state's share of apportionable income}\right]$$

$$\text{state's share of apportionable income} = \frac{\left[\dfrac{\text{property in-state}}{\text{total property}} + \dfrac{\text{payroll in-state}}{\text{total payroll}} + \dfrac{\text{sales in-state}}{\text{total sales}}\right]}{3}$$

Property, payroll, and sales are generally used as apportioning factors because they are thought to be closely linked with income-producing activity and their geographic location is relatively easy to identify. (A hypothetical example highlighting the difference between separate accounting and apportionment by formula is presented in the Appendix.)

Apportionment by formula was first used in the United States in the second half of the nineteenth century in the levying of capital stock taxes on railroads, canals, telegraph, and express companies. In order to determine their shares of the intangible property of such companies, states used crude formulas based on ratios of in-state to total miles of railroad track, waterway, or telegraph lines. The Supreme Court has upheld the constitutionality of these formulas in cases heard as early as 1873.[3]

Although now widely preferred to separate accounting, apportionment by formula has given state tax officials plenty of administrative headaches. Measuring each taxpayer's apportionable income, total property, total payroll, and total sales has proven especially difficult, because it requires the identification of the whole multiestablishment enterprise, or "unitary" business, with which the taxpayer is connected. Criteria for making this identification have been far more controversial than the principle of apportionment by formula itself.

Until the mid-1930s, all states identified unitary businesses according to the following rule. If the taxpayer was a branch of a U.S.-based corporation, the corporation was the taxpayer's unitary business, whose total income became the taxpayer's apportionable income and whose total payroll, property, and sales became the denominators of the factor ratios used in the apportionment formula. Any separately incorporated affiliates of the corporation were excluded from the taxpayer's unitary business. Similarly, if the taxpayer was a corporation operating solely within a single state but affiliated with a centrally controlled group of corporations, none of the corporations comprising the group was considered unitary with the taxpayer. All foreign taxpayers were subject to separate accounting.

As more and more businesses organized themselves as centrally controlled groups of corporations, this narrow definition of a unitary business became increasingly inadequate. States and taxpayers found themselves arguing about the pricing of transfers among separately incorporated affiliates instead of branches of a single corporation. Two taxpayers, similar in every respect except their organizational structure, frequently paid very different taxes. Several states recognized the need for a definition of a unitary business that was independent of formal organizational arrangements.

In the 1930s, California became the first state to develop such a definition and use it regularly to identify the unitary businesses of its corporate taxpayers. The following definition, set forth by the California

[2] Most states also allocate certain items of income (mostly nonbusiness income) according to a method known as specific allocation. Each item of income allocated in this fashion is attributed entirely to a single state according to rules designed to identify the item's geographic source. For example, Wisconsin taxes all the interest income of a taxpaying corporation if the state is the corporation's legal domicile. Iowa taxes 100 percent of rents from real estate located within its borders. For a further discussion of specific allocation, see U.S. Congress, House, Committee on the Judiciary, *State Taxation of Interstate Commerce, Vol. 1*, House Report No. 1480, 88th Cong., 2d Sess., pp. 197-217.

[3] For example, *Erie Railroad Company v. Pennsylvania*, 88 U.S. 492, *State Railroad Tax Cases*, 92 U.S. 575, and *Western Union Telegraph Company v. Massachusetts*, 125 U.S. 530.

Supreme Court in 1947, is still widely accepted:

> If the operation of the portion of the business done within the state is dependent upon or contributes to the operations of the business without the state, the operations are unitary.[4]

The California courts have set forth three further criteria of identification: unity of ownership, of operation, and of use. Rulings elaborating these criteria suggest that a group of corporations exhibits unity of ownership when a common owner possesses at least 50 percent of the voting stock of each corporation. Unity of use is evidenced by the presence of a central executive authority which performs important line functions for each member of the group. Such functions include the definition and control of the general system of producing profits; budgetary allocation; approval of major capital expenditures; appointment, assignment, and transfer of executive personnel; and determination and enforcement of procedures to insure compliance with the law. Unity of operations is indicated by centralization of staff functions, such as advertising, accounting, legal counseling, financing, and retirement planning.[5]

III. Domestic Combination, Water's Edge, and Combined Worldwide Unitary Accounting

The extent to which states actually include separately incorporated affiliates[6] in a unitary business is difficult to ascertain. Formal laws, regulations, and judicial rulings governing the identification of a unitary business are generally vague. In the absence of clear guidelines, the practices of some states have been arbitrary and inconsistent. Consequently, tax experts have yet to agree on what geographic and organizational constraints each state actually imposes on the scope of a unitary business.

According to a study published in late 1983, 15 states regularly include affiliates in a unitary business, although five of them exclude overseas affiliates. (See the map) Of these five, four—Kansas, Maine, Minnesota, and Nebraska—include in apportionable income the profits of U.S. affiliates no matter where earned, a practice known as domestic combined accounting (hereafter referred to as "domestic combination"). To illustrate, suppose that the Minnesota steel factory in the above example had a branch operation in Canada (not separately incorporated) and a separately incorporated affiliate in London. Under domestic combination, the Canadian branch could be part of the factory's unitary business, but the British affiliate could not. One state, Illinois, limits the permissible scope of a unitary business to the *domestic* operations of affiliates incorporated in the United States, a practice known as "water's edge" accounting (hereafter referred to simply as "water's edge").[7] Under water's edge, neither the British affiliate nor the Canadian branch could be declared unitary with the Minnesota factory.

Two developments have induced some states to extend the scope of a unitary business beyond the nation's borders. First, multinational centrally controlled groups of corporations have grown in size and number. As a result, the same administrative and conceptual difficulties that plagued separate accounting and unitary assessment limited to single corporations have also plagued water's edge and domestic combination. Once again, the prices of intraorganizational transfers have been an issue, this time between domestic corporations and their overseas affiliates rather than among domestic affiliates and branches. Furthermore, in many cases the components of a multinational business are so interdependent that states have been unable to isolate the contribution of its domestic operations to its total profits. In the view of many tax officials, the only solution to these problems is combined worldwide unitary assessment, the removal of all geographic constraints on the identification of a unitary business. They see this practice as a logical extension of the principle that the definition of a unitary business should be independent of organizational form.[8]

In recent years, fiscal stress has also stimulated interest in combined worldwide unitary accounting (hereafter referred to as "worldwide combination"),

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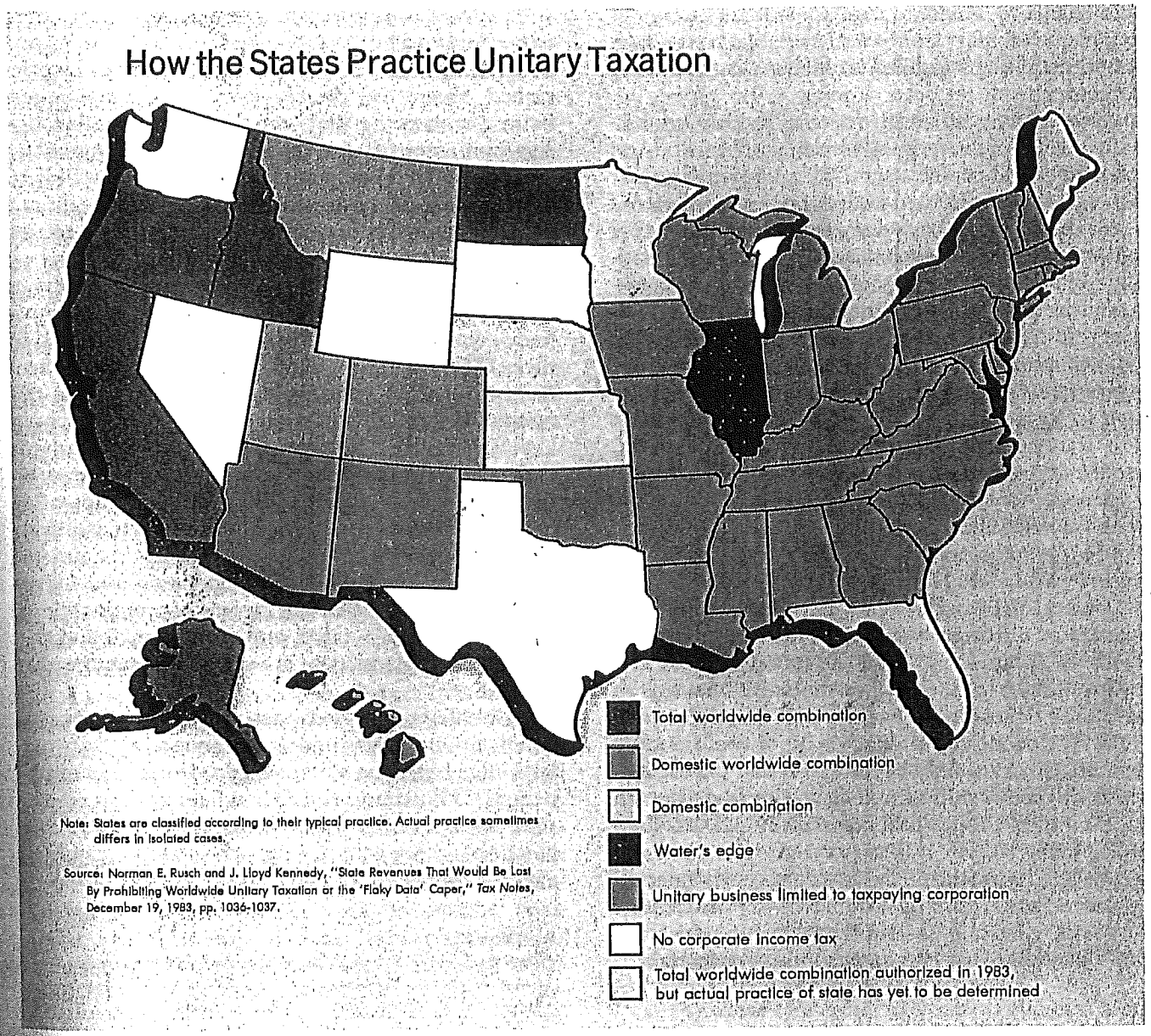
[4] *Edison California Stores v. McColgan*, 30 Cal. 2d, 472, 481, 183 P. 2d 16, 21; *Superior Oil Co., v. Franchise Tax Board*, 60 Cal. 2d 406, 412, 34 Cal. Rptr. 545, 548, 386 P. 2d 33, 36.

[5] See *Butler Brothers v. McColgan*, 17 Cal. 2d, 664, 678, 111 P. 2d 334, 341; *Superior Oil Co. v. Franchise Tax Board*, 60 Cal. 2d 406, 412, 34 Cal. Rptr. 545, 548, 386 P. 2d 33, 36.

[6] Throughout this study, "affiliate" refers to a separately incorporated component of a centrally controlled group of corporations, while "branch" refers to a component of a single corporation.

[7] Norman E. Rusch and J. Lloyd Kennedy, "State Revenues That Would Be Lost by Prohibiting Worldwide Unitary Taxation or the 'Flaky Data' Caper," *Tax Notes*, December 19, 1983, pp. 1036-1037. For an alternative classification of state practices, see "Which States Use the Unitary Method?" (Multistate Tax Commission, processed), August 1, 1983.

[8] For a further elaboration of the states' views on this issue, see *State Taxation of Multinational Corporations* (Washington, D.C.: Advisory Commission on Intergovernmental Relations, 1983), pp. 4-7.



Note: States are classified according to their typical practice. Actual practice sometimes differs in isolated cases.

Source: Norman E. Rusch and J. Lloyd Kennedy, "State Revenues That Would Be Lost By Prohibiting Worldwide Unitary Taxation or the 'Flaky Data' Caper," *Tax Notes*, December 19, 1983, pp. 1036-1037.

since the 10 states that practice it regularly claim that in 1983 it increased their corporate income tax revenues by $500 to $700 million.[9] Cutbacks in federal aid, tax cuts legislated in response to the "taxpayers' revolt," and a stagnant national economy slowed growth in state revenues dramatically from 1979 through 1982.[10] The Economic Recovery Tax Act of 1981 (ERTA) aggravated the revenue problems of those states whose individual and corporate income taxes were coupled to their federal counterparts. On the spending side, over the last 15 years state governments have accelerated outlays for primary and secondary education, medicaid, and environmental

[9] The amount of revenue states gain by practicing worldwide combination is a matter of some dispute. For alternative estimates see Rusch and Kennedy, "State Revenues That Would Be Lost," pp. 1037-1043 and James C. Rosapepe and Gerald H. Goldberg, "The Revenue Effects of the Unitary Method: Two Responses to Shell's Views," *Tax Notes*, January 9, 1984, pp. 147-50.

[10] U.S. Bureau of the Census, *State Government Finances 1982* (Washington, D.C.: GPO, 1983), several tables.

maintenance.[11] Worldwide unitary assessment seems to offer partial relief from these budgetary pressures without requiring legislated tax increases or spending reductions.

Two versions of worldwide combination are currently practiced: *domestic* worldwide combination and *total* worldwide combination. The alternatives differ in their treatment of taxpayers that are subsidiaries of parent corporations located in other countries. Under domestic worldwide combination, the state automatically excludes from the unitary business of such taxpayers the parent and the foreign subsidiaries of the parent. To illustrate, suppose that the steel factory and coal mine in the above example were separately incorporated subsidiaries of a parent corporation located in Paris. Minnesota is a domestic combination state. If it adopted domestic worldwide combination, it could declare the steel factory unitary with respect to all operations except the British affiliate and the French parent. States currently practicing domestic worldwide combination include Colorado, Massachusetts, Montana, New Hampshire, and Utah.[12]

Under total worldwide combination, the unitary business of a foreign-based corporation can include *any* of its affiliates, including its foreign parent and foreign affilates conducting no trade or business in the United States. In the example, if Minnesota were a total worldwide combination state, it could declare the steel factory unitary with its French parent and British distributorship as well as its Canadian branch and the North Dakota coal mine. Only Alaska, California, Idaho, North Dakota, and Oregon currently engage in this practice. Florida has recently enacted legislation authorizing its tax officials to practice total worldwide combination, but the extent to which the state will actually use its new authority is uncertain.[13]

IV. Arguments against Worldwide Combination

The U.S. Treasury Department and multinational corporations oppose worldwide combination because it allegedly 1) exposes multinational controlled groups to double taxation;[14] 2) saddles taxpayers with intolerable administrative burdens; 3) alienates our major trading partners; and 4) violates the Constitution. The Treasury Department is especially concerned about the double taxation and alienation issues, contending that worldwide combination upsets arrangements for international tax harmonization that have taken more than 50 years to establish. The linchpin of these arrangements is the treatment of multinational controlled groups by most countries on a water's edge basis. For example, the Internal Revenue Service taxes the domestic source income of U.S. parents and their U.S. subsidiaries but exempts the income of foreign subsidiaries until repatriated to their U.S. parents.[15] Similarly, the federal government taxes U.S. subsidiaries of foreign parents but neither the foreign parents themselves nor their non-U.S. subsidiaries. It enforces arm's length standards to deprive multinational corporations of the opportunity to understate their U.S. income by manipulating international transfer prices. This approach, explicitly recommended by both the United Nations and the Organization for Economic Cooperation and Development,[16] ensures that the income of a multinational controlled group is taxed only at its source and that no portion of its income is ever taxed by more than one nation.

Double taxation becomes a possibility, however, when national governments continue to abide by water's edge but some states practice worldwide combination. To illustrate, consider what happens when a state switches from water's edge to worldwide combination. Under water's edge, the state's formula for a corporation's taxable income is:

$$\underbrace{\text{domestic income}}_{\text{apportionable income}} \times \underbrace{\left[\frac{\frac{\text{property in-state}}{\text{total domestic property}} + \frac{\text{payroll in-state}}{\text{total domestic payroll}} + \frac{\text{sales in-state}}{\text{total domestic sales}}}{3}\right]}_{\text{state's share of apportionable income}}$$

[11] U.S. Bureau of the Census, *State Government Finances*, several years.

[12] Rusch and Kennedy, "State Revenues That Would Be Lost," pp. 1036-37.

[13] Ibid., p. 1037.

[14] For the purposes of this article, double taxation refers to the taxation of income by the governments of more than one nation. By this definition, the exposure of corporate income to both federal and state taxation is not double taxation.

[15] The United States taxes the worldwide income of domestic corporations if their overseas operations are organized as foreign branches. In these cases it avoids double taxation by granting a credit for income taxes paid to foreign countries.

[16] See Organization for Economic Cooperation and Development, *Model Double Taxation Convention on Income and on Capital* (Paris: OECD, 1977), and United Nations, *Model Double Taxation Convention Between Developed and Developing Countries* (New York: U.N., 1980). For a further discussion of international practice concerning the taxation of corporate income, see George Carlson and Harvey Galper, "Water's Edge Versus Worldwide Unitary Combination," in Charles McClure, ed., *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (Palo Alto, California: Hoover Institution Press, 1984).

The change to worldwide combination alters the formula in two ways. First, apportionable income increases from domestic to worldwide income. Second, the state's share of apportionable income shrinks because the denominators of the apportionment factors—property, payroll, and sales—are now calculated on a worldwide rather than a domestic basis. Taxable income rises if the percentage increase in apportionable income exceeds the percentage decrease in the state's share of that income. This condition holds in cases where the taxpayer's overseas operations have higher ratios of income to payroll, property, and sales than do its U.S. operations.

Meanwhile, neither the federal government nor the governments of other countries decrease their shares of the taxpayer's worldwide income. Consequently, the taxpayer becomes subject to double taxation in that income taxed by all nations now exceeds its value under previous rules, which insured that each dollar of income was subject to tax by one, and only one, nation. Under total worldwide combination, subsidiaries of foreign-based multinationals allegedly suffer most from this treatment because their home governments do not allow a credit or deduction for income taxes paid to U.S. states. By contrast, U.S.-based multinationals may deduct U.S. state income taxes from their federal taxable income[17] and in addition are not taxed on a worldwide combination basis by the subnational governments of other countries.

To the extent that double taxation occurs, it discourages productive investment by multinationals in their non-U.S. affiliates. It also puts affiliates of multinationals at a disadvantage with competitors organized as independent establishments. Under domestic worldwide combination, U.S.-based multinationals exposed to double taxation are put at a disadvantage with their foreign-based multinational competitors as well because this accounting rule in effect shields the latter from double taxation.

To what extent does worldwide combination actually expose multinationals to double taxation? As pointed out above, this depends on the extent to which the overseas operations of multinationals have higher ratios of income to payroll, property, and sales than their domestic operations. U.S.-based multinationals generally maintain that their foreign operations often have higher income-to-factor ratios because outside the United States land, labor, buildings, and other inputs are generally cheaper and regulatory environments are more hospitable. Furthermore, rates of return tend to be higher because they include higher risk premiums. These differences, they argue, invalidate the underlying premise of worldwide combination, that in the long run a dollar of wages, a dollar of property, and a dollar of sales produce approximately the same amount of income the world over.

If this argument is correct, then the taxable income of multinational companies should be greater under worldwide combination than under water's edge. The table suggests that this is in fact the case for U.S.-based multinationals as a whole. The table compares estimates by industry of the 1977 taxable income of U.S.-based multinational corporations subject to state taxation under two alternative accounting assumptions. Under the first, all states use worldwide combination, under the second, they all use water's edge. Differences between the estimates approximate the foreign-source (domestic-source) income that would be "double taxed" (not taxed) under the universal regime of worldwide combination. (See the Appendix for discussion of limitations and biases of data on which estimates are based.)

Worldwide combination allegedly exposes multinational controlled groups to double taxation.

The table indicates that under universal worldwide combination the estimated 1977 taxable income of U.S.-based multinationals would be about 14 percent higher under universal worldwide combination than under universal water's edge. However, this aggregate figure is heavily influenced by producers of petroleum and coal products because in 1977 they accounted for such a large proportion of the net income of U.S.-based multinationals and would have fared much worse under worldwide combination than under water's edge. In the absence of these producers the estimated 1977 taxable income of U.S.-based multinationals would have been 2.4 percent *lower* under the worldwide combination regime. Almost half of the industries listed in the table would have had low-

[17] Foreign-based subsidiaries may deduct their state income taxes from their federal income taxes. This privilege provides no tax relief, however, because their federal U.S. taxes may be credited against taxes owed to their home governments.

Worldwide Unitary Accounting versus Water's Edge: How Industries Would Fare Under Each (millions of dollars, 1977 data)

Industry	(1) Net Income under Combined Worldwide Unitary Accounting	(2) Net Income under Water's Edge	(3) Worldwide – Water's Edge [(1) – (2)]	(4) Percentage Difference in Net Income (Worldwide – Water's Edge) / Water's Edge ×100
ALL INDUSTRIES*	144,789	127,541	+17,248	+ 13.5
Mining (other than oil and gas extraction)	421	444	−23	−5.2
—metal mining	142	99	+43	+43.4
—coal & other nonmetallic minerals	279	345	−66	−19.1
Petroleum	42,654	22,265	+20,389	+91.6
—oil & gas extraction	1,515	1,590	−75	−4.7
—petroleum & coal products	38,622	18,780	+19,842	+105.7
—petroleum wholesale trade	1,368	776	+592	+76.3
—other	1,149	1,119	+30	+2.7
Manufacturing (other than petroleum and coal products)	69,859	72,531	−2,672	−3.7
—food & kindred products	5,906	5,969	−63	−1.1
—chemicals & allied products	11,765	12,490	−725	−5.8
—primary & fabricated metals	4,689	4,295	+394	+9.2
primary metals	1,969	1,470	+499	+33.9
ferrous	674	244	+430	+176.2
nonferrous	1,295	1,226	+69	5.6
fabricated metal products	2,720	2,825	−105	−3.7
—machinery—except electrical	12,134	12,307	−173	−1.4
—electric & electronic equipment	6,008	6,390	−382	−6.0
—transportation equipment	13,495	14,848	−1,353	−9.1
motor vehicles & equipment	9,726	11,004	−1,278	−11.6
other	3,769	3,844	−75	−2.0
—tobacco manufactures	1,537	1,670	−133	−8.0
—textile products & apparel	1,767	1,705	+62	+3.6
—lumber, wood, furniture & fixtures	1,645	1,708	−63	−3.7
—paper & allied products	2,607	2,663	−56	−2.1
—printing & publishing	1,957	1,944	+13	+0.7
—rubber products	835	1,054	−219	−20.8
—miscellaneous plastics products	380	349	+31	+8.9
—glass products	504	531	−27	−5.1
—stone, clay, cement & concrete	1,057	1,056	+1	+0.1
—instruments & related products	2,810	2,802	+8	+0.3
—other	763	750	+13	+1.7
Trade (other than petroleum wholesale and retail trade)	6,754	6,701	+53	+0.8
—wholesale trade	1,575	1,532	+43	+2.8
—retail trade	5,179	5,169	+10	+0.2
Finance (except banks) & insurance	8,805	9,391	−586	−6.2
—finance, except banking	864	799	+65	+8.1
—insurance	7,941	8,592	−651	−7.6
Selected Other Industries	16,296	16,209	+87	+0.5
—transportation, communication, & public utilities	13,599	13,500	+99	+0.7
—services	2,697	2,709	−12	−0.4

*Industries not included due to unavailable data include: real estate; holding companies; agriculture, forestry, and fishing; and construction.

Note: See Appendix, Section C, for explanation of calculations used to produce table and limitations and biases of underlying data.

Source: Author's calculations and U.S. Department of Commerce, Bureau of Economic Analysis, *U.S. Direct Investment Abroad, 1977* (Washington, D.C.: GPO, 1981).

er 1977 taxable incomes under universal worldwide combination.

Keep in mind that the figures reported in the table are industry-wide averages. The experiences of individual firms within each industry may vary widely. Furthermore, since the table reports estimates for one year only, it does not take into account possible cyclical influences on the results. Finally, the estimates are based on figures reported to the Department of Commerce, not the Internal Revenue Service.

In addition to arguing that worldwide combination exposes them to double taxation, multinationals complain that it burdens them with difficult and costly bookkeeping requirements. The difficulties allegedly arise from both the volume of data taxpayers must provide and the incompatibility of the accounts of foreign affiliates with accounting requirements of state taxing authorities. Compliance costs are said to be especially severe in the case of foreign-based multinationals.

In order to identify the unitary enterprise of multicorporate taxpayers, states that practice worldwide combination frequently ask them to provide for each of their affiliates several documents, including profit and loss statements, balance sheets, descriptions of principal products and services, lists of officers and directors, reports of audits by certified public accountants, and lists of reports filed with goverment agencies. In order to satisfy these requests, state taxpayers with large, far-flung operations often must retrieve documents from hundreds of affiliated corporations operating around the world. Many of the documents require translation from a foreign language.

The translation of values expressed in foreign currencies to values expressed in U.S. dollars also poses problems. For example, taxpayers must determine the dollar values of foreign affiliates' sales, payroll, and property in order to apportion the worldwide taxable income. The Internal Revenue Service has established procedures for making translations required of taxpayers when they file consolidated federal returns. State procedures vary and do not always conform to federal guidelines.

Multinational corporations further allege that, because foreign accounting rules differ from U.S. rules, tax data demanded by worldwide combination states are difficult to extract from the accounts of foreign affiliates. Taxpayers who elect to file federal consolidated returns have to adjust the books of foreign operations to U.S. tax laws anyway. Nevertheless, the foreign accounts require further adjustments to conform to state tax requirements because state corporate income tax laws frequently differ from their federal counterpart. These differences have grown since 1981, because many states have refused to accept the Accelerated Cost Recovery System and its attendant revenue losses. Foreign-based multinationals find the conversion of their accounts especially difficult because, compared to American-based multinationals, more of their records are geared to foreign accounting principles and they are not permitted to file a consolidated federal return.

The U.S. Treasury Department has been especially disturbed by the resentment of the country's principal trading partners against the growing practice of total worldwide combination. Several of them, including Great Britain, France, Canada, and the Netherlands, have sought treaty provisions prohibiting the application of worldwide unitary to their multinational corporations. The U.S. Senate, however, has refused to consent to any such provision on the grounds that international treaties are not appropriate vehicles for the federal regulation of state taxation. The Netherlands, which has recently negotiated a new bilateral tax treaty with the United States, has indicated that it will not sign the treaty without assurances that the states will be forbidden to apply worldwide combination to Dutch multinationals. Some of our trading partners are explicitly threatening retaliatory action if their companies continue to be subject to the practice.

The argument that worldwide combination is unconstitutional rests heavily on the three criticisms discussed above. In cases argued before the Supreme Court, both taxpayers and the Solicitor General of the United States have contended that the practice violates the foreign commerce clause of the Constitution, which reserves to Congress the right "to regulate commerce with foreign nations." State tax officials, on the other hand, see constitutional justification of the practice in the Tenth Amendment, which reserves to the States "the powers not delegated to the United States by the Constitution, nor prohibited by it to the States."

The Court has ruled that a law, regulation, or practice in the field of state taxation violates the foreign commerce clause if it 1) "creates a substantial risk of multiple international taxation?" and 2) "prevents the Federal government from speaking with one voice when regulating commercial relations with foreign governments."[18] In 1983, the Court ruled that

[18] *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979).

domestic worldwide combination meets neither of these criteria of unconstitutionality. (The Court has yet to rule on the constitutionality of total worldwide combination.)[19] The Court pointed out that the practice does not inevitably result in international double taxation and in many instances actually reduces the liabilities of a taxpayer. To buttress its point, the Court cited a petition by Caterpillar Tractor Corporation to the State of Illinois asking that its taxable income be determined on a worldwide combination rather than domestic combination basis.[20] The Court further argued that, given the imprecision of the arm's length standard, taxpayers are just as likely to be subject to international multiple taxation under separate accounting, water's edge, or domestic combination.

The Court stated that a tax policy of a state violates the "one voice" standard if it either 1) "implicates foreign policy issues which must be left to the federal government" or 2) "violates a clear federal directive." According to the Court, the possibility of offending foreign trading partners and provoking them into retaliation against the United States as a whole is the most serious foreign policy implication of a tax-related law, regulation, or administrative practice conducted by a state. The Court decided that in the case of domestic worldwide combination, the threat of retaliation is not substantial because the practice does not automatically result in double taxation and does not directly affect foreign-based enterprises. The Court also concluded that domestic worldwide combination violates no clearcut federal directive because no federal law forbids it and those treaties affirming the water's edge principle of international taxation apply to federal taxes only.[21]

Conclusion

Given that multijurisdictional enterprises are integrated economic units, any method of dividing their taxable income geographically is necessarily arbitrary and administratively complex. All states levying corporate income taxes have chosen formulary apportionment as the preferred method of dealing with this problem. The method is useless, however, unless states can identify the enterprise whose income should be apportioned, that is, the business with which each taxpayer is unitary. As multistate and multinational enterprises have grown in size, number, and organizational complexity, more and more states have relaxed geographic and legal structural constraints on criteria for identifying a unitary business. Today 10 states practice combined worldwide unitary accounting, the inclusion of foreign, independently incorporated affiliates in taxpayers' unitary businesses.

Disallowing total worldwide combination would not necessarily diminish the amount of tax revenue a state could collect from multinational enterprises.

When a state applies this practice to foreign-based multinational enterprises, it becomes entangled in the nation's web of relations with foreign governments and as a result can diminish the coherence and consistency of American international economic policy. Foreign nations view total worldwide combination as a clear violation of formally negotiated international rules of taxation by which they have faithfully abided for decades. It adds to tensions generated by such issues as tariffs, quotas, third world debt, and high U.S. interest rates, and enhances the probability of retaliation.

For this reason, state governments should refrain from practicing total worldwide combination. The Task Force of the Secretary of the Treasury's Worldwide Unitary Taxation Working Group has already recommended this course of action.[22] If states fail to adopt this recommendation voluntarily, the Congress should probably enact legislation explicitly disallowing the practice.

Such a restriction would not necessarily diminish the amount of tax revenue a state could collect from multinational enterprises. The revenue consequences to a state of abandoning or foregoing total worldwide combination depend upon the characteristics of the

[19] *Container Corporation of America v. Franchise Tax Board*, 103 U.S. 2933, and particularly 2952 n. 26 (1983).

[20] The tax treatment of Caterpillar Tractor was the subject of another Supreme Court case, *Chicago Bridge and Iron v. Caterpillar Tractor Co.*, U.S. No. 81-349, 103 Sup. Ct. 3562 (1983), which the Court dismissed for lack of a federal question.

[21] For a more detailed analysis of the Court's decision in the *Container* case, see George B. Javaras and James R. Browne, "Litigation, Prospects After Container: The Foreign Parent Issue," *Tax Notes*, December 19, 1983, pp. 1028-30.

[22] "Report to Worldwide Unitary Taxation Working Group" (U.S. Department of the Treasury, Office of Tax Policy; processed), May 1, 1984, p.8.

particular foreign-based multinational businesses operating within its borders. Such a switch could raise the tax liabilities of foreign-based multinationals if their operations outside the United States are generally less profitable than their U.S. operations.

The federal government could discourage the use of total worldwide combination without resorting to legislation by helping states to administer alternative approaches to the apportionment of corporate income. The Task Force of the Worldwide Unitary Taxation Working Group has suggested several forms that such assistance might take. For example, the Congress could pass laws requiring corporate taxpayers to provide each state that eschews total worldwide combination with specific documents revealing international income flows; geographic sources of income; geographic location of payroll, property, and sales, broken down by each separately incorporated affiliate; the identity of key employees familiar with company policies concerning intracompany transfer pricing; and state corporate tax returns filed in each state. The Internal Revenue Service could audit federal corporate taxpayers more aggressively and share more of the information gleaned from its audits with state tax authorities. The IRS could also directly assist state tax auditors in enforcing domestic worldwide combination, domestic combination, and water's edge if and when such assistance were requested.[23]

Whatever definitions states use to identify a unitary business, they should try to make them as clear and uniform as possible. Clarity and uniformity reduce corporations' uncertainty about their tax liabilities and ease compliance costs. At the very least states could lighten administrative burdens by adopting reporting procedures that conform more closely to those required for federal consolidated returns.

[23] Ibid., pp. 12-15.

APPENDIX

A. Example of How a Multistate Corporation Can Reduce Its Overall Tax Liability under Separate Accounting by Misrepresenting Intracompany Transfer Prices.

Suppose that the steel factory and coal mining operation in the example used throughout the article had the following balance sheets:

Item	Steel factory ($ millions)	Coal mining operation ($ millions)
(1) Gross sales	$100.0	$5.0
(2) Total Expenses [(3) + (4) + (5)]	90.0	4.5
(3) Coal	5.0	0
(4) Compensation	30.0	2.0
(5) Other	55.0	2.5
(6) Net income [(1) − (2)]	10.0	0.5
(7) Property	200.0	15.0

Suppose further that Minnesota, where the steel factory is located, taxes corporate income at a flat rate of 10 percent, while North Dakota, where the coal mining firm is located, taxes corporate income at a flat rate of 5 percent. If the arm's length price of the coal used by the factory and produced by the mines is $5 million, the total state income tax liability of the two-firm corporation would be (.10)($10 million) + (.05)($0.5 million) = $1.025 million. If the corporation priced the coal at $8 million instead, the steel factory's net income would shrink to $7 million, while the coal mining firm's income would expand to $3.5 million. The corporation's net income tax liability would shrink to (.10)($7 million) + (.05)($3.5 million), or $0.860 million.

B. An Illustration of the Difference between Separate Accounting and Formulary Apportionment

In the above example, the corporation's Minnesota taxable income would be calculated under formulary apportionment as follows:

If the coal were valued at $5 million, then

$$\begin{bmatrix}\text{Taxable}\\ \text{income}\end{bmatrix}_{\text{Minn.}} = \begin{bmatrix}\text{Total apportionable}\\ \text{income}\end{bmatrix} \frac{\left[\frac{\text{property}_{\text{Minn.}}}{\text{property}_{\text{total}}} + \frac{\text{payroll}_{\text{Minn.}}}{\text{payroll}_{\text{total}}} + \frac{\text{sales}_{\text{Minn.}}}{\text{sales}_{\text{total.}}}\right]}{3}$$

$$\begin{bmatrix}\text{Taxable}\\ \text{income}\end{bmatrix}_{\text{Minn.}} = \$10.5 \; \frac{\left[\frac{\$200}{\$215} + \frac{\$30}{\$32} + \frac{\$100}{\$105}\right]}{3} = \$9.9$$

(all figures expressed in $ millions)

At a tax rate of 10 percent, the corporation's income tax liability would be $0.990 million, compared with $1.025 million under separate accounting.

C. Explanation of Calculations Used to Produce Table and Limitations of Underlying Data

All calculations reported in the table are based on data provided in the U.S. Department of Commerce, Bureau of Economic

Analysis, *U.S. Direct Investment Abroad, 1977* (Washington, D.C.: GPO, 1981). The universe sampled in the study differs in two respects from the universe of the establishments likely to be deemed unitary with U.S.-based multinational corporate income taxpayers. First, it includes entities other than corporations that own foreign businesses, such as: partnerships; proprietorships; religious, charitable, or other nonprofit organizations; governments, trusts, individuals, etc. Second, it is limited to entities that own more than a 10 percent interest in a foreign business. Since the percentage used in the unity of ownership test is usually 50 percent, the universe includes some businesses whose income would not be apportioned under combined worldwide unitary accounting. The net direction of the biases introduced by these two characteristics of the sampled universe is unclear.

Enterprises were assigned to an industrial category according to the primary economic activity of their domestic operations. Domestic operations include those of 1) the U.S. parent corporation of the enterprise, whose "voting securities are not owned more than 50 percent by another U.S. corporation," and 2) "proceeding down each ownership chain from the parent, any U.S. corporation whose voting securities are more than 50 percent owned by the corporation above it." (*U.S. Direct Investment Abroad, 1977*, pp. 3-4.)

For each industrial category, taxable income under water's edge was assumed to equal the combined pre-tax net income of all the domestic operations in that category. Taxable income under domestic worldwide combination was calculated according to the following formula:

$$Y^x_d = Y^x_{(d+f)} \frac{\left[\frac{S^x_d}{S^x_{(d+f)}} + \frac{(PR)^x_d}{(PR)^x_{(d+f)}} + \frac{(PAY)^x_d}{(PAY)^x_{(d+f)}}\right]}{3}$$

where x = the industry in question
d = total for domestic operations
f = total for foreign affiliates and branches
y = net income before income taxes (federal, state, and local income taxes in the case of domestic operations, foreign income taxes in the case of the operations of foreign affiliates and branches)
(S) = total sales
(PR) = the total net value of property, plant, and equipment
(PAY) = total employee compensation

Because each industry is in effect treated as a single firm, the losses of unprofitable enterprises offset the profits of profitable enterprises in the calculation of net income. In reality, of course, individual profitable taxpayers can not reduce their taxable incomes by claiming the losses of their competitors. Thus, the table systematically understates industry-wide *taxable* incomes for both foreign and domestic operations. Because the bias affects all operations regardless of geographic location, there is no a priori reason to believe that the estimated percentage *differences* between taxable incomes under water's edge and domestic worldwide combination are biased.

APPENDIX BB

"Recommendations of the State and Local Fiscal Modernization Study Commission to the General Assembly"
(by North Carolina State and Local Fiscal Modernization Study Commission, undated)

Recommendations of the State and Local Fiscal Modernization Study Commission to the General Assembly:

The following recommendations have been identified as high priority items by the State and Local Fiscal Modernization Study Commission. In summary, the recommendations:

- make the sales tax more progressive by broadening the sales tax base to include many services that are currently exempt from the sales tax (warranty and repair services, entertainment services, etc.) and by broadening the sales tax base to include currently exempt food items;

- broaden the individual income tax base, take low-income taxpayers off the tax rolls and reduce income tax rates across all income levels;

- reduce the top corporate tax rate and adopt combined reporting;

- provide relief to local government through the State's assumption of a portion of Medicaid costs;

- provide greater flexibility to city and county governments with respect to how they raise revenue by allowing a menu of options including real estate transfer fees or deed stamp taxes, impact fees, motor vehicle license fees and other vehicle use fees, taxes on prepared food and drink, and occupancy taxes;

- provide funding for water and sewer infrastructure;

- eliminate differential sales tax rates; and

- modernize the local ad valorem tax on real property and provide local governments flexibility in providing tax relief for elderly and fixed income residents.

The Commission believes that these recommendations should be approved by the General Assembly and signed into law by the Governor during this legislative session. As the General Assembly considers options to modernize the state and local system of taxation, the Commission respectfully urges its members <u>not</u> to make changes unless they are consistent with these recommendations. Members of the General Assembly should also be aware that the Commission has made other recommendations which while not as high a priority are nonetheless important and should be considered by the legislature in the future.

Each of the recommendations can stand alone with the exception of the first and second recommendations. Significant income tax rate reductions can only be accomplished in a revenue-neutral manner by offsetting the revenue loss with additional revenue from broadening the sales tax base.

Detailed revenue estimates of each recommendation are not available at this time. Accordingly, it may be necessary to adjust tax rates in order for the recommendations to be revenue neutral. In addition, a detailed incidence analysis of the recommendations is not available at this time. To the extent that low-income taxpayers are adversely affected by the recommendations, the proposed standard deduction and or exemption amounts should be modified.

Specific Recommendations:

1. Broaden the sales tax base and lower the sales tax rate.

(A). Effective January 1, 2008, the following services which are commonly taxed by other states should be included in the sales tax base and taxed at the combined general rate:

- pet grooming services;
- landscaping;
- typesetting;
- storage (automotive, fur, household goods, marina services, and so on);
- carpet and upholstery cleaning;
- garment repair and altering;
- gift and package wrapping;
- services provided by health clubs and tanning parlors;
- shoe repair;
- swimming pool cleaning and maintenance;
- janitorial services;
- exterminating services;
- telephone answering services;
- tire recapping and repairing;
- window cleaning;
- automotive services;
- entertainment services (some of which are currently taxed at 3%);
- warranty services; and
- currently exempt installation and repair services.

The Commission recommends that the sales tax should be expanded to include a broad range of additional services but has identified significant issues which must be addressed before final recommendations can be made.

(B). Effective January 1, 2008, currently exempt food items should be taxed at the combined general rate. The Commission recommends that low-income taxpayers receive targeted income tax relief to offset the additional sales tax burden caused by taxing food at the combined general sales tax rate.

Increases in sales tax revenue from the base broadening described above should be used to offset revenue losses from changes in the income tax. To the extent that additional sales tax revenue exceeds reductions in income tax revenue, both state and local sales tax rates should be lowered in a revenue neutral fashion.

2. Reduce the top marginal individual income tax rate, broaden the individual income tax base and reduce the number of individual income tax filers.

(A). Effective January 1, 2008, the base for calculating North Carolina taxable income should be federal adjusted gross income (AGI) with minimal exclusions and deductions as required by law (retirement income exempted from North Carolina income tax under the *Bailey* decision, interest on federal obligations, interest on in-state municipal bonds) or equity considerations (North Carolina income tax refunds included in federal AGI and a deduction for higher education tuition payments when a credit is claimed on the federal return).

(B). Effective January 1, 2008, individual income tax rates should be reduced as shown in the following table:

Marginal Rate on Taxable Income*	Single/MFS	MFJ/QW	HOH
3 – 4%	Up to $10,000	Up to $20,000	Up to $15,000
4 – 5%	$10,001 - $60,000	$20,001 - $120,000	$15,001 - $90,000
5 – 6%	$60,001 - $120,000	$120,001 - $240,000	$90,001 - $180,000
6 – 7%	$120,001 +	$240,000 +	$180,000+

* The proposed rates assume that additional revenues from broadening the sales tax will be used to offset revenue losses resulting from reductions in individual income tax rates. To the extent that increased revenues from the sales tax are used to reduce sales tax rates and not income tax rates, the rate reductions proposed above will not be possible.

(C). Effective January 1, 2008, a standard deduction from federal AGI should be allowed. For low income taxpayers, this standard deduction is intended to remove significant numbers of taxpayers from tax filing and payment obligations and to offset the impact of increasing sales taxes. A smaller standard deduction should be allowed for taxpayers with moderate and higher amounts of income.

The standard deduction should range from $0 to $16,000 as shown in the following table:

Standard Deduction**	Single/MFS	MFJ/QW	HOH
$8,000/$16,000/$12,000	$0 - $60,000	$0 - $120,000	$0 - $90,000
$4,000/$8,000/$6,000	$60,001 - $120,000	$120,001 - $240,000	$90,001 - $180,000
None	$120,001 +	$240,000 +	$180,000+

* These amounts should be modified as necessary in order to ensure that low income taxpayers are not adversely impacted by the recommended changes.

(D). Effective January 1, 2008, deductions from federal AGI should be allowed for personal and dependency exemptions. The allowable exemption amount should vary depending on filing status and North Carolina taxable income as shown below:

Exemption Amount	Single/MFS	MFJ/QW	HOH
$2,000	$0 - $60,000	$0 - $120,000	$0 - $90,000
$1,200	$60,001 - $120,000	$120,001 -$240,000	$90,001 - $180,000
None	$120,001 +	$240,000 +	$180,000+

Comparison of Tax Payment Thresholds Under Current Law with Recommended Changes

Under current law, the first $5,500 of income of a single taxpayer with no dependents would be exempt from North Carolina income tax. Under the Commission's recommendations, this taxpayer could earn up to $10,000 without owing any North Carolina income tax.

Under current law, a taxpayer that files as head of household with two dependents would pay no income tax on $15,224 of income (after taking into account the current child credit of $100 per child). Under the Commission's recommendations, this taxpayer could earn up to $18,000 without owing any North Carolina income tax (before any allowable child tax credit).

Under current law, $11,000 of income of a married couple with no children would be exempt from North Carolina income tax. Under the Commission's recommendations, this taxpayer could earn up to $20,000 without owing any North Carolina income tax.

Under current law, a married couple with two children would pay no income tax on the first $19,334 of income (after taking into account the current child credit of $100 per child). Under the Commission's recommendations, this family could earn up to $24,000 without owing any North Carolina income tax (before any allowable child tax credit).

(E). Under current law, a variety of income tax credits are allowed including credits for child and dependent care expenses, credits for children, credits for charitable contributions for non-itemizers, credits for qualified business investments, business incentives and energy tax credits, credits for disabled taxpayers, dependents and spouses, credits for real property land donations, credits for rehabilitating historic structures and mill facilities, credits for property taxes on farm machinery, credits for handicapped dwelling units, credits for conservation tillage equipment, credits for gleaned crops, credits for poultry composting, and credit for recycling oyster shells.

The Commission recommends that the Revenue Laws Study Committee should review the current individual income tax credits to determine the extent to which the current credits should be continued, recommend any phase-outs of the current credits and determine the extent to which the tax rates above would need to be adjusted in order to maintain revenue neutrality if any or all credits are retained. The Revenue Laws Study Committee should also consider whether an education deduction should be allowed for higher education tuition payments when an education credit is taken instead of a deduction for federal tax purposes.

3. Reduce the corporate income tax rate and require combined reporting.

Effective January 1, 2009, affiliated groups of corporations that are engaged in a unitary business should be required to file combined returns. An affiliated group is defined as a group of two or more corporations in which more than 50% of the voting stock of each member corporation is directly or indirectly owned by a common owner or owners, either corporate or non-corporate, or by one or more of the member corporations. A unitary business is defined as one or more related business organizations engaged in business activity both within and without the State among which one or more of the following exist: a unity of ownership, operation or use or an interdependence in their functions. A unitary business should be defined as broadly as allowed under current judicial authority.

Members of a combined group should be allowed to make a "water's edge" election and thereby elect to disregard the income and apportionment factors of a member of the combined group that is a foreign corporation that conducts eighty percent or more of its business activity outside the United States and outside a tax haven country.

The corporate tax rate should be reduced in a revenue neutral fashion. Based on conservative assumptions of the impact of combined reporting, the corporate rate should be reduced to 6% or lower.

4. The State should assume responsibility for the nonfederal share of Medicaid Assistance Program costs, excluding administrative costs.

Alternatives include:

(A). An immediate takeover at a cost to the State of approximately $500 to $600 million, or

(B). A takeover accomplished over 3 to 4 years. Alternatives include:

(1). assuming responsibility for a portion of Medicaid in excess of a percentage of property values in each county. Complete Medicaid relief would be phased-in over 3 to 4 years by reducing the threshold required for relief. For example, the State could immediately assume responsibility for Medicaid expenditures in excess of the revenue received by a $.10 tax on real property within each county. The one-year cost to the state would be approximately $51 million. Phasing in the takeover in this manner would provide immediate relief for about one-third of the counties in the State.

(2). cutting the county share of Medicaid across the board in order to provide relief to all counties.

The shift in responsibility from the counties to the State should be accompanied by a shift in funding sources or by the State identifying new sources of revenue. A shift in funding sources could be accomplished through the counties giving up the 2% local sales tax on food or other sources of revenue currently shared among the State and the counties such as the 2.5% local sales tax, lottery proceeds, corporate income tax, etc.

5. The State should provide greater flexibility to city and county governments with respect to how they raise revenue by providing a menu of options including real estate transfer fees or deed stamp taxes, impact fees, motor vehicle license fees and other vehicle use fees, taxes on prepared food and drink, and occupancy taxes.

   Each city and county government should have the same authority and the ability to pick and choose which revenue sources are appropriate.

   The Revenue Laws Study Committee should study and set maximum rates for each tax.

6. Provide funding for water and sewer infrastructure.

   The State of North Carolina should issue bonds, the proceeds of which should be used to provide funding for water and sewer infrastructure. Funds should be allocated to local utilities with the greatest need and should be used to provide incentives to regionalize or otherwise provide more cost effective services.

7. Eliminate differential rates in the sales tax.

The following transactions that are currently subject to sales or excise tax at special rates should be taxed at the combined general sales tax rate.

(A). All sales of motor vehicles taxed under the highway use tax. The tax is to be assessed on the retail value of the motor vehicle with no reduction for an allowance given by the seller for trade-ins. Taxes collected on motor vehicles at the combined general tax rate should be credited to the North Carolina Highway Trust Fund.

(B). Admissions and amusements currently taxed at 3%.

(C). Long-term leases and rentals of motor vehicles.

8. Modernize the local ad valorem tax on real property and provide local governments flexibility in providing tax relief for elderly and fixed income residents.

   (A). Effective January 1, 2008, local governments should be given the option to provide property tax deferrals for elderly and fixed income residents. Requirements for deferral and events that result in the payment of deferred tax should be uniform across the state and determined by the Property Tax Subcommittee of the Revenue Laws Study Committee.

   (B). Effective January 1, 2008, the State should require each county of the State to:

      (1). reappraise all real property in any year following a year in which the median sales assessment ratio (as conducted by the Department of Revenue) does not exceed .90, or

      (2). revalue property on an annual basis using annual indexing with an index to be determined for each county by the Department of Revenue.

APPENDIX CC

"A Green Mountain Miracle and the Garden State Grab:
Lessons from Vermont and New Jersey on State Corporate Tax Reform"
(by Mark J. Cowan and Clint Kakstys, dated August 8, 2007)

A GREEN MOUNTAIN MIRACLE AND THE GARDEN STATE GRAB: LESSONS FROM VERMONT AND NEW JERSEY ON STATE CORPORATE TAX REFORM

*Mark J. Cowan**
*Clint Kakstys***

TABLE OF CONTENTS

I. INTRODUCTION 352

II. PROBLEMS WITH STATE CORPORATE INCOME TAXES 353
- A. General Problems with Taxing Corporate Income 354
- B. Holding Companies 355
  - 1. Economic Substance 356
  - 2. Taxing the Holding Company Itself: *Geoffrey* and Its Aftermath 359
  - 3. Add Back Statutes 361
    - a. Overview 361
    - b. Potential Problems 362
- 4. Mandatory Combined Reporting 363
    - a. Overview 363
    - b. Advantages of Combined Reporting 366
    - c. Arguments Against Combined Reporting 367
- C. Other Issues with Corporate Income Taxes 369
  - 1. Apportionment Formulas 369
  - 2. Tax Incentives 372
- D. Summary 373

III. THE NEW JERSEY TAX REFORMS OF 2002 373
- A. Overview 373

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**Associate, Sills Cummis Epstein & Gross P.C., Newark, New Jersey; Princeton University, A.B., 2000; University of Connecticut, J.D., 2004. My thanks go to Alan Sherman for his comments to this Article and to Nicole Hudak for her support and assistance. I also thank Jennifer Leavitt for her comments to an earlier draft. The opinions expressed in this Article are those of the authors, and not necessarily those of Sills Cummis Epstein & Gross or its clients.

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5--KAK.indd 351 8/8/07 12:12:51 PM

B. The AMA as an End-Run Around Public Law 86-272 375
1. Structure of the AMA 375
2. Creation and Judicial Interpretation of Public Law 86-272 376
3. Analysis 378
C. New Jersey's Add Back Statute 381
D. The Throwout Rule 382
1. Increasing New Jersey's Apportionable Share of a Taxpayer's Worldwide Income 382
2. Analysis 383
E. Aftermath 384
1. Fair and Equitable Distribution of the CBT 385
2. Future Tax Avoidance by Profitable Companies 386
3. Realization of Revenue Goals 386
4. Combined Reporting 387
5. Alternative Minimum Assessment 388
F. Summary 389

IV. THE VERMONT TAX REFORM OF 2004 389
A. The Story Behind the Adoption of Mandatory Combined Reporting in Vermont 390
1. Briefing by the Vermont Department of Taxes 392
2. Testimony in Favor of Combined Reporting 399
3. Testimony Against Combined Reporting 401
B. Vermont's Version of Mandatory Combined Reporting 405
C. Summary 408

V. COMPARING THE NEW JERSEY AND VERMONT EXPERIENCES 409
A. New Jersey Versus. Vermont 409
B. Classic Tax Reform 410

VI. CONCLUSION 412

"Like a dike, the corporate income tax requires constant vigilance, maintenance, and repair."[1]

I. INTRODUCTION

Revenue from state corporate tax systems has declined substantially in recent years.[2] States have begun to update their corporate tax codes in an effort to stem

[1]Richard D. Pomp, *The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer*, *in* THE FUTURE OF STATE TAXATION 49, 66 (David Brunori ed. 1998) [hereinafter Pomp, *The Future of the State Corporate Income Tax*].

[2]*See*, *e.g.*, DAVID BRUNORI, STATE TAX POLICY: A POLITICAL PERSPECTIVE 87-88 (2d ed. 2005) (indicating that state corporate tax revenues have been declining for at least 20 years and that this decline is expected to continue).

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this erosion. The recent efforts of two states, New Jersey and Vermont, to take up the challenge of corporate tax reform are particularly instructive. These two states were operating under different circumstances and ultimately took two very different approaches to fixing their corporate tax systems. In 2002, New Jersey, facing a significant fiscal crisis, used a complex mixture of traditional and groundbreaking techniques to expand the reach of its corporate tax system.[3] In 2004, Vermont, in an attempt to more equitably distribute its corporate tax burden, became the first state in over 20 years to enact a mandatory combined reporting law.[4] The purpose of this Article is to analyze the 2002 New Jersey and 2004 Vermont tax reforms to determine if they can provide any guidance to other states hoping to repair their own corporate tax systems.

To set the stage for the analysis in this Article, Part II explains the current problems with state corporate tax codes, the common planning techniques taxpayers employ to avoid the corporate income tax, and surveys some of the ways the states have attempted to address these problems. With this as background, Part III explores in detail the 2002 New Jersey tax reform and its aftermath. The focus in Part III is on the complex mechanics of New Jersey's tax reform, since these legislative devices can provide guidance to other states facing fiscal crises and hoping to increase the revenue generated by their corporate tax systems. Part IV explores the adoption of combined reporting in Vermont. Since the mechanics of Vermont's reform are fairly straightforward, the focus in this Part is on the process Vermont used to enact mandatory combined reporting. Specifically, Part IV reviews the available legislative history of Vermont's reform in an effort to provide guidance to other states hoping to successfully enact combined reporting. Part V speculates as to why each state took its own path to shoring up its corporate tax system and measures each state's efforts against normative concepts of tax reform. Part VI concludes that the process behind Vermont's 2004 reform provides an excellent road map to other states hoping to truly reform their corporate tax systems through combined reporting. Further, Part VI concludes that the mechanics of New Jersey's 2002 corporate tax changes, while falling short of true reform, can nonetheless provide some guidance to states in fiscal distress that lack the political will to enact combined reporting.

II. PROBLEMS WITH STATE CORPORATE INCOME TAXES

Commentators have long lamented the problems with state corporate income taxes in today's economy.[5] This Part will examine some of these problems. First, Part II.A discusses the general, overarching problems with state attempts to tax

[3]*See infra* Part III.

[4]Emily Dagostino, *Is New Vermont Law a Sign of a Combined Reporting Comeback?,* 2004 State Tax Today 189-2 (Sept. 24, 2004). The reforms enacted by Vermont in 2004 were not effective until 2006. *See id.*; *infra* Part IV (discussing tax reforms in Vermont).

[5]*See*, *e.g.*, Brunori, *supra* note 2, at 83; David Brunori, *Stop Taxing Corporate Income*, 25 State Tax Notes 47 (July 1, 2002); Charles E. McLure Jr., *How—and How Not—to Tax Business*, 2005 State Tax Today 63-3 (Apr. 4, 2005).

corporate income. Part II.B considers the holding company planning device, which allows taxpayers to redirect profits from high-tax states to low or no-tax states. Much of state corporate tax reform is aimed at these types of transactions. Part II.C briefly surveys some other problems with the state corporate income tax—such as tinkering with apportionment factors and offering targeted tax incentives. The problems discussed in Part II.C are not the result of tax planning by taxpayers but rather are the result of affirmative decisions by the states to forgo revenues in the hopes of fostering economic growth.

A. *General Problems with Taxing Corporate Income*

Aside from tax planning by corporations, there are basic problems with state attempts to tax corporate income. First, the corporate tax is not a significant source of state revenue. In recent years, taxation of corporate profits has represented only five percent of state tax revenues nationally.[6] In comparison, sales taxes represented 31%, personal income taxes 33% and aggregate excise taxes totaled 20% of state tax revenues.[7] In addition, the revenue generated from corporate income taxes has been declining and is expected to continue to decline in the future.[8]

Second, the problem of relatively paltry returns is exacerbated by the high cost to the states of administering a corporate income tax.[9] One commentator in the local tax field has noted that the tax on corporate income is "probably the most inefficient, least cost-effective revenue source available to the states."[10]

Third, using corporate income as a tax base is not particularly fair.[11] For taxes on businesses to be economically neutral, the taxes should be designed only to collect enough revenue to cover the benefits that the businesses receive from the state.[12] A tax on corporate income violates this principle because the higher a corporation's income, the higher its tax liability.[13] Corporate income, however, is "a poor measure of the benefits of public services the state provides to businesses."[14]

Fourth, corporate taxes violate the important tax policy goal of transparency.[15] A tax is only transparent if it is "what it seems to be, not something else, and its economic effects [can] be easily understood."[16] Corporate income taxes are not

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[6]*See* Brunori, *Stop Taxing Corporate Income*, *supra* note 5 (surveying the ineffectiveness of the corporate income tax in several states).

[7]*Id.*

[8]*Id.* at 49. One of the drivers of the revenue drainage is the rise of limited liability companies, which afford taxpayers liability protection without an entity level tax. Brunori, *supra* note 2, at 92-93. Many businesses are choosing the limited liability company (or similar) entity form in lieu of the corporate form, which reduces the number of tax-paying corporations. *See id.* This is an important issue, but is not directly relevant to the discussion in this Article and will not be discussed further.

[9]*See* Brunori, *Stop Taxing Corporate Income*, *supra* note 5, at 47-48.

[10]*Id.* at 48.

[11]McLure, *supra* note 5.

[12]*Id.*

[13]*See id.*

[14]*Id.*

[15]*Id.*

[16]*Id.*

5--KAK.indd 354 8/8/07 12:12:51 PM

transparent because it is quite possible that the burden of the tax is borne not by corporate shareholders, but largely by workers.[17] Corporate income taxes, in short, are not what they appear to be; they are "lambs in wolves' clothing."[18]

Given the problems with taxing corporate income, many commentators believe that states should repeal their corporate income taxes.[19] Despite this advice, the vast majority of states still tax corporate income.[20] In fact, only Nevada, Washington, and Wyoming do not tax corporate income in any form,[21] and, with the recent exception of Ohio, no state is seriously considering repealing their existing taxes on corporations.[22] This is largely because it is not politically feasible to eliminate the corporate income tax.[23] Thus, while the best corporate tax reform would be to eliminate the tax entirely, states must instead settle for making the tax as fair and effective a revenue generator as possible.

B. *Holding Companies*

Aside from the general problems with the corporate tax, there are specific, well-known planning devices that taxpayers use to avoid the tax. One such device involves deductions for payments to affiliated businesses. By using holding companies, corporate taxpayers can shift income out of a taxing state and into a state with no tax.[24] A common business plan is for a parent to set up such a subsidiary

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[17]*Id*. McLure opines that a corporation would not remain in the taxing state unless it was able to shift the burden of the tax on to others. Corporations would most likely pass the burden of the tax on to workers, presumably in the form of lower wages. *See id.*

[18]*Id.*

[19]*See*, *e.g*., Brunori, *supra* note 2, at 94-96; Brunori, *Stop Taxing Corporate Income*, *supra* note 5, at 47-50; McLure, *supra* note 5.

[20]*See* Brunori, *supra* note 2, at 83.

[21]*Id.*

[22]*Id*., at 95-96; *see also* Pomp, *The Future of the State Corporate Income Tax*, *supra* note 1, at 49. Ohio recently repealed its corporate franchise tax and replaced it with a "Commercial Activity Tax" which imposes a gross receipts tax on all businesses doing business in Ohio. *See* Arthur Rosen & Margaret C. Wilson, *Ohio's New Commercial Activity Tax—To Pay or Not to Pay?*, 2005 State Tax Today 161-17 (Aug. 22, 2005). Nonetheless, Ohio is still taxing corporations—only now on a gross rather than on a net basis. Ohio's movement to a gross receipts tax mirrors New Jersey's use of the Alternative Minimum Assessment, *see* discussion *infra* Part III.B, and circumvents Public Law 86-272, a federal law limiting state taxing jurisdiction. *See infra* Part III.B.2. While Ohio completely repealed its normal corporate franchise tax in favor of the Commercial Activity Tax, New Jersey kept its existing corporate tax and required corporations to pay the greater of the tax calculated under its normal corporate income tax or the Alternative Minimum Assessment. *See infra* Part III.B.1.

[23]Pomp, *The Future of the State Corporate Income Tax*, *supra* note 1, at 49.

[24]These holding companies are normally based in Delaware. Richard D. Pomp & Oliver Oldman, State and Local Taxation 10-41 (5th ed. 2005). In Delaware, income earned by corporations which restrict their activities to holding, maintaining, and managing intangible assets is exempt from taxation by the state. Del. Code Ann. tit. 30, § 1902(b)(8) (1997 & Supp. 2000). Another popular state for intangible holding companies is Nevada, which has no state corporate income tax. Pomp & Oldman, *supra*, at 10-41 n. 220. Further, a taxpayer can locate the holding company in a combined reporting state where it is already doing business. Taxes will still be saved in separate reporting states but it looks like less of a red flag to auditors. *Id.*; *see infra* Part II.B.4.a (discussing the difference between combined reporting states and separate reporting states). Vermont, prior to its 2004 reform, also tried to establish itself as a haven for intangible holding companies by limiting the amount of corporate tax

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holding company and transfer intellectual property to it.[25] The parent will then license the intellectual property back from the subsidiary and deduct the payments from income as a business expense.[26] Another way to shift income to a low or no-tax jurisdiction is to move cash to a financing subsidiary in a no-tax state. The financing subsidiary will then lend money to its operating affiliates, who will pay interest to the financing subsidiary and deduct the payments as a business expense.[27] There are often legitimate business reasons for using holding companies to manage intellectual property or debt, and businesses are not required to adopt the least tax advantageous structure available, but this structure does provide a means for abuse. At any rate, even a legitimate strategy which minimizes taxable income is contrary to a taxing authority's interest. The taxing authority must, therefore, structure its corporate income tax to combat such tax planning. States have taken four different approaches to combat the use of the intangible holding company, which are discussed in the sections that follow. First, as discussed in Part II.B.1, states have argued that holding companies lack economic substance. Second, as pointed out in Part II.B.2, states have contended that they have the right to tax the holding company itself because it has nexus in the taxing state. Third, as discussed in Part II.B.3, some states have enacted so-called "add back" statutes, which disallow deductions for certain payments made to related corporations.[28] This was, in part, the approach taken by New Jersey in its 2002 tax reform.[29] Fourth, as considered in Part II.B.4, states can avoid the holding company problem by enacting mandatory combined reporting. This was the approach taken by Vermont in its 2004 tax reform.[30]

1. *Economic Substance*

States have used the economic substance doctrine to litigate holding company issues. Two cases from the Supreme Judicial Court of Massachusetts illustrate the contours of how a court may decide whether a holding company has economic substance or is merely engineered for tax avoidance. In *Sherwin-Williams Co. v.*

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paid by such companies. Vt. Stat. Ann. § 32-5837 (repealed effective Jan. 1, 2006). Under Vermont's holding company law, if a company incorporated in Vermont merely held investment property, it needed to only pay the minimum $250 tax rather than the normal corporate tax. *Id.* All in all, Vermont had about 65 holding companies. *Hearing on H.0784 Before the Vt. House Comm. on Ways and Means*, 2003-2004 Leg. Sess. (Jan. 21, 2004) (testimony of Vt. Dep't of Taxes) (CD No. 040022). See *infra* note 359 for details on this testimony and how it is cited in this Article. The special rules for holding companies were repealed as part of Vermont's tax reform effective January 1, 2006. Vt. Stat. Ann. § 32-5837 (repealed effective Jan. 1, 2006). See *infra* note 399 for further discussion about how these holding companies figured into Vermont's reform proposals.

[25]*See* Archer & Greiner, P.C., Tax Alert: The New Jersey Business Tax Reform Act 2 (Aug. 2, 2002), *available at* http://www.archerlaw.com/articles/tax_alert073102.pdf.

[26]*Id.*

[27]Pomp & Oldman, *supra* note 24, at 10-41.

[28]These add back statutes are also sometimes referred to as "anti-PIC" statutes (anti-passive investment company statutes).

[29]*See infra* Part III.

[30]*See infra* Part IV.

5--KAK.indd 356 8/8/07 12:12:52 PM

Commissioner of Revenue, the taxpayer challenged the state tax commissioner's disallowance of $47 million in deductions for royalty payments to two wholly-owned subsidiaries.[31] The court ultimately held for Sherwin-Williams and reversed the commissioner's decision after a close examination of the facts in the case.[32]

The key to the decision was the Massachusetts court's finding that Sherwin-Williams's business plan had economic substance and therefore passed muster under the sham transaction doctrine.[33] The court's analysis was limited to whether the payments were shams in substance, as opposed to shams in fact (*i.e.*, transactions that never actually occurred).[34] Whether a transaction is a sham in substance presents a question of fact, in which the taxpayer bears the burden of proof.[35]

Applying the sham transaction doctrine, the Massachusetts court started with two principles espoused by Judge Learned Hand.[36] "The first principle is: 'Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.'"[37] "The second principle is that a transaction 'does not lose its [tax] immunity, because it is actuated by a desire to avoid, or, if one chooses, evade, taxation.'"[38]

Having thus blessed tax minimization strategies as not being shams in and of themselves, the court said that to avoid the sham label "the taxpayer must demonstrate that the reorganization results in 'a viable business entity,' that is 'formed for a substantial business purpose or actually engages in substantive business activity.'"[39] A two-pronged test is commonly used to determine the existence of economic substance. The first prong, the "objective economic substance test," looks at whether a transaction has economic effect other than creating a tax benefit for the corporation.[40] The second prong, the "subjective business purpose test," examines the motivations underlying the business decisions made.[41]

The court found the following facts most compelling. The plan to reorganize for purposes of managing trademarks was generated internally by Sherwin-Williams's senior corporate counsel for patents and trademarks.[42] Legal title to and physical possession of the marks passed to the subsidiaries.[43] The subsidiaries entered into agreements with third parties for the use of those marks and were free to do so

[31] 778 N.E.2d 504 (Mass. 2002).
[32] *Id.* at 520-21.
[33] *Id.* at 509.
[34] *Id.* at 513 n.6.
[35] *Id.* at 513.
[36] *Id.* at 513 (citing Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934)).
[37] *Id.* at 513 (citation omitted).
[38] *Id.* at 514 (citation omitted, alteration in original).
[39] *Id.* at 515 (citation omitted).
[40] *Id.* at 515.
[41] *Id.* at 515.
[42] *Id.* at 509.
[43] *Id.* at 517.

5--KAK.indd 357 8/8/07 12:12:52 PM

without shareholder approval.[44] Perhaps the most persuasive detail was that monies received by the subsidiaries were not returned to the parent as dividends.[45] Instead, the revenues were invested at the subsidiaries' discretion in enterprises that were outside the control of Sherwin-Williams.[46]

On the same day it heard arguments in *Sherwin-Williams*, the Supreme Judicial Court of Massachusetts also heard arguments in *Syms Corp. v. Commissioner of Revenue*.[47] If *Sherwin-Williams* demonstrated something of an ideal as to how one should set up a holding company and maintain tax immunity, *Syms* provides an excellent example of precisely what not to do. Scrutinizing the facts in *Syms* under the sham transaction doctrine, the court this time held resoundingly against the taxpayer.[48]

As in *Sherwin-Williams*, the state tax commissioner had denied Syms a deduction from income for royalty payments made to a Delaware subsidiary.[49] However, differences in the operation of the subsidiaries in the two cases abound. First, the idea of setting up a Delaware holding company to own trade names, trademarks, and the like came not from internal sources, but rather was pitched to Syms management by an outside financial consultant.[50] The Syms CFO entered into an agreement with the consultant who stated that his company had "developed a program . . . for reducing [Syms's] income taxes by reorganizing the business activities of [Syms] in certain areas."[51] The plan called for Syms to set up a subsidiary holding company in Delaware and make large royalty payments to it annually, generating a tax deduction for Syms and zero state tax liability for the subsidiary under Delaware law.[52] As compensation for laying down the framework, Syms would pay the financial consulting company 25% of its tax savings in the first year and decreasing percentages of the tax savings in each of the following four years.[53] It raised a red flag for the court that Syms held part of this compensation in escrow in case the tax savings were later disallowed during an audit.[54]

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[44]*Id.* at 517-18.

[45]*See id.* at 518.

[46]*Id.* The Board of Directors set forth a number of business reasons for the reorganization. Specifically, the formation of the subsidiaries improved management of the marks, "enhanced the company's ability to enter into thirdparty licensing arrangements at advantageous royalty rates," "increased overall profitability," "maximized investment returns associated with the marks due to separate and centralized investment management," "enhanced borrowing capabilities," "insulated the marks from SherwinWilliams's liabilities," "provided flexibility in preventing a hostile takeover," and "increased liquidity." *Id.* at 510. The court did not view these stated reasons as valid. *Id.* at 518. Despite its rejection of these reasons, the court nonetheless held that the reorganization created a viable business entity that was engaged in actual business operations. *Id.* at 519.

[47]765 N.E.2d 758 (Mass. 2002). Both *Sherwin-Williams* and *Syms* were argued on September 10, 2001, but *Syms* was decided on April 10, 2002 and *Sherwin-Williams* was decided on October 31, 2002. *Sherwin-Williams*, 778 N.E.2d at 504.

[48]*Syms*, 765 N.E.2d at 760.

[49]*Id.*

[50]*Id.* at 761.

[51]*Id.* (alteration in original).

[52]*Id.*

[53]*Id*. at 761.

[54]*See id.*

5--KAK.indd 358 8/8/07 12:12:52 PM

Aside from its somewhat shady origins, the new subsidiary was operated suspiciously as well. The entire arrangement seemed to lack any business purpose or economic substance. Syms made a sizeable royalty payment once a year.[55] The subsidiary would hold the payment in Delaware for a couple weeks and then return the funds, less expenses, to Syms as a tax-free dividend payment.[56] The subsidiary's only income came from Syms, and its expenses were only about one-tenth of one percent of its income.[57] Furthermore, management of the intellectual property remained unchanged after the subsidiary was created, and Syms continued to pay all intellectual property related expenses despite the existence of the subsidiary.[58] Syms presented many of the same nontax business purposes as the Sherwin-Williams directors had entertained, but these were ultimately rejected in *Syms* because they did not fit with many of Syms's traditional business methods and because of the structure of this particular deal.[59] The overwhelming weight of the evidence, particularly with respect to how the subsidiary was run, led the court to hold that the deductions were "created solely for the purpose of effectuating a camouflaged assignment of income" and therefore should have been disallowed.[60]

2. *Taxing the Holding Company Itself:* Geoffrey *and Its Aftermath*

An unsettled issue in state and local tax law may allow the taxing state to make an assessment against the holding company that receives the payment. The case that is paradigmatic of this wrinkle is *Geoffrey, Inc. v. South Carolina Tax Commission*.[61]

Geoffrey, a wholly-owned subsidiary of Toys R Us, Inc., was incorporated in Delaware and had its principal offices there.[62] Geoffrey had no employees, offices or tangible property in South Carolina.[63] The subsidiary owned the "Toys R Us" trade name and other intellectual property, which it licensed to Toys R Us by agreement, receiving a percentage of net sales made by Toys R Us as compensation.[64] These sales were reported by Toys R Us to Geoffrey in aggregate form on a monthly basis, and royalty payments were made annually from a Toys R Us account in Pennsylvania to a Geoffrey account in New York.[65]

Toys R Us began doing business in the state of South Carolina and made royalty payments to Geoffrey based on its South Carolina sales.[66] When reporting its income to South Carolina, Toys R Us deducted royalty payments relating to

[55] *Id.* at 762.
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] *Id.* at 764 n.12 (Mass. 2002).
[60] *Id.* at 765.
[61] 437 S.E.2d 13 (S.C. 1993).
[62] *Id.* at 15.
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Id.*

5--KAK.indd 359 8/8/07 12:12:52 PM

the South Carolina sales.[67] These deductions were first disallowed by the South Carolina Tax Commission, but later the commission decided that Toys R Us was entitled to the deduction.[68] The commission decided instead to tax Geoffrey on the royalty income.[69] Geoffrey paid the taxes but also instituted an action for a refund, arguing that it did not have sufficient nexus with South Carolina for the state to have taxing jurisdiction over the company.[70] Holding against Geoffrey, the South Carolina Supreme Court undertook a two-part analysis to determine whether the state had taxing authority under the Due Process and Commerce Clauses.[71]

In its due process analysis, the court noted that physical presence is not a necessary element for taxing jurisdiction.[72] The court instead considered whether Geoffrey purposefully directed its business toward South Carolina.[73] Purposeful direction was found insofar as Geoffrey licensed its intellectual property to Toys R Us for use in South Carolina.[74] The court also held that Geoffrey owned intangible property within the state, providing an alternate ground for the minimum connection that the Due Process Clause requires.[75]

In its Commerce Clause analysis, the court rejected Geoffrey's argument that physical presence is necessary to establish the substantial nexus that a taxpayer must have with a state before it can be taxed there.[76] Instead, the court pointed to a long line of cases standing for the proposition that physical presence is not necessary for the assessment of an income tax in a state whose markets a corporation regularly exploits and from whose protections a corporation benefits.[77] The presence of Geoffrey's intangible property within the state was held to satisfy the nexus requirement.[78]

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[67]*Id.*

[68]*Id.*

[69]*Id.*

[70]*Id.*

[71]*Id.* at 16. Bifurcation of the nexus requirements for taxing jurisdiction under the Due Process and Commerce Clauses was introduced in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). *Quill* decided a state's authority to compel an out of state seller to collect its use tax. *Id.* at 301-02. The Court recognized that since *International Shoe Co. v. Washington*, 326 U.S. 310 (1945), due process jurisdictional requirements gravitated toward a minimum contacts standard from a physical presence standard. *Quill Corp*., 504 U.S. at 307. However, the Court held that a company may have minimum contacts with a state that do not amount to satisfaction of the substantial nexus requirement embedded in the Commerce Clause. *Id.* at 313. Thus, a mail order company that had no activity in the state except for advertising and mail order sales shipped into the state via the U.S. mail or common carrier was not required to collect use taxes in the state. *Id.* at *319.* Many taxpayers have interpreted this ruling as setting forth a physical presence test for nexus. The Court expressly noted, however, that this bright line rule had not been adopted as to other taxes. *Id.* at 317-18. Beyond its recognition that Commerce Clause and Due Process Clause standards can differ, *Quill's* value in determining a state's authority to impose a tax on income remains somewhat dubious.

[72]*Geoffrey, Inc.*, 437 S.E.2d at 15.

[73]*Id.* at 16.

[74]*Id.*

[75]*Id.*

[76]*Id.* at 18.

[77]*See id.*

[78]*Id.*

5--KAK.indd 360 8/8/07 12:12:53 PM

The *Geoffrey* decision was very controversial and touched on several constitutional issues, yet an appeal to the Supreme Court was denied.[79] Without an authoritative ruling from the Supreme Court, the states have been divided over whether to accept or reject the *Geoffrey* doctrine.[80] Some states have adopted the *Geoffrey* approach by regulation.[81] For example, Florida revised its rules shortly after *Geoffrey* was decided, to include selling or licensing intangible properties as taxable activities.[82] Other states that have adopted *Geoffrey* either administratively or judicially include Massachusetts, New Mexico, Illinois, North Carolina, Indiana, West Virginia, Oklahoma, and New Jersey.[83] States such as Tennessee, New York, and Texas have refused to follow the *Geoffrey* doctrine in varying degrees.[84] Alabama initially rejected *Geoffrey* by requiring physical presence, only to perform a recent about face.[85]

3. *Add Back Statutes*

a. *Overview*. In an effort to stem revenue losses from the use of holding companies, some states have amended their tax codes to include so-called add back statutes.[86] These statutes require companies to add back, to their federal taxable income, deductions for interest or royalties paid to related companies when calculating their state corporate income tax liability.[87] While the holding company's income remains non-taxable, the payments to the holding company are no longer deductible—thereby eliminating the state tax benefit of such arrangements.

States that have add back statutes often carve out exceptions to avoid penalizing legitimate business transactions.[88] These exceptions generally come in four varieties.[89] First, there is an exception for payments made to a related company that is subject to tax in the taxing jurisdiction or in another jurisdiction.[90] Second, there

[79]Geoffrey, Inc. v. S.C. Dep't of Revenue & Taxation, 510 U.S. 992 (1993), *denying cert. to* 437 S.E.2d 13 (S.C. 1993)).

[80]*See* Craig J. Langstraat & Emily S. Lemmon, *Economic Nexus: Legislative Presumption or Legitimate Proposition?*, 14 Akron Tax J. 1, 15-18 (1999).

[81]I Jerome R. Hellerstein & Walter Hellerstein, State Taxation ¶ 6.11[3](a) (3d ed. Supp. 2006).

[82]*Id.*

[83]*Id.* For a discussion of recent developments in New Jersey see *infra* notes 275-280 and accompanying text.

[84]Hellerstein, *supra* note 81, at ¶ 6.11[3](b).

[85]*Id.* at ¶ 6.11[3](a)(xi).

[86]Michael A. Guariglia et al., *Exceptions to Interest Addback Requirements for Related-Member Interest and Intangible Expenses*, 2005 State Tax Today 146-4 (Aug. 1, 2005) (Lexis, STT file, elec. Cit. 2005 STT 146-4). Guariglia summarizes, by state, the add back statutes and the exceptions thereto.

[87]*Id.*

[88]*See id.*

[89]*Id.*

[90]*Id.* Delaware has attempted to allow taxpayers to take advantage of this exception by creating a special holding company entity which is technically subject to a tax. Pomp & Oldman, *supra* note 24, at 10-44 to -45. The tax, however, is offset to a great extent by a credit. *Id.* The idea is that the holding company will be taxable in Delaware, thereby invoking the add back exception. *Id.* In reality, any net tax paid to Delaware will be minimal. *Id.*

5--KAK.indd 361 8/8/07 12:12:53 PM

is an exception for payments in which the related holding company is merely a conduit—passing the payment through to an unrelated third party.[91] Third, there is an exception for transactions that have a valid business purpose (unrelated to tax considerations).[92] Fourth, there is an exception for transactions that are at arm's length.[93] In addition to these four categories of exceptions, some states also have a general exception for cases where the add back would be considered unreasonable.[94]

b. *Potential Problems*. While at first glance these add back statutes appear to effectively address the holding company problem, in fact they operate as blunt instruments that are both over-inclusive and under-inclusive.[95] Specifically, there are four problems with add back statutes that make them the "second best solution" in addressing holding company issues.[96]

First, add back statutes are fairly easy to plan around.[97] For example, if a statute requires the add back of related party royalty payments, the taxpayer can restructure the arrangement to turn the payments into something other than royalties, like management fees.[98] If the state changes the statute to require the add back of management fees, the taxpayer can restructure yet again and label the payments as something other than management fees.[99] All in all, add back statutes are aimed at a moving target, with the taxpayers planning around them and the state constantly trying to catch up.[100]

Second, the exceptions to add back statutes create litigation.[101] These exceptions are necessary to keep the add back statute from disallowing legitimate business transactions that were not entered into for tax avoidance purposes.[102] However, these exceptions can be ambiguous.[103] For example, if a statute says that related-

[91]Guariglia et al., *supra* note 86, at 2.

[92]*Id.*

[93]*Id.*

[94]*Id.*

[95]*Id.* This is despite the fact that many in the business community view them as less radical than the use of mandatory combined reporting. *See infra* Part IV.A.3.

[96]Pomp & Oldman, *supra* note 24, at 10-45; *Hearing on H.0784 Before the Vt. House Comm. on Ways and Means*, 2003-2004 Leg. Sess. (Mar. 25, 2004) [hereinafter *Mar. 25, 2004 Hearing*] (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040117). See *infra* note 359 for more information on this testimony and how it is cited in this Article. The best solution to the problem, according to commentators, is mandatory combined reporting. Pomp & Oldman, *supra* note 24, at 10-45. See *infra* Part II.B.4 for further discussion.

[97]*Mar. 25, 2004 Hearing*, *supra* note 96 (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040117). This is one reason why businesses tend to prefer add back statutes to mandatory combined reporting. *See infra* Part IV.A.3 (discussing business groups suggesting that Vermont enact an add back statute rather than a mandatory combined reporting law).

[98]*Mar. 25, 2004 Hearing*, *supra* note 96 (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040117).

[99]*Id.*

[100]*Id.*

[101]*Id.*

[102]*Id.*

[103]*Id.*

5--KAK.indd 362 8/8/07 12:12:53 PM

company royalties need not be added back if they are legitimate or reasonable, or have economic substance, the taxpayer and the state may disagree as to what these terms mean.[104] This can result in a lot of litigation, tying up the state's resources.[105]

Third, add back statutes do not address the shifting of income that occurs from the movement of assets to no-tax states.[106] For example, if a business moves all of its investments to a holding company based in a no-tax state, the income from those investments will escape taxation in other states.[107] Add back statutes do not address this situation.[108]

Finally, there may be constitutional issues with add back statutes.[109] The basic argument is that by requiring an add back of intercompany payments, the state is effectively taxing the holding company, which has no nexus with the state.[110] This may be viewed as violating the Due Process and Commerce Clauses of the U.S. Constitution.[111] While courts have not ruled definitively on this point, taxpayers have begun to raise the issue.[112] Whether taxpayers will prevail on this issue remains to be seen, but the fact the issue remains unresolved is a disadvantage of using the add back statute approach.

The bottom line is that add back statutes are not the most effective way to address the holding company issue. Such statutes are, however, politically palatable to the business community because tax advisors can devise ways to plan around them. Thus, states, such as New Jersey, usually can muster the political will to enact them. Unfortunately, add back statutes are, at best, a partial solution to the holding company problem.

4. *Mandatory Combined Reporting*

a. *Overview*. Leading state tax experts have long advocated that states adopt mandatory combined reporting because it is the fairest way to tax corporations, and it effectively prevents corporations from using tax planning devices like the

[104]*Mar. 25, 2004 Hearing*, *supra* note 96 (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040117). This is not to say that there is no guidance. *See, e.g.*, *supra* Part II.B.1 (discussing the *Syms* and *Sherwin-Williams* cases). These cases help clarify some of the fuzzy issues (on economic substance and business purpose) that can arise if such terms are included as exceptions to add back statutes.

[105]*Mar. 25, 2004 Hearing*, *supra* note 96 (testimony of Richard Pomp, University of Connecticut School of Law) (CD No. 040117). This is ironic in that add back statutes were meant to allow the state a more straightforward alternative to *Syms*, *Sherwin-Williams*, or *Geoffrey* type litigation.

[106]Pomp & Oldman, *supra* note 24, at 10-45.

[107]*Id.*

[108]*Id.* Combined reporting, however, does address this problem. *Id.*; *see infra* Part II.B.4 (discussing combined reporting).

[109]*Mar. 25, 2004 Hearing*, *supra* note 96 (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040117).

[110]Philip Plant, *The Addback Statute Wars—The Taxpayer's Case*, 2005 State Tax Today 161-4 (Aug. 22, 2005).

[111]*Id. But see supra* Part II.B.2 (discussing *Geoffrey*).

[112]Plant, *supra* note 110 (discussing detailed arguments by the taxpayers and the state). Such discussion is beyond the scope of this Article; suffice it to say that this issue is lurking in states that use the add back approach.

5--KAK.indd 363 8/8/07 12:12:53 PM

holding company.[113] Such experts have written about this issue in detail.[114] Only a summary of the virtues and potential problems of mandatory combined reporting, therefore, is provided here.

States generally tax corporations on either a separate entity basis or a combined reporting basis.[115] To understand the difference between these approaches, assume an enterprise operates two shoe stores. One store is located in State A and is owned and operated by Corporation X. The second store is located in State B and is owned and operated by Corporation Y. Corporation X owns 100% of the stock of Corporation Y. The shoe store business (both in State A and State B) is operated as one unitary business.[116] A separate entity state would tax only the activity of the unitary business operated through the legal entities that have nexus in the state.[117] Thus, if State A were a separate entity state, it would look only at the taxable income and apportionment factors[118] of Corporation X (the only legal entity with nexus in State A) in calculating its corporate tax. Neither the income nor the apportionment factors of Corporation Y are reported to State A because Corporation Y has no nexus with State A.

In contrast, a combined reporting state would consider the activity of an entire unitary business with nexus in the state—disregarding the legal entities through which the business is operated.[119] Thus, if State A were a combined reporting state, it would consider the income and apportionment factors for the entire unitary shoe store business—both the store owned by Corporation X and the store owned by Corporation Y—in figuring the amount of State A corporate tax. Under separate entity reporting, State A would tax a large portion (likely 100%) of Corporation X's income and none of Corporation Y's income. Under combined reporting, State A would tax its apportioned share (less than 100%) of both Corporation X's and Corporation Y's income. Under separate entity reporting State A gets a big slice of

[113]*E.g.*, Brunori, *supra* note 2, at 91-92, 96-97; Pomp & Oldman, *supra* note 24, at 10-39; Pomp, *The Future of the State Corporate Income Tax*, *supra* note 1, at 59-65; Richard D. Pomp, *State Tax Reform: Proposals for Wisconsin*, 88 Marq. L. Rev. 45 (2004) [hereinafter Pomp, *State Tax Reform*]; Michael J. McIntyre et al., *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*, 61 La. L. Rev. 699 (2001); Charles E. McLure, Jr. , *The Nuttiness of State and Local Taxes—and the Nuttiness of Responses Thereto*, State Tax Notes, 851 (Sept. 16, 2002); Lee A. Sheppard, *Self-Inflicted Wounds: What Europe Can Teach the States*, State Tax Notes, 309 (July 26, 2004).

[114]*See supra* note 113.

[115]Pomp & Oldham, *supra* note 24, at 10-37.

[116]The definition of "unitary" is explored at *infra* note 122 and accompanying text. For now, suffice it to say that Corporations X and Y are operated as one business, thus making them unitary. Combined reporting is sometimes mislabeled "unitary reporting" and separate entity reporting is sometimes mislabeled "non-unitary reporting." Pomp & Oldham, *supra* note 24, at 10-37. The reality is that both combined reporting states and separate entity states tax based on the unitary concept—the only difference is that separate entity states only tax the portion of the unitary business operated by a corporation that has nexus in the state. *See id*.

[117]*See* Pomp & Oldham, *supra* note 24, at 10-37.

[118]*See infra* Part II.C.1 for a general discussion of apportionment.

[119]*See* Pomp & Oldham, *supra* note 24, at 10-37.

5--KAK.indd 364 8/8/07 12:12:54 PM

a small pie (Corporation X). Under combined reporting, State A gets a small slice of a big pie (Corporations X and Y combined). Whether the shoe store business will pay more corporate tax to State A under separate entity reporting or combined reporting is not readily apparent; it depends on the relative income or loss and apportionment factors of both Corporations X and Y.[120]

If a state uses combined reporting, it must define what it means by a "unitary business."[121] Only income and apportionment factors from a single unitary business should be included in the combined tax return. The unitary concept is a flexible one that has evolved over the years under state law and various Supreme Court decisions.[122] First, there must be unity of ownership: a threshold level of common ownership of the corporations that comprise the purported unitary group—usually set at more than 50%.[123] Beyond this, states generally look for factors such as unity of use and management, functional integration, centralization of management, economies of scale, mutual interdependence of operations, and a flow of value between the affiliated companies.[124]

A combined reporting state must also determine whether it will use worldwide combined reporting or water's edge reporting (or allow the taxpayer to elect which one to use).[125] Under worldwide combined reporting, all corporations in the unitary business must be included in the combined return—whether domestic or foreign.[126] Under a water's edge approach, only domestic corporations that are part of the unitary group are included in the combined return.[127] Because only domestic entities are included in a water's edge return, it is possible for companies to use holding companies, non-arm's length transfer pricing, and other tax motivated transactions with their overseas affiliates.[128] Worldwide combined reporting is therefore more effective at not only foreclosing domestic tax planning, but international tax planning as well. Nonetheless, because of pressure from the federal government, foreign governments, and the business community, none of the combined reporting states currently mandate worldwide combined reporting.[129] Instead, the combined reporting states either take a water's edge approach or allow taxpayers to elect worldwide or water's edge reporting.[130]

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[120]*Id.* See *infra* Part IV.A.1 for a numerical example showing how combined reporting can cut both ways.

[121]*See* Pomp, *State Tax Reform*, *supra* note 113, at 58-59.

[122]*Id.* Only a brief overview of the unitary concept need be provided here. *See* Idaho Guide to Combined Reporting 1-3, available at http://tax.idaho.gov/pdf/2000/BIT/2001%20Combined%20Reporting.pdf (succinct summary of the case law on the unitary concept).

[123]Pomp & Oldman, *supra* note 24, at 10-38.

[124]Pomp, *State Tax Reform*, *supra* note113, at 59.

[125]*See* Pomp & Oldman, *supra* note 24, at 10-43.

[126]*Id.* at 10-43 to -44.

[127]*Id.*

[128]*See id.* at 10-43.

[129]*Id.* at 10-44.

[130]*Id.*

5--KAK.indd 365 8/8/07 12:12:54 PM

The U.S. Supreme Court has ruled that the use of combined reporting is constitutional.[131] However, most states are separate entity states.[132] Currently only 17 states have mandatory combined reporting (including now Vermont).[133]

b. *Advantages of Combined Reporting*. Combined reporting is superior to separate entity reporting for several reasons. First, because the entire unitary business is subject to taxation, techniques such as the use of holding companies are effectively rendered moot.[134] The holding company would be considered part of the unitary group and intercompany transactions (such as royalty or interest payments) would be eliminated on the combined return.[135] In fact, "[e]very single [state] tax shelter trend . . . is directly traceable to the failure to require combined filing. Every (here insert crude New York City all-purpose modifier) one."[136] Thus, combined reporting states need not worry about revenue losses from holding company and related planning techniques.

Second, a business' tax liability in a combined reporting state will be the same regardless of how it is organized along legal entity lines.[137] Companies will be free to structure their legal entities in the way that makes the best sense from a business and legal standpoint—apart from tax reasons.[138] This advances the important tax policy goal of tax neutrality.[139]

Third, combined reporting is more equitable for companies that operate exclusively within the taxing state.[140] These local, intrastate companies are unlikely to be able to take advantage of tax planning devices such as the holding company.[141] When a separate reporting state allows multistate companies to use devices such as the holding company technique to save state corporate taxes, local intrastate corporations end up shouldering a disproportionate share of the tax burden.[142] Under combined reporting, sheltering transactions such as the holding company

[131]Barclays Bank PLC v. Franchise Tax Board, 512 U.S. 298, 329-31 (1994); Container Corp. of Am. v. Franchise Tax Board, 463 U.S. 159, 197 (1983). The Court approved combined reporting in its broadest form—worldwide combined reporting. *Barclays Bank*, 512 U.S. at 330-31. Therefore, the narrower water's edge combined reporting statutes used by combined reporting states would clearly pass constitutional muster as well. In contrast, add back statutes may well be subject to constitutional challenge. *See supra* notes 109-112 and accompanying text.

[132]*See* Sheppard, *supra* note 113, at 310.

[133]*Id.* The combined reporting states are Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, Utah, and Vermont. *Id.* West Virginia will soon join this list, having enacted mandatory combined reporting in April of 2007 that will be effective January 1, 2009. Thomas D. Miller, *West Virginia Enacts Franchise Tax Cuts, Combined Reporting Requirement*, 2007 State Tax Today 68-20 (Apr. 9, 2007).

[134]Pomp & Oldman, *supra* note 24, at 10-42.

[135]*Id.*

[136]Sheppard, *supra* note 113, at 310.

[137]Pomp & Oldman, *supra* note 24, at 10-42.

[138]*Id.*

[139]*See id.*

[140]*Id.* at 10-43.

[141]*Id.* at 10-44 to -46.

[142]*See id.*

5--KAK.indd 366 8/8/07 12:12:54 PM

are ineffective, and thus multistate and intrastate companies end up on the same footing from a corporate tax standpoint.[143] This furthers the important tax policy goal of horizontal equity.

Fourth, combined reporting provides a more accurate measure of the corporate income earned within the state.[144] Combined reporting captures, and separate entity reporting fails to capture, the flow of value, synergies, and interdependencies that exist between related corporations that are in the same unitary business.[145] Combined reporting lets the state tax a fair portion of the enterprise as a whole, rather than a mere portion of a business that just happens to be cabined in a particular legal entity.[146]

Fifth, combined reporting frees the state from having to review transfer pricing among related corporations.[147] In separate reporting states, a business can shift income from high tax states to low tax states simply by adjusting the prices charged on intercompany transactions.[148] Returning to the shoe store example above,[149] assume that Corporation Y (100% based in State B) has excess inventory and sells some to Corporation X (100% based in State A). Assume further that State A has a high tax rate and State B has a low tax rate. If the price is set above market, Corporation X's income will be reduced below what it would have been had it purchased the inventory from an unrelated party. Corporation Y's income will be increased by an equal amount. If State A is a separate entity state, the tax paid by the shoe enterprise will go down because Corporation X overpaid for inventory and State A will not pick up the income recognized by Corporation Y. If State A is a combined reporting state, however, then the inventory sale will have no impact on the shoe enterprise's State A tax liability. Corporations X and Y will file a combined return. The intercompany sale of inventory will be eliminated and have no impact on the unitary business's overall income and State A tax. Separate reporting states therefore need to monitor transfer prices on transactions between in-state corporations and related out-of-state corporations. Combined reporting states do not have this concern.

c. *Arguments Against Combined Reporting*. Despite the benefits of combined reporting, only a minority of states use it, and until Vermont adopted it in 2004, no state had adopted it in over 20 years. The biggest reason for this is opposition by the business community.[150] Businesses are obviously opposed to combined reporting because it would prevent them from using tax shelter techniques like the holding company.[151] Combined reporting converts the state corporate income tax

[143]*See id.* Equity for intrastate corporations was one of the main drivers behind the enactment of combined reporting in Vermont. *See infra* Part IV.

[144]Pomp & Oldman, *supra* note 24, at 10-43.

[145]*Id.*

[146]*See id.* at 10-40.

[147]*Id.*

[148]*Id.*

[149]*See supra* note 115 and accompanying text.

[150]Pomp, *State Tax Reform*, *supra* note 113, at 59.

[151]*Id*. at 59-60.

5--KAK.indd 367 8/8/07 12:12:54 PM

"from a voluntary one into a real one."[152]

The business community normally does not challenge the merits of combined reporting, but instead claims that it will chill the business climate in the state and will be needlessly complex for both taxpayers and the state taxing authority.[153]

On the business climate score, opponents of combined reporting claim that combined reporting will cause companies to leave the state, discourage other businesses from entering the state, and result in the loss of jobs.[154] These claims are usually not substantiated with empirical evidence.[155] As one commentator noted, "[i]t is a wonder they do not predict that combined reporting will turn [the state] into a preagrarian economy of pagan worship."[156] In fact, combined reporting states do not seem to be suffering economically from their choice of corporate tax systems.[157]

As far as complexity is concerned, businesses do have a point. First, companies will have to determine their unitary combined group. This is likely to differ from the taxpayer's federal consolidated group.[158] Since the unitary business concept is a flexible one, litigation can result between the state and taxpayers over which corporations should be in the combined return and which should not.[159] However, combined reporting is nothing new—California has been using it since the Great Depression.[160] Therefore, many multistate taxpayers are already accustomed to it.

The adoption of combined reporting will create a learning curve for the state taxing authority, but this is not an insuperable barrier. The taxing authority certainly has plenty of other combined reporting states to look to for guidance on ways to handle combined reporting issues.[161]

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[152]*Id.* at 59.

[153]*Id.* at 59-60.

[154]*Id.* at 60.

[155]*Id.*

[156]Pomp, *State Tax Reform*, *supra* note 113, at 60.

[157]*See infra* note 376.

[158]Pomp & Oldman, *supra* note 24, at 10-38. The federal consolidated group includes most corporations with at least 80% control. I.R.C. § 1504(a) (2000). In contrast, the state combined return includes corporations with at least 50% control, but only those corporations that are part of the same unitary business. Pomp & Oldman, *supra* note 24, at 10-38. Thus, the state combined return may include more or fewer affiliates than the federal consolidated return. For example, the combined return may include affiliates with 50%-80% ownership while the federal consolidated return will not. However, the consolidated return will include all affiliates with 80% or more ownership, whether or not part of the unitary group, while the combined return will exclude affiliates that are not in the same unitary business.

[159]*See*, *e.g.*, *Hearing on H.0784 Before the Vt. House Comm. on Ways & Means*, 2003-2004 Leg. Sess. (Mar. 24, 2004) (testimony of Bill Driscoll, Assoc. Industries of Vt.) (CD No. 040117). See *infra* note 359 for information on these hearings and how they are cited in this Article. There will be litigation, however, no matter what reforms the state makes. For example, add back statutes often lead to litigation. *See supra* Part II.B.3.

[160]*March 25, 2004 Hearing, supra* note 96 (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040117). *See infra* note 359.

[161]*See*, *e.g.*, *March 25, 2004 Hearing, supra* note 96.

5--KAK.indd 368 8/8/07 12:12:54 PM

Although business opposition to combined reporting is refutable, it cannot be ignored by the legislature.[162] Ultimately, the legislature must listen to its business constituency and often ends up enacting an add back statute to deal with tax shelters instead of going for full-blown combined reporting.[163] This is the approach New Jersey took in light of business opposition and the need for a quick fix in order to fill a budget gap.[164] In contrast, Vermont was able to get past the political issues to enact mandatory combined reporting.[165]

C. *Other Issues with Corporate Income Taxes*

Income-shifting poses a substantial threat to the efficacy of state corporate income tax systems. However, such techniques are hardly the only drains on state corporate tax revenues. In this Part II.C, we briefly look at two other problems with modern day corporate income tax systems. Specifically, Part II.C.1 reviews the movement by states towards putting more weight on their sales factors in their apportionment formulas, and Part II.C.2. reviews the state tax incentives that are being offered by many states to attract and retain industry. Neither of these problems with corporate tax systems is the result of tax planning by taxpayers, but rather both are affirmative decisions by the states to forgo revenues in the hopes of fostering economic growth. These issues are not critical for discussion in this Article, because state reforms, such as those pursued by New Jersey and Vermont, are generally not aimed at curtailing these types of incentives. Nonetheless, they contribute to the problems in corporate income tax systems (specifically the paltry revenue that such systems generate). These issues are therefore briefly discussed here to provide a more complete picture.

1. *Apportionment Formulas*

One of the challenges of taxing an enterprise with interstate operations is to determine how much of the company's income a state is entitled to tax, since several states may have jurisdiction to tax at least a portion of the company's total income. The second prong of the Supreme Court's *Complete Auto* test requires that such income be fairly apportioned, but offers no guidance on how to accomplish fair apportionment.[166] The three accounting methods that have historically been used to calculate a state's fair share of corporate income are separate accounting, specific allocation and formulary apportionment.[167] The overwhelming majority of states

[162]Pomp, *State Tax Reform*, *supra* note113, at 60.

[163]*See supra* Part II.B.3.b (noting that businesses usually agree to add back statutes since they can plan around them).

[164]*See infra* Part III.

[165]*See infra* Part IV.

[166]Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977). In theory, fair apportionment serves the dual purposes of eliminating the risk of multiple or duplicative taxation and of preventing extraterritorial taxation. Bradley W. Joondeph, *The Meaning of Fair Apportionment and the Prohibition on Extraterritorial State Taxation*, 71 Fordham L. Rev. 149, 150 (2002).

[167]Pomp & Oldman, *supra* note 24, at 10-8.

5--KAK.indd 369 8/8/07 12:12:55 PM

with a corporate income tax use formulary apportionment because it provides a systematic and rational approach to determine a corporation's income attributable to in-state activities and avoids many of the arbitrary line-drawing problems inherent in separate accounting and specific allocation.[168]

Historically, states generally used a standard three-factor formula to calculate taxable income.[169] The basic formula was a simple average of three factors: (1) sales in the state over sales everywhere; (2) payroll in the state over payroll everywhere; and (3) property in the state over property everywhere.[170] The sales, payroll, and property factors were equally weighted under this approach.[171] Recently, the majority of states have moved towards putting more weight on the sales factor; most often doubling it.[172]

States are moving toward double-weighting the sales factor under the theory that it lowers the tax on companies with primarily property and payroll in the state (but few sales) and increases the tax on companies with primarily sales in the state (but little property and payroll).[173] The states want to favor those companies with substantial in-state property and payroll since such companies are important employers in the state and the state's economy would suffer were such companies to move out of the state.[174] In contrast, states figure they can disfavor companies which only have sales in the state.[175] In theory, such companies do not employ many workers in the state and merely use the state as a market.[176] Such companies would presumably not abandon the state merely because their tax burden had increased.

Despite these theories, there is little empirical evidence that double-weighting sales factors affects corporate location decisions in any meaningful way.[177] This is unfortunate, since double-weighting can be very costly.[178] One estimate puts

[168]McIntyre, *supra* note 113, at 728 ("Almost all states that have a corporate income tax apportion income to their state by using an apportionment formula.") Problems often attributed to the separate accounting system are that it is difficult and expensive to administer and that it does not accurately reflect the economies of scale inherent to many multistate operations. *See* Pomp & Oldman, *supra* note 24, at 10-11. Specific allocation is normally used to assign nonoperational or nonbusiness income. *See id.* at 10-26.

[169]*See* Pomp & Oldman, *supra* note 24, at 10-12.

[170]*Id.*

[171]*See id.*

[172]Pomp, *The Future of the State Corporate Income Tax*, *supra* note 1, at 56. Some states have gone so far as to eliminate the payroll and property factors entirely—relying only on a single sales factor. *Id.* at 57. Iowa was the first to do this (in the 1930s), in an attempt to aid in-state companies John Deere and Maytag. *Id.* Iowa's approach has been upheld by the U.S. Supreme Court. Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978).

[173]Pomp, *The Future of the State Corporate Income Tax*, *supra* note 1, at 56.

[174]*Id.*

[175]*Id.*

[176]*Id.* As such, these companies tend to have little influence in the state legislature. *See id.*

[177]*Id.* at 57.

[178]*Id.*

5--KAK.indd 370 8/8/07 12:12:55 PM

the lost revenue to the states at $500 million annually.[179] The lack of evidence regarding the benefits of double-weighting has led one commentator to call double-weighting the ultimate "'lose-lose' situation, no bucks *and* no bang."[180]

Deviations from the standard three-factor formula will generally pass muster under the U.S. Constitution.[181] The Supreme Court recognizes that precision is not the goal of formulary apportionment.[182] Accordingly, the Court pays a great deal of deference to the states, affording them a "wide latitude in the selection of apportionment formulas."[183] The risk of some overlap when taxable income is computed by states with differing formulas is constitutionally acceptable, since the Supreme Court is unwilling to engage in the "extensive judicial lawmaking" that would be necessary to attain uniformity.[184]

Rather than mandate a single method of taxation, the Court instead tests individual apportionment schemes for internal and external consistency.[185] A state's tax will pass the internal consistency test if it is structured "so that if every State were to impose an identical tax, no multiple taxation would result."[186] The boundaries of the external consistency test are less clear. For external consistency to exist, the "factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."[187] While the possibility of overreaching is an insufficient basis for invalidating an apportionment formula, the Court "will strike down the application of an apportionment formula if the taxpayer can prove by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportions to the business transacted in that State or has led to a grossly distorted result."[188] This is a difficult standard to meet, and thus double-weighting of sales is unlikely to pose any constitutional issues.

Any potential revenue loss from double-weighting is avoidable by simply not enacting a double-weighted sales factor in the first place. Political pressure to

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[179]*Id.* at 59. States that are primarily home to manufacturers will lose revenue but states that are primarily market states will gain revenue. *Id.* at 57. In the aggregate (across all states) the double-weighted sales factor will generally cost revenue. *Id.* at 59.

[180]*Id.* The discussion here is admittedly somewhat simplified. In order to determine the impact of double-weighting, the impact of Public Law 86-272 (federal law preventing states from taxing certain taxpayers that merely sell into the state), and whether the state has a "throwback" or "throwout" rule must be considered. *See id.* at 58. For a discussion of Public Law 86-272, see *infra* Part III.B.2. For a discussion of the throwout rule, see *infra* Part III.D. Suffice it to say that it is unclear how much benefit states get out of double-weighting their sales factors.

[181]*See* Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978).

[182]*Moorman*, 437 U.S. at 273. "This method . . . does not purport to identify the precise geographical source of a corporation's profits; rather, it is employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State." *Id.*

[183]*Id.* at 274.

[184]*See id.* at 278-80 (refusing to constitutionalize division of income problems but leaving open the possibility of achieving uniformity through congressional action under the Commerce Clause).

[185]Goldberg v. Sweet, 488 U.S. 252, 261 (1989).

[186]*Id.*

[187]Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983).

[188]*Id.* at 170 (internal quotations omitted) (citing Norfolk & W. Ry. Co. v. Missouri State Tax Comm'n, 390 U.S. 317, 326 (1968); Hans Rees' Sons v. North Carolina, 283 U.S. 123, 135 (1931)).

5--KAK.indd 371 8/8/07 12:12:55 PM

double-weight, however, is difficult to overcome, as evidenced by the experiences of the two states reviewed in this Article. New Jersey had a double-weighted sales factor prior to (and after) its 2002 tax reform.[189] Vermont enacted a double-weighted sales factor at the same time it enacted its mandatory combined reporting law in 2004 (effective in 2006).[190]

2. *Tax Incentives*

State corporate tax revenues are also being drained by targeted tax incentives, such as special credits against the corporate income tax.[191] These credits are intended to encourage specific business interests to maintain or increase their workforce in the state.[192] For example, in recent years, Alabama created an incentive package worth $300 million to entice Mercedes Benz to locate a plant in the state,[193] Tennessee provided $150 million in incentives to General Motors for a local Saturn plant,[194] Idaho provided a special tax package to keep Albertson's supermarket corporate headquarters in the state,[195] and Ohio notoriously provided a substantial credit to DaimlerChrysler for a Jeep plant.[196]

Although legislators may believe the economic activity stimulated by these incentives is worth the lost revenue, there is little evidence to support this.[197] In fact, these incentives likely reward corporations for business decisions they would have made anyway.[198] States have stepped up efforts to attract business, allowing corporations to play various states and cities against one another to see who can offer the most lucrative tax package.[199]

Corporate tax incentives have recently been challenged as violating the Commerce Clause of the U.S. Constitution.[200] The Sixth Circuit ruled that such incentives violate the Commerce Clause,[201] but the Supreme Court vacated the decision, ruling that the plaintiffs lacked standing.[202] Thus, these incentives remain and pose yet another obstacle to the maintenance of a viable corporate income tax base. States can easily solve this problem by simply not enacting such incentives in the

[189]N.J. Stat. Ann. § 54:10A-6 (West 2002 & Supp. 2006).

[190]Vt. Stat. Ann. § 32-5833(a) (2006). For a discussion as to why Vermont decided to double-weight its sales factor, see *infra* Part IV.B.

[191]Pomp, *The Future of the State Corporate Income Tax*, *supra* note 1, at 53-55.

[192]*Id.*

[193]*Id*. at 54.

[194]*Id.*

[195]Dave Wasson, *Idaho Incentives Fail to Retain Large Grocer's Headquarters*, 2006 State Tax Today 17-7 (Jan. 26, 2006). Albertson's headquarters ended up leaving Idaho anyway when the company was sold. *Id.*

[196]Cuno v. DaimlerChrysler, Inc., 386 F.3d 738, 741 (6th Cir. 2004), *vacated*, 126 S. Ct. 1854 (2006). The total package was estimated at $280 milllion—which included corporate tax credits and property tax relief. *Id.*

[197]Pomp, *The Future of the State Corporate Income Tax*, *supra* note 1, at 54.

[198]*Id.*

[199]*Id.*

[200]*DaimlerChrysler, Inc.*, 386 F.3d 738.

[201]*Id.* at 746.

[202]DaimlerChrysler Corp. v. Cuno, 126 S.Ct. 1854, 1868 (2006).

5--KAK.indd 372 8/8/07 12:12:55 PM

first place. Political pressure to do so however, often trumps any concerns about lost revenue.[203]

D. *Summary*

Corporate tax systems are badly in need of repair. While elimination of the corporate tax would be the best option, it is not politically feasible. Therefore, states must work to reform their tax systems to stop planning devices such as the holding company and should think long and hard before giving away more revenue via double-weighting or incentive tax credits. With the stage now set, we turn our attention to the specific ways in which New Jersey and Vermont have recently attempted to reinforce their corporate tax systems.

III. THE NEW JERSEY TAX REFORMS OF 2002

A. *Overview*

In the summer of 2002, New Jersey desperately sought new sources of revenue to stave off a budget crisis. As the New Jersey constitution requires a balanced budget for any fiscal year,[204] the government struggled to overcome a projected $5.3 billion deficit in formulating the state's budget for fiscal 2003.[205] In his budget address to the state legislature, Governor McGreevey ambitiously proposed to overhaul New Jersey's corporation business tax ("CBT") in order to close the gap without raising sales taxes or taxes on personal income.[206] Introducing his budget plan, the governor noted, "This year, we're going to restructure the [corporation business] tax to provide for greater equity and fairness to achieve . . . $1.8 billion . . . in revenues . . . ."[207] The resulting Business Tax Reform Act[208] was a patchwork makeover, which addressed many of the hot-button issues in state corporate taxation. While falling short of classic tax reform,[209] New Jersey's reforms provide a blueprint for other states in fiscal distress that are looking to revamp their corporate tax codes to maximize revenues derived from interstate commerce.

New Jersey's corporate income tax was emblematic of the problems, discussed supra in Part II, that plague state corporate income tax systems. In 1982, the CBT raised $838 million, representing 15% of New Jersey's total revenues.[210] By 2001,

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[203]Pomp, *The Future of the State Corporate Income Tax*, *supra* note 1, at 54.

[204]N.J. Const. art. VIII, § 2, cl. 2.

[205]Laura Mansnerus, *Racing to Plug a Budget Hole in New Jersey*, N.Y. Times, June 18, 2002, at B1.

[206]Governor James McGreevey, Budget Address to the Joint Session of the Legislature (Mar. 26, 2002) (transcript on file with authors). McGreevey made it a point in his address to note that he sought to balance the budget without raising personal income or sales taxes. *Id.* He couched his corporate tax reforms in terms of making sure that businesses would be shouldering their fair share. *Id.*

[207]*Id.*

[208]Business Tax Reform Act, 2002 N.J. Laws 40 (July 2, 2002) (codified in scattered sections of N.J. Stat. Ann. §§ 52, 54).

[209]*See infra* Part V.B.

[210]Office of Management and Budget, State of New Jersey, Budget Fiscal Year 2002-2003 C-4 (2002).

5--KAK.indd 373 8/8/07 12:12:56 PM

the CBT contributed only 6.6% of the state's tax revenues.[211] Studies estimated that without revision, the CBT would collect $820 million in 2003, only four percent of the state's revenues and less than the amount that was collected two decades earlier.[212]

There appeared to be no correlation between the amount of tax collected and corporate profit growth over the years. From fiscal year 1991 to fiscal year 2001, corporate profits had risen dramatically, from $15.55 billion to $31.21 billion.[213] During that same span, however, revenues from the CBT showed only modest growth from $1.08 billion to $1.39 billion, and even sank below 1991 levels during years of steady corporate profit growth.[214] In stark contrast, New Jersey's gross income tax and sales tax revenues had grown by 518% and 377%, respectively, since 1982.[215]

Notwithstanding the deficiencies in corporate taxation recognized by academics and government officials, New Jersey's Business Tax Reform Act was met with stern opposition from business leaders who were fearful not only of increased tax liability in New Jersey,[216] but also that the reforms would be duplicated elsewhere in other cash-strapped states.[217] Professor Richard Pomp noted, "That is one of the reasons that the national business community was so intent on stopping New Jersey. There was the fear that as New Jersey went, so went the rest of the country because the states are hurting so badly and looking around for possible ideas."[218]

The New Jersey Chamber of Commerce, New Jersey Retail Merchants Association, New Jersey Food Council and the New Jersey Small Business Federation blitzed the media with a $300,000 "Save Sally's Job" campaign, which was premised on the notion that increased tax liability would leave less money for companies to pay for salaries and benefits.[219] Many businesspeople felt that they were being held responsible for a fiscal crisis for which they did not bear blame.[220] The business community continued to express its ire toward New Jersey's business tax reforms even after their passage by the state legislature. James M. Zimmer-

[211] *Id.*

[212] *Id.*

[213] *Id.* at C-11.

[214] *Id.*

[215] *Id.* at C-5.

[216] Thirty of the fifty largest employers in New Jersey paid the minimum $200 tax in 2001. Geeta Sundaramoorthy, *A Tax Hike That Everyone Will Feel*, NJBiz, July 15, 2002.

[217] Sara Hansard, *Garden State Sprouts Financial Services Taxes: N.J. Law May Inspire Other States to Cash In*, Investment News, Oct. 21, 2002, at 1.

[218] *Id.*

[219] Mary E. Forsberg, *New Jersey Policy Perspective, A Question of Balance: Taxing Business in the 21st Century*, 27 State Tax Notes 20 (2003).

[220] *See State of New Jersey Department of the Treasury Corporation Business Tax Study Commission Public Hearing* (May 29, 2003) (statement of Joseph R. Crosby, Legislative Director, Council on State Taxation) ("In terms of the political process . . . it's clear that corporations were made the scapegoat for the fiscal crisis. At least that's the perception in the business community.").

5--KAK.indd 374 8/8/07 12:12:56 PM

man, CEO of Federated Department Stores, Inc., parent company of Macy's and Bloomingdale's, wrote to Governor McGreevey, "We cannot and will not absorb a $5.7 million New Jersey tax increase without taking commensurate measures to reduce expenditures there. For the good of New Jersey and its citizens, this ill-advised legislation should be repealed."[221] Others in the field predicted that corporations would respond by restructuring the forms in which they do business in the state but noted that the legislation provides little guidance on how that could be accomplished.[222]

This Part III analyzes three sections of New Jersey's Business Tax Reform Act that target interstate commerce. Part III.B examines the newly introduced Alternative Minimum Assessment ("AMA"), concluding that it successfully skirts certain jurisdictional restrictions currently placed on states' taxing power by federal law. Part III.C analyzes the legislature's efforts to address the holding company structure via an add back statute. This analysis focuses on the role of the sham transaction doctrine as a tool for determining which deductions should be disallowed under the new add back statute. For those deductions allowed by the add back statute, Part III.C considers the possibility of taxing the holding company itself under the *Geoffrey* doctrine. Part III.D looks at the throwout rule, which altered the state's apportionment formula by increasing the amount of corporate income that would be taxable in New Jersey. All in all, the Business Tax Reform Act provides a model to other states in fiscal distress, as the measures discussed should both increase the effectiveness of the tax and survive judicial challenge.[223]

B. *The AMA as an End-Run Around Public Law 86-272*[224]

1. *Structure of the AMA*

The creation of the Alternative Minimum Assessment was the centerpiece of New Jersey's Business Tax Reform Act. Under the new provisions, all corporations pay the greater of the amount computed under the existing net income tax or the amount computed under the AMA.[225] The true importance of this mechanism is not simply that it potentially increases any corporation's tax liability, but rather that its structure will allow New Jersey to tax income which would otherwise be exempted by federal law.

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[221]Dunstan McNichol, *CEO Warns Tax Changes Could Spur Macy's Cuts: Foes of Plan Predict the Loss of More Jobs*, The Star Ledger, July 10, 2002, at 15.

[222]Sundaramoorthy, *supra* note 216.

[223]*But see infra* note 231 (discussing potential constitutional problems with a sunset provision in the AMA). Further, as noted at *infra* note 265, gross receipts taxes, such as the AMA, may have negative economic consequences. States must take into account such consequences when deciding whether to follow New Jersey's lead.

[224]Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555 (codified at 15 U.S.C. §§ 381-384).

[225]N.J. Stat. Ann. § 54:10A-5 (West 2002 & Supp. 2006).

5--KAK.indd 375 8/8/07 12:12:56 PM

Calculation of the AMA is based on either gross receipts attributable to New Jersey[226] or gross profits attributable to New Jersey.[227] The taxpayer may elect which method will be used in computing the AMA, but will be bound by that election for the following four privilege periods.[228] After gross receipts or profits are calculated, a rate schedule is applied to the result.[229]

The AMA was enacted with an automatic sunset after June 30, 2006 except as applied to corporations that are shielded by Public Law 86-272, a federal law limiting a state's power to impose a net income tax on certain out-of-state taxpayers.[230] In order to avoid the AMA in years following 2006, the otherwise exempt taxpayer must file a consent submitting to jurisdiction under New Jersey's net income tax.[231]

2. *Creation and Judicial Interpretation of Public Law 86-272*

The landmark case of *Northwestern States Portland Cement Co. v. Minnesota*,[232] sparked intense business lobbying that precipitated the hasty drafting and adoption of Public Law 86-272.[233] In *Northwestern States*, the Supreme Court held "[N]et income from the interstate operations of a foreign corporation may be subjected to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the same."[234] The subject taxpayer was a cement manufacturer incorporated in Iowa.[235]

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[226]New Jersey gross receipts include receipts arising from sales of tangible personal property located within the state at the time of receipt and shipped in state, sales of tangible personal property located outside the state and delivered in state, services performed in state, rentals from property and royalties from the use of patents or copyrights within the state, and all other business receipts earned within the state. *Id.*

[227] New Jersey gross profits are defined as "New Jersey gross receipts reduced by returns and allowances attributable to New Jersey gross receipts, less the cost of goods sold." *Id.*

[228]*Id.*

[229]If the taxpayer elects to compute its liability based on gross receipts, the scale ranges from no assessment if gross receipts are less than $2,000,000 to an assessment of 0.004 times total gross receipts if they exceed $75,000,000. The law provides a scale ranging from no assessment for gross profits of less than $1,000,000 to a tax of 0.008 times total gross profits if they equal more than $37,500,000. *Id.*

[230]*Id*.

[231]*Id.* Denying a sunset to those corporations protected by Public Law 86-272, which would obviously be out-of-state corporations operating in interstate commerce, would likely be subject to constitutional challenge on Commerce Clause grounds. After the sunset, the AMA would only apply to out-of-state companies. This would appear to be facial discrimination against interstate commerce, which is generally considered per se unconstitutional. *See* Fulton Corp. v. Faulkner, 516 U.S. 325, 331 (1996). The state would need to argue that the AMA on out-of-state companies is meant to compensate for the fact that such companies do not pay the normal corporate income tax. It is unclear whether New Jersey would be able to succeed in such an argument, but such compensatory tax arguments rarely work. *See Fulton*, 516 U.S. at 338 (indicating that the use tax, which compensates for the sales tax, is the only tax the Court has upheld as satisfying the compensatory tax doctrine). At this time, it is unclear how this issue would play out in the courts.

[232]358 U.S. 450 (1959).

[233]Michael F. Fatale, *Federalism and State Business Activity Tax Nexus: Revisiting Public Law 86-272*, 21 VA. Tax Rev. 435, 474-76 (2002).

[234]*Northwestern States*, 358 U.S. at 452.

[235]*Id.* at 453.

5--KAK.indd 376 8/8/07 12:12:56 PM

Its manufacturing and sales centers were located there as well.[236] Despite making 48% of its sales through dealers in Minnesota, the company filed no tax returns there and was eventually presented with an assessment for taxes owed together with penalties and interest.[237] Northwestern States challenged this assessment, which was made under a provision of the Minnesota code taxing "domestic and foreign corporations . . . whose business within this state during the taxable year consists exclusively of foreign commerce, interstate commerce, or both."[238]

The Supreme Court noted that while Congress had thus far been silent on this issue, "interstate commerce shall be free from any direct restrictions or impositions by the States."[239] Looking at its past jurisprudence, the Court ruled that while the Constitution prevents states from levying taxes or duties on articles of commerce moving between states, the effect of a net income tax on interstate commerce would, at most, be indirect and remote.[240] Upholding the assessment, the Court held that the state's apportionment formula alleviated risk of multiple taxation of the same income in various states and found it important that the tax in question was not imposed on "the privilege of doing business within the state."[241] The nexus requirement of the Due Process Clause was deemed satisfied based on the taxpayer's engaging in "substantial income-producing activity in the taxing States."[242]

Congress swiftly cabined the Court's broad view of taxing jurisdiction by enacting Public Law 86-272. Since the law's passage, a state cannot impose a net income tax on an out-of-state taxpayer if the taxpayer's only activity in that state is the solicitation of orders for tangible personal property that are sent out of state for approval or rejection, and are filled by shipment from out of state.[243]

To date, the leading case interpreting Public Law 86-272 is *Wisconsin Department of Revenue v. Wrigley Co.*, where the Supreme Court attempted to define

[236]*Id.*

[237]*Id.* at 454-455.

[238]*Id.* at 453.

[239]*Id.* at 458.

[240]*Id.* at 459.

[241]*Id.* at 463-64. Years later, the Supreme Court's Commerce Clause jurisprudence in the area of state taxation changed dramatically with its decision in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). Upholding a Mississippi tax on the privilege of conducting activities relating to interstate commerce, the Supreme Court questioned the viability of the blanket prohibition against taxing the "privilege of doing business" as it bore no relation to economic realities and instead merely stood "as a trap for the unwary draftsman." *Id*. at 274, 279. The *Complete Auto* Court cited Justice Rutledge's concurring opinion in *Freeman v. Hewit*, 329 U.S. 249 (1946) for the proposition that a "tax should be judged by its economic effects rather than by its formal phrasing." *Complete Auto*, 430 U.S. at 280. Since *Complete Auto*, the standard has been whether "the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Id.* at 279.

[242]*Northwestern States*, 358 U.S. at 465. The Supreme Court would later bifurcate the nexus requirements of the Due Process and Commerce Clauses, but this was in the context of use tax collection requirements. *See supra* note 71.

[243]15 U.S.C. § 381 (2000).

5--KAK.indd 377 8/8/07 12:12:56 PM

the boundaries of solicitation as used in the statute.[244] The Wrigley Company was headquartered in Chicago and distributed chewing gum throughout the United States through a marketing system that divided the nation into districts, regions, and territories.[245] Field representatives for the Milwaukee region were Wisconsin residents, who were provided with company cars, but not offices.[246] Field representatives typically spent their days visiting retailers and performing such duties as distributing promotional materials, setting up and deciding on locations for display racks that were provided for free to retailers, taking orders for gum, and replacing stale supplies of gum without charge.[247] Wrigley neither owned nor leased real property in Wisconsin.[248] "All Wisconsin orders were sent to Chicago for acceptance" and then were filled from outside the state via common carrier.[249]

Wrigley never filed or paid Wisconsin taxes, but the Department of Revenue concluded that the company's activities in the state were sufficient to grant it taxing authority and issued an assessment.[250] Wrigley objected, claiming exemption under Public Law 86-272.[251] The Supreme Court rejected Wisconsin's invitation to construe the phrase "solicitation of orders" narrowly, but also refused to give a broad interpretation as urged by Wrigley.[252] Instead the Court noted that, "unless Congress conveys its purpose clearly, it will not be deemed to have significantly changed the Federal-State balance."[253] Since Public Law 86-272 limits state taxation powers, the Court simply endeavored to ascertain a "fair meaning" of the statutory text.[254] In the end, the opinion followed a middle ground. The Court stated that solicitation "covers more than what is strictly *essential* to making requests for purchases" but held that Wrigley's activities in Wisconsin still crossed the line.[255]

3. *Analysis*

Congress was explicit in defining "net income tax" as "any tax imposed on, or measured by, net income."[256] It is extremely unlikely under the *Wrigley* test that a tax on gross receipts or profits would be held to fit within the fair meaning of "net income tax." For example, the distinction between a net income tax and a tax on gross receipts was central in a Washington Supreme Court decision when it held that the state's business and occupation tax imposed on gross receipts was not

[244]505 U.S. 214, 216 (1992).
[245]*Id.*
[246]*Id.* at 217.
[247]*Id.* at 218.
[248]*Id.* at 219.
[249]*Id.*
[250]Wis. Dep't of Revenue v. Wrigley Co., 505 U.S. 214, 216 (1992).
[251]*Id.*
[252]*Id.* at 224, 228.
[253]*Id.* at 224 (quoting Heublein v. South Carolina Tax Comm'n, 409 U.S. 275, 281-82 (1972)).
[254]*Wrigley*, 505 U.S. at 224.
[255]*Id.* at 228, 235 (emphasis in original).
[256]15 U.S.C. § 383 (2000).

5--KAK.indd 378 8/8/07 12:12:57 PM

governed by Public Law 86-272.[257] Based on this statutory analysis, it is likely that the Business Tax Reform Act has skirted the restrictions of Public Law 86-272 by employing the AMA.

The result of this maneuver is a bit unsettling in light of the "economic effects" test, which is currently employed to determine the validity of a state's taxing scheme.[258] Though Congress is not bound by this doctrine, it does provide a useful tool for evaluating the efficacy of Public Law 86-272. If the statute's purpose is to prevent the actual economic effect of taxing the protected spheres of interstate commerce, its current form fails to meet this end. As demonstrated above, a state can tax income derived from the same activities that Public Law 86-272 protects simply by shifting the formal structure of its corporate income tax to assess gross receipts or profits rather than net income. In theory, the taxing state could then adjust its rates to approximate the same economic effect as if it were taxing net income. A gross receipts tax will actually have a greater economic effect on the protected class of interstate commerce, as it may affect not only businesses that would have net income tax liability, but also those unprofitable enterprises with receipts but no net income.

This weakness in the statute is most likely a result of the prevailing Commerce Clause jurisprudence at the time of its enactment. The tax immunity doctrine, which dictated that interstate commerce was immune from state taxation, was not abandoned by the Supreme Court until 1977.[259] However, the grant of immunity was not complete.[260] The Supreme Court limited the tax immunity doctrine by employing the nebulous standard of whether a tax posed a direct or indirect burden on interstate commerce.[261] A trend developed whereby taxes on gross income were considered a direct burden and therefore unconstitutional, while net income taxes were considered to pose only an indirect burden.[262] As a result, when Public Law

[257]Tyler Pipe Industries, Inc. v. Dep't of Revenue, 715 P.2d 123, 128 (Wash. 1986) ("The federal statute applies only to a 'net income tax'; Washington's B & O tax is not a net income tax or a net tax on anything."), *vacated on other grounds by* 483 U.S. 232 (1987).

[258]*See* Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

[259]David F. Shores, *State Taxation of Gross Receipts and the Negative Commerce Clause*, 54 Mo. L. Rev. 555, 558 (1989).

[260]*See* Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 254 (1938) ("It was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden . . . .").

[261]Shores, *supra* note 259, at 559.

[262]*Recent Case Legislation, Limitations on Power of States to Tax Net Income Derived From Interstate Commerce: P.L. 86-272*, 108 U. Pa. L. Rev. 1077, 1078 (1960). This distinction dates back to 1918, when the Supreme Court ruled:

> A tax upon gross receipts affects each transaction in proportion to its magnitude and irrespective of whether it is profitable or otherwise. Conceivably it may be sufficient to make the difference between profit and loss, or to so diminish the profit as to impede or discourage the conduct of the commerce. A tax upon the net profits has not the same deterrent effect, since it does not arise at all unless a gain is shown over and above expenses and losses, and the tax cannot be heavy unless the profits are large.

United States Glue Co. v. Town of Oak Creek, 247 U.S. 321, 329 (1918).

5--KAK.indd 379 8/8/07 12:12:57 PM

86-272 was enacted, the legislation needed only to focus on taxation of net income. However, by rejecting the tax immunity doctrine, the Supreme Court broadened the states' power to apply gross receipts taxes to interstate commerce. The scope of Public Law 86-272's prohibition did not expand correspondingly.

Legislation introduced in 2001 proposed such an expansion in the law's scope by removing the references to "net income tax" and replacing them with the term "business activity tax," which was defined as:

> [A] tax imposed on, or measured by, net income, a business license tax, a business and occupation tax, a franchise tax, a single business tax or a capital stock tax, or any similar tax or fee imposed by a State or subdivision thereof on a business for the right to do business within the State or subdivision or which is measured by the amount of such business or related activity.[263]

Though this particular bill stalled in Congress, passage of such legislation would certainly thwart New Jersey's efforts.[264] The AMA employs a tax on *gross* profits or receipts as a mechanism for avoiding the restrictions of Public Law 86-272. This construction exploits the federal law's focus on net income and the Supreme Court's conservative interpretation of the statute's scope. The proposed language cited above would expand the federal exemption's scope to include the forms of taxation imposed by the AMA. For the moment, however, the AMA's structure deftly skips around the federal law's restrictions on state taxation.

While gross receipts taxes such as the AMA can help states in fiscal distress avoid the restrictions of Public Law 86-272, expand their taxing jurisdiction, and raise desperately needed revenue, such taxes may have pernicious economic effects. In fact, one expert commentator has gone so far as to say, based on a study of existing gross receipts taxes, that "there is no sensible case for gross receipts taxation" and that such taxes "do not belong in any program of tax reform."[265] States considering whether to follow New Jersey's lead in raising revenue through a gross receipts tax must study the possible negative economic consequences of

[263]Internet Tax Fairness Act of 2001, H.R. 2526, 107th Cong. (2001).

[264]This issue again came up in Congress as part of a broader bill. The proposed Business Activity Tax Simplification Act of 2005 would, among other things, amend Public Law 86-272 by imposing the law's restrictions not only on net income taxes, but also on any "other business activity tax." H.R. 1956, 109th Cong. (2005). The definition of "other business activity tax" includes "a tax imposed on or measured by gross receipts, gross income, or gross profits." *Id.*

[265]John L. Mikesell, Tax Foundation Background Paper: Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance 2 (Jan. 2007), *available at* http://www.taxfoundation.org/files/bp53.pdf. As discussed at *infra* Part V, New Jersey was restructuring its tax system with one goal in mind: to raise revenue quickly. Issues of true tax reform and long-term economic impact were absent. States embarking on true tax reform, like Vermont, should, as Mikesell advises, avoid gross receipts taxes. However, states that must generate immediate revenue but lack the political will to embrace true, fundamental tax reform may have little choice but to follow New Jersey's lead and resort to economically troublesome tactics such as gross receipts taxes. A review of the economic impact of gross receipts taxes is beyond the scope of this Article. For further details, see *id*.

adopting such a tax. Unfortunately, many states may find, like New Jersey did, that the need for immediate revenue will trump the pursuit of sound economic policies.

C. *New Jersey's Add Back Statute*

As noted above in Part II.B, one of the perceived loopholes endemic to state corporate taxation involves deductions for payments to affiliated businesses—that is, the use of some variation of the holding company structure. To combat this problem, the Business Tax Reform Act introduced a new section to the CBT, which governs expenses and costs relating to intangibles.[266] The statute provides that a taxpayer must add back any otherwise deductible "intangible expenses" which were paid directly or indirectly to a "related member."[267] The add back provisions do not apply, however, when payments were made to a related member in a foreign country having a comprehensive tax treaty with the United States, where the taxpayer can establish that such an adjustment would be unreasonable, or where the taxpayer and the state agree to an alternative method of apportionment.[268] The statute also carves out an exception for a portion of intangible expenses where "the related member during the same income year directly or indirectly paid, received, accrued or incurred the portion to or from a person that is not a related member" if the taxpayer can also prove that the principal purpose of the transaction between the taxpayer and related member was not tax avoidance.[269]

These provisions of the Business Tax Reform Act bring the use of holding companies under scrutiny and may eviscerate any tax advantage gained through their employment.[270]

Through the restriction on deductions for payments among related entities, New Jersey has taken steps to combat tax arbitrage by making it more difficult for companies to shift income out of state tax-free. Examining the Massachusetts court's holdings in *Syms* and *Sherwin-Williams*[271] for an understanding of the sham transaction doctrine reveals that fair and workable standards can be developed to enforce this provision of the Business Tax Reform Act. Such a study also provides valuable insight into how one should structure intercorporate transactions among related entities to avoid a determination that tax avoidance was the principal purpose.

From the sham transaction cases one can derive key criteria, which can be used to demonstrate that intercorporate transactions are not shams. These include:

[266]Business Tax Reform Act, N.J. P.L. 2002, ch. 40, § 5 (July 2, 2002) (codified at N.J. STAT. ANN. § 54:10A-4.4). This section also governs interest payments to related entities and treats them in the same manner. *Id.*

[267]*Id.* at § 5(b).

[268]*Id.* at § 5(c).

[269]*Id.* at § 3.

[270]*But see supra* Part II.B.3.b (discussing the limitations of add back statutes).

[271]*See supra* Part II.B.1 (discussing *Syms* and *Sherwin-Williams*).

5--KAK.indd 381 8/8/07 12:12:57 PM

giving the subsidiary autonomy and the power to carry out its stated purpose independently; encouraging or at least allowing the subsidiary to deal with unrelated third parties; and allowing the subsidiary to control its revenues, especially avoiding a scenario of revolving royalty payments that return to the parent as dividends.

Even if a transaction passes muster under the sham transaction doctrine, however, New Jersey could, and likely would, reach at least some of the income being sent out of state by invoking the *Geoffrey* doctrine.[272] When calculating its liability under the AMA, a corporation must take into account "royalties from the use of patents or copyrights, within the State."[273] Tax liability for this type of income was already included in New Jersey's CBT before the enactment of the Business Tax Reform Act.[274] These provisions clearly direct the tax collector to follow South Carolina's lead in taxing out-of-state holding companies on income derived from in-state activities.

A New Jersey court recently gave its blessing to the *Geoffrey* doctrine in *Lanco, Inc. v. Director, Division of Taxation*.[275] Lanco was a Delaware corporation with no employees, offices, or real or tangible property in New Jersey.[276] Lanco licensed intellectual property to its affiliate, Lane Bryant, Inc. in return for royalty payments.[277] Lane Bryant then used these intangibles in its retail operations, including those in New Jersey.[278] The court noted that the CBT is intended to reach as broad a tax base as constitutionally possible and, citing to *Geoffrey* and its progeny, held that the physical presence requirement,[279] while applicable to use and sales taxes, is not applicable to the state's income tax jurisdiction.[280] Thus, a Delaware holding company with no other taxable New Jersey income will have liability for royalty income under the AMA or the CBT.

D. *The Throwout Rule*

1. *Increasing New Jersey's Apportionable Share of a Taxpayer's Worldwide Income*

Like the overwhelming majority of states with a corporate income tax,[281] New Jersey uses formulary apportionment to determine its share of taxable income.[282] New Jersey's share is calculated per the following three-factor formula:[283]

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[272]*See supra* Part II.B.2.

[273]Business Tax Reform Act, N.J. P.L. 2002, ch. 40, § 7 (July 2, 2002) (codified at N.J. Stat. Ann. § 54:10A-5a).

[274]N.J. Stat. Ann. § 54:10A-6(B)(5).

[275]879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005), *aff'd*, 908 A.2d 176 (N.J. 2006).

[276]*Lanco*, 879 A.2d at 1236.

[277]*Id.*

[278]*Id.*

[279]The physical presence requirement is derived from *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[280]*Lanco*, 879 A.2d at 1238-42; *see supra* note 71 (discussing *Quill*).

[281]*See supra* Part II.C.1 (general discussion of apportionment).

[282]N.J. Stat. Ann. § 54:10A-6.

[283]*See* N.J. Stat. Ann. § 54:10A-6.

5--KAK.indd 382 8/8/07 12:12:58 PM

$TI_{NJ} = TI_{WW} \times (1/4)(Property_{NJ}/Property_{WW} + 2(Sales_{NJ})/Sales_{WW} + Payroll_{NJ}/Payroll_{WW})$.[284]

The Business Tax Reform Act modified this calculation by introducing the throwout rule, which provides "that if receipts would be assigned to a state . . . in which the taxpayer is not subject to a tax on or measured by profits or income, or business presence or activity, then the receipts shall be excluded from the denominator of the sales fraction."[285]

To demonstrate the throwout rule in action, consider the following example. Corporation X is liable for taxes in New Jersey but neither has property, nor pays any portion of its payroll in the state. Its worldwide sales total $1000, $100 of which is assignable to New Jersey and $200 of which is assignable to states in which Corporation X is not subject to taxation. Without the throwout rule, 1/20 of worldwide income would be apportioned to New Jersey ((1/4)(0 + [2 x 100/1000] + 0)). With the throwout rule, however, 1/16 of worldwide income would be apportioned to New Jersey ((1/4)(0 + [2 x 100/800] + 0)). Thus, the throwout rule increases the amount of worldwide corporate income apportioned to New Jersey by shrinking the sales factor's denominator while leaving the numerator untouched.

2. *Analysis*

New Jersey had leeway when structuring its apportionment formula, and the state would be given deference if the formula were challenged in court.[286] The "three-factor" formula is well regarded by the Supreme Court, and doubling the weight of the sales factor doesn't affect the constitutionality of New Jersey's formula, as the Court considers the weight given to each factor to be "essentially arbitrary."[287]

Likewise, the addition of the throwout rule will not adversely affect the apportionment formula's constitutionality. By its terms, the throwout rule will not violate internal consistency, as it only affects the distribution of taxable income by swallowing up a percentage of income that is not being taxed already. To see how this works, consider an example involving an entity with equal sales in states A, B, and C and no nexus with any other state. For simplicity, assume each of the

[284](1) TI_{NJ} represents the share of the taxpayer's income apportioned to New Jersey; (2) TI_{WW} represents the taxpayer's worldwide apportionable income; (3) $Property_{NJ}$ represents the average value of the taxpayer's property held in New Jersey; (4) $Property_{WW}$ represents the average value of the taxpayer's property held worldwide; (5) $Sales_{NJ}$ represents receipts earned by the taxpayer in New Jersey; (6) $Sales_{WW}$ represents receipts earned by the taxpayer worldwide; (7) $Payroll_{NJ}$ represents salaries, wages and other compensation paid by the taxpayer to employees in New Jersey; and (8) $Payroll_{WW}$ represents salaries, wages and other compensation paid by the taxpayer to employees worldwide.

[285]Business Tax Reform Act, N.J. P.L. 2002, ch. 40, § 8 (July 2, 2002) (codified at N.J. STAT. ANN. § 54:10A-6).

[286]*See* Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978); *see also supra* Part II.C.1 (discussing the leeway that states have in structuring their apportionment formulas).

[287]*See* Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 170, 183 n.20 (1983). The Court also recognizes that "the relationship between each of the factors and income is by no means exact." *Id.* at 183 n.20.

5--KAK.indd 383 8/8/07 12:12:58 PM

states has the same single factor apportionment formula based on sales, but C does not have taxing jurisdiction over the corporation. Without the throwout rule, A and B each will be apportioned one-third of the corporation's apportionable income, and one-third will go untaxed by any state. Keeping the same facts but introducing the throwout rule to each state's apportionment formula, A and B each will be apportioned one-half of the corporation's apportionable income, and C will still tax nothing. The percentages will change relative to each state, but in the aggregate, the throwout rule will not cause more than 100% of a corporation's apportionable income to be taxed.

The throwout rule will likely survive a challenge on external consistency grounds as well, as the standards required for a taxpayer to win on such an argument are very high. Recognizing that formulary apportionment produces imperfect results, the Court in *Container Corp. of America v. Franchise Tax Board* noted that it will occasionally find a formula to have a "distortive effect . . . so outrageous in a particular case as to require reversal."[288] In order to win on this argument, a taxpayer would have to demonstrate that the difference between the amount of taxable income attributed to a state, using its formula, and the amount attributable to the state, using an alternate method of accounting, would produce a distortion outside of "the substantial margin of error inherent in any method of attributing income among the components of a unitary business."[289] In *Container*, a distortion of 14% was considered to be within this permissible margin of error.[290] Since *Container*, the states have been greatly empowered to defend against such challenges.[291] It is extremely unlikely that a corporation would be able to demonstrate that New Jersey's throwout rule produces enough of a distortion to warrant a different method of apportionment.

E. *Aftermath*

The Business Tax Reform Act created a Corporation Business Tax Study Commission (the "Commission") to study the effectiveness of the reforms and issue a report summarizing its findings and recommendations.[292] The report addressed the following questions: (1) whether the CBT is equitable and fairly borne and distributed; (2) whether the tax can be more fairly and equitably borne and distributed without reducing anticipated revenues; (3) whether profitable corporations

[288]*Container Corp,* 463 U.S. at 182-83. However, the Court went on to praise the three-factor method of apportionment for avoiding such an effect in many cases. *Id.* at 183.

[289]*Id.* at 183-85.

[290]*Id.* at 184.

[291]*See* Ronald W. Blasi & C. James Judson, *Supreme Court Provides Guideline for Taxing of Federal Securities by States,* 64 J. Tax'n 42, 45 (1986) (noting the increased power of the states "for blunting the challenge by interstate taxpayers to taxation of interstate activities").

[292]Business Tax Reform Act, N.J. P.L. 2002, ch. 40, § 31 (July 2, 2002) (codified at N.J. Stat. Ann. § 54:10A-41). The law called for the creation of a nine-member bipartisan commission consisting of New Jersey residents having expertise in corporate taxation, including members of the academic community, the tax bar, the large business community, the small business community and the accounting industry. *Id.*

5--KAK.indd 384 8/8/07 12:12:58 PM

can avoid paying their fair share of taxes by employing tax minimization and tax avoidance strategies; (4) whether the Business Tax Reform Act will yield recurring revenue goals; (5) whether New Jersey should switch to combined reporting; and (6) whether the AMA should be terminated.[293]

1. *Fair and Equitable Distribution of the CBT*

The Commission combined the first two questions into one analysis.[294] The Commission concluded that the Business Tax Reform Act produced higher than anticipated revenue increases, but based on available data, the Commission was unable to determine with any precision how the tax burden was distributed.[295] Noting that some features of the Business Tax Reform Act did increase the fairness and equity of the CBT, the Commission recommended some changes to address perceived unfairness of certain other elements.[296]

The Commission recommended revising the add back rule to lower the burden of proof for taxpayers that attempt to demonstrate that disallowance of the deduction would be unreasonable.[297] A further recommendation was to provide statutory or regulatory clarification that explicitly deems it unreasonable to disallow the deduction for a transaction that has economic substance, is made on arms-length terms, and has a valid non-tax purpose.[298] This recommendation echoes the "sham transaction" doctrine, discussed above.[299] The statute remains as it was enacted in the Business Tax Reform Act.[300] The regulations currently provide that the add back rule shall not apply if the taxpayer establishes that: (1) the related member to whom the payments were made "directly or indirectly paid, received, accrued or incurred the portion to or from a person that is not a related member" and (2) the transaction did not have tax avoidance as its principal purpose.[301]

To increase the fairness of the CBT, the Commission also recommended repealing the throwout rule, noting that it presents a risk of overstating income derived from activities in the state.[302] This distortive effect is a risk that is inherent in any instance of formulary apportionment, and while the throwout rule does push the boundaries, its mechanics do appear to fall within the framework set forth by the Supreme Court.[303] The throwout rule remains in effect.[304]

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[293]New Jersey Corporation Business Tax Study Commission, Final Report (June 29, 2004) [hereinafter N.J. Final Report].

[294]*Id.* at 4.

[295]*Id.*

[296]*Id.* Some of the Commission's recommendations fall beyond the scope of this Article, including those relating to the suspension of the net operating loss deduction, treatment of nonoperational income and taxation of partnerships. *See generally id.* at 4-12.

[297]*Id.* at 7.

[298]*Id.* at 7.

[299]*See supra* Part II.B.1.

[300]N.J. Stat. Ann. § 54:10A-4.4.

[301]N.J. Admin. Code § 18:7-5.18(b) (2006).

[302]N.J. Final Report, *supra* note 293, at 9.

[303]*See supra* Part III.D (discussing the throwout rule).

[304]*See* N.J. Stat. Ann. § 54:10A-6.

5--KAK.indd 385 8/8/07 12:12:58 PM

2. *Future Tax Avoidance by Profitable Corporations*

Addressing the third question presented above, the Commission stated that insufficient data was available to reach a definitive conclusion about the continued ability of profitable corporations to take advantage of tax avoidance strategies.[305] The Commission noted that the Business Tax Reform Act curbed many abusive tax avoidance strategies and went on to note that the state has sufficient statutory authority to address any remaining tax avoidance strategies.[306]

3. *Realization of Revenue Goals*

Turning to whether the Business Tax Reform Act yielded recurring revenue goals, the Commission stated that, "the revenue raising provisions of the BTRA exceed all expectations and contributed substantially to the State's fiscal condition."[307] In its first year, the Commission attributed $1.415 billion of additional collections to the Business Tax Reform Act, which was $462 million more than the projected $953 million that was expected when the legislation was passed.[308] The Commission expected the impact of the reforms to continue exceeding expectations in future years.[309]

The state sustained growth in CBT revenues. In fiscal year 2002, the year before the Business Tax Reform Act was passed, CBT collections were $1.17 billion, or 6.5% of New Jersey's tax revenues.[310] In 2003, the totals jumped to approximately $2.53 billion, or 12.9% of revenues, and they leveled off in 2004 to $2.37 billion, or 11.3%.[311] Of course, these figures were impacted to some extent by outside factors such as changing economic conditions, but considering the CBT's past performance[312] and the Commission's analysis, it is clear that the Business Tax Reform Act had a very positive effect on the state's coffers.

Unfortunately, this success was not enough to forestall yet another fiscal crisis in June of 2006.[313] It is clear that New Jersey has more fundamental fiscal problems than can be fixed by a mere overhaul of its corporate tax system. It is now apparent that the state is struggling with a "structural deficit" brought about by eroding revenues and ever escalating costs of pensions, healthcare, and education.[314] The 2006 budget crisis forced, for the first time in New Jersey history, a temporary

[305]N.J. Final Report, *supra* note 293, at 12.

[306]*Id.*

[307]*Id.* at 16.

[308]*Id.* at Appendix F. Data available to the Commission indicated that certain portions of the legislation performed better than expected, while some fell short of expectations, but all of the changes analyzed did contribute additional revenues. *Id*. For example, the intangible expense disallowance yielded $73 million versus $30 million projected, and the interest expense disallowance yielded $67 million versus $25 million projected. *Id.* The Alternative Minimum Assessment yielded $213 million versus $240 million projected, and the throwout rule yielded $31 million versus $50 million projected. *Id.*

[309]*Id.* at 16.

[310]Division of Taxation, 2004 Annual Report, at 17 (2005).

[311]*Id.*

[312]*See supra* notes 210-15 and accompanying text (highlighting CBT stagnation over the years).

[313]*See* Frank Shafroth, *New Jersey's Tax Changes*, 41 State Tax Notes (TA) 327 (July 31, 2006).

[314]*Id.*

5--KAK.indd 386 8/8/07 12:12:58 PM

shutdown in state services.[315] Courts, casinos (which are regulated by the state), beaches, and parks were forced to close.[316] The crisis was ultimately resolved by a litany of new tax increases, mostly involving reforms to New Jersey's sales and use taxes.[317]

The 2006 crisis would most likely have been much worse had New Jersey not enacted its 2002 reforms. While New Jersey will no doubt continue to struggle with its structural deficit, the 2002 reforms clearly have helped the state to at least generate more revenue from its corporate taxpayers.

4. *Combined Reporting*

The Commission considered the question of whether the state and its taxpayers would be better served by a mandatory combined reporting system and concluded that further study and debate would be necessary to answer this question.[318] The Commission attached a five—page appendix to its report, listing the major issues that needed further study and discussion.[319] This list included topics such as treatment of nonbusiness income, treatment of intercompany transactions, treatment of dividends between unitary group members, dealing with taxpayers on different fiscal years, treatment of holding companies, whether to use worldwide or water's edge reporting, and several other mechanical questions.[320]

The Commission noted that some commentators would implement a combined reporting system, were they starting from scratch.[321] However, the Commission also expressed concern over the potential that combined reporting would be perceived as unfriendly to business, the potential education and training costs, and the potential for litigation over which entities constitute the unitary group.[322]

Finally, the Commission noted uncertainty over the impact that combined reporting would have on revenues.[323] This type of concern was a recurring theme, as at least one of the explanations for why combined reporting was not enacted by New Jersey in 2002 was a fear that the state might end up losing money.[324] The state had

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[315]*Id.*

[316]*Id.* This caused the state to lose nearly $15 million in revenue from casino tax revenue and lottery income. *Id.*

[317]*See* Michael A. Guariglia et al., *New Jersey Enacts Multiple Tax Increases*, 41 State Tax Notes 267 (July 24, 2006) (summarizing the key tax law changes).

[318]N.J. Final Report, *supra* note 293, at 17.

[319]*Id.* at Appendix G.

[320]*Id.*

[321]*Id.* at 18.

[322]*Id.; see infra* Part IV.A (noting how these concerns figured in the debate over combined reporting in Vermont).

[323]*See* N.J. Final Report, *supra* note 293, at 18.

[324]*State of New Jersey Department of the Treasury Corporation Business Tax Study Commission Public Hearing* (May 29, 2003) (testimony of Mary Forsberg, Senior Policy Analyst, New Jersey Policy Perspective)("I was told that the administration considered combined reporting and backed off because they thought they might lose money"). This seems odd because if corporations were siphoning income away from New Jersey via holding companies, combined reporting would *increase* revenues. As noted at Part II.B.4.a and Part IV.A.1, combined reporting may cause some businesses to pay more tax and other businesses to pay less tax than under a separate reporting system. The overall impact on state revenues may thus be difficult to gauge. *See infra* note 364 (discussing Vermont's

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considered offering corporations the option of basing their state tax returns on their consolidated federal tax filings, but this proposal fell by the wayside as well.[325]

The Business Tax Reform Act granted the Director of the Division of Taxation the power to force consolidated reporting in cases where abuses are suspected.[326] The Commission recommended that the Director exercise this power sparingly, as it runs counter to the general requirement of separate reporting.[327]

5. *Alternative Minimum Assessment*

The Business Tax Reform Act provided that the AMA could be terminated on the Commission's recommendation.[328] The final section of the Commission's report focused on this provision.

The Commission noted that the AMA would stabilize tax revenues from year to year because liability is based on gross receipts or profits, and not on net income.[329] However, the Commission questioned whether gross receipts or gross profits provide the best measure for calculating an alternative tax, as these numbers may not necessarily be commensurate with the taxpayer's ability to pay.[330]

The Commission also suggested that the AMA "may provide a backstop to other 'loophole closing' measures," but noted that insufficient data existed to determine whether such a backstop would be necessary.[331] Overall, only 3.27% of corporate taxpayers were subject to the AMA in its first year, but 21% of corporations with New Jersey gross receipts above $2,000,000 were subjected to the alternative tax.[332] The Commission expressed concern that these corporations may become systemic payers of an alternate tax, but noted that insufficient data existed to corroborate those fears.[333]

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difficulty in estimating the revenue impact of enacting combined reporting). Given the uncertainty, New Jersey presumably looked for alternative ways to raise the revenue necessary to close its budget gap (for example, the AMA, add back statutes, the throwout rule).

When Vermont was considering adopting mandatory combined reporting in 2004, two witnesses before the House Committee on Ways and Means presented different reasons for New Jersey's failure to enact combined reporting. According to Professor Richard Pomp, the issue was lack of time. *March 25, 2004 Hearing, supra* note 96 (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040117). Representatives from New Jersey had asked Pomp to draft a combined reporting bill—but they only gave him a week to get it done. *Id.* Obviously, this was not enough time for an outside advisor to draft a viable bill. *Id.* In contrast, Joe Crosby of the Council on State Taxation testified that New Jersey failed to adopt combined reporting not because of a lack of time, but because it simply would not have raised enough revenue to close the state's budget gap. *Id.* (testimony of Joe Crosby, Legislative Director, Council on State Taxation) (CD No. 040120). Thus, there appears to be no consensus as to why New Jersey did not enact a mandatory combined reporting bill. *See infra* note 359.

[325]Forsberg, *supra* note 219, at 22.

[326]Business Tax Reform Act, N.J. P.L. 2002, ch. 40, § 10 (July 2, 2002) (codified at N.J. Stat. Ann. § 54:10A-10).

[327]N.J. Final Report, *supra* note 293, at 14-15.

[328]Business Tax Reform Act, N.J. P.L. 2002, ch 40, § 31 (July 2, 2002) (codified at N.J. Stat. Ann. § 54:10A-41).

[329]N.J. Final Report, *supra* note 293, at 19.

[330]*Id.* at 20.

[331]*Id.*

[332]*Id.* at 19.

[333]*Id.* at 22.

5--KAK.indd 388 8/8/07 12:12:59 PM

Further, the Commission found some unfairness in the mechanics of the AMA. For example, it found the AMA's cliffs in the tax rate schedule to be unfair, and recommended structuring the assessment as a progressive tax.[334] The Commission noted unfairness insofar as service companies cannot take a deduction for cost of goods sold, while sellers of tangible goods can, and suggested making this deduction available for all taxpayers subject to the AMA.[335] The Commission also raised but did not answer questions as to the constitutionality of the AMA's partial sunset.[336]

In the end, the Commission did not recommend terminating the AMA because of the potential budget impact that early termination would have.[337] However, it did recommend against any extension of the AMA and for a sunset of the assessment for all taxpayers, including those shielded by Public Law 86-272.[338]

The Commission's recommendations did not find their way into the statute or the regulations.[339] As the Commission noted, some of the mechanics of New Jersey's AMA should have been restructured to promote greater fairness. However, the concept of utilizing an alternate tax based on gross profits or gross receipts remains an option for states that are looking to increase revenues by escaping the restrictions of Public Law 86-272.

F. *Summary*

When facing a state budget crisis, Governor McGreevey responded with political courage to overhaul a grossly inefficient corporate tax system by aggressively taxing income derived from interstate commerce. The Business Tax Reform Act placed New Jersey at the cutting edge of the state and local tax practice, and the reforms encapsulate many of the major issues being debated in the field today. The changes were deep and controversial, but the state has done a fine job of pushing the frontiers of its taxing power without stepping beyond its authority. New Jersey's reforms were rather complex, but this was necessary in order to get a viable package passed. Vermont, on the other hand, took a more direct approach to corporate reform, to which we now turn.

IV. THE VERMONT TAX REFORM OF 2004

"Vermont was a puddle of insignificance in the dynamic American scene. It was an anachronism, a place to talk about if you wanted to say how life used to be, not where it was going."[340]

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[334]N.J. Final Report, *supra* note 293, at 20. For an explanation of the mechanics of the tax, see *supra* notes 225-29 and accompanying text.

[335]N.J. Final Report, *supra* note 293, at 20.

[336]*Id.* at 22; *see also supra* note 231.

[337]N.J. Final Report, *supra* note 293, at 22.

[338]*Id.*

[339]*See* N.J. Stat. Ann. § 54:10A-5a (West 2002 & Supp. 2006); N.J. Admin. Code §§ 18.7-18.1 (2006).

[340]Joe Sherman, Fast Lane on a Dirt Road: A Contemporary History of Vermont 37-38 (Chelsea Green Publishing Company 2000).

5--KAK.indd 389 8/8/07 12:12:59 PM

Vermont, it seems, is either one of the first states to do something or one of the last states to do something. Vermont was the first state to officially abolish slavery[341] and the first state to allow civil unions for homosexual couples;[342] but was the last state to implement a statewide 911 service[343] and was the last state to allow a Wal-Mart to open within its borders.[344] In 2004, Vermont became the first state in over 20 years to adopt mandatory combined reporting.[345] This event has been called "the most significant development in state corporate tax of the past decade."[346] Given the strong opposition traditionally marshaled against combined reporting proposals, it is a near miracle that Vermont was able to enact a combined reporting law.[347] Whether Vermont will turn out to be the first of many states to mandate combined reporting remains to be seen.[348] Unlike New Jersey, Vermont approached its tax overhaul from a pure "reform" standpoint and was not necessarily in desperate need of additional revenue. Part IV.A discusses the genesis of Vermont's combined reporting law, focusing on the available legislative history, in an attempt to determine how Vermont was able to successfully enact mandatory combined reporting. Part IV.B then discusses the combined reporting rules that were ultimately enacted by Vermont. Throughout this Part IV, the focus is on the process behind the reform, rather than the mechanics of the law that was ultimately enacted. This is because it is the process that might be most useful for other states to study and emulate.[349]

A. *The Story Behind the Adoption of Mandatory Combined Reporting in Vermont*

Unlike New Jersey, Vermont's reform efforts were not forged in the kiln of a fiscal crisis. Rather, Vermont's 2004 corporate reforms were developed in response to the governor's request to overhaul the Green Mountain State's entire tax structure. In fact, the reform effort was sold as a tax *decrease* for Vermont citizens and local businesses.

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[341]Abolition of Slavery in Vermont, http://www.anti-slaverysociety.addr.com/hus-vermont.htm (last visited Aug. 6. 2006).

[342]Ellen Goodman, *Vermonters are Caught Up in a Civil War Over Civil Unions*, Boston Globe, Nov. 2, 2000, at A27.

[343]Vermont Dials 911 Nat'l Public Radio (Dec. 14, 1998), *available at* http://www.npr.org/templates/story/story.php?storyId=1023782.

[344]John Larrabee, *Wal-Mart Ends Vermont's Holdout*, USA Today, Sept. 19, 1995, at 4B.

[345]Dagostino, *supra* note 4.

[346]Karen Setze, *Vermont General Assembly Approves Unitary Combined Reporting*, State Tax Notes (TA) (May 25, 2004) (quoting Richard Pomp, Alva P. Loiselle Professor of Law at the University of Connecticut).

[347]*See supra* Part II.B.4.c and *infra* Part IV.A.3 (discussing business opposition to combined reporting).

[348]Dagostino, *supra* note 4 (indicating the "jury's still out" and that several other states had considered combined reporting in recent years but had failed in their efforts). See *infra* note 521 for a summary of legislative activity on the combined reporting front.

[349]Compare New Jersey's reforms explained in *supra* Part III. Other states that lack Vermont's political will can be informed by the mechanics of New Jersey's reforms rather than the process by which they were enacted.

In his 2004 State-of-the-State Message, Governor James Douglas set forth an ambitious set of tax reform measures designed to make Vermont's taxing regime "more fair and equitable for all."[350] The governor's proposals were based on substantial input from the Vermont Department of Taxes.[351] Included in these measures was a proposal to reduce the corporate income tax rate beginning in 2006 such that Vermont's corporate rate would drop from "5th highest to 16th in the nation."[352] This corporate rate reduction would be financed by "closing loopholes in our tax code that allow some multi-state corporations to redirect profits to other states to avoid declaring them in Vermont."[353] This is obviously a reference to the adoption of combined filing to combat techniques such as the use of holding companies.[354] The governor noted that many "huge [multistate] companies pay only a minimum $250 tax while our homegrown Vermont businesses—particularly our small businesses—pick up the rest of the tab."[355] Thus, from the beginning, the corporate tax reform plan was cast as a tax decrease for small, local companies paid for by a tax increase on large, multistate companies that were heretofore not paying their fair share. The governor used good politics (help out the local Vermonter-owned businesses while getting the big out-of-state corporations to pay more) to advance what was, at bottom, good policy (the fairness and equity that comes from mandatory combined reporting).[356]

The governor's plan was reported favorably in the local press:

> This is one of those plans that sounds like a winner all the way around: Stick it to big, bad companies that have been cheating Vermont's other taxpayers, give Vermont-based companies an average 14 percent reduction in their tax bills, and drop the state's top corporate tax rates, currently the fifth highest in the nation.[357]

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[350]James Douglas, Governor of Vermont, State-of-the-State Message (Jan. 6, 2004), *available at* http://www.leg.state.vt.us/docs/legdoc.cfm?URL=/docs/2004/journal/ja040106.htm [hereinafter State-of-the-State]. The governor had asked the Vermont Department of Taxes to review Vermont's entire tax structure. *Id.*

[351]*See id.* The Vermont Department of Taxes played a key role in selling mandatory combined reporting to both the governor and the legislature. *See infra* Part IV.A.1 (discussing the Vermont Department of Taxes' involvement as an advisor to the Vermont House Committee on Ways and Means).

[352]State-of-the-State, *supra* note 350. The governor's reform proposals also included lowering the statewide property tax, eliminating the capital gains preference in the personal income tax, and across the board rate cuts in the personal income tax. *Id*. Since these proposals are not relevant to this Article, they will not be discussed further.

[353]*Id.*

[354]*See supra* Part II.B.

[355]State-of-the-State, *supra* note 350.

[356]As noted at *supra* Part II.B.4, the claims made by the governor are somewhat dubious. It is an empirical question as to whether a company's taxes will go up or down as a result of combined reporting. See *infra* Part IV.A.1 for an example. Further, it would be unconstitutional (in violation of the Commerce Clause) to explicitly discriminate in favor of in-state companies. *See, e.g.*, Fulton Corp. v. Faulkner, 516 U.S. 325, 331 (1996). The governor's plan does not, in reality, discriminate in favor of in-state companies, but his sales pitch seems to imply that this is in fact what is happening.

[357]Darren Allen, *Vermont Commentary: Closing Corporate Tax Loophole Takes Careful Mending*, Rutland Herald, Jan. 24, 2004.

5--KAK.indd 391 8/8/07 12:13:00 PM

The press reports were skeptical, however, of whether the governor's proposal would actually work—given the sophistication of tax planners—and therefore urged lawmakers "to make sure they don't merely change the method by which out-of-state companies can avoid Vermont taxes."[358]

The legislature went to work on crafting a combined reporting law in early 2004, based on the governor's proposals. The following is a summary of the relevant discussion that took place in legislative committee meetings leading up to the adoption of the combined reporting law. Several meetings were held by the Vermont House Committee on Ways and Means (the "Committee") regarding the proposed combined reporting law. Excerpts of the committee meetings discussing the combined reporting proposal were taken from recorded sessions provided on compact disc by the Vermont Legislative Council.[359]

1. *Briefing by the Vermont Department of Taxes*

The Vermont Department of Taxes (the "Department") provided the Committee with a comprehensive overview of combined reporting and the tax planning

[358] *Id.*

[359] In Vermont, like in many states, detailed legislative history is often not available. In July of 2005, we contacted the Vermont Legislative Council ("VLC"), the office that maintains all committee hearing records of the Vermont legislature, and requested any available legislative history on H.0784, the governor's proposed tax legislation, which included the combined reporting bill that was ultimately enacted in 2004.

According to the VLC, no transcripts are made of regular legislative committee meetings. However, such meetings have, in recent years, been recorded on compact discs ("CDs"). The VLC sent us a list of 58 CDs which contained recordings of House Committee on Ways and Means hearings and Senate Finance Committee hearings in which H.0784 was discussed. The CD list contained information on topics and speakers for each meeting and each CD. It was clear from the CD list that meetings often involved multiple topics—tax and non-tax, corporate tax and non-corporate tax, etc. In order to focus on the relevant material, we used the information on the CD list to identify the specific meetings (and CDs) in which the corporate tax portion of H.0784 appeared to be a key topic at the meeting (rather than just one component of a general discussion on tax reform or budgetary matters).

Based on this admittedly unscientific review, we identified 17 CDs in which the House Committee on Ways and Means or the Senate Finance Committee appeared to focus their discussion on H.0784. We then purchased copies of these 17 CDs from the VLC and listened to them in the hopes of understanding the process by which Vermont was able to enact its combined reporting statute. Upon review, 10 of the CDs provided by the VLC turned out to have information relevant to the combined reporting proposal. All of the relevant hearings were before the House Committee on Ways and Means. The results of our review are explained in the paragraphs in the text which follow.

Each time we cite these committee hearings, we have included the relevant CD numbers (as assigned by the VLC) on which the meetings were recorded in parenthesis after each cite. These CDs are available from the Vermont Legislative Council and are maintained on file by the authors. Where a witness at a hearing published his statement on the internet, we accessed the relevant statement and have cited that as well. Note that in the interest of time and cost we have only reviewed the 17 CDs obtained from the VLC. Also, some of those CDs (despite the best efforts of the VLC) were not always of the best audio quality, and speakers on the CDs were not always clearly identified. Where possible, we have identified the specific speaker in the cite. In many cases, however, the speaker is not clearly identified and only her affiliation is known (based on the VLC list). In addition, we could not identify the specific members of the committee making comments on the CDs. In such cases, we have only cited the department or association whose representatives are speaking or have indicated that a comment was made by a committee member. While it is possible we may have missed something in limiting our review of the legislative history to the 17 CDs provided by the VLC, we are reasonably confident that we have accessed the available information on H.0784 that is relevant to our discussion in this Article.

techniques that it prevents. Specifically, the Department provided the Committee members with a copy of a Massachusetts report on how combined reporting works and the sort of revenue that it might be expected to generate.[360] The Department also referenced a Multistate Tax Commission ("MTC") report estimating the lost revenue from the use of holding companies and related tax shelter activity.[361] This report estimated the annual aggregate state revenue loss from tax shelters to be in the range of $8.32 billion to $12.38 billion for fiscal 2001.[362] Revenue loss in Vermont from domestic tax shelters was estimated to be between $7 million and $14 million for fiscal 2001.[363] This made it clear to the Committee the numbers that would potentially be at stake. The Department estimated that the additional revenue generated from enacting mandatory combined reporting would be sufficient (even using conservative estimates) to offset the revenue loss from enacting a one percent across the board cut in Vermont's corporate income tax rates.[364]

Overall, combined reporting should increase tax revenues. However, some companies will pay more Vermont tax while other companies will pay less Vermont tax under combined reporting.[365] For example, assume an enterprise has one unitary

[360]*Hearing on H.0784 Before the Vt. House Comm. on Ways and Means*, 2003-2004 Leg. Sess. (Jan. 13, 2004) [hereinafter *Jan. 13, 2004 Hearing*] (testimony of Susan Mesner, Vt. Dep't of Taxes) (CD No. 040012). The report referenced in the testimony appears to be Massachusetts Budget and Policy Center, Combined Reporting: A Comprehensive Method of Closing Corporate Tax Loopholes (Mar. 27, 2003), *available at* http://www.massbudget.org/combined_reporting.pdf.

[361]*Jan. 13, 2004 Hearing*, *supra* note 360 (testimony of Susan Mesner, Vt. Dep't of Taxes) (CD No. 040012). The Multistate Tax Commission report referenced in the testimony appears to be Multistate Tax Commission, Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collection [hereinafter MTC Shelter] (Jul. 15, 2003), *available at* http://66.28.69.53/TaxShelterRpt.pdf.

[362]MTC Shelter, *supra* note 361, at 2.

[363]*Id.* at 3. The report also estimates that Vermont lost $8 million in revenue in fiscal 2001 from *international* tax shelters. *Id.* The Vermont Department of Taxes decided not to pursue these international tax shelters (it did not propose using worldwide combined reporting) for the reasons stated in *infra* notes 388 through 394 and accompanying text.

[364]*Jan. 13, 2004 Hearing*, *supra* note 360 (testimony of Vt. Dep't of Taxes) (CD No. 040012). The Department did caution the Committee that it did not have a reliable, sophisticated process by which it could estimate the revenue impact of enacting combined reporting. *Id.* (testimony of Vt. Dep't of Taxes and the Vt. Legis. Council) (CD No. 040013); *Hearing on H.0784 Before the Vt. House Comm. on Ways and Means*, 2003-2004 Leg. Sess. (Jan. 30, 2004) [hereinafter *Jan. 30, 2004 Hearing*] (testimony of Vt. Dep't of Taxes) (CD No. 040038). First, corporate tax revenues are volatile and are difficult to estimate even ignoring the impact of combined reporting. *Id.* Second, the only way to estimate the overall revenue impact of a combined reporting statute is to look at current filers who also file in a neighboring state that has already enacted combined reporting. *Id.* For example, when Wisconsin was considering combined reporting, it looked at Wisconsin filers who also filed in neighboring Minnesota (a combined reporting state) to gauge the impact. *Id.* The Department stated that, similarly, it was considering looking at selected Vermont corporate taxpayers who also file in neighboring New Hampshire (a combined reporting state) to get a better handle on the impact. *Id.* At this point in the process, however, the Department's estimates were based on studies used by other states. *Id.* The Department stated that it was being conservative in its estimates to ensure the revenue raised from combined reporting would be sufficient to offset the proposed corporate rate reduction. *Id.*

[365]*Jan. 13, 2004 Hearing*, *supra* note 360 (testimony of Vt. Dep't of Taxes) (CD No. 040013). This is true even ignoring the proposed across the board rate cut.

5--KAK.indd 393 8/8/07 12:13:00 PM

business that is operated through two affiliated corporations: Corporation A and Corporation B. Corporation A has nexus in Vermont and 100% of its income is apportioned to Vermont (the corporation only conducts business in Vermont).[366] Corporation B does not have nexus in Vermont and has no Vermont apportionment factors. Corporations A and B are both the same size (same total property, payroll, and sales), and thus, when combined, 50% of their income is apportioned to Vermont and 50% is apportioned elsewhere. For simplicity, assume the Vermont corporate tax rate is eight percent and that such rate remains the same after the enactment of combined reporting.[367] The impact of the enactment of combined reporting on these corporations would be as follows:

	Income	**Vermont Tax Under Separate Reporting**	**Vermont Tax Under Combined Reporting**
Corporation A (100% Vermont apportionment factors)	(10,000)	$250 Minimum Tax ($10,000 loss x 100% apportionment factor = 10,000 loss x 8% rate = 0 tax—so pay $250 minimum tax)	N/A—Calculated on a combined basis
Corporation B (0% Vermont apportionment factors)	20,000	$0 (No nexus in Vermont)	N/A—Calculated on a combined basis
Total	10,000	**$250**	**$400** (Combined net income of $10,000 x 50% apportionment factor = $5000 income x 8% rate = $400)

Thus, if the in-state corporation (Corporation A) has a loss, but out-of-state affiliated corporations in the same unitary business (such as Corporation B) have

[366]This example was not discussed in the committee hearings. It was made up by the authors to clarify the points that were being discussed in the committee hearings.

[367]This example is for illustrative purposes only. The actual combined reporting proposal calls for tax rates to go down by one percent after the enactment of combined reporting.

income, chances are the overall enterprise's Vermont tax liability will increase under combined reporting.[368]

If we reverse the facts and assume the in-state corporation has income and the out-of-state corporation has a loss, the overall enterprise's tax liability will decrease under combined reporting:

	Income	**Vermont Tax Under Separate Reporting**	**Vermont Tax Under Combined Reporting**
Corporation A (100% Vermont apportionment factors)	20,000	$1600 Tax ($20,000 income x 100% apportionment factor = $20,000 income x 8% rate = $1600 tax)	N/A—Calculated on a combined basis
Corporation B (0% Vermont apportionment factors)	(10,000)	$0 (No nexus in Vermont)	N/A—Calculated on a combined basis
Total	10,000	**$1600**	**$400** (Combined net income of $10,000 x 50% apportionment factor = $5000 income x 8% rate = $400)

Thus, if the in-state corporation (Corporation A) has income, but out-of-state affiliated corporations in the same unitary business (such as Corporation B) have losses, chances are the overall enterprise's Vermont tax liability will decrease under combined reporting.[369]

The Department also referenced certain tax planning websites that market the holding company tax saving vehicle to make it clear to the Committee how easily

[368]Of course, the increase is somewhat mitigated by the fact that state income taxes are deductible for federal income tax purposes. *See* I.R.C. § 164(a)(3).

[369]Although not discussed in the committee hearings, this reduction was in fact already available to savvy taxpayers under Vermont's separate reporting tax system. In our example, if Corporation A showed profits and Corporation B showed a loss, the overall enterprise could reduce its tax liability in Vermont by obtaining nexus for Corporation B in Vermont. Corporations A and B could then file a consolidated return in Vermont—with Corporation A's income offset by Corporation's B's loss. *See* VT. STAT. ANN. tit. 32, § 5832(c) (2006) (allowing for affiliated groups of corporations taxable in Vermont

5--KAK.indd 395 8/8/07 12:13:00 PM

such devices may be used by multistate corporations.[370]

The Department also prepared the Committee for arguments that business groups would likely make in opposition to mandatory combined reporting. First, the Department addressed potential complaints about the complexity of the combined reporting system.[371] The Department made it clear that large, multistate corporations are most likely doing business in many states and therefore would already be complying with combined filing requirements in other states.[372] In fact, even regional multistate taxpayers would be used to combined filing since they would already be contending with mandatory combined filing rules in Vermont's neighboring state, New Hampshire.[373]

Second, the Department addressed the likely argument that enacting a combined reporting statute would drive businesses out of Vermont.[374] The Department stated that Vermont taxes are likely a relatively small cost to multistate businesses and corporate taxes are unlikely to be *the* deciding factor when a business is making location decisions.[375] Further, the Department and the Committee discussed a Tax Foundation study which rated state corporate business climates and noted that 13 of the 16 mandatory combined reporting states were ranked higher than Vermont (which was 43rd).[376] This would indicate that merely having a combined reporting law is not necessarily a sign of a poor business tax climate.

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to file a consolidated return in lieu of separate returns). This was particularly useful for companies that had an in-state corporation that was profitable but had substantial debt and related interest expenses on another (out of state) corporation's books (for example, a parent company that had debt associated with the acquisition of the in-state company). Thus, if it was clear that the in-state corporation was normally profitable and an out of state corporation was normally in a loss position, it made sense to get nexus for the out of state loss company and file both companies in a consolidated Vermont return. Nexus, of course, is fairly easy to establish—merely having Corporation B have an employee or property based in Vermont should be sufficient. *See* Vt. Stat. Ann. tit. 32, § 5811(15) (2006) (defining a "taxable corporation" to generally include any corporation which receives "any income allocable or apportionable to this state" under Vermont's apportionment rules).

[370]*Jan. 13, 2004 Hearing*, *supra* note 360 (testimony of Vt. Dep't of Taxes) (CD No. 040012).

[371]*Id.* (testimony of Vt. Dep't of Taxes and the Vt. Legis. Council) (CD No. 040013).

[372]*Id.*

[373]*Id.*

[374]*Id.*

[375]*Id.* There was some discussion, however, about the potential impact on IBM, a major employer in Vermont. *Id.* The Committee and the Department ultimately determined that the corporate rate reduction would somewhat mitigate the impact on IBM. *Id.*

[376]*Id.* (testimony of Vt. Dep't of Taxes and the Vt. Legis. Council) (CD No. 040013). The report referenced in the Committee discussion was Scott A. Hodge et al., Tax Foundation Background Paper: State Business Tax Climate Index 6-7 (May 2003), *available at* http://www.taxfoundation.org/files/bp41.pdf. The combined reporting states ranking higher than Vermont were Arizona (17th), California (28th), Colorado (5th), Hawaii (42nd), Idaho (23rd), Illinois (20th), Maine (36th), Minnesota (33rd), Montana (16th), New Hampshire (37th), North Dakota (17th), Oregon (15th), and Utah (5th). *Id.* at 6. The mandatory combined reporting states that ranked below Vermont were Alaska (50th), Kansas (44th), and Nebraska (45th). *Id.* A more recent version of the report is Curtis S. Dubay & Scott A. Hodge, Tax Foundation Background Paper: State Business Tax Climate Index 12 (Feb. 2006), *available at* http://www.taxfoundation.org/files/bp51.pdf. The 2006 report shows that Vermont is still 43rd overall on the Tax Foundation's corporate tax index. *Id.* Of course, neither combined reporting nor the rate reduction became effective until 2006 and thus it is unclear whether this played any role in the Tax Foundation's rankings.

5--KAK.indd 396 8/8/07 12:13:01 PM

The Committee was concerned that only a minority of states used combined reporting.[377] The Committee was specifically concerned that Massachusetts had recently considered—and rejected—mandatory combined reporting.[378] The Department distinguished the situation in Massachusetts from the situation in Vermont.[379] Massachusetts was interested in raising revenue by adopting combined reporting and was not planning to reduce corporate tax rates in return.[380] This made Massachusetts's plan look like a "revenue grab" and thus was a tough sell from a political standpoint.[381] In contrast, Vermont's proposal was clearly not a revenue grab—the savings from combined reporting would be returned to corporate taxpayers through an across the board rate reduction.[382] Further, the Department noted that the Vermont governor was clearly supporting combined reporting, but the Massachusetts governor was not firmly behind the combined reporting proposal debated in the Massachusetts legislature.[383]

The Department explained to the Committee that, under the governor's tax proposal (introduced in early 2004), both mandatory combined reporting and the corporate tax rate cut would not be effective until 2006 (thus not affecting returns filed until 2007).[384] This was to give the Department time to develop a set of systematic and rational administrative rules for the new system.[385] It would also allow the Department time to study how the proposals would impact businesses and perhaps give them time to develop transition rules to ease the blow on adversely affected taxpayers.[386] This approach and attitude showed that the Department was

[377]*Jan. 13, 2004 Hearing*, *supra* note 360 (testimony of Vt. Dep't of Taxes and the Vt. Legis. Council) (CD No. 040013).

[378]*Id.*

[379]*Id.*

[380]*Id.*

[381]*Id.*

[382]*Id.*

[383]*Id.*

[384]*Jan. 30, 2004 Hearing*, *supra* note 364 (testimony of Vt. Dep't of Taxes) (CD No. 040038).

[385]*Id.* Details to be worked out in administrative guidance included how to handle corporations in the unitary group that had different fiscal years, how to handle net operating losses, etc. *Id.* (testimony of Vt. Dep't of Taxes) (CD No. 040039). The Department felt it would be "dangerous" to simply copy New Hampshire's administrative rules on combined reporting without considering the "other 15 flavors" available. *Id.* The Department noted that combined reporting states such as Maine often look to California's combined reporting rules for guidance but that Vermont would likely not need to get into as much detail as California, given its size and the make-up of its corporate taxpayers. *Id.* The Department took the stance that the Committee should not get "bogged down" in the details but rather should focus on the big picture. *Id.* The Department believed that it had the authority to issue regulations via its generic regulatory authority under Vermont law. *Id.*; *see* Vt. Reg. §§ 1.5862(d)(1)-(14) (2006) (containing the rules ultimately promulgated by the Department).

[386]*Jan. 30, 2004 Hearing*, *supra* note 364 (testimony of Vt. Dep't of Taxes) (CD No. 040038). No specific transition proposals were included in the proposed tax bill. *See id.* The Department indicated some mitigation provisions it might consider, including double-weighting the sales factor and perhaps offering some sales tax relief to certain companies. *Id.* None of this was discussed in detail—any potential "soft-landing" provisions were merely at the brainstorming stage. *See id.* Ultimately, however, double-weighting was enacted as part of the overall tax bill. *See infra* note 485 and accompanying text.

5--KAK.indd 397 8/8/07 12:13:01 PM

not rushing into combined reporting but rather had soberly considered the proposals and was willing to give itself and taxpayers time to adjust to the new rules.[387]

The Department explained that the combined reporting proposal took a water's edge approach.[388] This would avoid the problems that come with mandatory worldwide combined reporting.[389] The proposal did not allow for an election for worldwide combined reporting; all taxpayers would therefore be subject a water's edge rule.[390] The Department gave two reasons for not allowing a worldwide combined reporting election in the proposal.[391] First, there was fear of revenue losses from allowing the election—since only companies that would benefit from the election would make the election.[392] Second, the Department wanted to keep the new tax system as simple as possible.[393] Allowing an election for worldwide combined reporting would require two sets of rules: one for electing companies and one for non-electing companies.[394]

The Department made it clear to the Committee that the combined reporting proposal was true tax reform and not a way to milk corporate taxpayers for more revenue.[395] In fact, the Department framed the proposal as classic tax reform: "broaden the base, lower the rate."[396] The base, of course, is broadened by adopting combined reporting—thus capturing income that has been siphoned off to holding companies—and the rate is reduced via the one percent across the board corporate tax cut.[397] Throughout, the Department was sure to impress on the Committee that combined returns were fairer and helped spread the tax burden more equitably between intrastate and interstate businesses.[398] In essence, the Department dem-

[387]This was a luxury that New Jersey did not have, as New Jersey needed to make corporate tax changes in order to deal with a serious fiscal crisis. *See generally supra* Part III.

[388]*Jan. 30, 2004 Hearing*, *supra* note 364 (testimony of Vt. Dep't of Taxes) (CD No. 040039).

[389]*See id.* These problems are described *supra* Part II.B.4.

[390]*Jan. 30, 2004 Hearing*, *supra* note 364 (testimony of Vt. Dep't of Taxes) (CD No. 040039).

[391]*Id.*

[392]*Id.* Recall that the combined reporting law needed to raise sufficient revenue to cover the revenue loss from a one percent across the board corporate tax rate cut and that the Department was using very conservative estimates to make sure that the combined reporting proposal would generate enough revenue. *See id.*

[393]*Id.* One of the major criticisms of combined reporting is its complexity; *see supra* Part II.B.4.c and *infra* Part IV.A.3.

[394]*Jan. 30, 2004 Hearing*, *supra* note 364 (testimony of Vt. Dep't of Taxes) (CD No. 040039).

[395]*See Hearing on H.0784 Before the Vt. House Comm. on Ways and Means*, 2003-2004 Leg. Sess. (Jan. 21, 2004) [hereinafter *Jan. 21, 2004 Hearing*] (testimony of Vt. Dep't of Taxes) (CD No. 040022).

[396]*Id.*

[397]*See id.* For further discussion on how Vermont's adoption of combined reporting meets the definition of "tax reform," see *infra* Part V.B.

[398]*Jan. 21, 2004 Hearing*, *supra* note 395 (testimony of Vt. Dep't of Taxes) (CD No. 040022); *Jan. 13, 2004 Hearing*, *supra* note 360 (testimony of Vt. Dep't of Taxes and the Vt. Legis. Council) (CD No. 040013).

5--KAK.indd 398 8/8/07 12:13:01 PM

onstrated that the State would be seizing the high ground by adopting combined reporting in combination with a rate reduction.[399]

All in all, it is clear from the legislative history that the Vermont Department of Taxes and the Vermont Legislative Council did an excellent job of briefing the Committee on the combined reporting proposal.

2. *Testimony in Favor of Combined Reporting*

In addition to the helpful information provided by the Vermont Department of Taxes and the Vermont Legislative Council, the Committee also heard from outside experts who testified in favor of combined reporting. Perhaps the most influential witness was Professor Richard Pomp, a long-time advocate of combined reporting,[400] who presented articulate arguments in favor of combined reporting, fully

[399]Despite all of the self-congratulatory rhetoric, Vermont did not have unclean hands. First, it had its own version of the holding company. *See supra* note 24; VT. STAT. ANN. tit. 32, § 5837 (repealed effective Jan. 1, 2006). This was shut down by the combined reporting law, although at least one Committee member suggested perhaps keeping the Vermont holding company law even after combined reporting (assuming that the Vermont holding company law created a few jobs in the state). *Jan. 30, 2004 Hearing*, *supra* note 364 (testimony of Vt. Dep't of Taxes) (CD No. 040039). This discussion was quickly dropped, however, when the Department made it clear to the Committee that it could not argue both sides of the issue. *Id.* It would be a hard sell for the state to argue that combined reporting is fairer in that it shuts down holding companies, yet holding companies are acceptable if they are incorporated in Vermont. *Id.*

Another tax planning device that Vermont offers, and retains even after the enactment of combined reporting, is its preferential treatment for captive insurance companies. *See generally* VT. STAT. ANN. tit. 8, §§ 6001-6047 (2006) (Vermont's laws governing captive insurance companies). Captive insurance companies are subsidiaries set up by corporations to, in essence, self-insure other members of the affiliated group. *See* STATE OF VERMONT, CAPTIVE INSURANCE DIVISION, *available at* http://www.bishca.state.vt.us/Captive/about_c*Id.*asp. There are legitimate business reasons for using captive insurance companies, such as the prohibitively high cost of traditional insurance coverage. *See* Michael Kranish, *For Dean, 'Captive' Insurance a Vermont Boon*, BOSTON GLOBE, Dec. 12, 2003, at A1. The insured affiliates pay premiums to the captive just as it would to a third party insurance company. *See id.* Captives can produce state tax benefits. Affiliates in separate reporting states can take a deduction for the premiums against their state taxes, generating a state tax benefit. *See id.* Affiliates in combined reporting states may also be able to take advantage of captive benefits, provided they can successfully keep the captive out of the unitary group. The captive, if organized in a tax haven such as Vermont, will not be subject to income tax on the premiums. *Id.* Rather, it will be subject to a special, lower premium tax. *See id.* Further, any investment income earned by the Vermont captive (investments of premiums) will escape state tax. *Id.* (If properly structured, there may be federal benefits to using captive insurance companies as well. *See id.* This is a complex area and is beyond the scope of this Article).

Vermont is recognized as an important tax haven for captives. *See id.* Vermont has nearly 500 captives which pay $18.5 million annually in premium taxes to the state. *Id.* Further, the captive industry directly or indirectly supports approximately 1000 jobs in Vermont. *Id.* Captives are so important to Vermont that the Committee was afraid that if the holding company provision (see discussion *supra*) were repealed, then perhaps the companies would move their captives out of Vermont as well. *Jan. 30, 2004 Hearing*, *supra* note 364 (testimony of Vt. Dep't of Taxes) (CD No. 040039). Ultimately, the legislature decided to eliminate the holding company provision while retaining the captive insurance rules. VT. STAT. ANN. tit. 32, § 5837 (holding company provision repealed effective Jan. 1, 2006); VT. STAT. ANN. tit. 32, § 5811(22) (2006) (indicating that captive insurance companies—taxable under the premium tax of VT. STAT. ANN. tit. 8, § 6014 are not included in the combined return). Further discussion of captive insurance companies is beyond the scope of this Article. Suffice it to say that Vermont's tax code still offers tax planning devices to corporations via its captive insurance laws.

[400]*See supra* note 113 (partial list of Pomp's writings on this subject).

5--KAK.indd 399 8/8/07 12:13:01 PM

addressed all Committee member questions, and effectively prepared the Committee members for the arguments that the anti-combined reporting advocates would make.[401]

Pomp made many of the same points he has made in the past.[402] The following is a summary of those points that were particularly important in his testimony. First, Pomp assured the Committee that they were doing the right thing by going for combined reporting coupled with a rate reduction.[403] In doing so, they would be improving the business climate in Vermont.[404] A good business climate, as defined by Pomp, is one in which the tax system is even handed, applied to a broad base, and not subject to manipulation.[405]

Second, Pomp implored the Committee to take business cries of oppression with a large grain of salt.[406] He said that "business climate is a last refuge argument" because "it can mean whatever you want it to mean."[407] The reality is that combined reporting, and taxes in general, have very little impact on business decisions and economic growth.[408] Businesses do consider taxes, but they weigh other factors—such as an educated workforce, infrastructure, labor costs—much more in deciding where to locate.[409] These other factors assume an education system and other governmental services—which of course should be provided by revenues derived from a sound, fair tax system.[410]

Pomp explained to the Committee why combined reporting was a much better way to address the holding company issue than an add back statute.[411] Add back statutes must be constantly revised as taxpayers find ways to work around them.[412] Further, if Vermont were to draft an add back statute, companies would come forward and present sympathetic fact patterns that genuinely require exceptions to be made.[413] If Vermont were to adopt these reasonable exceptions, other taxpayers would then take advantage of them.[414] Finally, Pomp noted that many necessary exceptions to add back statutes are invitations to litigation.[415] For example, a

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[401]*March 25, 2004 Hearing*, *supra* note 96 (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD Nos. 040117 and 040118).

[402]*See supra* note 113.

[403]*March 25, 2004 Hearing*, *supra* note 96 (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD Nos. 040117).

[404]*Id.*

[405]*Id.* Compare the way the business community views "business climate." *See infra* Part IV.A.3.

[406]*March 25, 2004 Hearing*, *supra* note 96 (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040117).

[407]*Id.*

[408]*Id.* In particular, Pomp noted that combined reporting can neither be blamed for the economic downturns in California nor credited for boom times in California. *Id.* (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040118). Combined reporting has a neutral impact. *Id.*

[409]*Id.* (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040117).

[410]*Id.*

[411]*Id.*; *see supra* Part II.B.3.b (discussion on the problems with add back statutes).

[412]*March 25, 2004 Hearing*, *supra* note 96 (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040117).

[413]*Id.*

[414]*Id.*

[415]*Id.*

5--KAK.indd 400 8/8/07 12:13:02 PM

statute with an economic substance exception would likely generate lots of costly litigation.[416] All in all, add back statutes may give the Committee some political cover, but they are not as effective as they appear.[417]

Pomp also urged the Committee not to give much credence to complaints of "complexity" by the business community.[418] Unitary concepts are difficult, but there are 16 other states that have mastered the concepts and Vermont can look to their experience for guidance.[419] California, in particular, has been dealing with combined reporting concepts since the Great Depression, when it first established combined reporting to keep the movie industry from siphoning off profits to tax-free Nevada.[420]

Pomp warned the Committee that business opposition to combined reporting would be strong.[421] This is not because businesses fear an increase in their Vermont tax bill, but because they fear that Vermont would be the "vanguard," kicking off a new series of states adopting combined reporting statutes.[422]

Finally, Pomp made it clear to the Committee that the time was ripe to adopt combined reporting.[423] Through the KPMG tax shelter case and more frequent news reports about corporate scandals, the public was aware, more so than ever before, about the tax games played by corporations.[424] As a result, the public was "hungry for reform."[425] This presented a unique opportunity for Vermont to "seize the high ground" via combined reporting and put the opposition "on the defensive."[426]

Pomp's testimony, coupled with information provided by the Department, convinced the Committee that combined reporting was the best way to go and armed the Committee to respond to any opposition that would inevitably arise. It is to that opposition we now turn.

3. *Testimony Against Combined Reporting*

Two witnesses testified against combined reporting, both representing Associated Industries of Vermont ("AIV"), an organization of manufacturers.[427] In addi-

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[416]*Id.*

[417]*Id.*

[418]*Id.*

[419]*Id.*

[420]*Id.*

[421]*Id.* While a reasonable prediction, opposition was in fact rather light. *See infra* Part IV.A.3.

[422]*March 25, 2004 Hearing*, *supra* note 96 (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040117).

[423]*Id.*

[424]*Id.*

[425]*Id.*

[426]*Id.*

[427]*Hearing on H.0784 Before the Vt. Comm. on Ways & Means, 2003-2004 Leg. Sess.* (Mar. 24, 2004) [hereinafter *March 24, 2004 Hearing*] (testimony of William Driscoll, Assoc. Industries of Vt.) (CD No. 040117); *Mar. 25, 2004 Hearing*, *supra* note 96 (testimony of William Sayre, Assoc. Industries of Vt.) (CD No. 040120). Mr. Driscoll's prepared written testimony is available at http://www.aivt.org/ucrtestimony.html (last visited Feb. 1, 2007). The Associated Industries of Vermont website is http://www.aivt.org/.

5--KAK.indd 401 8/8/07 12:13:02 PM

tion, the Council on State Taxation ("COST") testified before the Committee.[428] Although COST takes no official position on combined reporting, most of COST's comments emphasized the possible negative impact of mandatory combined reporting.[429] COST's testimony is therefore analyzed in this part of the Article as well. The following is a summary of the points made by AIV and COST in their testimony.

AIV characterized combined reporting as "out of the mainstream," in that only 16 states used it and that no state had adopted it in over 20 years.[430] While AIV agreed that Vermont was justified in stemming the use of holding companies, AIV advocated that Vermont adopt an add back statute rather than combined reporting.[431] Such an approach would be less "heavy handed" than mandatory combined reporting and would likely generate much less litigation.[432]

AIV asserted that combined reporting discourages jobs and leads to complexity for both the taxpayer and the Department.[433] In response the Committee speculated that many multistate businesses in Vermont that would be negatively impacted, such as Home Depot, would certainly not leave the state or scale back their operations merely because their Vermont taxes went up under a combined reporting system.[434]

AIV suggested, however, that local (in-state) start-up businesses would be hurt by the enactment of combined reporting.[435] The theory was that that when it comes time for the local business to be sold to a multistate enterprise, the purchase price will be less if it pulls the purchasing corporation into a combined reporting state.[436] AIV offered no empirical evidence on this point, and the Committee seemed skeptical, especially since any potential purchaser would most likely already have operations in a combined reporting state (such as California).[437]

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[428]*Mar. 25, 2004 Hearing*, *supra* note 96 (testimony of Joseph Crosby, Legislative Director, Council on State Taxation) (CD Nos. 040119 and 040120). Mr. Crosby's prepared written testimony is available at http://www.statetax.org/Template.cfm?Section=By_State3&template=/ContentManagement/ContentDisplay.cfm&ContentID=5415 (last visited Jul. 23, 2006). The COST website is http://www.statetax.org/COSTHome.cfm.

[429]*See Mar. 25, 2004 Hearing*, *supra* note 96 (testimony of Joe Crosby, Legislative Director, Council on State Taxation) (CD Nos. 040119 and 040120).

[430]*March 24, 2004 Hearing*, *supra* note 427 (testimony of William Driscoll, Assoc. Industries of Vt.) (CD No. 040117); *March 25, 2004 Hearing*, *supra* note 96 (testimony of William Sayre, Assoc. Industries of Vt.) (CD No. 040120).

[431]*March 24, 2004 Hearing*, *supra* note 427 (testimony of William Driscoll, Assoc. Industries of Vt.) (CD No. 040117); *March 25, 2004 Hearing*, *supra* note 96 (testimony of William Sayre, Assoc. Industries of Vt.) (CD No. 040120). In his testimony, Sayre referred to the add back statute as an "anti-PIC" (anti-passive investment company) statute. *Id.*

[432]*March 24, 2004 Hearing*, *supra* note 427 (testimony of William Driscoll, Assoc. Industries of Vt.) (CD No. 040117).

[433]*Id.*; *March 25, 2004 Hearing*, *supra* note 96 (testimony of William Sayre, Assoc. Industries of Vt.) (CD No. 040120). AIV did not elaborate on its general statements on complexity and job losses.

[434]*March 24, 2004 Hearing*, *supra* note 427 (testimony of William Driscoll, Assoc. Industries of Vt.) (CD No. 040117).

[435]*March 25, 2004 Hearing*, *supra* note 96 (testimony of William Sayre, Assoc. Industries of Vt.) (CD No. 040120).

[436]*Id.*

[437]*Id.*

5--KAK.indd 402 8/8/07 12:13:02 PM

While against combined reporting, AIV did testify in favor of the rate reduction that was to be financed by the combined reporting law.[438] AIV stated that, given Vermont's high corporate tax rates, revenue neutrality was not a viable option.[439] Instead, it was suggested that Vermont should reduce its tax rates and finance the reduction, not with combined reporting, but with spending cuts.[440] This caused some consternation on the part of some of the Committee members, who demanded to know the specific programs AIV thought should be cancelled to fund the tax cut.[441] AIV did not have a response.[442] The Committee also noted that the tax package was specifically being sold as revenue neutral; the revenue from the combined reporting provisions would be used to fund an across the board cut in the corporate tax rate.[443] It was important that the tax reform not be viewed as a tax increase on corporations—to avoid Vermont being tagged as being unfriendly to business.[444] It was equally important, however, that the tax reform not be viewed as a tax *decrease* for corporations so as to avoid Vermont being characterized as giving away revenue to corporations when there were so many other unmet needs in the state.[445]

The Committee wanted to know why, if combined reporting was so bad, AIV was the only group so far to complain.[446] The Committee had yet to hear an outcry from other groups or from individual businesses.[447] AIV speculated that companies were not coming forward because Vermont's message to the public was, "if you end up paying more under combined reporting, then you were doing something wrong to begin with."[448] Companies that would be hurt by combined reporting were thus reluctant to come forward and oppose the proposed law, at least on the record in full public view.[449]

COST raised concerns similar to those raised by AIV, although COST officially takes no position on combined reporting.[450] COST focused its testimony on the

[438]*March 24, 2004 Hearing*, *supra* note 427 (testimony of William Driscoll, Assoc. Industries of Vt.) (CD No. 040117); *March 25, 2004 Hearing*, *supra* note 96 (testimony of William Sayre, Assoc. Industries of Vt.) (CD No. 040120).

[439]*March 24, 2004 Hearing*, *supra* note 427 (testimony of William Driscoll, Assoc. Industries of Vt.) (CD No. 040117).

[440]*Id.*

[441]*Id.*

[442]*Id.* The Committee chairman suggested that AIV should submit their suggestions on spending cuts to the House Appropriations Committee. *Id.*

[443]*Id.*

[444]*Id.*

[445]*Id.* The Committee did not elaborate as to what those unmet needs were—other than a vague reference to Medicaid expenses. *Id.*

[446]*Id.*

[447]*Id.*

[448]*Id.*

[449]*Id.* The Committee indicated that individual members would be happy to hear from impacted businesses off the record. *Id.* It is not clear if any businesses did come forward since there is obviously no public record to review on this point.

[450]*See March 25, 2004 Hearing*, *supra* note 96 (testimony of Joe Crosby, Legislative Director, Council on State Taxation) (CD Nos. 040119 and 040120).

5--KAK.indd 403 8/8/07 12:13:02 PM

complexity of combined reporting and the potential for costly litigation that may accompany it.[451] COST also suggested that combined reporting would have a chilling effect on the business climate in Vermont.[452] COST pointed to California as a prime example of why Vermont should not adopt combined reporting.[453]

COST cited California as an example of a combined return state with major complexity in its tax code and lots of litigated issues.[454] COST claimed that California has "decades old" litigation on the issue of which affiliates should be considered part of a unitary business (and thus included in the combined return).[455] COST indicated that whether an affiliate is unitary is often an "I know it when I see it" proposition, with the state arguing that affiliates with net income are unitary but affiliates with net losses are not.[456] This approach can lead to many disputes with taxpayers and a lot of litigation—much more so than would result under an add back statute.[457] COST questioned whether litigation over unitary issues would be the best use of the Department's limited resources.[458]

COST also noted that combined reporting would send a message to the business community that Vermont is not a good place to do business.[459] Even if combined reporting is, in reality, a fair way to tax, it is *perceived* as being unfriendly to multistate businesses.[460] When layered on top of Vermont's other negative factors—such as its high utility rates and a highly-regulated permitting process—it would make Vermont a very unattractive place to do business.[461] COST suggested that businesses may be willing to bear the burden of combined reporting in California because they need to operate there due to the importance of California's market.[462] Businesses may not be similarly willing to bear the burden of combined reporting in Vermont, given the relative size of its market.[463]

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[451]*See generally id.*

[452]*Id.* (testimony of Joe Crosby, Legislative Director, Council on State Taxation) (CD No. 040120).

[453]*Id.*

[454]*Id.* But see Professor Pomp's testimony, which cited California as an example of how well combined reporting can work. *Id.* (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD Nos. 040117 & 040118). In a lighter moment, one of the Committee members expressed some skepticism about California's problems, noting that California has had combined reporting for 67 years, making it "eligible to collect Social Security." *Id.* (testimony of Joseph Crosby, Legislative Director, Council on State Taxation) (CD No. 040120).

[455]*Id.* (testimony of Joseph Crosby, Legislative Director, Council on State Taxation) (CD No. 040120).

[456]*Id.*

[457]*Id.*

[458]*Id.* COST also made a suggestion that the Department's in-house accountants and lawyers may not be able to handle combined reporting issues. *Id.* This was based on COST's understanding that New Jersey had no in-house expertise on combined reporting when it was considering adopting it. *Id*. The Committee and the Department representatives present took strong exception to this. *Id.* Recall that it was the Department that developed the combined reporting proposal and so effectively described it to the Committee. *See supra* Part IV.A.1.

[459]*March 25, 2004 Hearing*, *supra* note 96 (testimony of Joseph Crosby, Legislative Director, Council on State Taxation) (CD No. 040120).

[460]*Id.*

[461]*Id.*

[462]*Id.*

[463]*Id.*

5--KAK.indd 404 8/8/07 12:13:02 PM

Overall, there was very little in the way of articulated, vocal opposition. It could be (as AIV suggested) that companies were embarrassed to complain. It may also be that the tax to be paid in Vermont was not material, and perhaps the business community did not see Vermont as a harbinger of combined reporting mandates in other states. Only AIV and (unofficially) COST, testified against combined reporting. Their testimony focused on complexity, litigation, and general business climate issues. It was clear throughout that the Committee, having been well-prepared by the Department and Professor Pomp, was willing to intelligently challenge COST and AIV on its testimony. The Committee felt that it had seized the high ground because it was using the revenue from combined reporting to reduce the corporate tax rate. This insulated the Committee from COST's and AIV's charges of being anti-business. Ultimately, the Committee was unmoved by the opposition's testimony.

B. *Vermont's Version of Mandatory Combined Reporting*

H.0784 was passed by both chambers of the Vermont General Assembly and was signed by the governor on June 7, 2004 as Act 152. As noted earlier, most of the lessons that the Vermont encounter with reform can teach are embedded in the process described above in Part IV.A. Because of this, and because the combined reporting law enacted is relatively straightforward, only a brief overview is provided here.

Before reviewing the details of the new law, it is important to note the new law's statement of intent:

> In recognition of the fact that corporate business is increasingly conducted on a national and international basis, it is the intent of the general assembly to adopt a unitary combined system of income tax reporting for corporations, and as an integral part of this proposal, to lower the corporate income tax rates. Vermont's separate accounting system is inadequate to measure accurately the income of a corporation with non-Vermont affiliates and creates tax disadvantages for Vermont corporations which compete with multistate and multinational corporations doing business in Vermont. It is the intent of the general assembly, in adopting a unitary combined reporting system, to put all corporations doing business in Vermont on an equal income tax footing, and with the revenue from the expanded and more accurate tax base, to lower Vermont's corporate income tax rates.[464]

This makes it clear that the legislature believed it was truly reforming its tax system, rather than trying to raise taxes on corporate taxpayers.[465]

[464]2004 Vt. Act 152, § 1, *available at* 32 V.S.A. T.32, Pr. 3, ch. 151, subch. 3, Ref. & Annos. (2007).

[465]A representative in the Vermont House introduced a proposal to eliminate the rate reduction and simply add any revenue raised from combined reporting to the state's general fund. Paul Hanlon, *Vermont House Approves Combined Reporting, Other Corporate Tax Changes*, 2004 State Tax Today 95-38 (May 17, 2004). The proposal was defeated by a 94-40 vote. *Id.* The House did approve a provision to revisit the issue of how the combined reporting funds should be used. *Id.*

5--KAK.indd 405 8/8/07 12:13:03 PM

There are four major corporate tax components to the new law: combined reporting, rate reductions, repeal of the holding company exception, and double-weighting of the sales factor.[466] The combined reporting, holding company repeal, and double-weighting provisions are effective for tax years beginning on or after January 1, 2006.[467] The rate reductions are phased in starting for tax years beginning on or after January 1, 2006 and becoming fully effective for tax years beginning on or after January 1, 2007.[468]

The first major component of the law deals with combined reporting. Specifically, the new law mandates that an affiliated group of corporations engaged in the same unitary business must file on a combined basis.[469] An "affiliated group" is defined as "a group of two or more corporations in which more than 50% of the voting stock of each member corporation is directly or indirectly owned by a common owner or owners, either corporate or noncorporate, or by one or more of the member corporations . . . ."[470] So-called "overseas business organizations," defined as organizations that normally have 80% or more of their payroll and property outside of the United States,[471] are excluded from the affiliated group.[472] There is no election available to include such overseas organizations in the group, and therefore Vermont is a mandatory water's edge state.[473] Captive insurance companies that are subject to Vermont's premium tax are also excluded from the affiliated group—and thus from the combined return.[474] Thus, the new law does not disturb the favorable treatment afforded to captive insurance companies in Vermont.[475]

A "unitary business" is "one or more related business organizations engaged in business activity both within and without the state among which there exists a unity of ownership, operation, and use; or an interdependence in their functions."[476] The Department issued regulations effective January 1, 2006, which provide more

[466]Other miscellaneous provisions in Act 152 that do not apply directly to corporations are not relevant for the discussion in this Article.

[467]Act of 2004, No. 152, § 23 (1), (3), 2004 Vt. Acts & Resolves 596, 603 (for combined reporting and the double-weighting of the sales factor); Act of 2004, No. 152, § 8, 2004 Vt. Acts & Resolves 596 (for the repeal of the holding companies law).

[468]Act of 2004, No. 152, § 23(1)-(2), 2004 Vt. Acts & Resolves 596, 603.

[469]Vt. Stat. Ann. tit. 32, § 5862(d) (Supp. 2006) (mandating combined returns); Vt. Stat. Ann. tit. 32, § 5811(18)(C)(Supp. 2006) (indicating that "Vermont net income" is calculated based on the apportioned share of the net income of the group filing the combined return).

[470]Vt. Stat. Ann. tit. 32, § 5811(22) (Supp. 2006).

[471]*Id.* § 5811(24).

[472]*Id.* § 5811(22).

[473]*See supra* note 390 and accompanying text.

[474]Vt. Stat. Ann. tit. 32, § 5811(22) (Supp. 2006) (excluding "corporations taxable under section 6014 of Title 8," that is, Vermont captive insurance companies).

[475]*See supra* note 399.

[476]Vt. Stat. Ann. tit. 32, § 5811(23) (Supp. 2006).

5--KAK.indd 406 8/8/07 12:13:03 PM

detailed guidance as to how combined reporting will work in Vermont.[477]

The second major component of the new law is the reduction in tax rates. There is an approximately one percent across the board reduction in corporate tax rates in all income brackets, which is phased in over 2006 and 2007.[478] The following chart depicts the changes:

Apportioned Taxable Income	For tax years beginning before January 1, 2006[479]	For tax years beginning on or after January 1, 2006[480]	For tax years beginning on or after January 1, 2007[481]
0-10,000	7%	6%	6%
10,001-25,000	8.1%	7%	7%
25,001-250,000	9.2%	8.75%	8.5%
250,001 and over	9.75%	8.90%	8.5%

The third major component of the law was the repeal of Vermont's version of the holding company.[482] Prior to Act 152, corporations could establish passive investment companies in Vermont that would only be subject to the $250 minimum tax.[483] Thus, companies could base a holding company in Vermont (instead of, for example, Delaware) and shift income from other states into Vermont with no tax consequence. Since Vermont enacted combined reporting in part to eliminate the use of holding companies, it needed to eliminate its own holding company law to avoid charges of hypocrisy.[484]

The fourth major component of the law was the double-weighting of the sales factor.[485] Double-weighting was not part of the governor's original proposal and was only discussed as a possible idea in the hearings before the Vermont House Committee on Ways and Means reviewed in Part IV.A.[486] According to a representative of the Vermont Department of Taxes, the double-weighting provision

[477]Vt. Reg. § 1.5862(d)(1)-(14) (Supp. 2006). These rules provide guidance for taxpayers and practitioners in implementing the new law, but are of little importance for purposes of this Article. The remarkable aspect of combined reporting in Vermont is that it was enacted in the first place. It is this successful *process* (discussed at *supra* Part IV.A. and *infra* Part V) that other states considering combined reporting should study. The specific mechanical details of Vermont's combined reporting regime are far less important. Therefore, a detailed review of the regulations is beyond the scope of this Article.

[478]Act of 2004, No. 152, sec.3-4, § 5832, 2004 Vt. Acts & Resolves 596, 598-99.

[479]1997 Vt. Acts & Resolves 340-41.

[480]Act of 2004, No. 152, sec.3, § 5832(1), 2004 Vt. Acts & Resolves 596, 598.

[481]Act of 2004, No. 152, sec.4, § 5832(1), 2004 Vt. Acts & Resolves 596, 598-99 (amending Vt. Stat. Ann. tit. 32, § 5832(1) effective January 1, 2007).

[482]Act of 2004, No. 152, sec.8, § 5837, 2004 Vt. Acts & Resolves 596, 599.

[483]2004 Vt. Acts & Resolves 16.

[484]*See supra* note 399.

[485]Vt. Stat. Ann. tit. 32, § 5833(a) (Supp. 2006).

[486]*See*, *e.g.*, *Jan. 30, 2004 Hearing*, *supra* note 364 (testimony of Vt. Dep't of Taxes) (CD No. 040038); *see also supra* note 386.

5--KAK.indd 407 8/8/07 12:13:03 PM

was added to the governor's tax proposal by the Committee and the Department did not object.[487] The main driver behind the double-weighting was to protect Vermont manufacturers shipping goods to other states.[488] The Department and the Committee felt that it would be good policy to align Vermont with other states on this score.[489] Of course, double-weighting also served to soften the blow of combined reporting on multistate companies with manufacturing operations in Vermont—such as IBM and General Electric.[490] Thus, double-weighting can be viewed as a sort of sugar-coating on the combined reporting law. It is far from clear, however, whether double-weighting was *necessary* to assure passage of combined reporting.[491] Combined reporting may well have passed in the absence of double-weighting, and the Department never viewed double-weighting as a mere tool to get combined reporting through the legislature.[492] Rather, it was a reform independent of combined reporting that may, as a byproduct, have helped the combined reporting law pass.[493]

C. *Summary*

By successfully enacting a mandatory combined reporting statute, Vermont embraced a simple, yet significant tax reform. The record reveals that this success was made possible because the proposal was raised at a time of relative fiscal stability and was coupled with a rate reduction, avoiding the "revenue grab" tag that typically applies to corporate tax overhauls. Further, the Vermont Department of Taxes was able to deftly steer the governor, the Vermont House Committee on Ways and Means, and ultimately the legislature, through the rough waters of business and political opposition that had drowned similar efforts in other states. Other states would do well to study Vermont's reform process in formulating their own strategies for effective corporate tax reform.

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[487]E-mail from George Phillips, Policy Analyst, Vermont Department of Taxes (Jul. 26, 2006) (on file with authors) [hereinafter *E-mail from George Phillips*].

[488]*Id.*

[489]*See id.* While it may have made sense for Vermont, double-weighting can be problematic from a tax policy standpoint. *See supra* Part II.C.1. In fact, Professor Richard Pomp advised the Committee to thoroughly analyze their situation before enacting a double-weighted sales factor. *March 25, 2004 Hearing*, *supra* note 96 (testimony of Prof. Richard Pomp, University of Connecticut School of Law) (CD No. 040117). He suggested that the Committee work with Vermont's economic development experts to determine whether double-weighting would really be the best way, out of all the available alternatives, to encourage economic development in the state. *Id.* The Committee did not heed this advice, but did slip a provision into the new law requiring the Department to report to the Committee, by February 1, 2005, on the estimated impact of double-weighting and possible alternatives to double-weighting to encourage economic growth. 2004 Vt. Act 152, § 22. By the time the report was due, however, the Committee seemed to have lost interest in the entire issue. *E-mail from George Phillips*, *supra* note 487. The Department presented a summary, cryptic report to comply with the law, but not much discussion took place. *Id.* In the report, the Department indicated that double-weighting may cause some revenue loss, but they could not yet quantify such loss. *Id.*

[490]*See E-mail from George Phillips*, *supra* note 487.

[491]*Id.*

[492]*Id.*

[493]*See id.*

5--KAK.indd 408 8/8/07 12:13:03 PM

V. COMPARING THE NEW JERSEY AND VERMONT EXPERIENCES

With the New Jersey and Vermont reforms explained, this Part V will now analyze why New Jersey used an add back statute and other jurisdiction expanding legislation in its reform efforts while Vermont successfully adopted a combined reporting regime. Part V.A highlights some of the inherent differences between New Jersey and Vermont which may account for their different approaches to tax reform. Part V.B then looks at the Vermont and New Jersey approaches against the standard of classic tax reform. This analysis can provide other states with a roadmap to restructuring their own corporate tax systems.

A. *New Jersey Versus Vermont*

"When you tell somebody something, it depends on what part of the United States you're standin' in as to just how dumb you are."[494]

While Vermont and New Jersey are both located in the northeastern part of the United States, they are two very different places. Further, they passed their reforms at different historical junctures. New Jersey was in the middle of a serious fiscal crisis during its reform while Vermont was not. This allowed Vermont to seize the moral high ground by making a revenue neutral improvement to its corporate tax system. New Jersey needed revenue and could not afford to offer a rate reduction in exchange for combined reporting. These inherent differences obviously account for some of the reason as to why Vermont was able to enact combined reporting while New Jersey had to settle for hybrid adjustments to its tax system.

Vermont is a small, rural state[495] and a multistate corporation's tax liability in Vermont is likely to be a very small component of its overall state tax liability. Thus, adverse tax changes in Vermont are not as likely to raise the ire of the multistate business community as they might in other states. This may explain why only one group, Associated Industries of Vermont, came out publicly in opposition to combined reporting.[496] Further, Vermont's reforms, because they included a rate reduction and shut down tax shelters used primarily by large, multistate businesses, actually cut taxes on local intrastate companies. This was great politics and allowed the governor and the legislature to claim they were helping out small businesses. Thus, good policy and good politics went hand in hand.

In contrast, New Jersey's economy simply dwarfs Vermont's. According to the United States Department of Commerce's Bureau of Economic Analysis, Gross State Product in New Jersey for 2005 was $430,787,000,000, while Vermont came in at $23,134,000,000.[497] Thus, New Jersey taxes are likely to be much more material to large multistate businesses than is the case with Vermont taxes.

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[494]Smokey and the Bandit (Universal Pictures 1977).

[495]Vermont's 2005 population is only around 623,050. U.S. Census Bureau, State and County Quick Facts, *available at* http://quickfacts.census.gov/qfd/states/50000.html (last visited Sep. 25, 2006). Vermont ranks 49th among the states in terms of population.

[496]*See supra* Part IV.A.3.

[497]Gross State Product (GSP) Interactive Map, *available at* https://bea.gov/bea/regional/gspmap/mappage.asp (last visited Feb. 8, 2007).

Further, New Jersey was clearly seeking revenue to close its budget gap. Its reforms were not revenue neutral—they reeked of a revenue grab. New Jersey was under pressure to balance its budget and hesitated to enact combined reporting without further study of the system's costs, benefits and impact on the bottom line. Unable to seize the moral high ground, New Jersey was on the defensive from an outraged business community, which felt like the scapegoat for the state's fiscal woes.

B. *Classic Tax Reform*

A recent review of the literature surrounding state tax reform identified seven key factors for success.[498] These seven factors are reviewed below in light of the Vermont and New Jersey experiences with corporate tax overhaul.

First and foremost, successful reform involves broadening the base and lowering the rates.[499] This is exactly what Vermont did: it broadened the base via combined reporting, foreclosing holding company and similar planning techniques, and used the revenue to lower the overall corporate tax rates.[500] New Jersey, however, was focused mainly on raising additional revenue and even raised its minimum tax as part of the legislation.[501]

Second, successful reform starts with some guiding principals of good tax policy.[502] For example, reform should advance such laudable goals as tax neutrality.[503] Vermont's combined reporting law advances tax neutrality by leaving taxpayers free to structure their legal entities without regard to tax consequences. New Jersey, in its own way, also advanced tax neutrality via its 2002 tax reform. By enacting the add back statute, New Jersey has at least attempted to remove tax considerations from the decision whether to use holding company structures.[504] Of course, as previously noted, add back statutes do not entirely foreclose the use of holding companies, and thus do not fully advance the tax policy goal of tax neutrality.[505]

Third, reforms should be revenue neutral.[506] This was the goal in Vermont: any additional revenue generated from combined reporting was given right back to corporate taxpayers in the form of a rate cut. This obviously was not the case in New Jersey, which needed to structure its corporate tax to collect more revenue.

Fourth, the entire tax system should be reformed; not its individual pieces.[507] The Vermont governor's tax proposals initially involved individual, sales and use, and

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[498]Benjamin Russo, *State Tax Reform: Evidence, Logic, and Lessons from the Trenches*, 39 State Tax Notes (TA) 467, 475 (Feb. 13, 2006).

[499]*Id.*

[500]*See supra* Part IV. Of course, the reform was not complete—captive insurance companies remained and the sales factor was double-weighted.

[501]Business Tax Reform Act, N.J. P.L. 2002, ch. 40, § 7 (July 2, 2002) (codified at N.J. Stat. Ann. § 54:10A-5).

[502]Russo, *supra* note 498, at 475.

[503]*Id.*

[504]*See supra* Part III.C.

[505]*See supra* Part II.B.3.b.

[506]Russo, *supra* note 498, at 475.

[507]*Id.*

5--KAK.indd 410 8/8/07 12:13:04 PM

corporate taxes.[508] In reality, these were treated as separate components throughout the process. Thus, while Vermont did overhaul its corporate tax system, it failed to overhaul its entire tax system. In New Jersey, reform was focused squarely on the corporate tax system, and even that reform was only piecemeal.

Fifth, lawmakers should listen to the advice of tax administrators in crafting reforms.[509] Vermont did a great job on this point: the Vermont Department of Taxes was intimately involved in advising (and convincing) both the governor and the legislature (specifically the House Committee on Ways and Means) to support combined reporting. In New Jersey, there was more of a "legislate now, ask questions later" approach. The state was in a fiscal crisis, seeking to quickly balance its budget. The Business Tax Reform Act did create the Corporation Business Tax Study Commission to study the effects of the tax law changes and make recommendations based on its findings. However, the commission's proposals had minimal impact.

Sixth, acknowledge that the proposed reforms will involve some losers.[510] Failure to do this gives the impression that the state is trying to hide the negative impact on certain groups of taxpayers. In Vermont, lawmakers understood and acknowledged that some corporations would pay more tax under combined reporting. They sought advice from the Department of Taxes and business groups as to who would be adversely impacted and how the reform might be structured to allow for a soft landing for such taxpayers. Specifically, the delayed start date (combined reporting was enacted in 2004 but not effective until 2006) allowed taxpayers and the state to get comfortable with the impact of combined reporting and allowed the Department of Taxes and the legislature time to address any problems that came to their attention. Further, the rate reduction allowed the state to take the high road and put any opposition on the defensive. Finally, the double-weighted sales factor likely mitigated the extra tax to be incurred by some of the most important losers under combined reporting—multistate companies with manufacturing operations in Vermont. In contrast, New Jersey's changes were retroactive.[511] Also the New Jersey reforms were enacted in the midst of a very public debate between the business community and the McGreevey administration, with clearly marked battle lines. On the one side, businesses argued that they were being unfairly burdened. On the other side, the administration made the argument that it was battling abuses and making sure that all corporations were paying their fair share.

Finally, a key ingredient in successful tax reform is the education of policymakers.[512] Vermont did an excellent job here. As evidenced by the extensive testimony recounted above in Part IV.A., the Department of Taxes, the Vermont Legislative Council, and outside experts (such as Professor Pomp) did an exemplary job of

[508] *State-of-the-State*, *supra* note 350; *see supra* note 352.

[509] Russo, *supra* note 498, at 475.

[510] *Id.*

[511] *E.g.*, Business Tax Reform Act, N.J. P.L. 2002, ch. 40, § 33 (July 2, 2002) (codified at N.J. STAT. ANN. § 54:10A-2).

[512] Russo, *supra* note 498, at 475.

5--KAK.indd 411 8/8/07 12:13:04 PM

getting the governor and the House Committee on Ways and Means up to speed on combined reporting. This eliminated the misunderstandings that typically plague the lawmaking process and allowed lawmakers to respond effectively to challenges to the new law that were raised by the business community. In short, a savvy and sophisticated Department of Taxes advised a savvy governor and a savvy group of lawmakers to pursue a potentially risky path to an ultimately fairer tax system.

In New Jersey, the record is unclear as to just how much education was going on. While the state did reach out to noted tax experts, it appears that the legislature was in too much of a crisis mode to heed their advice.[513] Further, it appears that New Jersey lacked what Vermont had: in-house experts on combined reporting who were ready, willing, and able to educate the governor and the legislature about the contours of combined reporting.[514]

In summary, New Jersey really wasn't attempting classic tax reform; it was trying to raise revenue to solve its fiscal crisis. It did what it had to do via piecemeal legislation to raise the revenue it needed. It did not have the time or political will to undertake a true tax reform. Nonetheless, the provisions that New Jersey did implement can provide a guide to states in need of revenue which are not in a good position to push more fundamental reforms like combined reporting.

Vermont, on the other hand, did accomplish real tax reform. Vermont did just as experts had been advising for years: adopt unitary combined reporting but "give back whatever money is raised though reductions in the corporate tax rate" to show that the "issue is not one of increasing taxes but rather taxing fairer and more efficiently."[515] The Department of Taxes indicated as much once the combined reporting bill was passed: "Had we been reaching for additional corporate income tax, we probably would have had some resistance."[516] This was a luxury that New Jersey did not have.

VI. CONCLUSION

Our case studies of recent New Jersey and Vermont corporate tax changes present two different ways in which states can shore up their corporate tax systems. The New Jersey approach provides some innovative ways for states in a fiscal crisis to squeeze more revenue out of their corporate tax systems by addressing commonly perceived loopholes inherent in most separate reporting systems. The techniques used by New Jersey, such as the AMA and the add back statute, are what other states should study. These are not true "reforms," but rather are changes designed to bring in some revenue while limiting vulnerability to business opposition that often comes with a full-scale overhaul of the corporate tax regime.

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[513]*See supra* note 324 (discussing Prof. Richard Pomp's dealings with New Jersey).

[514]*See supra* note 458 (discussion before the Vermont House Committee on Ways and Means suggested that New Jersey lacked in-house expertise on combined reporting).

[515]Pomp, *State Tax Reform*, *supra* note 113, at 58.

[516]Dagostino, *supra* note 4 (quoting George Phillips of the Vermont Department of Taxes).

5--KAK.indd 412 8/8/07 12:13:04 PM

The Vermont changes, in contrast, are true reforms—broadening the base and lowering the rate—designed to create a fairer corporate tax system. Unlike New Jersey, Vermont did not use any innovative taxing techniques. Rather, Vermont relied on mandatory combined reporting, which has been used by other states for nearly 70 years. What other states can learn from Vermont is not the technical substance of its combined reporting law, but rather the procedure it used to get the law passed in the first place. Vermont teaches us that better corporate tax systems come from striving for true reform, rather than a short-term solution to a pressing fiscal crisis. The reform should be based on sound tax policy principles, revenue neutral, and orchestrated in an unhurried manner by a knowledgeable taxing authority and informed policymakers.

Other states struggling with their own shrinking corporate income tax bases would be well advised to look at the experiences of New Jersey and Vermont in framing their own reforms. New Jersey provides a second-best model of how to raise revenue from a corporate tax when real reform cannot feasibly be accomplished.[517] Other states have begun to follow New Jersey's approach, at least with respect to the AMA. Ohio recently scrapped its corporate income tax in favor of a gross receipts tax similar to the AMA.[518] Kentucky and Texas have also modified their corporate tax codes to include a gross receipts component similar to the AMA.[519] Whether this trend will spread to other states is yet to be seen.

Vermont, which succeeded where no other state had in over 20 years, provides an almost[520] perfect model of how to accomplish real tax reform in spite of business opposition. To date, however, West Virginia is the only other state to successfully enact mandatory combined reporting.[521] Perhaps once Vermont has established a

[517]*But see supra* Part III.E.3 (regarding New Jersey's 2006 fiscal crisis). While New Jersey can show other states how to generate more revenue from their corporate tax systems, it is now clear that mere corporate tax reform is not a panacea for a state's more fundamental fiscal problems. Further, see *supra* note 265 for a warning that gross receipts taxes, such as the AMA, may have negative economic consequences.

[518]*See supra* note 22.

[519]Scott Salmon et al., *Sweeping Texas Franchise Tax Changes: The Margin Tax*, Tax Adviser, Sept. 2006, at 550.

[520]We say "almost" because a double-weighted sales factor was enacted as part of the law, which may not be ideal, and Vermont remains a tax haven for captive insurance companies. *See generally supra* Part IV.

[521]Thomas D. Miller, *West Virginia Enacts Franchise Tax Cuts, Combined Reporting Requirement*, 2007 State Tax Today 68-20 (Apr. 9, 2007). In addition, Texas's new *gross receipts tax* includes a combined reporting element. Salomon, *supra* note 519. However, other states have so far not been able to replicate such successes in their corporate income tax systems. In 2005 alone, combined reporting bills were introduced (but not enacted) in Arkansas, Massachusetts, New York, Maryland, and Ohio. Chris Atkins, Tax Foundation Background Paper; A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems (Sept. 2005), *available at* http://www.taxfoundation.org/files/4efb91276d95e6383a066e5d02ad19f1.pdf. Pennsylvania came close to enacting combined reporting, but failed to do so. *See* David Brunori, *Weakening Pennsylvania's Corporate Tax*, 2005 State Tax Today 242-8 (Dec. 19, 2005). New York recently increased the authority of its Taxation and Finance Department to require combined reporting where there are "substantial intercorporate transactions," but stopped short of adopting full-blown mandatory combined reporting for unitary

5--KAK.indd 413 8/8/07 12:13:04 PM

successful track record[522] in operating its new combined reporting system, other states will be emboldened to follow the Green Mountain State's example. However, given fiscal and political pressures, it is likely that many states will want to be Vermont, but settle, if they are lucky, for being New Jersey.

groups. Karen Setze, *New York Budget Accelerates Single Sales Factor, Lowers Corporate Tax*, 2007 STATE TAX TODAY 64-19 (Apr. 3, 2007).

[522]Recall that while Vermont enacted mandatory combined reporting in 2004, it made the rules effective for 2006 (first impacting tax returns filed in 2007). *See supra* note 384 and accompanying text.

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APPENDIX DD

"Designing a Combined Reporting Regime for a State Corporate Income Tax:
A Case Study of Louisiana"
(by Michael J. McIntyre, Paull Mines and Richard D. Pomp, dated 2001)

Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana†

61 *Louisiana Law Review* 699 (2001)

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TABLE OF CONTENTS

I. Introduction 700

II. Benefits of Combined Reporting 702
A. Better Measurement of In-State Income 703
B. Protection Against Tax-Minimization Strategies 706
C. Simplification 709

III. Major Design Features of a Combined Reporting Regime 711
A. The Combined Report 712
B. Defining a Unitary Business 716
1. Jurisdictional Issues 717
2. Definitional Guidance from the U.S. Supreme Court 718
3. Multiple Unitary Businesses 720
4. Some Specific Recommendations 721
C. Apportionable and Allocable Income 725
D. Formulary Apportionment of Income 728
E. Water's Edge Rules 732

IV. Practical Problems in Implementing a Combined Reporting System . . . 738

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The views expressed by the authors in this Article do not necessarily represent the views of the organizations with which they are associated. Indeed, in some instances, the views do not necessarily represent the unanimous views of the individual authors, notwithstanding their common commitment to the major reform goals advocated here. In some instances, they fashioned mutually acceptable compromises to reach a consensus position.

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A. Taxation of the Individual Members of a Unitary Group 739
1. Determining the Taxable Income of Individual Members of a Unitary Group 739
2. Treatment of Corporate Attributes 741
a. Ongoing Treatment of Corporate Attributes 741
i. Net Operating Losses (NOLs) 742
ii. Investment Tax Credit 742
b. Transition Rules for Corporate Attributes Carried Over from Separate Reporting Regime 744
B. Issues Arising When Members of a Unitary Group Do Not All Use the Same Accounting Period 745
1. Determining the Annual Accounting Period for a Unitary 746
2. Determining Combined Income When Members Employ Different Accounting Periods 749
3. Attributing the Combined Income of a Unitary Group to Members of the Unitary Group When Accounting Periods of Group Members Are Not Uniform 751
4. Selecting the Starting Date for Combined Reporting 752
C. Adjustments For Intra-Group Transactions 753
1. Description of the Wash Rule 753
2. Adjustments to the Basis of Affiliate Stock 755
3. Transition Issues 757
a. Transition Issues Under the Wash Rule 757
b. Ordering Rules 758
c. Transition Issues under the Basis-Adjustment Rules 759

V. Conclusion 760

I. INTRODUCTION

This article presents a plan for revitalizing the Louisiana corporate income tax through the adoption of a combined reporting regime. Our plan would require affiliated companies engaged in a unitary business in the State to pay their Louisiana income tax based on an apportioned share of their combined income. Combined reporting is the only effective way for any state to impose a fair and uniform corporation income tax on multistate and multinational enterprises and to gain or maintain control over its own tax base. The current Louisiana corporate income tax is subject to abuse through tax planning techniques that are very familiar to members of the tax-avoidance community. California and other states that have adopted combined reporting have demonstrated that combined reporting fairly and effectively responds to most of these common tax avoidance techniques.

Part II, below, discusses the potential benefits inuring to Louisiana from adopting a combined reporting regime. Those benefits are not mere speculation. California has been operating a combined reporting system successfully for nearly seven decades. In brief, the benefits are a uniform treatment of corporate groups

without regard for differences in their organizational structure, a strong bulwark against the use of tax-haven jurisdictions to avoid state taxation, a significant reduction in administrative burdens on the tax department and on complying taxpayers, and the removal of the competitive disadvantage currently imposed on local firms that are unable to engage in cross-border tax-avoidance.

In Part III, we address some basic issues in the design of an effective combined reporting regime. One of the important features of combined reporting is the use of a formula to apportion the unitary business income of a unitary enterprise between Louisiana and the rest of the relevant universe. Louisiana already uses formulary apportionment in its current corporate tax system. To operate a combined reporting regime, however, Louisiana must apply that formula not to the separate income of each corporation but to the combined income of a corporate group engaged in a unitary business in Louisiana. Yielding to political realities, we recommend that Louisiana offer companies a water's edge election that would allow them to exclude from their combined report the income derived by certain foreign affiliates that do not have an obvious close tie to the unitary business conducted in Louisiana.

Part IV addresses a variety of technical issues that Louisiana should address when adopting a combined reporting regime. We offer our views on how those issues should be resolved, drawing, when appropriate, on the experience of other combined-reporting states. Some of these issues relate to potential transition problems. Other issues relate to practical problems of assessing and collecting a tax from corporations operating in Louisiana on income that is computed by reference to the combined income of a unitary group. A brief conclusion is presented in Part V.

In adopting a combined reporting regime, we recommend that Louisiana follow the well-marked trail forged by California and other combined-reporting states. Those states have solved many technical difficulties and have won many important victories in the courts.[1] We see no good reason why Louisiana should fight those battles anew by introducing untested provisions into its combined reporting regime. We also strongly favor uniform state taxing rules, and uniformity is obviously enhanced when states borrow from the successful experiments of sister states. We do not suggest, however, that Louisiana should avoid innovation when the experience of the combined-reporting states has been unhappy. The combined-reporting regime we recommend, if adopted by Louisiana, would have a definite Cajun flavor.

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1. The two leading combined-reporting cases decided by the U.S. Supreme Court are *Container Corp. of America v. Franchise Tax Bd. of California*, 463 U.S. 159, 103 S. Ct. 2983 (1983), and *Barclays Bank PLC v. Franchise Tax Bd. of California*, 512 U.S. 298, 114 S. Ct. 2268 (1994). In *Container*, California successfully defended its combined-reporting regime, as applied to a U.S.-based multinational enterprise, against attacks based on the Commerce Clause and the Due Process Clause. *Barclays Bank* upheld the California system as applied to a foreign-based multinational enterprise against attacks based on the Foreign Commerce Clause.

II. BENEFITS OF COMBINED REPORTING

Louisiana has long employed a system of formulary apportionment for determining the Louisiana taxable income of a corporation that is operating within and without Louisiana through multiple divisions or branches. In adopting formulary apportionment, the Louisiana Legislature has implicitly concluded that apportioning income by payroll, property, and receipts (sales) is superior, as a system of tax accounting, to a system based on the separate transactions of the taxpayer, as reflected on its books of account. The case for combined reporting is a logical extension of the case for apportioning by formula the business income of an individual corporation. The rationale of both cases is that the substance of the business activities in the state should control, not the organizational structure of the business entity or entities conducting those activities. That is, whether a business enterprise chooses to have numerous divisions or whether it chooses to incorporate those divisions and operate them as subsidiaries should have as little impact as feasible on the amount of Louisiana income tax paid by that enterprise.

The U.S. Supreme Court has acknowledged that combined reporting is both a better method for measuring the income of a unitary business and a safeguard against taxpayer manipulation:

> The problem with [formal geographical or transactional accounting, including separate accounting] is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise. The unitary business/formula apportionment method is a very different approach to the problem of taxing businesses operating in more than one jurisdiction. It rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that "unitary business" between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction.[2]

Section II.A., below, presents support for the U.S. Supreme Court's assertion that combined reporting is a superior method for determining the in-state income of a member of a unitary group of corporations. In Section II.B., we explain how a combined reporting regime protects a state against various tax-avoidance techniques that multistate companies routinely use to lower their tax bills in separate reporting states. Section II.C., examines the potential of combined reporting for simplifying the Louisiana corporate income tax.

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2. *Container*, 463 U.S. at 164-65, 103 S. Ct. at 2940 (citations omitted). These sentiments were repeated in part in *Barclays Bank*, 512 U.S. at 303-04, 114 S. Ct. at 2272.

Our recommendation that Louisiana adopt combined reporting does not mean that we would eliminate the use of the separate accounting method entirely. Louisiana law currently permits taxpayers to apply to the tax department for permission to use separate accounting under certain conditions "if the taxpayer shows that the apportionment method produces a manifestly unfair result."[3] We would continue that rule as a useful safeguard against unfair results and as a protection against constitutional attacks on Louisiana's use of formulary apportionment.[4]

A. Better Measurement of In-State Income

Under Louisiana's separate reporting regime, the amount of corporate income taxes that a unitary group of corporations pays to Louisiana depends on the structure of the corporate group. A corporation is likely to pay a different amount of tax, for example, if it incorporates a branch or division or if it liquidates a subsidiary. Under combined reporting, unitary groups that are similarly situated generally would pay the same aggregate amount of Louisiana tax regardless of their corporate structure. There are some exceptions to the general goal, due to factors outside the control of the Louisiana Legislature. The exceptions, however, are just that; they do not undermine the general goal.[5]

Combined reporting also helps create a level playing field for intrastate corporate groups, whether large or small, and multistate corporate groups. A unitary group that is engaged in business only in Louisiana is taxable on all of its income under Louisiana's current system of separate reporting. The adoption of combined reporting would not change that result. A multistate corporate group, however, is currently able to reduce its Louisiana apportionable income, and hence its Louisiana income taxes, by isolating highly profitable parts of its

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3. La. R.S. 47:287.94(C) (2001). Some administrative flexibility may be required to prevent an unconstitutional tax on extraterritorial values. *See* Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123, 51 S. Ct. 2933 (1931) (allowing the taxpayer to introduce evidence to challenge the apportionment resulting under a one-factor (property) apportionment formula based on an offer of proof that the formula produced an unreasonable and arbitrary result, out of all appropriate relationship to the business activities in the state).

4. *See* Unif. Div. of Income For Tax Purposes Act § 18, 7A U.L.A. 331 (1985) [hereinafter UDITPA] (providing similar escape hatch). The Louisiana corporate tax statute is not based on UDITPA, although UDITPA and the Louisiana statute have many common elements. We do not discuss in this Article whether Louisiana should adopt UDITPA.

5. One significant exception to the equal treatment of similarly situated unitary groups is the result of the protection against state income taxation provided in Act of Sept. 14, 1959, Pub. L. No. 86-272, 1986 U.S.C.C.A.N. (73 Stat. 555) 613 (codified as 15 U.S.C. § 381 *et seq.*). That Federal law limits the ability of a state to tax a corporation when the corporation's only connection with the state is through the solicitation of sales within the state. That protection extends, however, only to the corporation itself—not to the unitary group of which it is a member. As a result, a corporate group that is organized as a single corporation might be ineligible for protection under Pub. L. No. 86-272, whereas a corporate group that placed its purely solicitation activities in one corporation and its disqualifying activities in another corporation might obtain at least some protection.

unitary business in a corporation that is not taxable in Louisiana. Under combined reporting, this advantage for the multistate enterprise is eliminated.[6]

The improved equity under combined reporting is due to its superiority over separate reporting as a method of tax accounting. The premise of combined reporting is that the synergies, interdependencies, and sharing of knowledge, know-how, and experiences that are typical features of a unitary business often cannot be properly captured by separate entity accounting. By taking into account only the income and factors of the corporation having nexus with the taxing state, separate-entity accounting often cannot provide an accurate measurement of the income of the unitary business that is properly attributable to that state. A combined reporting regime, in contrast, avoids this failing by automatically apportioning all of the unitary business income of a unitary group among the states where it is engaging in meaningful business activities.

To illustrate, consider a unitary oil enterprise that explores, refines, and markets oil products. The parent company is PCo. PCo is assured by its geologists that an oil field that straddles Texas and Louisiana is rich in oil. The geologists estimate that if ten wells are drilled, one is likely to be a gusher and the other nine wells will be dry holes. PCo directs LCo, its Louisiana subsidiary, to drill for oil on the Louisiana side of the oil field. It directs its Texas subsidiary, TCo, to drill on the Texas side. LCo drills five holes and finds no oil. TCo also drills five holes and discovers oil. The crude oil is transferred to RCo, another subsidiary of PCo, and RCo refines it into gasoline at a Texas refinery. The gasoline is sold in California by CCo, another PCo subsidiary. The profits for the year from the combined activities of the related companies are $100. Under separate accounting, none of that income would be apportioned to Louisiana. Yet the Louisiana activities were integral to finding oil in Texas and to the other operations of the unitary business.

Adding additional facts to the scenario above would further complicate the problem of assigning income under a separate reporting system. Assume, for example, that RCo, the Texas refinery, used oil produced in a prior year by LCo, the Louisiana subsidiary, in producing gasoline for the California market. Under separate reporting, LCo would have no income in the current year, notwithstanding its substantial contribution to the profits of the unitary business. It would have income in the prior year, however, calculated by assigning a sales price to its transfer of crude oil to RCo. Under a combined reporting regime, LCo would be taxable on its apportioned share of the income of the unitary business in the year the income was actually earned.

The more facts that are added to the above example, the more difficult it becomes to determine the income of each affiliated company under a separate reporting regime. Assume that PCo's geologists, based in Oklahoma, were extraordinarily talented in predicting where the unitary business should drill. Should the activities of the geologists be taken into account in computing the

6. Examples of the tax-planning advantages available to the multistate enterprise under the separate reporting system are addressed *infra* in Section II.B.

income apportioned to Louisiana? In what way? Assume also that the Texas refinery, RCo, was inefficient because it used obsolete equipment. Should no profits be attributed to it? What if RCo used that equipment temporarily in order to allow the unitary group to hold its market while a new refinery was under construction? What if the $100 of profits were attributable entirely to a spike in the world price of oil resulting from a decision of the OPEC cartel?

All of the above questions must be answered in a satisfactory and consistent way for separate accounting to operate successfully. In addition, they must be answered consistently in the states where the unitary business operates. They will be answered initially by the taxpayer when it prepares its tax books. The taxpayer is likely to resolve doubtful issues in its favor. The tax department may have difficulty challenging the taxpayer's reported income absent some clear showing of abuse.

The example above dealt with affiliated companies engaged in transactions between related entities for which the market provides at least some evidence of arm's length prices.[7] In many cases of related-person transactions, however, market prices cannot be determined with reasonable accuracy. Market prices are particularly difficult to obtain for the value contributed through use of intangible property, such as a trademark, patent, trade secret, franchise, customer list, copyright, unique management system, and know-how.

Market prices are also difficult to estimate when one related company transfers value to another under conditions that would not be duplicated in transactions between unrelated persons. Consider, for example, the transfer of value that occurs when the vice president of LCo, an affiliated company that manufactures telephones, calls the vice president of TCo, the affiliated company engaged in research and design. The LCo vice president resolves a problem facing TCo in a way that will increase corporate profitability significantly. LCo operates only in Louisiana and TCo operates only in Texas. No comparable prices will be available to allow LCo and TCo to determine in an objective manner the value of that telephone call.

As a further example, consider a unitary business that operates two stores. One store is operated by LCo in Louisiana and the other store is operated by MCo in Mississippi. LCo, the parent corporation, buys inventory centrally for itself and MCo, getting a volume discount. On a separate accounting basis, MCo reports a high profit to Mississippi and LCo breaks even in Louisiana. If LCo closed its store in Louisiana, the profits of MCo would decline because its unit costs for inventory would increase. Under these facts, it is clear that LCo contributes to the profitability of MCo. The result reached under separate accounting, which does not take LCo's contribution into account, is misleading.[8]

In a combined reporting regime, none of the difficult questions posed above needs to be answered. The goal of combined reporting is to apportion the entire

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7. In *Exxon Corp. v. Dept. of Revenue of Wisconsin*, 447 U.S. 207, 100 S. Ct. 2109 (1980), the Court held that combined reporting and formulary apportionment is preferred to the arm's length method of apportionment even in the face of good price data.

8. *See* Butler Bros. v. McColgan, 315 U.S. 501, 62 S. Ct. 701 (1942).

unitary income of a business enterprise among the states where it operates. By using a fixed formula, the combined report largely eliminates opportunities for a state to manipulate the rules to maximize its revenues. Similarly, it eliminates opportunities for unitary businesses to manipulate the rules to minimize their tax obligations. Minor imperfections in the operation of combined reporting are likely to average out over time because of the absence of any systemic bias in favor of increasing or reducing a state's entitlement to tax revenue.

B. Protection Against Tax-Minimization Strategies

The many techniques that tax planners have developed to exploit the weaknesses of a separate reporting system are too numerous to catalog in this Article. One popular strategy for a corporate group is to isolate nexus-creating activities and property of its unitary business in one corporation. That corporation is taxable by the state on an apportioned share of its taxable income. Other members of that group, however, have no nexus-creating activities or property in the state and are thereby insulated from tax by that state on any part of their unitary income. As a result, the state only gets to tax that portion of the income of the unitary group that appears on the books of account of the corporation having nexus with the state, even though all of the members of the corporate group are engaged in the same unitary business.

Another technique used by multistate and multinational corporate groups to minimize state income taxes is to create an intra-group expense on the books of a corporation having nexus with the state that is payable to another member of the unitary group located outside the state, typically in a tax haven. Yet another technique is for the members of a unitary group to set the prices charged for the transfer or provision of goods and services to related persons in a way that allows them to shift income from high-tax states to low-tax states. Tax planners may use some or all of these techniques simultaneously.

A separate reporting state is not defenseless against these tax-planning techniques. To combat them, however, its tax department must take aggressive action to detect their use and to find some way under the separate reporting rules to subject the deflected income to tax. Sometimes the tax department will enjoy some measure of success. In some cases, however, the unitary group is successful in having its tax-planing techniques upheld.[9]

The combined report directly blocks these techniques and other similar tax-minimization strategies. The isolation of nexus-creating activities in a single corporation is impossible because the state imposes its income tax on an apportioned share of the aggregate income of the members of the unitary group. Deflecting income by manipulating transfer prices or by setting up inter-company

9. In *SYL, Inc. v. Comptroller of the Treasury*, Circuit Court for Baltimore City, No. 24-C-99-002389 AA (Mar. 17, 2000), *aff'g* Maryland Tax Court, No. C-96-0154-01 (Apr. 26, 1999), the court indicated that it would not stretch the letter of the law to prevent tax avoidance when the state could have prevented that avoidance by adopting a combined reporting regime.

payables is unsuccessful because transactions between members of a unitary group are washed out in preparing the combined report.[10]

The advantages of combined reporting in combating tax avoidance are nicely illustrated by examining the treatment of tax-haven holding companies under separate reporting and combined reporting. The use of a holding company is a common tax-minimization technique in Louisiana and other separate reporting states.[11] In the typical approach, the holding company is domiciled in a state that has no income tax or has favorable rules on the taxation of passive income. One state with these favorable rules is Delaware. Under Delaware law, a corporation is not subject to Delaware tax if its activities in that State are limited to maintaining and managing intangible assets that generate income such as capital gains, dividends, interest, and royalties.[12]

As an example of the potential advantages of using a holding company, assume that PCo is a corporation that is domiciled in Texas and is engaged in business in Louisiana. PCo establishes HCo, a holding company domiciled in Delaware.[13] PCo transfers valuable trademarks and trade names that it is using in its business to HCo. HCo executes a license agreement allowing PCo to use the transferred property in exchange for a royalty equal to five percent of its sales receipts. PCo deducts the royalty payment to HCo in calculating its pre-apportionment income. The royalty income is not taxed by Delaware.

The licensing of a trademark is only one way of using a Delaware holding company to generate a deduction for the payer without any tax being paid by the payee. Another way involves loans made by the Delaware corporation to the related payer corporations. Assume, for example, that PCo in the example above needs additional capital for its business. HCo has accumulated a large cash pool from its royalty income. HCo loans PCo $500 at a market interest rate of 8 percent. The annual interest payment of $40 ($500 × .08) is deducted by PCo in computing its pre-apportionment income. The interest income of that same amount is not taxable to HCo because of the exemption provided by Delaware.

As noted above, a separate reporting state like Louisiana can assert a variety of arguments to defeat the tax-minimization strategies described above. The tax

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10. For discussion of the wash rule, *see infra* Part IV.C.1.

11. There are many types of holding companies. Here we are concerned primarily with companies organized in a tax-haven jurisdiction that hold intellectual property or other intangible property made available for a fee to affiliated companies engaged in business in the taxing state.

12. Del. Code Ann. tit. 30, § 1902(b)(8) (1997). As an alternative to Delaware, a holding company could be based in a state without an income tax, such as Nevada. An even better strategy, because it is less of a red flag to auditors, may be to create a holding company in a state in which the taxpayer is already filing a combined report.

13. The creation and operation of Delaware holding companies has become a specialty of certain Wilmington-based banks. A pamphlet of one of these banks promises to arrange for the rental of office space, telephone answering services, secretarial help, and accounting and legal services through Delaware's top accounting and legal firms. "By developing relationships with these Delaware professionals, the substance of your Delaware holding company will be further reinforced." *See* Richard D. Pomp and Oliver Oldman, State & Local Taxation 10-34 n.204 (4th ed. 2001) [hereinafter Pomp & Oldman, State & Local].

department may argue that the holding company lacks substance and should be ignored for tax purposes. The transfer of intangible assets to the holding company might be challenged as lacking a business purpose or lacking substance. Louisiana might assert nexus over the holding company on account of the company's exploitation of the Louisiana market[14] or the business situs of the intangible property generating the income. It might try to impose a withholding tax on the income paid to the holding company.[15] It might deny the in-state company a deduction for amounts paid to the holding company on the ground that they are not legitimate business expenses.[16] It might recharacterize the payments to the holding company as capital expenditures. It might recharacterize the holding company's debt instrument as an equity investment, so that payments on that instrument would become non-deductible dividends.

Whether some or all of the various arguments suggested above will prevail in court is likely to depend on the facts and circumstances of each case. There can be legitimate reasons for creating a holding company, and special-purpose subsidiaries are a common feature of corporate America. The case law is full of illustrations of the good, the bad, and the ugly.[17]

The advantage of combined reporting is that it makes arguments of the type suggested above unnecessary. The tax advantage of the holding company is nullified without the state having to prevail on one or more of these arguments as

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14. *See*, *e.g.*, Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (1993).

15. Under the Internal Revenue Code, a foreign corporation licensing a trademark for use in the United States would be subject to federal tax on the amount of the royalties, typically at a rate of 30 percent. *See* I.R.C. §§ 861(a)(4); 881(a)(1) (2001); Treas. Reg. § 1.861-5 (as amended in 1975). Many U.S. tax treaties provide an exemption or reduced withholding rate for residents of the Contracting States on a reciprocal basis. *See*, *e.g.* Convention with Respect to Taxes on Income and Capital, Sept. 26, 1980, U.S.-Canada, T.I.A.S. No. 11087 at 15 (enforceable Aug. 16, 1984) (reducing withholding rate in both countries to 10 percent); Convention on Taxes on Income and Capital Gains, Dec. 31, 1975, U.S.-U.K., 31 U.S.T. 5681 (enforceable Apr. 25, 1980) (reducing withholding rate to zero). Unlike the states, the Federal government is free to tax royalties without the constraints imposed by the dormant Commerce Clause.

16. Some states have recently adopted anti-holding company legislation disallowing deductions for payments made to certain related entities. *See* Ohio Rev. Code Ann. § 5733.052 (West Supp. 2001); Iowa Code Ann. § 422.61 (West 1998); Conn. Gen. Stat Ann. § 12-218c (West 2000).

17. For a sampling of cases in which a state challenged a holding company arrangement, see *In the Matter of the Petition of Sherwin-Williams*, No. 816712 (N.Y. Tax App. June 7, 2001), *SYL, Inc. v. Comptroller of the Treasury*, No. C-96-0154-01, 1999 WL 322666 (Md. Tax Ct. Apr. 26, 1999); *Crown Cork & Seal v. Comptroller of the Treasury*, No. C-97-0028-01, 1999 WL 322699 (Md. Tax Ct. Apr. 26, 1999); *In re Burnham Corp*., DTA No. 814531, 1997 N.Y. Tax Lexis 304 (N.Y. Tax App. July 10, 1997); *In the Matter of the Petition of Express, Inc. et al.*, DTA Nos. 812330, 812331, 812332, 812334,1995 N.Y. Tax Lexis 493 (N.Y. Tax. App. Sept. 14, 1995); *Kmart Properties, Inc. (KPI), Decision of Hearing Officer, New Mexico Taxation and Revenue Department*, No. 00-04, NM ID. No. 01-287446-00 6 (Feb. 1, 2000), available at <http://www.state.nm.us/tax/d&o/dno2000_04.htm> (citing memorandum from Detroit office of Price Waterhouse that concluded that "if structured properly, a company formed to hold and license Kmart's intellectual property could generate significant state and local income tax savings for Kmart in states which allow separate entity filing for corporate income taxes as well as other non-tax benefits"). *See generally* Peter L. Faber, *Planning for the Use of Intangible Holding Companies*, 14 State Tax Notes 1931 (1998). For a recent case interpreting the meaning of business purpose, see *Ex parte Sonat*, 752 So. 2d 1211 (Ala. 1999).

long as the holding company is an includable member of the unitary group conducting business in the state. In a combined reporting state, the income of the holding company (often substantial) is added to the pre-apportionment tax base of the unitary group, and the factors of the holding company would be taken into account in applying the apportionment formula.

In some cases, a unitary group may argue that its holding company is not part of its unitary business. If that argument succeeds, then the income of the holding company would not be included in the combined report.[18] That argument, however, is often difficult for the taxpayer to win, due to the general presumption that the activities of the members of a commonly controlled group are part of that group's unitary business.[19] In addition, a unitary group attempting to keep the income of a holding company out of the combined report by claiming that the holding company's activities are unrelated to the unitary business may have difficulty convincing a court that it had a legitimate business reason for engaging in a license or other transaction with that holding company.[20]

C. Simplification

The transition from one tax regime to another typically involves some complexity, even if the new system, once up and running, is significantly less complex than the system it replaces. In some respects, a combined reporting system would be more complicated to administer than Louisiana's current separate reporting system. Overall, however, it would be simpler. In addition, both systems have so many points of commonality that a transition to the new regime should not present substantial problems for the tax department. Both systems, for example, use formulary apportionment, both require a definition of a unitary business, and both require an identification of "allocable" or "nonbusiness income"—that is, income that a non-domiciliary state may not apportion by formula under U.S. Supreme Court decisions.

The one major increase in administrative burden under combined reporting arises from the need to audit members of a unitary group that were not taxable in

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18. For discussion of whether a holding company is part of a unitary business, see Eric J. Coffill & Clare M. Rathbone, *"Unitary" Holding Companies: Uncertainty and Pitfalls Under Current California Law*, 6 State Tax Notes 757 (1994).

19. *See e.g.*, Container Corp. of America v. Franchise Tax Bd. of California, 463 U.S. 159, 103 S. Ct. 2983 (1983) (clear and cogent evidence required). For recent cases involving holding companies, see *Shaklee Corp. v. Dept. of Revenue*, 738 N.E.2d 236 (Ill. App. 1st Dist. 1998) (Japanese holding company unitary with Shaklee); *Extrusion Dies, Inc. v. Wisconsin Dept. of Revenue*, Nos. 94-I-1463, 94-I-1464 (Wis. Tax App. Comm'n Aug. 21, 1996) (corporation acting as a holding company and owning stock in a subsidiary unable to deduct net losses because it lacked nexus with Wisconsin and was not subject to the Wisconsin franchise tax).

20. As discussed *infra* in Part III.E., we recommend that Louisiana permit a water's edge election, under which an enterprise conducting a unitary business partly in Louisiana could exclude certain foreign corporations from the unitary group. In this situation, special anti-avoidance rules are necessary to prevent use of foreign holding companies for tax avoidance purposes. *See* Part III.E. and especially text at *infra* note 137.

Louisiana. Assume, for example, that PCo operates a store exclusively in Louisiana and its subsidiary, SCo, operates a store exclusively in Mississippi and that the two operations are part of a unitary business. Under current law, SCo would not be taxable in Louisiana and Louisiana would not need to audit SCo. Under combined reporting, the unitary income of both companies must be reported to the Louisiana tax department and apportioned by formula among the states where the unitary business operates. The department must do whatever is appropriate in a voluntary compliance system to make sure that the information provided to it is accurate.

The additional burden created by the increased audit coverage of corporations that do not have nexus with Louisiana is offset, however, by eliminating the need to pursue costly and complex investigations to monitor the type of tax-planning opportunities discussed in Section II.B., above. Obviously the magnitude of the administrative benefits derived, for example, from ending the tax benefits of holding company tactics and improper transfer prices depends on the vigor with which the department has pursued those schemes in the past. If the department has not been diligent, the administrative benefits may be modest. In that event, however, the revenue gains to the Louisiana treasury from adopting the combined reporting regime are likely to be very substantial.

The biggest potential gain in simplicity from adopting combined reporting comes from eliminating the need to police most intra-group transfer pricing practices.[21] Determining the proper price on a transfer of property is often difficult, for the taxpayer and the tax department.[22] In the case of transfers of valuable intangible property, the problem is particularly acute. In a separate reporting state like Louisiana, a unitary group may use intercorporate transactions to shift profits from Louisiana to a state with a lower effective tax rate.[23] Because those gambits do not work under combined reporting, the tax department is spared the expense of monitoring them for abuse.

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21. Taxpayers would also enjoy some gains from simplification. One commentator, writing during a period when separate accounting was commonly used, described it as so expensive to implement that the bookkeeping costs could far exceed the tax due under formulary apportionment. Charles W. Gerstenberg, Allocation of Business Income, 1931 Nat'l Tax Assoc. Proc. 301, 306.

22. Nearly every state allows its tax administration to adjust transfer prices to reallocate income among companies in order to reflect income accurately. In some states, this power is more constrained than that possessed by the IRS under I.R.C. § 482 (2001). The states seem to be getting more aggressive in adjusting intercorporate pricing and related expenses. The courts have not always supported these efforts. For recent cases, see *SLI Int'l. Corp. v. Crystal*, 671 A.2d 813 (Md. 1996); *New York Times Sales, Inc. v. Comm'r of Rev.*, 667 N.E.2d 302 (Mass. 1996); *Petition of Express, Inc.*, Nos. 812330, 812331, 812332, 812334, 1995 N.Y. Tax Lexis 493 (N.Y. Tax App. Sept. 14, 1995); *Aaron Rents, Inc. v. Collins*, No. D-96025 (Super. Ct., Fulton County, Ga., 1994); *Comm'r of Revenue v. AMIWoodbroke Inc.*, 634 N.E.2d 114 (Mass. 1994); *Trans-Lux Corp. v. Meehan*, 652 A.2d 539 (Conn. 1993); *Petition of Bausch & Lomb, Inc.*, No. TSB-D-90(11)C, 1990 N.Y. Tax Lexis 325 (N.Y. Tax App. July 19, 1990); *Petition of Hilton Hotels Corp.*, 1989 N.Y. Tax Lexis 63 (Feb. 24, 1989); *Commonwealth v. General Electric Co.*, 372 S.E.2d 599 (Mass. 1988). For a survey of these issues, see Mary Jane Egr, *State Section-482 Type Authority*, 11 State Tax Notes 1547 (1996).

23. In planning a transaction at the state level, advisers cannot focus solely on the nominal tax rates in the relevant states. The focus should be on the corporation's effective tax rate in each state.

Consider for example, PCo, a parent corporation that manufactures widgets in Louisiana. It sells the widgets to SCo, its subsidiary. SCo sells the widgets in Washington, a state that does not have an income tax. PCo is taxable only in Louisiana, and SCo is not taxed under Washington law, although Washington has jurisdiction to impose an income tax. In a separate filing regime, PCo's income depends on the price at which the widgets are sold to SCo. Because Louisiana has a higher effective tax rate than Washington, the corporate group is tempted to sell the widgets at the lowest defensible price. Indeed, if the taxpayer doubts the ability of the Louisiana tax department to pursue transfer pricing abuses effectively, it may arrange the sale to be made at what objectively may be an indefensible price.[24]

In combating transfer pricing abuses, a separate filing state cannot expect effective assistance from the Internal Revenue Service. Except in some very special cases, a shift of income from one domestic corporation to another has no impact on Federal tax liability. As a result, the Federal tax authorities have no institutional obligation or incentive to police such shifting. The Internal Revenue Service is properly concerned in some cases about the use of transfer prices to shift income outside the United States to foreign entities. Its track record in preventing transfer pricing abuses, however, is at best mixed, notwithstanding its allocation of extensive resources to the issue.[25]

III. MAJOR DESIGN FEATURES OF A COMBINED REPORTING REGIME

In this part, we discuss the main building blocks of a combined reporting system. Section III.A., below, describes the rules applicable in preparing a combined report. In general, a combined report is an accounting of the total income derived by a corporate group from the operation of its unitary business. The corporations that participate in a unitary business, part of which is conducted in the taxing state, must include their unitary income in the combined report of that state.

Section III.B. describes the concept of a unitary business and discusses its constitutional parameters. In general, a unitary business is a common enterprise engaged in by one or more members of a group of affiliated entities. Louisiana employs a unitary business concept, at least implicitly, under current law. We suspect, however, that Louisiana has left the meaning of a unitary business fairly

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24. Although the example in the text involved the sale of tangible personal property, the same shifting of profits can occur using management fees, consulting fees, royalty payments, or interest charges.

25. For a full discussion of the IRS efforts at preventing transfer pricing abuses, see Michael J. McIntyre, The International Income Tax Rules of the United States ch. 6 (2d ed. 2000) [hereinafter McIntyre, Int'l Treatise]. For a comparison of the Federal rules on separate accounting and the state rules on formulary apportionment, see Michael J. McIntyre, Contrasting Methodologies: A Systematic Presentation of the Differences Between An Arm's-Length/Source-Rule System and a Combined-Reporting/Formulary-Apportionment System, Proceedings of the 86th Annual Conference, National Tax Association 226 (1994) (excerpted in Pomp & Oldman, State and Local, *supra* note 13, at 11-142).

undeveloped. To operate a combined reporting regime successfully, the State will have to give greater attention to the concept. We offer some recommendations at the end of this section on how Louisiana might define a unitary business.

Section III.C. addresses issues that arise in distinguishing apportionable business income from allocable income. In many states, allocable income is referred to as nonbusiness income.[26] Louisiana does not use that latter term in its tax statute. The name is not of any great importance. The substance of the Louisiana definition of allocable income, however, differs in some significant respects from the definition of nonbusiness income used by states that have incorporated UDITPA into their tax code.

In a combined reporting regime, the portion of the apportionable income of a unitary business that is taxable by a state is determined through application of an apportionment formula. Louisiana currently employs an apportionment formula in operating its separate reporting regime. That formula, in effect, apportions half of the income of a manufacturing or merchandizing business to the place of production and the other half to the place of sale. In Section III.D. we defend the constitutional right of Louisiana to use that apportionment formula in a combined reporting regime.

Section III.E. addresses so-called "water's edge" rules. In principle, a combined reporting regime should not recognize any geographical boundaries. That is, the unitary income apportioned to Louisiana should be computed by reference to the entire worldwide income of all members of the unitary combined group. For practical and political reasons, however, we recommend that Louisiana allow taxpayers to elect to exclude from their unitary group certain foreign corporations that are not engaged directly in nexus-creating activities in the State.

A. The Combined Report

A combined report is an accounting document prepared on behalf of a group of corporations engaged in a unitary business. It contains a tabulation of the aggregate taxable income derived by the members of the group from that unitary business. The initial step in preparing a combined report is to determine the scope of the group's unitary business.[27] In computing the aggregate taxable income of group members from that unitary business, transactions between members of the group generally are eliminated.[28] The combined report also includes a tabulation of each group member's apportionment factors used in the apportionment formula. In most states, including Louisiana, the factors are property, payroll, and receipts

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26. *See* UDIPTA, *supra* note 4, at § 1(e).

27. It is possible that some or all of the members of a group of entities would be engaged in more than one unitary business. In that event, a combined report typically would be prepared for each unitary business. For simplicity, our discussion in this part assumes that the combined group is engaged in only one unitary business. For discussion of issues arising when members of a combined group are engaging in more than one unitary business, *see infra* Section III.B.3.

28. For discussion of this wash rule, *see infra* Part IV.C.1.

(sales). The corporations that are included in a combined report are sometimes referred to as a combined group or a unitary group. We use these terms interchangeably in this Article. Although the combined report would be appended to the tax return of each group member that has a tax-filing obligation in Louisiana, it is not itself a tax return.

A combined reporting state requires the unitary group to use the combined report to determine the amount of the group's taxable unitary income apportioned to the state. That amount equals the aggregate taxable income of the group multiplied by the group's apportionment percentage. The apportionment percentage is determined by applying the apportionment formula. The application of the formula is described in detail in Section III.D., below. If the apportionment percentage is, for example, twenty-five percent, then twenty-five percent of the aggregate taxable unitary income of the combined group would be taxable in the state. The tax is not imposed, however, on the unitary group itself. Rather, each member of the group having nexus with the state is made taxable on its assigned share of the unitary income apportioned to the state under the apportionment formula. Issues that arise in determining the amount taxable to particular members of a unitary group are addressed in Part IV.A.1., below.

To be included in the combined group, a corporation must be engaged in a unitary business with the other members of that group. In addition, the corporation must be controlled, directly or indirectly, by a common parent corporation or by some consortium of related owners.[29] States using combined reporting generally determine control by reference to a minimum ownership of voting stock.[30]

Some states using combined reporting define "control," for purposes of a combined report, as common ownership of more than fifty percent of a corporation's voting stock.[31] For example, if PCo owns fifty-one percent of the voting stock of SCo and the two corporations are engaged in a unitary business, they would form a combined group.

An issue that sometimes arises in defining a combined group is the proper

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29. Louisiana should specifically provide that a combined group may exist if the members are owned by one or more individuals acting in concert. *See* Rain Bird Sprinkler Mfg. Corp., California State Board of Equalization, June 27, 1984, 84-SBE-094 (upholding the tax department's position that unity of ownership exists if a group of corporations is owned by members of a family); *but see* True v. Hietkamp, State Tax Comm'r, 470 N.W.2d 582 (N.D. 1991) (upholding the tax department's position that a unitary combined group must be controlled by a single entity that is a member of that group). As a matter of tax policy, we agree with the result in *Rain Bird* and disagree with the result in *True*.

30. *See*, *e.g.*, Cal. Rev. & Tax. Code § 25105(b) (West Supp. 2001). The Federal government has given considerable attention to the issue of defining control for purposes of its controlled foreign corporation rules. *See* I.R.C. § 958 (2001) (defining indirect and constructive ownership for purposes of defining a controlled foreign corporation). Similar rules should be adopted by Louisiana in determining ownership for purposes of a control test.

31. *See*, *e.g.*, Cal. Rev. & Tax. Code § 25105(b)(1) and (2) (West Supp. 2001); Idaho Code § 63-3027B(b)(1) and (2) (Michie 2000). *But see* Utah Code Ann. § 59-7-101(28)(a) (2000) (defining a unitary group as a group of corporations that are related through common ownership and are economically interdependent). For a comparable definition of control under Federal tax law, see I.R.C. § 957(a) (2001) (defining a controlled foreign corporation).

treatment of a company that is not itself engaged in an active business but simply is holding stock in affiliated companies that are actively engaged in a unitary business. Assume, for example, that PCo owns all of the stock of SCo and TCo and that SCo and TCo are actively engaged in the same unitary business. PCo is acting merely as a holding company and is not actively engaged in that unitary business. Consistent with the goals of combined reporting, PCo should be treated as a member of the combined group. California would treat PCo as a member of the combined group under these circumstances.[32]

Having a strong control test that is not easily avoided is an important aspect of a combined reporting regime. The more-than-fifty-percent stock-ownership rule used by most states is a rule of statutory convenience, not a rule mandated by the U.S. Constitution. We endorse that rule for Louisiana because of its familiarity and wide acceptance. We would buttress the rule, however, by giving the Tax Department the authority to include a corporation in a unitary combined group when there is control in fact and a failure to include it would result in a distortion of the income of the combined group.[33] We also would endorse regulations that would treat ownership of more than fifty percent of the value of stock[34] as establishing control and that would treat restrictions on transferability of stock as indicia of control in appropriate cases.[35]

A combined report is not a consolidated tax return.[36] In a combined reporting regime, each group member files its own tax return and pays tax on its determined share of the unitary income of the combined group. In a consolidated return, a single tax return is filed on behalf of all the members of the consolidated group. A major difference between a state combined report and a Federal consolidated return is that the consolidated return may be elected regardless of whether the included corporations conduct a unitary business.[37] The state concept of a unitary business,

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32. Cal. FTB Legal Ruling 95-7 (Nov. 29, 1995); Cal. FTB Legal Ruling 95-8 (Nov. 29, 1995).

33. *See* Treas. Reg. 1.957-1(b)(2) (as amended in 1997) ("Any arrangement to shift formal voting power . . . will not be given effect if in reality voting power is retained"). The Federal government defines control for purposes of adjusting intra-group prices without reference to any ownership percentage. Treas. Reg. § 1.482-1(i)(5) (1994). Two entities are presumed to be controlled if income or deductions are artificially shifted between them. Treas. Reg. § 1.482-1(i)(4) (1994). *See also* Idaho Tax Regulation 63-3027C(b) (giving the tax commissioner authority to include or exclude a corporation from a combined group).

34. In defining a controlled foreign corporation, ownership of over 50 percent of the stock by vote or value is sufficient to constitute control. I.R.C. § 957(a)(1) and (2) (2001).

35. California has a "stapled stock" rule that treats two or more corporations as members of a control group if over 50 percent of the shares of stock are "stapled" together as a result of restrictions on their transfer. The stock of two companies is stapled if a person acquiring a share of stock in one corporation must also acquire a share of stock in the other corporation. Cal. Rev. & Tax. Code § 25105(b)(3) (West Supp. 2001). We endorse the California rule. For a related Federal stapled-stock rule, see I.R.C. § 269B (2001) (treating a foreign corporation stapled to a U.S. corporation as a U.S. corporation).

36. Under Federal rules, certain eligible corporations that are related to one another through common ownership under an 80 percent-control test may elect to file a consolidated return rather than separate returns. *See* I.R.C. §§ 1501-1505 (2001).

37. *See generally*, William L. Goldman et al., 1130 T. M. Income Taxes: Consolidated Returns

developed in part to deal with issues under the Commerce Clause and Due Process Clause of the U.S. Constitution, has no federal counterpart in this context.[38]

Combined reporting is a neutral accounting system that neither favors nor penalizes the taxpayer or state. In some cases, a group of corporations may want to include a particular corporation in their control group; in other cases, they may want to exclude it from the group. Everything depends on the facts and circumstances of the particular case.

In general, a group of corporations would prefer combined reporting if one member of their unitary combined group has suffered a loss and the loss otherwise would not be useful to them. Consider, for example, PCo, a parent corporation with nexus in Louisiana. PCo has a unitary subsidiary, SCo, that operates at a loss in another state. PCo has income of $200 and SCo has a loss of $100. Under these facts, PCo would pay tax to Louisiana on $200 in a separate reporting regime. In a combined reporting regime, the pre-apportionment income of the unitary business would be only $100, so PCo's apportioned income taxable in Louisiana would be no more than $100.

Of course, a combined reporting regime may cause some combined groups to pay higher aggregate taxes. For example, if PCo in the above example had the loss of $100 and SCo had income of $200, PCo would not pay any tax in Louisiana in a separate reporting regime. In a combined reporting regime, however, the combined group of PCo and SCo would have pre-apportionment income of $100, some portion of which would be apportioned to Louisiana under the apportionment formula.

If multistate corporations were not engaging in tax planning to exploit defects in Louisiana's separating reporting regime, the overall revenue impact of adopting combined reporting probably would not be substantial. Some corporate groups would pay more and some would pay less, with the overall revenue impact uncertain. The major effect of the reform would be a better measure of in-state income and some simplification.[39] In the world we live in, however, the adoption of combined reporting would increase Louisiana tax revenues by reducing tax planning opportunities.[40] Although we do not have data necessary to make a revenue estimate, we expect that the revenue gains would be significant.[41] Of course the Louisiana legislature could adopt offsetting tax reductions if it wanted to make its overall reform package revenue neutral.

The Uniform Division of Income for Tax Purposes Act (UDITPA), promulgated in 1957 by the National Conference of Commissioners on Uniform State Laws and the

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and Combined Reporting (revised 2001).

38. Some states permit corporations that file—or could have filed—a federal consolidated return to file a similar state return. The taxpayer is not required to file a consolidated return; indeed, a mandatory rule probably would be unconstitutional in some situations because the unitary business principle both empowers and limits the tax jurisdiction of states.

39. *See supra* Parts II.A. and II.C.

40. *See supra* Part II.B.

41. *See* Richard D. Pomp, *The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer*, *in* The Future of State Taxation 49, 64-65 (David Brunori ed. 1998) [hereinafter Pomp, Future of State Taxation].

American Bar Association, contains no express statement on the use of combined reporting.[42] This silence is unfortunate, for UDITPA is the basic document used by the states to promote uniform corporate tax rules.

Section 18 of UDITPA does provide, inter alia, for "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income," if its rules on apportionment and allocation "do not fairly represent the extent of the taxpayer's business activity in [the taxing] state." Some courts have relied on Section 18 to uphold state regulations that require the use of combined reports.[43] That street, however, is one way. Taxpayers generally have been unsuccessful in invoking Section 18 to secure the right to file a combined return in the absence of legislative authorization.[44]

It makes no sense for Louisiana to adopt combined reporting unless the combined reporting regime is mandatory. Indeed, Louisiana taxpayers already can achieve the results of combined reporting by merging certain of their separate entities into other members. This self-help approach typically involves some transaction costs and other business obstacles that might outweigh the tax savings in some circumstances. If combined reporting were elective rather than mandatory, these costs and obstacles would be eliminated and the cost in revenue forgone by the Louisiana treasury would increase. Moreover, elective combined reporting would do nothing to reduce tax planning opportunities because taxpayers that are reducing their taxes by gaming the current system would simply decline to make the election.

B. Defining a Unitary Business

In Section III.B.1. below, we discuss the ways in which the unitary business concept both empowers and limits state taxing power. In Section III.B.2., we discuss the major pronouncements of the United States Supreme Court on the unitary business concept. In Section III.B.3., we address issues arising when affiliated entities engage in more than one unitary business. Section III.B.4. provides our practical advice to Louisiana on how to define a unitary business.

1. Jurisdictional Issues

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42. *See* UDITPA, *supra* note 4.

43. *See*, *e.g.*, Caterpillar Tractor Co. v. Lenckos, 395 N.E.2d 1167 (Ill. 1979); Pioneer Container Corp. v. Beshears, 684 P.2d 396 (Kan. 1984). For discussion, see Laura L. Farrell, *The State of Combined Reporting Today*, 11 State Tax Notes 635 (1996); 2000 Multistate Corporate Tax Guide at I-533 to I-550; I-613 to I-623 (J. Healy ed.).

44. The Supreme Court has not addressed the issue of whether a constitutional right exists to file a combined report. The taxpayer raised this issue in *Mobil*, but the Court did not address it on the grounds that it was not presented in a timely manner. Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425, 441 n.15, 100 S. Ct. 1223, 1233 (1980). The state courts have uniformly rejected taxpayer arguments that they have a constitutional right to file a combined report. *See*, *e.g.*, Ashland Pipe Line Co. v. Marx, 623 So. 2d 995 (Miss. 1993). Some courts have rejected attempts by the tax administration to impose a combined report if a statute did not explicitly authorize it. Polaroid Corp. v. Comm'r of Revenue, 472 N.E.2d 259 (Mass. 1984); Sears Roebuck & Co. v. State Tax Assessor, 561 A.2d 172 (Me. 1989).

Under well-established constitutional doctrine, a state cannot tax a corporation's income unless there is "some definite link, some minimum connection"[45] between the state and the corporation's income that the state seeks to tax. This necessary connection or relationship is referred to as "nexus." Nexus is present when the income of the corporation is attributable in a meaningful way to the unitary business, part of which is conducted in the taxing state.

To tax the income of corporations in a combined reporting regime, therefore, Louisiana must limit the reach of its tax to income having a nexus with the State. According to the United States Supreme Court, the "linchpin of apportionability in the field of state income taxation is the unitary-business principle."[46] In the Court's authoritative view, the income derived by a group of corporations from the operation of a unitary business has nexus with all of the states in which that unitary business is conducted. In sum, if a unitary business is being conducted in Louisiana, the State may apportion all the income of that unitary business regardless of where, why, how, or from what specific activities that income is realized.

To illustrate the implications of the Court's doctrine, consider a corporation, PCo, that conducts activities both within and without Louisiana. Louisiana obviously would have nexus over the in-state activities and could tax PCo on some portion of the income generated by those activities. Louisiana also would have nexus to tax PCo on an apportioned share of the income generated by the out-of-state activities if those activities had a sufficient relationship to the in-state business.[47] That relationship is established if the activities of PCo within and without Louisiana are integrated, interdependent, or synergistic—that is, if the activities of the enterprise constitute a unitary business.[48] The simple rule is that a taxing state may tax an apportioned share of the separately stated income attributable to activities that otherwise may be viewed as occurring outside the

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45. Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-45, 74 S. Ct. 535, 539 (1954).

46. *Mobil*, 445 U.S. at 439, 100 S. Ct. at 1232.

47. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 112 S. Ct. 2251 (1992).

48. For state cases interpreting and applying the concept of a unitary business, see *Earth Resources Co. v. Alaska, Dept. of Revenue*, 665 P.2d 960 (Alaska 1983); *Appeal of the Leland Corp., California State Board of Equalization*, No. 94A-0916 (Feb. 5, 1997); *Dental Ins. Consultants, Inc. v. Franchise Tax Bd.*, 1 Cal. Rptr. 2d 757 (Cal. Ct. App. 1991); *Arizona Dept. of Revenue v. Talley Indus.*, 893 P.2d 17 (Ariz. Ct. App. 1994); *Pledger v. Ill. Tool Works, Inc.*, 812 S.W.2d 101 (Ark. 1991); AMAX, Inc. v. Groppo, 550 A.2d 13 (Conn. App. Ct. 1988); *McLean Gardens Corp. v. District of Columbia*, No. 3158-82 (D.C. Sup. Ct. Jan. 31, 1983); *Albertson's Inc. v. Idaho Dept. of Revenue*, 683 P.2d 846 (Idaho 1984); *Citizens Utils. Co. v. Dept. of Revenue*, 488 N.E.2d 984 (Ill. 1986); *Super Value Stores, Inc. v. Iowa Dept. of Revenue*, 479 N.W.2d 255 (Iowa 1991); *Texas Co. v. Cooper*, 107 So. 2d 676 (La. 1958); *Md. Comptroller of Treasury v. Diebold*, 369 A.2d 77 (Md. 1977); *Russell Stover Candies, Inc. v. Dept. of Revenue,* 665 P.2d 198 (Mont. 1983); *Cox Cablevision Corp. v. Dept. of Revenue*, No. 3003, 1992 Ore. Tax Lexis 17 (Ore. Tax Ct. June 10, 1992); *Homart Dev. Co. v. Norberg*, 529 A.2d 115 (R.I. 1987); *Exxon Corp. v. S.C. Tax Comm'n.*, 258 S.E.2d 93 (S.C. 1979), *appeal dismissed*, 447 U.S. 917, 100 S. Ct. 3005 (1980); *Corning Glass Works, Inc. v. Va. Dept. of Taxation*, 402 S.E.2d 35 (Va. 1991), *cert. denied*, 502 U.S. 900, 112 S. Ct. 277 (1991); *Interstate Finance Corp. v. Wis. Dept. of Taxation*, 137 N.W.2d 38 (Wis. 1965); *see generally* Franklin C. Latcham, 1110 T.M., Income Taxes: Definition of a Unitary Business (revised 2001) [hereinafter Latcham, Unitary Business].

taxing state when those activities are a part of the unitary business conducted, in whole or in part, within the taxing state.

The example above illustrates the application of the unitary-business principle to a single corporation. The same principle applies, however, when two or more corporations are preparing a combined report. Assume that PCo, in the example above, organized a subsidiary, SCo, to conduct its out-of-state business activities. That change in legal organization would not affect Louisiana's jurisdiction to tax the income of SCo. SCo could be included in the combined report and its income subject to Louisiana tax if its activities are integrated, interdependent, or synergistic with the business of PCo.

A state is not permitted under the U.S. Constitution to tax all of the unitary income of a member of the combined group with which it has nexus. A state is only permitted to tax its apportioned share of that income.[49] The issue of fair apportionment is addressed in Section III.D.

2. Definitional Guidance from the U.S. Supreme Court

The U.S. Supreme Court has never attempted a rigorous, systematic definition of a unitary business.[50] The Court has acknowledged that "the unitary business concept is . . . not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach."[51] Instead, it has identified some of the indicia of a unitary business. Those indicia include the following:

(1) Unity of use and management;[52]

(2) A concrete relationship between the out-of-state and the in-state activities that is established by the existence of a unitary business;[53]

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49. Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 460, 79 S. Ct. 357, 363 (1959) ("[T]he entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs.").

50. The unitary business principle grew out of the "unit rule" of the late 19th century, which was used for apportioning the property tax of railroads, telegraph and express companies. Under the unit rule, the value of the entire enterprise was first determined and then apportioned to a taxing jurisdiction through the use of a formula. *Allied-Signal*, 504 U.S. at 778-79, 112 S. Ct. at 2258-59. *See* Elcanon Isaacs, *The Unit Rule*, 35 Yale L.J. 838 (1926). The unit rule respected the self-evident reality that the value of an assembled whole may be greater than the value of the individual elements that constituted the interconnected system being taxed. The Supreme Court at one point made the observation in defense of the unit rule that "[c]onsidered as distinct subjects of taxation, a horse is, indeed, a horse; a wagon, a wagon; a safe, a safe; a pouch, a pouch; but how is it that $23,430 worth of horses, wagons, safes and pouches produces $275,446 in a single year? . . . The answer is obvious." Adams Express Company v. Ohio State Auditor, 165 U.S. 194, 222-23, 17 S. Ct. 305, 310 (1897).

51. Container Corp. of America v. Franchise Tax Bd. of California, 463 U.S. 159, 167, 103 S. Ct. 2983, 2941 (1983).

52. Butler Bros. v. McColgan, 315 U.S. 501, 508, 62 S. Ct. 701, 704 (1942).

53. *Container*, 463 U.S. at 166, 103 S. Ct. at 2940.

(3) Functional integration, centralization of management, economies of scale;[54]

(4) Substantial mutual interdependence;[55] and

(5) Some sharing or exchange of value not capable of precise identification or measurement—beyond the mere flow of funds arising out of a passive investment or a distinct business operation.[56]

Whether the activities of one member of a corporate group are related to the business of another member of that group can depend on how that latter corporation's business is described. A corporation's business can be described in many ways, from the most specific to the most general. For example, assume that PCo manufactures widgets for use in the aerospace industry and that SCo, its subsidiary, manufactures widgets for the automotive industry. If PCo's business is described very specifically as conducting a unitary business of manufacturing widgets for the aerospace industry, then the activities of SCo might not appear to be related to that business.[57]

Moving to a slightly higher level of generality, PCo's unitary business might be described as manufacturing widgets. Under that definition, SCo's activities would more likely be considered to be unitary with PCo's business. Even more generally, PCo's unitary business might be described as a manufacturer. In that event, the activities of all of PCo's manufacturing subsidiaries might be unitary with PCo's business. On the highest level of generality, PCo could be described as in the business of allocating its resources to maximize its internal rate-of-return. At that level of generality, any activities of a subsidiary of PCo might be unitary with PCo's business. The United States Supreme Court, in *Allied-Signal*,[58] rejected the highest level of generality.[59] It almost certainly would reject the most

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54. Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425, 438, 100 S. Ct. 1223, 1232 (1980).

55. F.W. Woolworth Co. v. Taxation and Revenue Dept. of New Mexico, 458 U.S. 354, 371, 102 S. Ct. 3128, 3139 (1982).

56. *Container*, 463 U.S. at 166, 103 S. Ct. at 2940. For a detailed treatment of the definition of a unitary business, see Latcham, Unitary Business, *supra* note 48.

57. We certainly are not suggesting by this example and those that follow that similarity of the actual products being sold determines whether two separate entities are in a unitary relationship. California has recognized that businesses diverse in what they sell can be in a unitary relationship. *See* Mole Richardson Co. v. Franchise Tax Bd., 269 Cal. Rptr. 662 (1990) (rental of lighting for Hollywood and Colorado ranching held to be unitary).

58. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 112 S. Ct. 2251 (1992).

59. In defending its broad characterization of the business of *Allied Signal*, New Jersey did little to help the Court see that selecting the appropriate level of generality in defining a unitary business is an application of a more pervasive problem in the law. *See*, *e.g.*, Bruce Ackerman, *Levels of Generality in Constitutional Interpretation: Liberating Abstractions*, 59 U. Chi. L. Rev. 317 (1992); Laurence H. Tribe & Michael C. Dorf, *Levels of Generality in the Definition of Rights*, 57 U. Chi. L. Rev. 1057 (1990); Richard D. Pomp, *Issues in the Design of Formulary Apportionment in the Context of NAFTA*, 49 Tax L. Rev. 795, 802-03 (1995) [hereinafter Pomp, NAFTA]; Pomp & Oldman, State and Local,

limiting extreme as well. In the middle is the grey area where law suits are won and lost.

The Court has asserted that it "will, if reasonably possible, defer to the judgment of state courts in deciding whether a particular set of activities constitutes a 'unitary business.'"[60] The Court has declared that "our task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.'"[61] Some decisions suggest, however, that the Court will not actually apply its professed standard.[62]

Whether income is part of the unitary business cannot be determined by the label attached to it. For example, dividends, interest, or capital gains cannot automatically be assumed to be nonbusiness income. Similarly, rental income may not necessarily constitute business income. Whether an item of income should be included in the apportionable unitary business income of a corporation depends on the relationship of that item to the business being conducted in the taxing state. For example, if a corporation holds its working capital in a bank account, interest paid on this account would be part of the corporation's unitary business income because of its integral relationship to the corporation's business operations.[63]

3. Multiple Unitary Businesses

A corporate group, or even a single company, may simultaneously conduct more than one unitary business. In some cases, only one of these unitary businesses would have activities in the taxing state. In such a case, Louisiana should tax an apportioned share of the income from the unitary business that is conducted in part within the State. The corporate group would determine the taxable income of that unitary business and would apply the apportionment formula using only the property, payroll and receipts (sales) factors relating to that unitary business.

As an illustration, assume that a corporate group owns a chain of gas stations in Louisiana and Missouri and a chain of pharmacies in Arkansas and Mississippi.[64] Assume the corporate group is considered to be conducting two separate and independent unitary businesses. Louisiana and Missouri would apply formulary apportionment to determine their share of the income of the gas stations, and Arkansas and Mississippi would apply formulary apportionment to determine their

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supra note 13, at10-21.

60. *Container*, 463 U.S. at 175, 103 S. Ct. at 2945.

61. *Id*. at 176, 103 S. Ct. at 2946.

62. *See Allied-Signal*, 504 U.S. 768, 112 S. Ct. 2251 (1992). For discussion, *see* Benjamin Miller, *Allied-Signal—A Cursory Examination*, 2 State Tax Notes 888 (1992).

63. *See* Richard D. Pomp & Rebecca S. Rudnick, *Federal Tax Concepts as a Guide for State Apportionment of Dividends: Life After ASARCO*, 18 Tax Notes 411 (1982) (excerpted in Pomp & Oldman, State and Local, *supra* note 13, at 11-67); *Allied-Signal*, 504 U.S. at 787, 789, 112 S. Ct. at 2263, 2264. Louisiana currently deviates from the general principle that the label attached to a corporation's business income should not control the way it is taxed. Louisiana does not treat dividends and interest as apportionable income even if the income is related to a unitary business. For discussion of the treatment of allocable income under Louisiana law, see Section III.C.

64. *See* Pomp, NAFTA, *supra* note 59, at 802-03.

respective shares of the income of the pharmacies. Louisiana and Missouri would not include the income from the pharmacies in the corporate group's combined report, and the factors attributable to that operation would not enter into the apportionment formula.[65] Similarly, Arkansas and Mississippi would not include the income from the gas stations in the corporate group's combined report, and the factors attributable to the gas station business would not enter into the apportionment formula. Some method akin to separate accounting should be used to determine the separate incomes of the pharmacy business and the gas station business.

A corporation might conduct two unitary businesses, each of which was conducted in Louisiana. In this case, Louisiana should calculate the taxable income of each unitary business separately. It would then apply a separate apportionment formula for each of the businesses.

4. Some Specific Recommendations

In adopting a combined reporting system, we recommend that Louisiana adopt as broad a definition of a unitary business as the Court's Due Process and Commerce clause jurisprudence allows. In our view, it is consistent with that jurisprudence to define a unitary business as a common enterprise undertaken by one or more commonly controlled entities in pursuit of business profits. Evidence that a commonly controlled entity is engaged in a common enterprise would include:

> (1) that the participants in the enterprise contribute or are expected to contribute in a nontrivial way to each other's profitability;
>
> (2) that it is sharing or exchanging value with other participants in the enterprise;
>
> (3) that the prices it charges or is charged on transfers of assets or services to other participants in the enterprise are inconsistent with the arm's length principle;[66]

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65. The appropriate function of an apportionment factor is to measure the business activities in a taxing state relative to the business activities in the other states where the unitary business is conducted. When an apportionment factor is being used in two unitary businesses, the question arises as to how much of the value of that factor should be included in the apportionment formula of each business. One possibility would be to bifurcate the factor and allocate it between the two businesses. For example, if an employee spends forty percent of his time on one unitary business and sixty percent of his time on the other unitary business, it would seem appropriate to include forty percent of his salary in the payroll factor of the first business and sixty percent in the payroll factor of the other business. In other circumstances, bifurcating the factor may be inappropriate. For example, if an asset provides full benefits to both businesses without any diminution in the value to either business from the dual use, then it may be appropriate to include the full value of the factor in the apportionment formula of each business.

66. The fact that affiliates set their transfer prices in accord with the arm's length principle does

(4) that it is dependent on other participants in the enterprise or one or more of those participants is dependent on it for achieving some nontrivial business objectives;

(5) that its functions are integrated with the functions of one or more participants in the enterprise;

(6) that its activities are managed by some central authority of the enterprise; or

(7) that it offers some economies of scale or economies of scope that benefit the enterprise.

To avoid becoming enmeshed in disputes over the interpretation of particular court decisions, we have formulated our list of the evidentiary determinants of a unitary business without invoking the "magic" phrases that courts sometimes use to summarize their views on the unitary business concept. The court-approved phrases are intended to serve as a summary of the holdings of their prior decisions. Our listing is more suggestive of the legal and economic analysis required to determine the existence and scope of a unitary business.

By employing a definition of a unitary business that is co-extensive with its taxing power under the United States Constitution, Louisiana improves its chances of making substance rather than form control the treatment of unitary businesses. A broad definition provides less opportunities for manipulation by taxpayers and by the tax department and results in lower compliance costs for everyone.

In particular, we strongly recommend that Louisiana explicitly provide, by statute or authorized regulations, that holding companies may be included in a combined report even if their activities are primarily passive. We are concerned with two types of holding companies. The first, and most important, is a company that holds assets, such as trademarks and patents, that are used by the unitary business. As discussed in Part II.B., the courts are unlikely to allow a group of affiliated companies to exclude such a holding company from its combined report. To avoid litigating risks, nevertheless, we recommend that this important point be clarified in the statute or regulations. A rule requiring that holding companies be included in a combined report is consistent with constitutional standards.

The second type of holding company is a parent company that owns a controlling interest in two or more affiliated companies engaged in the same unitary business. As indicated in Section III.A., we believe that such a holding company should be included in the unitary group with its affiliated companies, even if its activities are essentially passive.[67] This rule is often helpful to the taxpayer, although the overall revenue implications of the rule are not likely to be large. In large measure, the rule simply removes a trap for unwary taxpayers that have not received

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not negate in any way the existence of a unitary business. *See* Exxon Corp. v. Dept. of Revenue of Wisconsin, 447 U.S. 207, 100 S. Ct. 2109 (1980).

67. *See* text at *supra* note 32.

good tax planning advice.

Although we favor a broad definition of a unitary business, we obviously recommend against a definition that would go beyond constitutional bounds. Some states have adopted taxing statutes that subject corporations to tax on an apportioned share of all of their income, regardless of the relationship of that income to the state.[68] These states, known as full apportionment states, would violate the Court's nexus holdings if they tax income generated by activities having no relationship to the state.[69] Not only do these states make their tax statutes subject to constitutional attack, they also lose whatever presumption the Court is willing to indulge that the state's determination of nexus is "within the realm of permissible judgment."[70]

We recommend that Louisiana adopt several rebuttable presumptions that would apply in establishing the existence of a unitary business. The goal of these presumptions is to treat income as part of a unitary business whenever that treatment is consistent with constitutional standards. Our proposed presumptions make clear that in the absence of any proof that a unitary relationship is lacking, a challenge, whether by the taxpayer or the state, against the presumption will fail.[71] We prefer that the presumptions be included in authorized regulations rather than in the tax statute so that they may be fine tuned by the tax department in light of its experience in administering a combined reporting regime.

In some cases, a presumption favoring the existence of a unitary business may be helpful to the taxpayer. In other cases, the presumption is likely to encourage taxpayers to volunteer information that will help the state determine whether a unitary business exists. Experience teaches that a non-cooperative taxpayer can make things difficult when a state engages in discovery. The use of presumptions may help overcome taxpayer recalcitrance and obstinacy.

We recommend that Louisiana consider adopting the following four presumptions:

> (1) A taxpayer or corporate group is presumed to be engaged in a unitary business when all of its activities are in the same general line;
>
> (2) A taxpayer or corporate group is presumed to be engaged in a unitary business when its various divisions, segments, branches, or affiliates are engaged in different steps in a vertically structured enterprise;

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68. *See, e.g.*, Conn. Gen. Stat. Ann. §§ 12-218 (West 2000); Md. Tax-Gen. §§ 10-401,402 (1997); N.J. Stat. Ann. §§ 54:10E-6, 54:10A-6 (West Supp. 2001); R.I. Gen. Laws § 44-11-14 (1999).

69. *See* Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 112 S. Ct. 2251 (1992).

70. Container Corp. of America v. Franchise Tax Bd. of California, 463 U.S. 159, 176, 103 S. Ct. 2983, 2946 (1983).

71. A presumption against the taxpayer has long been recognized by the Supreme Court. *See id*. at 164, 103 S. Ct. at 2939-40. "[T]he taxpayer has the distinct burden of showing by clear and cogent evidence that [the state tax] results in extraterritorial values being taxed." *Id*. at 175, 103 S. Ct. at 2945 (internal quotation marks and citations omitted). *See* Adams Express Co. v. Ohio State Auditor, 165 U.S. 194, 227, 17 S. Ct. 305, 311 (1897) ("Presumptively all the property of the corporation or company is held and used for the purposes of its business . . . .").

(3) A taxpayer or corporate group that might otherwise be considered as engaged in more than one unitary business is presumed to be engaged in one unitary business when there is a strong central management, coupled with the existence of centralized departments or affiliates for such functions as financing, advertising, research, or purchasing; and

(4) A taxpayer operating different business segments within the organizational structure of the single business entity is generally presumed to be engaged in a single unitary business with respect to the business segments.

Another set of presumptions should address when a newly-formed or acquired business would be considered as part of the unitary business of the corporation that formed or acquired it.[72] Based on our involvement with the Multistate Tax Commission's Public Participation Working Group on the Definition of a Unitary Business,[73] we believe that the following presumptions are desirable and are likely to meet the legitimate expectations of state tax administrators and corporate taxpayers:

(1) Newly-acquired corporations. When a corporation acquires another corporation, a presumption should exist against a finding of unity between the two corporations during the first year. Any party may rebut such presumption by proving that the corporations were unitary.[74] If the presumption is rebutted, the corporations shall be considered unitary as of the date of acquisition, unless the evidence shows that unity was established as of another date.

(2) Newly-formed corporations. When a corporation forms another corporation, a presumption should exist in favor of finding unity between the two corporations as of the date of formation. Any party may rebut such presumption by proving that the corporations were not unitary or that unity was established as of a later date.[75]

In addition to the presumptions noted above, Louisiana should adopt a presumption that the tax department's determination of whether a taxpayer is engaged in a unitary business is correct if the taxpayer unreasonably refuses to provide information pertinent to the determination of a unitary business. The taxpayer should not be allowed to use any of the unfurnished information that was covered by the request of the tax department to rebut that presumption at a later

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72. These presumptions are not suitable for statutory enactment but instead should be included in authorized regulations.

73. Information on the PPWG and on the Definition of a Unitary Business is available on line at <http://www.mtc.gov/PPWGs/ppwglist.html> (last visited May 14, 2001).

74. An instant unitary relationship might be established, for example, when the acquired company was previously an unaffiliated supplier to, or buyer from, the acquiring unitary business.

75. A newly formed affiliate might lack instant unity when the new affiliate was a separate business that had no ties to the existing business of the unitary business.

date.[76]

C. Apportionable and Allocable Income

A combined reporting regime applies only to income derived from a unitary business. That income is apportioned among the various states where the unitary business is conducted. Unitary business income subject to apportionment is referred to as "business income" or "apportionable income." The Louisiana tax statute uses the term apportionable income.[77] Income that does not constitute apportionable income is referred to as "nonbusiness income" or "allocable income." Allocable income is the term of choice in the Louisiana statute.[78] Allocable income is allocated to a single state without apportionment.

The states have not developed uniform practices on the treatment of allocable income. One very common approach, however, is to treat allocable income as the residual category and to apply allocation rules to income that does not constitute the unitary business income of the taxpayer.[79] This approach has been adopted by UDITPA.[80] Interest, dividends, rents, royalties, and certain capital gains are examples of income that sometimes can qualify as allocable income under this approach. All of these types of income, nevertheless, could constitute business income in many circumstances.

A less common approach, followed by Louisiana, designates certain categories of income as allocable income, regardless of whether the income in those categories arose from business activities. Typical examples of income subject to this rule include interest, dividends, rents, royalties, and certain capital gains.[81] In Louisiana, allocable income is limited to most interest and dividend income,[82]

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76. For an analogous Federal rule, see I.R.C. § 982 (2001) (prohibiting a taxpayer that fails to comply with a formal document request without reasonable cause from later using the requested document in a court of law to resist a tax assessment).

77. La. R.S. 47:287.92(A) (2001) ("items of gross income, not otherwise exempt, shall be segregated into two general classes designated as allocable income and apportionable income").

78. *Id*.

79. The definition of unitary-business income is addressed in *supra* Section III,B.

80. UDITPA, *supra* note 4, at § 1(e) ("'Non-business income' means all income other than business income.").

81. The rules allocating these categories of allocable income will vary, depending on the income at issue. *See, e.g.*, Del. Code Ann. tit. 30, § 1903 (1995); La. R.S. 47:287.91-.93 (2001); Ohio Rev. Code Ann. § 5733.051 (West 1995). States that define allocable income in terms of income categories typically adopted their statutes in the distant past, when the constitutional landscape was quite different. In those earlier times, allocation was thought to be appropriate for interest, dividends, rents, and royalties because they formed "no part of the trading profit and do not need to be apportioned by formula, since they can readily be specifically allocated to their proper sources." Report of the Committee of the NTA on Allocation of Income, 1939 NTA Annual Conference 190, 207.

82. La. R.S. 47:287.93(A)(4) (2001). In 1993, Louisiana adopted a special apportionment rule for certain dividend and interest income received by a corporation from a controlled subsidiary. La. R.S. 47:287.94(I)(1) and (2) (2001). Under the 1993 amendment, interest paid by a subsidiary on indebtedness having a situs in Louisiana generally would be apportioned pro rata to the payer's real and tangible personal property within and without Louisiana. A dividend from a subsidiary would be apportioned pro rata to the place where the profits out of which the dividend was paid had arisen. The

certain rents and royalties from tangible real and personal property,[83] royalties from intangible property, income from construction and repair services, and income from estates, trusts, and partnerships.[84]

We recommend in Section III.B.4., that a unitary business be defined as broadly as the Court's current constitutional jurisprudence allows. Consistent with this recommendation, corporate income should be subject to apportionment unless that income has no nexus with the states in which the corporation is engaging in a unitary business. Because a corporation's income is either apportionable income or allocable income, our broad definition of apportionable income results in a narrow definition of allocable income. By defining apportionable income as broadly as the United States Supreme Court allows, a state simplifies the administration of its tax and substantially reduces opportunities for tax avoidance.

The approach that we recommend is consistent with UDITPA but is not compelled by UDITPA. By defining nonbusiness income as income other than business income, however, UDITPA certainly suggests that business income is the primary category and nonbusiness income is the subordinate category.[85]

Our recommendation, however, goes beyond UDITPA. Under UDITPA, business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."[86] This language has been interpreted by some state courts as requiring a positive showing that an income item arose from normal business activities to be categorized as business income.[87] Under our view, any income having a nexus with a taxpayer's business would constitute business income subject to apportionment. An item of income would be classified as nonbusiness income only if the taxpayer established that the income did not have a nexus with its business or if there were a compelling reason why apportionment would not reach an appropriate result.

Our recommendation also goes beyond the definition of business income contained in a regulation that was under study in the mid-1990s by the Multistate Tax Commission.[88] That draft regulation attempted to modernize UDITPA's

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Louisiana Supreme Court held that the 1993 amendment violated Article III, Section 2 of the Louisiana Constitution, which prohibits the legislature from levying a new tax in an odd-numbered year. *See* Dow Hydrocarbons & Resources v. John Neely Kennedy, et al., 694 So. 2d 215 (La. 1997). With the demise of the 1993 amendment, the pre-1993 allocation rule applies.

83. The statutory phrase is "corporeal movable property."

84. La. R.S. 47: 287.92(B) (2001).

85. For development of the concept of nonbusiness income as residual and subordinate to the concept of unitary-business income, see Michael J. McIntyre, *Constitutional Limitations on State Power to Combat Tax Arbitrage: An Evaluation of the Hunt-Wesson Case*, 18/1 State Tax Notes 51, 63-64 (Jan. 3, 2000) (reprinted 86/14 Tax Notes 1907-1922 (Mar. 27, 2000)).

86. UDITPA, *supra* note 4, § 1(a); Multistate Tax Commission Allocation and Apportionment Regulations, Reg. IV.1 (adopted February 21, 1973, as revised through July 30, 1993) [hereinafter MTC].

87. *See* Pomp & Oldman, State & Local, *supra* note 13, at 10-28.

88. Multistate Tax Commission Allocation and Apportionment Regulations (Integrating

definition of business and nonbusiness income without the necessity of amending UDITPA. The draft regulation interprets the UDITPA definition of business income as containing a transactional test and a functional test.

Under the transactional test, business income includes only income arising from transactions and activity in the regular course of business. Under the functional test, business income also includes income arising from the acquisition, management, and disposition of property that constitutes an integral part of the taxpayer's regular trade or business. Some critics of the MTC regulation assert that the MTC has read the UDITPA definition of business income too broadly.[89] No one can fairly argue, however, that a state employing those two tests would be taxing extraterritorial values in violation of the United States Constitution.

Louisiana has not adopted UDITPA and is not constrained by its language in fashioning its definitions of apportionable income and allocable income. On most issues, we recommend that Louisiana follow UDITPA in order to contribute to more uniform state corporate taxing statutes. Tax professionals fully understand, however, that the UDITPA definition of business income is not an exemplar of clarity and therefore has failed as an instrument of uniformity. It currently is an instrument of complexity, confusion, and wasteful litigation.

To understand the logic of our recommendation, it is useful to review UDITPA's treatment of allocable income. Under UDITPA, allocable dividend and interest income is allocated to the taxpayer's state of commercial domicile.[90] The same rule applies to allocable gains derived from the sale of stock, bonds, and other intangible property, such as patents, copyrights, and knowhow.[91] It also applies in some cases to allocable rental and royalty income derived from tangible personal property and intangible property and to allocable capital gains from the sale of tangible personal property.[92]

When UDITPA was drafted, a domiciliary state was expected to tax—and generally did tax—all income allocated to it. The drafters of UDITPA did not invent novel rules but simply codified and standardized existing state practices, to avoid duplicative taxation, among other things.[93] In the world we live in, however, income allocated to a domiciliary state has become untaxed income much of the time. Connecticut and New York, for example, which serve as the commercial domiciles for many of the Fortune 500 companies, have very generous rules on the

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Amendment regarding Classification of Income as Business or Nonbusiness—April 1995 Proposal), available at <http://www.mtc.gov/uniform/Busnonbs.pdf> (visited May 5, 2001).

89. The Supreme Court of California disagrees. *See* Hoechst Celanese Corp. v. Franchise Tax Board, 22 P.3d 324 (Cal. 2001) (holding that the California statutory definition of business income, which "mirrors" the UDITPA definition, establishes separate transactional and functional tests and that the reversion to the taxpayer of surplus pension plan assets satisfies only the latter test).

90. UDITPA, *supra* note 4, at § 7. A common definition of "commercial domicile" is the place from which the business is directed or managed. UDITPA, *supra* note 4, at § 1(b).

91. *Id*. at § 6(c).

92. UDITPA, *supra* note 4, at §§ 5(b), 6(b), 8.

93. George N. Carlson et. al., *Perspectives on the Reform of UDITPA*, *in* State Taxation of Business: Issues and Policy Options (Thomas F. Pogue ed. 1992).

taxation of dividends, capital gains, and interest.[94] In this environment, the UDITPA rule on allocable income fosters manipulative tax avoidance and harmful tax competition—lessons not lost on America's largest companies.

In principle, the problem created by the disinclination of domiciliary states to tax income allocated to them might be mitigated by allocating that income to a jurisdiction more inclined to tax it.[95] Given the constitutional requirements of nexus, however, states may not always be able to allocate nonbusiness income to a state with the power and inclination to tax many important categories of income.[96] For that reason, we recommend that Louisiana address the problem by defining allocable income as narrowly as the United States Supreme Court will allow.

To adopt the strategy we recommend, Louisiana would not need to make radical changes in its treatment of allocable income. The current definition is already narrower in most respects than the UDITPA definition, and all income not fitting that definition is classified as apportionable income. Some income treated as allocable income, moreover, is allocated under current law to a state that would have the power and inclination to tax it. The one necessary change—constitutionally required whether or not Louisiana adopts combined reporting— is a broadening of the current definition of allocable income to include income of whatever type if the taxpayer demonstrates that it has no nexus with the state.

D. Formulary Apportionment of Income

Almost all states that have a corporate income tax apportion income to their state by using an apportionment formula.[97] States following the UDITPA rule apportion business income using an evenly-weighted three-factor formula. Those three factors are property, payroll, and sales.[98] Louisiana includes in the "sales" factor other receipts not generally considered to be sales receipts.[99] To avoid

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94. Conn. Gen. Stat. § 12-217(a)(1) (2000); N.Y. Tax Law § 209(9) (1998).

95. Allocation rules are a type of source rule. One hallmark of a good source rule is that it locates income in a jurisdiction that is willing and able to tax it. *See* McIntyre, Int'l Treatise, *supra* note 25, at § 3/C.4. Under this standard, the UDITPA allocation rules are defective.

96. Intangible assets and income from such assets are not easily located in a specific state except through legal fictions. One old doctrine, known as *mobilia sequuntur personam*, treats intangibles as being attached to the person that owns the intangible. *See* Pullman's Palace Car Co. v. Com. of Penn., 141 U.S. 18, 11 S. Ct. 876 (1891); St. Louis v. Ferry, 78 U.S. 423 (1870). That doctrine may be the source of the domiciliary rule of UDITPA that we have criticized. The Supreme Court has described that doctrine as falling into desuetude. Japan Line, 441 U.S. 434, 442, 99 S. Ct. 1813, 1818 (1979). *See also* Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425, 445, 100 S. Ct. 1223, 1235 (1980) ("the maxim *mobilia sequuntur personam*, upon which these fictions of situs are based, 'states a rule without disclosing the reasons for it'").

97. Mississippi uses separate accounting more than most states. Miss. Code Ann. § 27-7-23(c)(2)(B)(iii) (1999).

98. UDITPA, *supra* note 4, at §§ 10-17. The evenly weighted, three-factor formula is known as the Massachusetts formula, presumably because the drafters of UDITPA used that State's law as its model. Massachusetts has abandoned an evenly-weighted three-factor formula, moving first to a double-weighted receipts factor and most recently to a one-factor receipts formula for certain industries.

99. La. R.S. 47:287.95(F)(1)(c) (2001).

confusion, this Article sometimes refers to what UDITPA labels the "sales" factor as the "receipts (sales)" factor. In some states, this factor is referred to as the "revenue" factor.[100]

Probably the most common deviation from the UDITPA apportionment formula is the use of a formula that double-weights the receipts (sales) factor.[101] The effect of the double-weighted receipts formula for manufacturing and merchandising businesses is to apportion roughly half of the apportionable income to the market state[102] and the remaining half to the production state. For manufacturing and merchandising businesses, Louisiana uses the double-weighted receipts formula.[103] It uses a two-factor formula for certain transportation businesses,[104] service businesses,[105] and loan businesses.[106] It uses the UDITPA three-factor formula as the default rule for the remaining businesses.[107]

Contrary to popular belief, income apportionment does not involve an inquiry into the geographical location of income. The reason is that income, by its very nature, has no geographical place. It is a number, calculated by adding and subtracting other numbers. A number is a quantity that has shed its accidental properties of time, place, color, and so forth. This abstraction from all accidental properties other than quantity is a prerequisite to mathematical manipulation. As the U.S. Supreme Court has noted in one of its more pellucid pronouncements on income apportionment, dividing up income according to its geographical attributes is like "slicing a shadow."[108]

A virtue of apportionment by formula is that it can associate income with factors that can be located geographically. The locations of the three items in the typical apportionment formula—property, payroll, and sales—are not always unambiguous. Reasonable rules can be devised, nevertheless, for resolving or sidestepping those ambiguities. For example, many states exclude intangible assets, such as stock, bonds, copyrights, and goodwill, from the property factor due to the obvious difficulty of determining the physical location of an asset that has no physical attributes. In addition, many intangible assets benefit all aspects of a unitary business, and it would be folly in such circumstances to locate these intangibles for apportionment purposes on the basis of legal fictions. Based upon similar considerations, some states exclude receipts from the sale of intangible

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100. Colo. Rev. Stat. § 39-22-303(4)(a) (2000).

101. *See, e.g.*, 1993 Cal. Stat. 946; Cal. Rev. & Tax. Code § 25128 (West 2001).

102. This statement assumes the nearly uniform practice of the states in assigning sales of tangible personal property to the state where the goods are delivered. *See* UDITPA, *supra* note 4, at § 16. We do not address in this Article the issue of how the place of sale should be determined on the sale of intangible property or services.

103. La. R.S. 47:287.95(F)(2) (2001).

104. La. R.S. 47:287.95(A)(C) (2001).

105. La. R.S. 47:287.95(D) (2001).

106. La. R.S. 47:287.95(E) (2001).

107. La. R.S. 47:287.95(F)(1) (2001).

108. Container Corp. of America v. Franchise Tax Bd. of California, 463 U.S. 159, 192, 103 S. Ct. 2983, 2954 (1983).

property from the sales factor.[109]

In applying an apportionment formula to calculate its tax obligations under current Louisiana law, a non-domiciliary corporation performs the following steps:[110]

> First, it calculates its apportionable worldwide taxable income under Louisiana law. This amount represents a corporation's pre-apportionment income.
>
> Second, the corporation calculates its apportionment percentage by applying the appropriate apportionment formula. Only factors that helped generate the pre-apportionment income enter into the formula.
>
> Third, the corporation multiplies its pre-apportionment income, calculated in the first step, by the apportionment percentage calculated in the second step. The resulting amount is the corporation's taxable income apportioned to Louisiana.
>
> Fourth, the corporation applies the Louisiana rate schedule to determine its tentative tax due. The Louisiana tax rates are graduated, with income in the first bracket taxed at four percent and income in the top bracket taxed at eight percent.[111]
>
> Fifth, it reduces its tentative tax by any allowable tax credits.

In a combined reporting regime, the first three steps outlined above would be modified in two respects. First, the computation of pre-apportionment income would be made for the entire combined group, not separately for each member of that group. Second, the apportionment formula would be applied using the aggregate factors of the combined group and the aggregate taxable income of the combined group.

Louisiana's apportionment formula applicable to manufacturing and merchandising business uses three fractions—the property fraction, the payroll fraction, and the receipts (sales) fraction. In each of those fractions, the numerator would be the relevant aggregate Louisiana factors for the combined group and the denominator would be the relevant aggregate worldwide factors for that group.

For example, assume that PCo and its subsidiary, SCo, are engaged in a unitary business in Louisiana. PCo manufactures 100 widgets in Louisiana at a unit cost of $40 and sells the widgets to SCo for $50 each. SCo sells thirty widgets to unrelated customers in Louisiana and sells the remaining seventy widgets to

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109. MTC, *supra* note 86, Reg. IV.18.(c).(3).

110. This list is provided for illustrative purposes and is not intended to be exhaustive. In addition, the text does not address the treatment of allocable income.

111. La. R.S. 47: 287.12 (2001). The use of progressive corporate rates, like those used by Louisiana, is criticized in Richard D. Pomp, *Reforming a State Corporate Income Tax*, 51 Alb. L. Rev. 375, 484-508 (1987).

unrelated customers in Texas. SCo has a distribution cost for each sale of $30. All of SCo's sales are made at a unit price of $100. In step one, PCo and SCo would compute the pre-apportionment income for their combined group. In making that computation, the intra-group sales from PCo to SCo would be ignored. The gross receipts of the combined group would be $10,000 (100 unit sales × $100 unit sales price). From that amount, the combined group would deduct PCo's costs of $4,000 (100 units × $40 unit production costs) and SCo's sales costs of $3,000 (100 unit sales × $30 unit sales costs). Thus the pre-apportionment income of the combined group would be $3,000 ($10,000 – $4,000 – $3,000).

To do the calculations required in step two, some assumptions must be made about the property and payroll of PCo and SCo.[112] Assume that PCo has property of $900, located entirely in Louisiana. It has payroll of $2,000, all paid to employees located in Louisiana. SCo has property of $300 located in Louisiana and property of that same amount located in Texas. It has payroll of $1,000 in Louisiana and payroll of $2,000 in Texas. Under these facts, the combined group's Louisiana property relating to the unitary business would be $1,200 ($900 + $300) and the relevant worldwide property would be $1,500 ($900 + $300 +$300). The property fraction, therefore, would be 0.8 ($1,200/$1,500). The combined group's Louisiana payroll is $3,000 ($2,000 + $1,000) and its relevant worldwide payroll is $5000 ($2,000 + $1,000 + $2,000). The combined payroll fraction is 0.6 ($3,000/$5,000).

PCo has no relevant sales of widgets because its intra-group sales to SCo are eliminated in the combined report. SCo has Louisiana sales of $3,000 (30 unit sales × $100 unit price) and worldwide sales of $10,000 ($3,000 + (70 unit sales × $100)). Thus the sales fraction is 0.3 ($3,000/$10,000). Under these facts, the apportionment percentage, calculated under the double-weighted sales formula,[113] would be fifty percent (1/4 × (0.8 + 0.6 + (2 × 0.3)). As a result, $1,500, or fifty percent of the combined income of $3,000, would be apportioned to Louisiana.

Each member of a combined group would compute its separate tax liability by applying steps four and five outlined above. Before those steps can be applied, however, each member of the combined group must determine its share of the combined group's Louisiana taxable income. The process of making that calculation is referred to as intra-group apportionment. Our recommendations on how that apportionment should be accomplished are discussed in Part IV.A.1, below.

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112. The example ignores the possibility that the State might include the value of inventory in the property factor. In principle, a formula that seeks to allocate half of the profits to the production states and the other half to the market states should exclude inventory and assets related to the sale of inventory from the property factor because inventory property relates to marketing profits and not to production profits. Only "production assets" should be included in the formula. *See* McIntyre, Int'l Treatise, *supra* note 25, at § 3/A.2.3.3. The Federal government included inventory and related assets in its apportionment formula for over 70 years but finally got the correct theoretical answer in 1998. *See* Treas. Reg. § 1.863-3(c)(1)(i)(B) (as amended by T.D. 8786 (1998)).

113. In the UDITPA three-factor apportionment formula, the sum of the three fractions is multiplied by 1/3. That sum is multiplied by 1/4 in the example because of the double weighting of sales.

E. Water's Edge Rules

Even states that have not adopted a combined reporting regime often include what the Federal government characterizes as foreign source income in the pre-apportionment income of their corporate taxpayers. Under current law, Louisiana does not provide an exclusion for foreign source income. Corporations that participate in a unitary business similarly should be required to include in their combined report their aggregate worldwide unitary income. Excluding income that is classified as foreign source income under Federal tax concepts from the combined report would be inconsistent with formulary apportionment, which ignores federal concepts of source.[114] Including foreign source income in a combined report is correct in theory and is constitutionally valid. In addition, it should not present any serious practical difficulties in Louisiana.

In principle, a combined reporting regime should require foreign corporations to be included in the combined unitary group if they are participating in the group's unitary business. As discussed in Part II.A. above, the income of a unitary enterprise should be taxed without regard to its organizational structure. Substance should prevail over form. Form is elevated over substance when the income from the foreign activities of a unitary business are excluded from the combined report if they are conducted through a foreign corporation but are included in the combined report if they are conducted through a foreign branch of a domestic company. Obviously the operation of a unitary business is not confined by the borders of the United States.

The Multistate Tax Commission has supported worldwide combined reporting from its formation.[115] That method of taxation also has been supported by many academics.[116] Two major United States Supreme Court cases have upheld its constitutionality.[117] Its leading supporter among the states has been California. Notwithstanding its many supporters, worldwide combined reporting has been under relentless attack from the multinational corporations and much of the international tax community. During the Reagan Administration, the Treasury

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114. As long ago as 1924, the United States Supreme Court upheld the inclusion of foreign source income in the pre-apportionment income of a corporation operating within the United States through a branch. *See* Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271, 45 S. Ct. 82 (1924). *See also* Container Corp. of America v. Franchise Tax Bd. of California, 463 U.S. 159, 103 S. Ct. 2983 (1983), and Barclays Bank PLC v. Franchise Tax Bd. of California, 512 U.S. 298, 114 S. Ct. 2268 (1994).

115. Pomp and Oldman, State & Local, *supra* note 13, at 10-36.

116. *See, e.g.*, Reuven S. Avi-Yonah, *Slicing the Shadow: A Proposal for Updating U.S. International Taxation*, 58 Tax Notes 1511 (Mar. 15, 1993); Richard Bird & Donald Brean, *The Interjurisdictional Allocation of Income and the Unitary Taxation Debate*, 34 Canadian Tax Journal 1377 (1986); Paul R. McDaniel, *Formulary Taxation in the North American Free Trade Zone*, 49 Tax Law Review 691 (1994); Michael J. McIntyre, *Design of a National Formulary Apportionment Tax System*, 84th Conf. on Tax'n, Nat'l Tax Ass'n 118 (Frederick D. Stocker ed. 1991); Pomp, Future of State Taxation, *supra* note 41, at 63-64.

117. *Container*, 463 U.S. 159, 103 S. Ct. 2983; *Barclays*, 512 U.S. 298, 114 S. Ct. 2268.

Department joined the attack.[118]

In 1986, California adopted legislation that allowed a corporate group under some conditions to avoid including certain foreign corporations in their combined report.[119] The legislation is referred to as the water's edge election, and a combined group making that election computes its income according to a water's edge combined report. The water's edge election was liberalized in 1993.[120] Subject to certain restrictions, a unitary group making a water's edge election could eliminate many foreign corporations from its combined report. Both the income and the factors of those foreign corporations would not be taken into account in preparing the combined report.

A water's edge election has no necessary effect on the treatment of the foreign source income of domestic corporations that are included in the combined group. In California, for example, the foreign source income of included corporations remains includible in the unitary group's income.[121] Some other states that have provided a water's edge election, however, have also limited their taxation of foreign source income.[122] We recommend against any such limitation.

States that had followed California's lead in adopting worldwide combined reporting joined or preceded California in retreat from that position.[123] Without engaging in a comprehensive review of all state tax codes, we note that Alaska, California, Idaho, Montana, New Hampshire, North Dakota, and Utah employ worldwide combination,[124] and all of those States provide some form of water's

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118. The Treasury Department convened a working group on formulary apportionment that recommended that the states not include foreign corporations in their combined report. *See* The Final Report of the Worldwide Unitary Taxation Working Group: Chairman's Report and Supplemental Views (1984) (reprinted in Charles E. McLure, Jr., Economic Perspectives on State Taxation of Multi-jurisdictional Corporations 235 (1986)).

119. 1986 Cal. Stat. 660.

120. 1993 Cal. Stat. 881. For discussion of the 1993 legislation and the combination of pressures that led to its enactment, see Eric J. Coffill, *A Kinder, Gentler 'Water's Edge' Election: California Wards off Threats of U.K. Retaliation as Part of Comprehensive Business Incentive Tax Package*, 61 Tax Notes 477 (Oct. 25, 1993) (also published in 7 Tax Notes Int'l 1049 (Oct. 25, 1993)). Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting With Formulary Apportionment*, 60 Tax Notes 1131, 1139 (Aug. 23, 1993) (referring to the water's edge legislation as "a 'shotgun' marriage arrangement" because of the Federal and other pressures brought to bear on California).

121. Cal. Rev. & Tax. Code § 25110(a)(2) and (3) (West Supp. 2001) (including domestic corporations in the water's edge election without limitation as their income).

122. *See, e.g.*, Ariz. Rev. Stat. § 43-1122(7) (1998) (exempting foreign dividends).

123. For example, the Colorado Legislature overrode the governor's veto to adopt a water's edge election. 1985 Colo. Sess. Laws 309. Florida, which had adopted worldwide combined reporting in 1983, abandoned it in 1984. 1983 Fla. Laws ch. 83-349; 1984 Fla. Laws ch. 84-549. Oregon limited its combined group to corporations filing federal consolidated returns, from which foreign corporations are generally excluded. OR. VAB. 3029, 1984 Or. Spec. Sess. 1, ORS section 317.715.

124. Alaska Stat. § 43.20.072 (Michie 2000); Cal. Rev. & Tax Code §§ 25104-25137 (West Supp. 2001); Idaho Code 63-3027B (Michie 2000); Mont. Code Ann. §§ 15-31-301, 15-31-305 (1999); N.H. Rev. Stat. Ann. § 77-A:1,I (Supp. 2000); N.D. Cent. Code § 57-38-14.3 (2000); Utah Code Ann. § 59-7-403 (2000).

edge election.[125] Many other states have adopted a combined reporting regime but do not include foreign corporations in the combined unitary group.[126]

Notwithstanding the merits of the case for mandatory worldwide combined reporting, we do not recommend that Louisiana adopt it. In the current political climate, the potential benefits simply are not worth the inevitable conflicts. We also do not recommend a mandatory water's edge regime, due to our concerns about potential constitutional challenges to it on Foreign Commerce Clause grounds.[127] Our recommended strategy is to adopt worldwide combined reporting as the general rule and to allow taxpayers to make a water's edge election.

With some important exceptions, a unitary group making the water's edge election would be permitted to omit the income and apportionment factors of foreign affiliates from the combined report unless the foreign affiliates are engaged in business in the United States under Federal tax concepts.[128] All unitary domestic corporations, however, would be included in the water's-edge combined report. By permitting this election, Louisiana would avoid the need to audit the books of many foreign affiliates and would reduce compliance costs for many multinational corporations.[129]

In general, we suggest that Louisiana follow California's lead in specifying the details of the water's edge election.[130] Although we obviously do not recommend

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125. Alaska Stat. § 43.20.073 (Michie 2000); Cal. Rev. & Tax. Code 25110 (West Supp. 2001); Idaho Code 63-3027(t) (Michie 2000); Mont. Code Ann. § 15-31-322 (1999); N.H. Rev. Stat. Ann. 77-A:2-b (1991); N.D. Cent. Code § 57-38.4-02 (2000); Utah Code 59-7-402 (2000).

126. States that generally require unitary business groups to file a combined report only for their domestic members include Arizona, Hawaii, Illinois, Kansas, Maine, Minnesota, and Nebraska.

127. Under a purely domestic combination regime, a foreign incorporated enterprise would not have the same right to combine its affiliates as would a domestic enterprise. A foreign corporation that would have been better off under a combined report arguably would have a foreign commerce clause complaint. We note, however, that state statutes limiting combined reports to U.S. corporations have been upheld against foreign commerce clause attacks. *See* Caterpillar, Inc. v. C.I.R. of Minnesota, 568 N.W.2d 695 (Minn.), *cert. denied*, 522 U.S. 1112, 118 S. Ct. 1043 (1998); Appeal of Morton Thiokol, Inc., 864 P.2d 1175 (Kan. 1993); E.I. DuPont De Nemours & Co. v. State Tax Assessor, 675 A.2d 82 (Me. 1996).

128. Under Federal concepts, a foreign corporation is taxable on its business income that is effectively connected with a U.S. trade or business. *See* I.R.C. § 871(b)(1). For discussion of the Federal engaged-in-business concept, see McIntyre, Int'l Treatise, *supra* note 25, at § 2/B.3. California requires that a unitary foreign corporation be included in the water's edge combined report to the extent of its U.S. source business income. Cal. Rev. & Tax. Code § 25110(a)(5) (West Supp. 2001); 18 Cal. Code of Regs. § 25110(d)(2)(G)(i)(I).

129. Taxpayers have asserted that California's worldwide combined reporting system imposed unreasonable burdens on them. No doubt there are some special burdens, but the extent of those burdens is unclear. In the *Barclays Bank* case, Barclays estimated, and the trial court found, that it would have to pay $5 million to set up an appropriate accounting system and an additional $2 million annually to maintain that system. In contrast, the California Court of Appeal found that Barclays' actual annual compliance costs ranged from $900 to $1,250. *See* Barclays Bank PLC v. Franchise Tax Bd. of California, 512 U.S. 298, 313-14, 114 S. Ct. 2268, 2277-78 (1994).

130. California provides a useful summary of its water's edge rules, including copies of required forms, in California Franchise Tax Board, "FTB 100W Booklet—2000 Water's-Edge Booklet (2000) [hereinafter FTB Water's-Edge Booklet], available on-line at <http://www.ftb.ca.gov/forms/00_forms/00_100Wbk.pdf> (last visited Mar. 11, 2001).

a slavish adoption of all of the California rules, we do recommend that Louisiana use the various anti-abuse provisions built into the California water's edge rules as a check list in fashioning its own system.

We also recommend that Louisiana adopt the California system of requiring an electing water's edge group to sign an agreement consenting to taxation under the water's edge regime. The California consent agreement is binding on current members of the water's edge group and on any subsequent members that would have qualified for inclusion in the group at the time of the agreement.[131] As part of the agreement, the water's edge group obligates itself to provide the tax department, on request, with extensive documentation of its activities, including copies of relevant Federal tax forms.[132]

One important anti-abuse rule in the California system requires electing taxpayers to make a binding election for an initial period of seven years.[133] Seven years seems long enough to keep companies from moving into and out of the system based on the relative profitability of their U.S. and foreign activities.[134] We recommend, however, that Louisiana fine tune this election period by providing that the election is automatically extended for an additional five years unless the taxpayer gives notice of its intention not to renew before the beginning of the last two years of its election period.[135] We also recommend that a control group, after it has terminated a prior water's edge election, not be permitted to make a new election until the end of a three-year waiting period.[136] The tax department should have the authority to waive these restrictions in appropriate cases. The objective of these election restrictions is to reduce the administrative burdens associated with changes in the membership of a unitary group and to minimize tax planning opportunities.

To control certain tax-avoidance strategies, Louisiana should follow the

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131. 18 Cal. Code of Regs. § 25111-1(d)(2) (1998).

132. Cal. Rev. & Tax. Code § 25112(b) (West Supp. 2001). The members of the water's-edge combined group should also be required to provide the tax department with copies of any combined report filed with any other state. North Dakota requires an electing group to provide a spreadsheet showing its tax position in every state. N.D. Cent. Code 57-38.4-02.1.d (2000).

133. *See* Cal. Rev. & Tax. Code § 25111(a) (West Supp. 2001). As adopted in 1986, the election period was ten years. 1986 Cal. Stat. 660. It was reduced to five years by a 1988 amendment. 1988 Cal. Stat. 989 and increased to seven years in 1993. The election period is five years under North Dakota's water's edge regime. N.D. Cent. Code § 57-38.4-02.1.c (2000).

134. Idaho makes the water's edge election irrevocable, unless the intervening consent of the tax administrator is obtained. Idaho Code § 63-3027C(a) (Michie 2000). Utah follows the same rule. Utah Code § 59-7-402(2)(c) (2000). We do not favor this rule because we see some advantage in the tax department making periodical reviews of an electing group's status and modifying, when appropriate, certain terms of a water's edge renewal agreement.

135. California automatically renews an election for an additional year if the taxpayer has not given notice of an intent to terminate within 90 days of the anniversary date. Cal. Rev. & Tax. Code § 25111(a) and (d) (West. Supp. 2001).

136. The Federal rule on entity classification under the so-called check-the-box regulations is that a change in classification can only be made every five years. Treas. Reg. § 301.7701-3(g)(1)(ii). In the California water's-edge system, the fact that a taxpayer has terminated its election does not affect its ability to make a later election. 18 Cal. Code of Regs. § 25111-1(a)(4) (1998).

California lead and require the inclusion of some unitary foreign affiliates in the water's edge combined report. For example, Louisiana should require that a foreign holding company be included in the water's edge group if it is being used to park profits offshore that arose from the operation of the unitary group's business. California achieves this result for U.S.-based unitary enterprises by mandating that a controlled foreign corporation (CFC), as defined under Federal tax-haven legislation, be included in the water's edge group to the extent of its tax-haven income.[137] The Federal anti-haven rules, popularly referred to as the Subpart F provisions,[138] impose a current tax on various categories of passive income and certain active business income deflected to a tax haven.[139] By piggy-backing on the Federal legislation, Louisiana would block the most important types of foreign holding company abuses by U.S.-based multinational companies without adding substantially to their compliance burdens.

A different approach must be used to deal with foreign holding companies controlled by foreign-based multinational companies and other foreign interests because those holding companies are not subject to the Federal rules under Subpart F. California has not developed a mechanism for dealing with that issue under its water's edge regime.[140] Our recommendation is that Louisiana adopt an earnings-stripping rule that would deny members of the water's edge group a deduction against its pre-apportionment income for payments made to a foreign corporation controlled by foreign interests if two conditions are met. First, the foreign corporation receiving the payment must be part of a control group that includes members of the water's edge combined group. Second, the income received by the foreign corporation must be of a type that would be taxable by the Federal government under the Subpart F provisions if received by a CFC.[141] Because denial of a deduction for a payment is economically equivalent to a tax on the income out of which the payment was made, this anti-avoidance rule would result in functionally equivalent treatment of foreign tax-haven companies whether they are

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137. Cal. Rev. & Tax. Code § 25110(a)(7) (West Supp. 2001). The CFC includes in the water's edge combined report its tainted income and the apportionment factors that relate to earning that income.

138. I.R.C. §§ 951-964 (2001). These sections are contained in subpart F of Part III of subchapter N of chapter 1 of the Internal Revenue Code. The anti-avoidance rules applicable to certain foreign funds, contained in I.R.C. §§ 1291-1297 (2001), are usually treated as part of the subpart F regime.

139. For a detailed discussion of Subpart F and related rules, see McIntyre, Int'l Treatise, *supra* note 25, at ch. 7.

140. In *Barclays Bank*, 512 U.S. 298, 114 S. Ct. 2268 (1994), California successfully imposed worldwide combined reporting on a foreign corporation that had affiliates in many tax-haven countries, including Bahamas, Barbados, Bermuda, Cayman Islands, Channel Islands, Gibraltar, Hong Kong, Isle of Man, Nauru, Netherlands Antilles, New Hebrides, Singapore, Turks and Caicos, and the Virgin Islands. *See* Barclays International, A World of Banking—List of Offices (Nov. 1977). California's water's edge regime generally would not reach income deflected to affiliates organized in such countries.

141. The main category of income subject to the earnings-stripping rule would be income of the type classified as foreign personal holding company income, as defined in I.R.C. § 954(c)(1) (2001) and Treas. Reg. § 1.954-2(a)(1) (as amended in 1997). Absent special relief provisions, the Federal government typically would treat such income as periodical income subject to withholding under I.R.C. § 881 when received by a foreign corporation from U.S. sources.

controlled by U.S. interests or by foreign interests.[142]

The water's edge election should not allow foreign corporations having substantial business activities in the United States to avoid being included in a unitary group's combined report. California addresses this issue by requiring a unitary corporation, whether domestic or foreign, to be included in the water's edge combined group if twenty percent or more of its business activities, as measured by its apportionment factors, is conducted within the United States.[143] Corporations included in a water's edge combined report under this rule are popularly referred to as "80-20 companies."[144] Under the California system, foreign banks are not included in the water's-edge election under the 80-20 rule.[145] Thus a foreign bank is included in the water's edge combined report only to the extent of its U.S. source business income and the related apportionment factors.[146] Other states using the 80-20 rule do not have a special rule for foreign banks.[147] We endorse the 80-20 rule without the exception for banks.

A foreign corporation that is treated as a domestic corporation for purposes of the Federal consolidated return rules should be treated as a domestic corporation for purposes of determining the members of water's edge combined group.[148] In addition, the income and related apportionment factors of a unitary foreign corporation engaged in exporting goods from the United States should be included in the water's edge combined group to the extent that the income qualifies for favorable treatment under Federal tax laws. For example, a provision adopted by the Federal government in 2000 provides an exemption for so-called "extraterritorial income" that constitutes qualifying foreign trade income.[149] That income should be included in the water's edge combined report.[150]

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142. The Federal government denies a deduction to foreign controlled domestic corporations with respect to certain interest payments made to foreign related persons in order to prevent earnings stripping. *See* I.R.C. § 163(j) (2001).

143. Cal. Rev. & Tax. Code section 25110(a)(3). Sales are not double weighted for purposes of calculating the 20 percent figure. *See* FTB Water's Edge Booklet, *supra* note 130, at 8. Utah has a similar rule except that only payroll and property are taken into account. Utah Code Ann. §§ 59-7-101(26) and (33), 59-7-401(2)(a).

144. The term "80-20 company" probably was borrowed from the Federal tax lexicon. Under I.R.C. § 861(a)(1)(A) (2001), interest paid by a domestic company is foreign source income if 80 percent or more of its gross income for a three-year testing period is active foreign business income. A domestic corporation meeting the 80-percent active foreign business requirement is referred to as an 80-20 company. *See* McIntyre, Int'l Treatise, *supra* note 25, at 3/A.1.

145. *Id*.

146. *See* Cal. Rev. & Tax. Code § 25110(a)(5) (West Supp. 2001).

147. *See, e.g.*, Utah Code Ann. §§ 59-7-101(33)(a)(i)(B).

148. *See* I.R.C. § 1504(d) (allowing certain Canadian and Mexican real property holding companies to join a consolidated group). *See, e.g.*, Idaho Code 63-3027B(a).

149. I.R.C. § 114(a) and (b) (2001). Foreign trade income is defined in I.R.C. §§ 941-943 (2001).

150. This export incentive replaces the foreign sales corporation (FSC) rules that were found to be a prohibited export subsidy by the World Trade Organization. In 2001, a WTO dispute settlement body held that the new incentive scheme was a prohibited export subsidy. The United States appealed that decision to the WTO Appellate Body and lost. Under California's water's-edge regime, FSCs are included in the water's edge combined group. *See* Cal. Rev. & Tax Code § 25110(a)(1) (West Supp. 2001).

The interaction of a state's rules on allocable income and a water's edge election can lead to tax-avoidance opportunities. States employing a water's edge election should not permit taxpayers to use that election to convert what otherwise would be apportionable business income, subject to tax in a state, into allocable income that is not taxable in the state.

To illustrate the potential for tax avoidance from characterizing business income as nonbusiness allocable income, consider a unitary foreign affiliate that is excluded from a Louisiana water's edge combined report. If the water's edge election had not been made, the profits of the foreign affiliate would have been included in the income of the unitary combined group and an apportioned share would have been taxed by Louisiana. A subsequent dividend paid out of those profits to another member of the combined group would have been washed out. If the profits of the foreign affiliate are excluded from the water's edge combined report, however, a subsequent dividend paid out of those profits should be taxable. The proper result is reached by treating the subsequent dividend as apportionable business income and not as allocable nonbusiness income.[151]

A similar problem arises when a member of the water's edge combined group receives interest, royalties, and rents from a unitary foreign affiliate that is excluded from that group by the water's edge election. The solution to the problem is also similar. That is, the interest, royalties, or rents should be treated as unitary business profits and not as allocable income.[152]

IV. PRACTICAL PROBLEMS IN IMPLEMENTING A COMBINED REPORTING SYSTEM

If Louisiana decides to adopt a combined reporting system, the State should consider several conceptual and practical matters addressed in this Part. Section A discusses how a corporation having nexus with Louisiana that is a member of a combined group would compute its individual tax in a combined reporting regime. Section IV.A.1. focuses on how the aggregate income of a combined group is apportioned to individual members of the group. Section IV.A.2. deals with the proper treatment of net operating losses and other corporate attributes that can be attributed to some extent to combined reporting.

Section B addresses the issues that arise when members of a combined group do not all have uniform accounting periods. Section IV.B.1. offers guidance on determining the annual accounting period for the group. Section IV.B.2. examines the problem of determining the combined income of a unitary *group* when some

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151. *See* Cal. Rev. & Tax. Code § 25110(b)(2)(B) (West Supp. 2001) (treating certain dividends received by a water's edge combined group as business profits). Louisiana currently treats certain categories of income as allocable income without reference to the relationship of those income items to the taxpayer's unitary business. This aspect of Louisiana's allocation rules may present constitutional problems that need to be addressed whether or not Louisiana adopts a combined reporting regime.

152. The proposed rule is similar in function to the look-through rules used by the Federal government in characterizing dividends, interest, rents, and royalties as general business income under the separate basket rules of I.R.C. § 904(d) (2001).

members employ different accounting periods from each other. Section IV.B.3. explains how to determine the combined income of *individual members* of that group when accounting periods of members are not uniform. Section IV.B.4. explores the problem of selecting the statutory starting date for the adopting of a combined reporting regime.

Section C recommends approaches for handling intra-group transactions. In general, intra-group transactions should have no tax consequences—that is, they should result in a wash. This so-called wash rule is developed in Section IV.C.1. Section IV.C.2. sets forth rules for adjusting the basis in the stock of members of the combined group to account for intra-group transactions. Section IV.C.3. considers transitional issues that arise when transactions initiated under a separate reporting rule are consummated after a state adopts a combined reporting regime.

A. Taxation of the Individual Members of a Unitary Group

The combined report prepared by a unitary group is not itself a tax return.[153] Tax returns based upon the income of the unitary group are typically filed by the group's individual members.[154] Section IV.A.1., below, addresses issues that arise in imposing tax liability on individual members of a unitary group with respect to unitary income. Section IV.A.2. addresses issues relating to the assignment within a unitary group of certain corporate attributes, such as net operating losses, which appear on the individual books of an individual member of that group.

1. Determining the Taxable Income of Individual Members of a Unitary Group

The apportionment formula that a unitary group employs in preparing its Louisiana combined report determines the amount of unitary income attributable to, and properly taxable by, Louisiana. To collect tax on that income, however, Louisiana must assess one or more corporations that are members of the unitary group and engaged in business in the State. One approach would be to designate one member of the unitary group as a principal member and impose tax on that member.[155] Although this approach is workable,[156] we do not recommend it for Louisiana, largely because it would represent an unnecessary departure from the practices of other states using combined reporting without any significant policy gain.

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153. For discussion, see *supra* Part III.A.

154. Under some circumstances, a state may permit the unitary group to file a consolidated tax return. For a description of the California election rule, see Cal. FTB Pub. 1061 (1999) at 4, available at <www.ftb.ca.gov/forms/misc/index.htm> (last visited Feb. 25, 2001) [hereinafter Cal. FTP Pub. 1061].

155. It is useful to designate one member of a unitary group as the principal member for the purpose of determining the annual accounting period to be used by the unitary group in preparing its combined report. *See infra* Section IV.B.1.

156. Some may also object to this approach on esthetic grounds for it is not entirely consistent with the theory of the unitary business principle.

Our preferred approach is to use a pro rata intra-state apportionment formula to attribute the share of the income of the unitary group among the Louisiana-taxable members of the group that have contributed to the generation of that income. Under the intra-state apportionment formula, the income assigned to each taxable member would be the income of the combined group apportioned to Louisiana multiplied by a fraction. The numerator of that fraction would be the Louisiana apportionment percentage of the individual group member, and the denominator would be the aggregate Louisiana apportionment percentage for the unitary group.

To illustrate the operation of the intra-state apportionment formula, assume that XCo, YCo, and ZCo constitute a unitary group and that the group earns income from its unitary business of $1,000. The Louisiana apportionment percentage for the group, computed under the formula discussed in Part III.D., above, is assumed to be 40% (0.4). If the apportionment formula is applied only to XCo (i.e., the formula is applied using only XCo's Louisiana factors), XCo's Louisiana apportionment percentage would be 30% (0.3). If the formula is applied only to the Louisiana factors of YCo, YCo's apportionment percentage would be 10% (0.1). ZCo has no Louisiana factors, so its percentage would be zero.

Under these facts, $400 of the group's unitary income would be apportioned to Louisiana (40% × $1,000). Of that amount, $300 ($400 × 0.3/0.4) would be taxable to XCo and $100 ($400 × 0.1/0.4) would be taxable to YCo. None of the unitary business income of the combined group would be taxable to ZCo ($400 × 0.0/0.4). Indeed, under these facts, it is unlikely that ZCo would have any reporting obligation to Louisiana, a State with which ZCo is unlikely to have any nexus.

In practice, the above formula can be simplified. The Louisiana taxable income of a unitary group (A) equals the total taxable income of the group as shown on the combined report (B) multiplied by the Louisiana apportionment percentage shown on the combined report (C). That is, $A = B \times C$. The Louisiana taxable income of a group member (D) equals A multiplied by the Louisiana apportionment percentage of that group member (E) divided by C. That is, $D = A \times E/C$. Simple algebra shows that $D = (B \times C) \times E/C = B \times E$. That is, the taxable income of a group member equals the total taxable income of the unitary group multiplied by the group member's Louisiana apportionment percentage.[157]

Although we favor the use of the intra-state apportionment formula described above, we do not believe that a unitary group should be allowed to use the formula to reduce tax that is apportioned to Louisiana on the combined report. For example, we do not believe that the insolvency of one group member should reduce the tax due to Louisiana on income apportioned to Louisiana. To prevent a loss of revenue when income is attributed to an insolvent corporation under the intra-state apportionment formula, we recommend that all "Louisiana-taxable" members of a unitary group be jointly and severally liable (solidary liability in Louisiana) for

157. For an application of this simplified formula, see California Schedule R (Apportionment and Allocation of Income) (2000), available at <http://www.ftb.ca.gov/forms/00_forms/00_100R.pdf> (last visited Feb. 27, 2001).

the full amount of the tax assessed with respect to unitary income apportioned to Louisiana on the combined report.[158]

Assume, for example, that XCo in the above example is insolvent. In that event, Louisiana should be permitted to collect the share of income tax attributed to XCo from YCo. The XYZ corporate group should not be able to avoid Louisiana tax on the Louisiana income it has earned simply because one member of the joint enterprise is insolvent. This joint and several liability rule is particularly important when the unitary group has deprived one of its members of the resources necessary to pay its tax obligations.

2. Treatment of Corporate Attributes

Section IV.A.2.a., below discusses whether certain corporate attributes, such as net operating losses, should be available to members of a unitary group other than the member to which they were initially assigned under the tax laws. Section IV.A.2.b. discusses the proper transitional rule to apply to certain corporate attributes that arose, at least in part, under the prior separate reporting regime.

a. Ongoing Treatment of Corporate Attributes

Corporate attributes, by definition, are assigned under the tax law to a particular corporation. In designing a combined reporting regime, a state should consider whether the corporate attributes assigned to one member of a unitary group could be used by other members of the corporate group. In our view, the proper treatment of corporate attributes depends on the circumstances under which they initially arose.

In general, we recommend that a combined reporting regime permit members of a corporate group to obtain the benefits of another member's corporate attribute if that attribute arose from activities that are treated as group activities under the combined reporting regime. If the tax attribute arose from what are treated as the separate activities of the group member, we recommend that the benefits of that attribute be limited to the member to which it was initially assigned. We discuss the application of this approach in the context of two important corporate attributes: net operating losses (NOLs) and excess investment tax credits.

i. Net Operating Losses (NOLs)

158. In this respect, we propose that Louisiana follow the Federal consolidated return rule, which makes each member of the consolidated group severally liable for the tax on the consolidated income of the group. Treas. Reg. § 1.1502-6(a) (1966). Our recommendation on joint and several liability is based on practical realities and is not grounded on the unitary business principle. The fact that consolidated reporting is consensual and combined reporting is mandatory does not dissuade us from recommending this useful rule.

NOLs may arise from the combined activities of a unitary group or from the separate activities of a group member unrelated to the unitary business. In the first case, the NOL should be available to other members of the group if the member to which it was initially assigned is unable to use it. We suggest it be assigned to other members in proportion to their share of the group's unitary income in the year of assignment. The purpose of this pro rata rule is to provide certainty to taxpayers and to prevent possible abuses.[159]

For example, assume that PCo and SCo make up a unitary group. In year one, the group suffers an apportioned loss of $100, with $50 of the loss assigned to PCo and the remaining $50 assigned to SCo.[160] In year two, the unitary group enjoys an apportioned gain of $200. Because of changes in the apportionment percentages, only $30 of that gain is assigned to SCo. SCo would use $30 of the NOL to reduce its income to zero. Under our recommended rule, PCo would be permitted to utilize SCo's excess NOL of $20 to reduce its own income.[161] If SCo's excess NOL had arisen from losses incurred in a nonunitary business, however, PCo would not be permitted to use the NOL under our proposed rule.

ii. Investment Tax Credit

A corporation becomes eligible for an investment tax credit when it makes certain investments favored by the taxing state. In principle, an investment made by a member of a unitary group that qualifies for a tax credit may be viewed in one of two ways: as a subsidy to the unitary business, or as a subsidy to the individual member making the tax-favored investment. If viewed as the former, the credit should be available to other members of the group if the member to which it was initially assigned is unable to use it. As explained below, we believe the investment credit is best understood as a subsidy to the corporation making the investment. We conclude, therefore, that excess tax credits should remain with the member of the group that made the qualifying investment and should not be available to reduce the taxable income of any other members of the corporate group in the absence of specific statutory language to the contrary.

One might imagine that a state actually intended to grant an investment tax credit to a unitary business as a whole rather than to the individual members of that

159. Many issues arise in determining the proper treatment of NOLs that are outside the scope of this Article. We focus here on general principles and not on the myriad of issues that arise in applying those principles.

160. In a combined report, losses, like income, are apportioned under the applicable apportionment formula.

161. This example assumes that NOLs should be assigned to members of a combined group using the current apportionment factors rather than the factors that existed when the losses were incurred. If the change from the historical factors to the current factors is sufficiently large, it may be appropriate to use the historical factors for assigning losses in order to reflect fairly the extent of the taxpayer's business activities in the taxing state. A tax department should have the authority to achieve equitable apportionment in such circumstances. *See* UDITPA, *supra* note 4, at § 18 (allowing adjustments if the apportionment rule otherwise applied does not "fairly represent the extent of the taxpayer's business activity in the state"); La. R.S. 47:287.94(C) (2001) (permitting separate accounting in certain circumstances to prevent a "manifestly unfair result").

unitary business. In that event, the entitlement to the credit would be assigned initially among members of a unitary group in accordance with the interstate and intra-state apportionment formulas.[162] We believe, however, that such an intent is implausible and should not be inferred unless the legislature has stated such an intent clearly. In our experience, state tax incentives are always intended to promote investment within the state and are not intended to promote investment generally without reference to its location.[163]

In addition, members of a multistate unitary enterprise generally should not want to interpret a state statute granting a tax credit to individual companies as intended for the unitary group. If that interpretation prevails, then some of the credit allowable to individual companies under the statute should be apportioned to income taxes owed to other states. The result would be that only the credit apportioned to taxes paid to the state granting the credit should be allowable in reducing taxes owned to that state. From the perspective of the multistate enterprise, the credit apportioned to taxes imposed by other states would be wasted.

Assume, for example, that XCo, YCo, and ZCo constitute a unitary group, that XCo and YCo have all their property and payroll in Louisiana but make sales outside the State, and that ZCo has no property, payroll, or sales in Louisiana. The Louisiana apportionment percentage for the group is seventy percent; XCo has a Louisiana apportionment percentage of fifty percent, YCo has a Louisiana apportionment percentage of twenty percent, and ZCo has a Louisiana apportionment percentage of zero. XCo makes an investment that qualified for an investment tax credit of $1,000. If that investment is considered to be an investment of the unitary group, then XCo should be allowed an initial credit of $500 ($1,000 × 70% × (50%÷70%) against its Louisiana tax and YCo should be allowed an initial credit of $200 ($1,000 × 70% × (20%÷70%) against its Louisiana tax. The remaining credit of $300 would be apportioned to ZCo.

From the perspective of the unitary group, the portion of the credit attributed to ZCo would be wasted because ZCo owes no Louisiana income taxes. The tradeoff for this loss of credit would be that any credit that XCo could not use would be available to YCo, and vice versa. For multistate enterprises, we strongly suspect that this advantage will not offset the loss of the credit apportioned outside of Louisiana.

In the interest of completeness, we note that one might imagine that a state legislature intended to grant the full investment tax credit, on a pro rata basis, only to the members of the unitary group having a tax liability in the state. Under that scenario, a unitary group would be able to use all of the credit to offset taxes imposed by the state. The legislative intent supporting this scenario, however,

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162. A comparable result is achieved under the Federal consolidated return rules through a consolidated tax credit. *See* Treas. Reg. § 1.1502-3 (as amended in 2000).

163. We do not address in this Article whether this familiar locational bias presents potential discrimination under the Commerce Clause. For discussion of that issue, see Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 Harv. L. Rev. 377 (1996) [hereinafter Enrich, Saving the States]; Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 Cornell L. Rev. 789 (1996).

cannot be inferred from the legislature's adoption of the unitary business principle —indeed, it obviously would reflect a major departure from that principle. Such a legislative intent should only be "discovered" in the presence of clear evidence of its existence.

b. Transition Rules for Corporate Attributes Carried Over from Separate Reporting Regime

There are two main issues to address in designing transition rules applicable to corporate attributes. The first is the proper treatment under a combined reporting regime of corporate attributes that arose under the separate reporting regime. For example, how should a net operating loss (NOL) that arose in year one, a separate reporting year, be treated in year two, a combined reporting year? The second issue is the proper treatment of corporate attributes that have some link to a separate reporting year but did not fully mature until the combined reporting regime was in place. An example would be a sale arranged, but not closed, in year one (separate reporting year) and a recognition of the income from that sale in year two (a combined reporting year).

The appropriate rule for corporate attributes falling within the first category is that they should be treated as belonging to the entity that established them and should not be available to the combined group. Our rationale is that the corporate attribute, at the time it was created, was considered by the state and the taxpayer as an attribute of the corporation that established it. Our proposed transition rule would protect the reasonable expectations of the state and the taxpayer. Granting the corporate attribute to the unitary business is not required under any principle of fairness and would not result in any efficiency gain.[164]

Proper treatment of the second category of corporate attributes is harder to determine in the abstract. To promote simplicity, we recommend that corporate attributes that mature under the combined reporting regime be treated as if they had arisen entirely within that regime. For example, a sale contracted but not closed in a separate reporting year and closed in a combined reporting year should be treated as apportionable income includible in the combined report. Similarly, a loss that was recognized from the sale of property during the combined reporting regime should be included in the combined report even if the loss is attributable to a decline in value accruing during the separate reporting regime.

We recognize, nevertheless, that our proposed rule might produce an unreasonable result in some special cases. Assume, for example, that SCo, a corporation that has no nexus with State A, has made all the arrangements for a sale of a substantial portion of its assets. A few days before the sale is completed, State A adopts a combined reporting regime. Under the new regime, SCo and TCo form a unitary combined group. Assume also that TCo has most of its apportionment

164. For a brief analysis of fairness issues arising in the design of tax transition rules, see Michael J. McIntyre, *Transition Rules: Learning to Live with Tax Reform*, 4 Tax Notes 7 (Aug. 30, 1976). For a more detailed treatment, see Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. Pa. L. Rev. 47 (1977).

factors in State A and those factors are substantially larger than SCo's factors, which are not located in State A. Under these facts, a substantial portion of the income derived by SCo on the sale of its assets would be apportioned to State A. In such circumstances, the tax department of State A should be given the flexibility to fashion a relief measure that achieves substantial fairness.[165]

The tax department also should have the authority to prevent taxpayers from obtaining an unfair benefit from the transition to the new system. To prevent unfair results, it should have the discretionary authority to impose an equitable settlement on the taxpayer, similar to the discretionary authority to adjust inappropriate results that is reserved to the tax department under section 18 of UDITPA.

As an illustration of the need for such discretionary authority, assume that PCo has entered into an installment agreement that requires a payment of $10 million to be made to XCo, an unrelated person, at the end of year one. PCo is taxable in State L on all of its income—that is, all of PCo's apportionment factors are located in State L. If XCo makes the payment to PCo as agreed, PCo will be taxable in State L on all of the income derived from the installment sale. Assume, however, that PCo and XCo, for legitimate business reasons, change the agreement so that XCo makes the payment to PCo at the start of year two. Assume also that State L adopts a combined reporting regime beginning in year two. PCo is engaged in a unitary business with QCo. All of QCo's apportionment factors are located outside of State L, and those factors are large relative to PCo's factors. As a result, most of the income derived from the installment sale would be apportioned to states other than State L unless the tax department has the authority to adjust that result to achieve fairness.

B. Issues Arising When Members of a Unitary Group Do Not All Use the Same Accounting Period

Corporations that are members of the same unitary group may not all have the same annual accounting period. For example, one member of a unitary group may compute its income for financial accounting purposes and Federal income tax purposes using the calendar year, whereas another member of the same unitary group may use a fiscal year that does not start on January 1 and end on December 31. The lack of accounting-period uniformity within a unitary group presents three issues that a state adopting combined reporting must address.

As an initial matter, a state must specify the accounting period to be used by the unitary group in these circumstances. That issue is addressed in Section IV.B.1., below. In addition, a state must develop rules for determining the combined income of the unitary group for its accounting period when some members of that group are using a different annual accounting period. That issue

165. A case with somewhat analogous facts is *Firstar Corp. v. Comm'r of Revenue*, 575 N.W.2d 835 (Minn. 1998). In that case, the Minnesota Supreme Court granted relief to the taxpayer—a result we approve, at least in principle. Unfortunately, the Minnesota Supreme Court, in an attempt to avoid a constitutional question, improperly interpreted the Minnesota apportionment statute. The *Firstar* problem can be avoided by giving the tax department the discretion proposed in the text.

is addressed in Section IV.B.2., below. A related issue, addressed in Section IV.B.3., arises when the combined income of a unitary group for its accounting period must be assigned to the overlapping accounting periods of nonconforming members of the unitary group.

Section IV.B.4. addresses issues that arise in setting the initial starting date of the combined reporting regime when a separate-reporting state, such as Louisiana, introduces combined reporting. If all members of unitary groups used the calendar year as their annual accounting period, the new regime could begin on January 1 of the first year following its adoption. The choice of a starting state is more complex, however, when some members taxable under the new regime have adopted a fiscal year as their annual accounting period.

1. Determining the Annual Accounting Period for a Unitary Group

Income for tax purposes is measured over some accounting period. In general, the accounting period for a corporate taxpayer is a either a calendar year or a twelve-month fiscal year, although a short fiscal year may be used at the start or end of a taxpayer's corporate existence. A unitary group that files a combined report must adopt an annual accounting period for the purpose of computing the income included in the combined report. If all the members of the unitary group compute their separate incomes according to the same accounting period, then the choice of an accounting period for the unitary group is obvious. The choice is less obvious, however, when the accounting periods of the members are not uniform.

The Federal government addresses a similar issue under its consolidated return rules.[166] It has resolved the issue in large part by requiring all members of a corporate group filing a consolidated tax return to adopt the same taxable year.[167] The Federal solution greatly reduces the scope of a state's problem because corporations generally use the same annual accounting period for state purposes as they use for Federal purposes. The state problem remains, however, whenever the Federal consolidated group is not coterminous with the state combined group.[168] In addition, the problem arises for both the Federal government and the states for the transitional year in which members of a corporate group are adopting a uniform annual accounting period.

The California approach, which we endorse with some modifications, is to require a unitary group to use the annual accounting period of its "principal member."[169] If the unitary group has a hierarchal structure, with a parent corporation at the top of the hierarchy and subsidiaries and lower-tier corporations

166. *See* I.R.C. § 1501 *et seq*.

167. Treas. Reg. § 1.1502-76(a)(1) (as amended in 2000) ("[t]he consolidated return of a group must be filed on the basis of the common parent's taxable year . . . .").

168. The Federal consolidated group is based on stock ownership; no federal concept of a unitary business exists. Corporations not eligible to be included in a consolidated return may be members of the combined group.

169. Cal. Code Reg. § 25106.5(b)(12). For a detailed explanation of the California rule, see FTB Pub. 1061, *supra* note 154, at 5.

under it, the parent corporation would be the principal member.[170] This rule is easy to apply and promotes uniformity among the states.

If the unitary group does not include a common parent corporation for all members of the group, the selection of the appropriate accounting period for the unitary group is more complex. We suggest as a default rule that the unitary group, for the purpose of adopting its initial accounting period, designate as its principal member the member having the largest aggregate amount of property, defined in accordance with the rules for identifying property in the apportionment formula. The accounting period of the principal member in that year would become the accounting period for the unitary group. We recommend that the accounting period of the group, as determined under this rule, remain unchanged regardless of how the composition of the group may evolve in subsequent years. Thus we counsel against a change in the unitary group's accounting period even if the "principal member" leaves the combined group in some future year or is no longer the member with the most property.

Under our proposed rule, each member of the combined group must determine the aggregate amount of its property. For purposes of simplicity and uniformity, we recommend that "property" for this limited purpose be property of the type included in the denominator of the property ratio used in Louisiana's apportionment formula.[171] For example, intangible property not included in the formula would not be taken into account for this purpose as well. To conform to the treatment of the property factor in the many states that follow UDITPA, we recommend that the original cost of an item of property be used to set the "value" of the property for this limited purpose.[172] The Louisiana rule is to include property in the apportionment formula at original cost minus a reserve for depreciation.[173] Although we are not suggesting here that Louisiana modify its current rule for purposes of apportionment, we do recommend that it abandon it for the limited purpose of determining the principal member of a unitary group in order to promote uniformity among the states.

Under California law, the accounting period for a unitary group not having a parent member is the accounting period of the member having the largest amount of property in that State (as determined under the rules for computing the numerator of the property ratio in the apportionment formula).[174] The weakness of this approach is that if all states adopted a comparable rule, the accounting period of a unitary group might not be the same in all of the states where the unitary group conducts its unitary business. Our proposed rule, in contrast, promotes uniformity and, as a result, computational simplicity.

The operation of our proposed rule for unitary groups that do not have a parent corporation as a member is illustrated by the following example. Assume

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170. *Id*. The Federal approach is similar. *See* Treas. Reg. § 1502-76(a)(1) (as amended in 2000) ("each subsidiary must adopt the common parent's annual accounting period for the first consolidated return year for which the subsidiary's income is includible in the consolidated return").

171. *See supra* Part III.D.

172. *See* UDITPA, *supra* note 4, at § 11.

173. La. R.S. 47:287.95(G) (2001).

174. FTB Pub. 1061, *supra* note 154, at 5.

that ACo, BCo, and CCo are brother-sister companies. ACo has aggregate property of $50, determined under the rules that apply in determining its aggregate property in the apportionment formula of UDITPA. BCo and CCo have aggregate property, respectively, of $60 and $70. Under these facts, CCo would be the principal member of the combined group for the group's initial taxable year. Its accounting period would become the accounting period for the combined group, and that accounting period would not change in future years even if CCo no longer held the most property or if CCo left the combined group.

Our proposed rules for determining the accounting period of a combined group are relatively easy to apply and are designed to promote uniformity among states using the combined reporting method. As a further contribution to uniformity, we recommend that Louisiana allow a unitary group to elect its principal member when it files its first combined report if it has already selected a principal member in another state.[175] The purpose of the election is to allow a unitary group to reduce its accounting burdens by using the same annual accounting period in Louisiana that it is using in other states in which it is filing a combined report.

Regardless of the method used to select the initial annual accounting period, a unitary group should not be permitted to change its accounting period after its first filing period without the consent of the tax department. The tax department, moreover, should have the authority to require a unitary group to change its accounting period if such a change is necessary to reflect clearly the income of the unitary group. The department also should have the authority to require members of a unitary group to adopt the accounting period of its principal member if the unitary group is exploiting the lack of accounting-period uniformity within the group to distort its income.

We do not believe that a state should follow the Federal lead and require all members of a unitary group to adopt the same annual accounting period. The Federal consolidated return rules are voluntary. As a result, a corporate group that has strong business reasons for not adopting a uniform annual accounting period for its constituent members can achieve its business goals by declining to file a consolidated return. A combined report, however, must be mandatory to work effectively. As a result, a state should design its combined reporting rules to accommodate the business needs of its taxpayers. As discussed in Section IV.B.2. below, a state can encourage a unitary group to adopt a uniform annual accounting period by removing the tax benefits associated with having multiple annual accounting periods within a corporate group.

2. Determining Combined Income When Members Employ Different Accounting Periods

175. California allows a more comprehensive election. *See* Cal. Code Reg. § 25106.5(b)(12)(B) (allowing a combined group to elect its principal member in the initial year of a combined report "so long as consistently treated as such for the year of the election and thereinafter").

The combined income of a unitary group for an accounting period is simply the sum of the unitary income of each member of the unitary group for that accounting period. When the annual accounting period used by a member of a unitary group differs from the accounting period used in preparing the combined report, however, some method must be adopted for determining the income of that group member that relates to the accounting period employed in making the combined report. The following example illustrates the issue.

Assume that PCo, a parent corporation, and SCo, its wholly-owned subsidiary, are engaged in the operation of a unitary business in Louisiana. PCo uses the calendar year as its annual accounting period. SCo uses a fiscal year that starts on July 1 and ends on June 30. The unitary group uses the calendar year in preparing its combined report because that is the accounting period of PCo, its principal member. For calendar year 2002, PCo has unitary income of $30. For its fiscal year 2001/2002, SCo has unitary income of $12. It has unitary income of $24 for fiscal year 2002/2003. In determining the unitary group's combined income for calendar year 2002, it is necessary to determine the portions of SCo's income for fiscal years 2001/2002 and 2002/2003 that relates to calendar year 2002.

There are at least two possible ways to resolve the issue illustrated above. One way would be to require the nonconforming members of a unitary group to determine their income for purposes of the combined report by reconstructing their books of account. In the above example, SCo would determine its unitary income for calendar year 2002 by determining the income it would have earned in that year had it adopted a calendar year as its annual accounting period. We reject this approach as unnecessarily burdensome on taxpayers and subject to potential abuse.[176] The alternative way to resolve the issue set forth above is to use a formula to determine the income of a nonconforming member that relates to the annual accounting period of the principal member of its unitary group. Under the formula, a portion of the income from the nonconforming member's two overlapping years would be assigned to the taxable period used to compute the combined report. We recommend a formula that treats income from the two overlapping periods as earned uniformly throughout each year. This pro rata formula would determine the amount of income of a nonconforming member that would be included in the combined report for an annual accounting period as follows:

$Y_c = (Y_1 \times m_1 \div 12) + (Y_2 \times m_2 \div 12)$, where

Y_c is the income of the nonconforming member included in the combined report;

Y_1 is the income of the nonconforming member for its first overlap year;

Y_2 is the income of the nonconforming member for its second overlap

176. We are assuming that nonconforming members cannot adopt the accounting period used by the principal member without excessive difficulty. If that assumption is not valid, we would expect nonconforming members to adopt the accounting period of the principal member of their unitary group.

year;

m_1 is the number of months of the first overlap year that fall within the accounting period used in preparing the combined report; and

m_2 is the number of months of the second overlap year that fall within the accounting period used in preparing the combined report.

If the above formula is applied to the facts of the example above, then SCo would include $6 of its income in the combined report for fiscal year 2001/2002 ($12 × 6/12) and $12 ($24 × 6/12) for fiscal year 2002/2003, for a total inclusion in the combined report of $18. PCo would include its entire unitary income of $30 for calendar year 2002, bringing the total income of the unitary group included in the combined report to $48 ($18 + $30).

We recommend a similar approach be followed with respect to the factors of the nonconforming member. The property factor will be a pro rata portion of the non-conforming member's property numerator and denominator values for its respective separate accounting periods, reflecting the beginning and ending average property values for those separate accounting periods. For example, using the example above, SCo would first calculate its property factor for fiscal year 2001/2002. Half of that amount would enter into the group's property factor when calculating the group's apportionment formula for calendar year 2002. SCo also would calculate its property factor for fiscal year 2002/2003 and half of that amount would enter into the group's property factor when calculating the group's apportionment formula for calendar year 2002. SCo would follow a comparable approach with respect to its payroll and sales factors.

As this discussion indicates, a member of a unitary group with a nonconforming annual accounting period must compute its income and factors for both of the accounting periods that overlap the accounting period used in preparing the combined report. As a practical matter, the member may not have complete information about its income and factors for the second overlapping period when the combined report is being prepared.[177] For example, SCo in the example above may not know its income for fiscal year 2002/2003 at the time the combined report for fiscal year 2002 is being prepared. To avoid delays in the completion of the combined report, members with nonconforming accounting periods should be required to make their best estimate of their income for their second overlapping period.[178] They would file an amended return to reflect actual income figures for that period when those figures become available if the actual income and apportionment data result in a material change in the tax liabilities of the members of the group. If the change in income from the estimate is not material, it would be reflected in the tax return filed for the next accounting period.

We anticipate that most unitary groups would find the pro rata formula

177. Extensions of time to file the combined report may lessen the magnitude of having to prepare a combined report before all data from non-conforming members are available.

178. This is the California rule. *See* Cal. Code Reg. § 25106.5-4(c)(4).

convenient to use. To avoid potential hardship, however, we suggest that nonconforming members be permitted to elect to determine the amounts to be included in the combined report by reconstructing their books of account to reflect the taxable year of their principal member.[179] This election to use a reconstruction method should be binding for all future years unless the nonconforming member receives the consent of the tax authorities to change the election. In addition, the tax authorities should be permitted to require the nonconforming member to use the pro rata formula if the member fails to provide information adequate to justify its reconstructed books of account. Further, the tax department should be authorized to require a combined group that makes a change its accounting period for any reason to make adjustments in its income so as to ensure that the change does not result in a material distortion or omission of income.

3. Attributing the Combined Income of a Unitary Group to Members of the Unitary Group When Accounting Periods of Group Members Are Not Uniform

As discussed in Section IV.A.1., above, the combined report is not a tax return. The income computed on the combined report is apportioned among the members of the unitary group using an intra-state apportionment formula. Adjustments must be made in the application of the intra-state formula when the members of a unitary group do not have a uniform annual accounting period. These adjustments are similar in concept to the adjustments described in Section IV.B.2., above.

A member of a unitary group with a nonconforming annual accounting period should include in its income an amount from each of the combined group's annual accounting periods that overlaps its own accounting period. In general, the amount would be determined by application of a pro rata formula, similar to the formula described in Section IV.B.2., above.

Assume, for example, that PCo and SCo form a unitary group. PCo is the principal member of the group. Its annual accounting period, and the annual accounting period used to prepared the combined report, is the calendar year. SCo uses a fiscal year ending June 30 as its annual accounting period. For its fiscal year 2002/2003, SCo is taxable on one-half of its apportioned share of the combined group's income for calendar year 2002 and one-half for calendar year 2003. If SCo's apportioned share of the combined income for 2002 is $3,000 and for 2003 is $4,000, it should include $3,500 (½ × $3,000 + ½ × $4,000) in income for its fiscal year 2002/2003. The portion of the combined income for 2003 that SCo did not include in income for its fiscal year 2002/2003 would be included in income for fiscal year 2003/2004.

As a practical matter, a member of a unitary group with a nonconforming annual accounting period will not know the income that will be reported on the combined report for the second overlapping accounting period when it files its tax return. For example, SCo in the above example would not know the unitary group's combined income for calendar year 2003 when it files its own tax return for

179. *See* Cal. Code Reg. § 25106.5-4(b).

fiscal year 2002/2003. In such circumstances, the nonconforming member should make a good faith estimate of the unitary group's combined income for the second overlap year. It should be required to file an amended return if the estimated amounts depart in a material way from the actual income amounts. Otherwise, it should reconcile the estimate and the actual income when it files its next tax return.

4. Selecting the Starting Date for Combined Reporting

To designate a single date, like January 1, 2002, as the effective date for the adoption of a combined reporting regime unnecessarily creates tax accounting problems for a unitary group that is not using the calendar year as the accounting period for itself and all of its members. To reduce those problems, the date for filing the first combined report generally should be the first day of the taxable year of the principal member of the unitary group that begins after December 31 of a specified year. For example, if the taxable year of the principal member of a unitary group runs from July 1 to June 30 and the state adopts a combined reporting rule for taxable years beginning after December 31, 2002, then that unitary group would begin filing a combined report for its fiscal year beginning on July 1, 2003.

This approach permits members of a unitary group having a common annual accounting period to begin their first taxable year under the new regime without having to include in that taxable year any income realized and recognized for a reporting period governed by the old regime. The accounting simplicity from starting the new system at the start of the group's taxable year is obvious. We believe that a substantial majority of unitary groups would be able to take advantage of this accommodation.

Benefits from this approach also accrue to the principal member of a unitary group that does not have a uniform annual accounting period. For the principal member, the proposed starting date would fall at the start of its annual accounting period, thereby reducing the accounting burdens on it.[180] We do not see how one can avoid some inconvenience, however, to the members of the unitary group that do not have the same accounting period as the principal member. Members of the group with a different accounting period are likely to confront some significant accounting problems because they will have to file a separate report for a portion of the first year of operation of the new regime and a combined report for the remaining portion of that year. The obvious solution to those problems is for these taxpayers to adopt an accounting period that conforms to the period used by the principal member.

C. Adjustments For Intra-Group Transactions

180. We proposed in Section IV.B.1. that the tax department be granted the right to impose a particular accounting period on a combined group when necessary to reflect clearly the income of the combined group. The department might find it necessary to invoke this power if a combined group selects an inappropriate principal member simply to forestall application of the combined reporting regime.

The general rule in combined reporting is that transactions between members of a combined group, to the extent these transactions are part of the unitary business, are either totally ignored or deferred. Generally, the transactions are treated as a wash. This section addresses some refinements that a state should make in the wash rule to avoid duplicative taxation and to prevent tax avoidance.

Section IV.C.1. provides a general description of the operation of the wash rule. Section IV.C.2. describes the interaction of the wash rule with the rules for determining basis and discusses the adjustments that are needed in the basis rules to avoid both the undertaxation and the overtaxation of income. Section IV.C.3. addresses transitional problems.

1. Description of the Wash Rule

In general, the wash rule applies to transactions between members of the combined group that occur as part of the unitary business. For example, if PCo and its subsidiary, SCo, are members of a combined group, the proceeds and income from a sale by PCo to SCo of inventory property used in the unitary business would not be included in the combined report. A subsequent sale by SCo of the inventory property to retail customers, however, would be recognized. The gain would be computed by giving SCo a basis in the inventory property equal to PCo's basis. The proceeds of the sale would be included in the receipts (sales) factor of the apportionment formula.

The wash sale rule does not apply to transactions between members of the combined report that occur outside of the unitary business. For example, if PCo in the example above sells an investment asset to SCo that is not related to their unitary business, the gain or loss on the sale would be recognized currently but would not be included in the combined report. It would be included in PCo's separate income and would be taxable in accordance with the rules applicable to that type of income.[181]

In some circumstances, the wash rule helps the taxpayer. For example, eliminating intra-group dividends paid out of income derived from a unitary business prevents the group from being taxed once when the income is earned and again when the income is distributed as a dividend from one member of the unitary group to another. As illustrated in the example above, the wash rule also can prevent premature realization of income when inventory property has been sold to one member of the unitary group but still remains within the same unitary business.[182]

In other circumstances, the wash rule protects the government from taxpayer abuses. For example, it prevents taxpayers from recognizing losses on the intra-group sale of assets that continue to be used in the unitary business. Also, in some circumstances, the wash rule ensures that transactions between members of the combined report do not impact the apportionment of income of the unitary business through inappropriate changes in the property or sales factor.[183]

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181. The tax authorities should have the discretion to adjust the terms of a transaction between members of a combined group to reflect income properly if the wash rule is not applicable to that transaction.

182. *See* Cal. FTB Pub. 1061, *supra* note 154, at 6.

183. For a more complete description of the types of transactions that are treated as a wash, see Cal.

For example, if PCo and SCo constitute a unitary business, PCo's sale of an asset used in the unitary business to SCo not only will have no effect on the recognition of income or loss but also will have no effect on the original cost of the asset. The sale will have no effect on the property factor in Louisiana, which is the taxpayer's original cost in the asset minus the reserve.[184] If the sales proceeds otherwise would have been included in the sales factor,[185] the wash rule prevents the proceeds from affecting the sales factor. Without the wash rule one member of the combined group might sell an asset to another at a loss in order to realize the loss and to produce a more advantageous sales factor in the apportionment formula.[186]

The wash rule also prevents inappropriate changes in the tax attributes associated with the intra-group sale of unitary assets. For example, under the wash rule, a unitary group would not recognize gain on the sale of depreciable property from one member of a unitary group to another, and the purchaser would not acquire a stepped-up basis in the asset for purposes of depreciation deductions. Gain or loss would be recognized when the buyer or seller ceases to be a member of the unitary group or when the asset is no longer used within the unitary business.[187]

Under recently adopted regulations, California does not employ the wash rule to intra-group sales of depreciable property. Consistent with the wash rule, it does exclude the proceeds from the sale of depreciable property from the income of the combined group. Contrary to the wash rule, however, it allows the buyer to take a stepped-up basis in the depreciable property. To prevent a double benefit, the seller is required to recognize income each year for the incremental increase in the allowable depreciation deduction that the buyer claims on account of the increase in its depreciable basis.[188] This same approach is used by taxpayers filing a Federal consolidated return.[189] California's apparent purpose in departing from the wash rule is to allow a unitary group to conform its accounts kept for California purposes with the accounts it keeps for purposes of its Federal consolidated return.

For its general rule, we recommend that Louisiana adopt the less complex wash rule described above rather than the California rule. We do appreciate the benefit, however, of coordination with the Federal consolidated return regulations. To

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FTP Pub. 1061, *supra* note 154, at 5-6; 18 Cal. Code Reg. § 25106.5-1.

184. La. R.S. 47:287.95(G) (2001).

185. Under some circumstances, sales of capital assets are not reflected in the sales factor. *See* MTC, *supra* note 86, Reg. IV.18.(c).(1).

186. In the absence of a vigilant tax department, a combined reporting regime that permits a water's edge election may encourage some taxpayers to try to secure advantages in the apportionment formula through transactions with an affiliated company that is excluded from the combined group because of the water's edge election. This possibility is one of the unfortunate costs of permitting a water's edge election. As noted in *supra* Part III.E., we recommend the water's edge election for practical and political reasons, not for tax policy reasons.

187. Cal. FTB Pub. 1061, *supra* note 154, at 5-6.

188. *See* 18 Cal. Code Reg. § 25106.5-1 (2001).

189. *See* Treas. Reg. § 1.1502-13(c)(7)(ii)(Ex. 4) (as amended in 2000).

achieve that goal, we recommend that a unitary group filing a Federal consolidated return be permitted to elect, with the permission of the tax department, to use the California rule. The tax department should be authorized to impose conditions on the election that it believes are necessary to reflect income clearly or to prevent abuse.

2. Adjustments to the Basis of Affiliate Stock

One policy goal of tax basis rules in an income tax is to prevent taxpayers from being subject to duplicative taxation on the disposition of assets acquired with money or other property that had previously been subject to the income tax. Another important policy goal is to limit allowable losses on the disposition of an asset to the amount paid for that asset out of previously taxed income. As explained below, it is sometimes necessary to make certain basis adjustments for intra-group transactions to achieve these goals for members of a unitary group filing a combined report. The Federal government in its consolidated return rules requires adjustments similar to the ones we recommend for Louisiana.[190]

In furtherance of the general policies set forth above, it is sometimes appropriate in a combined reporting system to allow a parent corporation to increase its basis in the stock of its subsidiary when the income of that subsidiary has been included in the pre-apportionment income of the unitary group. Similarly, it is sometimes necessary to require a parent corporation to reduce its basis in the stock of its subsidiary when a loss incurred by that subsidiary has been deducted from the pre-apportionment income of the unitary group.[191]

To illustrate the duplicated gain issue, consider PCo, a parent corporation that forms SCo, a subsidiary, with a contribution to capital of $100. Accordingly, PCo's basis in the SCo stock is $100. PCo and SCo are engaged in a unitary business in State L and other states and file a combined report in State L. SCo earns $500 of pre-apportionment unitary business income, and the value of its stock thereby increases by $500, from $100 to $600. The $500 of unitary business income earned by SCo is added to the unitary group's pre-apportionment taxable income. The group apportions this amount to State L and other states under the applicable apportionment formula.

Assume that PCo sells its SCo stock to an unrelated buyer for $600. In the absence of a basis adjustment, PCo would recognize gain on the sale of $500 ($600 – $100), which would be included in the pre-apportionment income of the unitary business. The result would be duplicative taxation of the profits of $500 earned by SCo. To prevent that result, PCo should be allowed to increase its basis in its SCo stock by $500 (the amount of SCo profits included in the pre-apportionment income of the unitary group). If the SCo stock sold for $700, however, PCo would recognize a gain of $100 — an appropriate result because that additional $100 in

190. *See* Treas. Reg. § 1.1502-32(b) (as amended in 1999).

191. The basis adjustment rules for earnings and distributions are strongly analogous to the rules developed by the Federal government for preventing duplicative taxation of gain derived from the sale of a CFC. I.R.C. § 961(a) (2001). *See* McIntyre, Int'l Treatise, *supra* note 25, at § 7/B.4.2.

gain was due to a previously untaxed appreciation in the value of SCo's assets.

Rather than duplicative gain, duplicative loss can also occur without proper basis adjustments. To illustrate, assume that PCo in the example above owns all of the stock of TCo. It formed TCo by contributing $100 in exchange for the TCo stock. As a result, its basis in the TCo stock is $100. TCo suffers a pre-apportionment unitary business loss of $50 on the PCo and TCo unitary business. That loss reduces the pre-apportionment business income of the unitary group by $50. It is also likely to reduce the value of the TCo stock from $100 to $50. Assume that PCo sells the TCo stock for $50. Unless PCo's basis in the stock is reduced by $50, PCo will realize a $50 loss on the sale of the stock, thereby reducing the pre-apportionment income of the unitary group a second time by $50.

California, the leading state practitioner of combined reporting, apparently does not make the adjustments to basis that we recommend for Louisiana. The California statute does not specifically provide for these basis adjustment, due, we assume, to legislative indifference. The California tax authorities attempted to prevent the double use of a loss, as described above, by invoking their general interpretive powers. California's attempt failed.[192] The California experience suggests that a state that is adopting a combined reporting rule should include a basis adjustment rule in the enabling legislation. The details of the rule, however, should be worked out in department regulations.[193]

If a combined reporting state provides for an upward adjustment in a parent company's basis in the stock of its subsidiary to reflect the unitary income earned by that subsidiary, it should make a corresponding reduction in that basis when the income is distributed to the parent. For example, assume that SCo in the example above earns $500 of unitary taxable income and PCo increases its basis in the SCo stock by that amount. If SCo distributes the $500 of income to PCo, then PCo should be required to reduce its tax basis in its SCo stock by $500 to reflect the reduction in SCo's assets. Without that reduction in basis, PCo would have a loss of $500 if it sold the SCo stock for its presumed fair market value of $100. A reduction in the basis of the SCo stock from $600 to $100 would properly reflect PCo's remaining investment in SCo after the distribution and would eliminate an improper loss on the sale of the SCo stock.[194]

3. Transition Issues

When a state adopts combined reporting, it must decide what adjustment

192. Appeal of Safeway Stores, Inc., No. 62-SBE 014 (Cal. State Bd. of Eq. Mar. 2, 1962). In *Safeway Stores*, the second loss (on the stock) occurred as a part of a liquidation of the subsidiary. Under California law, the loss may possibly have been a nonbusiness loss. If so, *Safeway Stores* may not prevent the California tax authorities from requiring a basis adjustment when both of the losses clearly constitute business losses includible in a combined report.

193. A state may prefer to deal with the duplicative gain and loss issue entirely by regulation. In that case, the statute's delegation of regulatory authority to the tax department should be unambiguous so that the resulting regulations would be given the force of law by the courts.

194. The adjustment to basis should be made whether the distribution is made by payment of a dividend or through some alternative mechanism.

should be made for intra-group transactions that were initiated at least in part under the old regime. In our view, transition relief is appropriate to avoid duplicative taxation under the old and the new regime. It is inappropriate, however, when its effect is to extend a benefit obtainable under the new regime to transactions consummated under the old regime. In the grey areas between these extremes, we recommend flexibility and pragmatism.

Section IV.C.3.a. addresses transition issues arising from the general wash rule discussed in Section IV.C.1., above. Ordering rules used to determine whether a dividend has been paid out of profits accumulated before or after the adoption of combined reporting are addressed in Section IV.C.3.b. Transition issues relating to basis adjustments are addressed in Section IV.C.3.c.

a. Transition Issues Under the Wash Rule

In general, transition rules are not necessary or desirable to modify the tax consequences under the wash rule of an intra-group transaction that was concluded prior to the adoption of a combined reporting regime. A separate reporting system typically contains its own rules to prevent duplicative taxation. The shift to a combined reporting regime should not be the occasion for redesigning those rules. The wash rule should not be applied retroactively to transactions that occurred under the separate filing regime absent a showing that the latter rules would be ineffective in blocking duplicative taxation due to the adoption of combined reporting.

Consider, for example, the wash rule that eliminates a sale of inventory property between members of a combined group. Assume that PCo sells inventory property to SCo, its subsidiary in year one, and SCo sells that property to unrelated persons in year two. Year one is a separate reporting year and year two is a combined reporting year. PCo and SCo constitute a unitary group, so the sale from PCo to SCo would have been ignored if the wash rule had applied to year one. Taking the sale into account in year one, however, was a perfectly acceptable result under a separate accounting regime. Protection against duplicative taxation is provided, moreover, by allowing SCo to take a tax basis in the inventory property equal to the price paid to PCo. Under these conditions, it would be cumbersome and unnecessary to retroactively apply the wash rule to the sale between PCo and SCo and to undo the basis adjustment made under the prior regime.

Transition relief is appropriate, however, when the application of the combined reporting regime to transactions having some link to the prior separate reporting regime present a special risk of duplicative taxation. We believe that such a risk may arise when a dividend is paid after the adoption of combined reporting out of profits that were earned under the prior separate reporting regime. If those dividends would have been exempt from tax under the prior separate reporting regime, they also should be exempt under the combined reporting regime.

Under current Louisiana law, a corporation may exclude a dividend from its income to the extent that the dividend was paid out of income previously taxed by

Louisiana.[195] If Louisiana adopts combined reporting, it will need a transition rule to preserve that policy with respect to dividends received under the combined reporting regime and paid out of income earned under the separate reporting regime.[196]

The proposed transition rule would apply to exclude that part of any dividend that is paid out of profits that were taxed by Louisiana because of the operation of its apportionment formula under the separate reporting regime. The proposed transition rule should not apply to a dividend that was paid out of profits accumulated prior to the adoption of the combined reporting regime that were never taxed by the State.

Consider, for example, PCo and its subsidiary, SCo, members of a unitary group. In year one, a separate reporting year, SCo earned profits of $400. Louisiana taxed SCo on $100—its apportioned share of those profits under the separate reporting regime then in place. In year two, Louisiana adopted combined reporting. In that year, SCo distributed a dividend of $400 to PCo. Under these facts, we believe that $300 of the dividend should be included in the combined report and $100 should be excluded in order for the treatment of dividends to be consistent with the dividend policy of current Louisiana law.

b. Ordering Rules

In some cases, a member of a unitary group making a distribution to its parent corporation may have untaxed profits accumulated under a separate reporting regime and also taxed profits accumulated under the combined reporting regime. To deal with such a situation, a state needs to employ an accounting convention that determines the category of accumulated profits out of which a particular distribution is deemed to be made. The rules specifying that convention are typically referred to as ordering rules. We propose the following ordering rules:[197]

> (1) Dividends are treated as paid out of current earnings and profits to the extent thereof.
>
> (2) If the dividends paid exceed current earnings and profits, then the dividends are treated as paid out of earnings and profits accumulated in preceding years, beginning with the year closest (i.e., reverse chronological order) to the current year.

To illustrate the operation of the above ordering rules, assume that SCo began operations in year one and the current year is year five. SCo has earnings and

195. La. R.S. 47:287.73(C)(1) (2001) and L.A.C. 61:1115. This method of eliminating duplicative taxation is being litigated in California in *Farmer Brothers Co. v. FTB*, Los Angeles Superior Court Case No. BC237663, as violating the Commerce Clause because relief is extended only to dividends paid from in-state sources.

196. We are not necessarily endorsing the practice of Louisiana and many other states of exempting only that portion of a dividend that is paid out of income previously taxed by the state. The proper treatment of such dividends is a matter beyond the scope of this Article.

197. *Cf.* Cal. Rev. & Tax. Code § 25106 (West Supp. 2001).

profits for each of those years of $1,000. In year five, SCo paid a dividend of $2,500 to PCo, its parent corporation and a member of its unitary group. Under the ordering rules, $1,000 of the dividend will be treated as paid out of the earnings and profits arising in year five, $1,000 out of the earnings and profits arising in year four, and $500 out of the earnings and profits arising in year three.

As with most accounting conventions, there is some element of arbitrariness to the above rules. We favor the first ordering rule because it allows a unitary group to be taxed on dividends under the combined reporting regime as long as the dividends paid by a member of the unitary group do not exceed its current earnings and profits. We believe the results achieved under combined reporting are desirable and the sooner they apply to corporations the better. The rule is also relatively simply to administer and conforms to the Federal ordering rule for dividends.[198] We favor the second rule because it corresponds to the dividend ordering rules of the Internal Revenue Code[199]and taxpayers are presumably well versed in its application.

c. Transition Issues under the Basis-Adjustment Rules

In general, the basis rules described in Section IV.C.2. should not be applied retroactively to give a member of a unitary group an addition to, or subtraction from, its basis in the stock of another member of the unitary group to take into account events occurring before the adoption of combined reporting. The purpose of the basis rules is to prevent duplicative taxation of combined profits or duplicative use of combined losses. These rules, by their own terms, do not apply to companies that are not part of the unitary combined group. It would be anomalous to provide these rules to transactions that occurred when those members were not being taxed as members of that group.

Assume, for example, that PCo owns all of the stock of SCo and that the two companies are engaged in a unitary business. In year one, a separate reporting year, SCo earns income of $600. In year two, a combined reporting year, PCo sells its stock in SCo to unrelated persons. PCo would not be entitled to an increase of $600 in its basis in the stock of SCo because the $600 of profits were not included in the combined report. There is no strong reason for fashioning a special transition rule to deal with this case because the potential for duplicative taxation was part of the tax regime in place when the income of $600 was earned. In these circumstances, PCo should not receive a basis adjustment.

Similarly, we would not require a member of a unitary group to reduce its basis in the stock of a subsidiary because the subsidiary suffered a loss under the prior separate reporting regime. Assume, for example, that PCo and its two subsidiaries, SCo and TCo, form a unitary group. PCo acquired the SCo stock in a taxable transaction for $1,500. In year one, a separate reporting year, SCo suffered a loss of $500. That loss had the effect of reducing the value of SCo stock from $1,500

198. I.R.C. § 316(a) (2001) (flush language).
199. *Id*.

to $1,000. In year two, a combined reporting year, PCo sold the SCo stock for $1,000. The sale produces a loss of $500 unless PCo is required to adjust its basis downward by $500 for the loss incurred in year one. We recommend that no basis adjustment be made. The potential for a duplicative loss was part of the tax regime in place when the loss of $500 occurred. Assuming the sale was made as part of the unitary business, the loss of $500 should be includible in the combined report.

V. CONCLUSION

Saving nickels, saving dimes
Workin' till the sun don't shine
Lookin' forward to happier times
On Blue Bayou.[200]

The Louisiana corporate income tax will not be a stable source of revenue for government spending programs unless Louisiana protects it from the encroachments of the corporate tax planners. Over the past decade, multistate tax planning has become increasingly concentrated in the large, multinational accounting firms and a small number of specialized law firms. Those accounting firms no longer make their large profits from compliance work—the traditional function of accountants. They now have dynamic and growing state practices geared to minimizing state corporate taxes for their multi-state and multinational clients.[201] A state that does not respond to the emerging reality of scorched-earth tax avoidance is almost certain to lose the ability to raise more than "nickels and dimes" from its corporate income tax.

Happier times are ahead, however, if Louisiana adopts a combined reporting regime. Combined reporting offers a formidable defense against many of the most pernicious forms of tax avoidance. In this Article, we have presented a detailed proposal for implementing a combined reporting regime in Louisiana. Whenever possible, we have borrowed design features that have been used successfully by California and the other combined-reporting states. Our proposal, however, has some distinctive design features of its own. We are confident that this spicy concoction will not suit the taste of the out-of-state tax evaders.

No one should expect that multinational and multi-state firms will embrace a proposal to enact a combined reporting rule. Many of them will oppose it for the same reason we support it—because it will increase the tax liability of multi-state businesses engaging in tax-avoidance schemes. Opponents of corporate tax reform in the business community usually assert that adoption of reforms they oppose will be bad for a state's "business climate." The Louisiana Legislature should expect that this loose charge will be made if it moves to adopt combined reporting. At

200. Roy Orbison, "Blue Bayou" (1963).

201. One recent study indicates that $1 of investment in tax planning typically results in a cut in state taxes of $100. *See* Sanjay Gupta & Lillian F. Mills, *Multistate Tax Planning: Benefits of Multiple Jurisdictions and Tax Planning Assistance* (unpublished study, June, 2000).

best, the charge is unproven.[202] At worst, it suggests that the only corporate tax that is compatible with a good business climate is a tax that corporations are able to avoid.

202. In his Senate confirmation hearings, Treasury Secretary-designate Paul O'Neill stated: "As a businessman I never made an investment decision based on the tax code . . . If you give money away I will take it, but good business people don't do things because of inducements." Joseph Kahn, *Treasury Choice Varies from Bush on Tax Outlook*, N.Y. Times, Jan. 18, 2001, at A-1, A-16. Roger Smith, former Chairman of General Motors, whose Saturn plant was sought after by nearly every governor, stressed that "tax breaks can't make a silk purse out of a sow's ear." Detroit Free Press, Mar. 18, 1985, at 1A. According to Smith, "we're going to be in business for the long term . . . you've got to look at more than just what the great big cookie is that's coming in on the plate." *Id*. Consistent with this philosophy, the first state GM eliminated as a site for the Saturn plant was Florida, a state that is perceived as having an extremely favorable tax climate (*e.g*., no personal income tax, no estate tax, a double-weighted receipts factor, and no worldwide combined reporting). For an overview of the business climate literature, see Enrich, Saving the States, *supra* note 163, at 392-97; Pomp, *supra* note 111, at 393.

APPENDIX EE

"Combined Reporting Issues List for MTC Income and Franchise Tax Uniformity Subcommittee" (by Multistate Tax Commission, undated)

Combined Reporting Issues List
for MTC Income and Franchise Tax Uniformity Subcommittee

1. Should a combined report be mandatory, or an anti-abuse tool? Discretionary with the taxing agency? "Permit or require?" Or "necessary to reflect income?"

2. Should the combined reporting group be treated as a single taxpayer for purposes of liability for tax, or should each specific entity doing business in a state be a taxpayer, with its own liability independently determined?

3. If the combined reporting group is a single liability taxpayer:

    a. How is nonbusiness income to be treated?

        i. Does the unitary group have a "group" domicile for purposes of nonbusiness intangible income?

        ii. Is it constitutionally appropriate under Allied Signal to make all members of the group jointly and severally liable for the nonbusiness income of another one of its members?

    b. What happens if a group of affiliated corporations are engaged in two separate nonunitary businesses?

        i. Is there a constitutional problem treating all members as a single taxpayer?

        ii. If there is, what are the mechanics of apportioning nonunitary businesses, if one entity has two divisions, and each of the divisions are unitary with the separate businesses, and the divisions are not unitary with each other?

4. If each member of the combined reporting group has its own liability based on its "share" of the unitary group's business income:

    a. How is the income assigned to the respective members for purposes of taxation? (E.g., intrastate apportionment?)

        i. Should each member be responsible for payment of tax on income measured by that member's share of group income determined by an apportionment percentage composed of payroll, property and sales factors. For example, each member's sales factor is that member's in-state sales divided by the total sales of the group. (*Joyce* Method)

1. Pros: Consistent with the theory of taxation that each member is responsible for payment of tax attributable to its own numerator activity.

2. Cons: May not prevent "nexus carve-ups" where the group separately incorporates the taxable activity in the state and then alleges P.L. 86-272 protections with respect to the other inbound sales.

ii. Should there be two stages of apportionment:

1. The first stage multiplies the business income of the group by an apportionment percentage determined by reference to the payroll, property and sales factors of the group as a whole (without regard to exempt status any of the members), and

2. The second stage then takes the state source income in the first stage and then "intrastate apportions" that income between the taxable members, based on the taxpayer's respective numerator activity in the state. (*Finnigan* Method)

3. Pros: Avoids potential for "nexus carve-ups"

4. Cons: Arguably inconsistent with the theory of intrastate apportionment; some potential P.L. 86-272 issues about indirect taxation of exempt income.

b. If each taxpayer member is independently liable, should there be a means for simplifying the tax returns so that a "key" corporation can file a "group" return on behalf of all members, to avoid having to have all of the taxpayer members file individual returns and duplicating data by multiple combined reporting schedules?

5. How is total income subject to apportionment computed?

a. Does each member determine income under the Code as if it were unconnected to the other members, or is there a computation of income and expense as if all members of the group were a single taxpayer?

b. Does the group as a whole have to make the same accounting elections (e.g., R&D, IDCs, etc.)?

c. How are expenses allocated to business and nonbusiness income, particularly when several members of the group have nonbusiness income? Is there a

problem assigning expense incurred by one member to the nonbusiness income of another member?

6. How are intercompany transactions (see Treas. Reg. §1.1502-13) handled?

    a. Should intercompany income be currently taxed?

    b. Should the income be "eliminated" and the basis in the asset transferred to the purchaser? Would this create too many federal/state differences?

    c. What happens if an asset is sold between affiliates that are not unitary, but the income is deferred for federal purposes?

    d. Should intercompany income be deferred for state purposes as in the federal system?

    e. What is a restoration event for state purposes? Does conversion of an asset to nonbusiness use constitute a restoration event?

    f. What apportionment percentage should be used when income is restored?

    g. What happens if a corporation receives a distribution with respect to stock in excess of tax basis (IRC §301(c)(3))?

    h. What is to prevent an entity with deferred income from simply leaving the state and not restoring income?

    i. Can income previously deferred before the taxpayer entered the state be taxed by the state when it is restored for federal purposes?

7. How should dividends paid between unitary members be treated?

    a. Like any other dividend?

    b. Eliminated?

    c. Eliminated to the extent paid from unitary income (but not from nonbusiness or separate trade or business income)?

8. How do you deal with taxpayers on different fiscal years?

9. How does combination work if a member enters the group or leaves the group at midyear?

10. Special Rules, Limitations and Carryovers.

a. How are net operating loss carryovers determined?

   i. Is there a unitary group carryover, or a post-apportioned carryover specific to each member?

   ii. If the group method is used, what happens to the carryover if some of the members leave the group? Is the loss allocated based on the separate accounting contribution of the member creating the loss, or is there some other allocation of loss?

   iii. What happens if a member joins the group with an NOL? Is the NOL limited to that member or can it be shared with other new members?

b. How are charitable expenses treated: as business, or proportionately business and nonbusiness, etc.?

   i. How is the charitable expense carried forward—specific to the entity that incurs the cost, or some kind of group carryover?

   ii. What happens if the members of the group disaffiliate when a charitable carryover remains unused?

c. How do you deal with business and nonbusiness capital gains and losses (including section 1231 assets, involuntary conversion income)? Is it appropriate for one member's nonbusiness capital gain to "free up" the business capital losses of the group?

11. How are tax credits to be handled?

   a. Is the credit available only to the specific legal entity that incurred a creditable cost, or all of to the taxpayer members of the group? If the latter, how is the credit allocated?

   b. How are credits to be carried forward if members leave or enter the group?

   c. Is appropriate that tax attributable the nonbusiness income of one of the members to be available to apply a credit attributable to the business income of the group?

12. How is partnership income treated in the context of a unitary group?

   a. What happens if the partnership is itself an apportioning entity?

   b. What if the partnership is unitary with a member of the group?

   c. What if the partnership itself has both business and nonbusiness income?

d. What if a partner is unitary with a second tier partnership but not the first tier partnership?

13. How is income of unitary financial institutions or insurance companies treated where those entities are not subject to the corporate income or franchise tax?

14. How should holding companies be treated?

a. What is a holding company?

i. A company that holds stock in another member(s), but has no operations?

ii. A company that holds stock in another member(s), but has central management activity (i.e., a management holding company)

iii. A company that holds intangibles and derives income therefrom, but has no other active operations (intangible holding companies)?

b. How should intermediate holding companies be treated (i.e., a holding company between two unitary members).

c. How should a parent holding company that holds only members of a single unitary group be treated?

d. How should a parent holding company be treated if it holds corporations that represent two distinct unitary businesses?

e. How should acquisition debt of a holding company be treated (e.g., leveraged buy-out)?

f. How are dividends that pass to or from or through a holding company treated?

15. Should combination be worldwide, water's edge or something in between?

a. How does combination work under a water's-edge system?

i. Should U.S. source income (under federal tax law) of an otherwise excluded foreign entity be included in a combined report?

ii. How does combined reporting work if a foreign entity has two divisions: a U.S. trade or business and a foreign trade or business.

b. How does combination work under a worldwide system?

i. What can be done to have constitutionally acceptable "rough approximations" of income and factors?

ii. How can a foreign entity take advantage of tax laws that are preferential compared to book income?

APPENDIX FF

"Report of the Hearing Officer regarding the
Proposed Model Statute for Combined Reporting"
(by Shirley Sicilian of Multistate Tax Commission, dated April 25, 2005)

Multistate Tax Commission

Report of the Hearing Officer regarding the proposed Model Statute for Combined Reporting

April 25, 2005

Submitted by Shirley Sicilian
Hearing Officer

Table of Contents

I. Introduction
II. Summary of Procedure
  A. Development of the Proposal
  B. Public Hearings
  C. Next Steps – Executive Committee Consideration and Action
III. Summary of Substantive Provisions
IV. Public Comment and Hearing Officer Recommendations
  A. Criteria for Combination.
    1. Unitary Business Requirement
    2. Relevance of Arm's Length Pricing
    3. Entities Not Subject to a Corporate Income Tax
    4. Partnerships
    5. Water's Edge Election
      (a) Members Doing Business in a Tax Haven
        (1) Definition of a "Tax Haven"
        (2) "Doing Business" in a Tax Haven
        (3) Foreign Commerce Clause
      (b) Subpart F Income
      (c) Members Earning 20% of Income from Activities Deductible by Another Member
      (d) Initiation and Withdrawal of Election
  B. Method of Combination
    1. Group Members as Individual Taxpayers vs. the Combined Group as a Single Taxpayer
      (a) Apportionment Factor Numerators
      (b) Credits
      (c) Losses
    2. Deferred Intercompany Transactions
    3. Elimination of Dividends
    4. Compliance Burdens
  C. Implications of Adopting the Model Combined Reporting Statute

Exhibits
Exhibit A McDermott, Will & Emery (MW&E) – Kimberley Reeder and Margaret Wilson
Exhibit B Southerland, Asbill & Brennan (SAB) – Kendall L. Houghton and Jeffrey A. Friedman
Exhibit C Council On State Taxation, American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (Insurance Group)
Exhibit D United Services Automobile Association (USAA) – Amy Cannefax
Exhibit E Heller Ehrman (HE) – Roy E. Crawford
Exhibit F Organization for International Investment (OFII)
Exhibit G Model Statute with Hearing Officer's Proposed Changes

Multistate Tax Commission

Report of the Hearing Officer Regarding the proposed Model Statute for Combined Reporting

April 25, 2005

I. Introduction

On November 11, 2004, the Multistate Tax Commission (MTC) Executive Committee approved an MTC proposed model statute on combined reporting for public hearing. The appointed hearing officer has held two public hearings and received five sets of written comments on the proposed model statute. This Report provides a procedural summary of the proposed model statute, an explanation of its key substantive features, a review of the public testimony received, and the hearing officer's recommendations for addressing that public testimony.

II. Summary of Procedure

A. Development of the Proposal

In June of 2003, the MTC Executive Committee requested the Uniformity Committee consider whether it would be feasible, appropriate and of service to the states for the MTC to develop model laws for combined reporting. After a review of preliminary research[1], the Uniformity Committee reported in July, 2003, that development of such model laws was feasible; would be useful for MTC member states; and would promote MTC principles of uniformity, ease of administration and sound tax policy. The Committee noted that this conclusion was consistent with a recommendation contained in the MTC's Federalism at Risk Report, published in June of 2003, that states adopt combined reporting for jointly owned and operated companies in order to appropriately report and assign income where it is earned.[2] On July 30, 2003, the

[1] See memorandum dated July 29, 2003 to Ted Spangler, Chair, and members of the Uniformity Committee from Shirley Sicilian titled *Executive Committee Request Regarding Combined Reporting*. The memorandum provided a general description of combined reporting, summarized its potential benefits, and identified key policy questions which would need to be addressed in developing a combined reporting rule.

[2] *Federalism at Risk, A Report by the Multistate Tax Commission*; p. 25 (June, 2003)

Executive Committee directed the Uniformity Committee, through its Income & Franchise Tax Subcommittee, develop model combined reporting statute and regulations.

The Income & Franchise Tax Uniformity Subcommittee organized the project into three phases: 1) education, 2) policy direction and 3) drafting. During the education phase, the Subcommittee established standard definitions for common terms used in discussing combined reporting, reviewed a number of MTC staff memorandums on the topic,[3] and heard a series of seminars on legal, mechanical and policy aspects of combined reporting.[4] In addition, the Subcommittee received several thought-provoking and constructive comments from the public at its March and July meetings, and during numerous teleconferences.[5]

The Subcommittee began the policy development phase by producing a list of combined reporting "pro's and con's." It then compiled a list of fifteen key policy issues to be addressed in the model statute or regulations.[6] During its March, 2004 meetings and three follow-up teleconferences, the Subcommittee provided direction on each of these fifteen policy issues for staff to follow in preparing a first draft of a combined reporting statute. In doing so, the Subcommittee took into consideration the recommendations of the MTC State Tax Compliance Initiative Steering Committee regarding adoption of combined reporting as a solution to corporate income tax compliance concerns.[7]

The Subcommittee reviewed and discussed the first draft statute at its July, 2004 meeting in Mystic, Connecticut. At that meeting, a small group of Subcommittee members volunteered to research the issue of whether corporations that are not income taxpayers should be included in the combined group, and report their findings to the

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[3]The Committee reviewed three memorandums from MTC staff member Shirley Sicilian: 1) dated October 6, 2003 to members of the Income & Franchise Tax Uniformity Subcommittee titled *Combined Reporting – State Statutes and Two Cases re Inclusion of Non-Income Taxpayers in the Unitary Group*; 2) dated December 15, 2003 to members of the Income & Franchise Tax Uniformity Subcommittee titled *Combined Reporting: 1) definition of common terms, and 2) interaction with* Joyce *and* Finnigan *rules;* and 3) dated February 10, 2004 to Jennifer Hayes, chair, and members of the Income & Franchise Tax Uniformity Subcommittee titled *Combined Reporting: More on Definitions of Common Terms.*

[4] The seminars were given by Michael Brownell, Senior Staff Attorney with the California Franchise Tax Board. Mr. Brownell addressed the following topics: March 14, 2004 –Overview of California's Approach to Combined Reporting and Some Alternatives; April 27, 2004 – Charitable Expenses & Holding Companies; May 25, 2004 – Intercompany Transactions; June 30, 2004 – Treatment of Partnerships.

[5] Professor Richard Pomp, Mr. Arthur Rosen, Ms. Diann Smith, Mr. Robert Montellione, and others provided helpful participation and comments.

[6] Mr. Brownell was the primary author of the combined reporting policy issues list.

[7] *Corporate Income Tax Sheltering Work Group Report*; Prepared for the State Tax Compliance Initiative Steering Committee; pp 15-16, 24-29 (June 17, 2004).

Subcommittee.[8] A second draft statute, which incorporated Subcommittee members' amendments from the July meeting, as well as recommendations of the small research group, was reviewed by teleconference on October 1, 2004. A group of insurance industry representatives met with members of the small research group on October 13, 2004 and provided insight and comments which led to further changes to the draft statute. The proposed model statute currently before the Executive Committee was posted to the MTC website on October 29, 2004.

On November 8, 2004 the Income & Franchise Tax Uniformity Subcommittee discussed the draft and voted to adopt it as a proposed model statute with a favorable recommendation to the Uniformity Committee.[9] On November 9, 2004, the Uniformity Committee considered the recommendation of the Subcommittee and voted to recommend the proposal favorably to the Executive Committee. On November 11, 2004 the Executive Committee approved the proposal for public hearings.

B. Public Hearings

Public Hearings were held January 4, 2005 in Oakland, California and March 29, 2005 in Washington, D.C., following more than 30 days notice in each case. Oral public comments were received at both hearings. In addition, six sets of written comments were received prior to the closure of the public comment period on April 1, 2005. The written comments are attached as Exhibits:

Exhibit A	McDermott, Will & Emery (MW&E) – Kimberley Reeder and Margaret Wilson
Exhibit B	Southerland, Asbill & Brennan (SAB) – Kendall L. Houghton and Jeffrey A. Friedman
Exhibit C	Council On State Taxation, American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (Insurance Group)
Exhibit D	United Services Automobile Association (USAA) – Amy Cannefax
Exhibit E	Heller Ehrman (HE) – Roy E. Crawford
Exhibit F	Organization for International Investment (OFII)

[8] Members of the small research group included Ted Spangler (ID); Wood Miller (MO); Mary Loftsgard and Robert Wirtz (ND); Janielle Lipscomb (OR); Robynn Wilson (AK); Michael Brownell and Larry Bobiles (CA).

[9] The Income & Franchise Tax Uniformity Subcommittee also appointed a small work group to consider whether it should recommend an amendment to the model statute to incorporate *Finnigan* style calculation of apportionment numerators as opposed to the *Joyce* approach currently contained in the model. On March 17, 2005, the small group recommended to the Subcommittee that the model statute should retain the *Joyce* rule. The small group noted that states adopting the model statute may also wish to separately consider a throw-back rule. The Subcommittee accepted the small work group's reconfirmation of the *Joyce* approach and voted to take no further action.

C. Next Steps – Executive Committee Consideration and Action.

This Report summarizes and makes recommendations for addressing the comments received through the public hearing process. For some comments, no change is recommended; while for others, alternative statutory language is proposed. The Executive Committee has several options. The proposed statute may be approved and passed on to the full Commission, amended and passed on to the Commission, disapproved entirely, or referred back to an earlier step in the process. If the Executive Committee chooses to pass any version of the proposal on to the Commission, it first authorizes (pursuant to MTC Bylaw 7) a polling of the affected Commission Member States to ensure that a majority of the affected States would consider adoption of the draft proposal. (This survey does not determine if the affected States will adopt the proposal—only whether the affected States will consider adoption of the proposal.) If the majority of the affected Commission Member States so indicate, the matter is referred to the full Commission for possible adoption as a recommended model uniform statute.[10] Once a model uniform statute has been adopted by the Commission, the Income & Franchise Tax Uniformity Subcommittee anticipates it will begin development of regulations to complement and expand on the principles reflected in that final version.

III. Summary of Substantive Provisions

The proposed model statute requires combination of all unitary entities that are subject to the state corporate income tax or that would be subject to the state corporate income tax if they were doing business in the state. Business conducted by any corporation through a partnership is treated as conducted directly by that corporation, to the extent of the corporation's distributive share of the partnership income. This is true whether the partnership is a general partnership, a limited partnership, an LLC or other entity treated as a partnership, or an S corporation. Other commonly-controlled, unitary entities, not otherwise subject to required combination because they are not income tax payers, may also be required to be included in the combined group by regulation if doing so would better reflect the proper apportionment of income of entire unitary businesses, or on a case-by-case basis if there is tax evasion.

Combination of eligible entities is required on a world-wide basis, unless taxpayers choose to make a water's-edge election. A water's-edge election limits the combined group to eligible domestic corporations, foreign corporations with U.S. source income, and corporations doing business in tax-haven countries.

The combined report required under this proposed model statute does not disregard the separate identities of the taxpayer members of the combined group. Each taxpayer member is responsible for tax based on its apportioned share of the business income of the combined group, together with that member's own allocated (nonbusiness)

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[10] Of course, all recommendations of the Commission are advisory to the States. For a recommendation to become effective in any State, that State must affirmatively adopt the proposal.

income, and its apportioned share of business income from any other combined group of which the taxpayer is a member. Business income of the combined group is calculated as the sum of all members' individually determined net business incomes. Dividends paid by one to another member of the combined group are eliminated from income, and no special treatment is provided for included foreign source income.

Because individual group members are recognized as separate taxpayers, as a general rule, a deduction or credit may be taken only by the specific taxpayer that earned it, and not against the total combined income or liability of the group. Likewise, the amount of total combined business income apportioned to a state is calculated as a function of each taxpayer's own factors in that state (the *Joyce* method), as opposed to the factors for the entire group as a whole in that state (the *Finnigan* method).

The statute does provide one exception to this general rule preserving the separate identity of the taxpayer. A charitable contribution deduction is allowed to be taken first against the business income of the combined group (subject to federal income limitations as applied to the entire business income of the group), and any remaining amount may then be treated as a nonbusiness expense allocable to the member that incurred the expense (subject to the federal income limitations applied to the nonbusiness income of that taxpayer member).

IV. Public Comment and Hearing Officer Recommendations

A. Criteria for Combination.

1. Unitary Business Requirement

Two commenters suggested it is not perfectly clear under the proposed statute that unity is required for combination. (MW&E p. 4-5; SAB oral comments) Both indicated their concern arises from the proposed language allowing the Director to adopt a regulation requiring combination "of any persons that are not included pursuant to [the mandatory combination provision], *but that are members of a unitary business*, in order to reflect proper apportionment of income of entire unitary businesses." (Emphasis added.) One of the two commenter suggested this language could possibly allow combination of unrelated taxpayers. (MW&E p. 4) The Hearing Officer believes this language clearly requires combination of only unitary entities. And, because the MTC's regulatory definition of unity requires common ownership and control, it would not allow combination of unrelated taxpayers. However, some states do treat the "common ownership and control" requirement as separate from the unity requirement. Thus, we recommend an explanatory note be added on this point to ensure clarity.

Several commenters expressed concerns with the proposed model's definition of "unitary business." The model defines a unitary business as:

> a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are

sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.

Section 1.F.

One commenter suggested this definition "provides little guidance by which taxpayers may determine whether they are indeed engaging in a unitary business." (MW&E p. 3; see also p. 4) We agree this proposed statutory definition is brief. Our intent is that the statute be supplemented by regulation. Indeed, this statutory language was drafted to dovetail precisely with the MTC's existing model uniform regulation defining a "unitary business."[11] The adopted MTC regulation begins with the identical language, and then expands on that definition at length. Because the statutory definition is derived from existing, adopted regulatory language, it would not, as one commenter warned, set a "new definitional standard." (SAB p. 1-2) In the Hearing Officer's opinion, the nine page MTC regulation associated with this proposed statutory language fully addresses commenters' concerns because it does thoroughly incorporate "the broad parameters of the unitary business principle [that] have been articulated by the U.S. Supreme Court in [its] long-standing opinions." (MW&E p. 2)

One commenter noted the definition of "unitary business" does not include any mention of "what constitutes a 'commonly controlled group.'" (MW&E p. 4) This question, too, is addressed through the existing MTC regulation. Under the regulation, common ownership and control are required for unity, and are defined at length.

Three commenters suggested that even if the proposed combined reporting statute is intended to work together with our adopted regulation, that intent should be made clear in the model statute. (SAB p. 1-2; MW&E p. 4; COST oral comments) The Hearing Officer agrees. The scope of this project is to draft a uniform model combined reporting statute. The definition of "unitary business" has already been addressed through a previous MTC uniformity project and we do not intend to address that issue again through this project. The Hearing Officer recommends brackets be placed around the definition of unity in the model statute, and a note be added to clarify that this statutory definition is intended to work together with the MTC's model uniform regulation. If a state intends to define "unitary business" in a manner inconsistent with the MTC's adopted regulation, it will need to insert its own brief statutory definition and develop its own regulations to expand on that definition accordingly.

2. Relevance of Arm's Length Pricing

Under the proposed model statute, combination is required of all unitary corporate income taxpayers, rather than permitted upon the request of either the corporation or the department, or contingent upon some type of showing by either the corporation or the department. One commenter suggested the model be amended to allow separate reporting

[11] See MTC General Allocation and Apportionment Regulations; Regulation IV.(b) Unitary Business (revised January 15, 2004) at http://www.mtc.gov/UNIFORM/ADOPTED.HTM

unless it can be shown that transactions between the entities are not at arm's length: "so long as related taxpayers charge each other the same amounts that they would charge to an unrelated business for the same transaction, no distortion or improper reflection of income would result." (MW&E p. 5) The commenter suggested that "[i]n fact, when related corporations do deal with one another on arm's length terms, combination may actually result in distortion." (MW&E p. 5) As a result, this commenter suggests the model require combined reporting "only when related corporations: (1) are engaged in a unitary business and (2) experience distortion attributable to a failure to conduct their intercompany transactions at arm's length." (MW&E p. 6)

In the opinion of the Hearing Officer, there is no rationale for conditioning combination on both a determination of unity and a finding of distortion through non-arm's length pricing. Combined reporting will attribute unitary business income in a manner conceptually superior to separate accounting whether or not the unitary entities are engaged in arm's length transactions. Indeed, under combined reporting, the income of a unitary business attributable to a state will not vary depending on whether a business chooses to operate as one corporation with numerous divisions or to incorporate those divisions into subsidiaries will not impact the amount of income produced by the business as a whole, subject to apportionment, and attributable to the state. By contrast, attempting to employ separate accounting where a business has chosen to incorporate its divisions is very difficult, if not, in truth, impossible. Separate accounting "…ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise."[12] The premise of combined reporting is that the synergies, interdependencies, and sharing of knowledge, know-how, and experiences that are typical features of a unitary business often cannot be properly captured by separate accounting.[13] With combined reporting, the enterprise-wide contributions to income that result from these features are not pigeon-holed into a few affiliates. Rather, they are apportioned across the entire enterprise, as they would be for a single corporation operating through divisions. In this way, the substance of the business activity conducted in the state controls the amount of income subject to apportionment, regardless of the organizational structure of the business entity or entities conducting those activities and regardless of any transactions that may take place between separately incorporated entities. Once unity has been determined, combination should occur, and there is simply no need to perform an additional test for arm's length pricing.

Nor does it make sense to "flip" the tests – so that a determination of unity is only required if there is a "gateway" finding of non-arm's length transactions. Adequately testing for arm's length pricing is extremely complex and time-consuming. Even if the test for arm's length pricing were no more burdensome than a test for unity, why subject taxpayers to two tests (first a test of arm's length pricing; and in cases where that test is not met, an additional test of unity) when it is only necessary to subject them to one (a

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[12] *Container Corp. of America v. Franchise Tax Bd. Of California*, 463 U.S. 159, 165; 103 S.Ct. 2268, 2940 (1983).

[13] *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; 61 Louisiana Law Review 699, 704, by Michael J. McIntyre, Paull Mines and Richard D. Pomp (2001).

test of unity)? In addition, required combined reporting of all eligible entities will help ensure the rule is applied uniformly, regardless of the impact on tax liability in individual cases. For these reasons, the Hearing Officer finds there is no need to modify the model statute to incorporate an additional test for arm's length pricing.

3. Entities Not Subject to a Corporate Income Tax.

Under the proposed model statute, only corporations subject to an income tax are specifically required to be combined. However, it is recognized that a single unitary business may be carried on by many types of business entities acting together, not just corporations and certainly not just corporations that are corporate income taxpayers. It is also recognized that it would be theoretically correct and, in many states, legally acceptable to statutorily require the inclusion of all such business entities in the combined group in order to properly apportion the income of the entire unitary business. In recognition of the theoretical basis for combination of all entities engaged in the unitary business, the model statute also authorizes combination of unitary non-corporate-income taxpayers to be required by regulation, provided such combination can be accomplished in a manner that will generally reflect a reasonable apportionment of income for those types of unitary entities. This theoretical consideration would not have been much of an issue until a few years ago - when the federal government began breaking down some of the barriers between different types of financial services industries.[14] One outcome of these changes is that industries such as banking and insurance companies, which are often not corporate income taxpayers, may now branch out and engage in a unitary business with other financial service industries that are subject to the corporate income tax.

Joint written comments on the potential for combination of non-corporate-income taxpayers were provided by the Council On State Taxation, American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (the Insurance Group). Similar comments were filed by United Services Automobile Association (USAA). These comments give a thorough review of the insurance company state tax system (including retaliatory taxes), benefits of this tax system for the states and the industry, and policy issues raised by the proposed model statute. (Exhibit C) Policy issues raised by the Insurance Group include complexities, implications and uncertainties for the insurance tax system if combination is viewed as indirectly subjecting insurance company income to a corporate income tax.

In fact, the *original* draft of the proposed model statute would have explicitly included all corporations, whether or not corporate income taxpayers, in the combined group. In addition to the theoretical basis for such inclusion, it was also recognized that including non-taxable entities in a combined group does *not* subject those entities, or their income, to a state's corporate income tax. For example, unitary entities that do not have nexus with the state, and cannot be taxed by the state, are routinely included in the combined group. Including these non-taxable entities in the combined group only includes those entities' income from the unitary business in the total pot of unitary business income from which the taxable corporations' share is apportioned. The tax is

[14] See *e,g,* Riegle-Neal Act and Gramm-Leach-Bliley Acts of 1994 and 1999.

then levied only on the taxable corporations' and their share of that income. The non-taxable corporations are not subject to the tax. Nor is any of the income from the unitary business that is attributable to those entities subject to tax.

This distinction was recognized in *State ex rel. Dept. of Revenue v. Penn Independent Corp*.[15], where the Oregon Tax Court found the apportionable income of a unitary group should include the income of an insurance corporation even though that corporation was not subject to Oregon's corporate income tax, but instead paid a gross premiums tax. The Tax Court noted "[i]t is important to remember that including the income of a nontaxable member of a unitary group does not subject that income to taxation by Oregon. It merely provides the base from which the taxable corporation's share is apportioned."[16] Indeed, the appropriateness of this holding has been recognized by Walter Hellerstein: "Although the result in this case is unusual, Judge Byers's thoughtful analysis of the theoretical justification for the result is plainly correct."[17]

However, after the original draft was issued, the Insurance Group raised its concerns. A small MTC subcommittee work group met with members of the Insurance Group to discuss these concerns. After discussion, the small work group agreed with the Industry Group that combination of entities which operate under significantly dissimilar financial and tax regimes can create mechanical issues which would need to be worked out, and that the resolution of those mechanical issues is likely to be different depending on the type of business entity or industry at issue. The small group agreed to balance the industry concerns against the correctness of combination and recommended to the Committee that the original draft be modified. The small group recommended that combination of dissimilar business entities could be attained through regulations which address the specific mechanical issues associated with combination for each of the different types of business entities. For example, combination of insurance companies may engender questions of how to establish "taxable income" for the insurance company that at the state level is subject only to a tax on gross premiums. Combination of non-income taxpayer financial institutions may raise issues surrounding the treatment of financial instruments in the calculation of the sales or property factors. In addition, different entities subject to different tax regimes in different states, *e.g.*, exempt organizations under IRC section 501(c)(3) may or may not be legally subject to combination in those states. A review of state legal authority for combination of each of the different entities may be required. For these reasons, the current version of the proposed model statute authorizes combination of other types of unitary entities to be required by regulation, so that appropriate rules can be developed to address each type of situation, rather than statutorily requiring combination in all situations. If the proposed model rule is adopted, the Committee will consider drafting model regulations for combination of one or more different types of business entities.

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[15] *State ex rel. Dept. of Revenue v. Penn Independent Corp*. 15 Or. Tax 68 (1999). http://www.publications.ojd.state.or.us/TC4321.htm.

16 Penn Independent, p. 74

17 Hellerstein, State Taxation: 2001 Cumulative Supplement No. 1, ¶ 8.11[3][e].

The model statute does also allow for combination to be required by the director on a case-by-case basis, but only in situations involving tax avoidance or evasion. Although it may be clear in individual cases that combination would better reflect the income or loss of a particular taxpayer, or better reflect proper apportionment of income of a particular unitary business, the remedy allowed in these situations is through regulation, and not through authority to combine on an individual, case-by-case basis.

The Hearing Officer believes these modifications to the original draft, reflected now in the draft before the Executive Committee, represent a compromise that reasonably balances the concerns of the industry with the need to adequately take into account these important segments of a single unitary business, and therefore the Hearing Officer does not recommend further changes.

4. Partnerships

Under the model statute, business conducted by a corporate income taxpayer through a partnership is treated as conducted directly by that corporate taxpayer, to the extent of the corporation's distributive share of the partnership income. This is true whether the partnership is a general partnership, a limited partnership, an LLC or other entity treated as a partnership, or an S corporation. Because the corporation is considered to be engaged in the partnership business directly, as though through a division, the corporate partner's distributive share of the partnership income and factors will "flow up" for apportionment on the partner, as opposed to the partnership, level, irrespective of any threshold level of the partner's ownership interest, distributive share or any other measure of its stake in the partnership. Under this statutory "as if done directly" treatment, if a partnership has state source income, so will the partner. The principle is consistent with federal sourcing rules that treat a resident of a foreign country as having U.S. source income if the partnership or an S corporation of which the resident is a member has income from a U.S. source (IRC §875(1); §1366(b)). And it has been sustained in state court.[18]

One commenter suggested the model should explicitly specify whether it follows the "aggregate" or the "separate" theory and noted the myriad of issues that arise from the inclusion of partnership income in the combined report. (COST oral comments) The Hearing Officer believes the statute is adequately clear regarding the basic policy to be followed, but agrees that additional, more detailed guidance could be provided, and recommends the appropriate procedure for providing that guidance is through regulation.

5. Water's Edge Election

Whether or not, or the extent to which, foreign affiliates are included in the combined group is one of the most significant policy issues addressed in the proposed model statute. In principle, a combined group should include all affiliates participating in the group's unitary business, domestic and foreign. If combination includes only

[18] *Valentino v. Franchise Tax Board*, 87 Cal.App.4th 1284 (2001).

domestic corporations, then the apportionment of income associated with the foreign activity of a multinational unitary business can be manipulated through changes in the corporate structure. The income (or loss) and apportionment factors associated with the foreign activity could be excluded by conducting the activity as a foreign affiliate, or it could be included by conducting the activity as a foreign division of the domestic corporation. Many tax experts have noted this policy rationale supporting world-wide combined reporting.[19] Indeed, the U.S. Supreme Court has also recognized the rationale and upheld state imposition of world-wide combined reporting.[20]

Despite its conceptual superiority, the world-wide approach is extremely unpopular with multinational corporations and much of the international tax community.[21] Indeed, a number of hearing participants lent support to that supposition in both oral and written comments. (See e.g. MW&E p. 7-8; OFII p. 1) As a practical matter, a water's-edge combination is likely to be administratively simpler, for both the taxpayer and the state, and far less contentious. Thus, the proposed model statute requires world-wide combination, with a water's-edge election. (Section 5) This approach takes a policy position in support of world-wide combination, yet also realizes the practical benefits of administrative simplicity and conflict minimization that can be achieved through a water's-edge election. No commenters recommended a change to the basic approach requiring world-wide combination but allowing a water's edge election. However, several took issue with various specific aspects of the water's edge election, and these comments are addressed below.

(a) Members Doing Business in a Tax-Haven

Two commenters referred to the model's retention in the water's edge combined group of entities doing business in tax havens as a "back-door implementation of world-wide combination." (SAB p. 2; OFII p. 1) In the opinion of the Hearing Officer, the retention of tax haven companies in a water's edge election is justified in order to address documented wide-spread abusive international tax sheltering, and its limited application to only those countries identified as "tax havens" falls far short of a "quasi world-wide combination." Just as combined reporting is critical to addressing income shifting across states, it is also critical for addressing the serious problem of income shifting to foreign tax-haven jurisdictions. A July, 2003 study by the Multistate Tax Commission estimated the state revenue impact from corporations shifting income earned inside the U.S. to

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[19] See *Use of Combined Reporting by Nation States*, by Michael J. McIntyre, Tax Notes International; p. 945 (Sept. 6, 2004). See also *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; *Supra*, p. 732; citing to *Slicing the Shadow: A Proposal for Updating U.S., International Taxation*, by Reuven S. Avi-Yonah, 58 Tax Notes 1511 (March 15, 1993); *Design of a National Formulary Apportionment Tax System*, by Michael J. McIntyre, 84th Conf. on Tax'n, Nat'l Tax Ass'n 118 (Frederick D. Stocker ed. 1991); other citations omitted.

[20] *Container*, 463 U.S. 159, 103 S.Ct. 2983; *Barclays Bank PLC v. Franchise Tax Bd. Of California*, 512 U.S. 298, 114 S.Ct. 2268 (1994).

[21] *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; *Supra*, p. 732.

other nations.[22] Using conservative national estimates of international income shifting through transfer pricing, the study estimated state revenue losses of $5.3 billion for fiscal year 2001 alone.[23] World-wide combination addresses this issue by including all eligible unitary corporations, foreign as well as domestic, in the combined group. The proposed model's requirement that foreign corporations doing business in a tax haven jurisdiction be maintained as members of the combined group is necessary to avoid re-opening the foreign tax-haven opportunity through the water's-edge election. And, as further addressed below, the model's proscribed definition of tax-haven will reasonably limit the corporations to which the rule will apply.

(1) Definition of "Tax Haven"

- **Use of OECD Criteria**

The definition of "tax haven" in the proposed model statute is based on existing standards and criteria established by the Organization for Economic Co-operation and Development (OECD) in its 1998 report entitled Harmful Tax Competition: An Emerging Global Issue.[24] One commenter suggested the Section 1.I.i. should more specifically identify "to which list of OECD 'tax havens' it refers: there were 35 jurisdictions identified by the OECD in its 2000 Progress Report yet only seven jurisdictions identified in the 2004 Progress Report." (MW&E p. 10) Similarly, "there were 47 countries identified in the 2000 Progress Report of the [OECD] as having a potentially 'harmful preferential tax regime;" however, to date, none have been identified as having an actual "harmful preferential tax regime." The Hearing Officer believes it is intended that Section 1.I.i. refer only to jurisdictions and regimes that are actually on the OECD lists during the year in question.[25] Thus, the language of Section 1.I.i. could be clarified as follows:

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[22] *Corporate Income Tax Sheltering and the Impact on State Corporate Income Tax Revenue;* A Report of the Multistate Tax Commission by Elliott Dubin; p. 4 (July, 2003).

[23] *Ibid*, p.5. The MTC study bases its estimate on estimated federal revenue losses attributable to international tax sheltering of $30 billion. This number is consistent with a 1990 estimate by the Subcommittee on Oversight of the House Ways and Means Committee, chaired at the time by Rep. J.J. Pickle. Estimates from other sources have been higher, exceeding $53 billion annually. See *An Estimate of 2001 Lost U.S. Federal Income Tax Revenues Due to Over-Invoiced Imports and Under-Invoiced Exports* by Simon J. Pak and John Zdanowicz, (October 31, 2002).

[24] *Harmful Tax Competition: An Emerging Global Issue*, OECD, 1998. http://www.oecd.org/dataoecd/33/1/1904184.pdf In 2001, the OECD deleted consideration of whether a jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy as one of the criteria for distinguishing between "cooperative" and "uncooperative" tax havens. However, the consideration of significant untaxed offshore services remains one of the OECD criteria for the determination of whether a jurisdiction is a tax haven. Thus we have retained this consideration as one of several criteria to be examined in determining the existence of a tax haven under the model statute.

[25] It should be noted that Section 1.I.ii. could include jurisdictions that were once, but are no longer, on the OECD list of uncooperative tax havens. The OECD recognizes that removal of a jurisdiction or regime from its list does not mean that that jurisdiction or regime is no longer a tax haven under its definition, only that it has become a "cooperative tax haven" as opposed to an "uncooperative tax haven." As long as a

I. "Tax haven" means a jurisdiction that, during the tax year in question,:

i. ~~has been~~ is identified by the [OECD] as a tax haven or as having a harmful preferential tax regime …

- **Director Discretion**

The proposed model allows discretion on the part of the Director with respect to tax havens in two ways. First, the Director may classify a jurisdiction as a tax haven if he or she "determines [the jurisdiction] has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, …." (Section 1.I.iii.) Second the Director "may treat an activity of the member as not having been conducted in a tax haven" if the activity is "entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in [the definitional section.] (Section 5.A.vii.) Three commenters objected to the amount of discretion afforded the Director with respect to tax havens. (MW&E p. 10; SAB p. 3; COST oral comments) One commenter explained that "[t]he obvious effect of such discretion is the lack of uniformity across states that implement [the] proposed model statute." (SAB p. 5) The Hearing Officer acknowledges the importance of uniformity and believes amendments are possible which would reduce the amount of discretion afforded the Director without seriously compromising the effectiveness of the model provisions, as follows:

Changes to Section 1.I.:

I. "Tax haven" means a jurisdiction that:

…ii. exhibits the following characteristics established by the OECD in its 1998 report entitled Harmful Tax Competition: An Emerging Global Issue as indicative of a tax haven or as a jurisdiction having a harmful preferential tax regime, regardless of whether it is listed by the OECD as an un-cooperative tax haven:

(a) has no or nominal effective tax on the relevant income; and

(b) (1) has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;

(2) has tax regime which lacks transparency. A tax regime lacks transparency if the details of legislative, legal or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers, or if the information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available;

"cooperative tax haven" is still a "tax haven," the jurisdiction will continue to meet the OECD definition in Section 1.I.ii. This is not inconsistent with the OECD's own caveat that a conclusion that a regime is not actually harmful does not in any way preclude the application of any domestic measure (such as CFC, FIF or any anti-abuse provisions) of a country to that or any other regime in *OECD's Project on Harmful Tax Practices: The 2004 Progress Report*, Part II ¶18.

> **(3)** facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy; ~~**or**~~
>
> **(4)** explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or
>
> ~~**iii.**~~**(5)** ~~the director determines~~ has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy.

Changes to Section 5.A.vii.:

> the entire income and apportionment factors of any member that is doing business in a tax haven. If the member's business activity within a tax haven is entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in Section 1.I., ~~the Director may treat~~ the activity of the member shall be treated as not having been conducted in a tax haven.

(2) "Doing Business" in a Tax Haven

Four commenters remarked that inclusion in the water's edge election of any taxpayer "doing business" in a tax haven is overly broad. (MW&E p. 9; SAB p. 2-4; OFII p. 1-2; COST oral comments) One commenter suggested that it is presumably the "process of organizing" an entity in a tax haven jurisdiction that creates some tax benefit. (MW&E p. 9) One commenter noted that Montana and Alaska both include only those corporations that are "domiciled in" a tax haven.[26] (SAB p. 3) The Hearing Officer agrees that the "doing business" criteria is overly broad. However, in the opinion of the Hearing Officer, a rule limiting inclusion to taxpayers domiciled, particularly legally domiciled, in a tax haven may not be adequate for our purposes. A corporation incorporated in one country can have a commercial domicile in a haven and take advantage of the secrecy and low tax rate rules of the haven. The Hearing Officer recommends that the language be modified as follows:

> …the entire income and apportionment factors of any member that is doing business in a tax haven, where 'doing business in a tax haven' is defined as being engaged in activity sufficient for that tax haven jurisdiction to impose a tax under United States constitutional standards.

Section 5.A.vii.

(3) Foreign Commerce Clause

Two commenters suggest the MTC's adherence to the OECD's criteria would violate the foreign commerce clause. (SAB p. 4; OFII p. 2) The foreign commerce clause

[26] Mont. Code §§15-31-322 and Alaska Code §43.20.073

restrictions established in *Japan Lines* are that state tax measures may not impose a risk of multiple taxation at the international level and may not prevent the federal government from "speaking with one voice" on international policy matters. The model does not violate either of these restrictions. First, the model is fundamentally an adoption of world-wide combination, which has been upheld by the U.S. Supreme Court. The water's edge election is just that – an election – and it is at the taxpayer's option. Nothing is "imposed" through an election allowing taxpayers to limit the inclusion of the foreign unitary affiliates which could otherwise constitutionally be required to be included in their combined report.

Second, the United States is a member of the OECD, the organization which has produced the definitions the model proposes to follow. That the model will incorporate and follow definitions adopted by an organization of which the federal government is a member will promote, not prevent the federal government's ability to "speak with one voice." A commenter suggested that the OECD's 1998 criteria have been "clearly rejected by the Federal government," and thus the MTC's reliance on these criteria would violate the foreign commerce clause. (SAB p. 4) As evidence of rejection, the commenter pointed to testimony provided in 2001 by Treasury Secretary Paul O'Neill to the Senate Committee on Governmental Affairs. (SAB p. 4)

In the opinion of the Hearing Officer, Sec. O'Neill's testimony has been misinterpreted. Indeed, Sec. O'Neill reported his concern with prior OECD provisions. But the conclusion of his testimony was that these concerns have been addressed. In fact, Sec. O'Neil stated:

> Our review of the OECD project has been guided by two fundamental principles. First, we must do everything that we can to enforce our own tax laws, including working to obtain needed information that is in the hands of other countries. Second, we will not interfere in the internal tax policy decisions of other countries. These principles led me to conclude that the United States should attempt to refocus the OECD initiative on its core element: the need for countries to be able to obtain specific information from other countries upon request in order to prevent noncompliance with their tax laws.
>
> I am happy to report that, together with other OECD member countries, we have made substantial progress in focusing the initiative on its core element of effective information exchange and in addressing aspects of the initiative that seemed unfair to non-OECD countries. … I would like to summarize three significant modifications to the OECD tax haven work, each of which I will describe in greater detail below. First, coordinated defensive measures would not apply to "uncooperative" tax haven jurisdictions any earlier than they would apply to similarly-situated OECD member countries. Second, the "no substantial activities" criterion will no longer be applied to determine whether or not a jurisdiction is considered to be an "uncooperative" jurisdiction. Third, the time for tax haven jurisdictions to make a commitment to transparency and information exchange has been extended from July 31st to November 30th.

> *The United States argued for each of these modifications within the OECD, and strongly supports them.*

Testimony of Sec. O'Neil, emphasis added

Sec. O'Neill clearly believes his concerns have been addressed and shows strong support for the OECD's provisions as modified. And, none of the modifications changed the OECD's 1998 criteria, incorporated in the proposed model, which are used to identify tax havens. Modifications to the date by which coordinated defensive measures will be taken against uncooperative tax havens (Sec. O'Neill's first point) and to the deadline for tax havens to make transparency commitments (Sec. O'Neill's third point) had no impact whatsoever on the OECD's 1998 criteria for identifying tax havens. Sec. O'Neill's second point merely eliminates a criterion for distinguishing between cooperative and non-cooperative tax havens, but does not eliminate or change any of the criteria established in 1998 for determining whether the jurisdiction is a tax haven in the first place. In the opinion of the Hearing Officer, the testimony presented by Sec. O'Neill, if anything, is strongly supportive of the OECD provisions as they now stand and are reflected in the proposed model.

(b) Subpart F Income

Under the proposed model, controlled foreign corporations (CFCs) are to be included in the water's edge election to the extent of their subpart F income. One Commenter suggested the section could be read to wholly include a CFC "if it earns even one dollar of Subpart F income." (MW&E p. 8-9) The Hearing Officer agrees and recommends the model language be amended as follows:

> [Members of the combined report under a water's edge election include] any member of a "controlled foreign corporation," as defined in [IRC] Section 957, to the extent <u>of</u> the income of that member <u>that</u> is defined in [Subpart F]….

Section 5.A.v.

The same commenter suggests a need for "an explicit acknowledgment in either [the Subpart F] section or the dividend elimination provision that the same item of Subpart F income will not be included in the income of multiple entities in a tiered CFC structure." (MW&E p. 9) The Hearing Officer believes such a clarification is unnecessary. If the CFC is non-unitary or otherwise excluded from the combined group, its Sub F income will not be included as such in the combined report, so dividends paid out of any of that CFC's income (including Sub F income) to any member of the combined group should be included as income of that member and should not be eliminated. On the other hand, if the CFC is unitary and included in the combined report, dividend elimination would clearly be required under Section 3.C.ii (d).

The commenter also suggests the "high tax" exception to the Sub F rule be clarified to indicate "whether it is possible for a taxpayer to treat income as Sub F income

for federal purposes yet seek to take advantage of the high tax exception for state purposes." (MW&E p. 9) The Hearing Officer believes that an amendment clarifying high tax Sub F income is never included in a combined report would be sufficient to address this question. As long as the model excludes high tax income from the combined report, then even if the taxpayer elects not to exercise the high tax provision for federal purposes, the income will still be excluded from the combined report for state purposes. The Hearing Officer recommends the following amendment to Section 5.A.v. (water's edge election):

> [A]ny item of income received by a controlled foreign corporation ~~may~~ shall be excluded if ~~the taxpayer establishes to the satisfaction of the Director that~~ such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in [IRC] Section 11;

Section 5.A.v.

Clarification of this issue for purposes of a world-wide combined filing may be accomplished through regulation.

(c) Members Earning 20% of Income from Activities Deductible by Another Member

The proposed model would include in the water's edge combined report "any member that earns more than 20 percent of its income, directly or indirectly, from activities that are deductible against the business income of the other members of the combined group, to the extent of that income and the apportionment factors related thereto…" (Section 5.A.vi.) The purpose of this proposal is to address the potential for income shifting through intangible holding companies which would otherwise be excluded from the combined report under a water's edge election. One commenter expressed a concern that the provision is potentially over-broad. As an example, the commenter pointed out that a foreign parent manufacturer selling to a related party U.S. distributor could potentially see most of its income included in the water's edge group under this provision. (MW&E p. 9; COST oral comments) Another commenter sited this provision as overly burdensome because it would impose an "annual requirement to assess whether any foreign affiliate [meets the criteria]. (SAB p. 2)

In the opinion of the Hearing Officer, the breadth of this provision could be reduced without significantly jeopardizing its effectiveness as follows:

> any member that earns more than 20 percent of its income, directly or indirectly, from intangible property or service related activities that are deductible against the business income of other members of the combined group, to the extent of that income and the apportionment factors related thereto;

Section 5.A.vi.

(d) Initiation and Withdrawal of Election

The availability of any election can have revenue implications as taxpayers would reasonably choose the methodology that produces the lower tax in each case. The model statute minimizes the potential for this type of impact by making the water's-edge election more of a long-term consideration. Under the proposal, the election is binding for all future tax years, and may be withdrawn or reinstituted after withdrawal only in restricted circumstances. One commenter voiced a concern that these circumstances are too restricted and recommended an election withdrawal option after a fixed period. (COST oral comments). In the interest of compromise, the Hearing Officer believes there would be no problem with a 10 year rolling option. A non-rolling option that defaults to the existing election, unless changed, for another 10 year period could also be acceptable. The Hearing Officer recommends the following amendment:

> A water's-edge election is binding for and applicable to the tax year it is made and all tax years thereafter <u>for a period of 10 years</u>. It may be withdrawn or reinstituted after withdrawal <u>prior to the expiration of the 10 year period</u>, only upon written request for reasonable cause based on extraordinary hardship due to unforeseen changes in state tax statutes, law, or policy, and only with the written permission of the Director. If the Director grants a withdrawal of election, he or she shall impose reasonable conditions as necessary to prevent the evasion of tax or to clearly reflect income for the election period prior to or after the withdrawal. <u>Upon the expiration of the 10 year period, a taxpayer may withdraw from the water's edge election. Such withdrawal must be made in writing within one year of the expiration of the election, and is binding for a period of 10 years, subject to the same conditions as applied to the original election. If no withdrawal is properly made, the water's edge election shall be in place for an additional 10 year period, subject to the same conditions as applied to the original election</u>.

Section 5.B.iv.

One commenter voiced a concern that the circumstances under which the Director may disregard the election are too broad. (See MW&E p. 10) The Hearing Officer agrees that the circumstances could be more fully described, but believes this would be more appropriately accomplished through regulation. The same commenter suggested that if the election is disregarded in part, in no circumstances should the Director's disregard of the election result in the payment of more tax than would have been paid on a world-wide combined basis. (MW&E p. 10-11) The Hearing Officer disagrees. It is possible that in any one year a world-wide combination would produce a significantly lower tax liability than a water's edge election. If a water's edge election is disregarded in part because, for example, the taxpayer has availed itself of an abusive tax shelter, the result should not be an even lower tax (through world wide combination) than would have otherwise resulted had the taxpayer not used the abusive tax shelter.

B. Method of Combination

1. Group Members as Individual Taxpayers vs. the Combined Group as a Single Taxpayer

As mentioned above, the combined report required under the proposed model statute does not disregard the separate identities of the taxpayer members of the combined group. The model is quite consistent in its treatment of the combined group as a set of individual entities rather than a single taxpayer: business income subject to apportionment is calculated as the sum of all members' individually determined net business income or loss; as a general rule, deductions and credits are taken only by the specific taxpayers that earned them; and, the amount of total combined business income apportioned to a state is calculated as a function of each taxpayer's own factors in that state (the *Joyce* method), as opposed to the factors for the entire group as a whole in that state (the *Finnigan* method).

An exception to this general rule is that charitable contribution deductions are allowed to be taken first against the group business income, and any remainder is then allocable to the specific taxpayer that earned the deduction. One commenter cited to this exception, plus a "sales factor throwback [recommendation] to be applied on the basis of *Finnigan,"* and the fact that "a taxpayer's share of business income apportionable to the state is calculated by reference to all business income of the individual members in combination," as indication that there is an "MTC preference in each discrete instance of drafting for the approach – "taxpayer" defined as the discrete entity/member of a unitary group v. "taxpayer" defined as the combined unitary group – that is likely to generate the greatest tax liability for the taxpayer." (SAB p. 6; also COST oral comments)

The Hearing Officer would disagree with the characterization of a throwback rule as a *Finnigan* style attribute. However, this point is irrelevant as the model statute takes no position on throwback.

The Hearing Officer would agree that a taxpayer's share of business income apportionable to the state is calculated by reference to all [net] business income of the individual members in combination. However, such combination is not the equivalent of treating the entire combined unitary group as a *single taxpayer*. It is simply the recognition of the entire combined unitary group as a *single business*. The proposed model then utilizes the combined report as a worksheet for properly apportioning the total income from that *single business* across the *individual taxpayer* members that are engaged in that single business.

So in fact, the only true exception to the general rule cited by the commenter is the charitable contribution deduction. Under the proposed statute, a charitable deduction is allowed to be taken first against the business income of the combined group (subject to federal income limitations as applied to the entire business income of the group), and any remaining amount may then be treated as a nonbusiness expense allocable to the member

that incurred the expense (subject to the federal income limitations applied to the nonbusiness income of that taxpayer member).

The Hearing Officer agrees that consistency in whether each individual group member or the group as a whole is considered the taxpayer is a rationale goal. Although the proposed model is not perfectly consistent in its treatment of group members as individual taxpayers, the exceptions to the general rule are limited and reasonable. For example, perfect consistency would require us to abandon the model's treatment of the charitable deduction, which would result in "trapping" of these particular incentives at the parent level from which these contributions are often made. (One industry commenter specifically noted appreciation for the model's handling of charitable deductions [COST, oral comments]). An alternative model could be developed which perfectly consistently treats the entire group as a single taxpayer. Such a model would allow credits and deductions earned by any one entity to be usable by the entire group. In addition, under this "single taxpayer" model the state apportionment factor numerators would reflect the property, payroll and sales of the entire group as a single taxpayer, not just those entities considered to have nexus when viewed as if each were an individual taxpayer.

In the opinion of the Hearing Officer, the proposed model's approach of generally treating each member as an individual taxpayer, with a small number of exceptions where necessary and reasonable, is a sensible approach. The model's deviation from this approach in the case of charitable deductions in particular is an example of a limited, reasonable allowance and should be appreciated by taxpayer groups. Therefore, the Hearing Officer does not recommend a change to the model on this point. Additional comments on the treatment of apportionment factor numerators, credits and losses are discussed below.

(a) Apportionment Factor Numerators

As noted above, the proposed model follows the *Joyce* approach and determines apportionment factor numerators for each taxpayer member on an individual taxpayer basis. This approach is consistent with the MTC's Policy Statement on Information Concerning Practices of Multistate Tax Commission and Signatory States under Public Law 86-272, which was originally adopted in 1986. The policy choice was also recently reaffirmed by a small work group assigned to review the issue by the Income & Franchise Tax Subcommittee. No commenters objected to the model's use of the *Joyce* approach for determining the apportionment factor numerators. One commenter remarked that it "agree[s] wholeheartedly with the Model's use of a *Joyce* approach to determining the proper apportionment of the combined tax base on a taxpayer-by-taxpayer basis." (MW&E p. 7)

(b) Credits

As noted above, the proposed model also requires tax credits be allowed only on an individual taxpayer basis (unless the credit statute explicitly directs otherwise). Two

commenters took the position that credits "should be applied to offset the income of the combined group." (MW&E p. 6; also COST oral comments) However, credits do not "offset *income*," they offset *tax liability*. If the proposed model were to treat the entire group as a single taxpayer with a single tax liability, then it might make some sense for credits to be applied against that single tax liability. But in a model such as the proposal before the Committee which treats each group member as an individual taxpayer with an individual tax liability, there is simply no rationale, absent statutory direction, for allowing a tax credit earned by one taxpayer member to offset the separate tax liabilities of other taxpayer members.

In addition, it is not at all clear to the Hearing Officer how credits could reasonably by apportioned and tracked from year to year if the commenters' position were adopted. For each credit earned by an individual taxpayer, a determination would need to be made as to whether the credit arose from an investment that was unitary business related and apportionable, or non-business related and not apportionable, or some of each. Taxpayers would need to separately track their use of credits and prioritize which credits were being applied first, in order to know whether a particular carryover credit were unitary business related and (possibly) available for use by the entire business in the second year, or not unitary business related and available for use only by that taxpayer in the second year. Some of both types of credit might carryover. Characterizing, apportioning and tracking the usage of different types of credits by multiple members of a unitary group, especially if the group members are changing from year to year, would certainly require a much more complex administration than that required under the approach recommended by the model.

For the above reasons, the Hearing Officer does not recommend a change to the proposed model on this point.

(c) Losses

As noted above, the proposed model also restricts net operating loss carryover deductions to the individual taxpayers that originally earned them. Two commenters believe this aspect of the proposed model is "inconsistent with the combined reporting concept. … If a group of corporations are required to combine their income in order to produce an accurate reflection of the income attributable to any one state, then the same logic ought to extend to the losses generated by that same group of corporations." (MW&E p. 6; COST oral comments) One commenter explained that "[i]f income is computed on a combined basis, it is logical that losses (and carryforwards) must also be computed and applied in a similar fashion."

In the opinion of the Hearing Officer, this position is only partly correct. The Hearing Officer agrees with the commenters that a net loss, like net income, is subject to apportionment among the members of the combined group. However, once apportioned, the net loss has been identified as attributable to a particular taxpayer member. It may be used to offset other types of income of that member - *e.g.*, the taxpayer's allocated non-business income, or business income arising from a different combined group. There is

no rationale for allowing any remaining amounts of loss attributed to a particular taxpayer member to be *re-apportioned* among the entire group in the following year. Rather, the loss, once apportioned, should remain associated with the factors by which, and the individual taxpayer to which it was attributed in the year it was created. In addition, continued re-apportionment of NOL carryforwards would entail the same potentially significant administrative difficulties discussed with respect to apportionment of tax credits, above. Thus, the Hearing Officer does not recommend any changes to the model based on this point.

2. Deferred Intercompany transactions

The model provides that restorations of deferred company income resulting from an intercompany transaction between members of a combined group shall be apportioned as business income. One commenter suggested that a specific determination should be made in each case as to whether the restoration should be treated as business or non-business income. In the opinion of the Hearing Officer, this is not necessary because only business income should be deferred in the first instance, so all restorations should be restorations of business income. To ensure that that is the case, the Hearing Officer recommends the following amendment:

> Except as otherwise provided by regulation, <u>business</u> income from an intercompany transaction between members of the same combined group shall be deferred in a manner similar to 26 CRF 1.1502-13. Upon the occurrence of any of the following events, deferred <u>business</u> income resulting from an intercompany transaction between members of a combined group shall be restored to the income of the seller, and shall be apportioned as business income earned immediately before the event: …

Section 3.C.ii(e)

3. Elimination of Dividends

The proposed model provides that:

> All dividends paid by one to another of the members of the combined group shall, to the extent those dividends are paid out of the earnings and profits of the unitary business included in the combined report, in the current or an earlier year, be eliminated from the income of the recipient. This provision shall not apply to dividends received from members of the unitary business which are not a part of the combined group.

One commenter suggested amendments to this language to clarify the proper treatment of dividends paid by one to another member of the combined group out of pre-acquisition (or pre-unity) earnings and profits, and whether earnings and profits are determined for the purpose this provision on a separate return basis or on a “recomputed” basis as a share of combined business income. In the opinion of the Hearing Officer, this statutory language correctly states the intended rule in general terms. It is acknowledged that additional guidance would be helpful on these (and other) points, and the Hearing

Officer recommends the appropriate method for providing such guidance would be through regulations.

4. Compliance Burdens

One commenter expressed a concern for "compliance burdens" generated by the proposed model statute. (SAB p. 2) However, most of these concerns are simply related to the need for a taxpayer to calibrate foreign affiliates income with the income that would be recognized under state law. This is necessary if the taxpayer does not make the water's edge election. And in some cases, may be necessary under the water's edge election. Additional guidance may be provided by regulation to minimize any burdens. Other examples of potential burden given by the commenter have been addressed above.

C. Implications of Adopting the Model Combined Reporting Statute

One commenter suggested that if a state adopts the proposed model combined reporting statute, it may repeal any throwback, throwout or add-back provisions. (MW&E p. 3) In the opinion of the Hearing Officer, this is incorrect with respect to throwback or throwout provisions, and is not necessarily the case with respect to add-back provisions. The purpose for the throwback rule is to avoid no-where income, and avoid discrimination against wholly instate businesses that can't cause nowhere income to "fall between the cracks." The policy of throwback is just as important and necessary to that objective in a combined reporting setting than in a single entity setting. Add-backs may still be appropriate for taxpayers that elect water's edge and create foreign intangible holding companies or for insurance companies if combination isn't available. That said, the Hearing Officer would note that these issues are beyond the scope of recommendations for changes to the model combined reporting statute.

Respectfully Submitted,

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Shirley K. Sicilian
Hearing Officer

APPENDIX GG

"Supplemental Report of the Hearing Officer regarding the
Proposed Model Statute for Combined Reporting"
(by Shirley Sicilian of Multistate Tax Commission, amended June 21, 2005)

Multistate Tax Commission

Supplemental Report of the Hearing Officer Regarding the proposed Model Statute for Combined Reporting

June 3, 2005
[Amended June 21, 2005]

I. Introduction and Summary

This report is a supplement to the April 25, 2005 Hearing Officer's Report, which was presented to the Executive Committee at its April 27, 2005 meeting in Washington, D.C. At that meeting, the Executive Committee determined that before taking action on the proposed model uniform combined reporting statute and the Hearing Officer's proposed changes, it would like to receive comments from the Uniformity Committee, and additional comments from taxpayer representatives and MTC member states. In order to receive those comments, a teleconference meeting of the Uniformity Committee was held on May 13, 2005. This Supplemental Report provides a review of the comments made at that meeting. Six members of the public spoke during the public comment period to address issues regarding insurance companies, companies doing business in tax havens, and allowance of tax credits. Uniformity Committee members also commented on these issues. The Uniformity Committee as a whole concluded it concurs with the changes proposed by the Hearing Officer in the April 25 Report. The Hearing Officer recommends no additional changes.

II. Public Comments

A. Taxpayer Representative Comments

1. Potential for Inclusion of Insurance Companies in the Combined Group.

Diann Smith, Council on State Taxation (COST), spoke on behalf of American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (the Insurance Group). She reiterated the Insurance Group's concern that inclusion of insurance companies in a combined group with corporate income taxpayers would raise a host of technical problems with respect to the

determination of the income base, apportionment factor consistency and other issues. This concern was also expressed by Jim Hall (ACLI). (*See Also* Insurance Group written comments filed March 28, 2005, pp. 11-16). In addition, Ms. Smith and Mr. Hall commented that most insurance companies do not purposely engage in transactions intended to distort the apportionment of income, and thus combination could be limited to a case-by-case requirement in situations of abusive tax avoidance or evasion, such as those that have occurred with captive insurance companies. Both Ms. Smith and Mr. Robert Monteleon (Prudential) suggested that because most states have two separate taxing regimes for insurance companies and corporations subject to the income tax, at some point, there should be a dialog between departments of revenue and departments of insurance regarding the proposal.

In the opinion of the Hearing Officer, it is well accepted that inclusion in the combined group of unitary entities that are not corporate income taxpayers will raise technical questions. It is because of these questions that the proposed model statute does not require combination of these unitary entities outright. Instead, the statute allows for combination to be required by regulation, after technical matters have been carefully considered and addressed. Of course, if technical matters cannot be resolved, combination can not and will not be required, regardless of the allowance provided by statute. (This issue was also addressed in the Hearing Officer's Report of April 25. *See* pp. 8-10.) Therefore, the Hearing Officer does not recommend amendment to the proposal on this point.

Nor does the Hearing Officer recommend limiting combination to cases of evasion or abuse. Combination of insurance companies, like combination of any other taxpayers, is not merely a means for addressing tax evasion and abusive income shifting; it is, more fundamentally, the most efficient and theoretically sound method for identifying and apportioning the income of a single, unitary business – regardless of whether there is distortion, evasion or abuse. Ideally, combination of all unitary entities would be employed wherever possible. As drafted, the proposed model statute will allow for combination wherever technical issues can be addressed through regulation. The Hearing Officer believes this is a reasonable and preferable approach.

2. Inclusion of Companies Doing Business in Tax Havens in the Water's Edge Combined Group

Kendal Houghton, Southerland, Asbill & Brennan, cautioned that defining the "doing business" standard as a constitutional standard will be no easier to apply with respect to tax havens than with respect to states and that, because it is not uniformly interpreted among the states, it may lead to lack of uniformity. Ms. Houghton suggested the Commission use its factor presence nexus proposal to define "doing business."

Mr. Jeffrey Friedman, also with Southerland, Asbill & Brennan, stated his opinion that a combination rule which includes a corporation depending on whether or not the corporation does business in particular country is a violation of the foreign commerce clause, and is not insulated by the fact that the rule results from an election that is at the

taxpayer's option. Ms. Diann Smith, speaking on behalf of COST, recognized that there have been high-profile cases of abusive tax sheltering involving tax havens, but expressed agreement with Mr. Friedman. Ms. Smith noted the current proposal indicates a bias that corporations doing business in "tax haven" countries are doing something wrong and suggested that the bias should be removed.

The Hearing Officer appreciates Ms. Houghton's suggestion that the combined reporting proposal incorporate the Commission's factor presence nexus proposal for purposes of determining whether an entity is "doing business" in a tax haven. However, no state has yet adopted the Commission's factor presence nexus proposal. The Hearing Officer recommends that a state's standard be the same for determining whether an entity is doing business in the state or in a tax haven jurisdiction. Thus, the combined reporting model should retain the constitutional standard currently used by most states for determining nexus. While it is true that applying this standard to tax havens will be no easier than applying it to the state's own jurisdiction, by the same token it will be no more difficult either. Therefore, when and if a state moves to adopt the factor presence nexus standard, it should at the same time consider modifying its combined reporting rule with respect to doing business in tax havens. (*See also* Hearing Officer's Report of April 25, p. 14)

The question of whether the proposals retention of corporations doing business in tax havens in the water's edge election violates the foreign commerce clause was addressed in the original Hearing Officer's Report of April 25. (*See* Hearing Officer's Report of April 25, pp. 14-16). The Hearing Officer does not recommend additional changes to the proposal on this point.

3. Treatment of Credits and Net Operating Loss

Mr. Roy Crawford, of Heller Ehrman, commented that the proposal's limitation of a tax credit to the taxpayer that earned it (unless the credit statute specifically directs otherwise) should be modified. Mr. Crawford suggests that limiting tax credits to the liability of the taxpayer that earned the credit is a departure from the unitary concept, and that a credit should be apportioned across the entire unitary group where the activity that generated the credit is related to the unitary business and to apportionable income. Ms. Smith commented that COST received more comments on this issue than on any other and suggested that the default, instead of restricting the credit to the taxpayer member, should be application of the credit to the entire group. Ms. Smith also noted that this issue is being litigated in the *General Motors* case currently pending in the California Supreme Court and encouraged committee members to review the briefs filed in that case.

This issue was also addressed in the original Hearing Officer's Report of April 25. (*See* pp. 19-22, esp. pp. 20-21) In the opinion of the Hearing Officer, while combined reporting should reflect the principles of UDITPA and unitary theory, nothing in either UDITPA or unitary theory requires a credit earned by one taxpayer to be allowed against the separate tax liabilities of the other taxpayer members of a combined group. UDITPA

is a method for apportioning the income of a single, unitary business across the multiple taxpayers engaged in that business, so that the tax base of each of those members may be determined. Once that is accomplished, there is simply no basis for reaching past income apportionment to the "apportionment" of other tax provisions such as credits.

If the proposed model were to treat the entire group as a single taxpayer with a single tax liability, then it might make some sense for credits to be applied against that single tax liability. (And in such case it would also make sense that nexus for any part of that unitary business would provide nexus for the entire unitary business.) But in a model such as the proposal before the Committee which treats each group member as an individual taxpayer with an individual tax liability, there is simply no rationale, absent statutory direction, for allowing a tax credit earned by one taxpayer member to "apportioned" and allowed to offset the separate tax liabilities of other taxpayer members. In fact, doing so could cause a credit to be apportioned to members of the combined group that are not income taxpayers in that state and thus portions of the credit earned in the state would be unavailable to offset state tax liability. The Hearing Officer does not recommend an amendment on this point.

4. Other

Ms. Smith, COST, expressed appreciation for certain changes recommended by the Hearing Officer in the original Report, such as the time limit on the election, and modifications to the treatment of U.S. affiliates.

B. Uniformity Committee Comments

Michael Brownell, California Franchise Tax Board, commented that the States are not all in agreement regarding combination of insurance companies. California has concerns with such combination, while other states are actively pursuing it. Mr. Brownell believes the proposal is a good compromise, and allows states to work out technical issues associated with combination of corporations that are not income taxpayers before requiring combination. Mr. Brownell also commented that the Franchise Tax Board would support the proposal's limitation of a tax credit to the individual taxpayer member that earned the credit. He noted that proposed treatment of credits does not conflict with the requirements or principles of either UDITPA or unitary theory in general. Mr. Brownell noted that the proposal's language regarding inclusion of entities doing business in tax havens has resolved most of the difficulties with which the Franchise Tax Board was originally concerned.

The Uniformity Committee as a whole then expressed concurrence with the Hearing Officer's recommendations as set forth in the original Hearing Officer's Report of April 25.[1]

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[1] Mr. Gene Walborn (MT) noted he concurred, but would like to discuss the proposal's treatment of insurance companies further with his Director.

III. Next Step – Executive Committee Consideration and Action

The Executive Committee has several options. The proposed statute may be approved and passed on to the full Commission, amended and passed on to the Commission, disapproved entirely, or referred back to an earlier step in the process. If the Executive Committee chooses to pass any version of the proposal on to the Commission, it first authorizes (pursuant to MTC Bylaw 7) a polling of the affected Commission Member States to ensure that a majority of the affected States would consider adoption of the draft proposal. (This survey does not determine if the affected States will adopt the proposal—only whether the affected States will consider adoption of the proposal.) If the majority of the affected Commission Member States so indicate, the matter is referred to the full Commission for possible adoption as a recommended model uniform statute. Of course, all recommendations of the Commission are advisory to the States. For a recommendation to become effective in any State, that State must affirmatively adopt the proposal. Once a model uniform statute has been adopted by the Commission, the Income & Franchise Tax Uniformity Subcommittee anticipates it will begin development of regulations to complement and expand on the principles reflected in that final version.

APPENDIX HH

"State-Local Business Taxation and the Benefits Principle"
(by William H. Oakland and William A. Testa, undated)

State-local business taxation and the benefits principle

William H. Oakland
and William A. Testa

In recent years, interest in state and local taxation of business has been fueled by concerns over the possible deleterious effects such taxes may have on economic development and, in particular, on the ability of a jurisdiction to provide jobs for its residents. Much ink has been spilled over whether or not fiscal factors have a significant effect on firm location decisions. However, without analyzing why business taxes are on the books in the first place, it may be impossible to properly evaluate the impact of such taxes on business location. In this article, we advance the proposition that general business taxation should be structured so as to recover the costs of public services rendered to the business community.

Economic development may be but one objective of tax policy. Other objectives, such as fairness, economic efficiency, and sound expenditure policy, are also important. For example, a local community may want to structure its taxes to discourage business activities which produce noxious side effects; state government may wish to restrict business activity in such a way as to promote monopoly power of home enterprise(s) serving an out-of-state clientele. Even in the absence of such motives for growth controls, business taxation may be desirable to recover the cost of government services provided to businesses within a jurisdiction. Not only does this promote fairness, by recouping the costs of such services from those who ultimately benefit from them, it also enhances economic efficiency by causing the prices of goods and services to reflect their full costs of production. Such prices enable people to make appropriate choices among consumer goods. Business benefits taxes similarly promote appropriate choices between private and public goods. Without recovery of the costs of business services, voters may not support otherwise worthy public services provided to business. Alternatively, the voting public and their representatives may believe that business taxes can be ratcheted skyward as a way to subsidize those public services provided to households.

One objective of this article is to develop a comprehensive framework for evaluating the efficacy of state-local business tax structures. This framework will then be applied to existing practices within the U.S., with specific focus upon the Seventh Federal Reserve District, which encompasses Iowa and major portions of Illinois, Indiana, Michigan, and Wisconsin. We will argue that the primary basis for general business taxation is to recover the costs of government services rendered to the business community. It follows that if general business taxes exceed or fall short of the cost of

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providing government services to business, the business tax structure is not neutral with respect to the location of business activity in general. Furthermore, it will not be neutral with respect to consumption patterns for consumer goods and the composition of spending on private goods and public goods.

It should be emphasized that, even where there is correspondence between business taxation and business expenditures, there may remain non-neutral location incentives for specific firms. This will be the case if the business tax structure is not neutral across firm types or if there are wide disparities among firm types in terms of service benefits received from government. In effect, what is true on average may not be true for particular firms. These issues should be considered when designing the optimal business tax structure.

We begin by providing a framework under which businesses might be taxed to optimal effect. Following definition and measurement of current state-local business taxation, we discuss alternative business tax structures. Among these alternatives, the benefits principle is identified as the best by far. Turning to the specifics of how to implement the benefits principle, today's practices are held up against the theoretical standard that business tax revenues should roughly cover direct public service costs. In the final section, we suggest how state-local government might lower taxation of business by levying uniform tax rates on a broad-based measure of business activity—value added.

A framework for business taxation

Definitions

Business taxes are not easy to define. Many business taxes are shifted from the legal or statutory taxpayer to other entities. Tax-shifting mechanisms are frequently subtle and indirect; as a result, theories of tax incidence are sometimes controversial. Furthermore, because only individuals, in their capacities as consumers, workers, entrepreneurs, or suppliers of land and capital, can bear the burden of taxes, the incidence of particular taxes contributes little to a useful definition of business taxes.

Our approach is to define business taxes to include any levy upon a firm's purchase of inputs, its transfer or ownership of assets, its earnings, or its right to do business—in short, any levy which would, in the absence of price adjustments, reduce the firm's bottom line. Included in this definition are corporate profits taxes; real and personal property taxes on business assets; franchise taxes and business license fees; sales and use taxes and gross receipts taxes upon a firm's purchase of equipment, services, and materials; and those payroll taxes for which the firm is the statutory taxpayer.

By this definition, business taxes can be seen to produce a prodigious flow of revenue to state and local governments. Table 1 shows revenues for fiscal year 1992 by category of tax and in total for the U.S. Business taxes accounted for 28.9 percent of all state-local tax revenue, amounting to approximately $160 billion. Among the categories, property taxes were the most significant single item, accounting for 42.8 percent of business taxes. Corporate income taxes, general sales taxes, and payroll taxes (that is, unemployment insurance) each accounted for a sizable share.

TABLE 1

State & local business taxes in the United States, 1992

	Total	Percent of business	Percent of total state-local taxes
Property	$68,644	42.8	12.4
Sales	$23,151	14.4	4.2
Unemployment insurance	$15,489	9.6	2.8
Corporate income	$21,937	13.7	3.9
Insurance	$4,043	2.5	0.7
Utility	$7,397	4.6	1.3
Motor fuel	$9,165	5.7	1.6
Other[a]	$10,687	6.7	1.9
Total business taxes	**$160,514**	**100.0**	**28.9**
Total taxes	**$555,479**	--	--

[a]Other taxes include occupational and business license taxes and selective sales taxes.

Source: Staff calculations based on data reported by the U.S. Department of Commerce, Bureau of the Census, Goverments Division and individual state fiscal agencies.

Together, these four categories accounted for more than 79 percent of all business taxes.

Excluded from our definition, for the most part, are general and selective sales taxes on items purchased by consumers; it is expected that such taxes are shifted to the purchaser.[1] However, if the buyer is a business enterprise, the tax payment will have been captured by our definition above.

We also exclude personal income tax liabilities upon the profits of unincorporated enterprises. While one might expect that profits taxes would be treated independently of the legal form of organization, that is not the case. Corporate income tax is an added layer of business tax; dividends and capital gains of firms that pay corporate income tax are also subject to personal income tax. Personal income tax applies to the returns of all capital investments made by an individual, including those arising from business ownership. Thus, if the individual proprietor failed to engage in business within the state, the assets would have been invested in other pursuits and subject to personal income tax. The only persuasive case for including such taxes as business taxes relates to those proprietors with out-of-state residences. For such individuals, personal income taxes paid to the host state are costs of doing business, which must be compared with costs existing elsewhere. Fortunately, however, the vast majority of unincorporated enterprises are owned by residents.[2]

Rationale for general business taxes

The widespread use of business taxes today does not in itself imply that their level and structure are in accord with the principles of good taxation.[3] In this section, we discuss the rationale for business taxation. Our discussion will be confined to those taxes which are imposed upon business enterprises in general, or on a large subset of business firms, such as corporations. Taxes upon specific activities, such as mineral extraction or chemical production, are not considered. Presumably, the objective of such taxes is to correct for externalities, such as environmental damage, or to capture benefits of natural resources for the citizenry as a whole. The rationale for such taxes does not apply to the argument for general business taxation. There may be a good case for specific business taxes to control for environmental damage or to capture some of the rents associated with a state's unique resources, such as mineral wealth or favorable location. Such taxes should be considered as supplements to the general business taxes that we treat below.[4]

A number of possible motives for state-local taxation have been suggested or can be inferred from current practice. These include ability to pay, tax exporting, political expediency, and the benefits principle. Each was analyzed by Oakland (1992). Only the benefits principle was shown to survive scrutiny. Most other motives were seen to be unattainable or based upon flawed economic reasoning. Only the three most compelling types of rationale will be treated here. The first two may account for the widespread use of business taxation. The third is prescriptive—how business should be taxed.

Ease of raising revenue

Business taxation offers governments the opportunity to collect large sums of revenue from relatively few taxpayers. In addition, because the incidence of business taxes is often uncertain, it may encounter relatively little political opposition. Many taxpayers may perceive that such taxes are paid out of the "deep pockets" of rich corporations and/or absentee rich shareholders. Others may not hold that opinion, but would vigorously oppose attempts to raise their personal taxes; in effect, business taxation may appear to public officials to be the only course available.

While ease of collection is a valid criterion for tax policy, particularly in less-developed economies, advances in tax administration have enabled governments in advanced economies to collect personal taxes at acceptable compliance costs.[5] Hence, collection costs cannot serve as a principal criterion for the choice of tax structure. As far as reducing citizen opposition to higher personal taxes is concerned, this is more properly viewed as a serious disadvantage of business taxes. Good tax policy should confront citizen-taxpayers with the true costs of providing public services. If citizens consistently underestimate these costs, they will support too large a range and level of public services.[6] Viewed in this light, general business taxation has the potential to do serious economic damage and should, therefore, be discouraged.

To export the tax burden

A common rationale for business taxation is that it extends the reach of the taxing jurisdiction to residents of other jurisdictions. We offer as evidence the increasingly disproportionate weighting of sales in allocation formulas to determine the state share of the profits of multistate or multinational corporations when levying corporate income tax.[7] We find further evidence in the rapid spread of legalized gambling activity, apparently prompted by the desire to attract out-of-state gamblers.[8]

Whether it be through taxing the profits of out-of-state shareholders, taxing out-of-state consumers of goods produced locally, or taxing the income of out-of-state landholders, business taxation may be viewed as a means of transferring some of the costs of local government to residents of other jurisdictions. While this may be legitimate if the activity is limited to recovering costs of government services extended to such "foreigners," there is no reason to suppose that the practice would be so limited.[9] The prospect of a "free lunch" has irresistible political appeal.

However, like most free lunches, the benefit is more illusion than reality. The opportunities for successful tax exporting are quite limited, and those that exist can be more successfully exploited by finer instruments than general business taxes. For example, consider the disproportionate use of sales factor by consuming states. The resultant higher taxes increase the cost of selling in the taxing state; this prompts a price increase so that the firm can receive the same net revenue as from selling the item in some other market. In general, the ability to export taxes is restricted to situations where the state has some competitive advantage, owing to superior or unique natural resources. Here the state can successfully capture the "rent" of these resources through taxation. However, the appropriate tax is not one on all businesses but a selective tax on the resource itself (for example, a severance tax) or on a product that uses the resource (for example, a tax on hotels). Hence, the case for general business taxation cannot be based upon tax exportation.[10]

To recoup the costs of public services

Government provides the business community with a legal framework for conducting its affairs, through its civil court system. It also offers direct services to businesses and their employees, such as transportation and public safety. These services make it possible for the firm to produce more efficiently, allowing for lower prices and/or higher wages and profits. Business taxation allows those who benefit from these services, whether within or outside the jurisdiction, to contribute to their costs. It also has the salutary effect of lowering the taxes to citizen-taxpayers, enabling them to make a more accurate assessment of the true costs of public services rendered directly to them and to the business community.[11]

In such circumstances, business taxation promotes the benefits approach to taxation. Without business taxation, this approach would be difficult, if not impossible, to adopt. For example, if the beneficiaries of business services are out-of-state individuals or business entities, the home state simply has no means of taxing them directly. On the other hand, if the beneficiaries are home-state residents, the state would have to know how the services translated into lower goods prices or higher wages and profits—an insurmountable task. By taxing business directly for services received, such computations are unnecessary, and ultimate beneficiaries would be taxed in proportion to the costs incurred by the government sector.

The benefits principle has particular relevance for state and local tax structures. Its rival criterion, the ability-to-pay principle, is difficult to implement at these levels of government because of mobility limitations. For household service provision and taxation, the well-to-do tend to flee from jurisdictions with punitive tax burdens. Mobility becomes a more compelling issue for businesses and may play an important role in economic development. In contrast, business taxes which conform to the benefits principle will be neutral with respect to economic development. They place the jurisdiction at neither a competitive advantage nor disadvantage per se.[12]

Can the benefits principle be implemented?

The merits of the benefits approach to business taxation have been noted in the tax literature. However, many analysts have questioned whether it can be implemented (ACIR 1978). These analysts argue that because most government services are provided to businesses free of charge, there is no objective measure of use by different business entities; ergo, the benefits principle cannot be implemented.

The major premise that business utilization rates of government services cannot be finely measured must go unchallenged. However, it does not follow that relative business utilization rates cannot be approximated. It surely is the case that within a broad industry grouping, for example, the finance, insurance, and real estate industry or manufacturing, larger firms utilize more services than smaller firms. Even among disparate industry groups, it is also likely that government services arising from employment are more heavily used by large employers than small ones. So business size is a likely important correlate of business service costs.

Using size as the sole measure of relative service benefits would undoubtedly be subject to error. However, the degree of error in relative treatment would be far less than that of a policy which charged business nothing for government services. A tax based upon size would eliminate the relative subsidy to large firms. Moreover, the failure to charge business taxes would distort the price facing citizens for their public consumption goods. To get this price right, business taxes in the aggregate should equal the cost of providing business services. Therefore, we believe there is merit in business benefits taxation on the average. While there will remain errors and distortions in the resulting pattern of business taxation, these errors will be smaller than if no tax at all were imposed. In the absence of any other sound basis for business taxation, it follows that the imposition of size-related business taxes is the appropriate policy prescription.

The case for business taxation

On the plus side, business taxes can be used to promote the principle of benefits taxation, which places the burden of taxation on those who enjoy the ultimate benefits of certain public services, and at the same time neither penalizes nor subsidizes economic development. On the negative side, because it may not be perceived as a cost to the citizen-taxpayer, business taxation may be pushed to excessive levels, encouraging wasteful expansion of publicly provided consumption services and leading to a diminution of job opportunities within a jurisdiction. Given that political expediency may prevail over economic efficiency, one might expect general business taxation to be carried to levels beyond that suggested by the benefits approach. In the empirical work to follow, this hypothesis will be examined in the Seventh District and in other regions. In addition, we measure how state-local governments might maintain the current level of business tax collections by levying taxes as a uniform percentage of value added.

Business taxes and business expenditures

Taxes

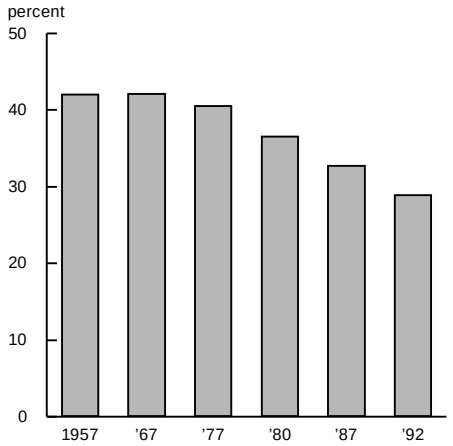
Businesses are taxed by both local and state governments. While authority for particular tax bases varies from state to state, generally speaking local governments rely primarily on the property tax for funding, while state governments generally collect sales taxes and corporate income taxes, as well as the bulk of tax revenues on insurance premiums, motor fuel sales, and the gross receipts of public utilities. In the Seventh District states, corporate income taxes, unemployment compensation, and insurance premiums are major business taxes which are exclusively collected for state government operations; taxes on general sales, public utility gross receipts, and motor fuel are levied at the state level and, to a lesser degree, at the local level. The property tax has been, in recent decades, almost exclusively a local tax source.

Drawing from data collected by the Bureau of the Census and from state fiscal authorities, business tax revenues at both the state and local levels can be distinguished from tax revenues from the household sector. Corporate income tax revenues and business license taxes can be wholly allocated to the business sector. In all other instances, the business and household sectors are taxed under the same statutes. For example, state sales taxes are imposed on the final retail purchases of households and on certain intermediate purchases made by businesses. Accordingly, revenues must be parceled between the household sector and the business sector for major revenue sources, which include the general sales tax, public utility gross receipts, insurance premiums, motor fuel, and property tax.

According to studies of business taxes for states and regions of the United States, business taxes declined from 42 percent of total state-local tax collection in 1957 to 29 percent in 1992 (ACIR 1967, 1981; Tannenwald 1993) (figure 1). The declining share of taxes attributed to business largely reflects the rising

FIGURE 1

Business' share of taxes in the U.S.



Source: ACIR (1981), appendix.

dominance of personal income taxation by states over the past 25 years, rather than any marked slowing in the pace of business tax collections. The rise in personal income taxation corresponds to the growing share of public services provided to households by state-local government—especially health and education.

Variation in the dependence on business taxes (as most commonly defined) in 1992 among regions, as defined by the U.S. Bureau of Economic Analysis, lies within a fairly narrow band. When we update this methodology, originally developed by the U.S. Advisory Commission on Intergovernmental Relations (ACIR), for the 1992 fiscal year, we find that in the Great Lakes region (that is, Illinois, Indiana, Michigan, Ohio, and Wisconsin), business taxes comprise 29.0 percent of state-local taxes, compared with 30.7 percent in the U.S. The Southwest leads with 41.3 percent, because of its heavy use of state severance taxes on energy minerals. All other regions lie within 3 percentage points of the national average (figure 2).[13]

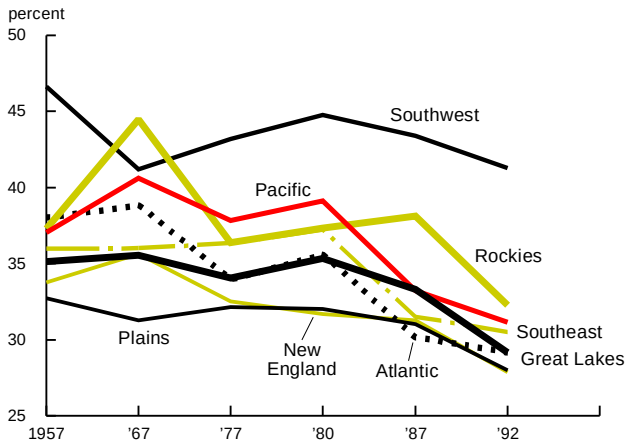
In measuring business taxes for the states of the Seventh District, we differ from much of the literature in both definition and methodology. We exclude from our business tax definition selective excise taxes, such as severance or lodging taxes, because they are often targeted to a specific industry, indicating to us that the intent of the tax is other than to cover the government expense of providing business services. Perhaps these selective taxes are intended to compensate for environmental damage or to expropriate the income on assets of out-of-state owners.

Some taxes that we do include may appear to be selective, such as insurance premiums, public utility gross receipts, and motor fuel tax. We include these because they are applied to a wide spectrum of each state's business sector and can, therefore, be considered a tax on intermediate inputs to business production. For these revenue sources, some care must be taken to apportion tax revenues accurately to the business sector rather than to the government and household sectors. So too, following DeBoer (1992) and Oakland (1992), data provided by state fiscal agencies can often be grouped more finely than nationally reported data for important hybrid taxes such as the property tax. Data collected nationally by federal agencies must understandably compromise some detail in exchange for a broad reporting of data.[14] (See appendix for methodology.)

In reviewing our business tax measurements, property tax collections dominate business tax collections in states of the District (figure 3).[15] An estimated 47 percent of 1992 business tax collections were derived from this revenue source. Corporate income (17.2 percent), unemployment compensation

FIGURE 2

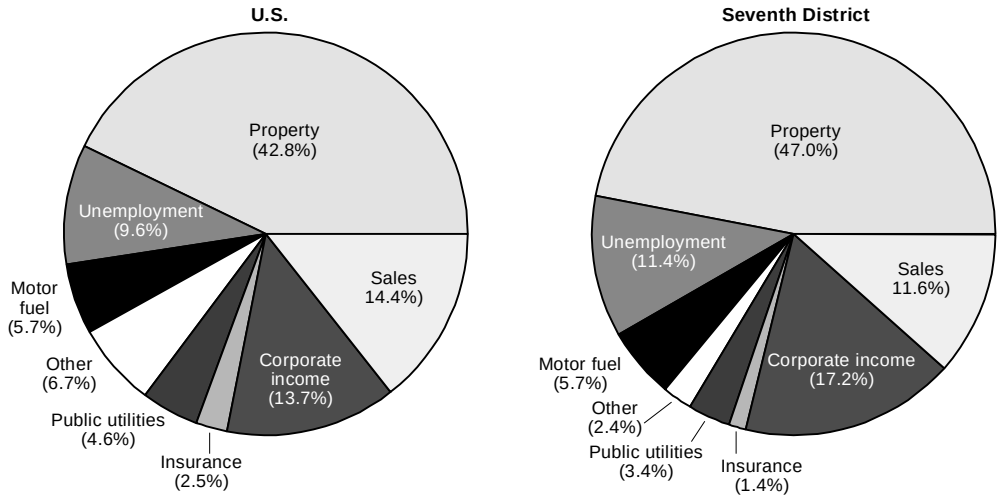
Business taxes paid, by BEA region



Source: ACIR (1981), appendix.

FIGURE 3

Distribution of business taxes, 1992



Source: Staff calculations based on data provided by state fiscal agencies and U.S. Department of Commerce, Bureau of the Census, Governments Division.

(11.4 percent), and the state sales tax portion collected on intermediate purchases by the business sector (11.6 percent) also represent major business taxes.

While we have chosen to define business taxes by their broad-based application to the business sector, there is at least one noteworthy imbalance in the business tax structure which suggests a lack of evenness and neutrality across types of businesses. Specifically, a heavy share of state-local business taxes in the Seventh District and in the nation is initially imposed on business capital by way of property tax and state corporate income tax. Such a system may skew any burden of taxation toward goods-producing industries and away from the service-producing industries which tend to employ more labor than capital. Heavy state taxation of public utility inputs and sales taxation of tangible inputs to production would only tend to aggravate such an imbalance.

We and others have long noted other imbalances in the structure of state-local business tax systems (ACIR 1978; Stocker 1972). The taxation of profits (within corporate net income tax) would seem to penalize exactly those (profitable) firms that may have desirable prospects for rapid growth and development.[16] Another imbalance may involve the unemployment insurance system, which frequently taxes new firms (having no employment history) at a very high rate. Many such firms tend to be labor intensive, small, and innovative.

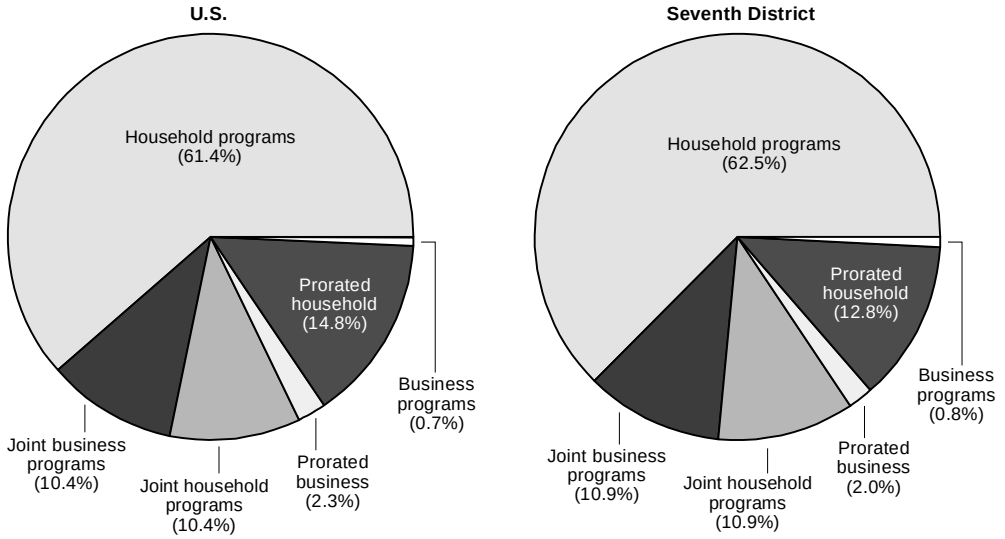
Expenditures

Expenditures by function for state-local governments are reported annually by the Governments Division of the Bureau of the Census, U.S. Department of Commerce. Total direct expenditures by function include all payments to employees, suppliers, contractors, beneficiaries, and all other final recipients of government payments. Intergovernmental expenditures—payments and grants between state and local governments—are excluded. Such expenditures become expenditures of those governments where the funds come to rest. Since we are interested only in those expenditures made by state-local government, federal grant monies by function are netted out of these same functional expenditures. Similarly, revenues derived from user charges and fees (such as college tuition and roadway tolls) are netted out of appropriate expenditures made by state-local government. The remainder represents those direct expenditures by function that are funded by state-local own-source tax revenues.

In allocating state-local spending to the Seventh District's business sector, we classify expenditure programs into business, household, prorated, and joint (shared). "Business" programs are identified as dedicated solely to

FIGURE 4

Distribution of state and local expenditures, 1992



Source: Staff calculations based on data provided by state fiscal agencies and U.S. Department of Commerce, Bureau of the Census, Governments Division.

business, for example, agricultural programs and water transportation terminals. These are estimated at less than 1 percent of total state-local direct expenditures in 1992 for the Seventh District states as a whole (see figure 4). In contrast, "household" expenditures comprise 62.5 percent overall, and are assumed to benefit households only, for example, education, welfare, health, parks and recreation, and housing.

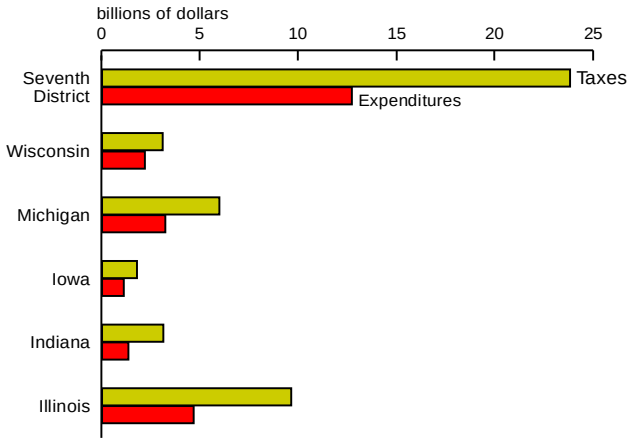
"Prorated" programs include "overhead" functions, such as general public buildings, legislative and financial administration. These expenditures are allocated to the business sector proportionately, based on the share of business expenditures to the total of business plus household expenditures. For the Seventh District, we find that prorated business expenditures account for 2.0 percent, in comparison to the 12.8 percent share commanded by the household sector.

Finally, "joint" or shared expenditures are perhaps the most difficult to allocate between the business and the household sectors, because of the broad categories into which state-local expenditure data are classified. We choose to liberally allocate shared expenditures to the business sector. Accordingly, these programs, which include police and fire, corrections, and transportation, are assumed to be shared equally between the business and household sectors, so that each sector commands 10.9 percent of state-local direct expenditure. All told, public spending that can be classified as an intermediate input to business production amounts to 13.8 percent of the total.

The large remaining share of state-local spending attributable to the household sector may seem disproportionate to some observers. While state-local government does provide essential business services, such as transportation infrastructure and protection of business property, its role has increasingly come to focus on welfare and education. From 1950 to 1992, the share of state-local government's direct general expenditure on education and social welfare (including health and hospitals) climbed from 44.4 percent to 58.9 percent. (Other services such as police, fire, transportation, and general administration are shared by the household sector.) While the business sector arguably benefits indirectly from such services, the direct benefits mainly accrue to households. To the extent that these services raise labor productivity, businesses will pay for higher productivity through wages paid to the household sector. More to the point, our intention here is to measure those expenditures and taxes directly accruing to business and directly paid by business. To the extent that general business expenditures are in alignment with

FIGURE 5

State and local business taxes versus public expenditures, Seventh District, 1992



Source: Staff calculations based on data previously cited (see appendix).

general taxes paid by business, it can be argued that the price signals between the voting public and its government sector are not distorted, so that the correct degree of both business services and household services will be chosen by public decisionmakers.

Even with somewhat generous assumptions about the direct benefits of shared expenditure programs, figure 5 suggests that in the Seventh District states overall and in each state individually business taxes exceed business expenditures by healthy proportions. In fiscal year 1992, business taxes in the District states overall exceeded expenditures almost twofold. This indicates that, taking the benefits principle approach, discussions of tax reform should be directed toward bringing business taxation and business expenditures into closer alignment.

Given the approximate nature of our calculations, especially in classifying expenditures on public services to businesses versus households, individual states have no reason to be alarmed about competitive harm vis à vis neighboring district states due to excess taxation. Expenditure classifications as reported by the Census Bureau are necessarily broad. Rather, the finding that general business tax collections tend to exceed expenditures suggests the need for further study, using individual state and local fiscal reporting systems that more finely distinguish business from household service expenditures.

Based on the 1992 data, states in every Census region appear to have taxed business in excess of direct business service expenditures (table 2). For fiscal 1992, state-local general business taxes in the U.S. exceeded expenditures by 70 percent, on average. Nonetheless, across the nine Census regions, the aggregate ratio of taxes to expenditures lies with a fairly tight band, ranging from 1.45 in the South Atlantic region to a high of 2.08 for the West South Central states. The Seventh District average of 1.87 is close to the national average.

Tax structure: Which business taxes to employ?

It is important to think about the combined effects of all general business taxes employed. It may well be that any particular tax is too narrow in application but that, in combination with some other tax, it provides a suitably

TABLE 2

State and local business taxes and expenditures, 1992

Region	Business expenditures	Taxes	Ratio of taxes to expenditures
	(---millions of dollars---)		
U.S.	$94,136	$160,514	1.71
New England	5,076	$9,022	1.78
Mid-Atlantic	16,762	29,899	1.78
East North Central	15,077	27,781	1.84
West North Central	6,228	$9,843	1.58
South Atlantic	15,735	22,837	1.45
East South Central	4,290	6,768	1.58
West South Central	8,589	17,909	2.08
Mountain	5,471	8,169	1.49
Pacific	16,906	28,285	1.67
Seventh District	12,760	23,816	1.87

Source: Staff calculations based on data reported by the U.S. Department of Commerce, Bureau of the Census, Governments Division and individual state fiscal agencies.

broad basis of business taxation. It is also clear from the above discussion, that any acceptable system must meet the test of comprehensiveness. The business tax system should reach all segments of the business community. This would rule out taxes such as the state corporation income tax, because there is no countervailing tax that would apply exclusively or mainly to unincorporated private sector enterprises or to nonprofit business enterprises, which do not earn taxable income.

Given that business benefits taxes should be size-related, what measures of size can be used? Here are two possibilities: (1) amounts of specific inputs; (2) amounts of output. It is possible to assess tax liabilities in accordance with labor inputs, capital inputs, or material inputs. The latter is unacceptable, given the widespread use of materials produced outside the jurisdiction. While labor or capital taxes would apply to all business entities, to focus on one or the other would induce the firm to move away from the taxed input to the non-taxed. It also would tend to favor or punish firms with differing degrees of capital intensity. In general, there is no reason to believe that capital-intensive firms consume more public services than labor-intensive firms. For some services, say fire protection, capital may be a preferred indicator. While for others, such as police protection, employment measures may be preferable.

Since neither measure is a superior benefit indicator, avoidance of substitution distortions and inequities is enhanced by a system which utilizes both measures. This raises the question of weights. One attractive weighting scheme would utilize input earnings; this is tantamount to an origin-based value-added tax. The outcome could be approximated by a combination of property taxes and payroll taxes. The quality of the approximation would, of course, depend upon the relative use of the two taxes.

The use of outputs as measures of business services leads to similar conclusions. Basically, there are two possible measures: gross receipts and value added. Gross receipts are an unacceptable measure for the same reason that materials are an unacceptable indicator of input—they include a major component of materials produced outside the district. Gross receipts taxation would also tend to be pyramided to the extent that materials flow from one producer to another within a jurisdiction. Hence, we are left with value added as our output indicator of firm size. Since value added also serves as an adequate measure of input use, it would seem to be the best candidate for allocating the cost of business services.

The administrative costs of levying business taxes according to value added by origin are not formidable for most industries. Michigan has been imposing a form of value-added tax since 1975.[17] Value added can be derived for each firm by summing its payments for factors of production, including payroll, interest paid, capital consumption, rents, and profits. Alternatively, value added can be derived by subtracting firm purchases of intermediate components and services from gross receipts. Either way, the tax base would reflect the degree of productive activities within the state, it would be largely neutral with respect to capital/labor proportions, and it would be neutral with respect to industry and legal form of business organization.

The viability of subnational value-added taxation is best illustrated by the relative ease with which a rough approximation of the state tax rates needed to raise revenue can be presented.[18] The Bureau of Economic Analysis (BEA) publishes annual estimates (by industry) of value added.[19] Taking our estimates of FY1992 business tax collections as a numerator, and BEA value added for the nongovernment sector as a denominator, we produce the uniform *ad valorem* tax rates necessary to raise equivalent business tax revenues in District states (table 3). These figures show that a business tax rate running between 1.5 percent and 2.5 percent of value added would generate the revenue equivalent of all state-local business taxes, based on data for 1992.

These rates are low compared with the statutory rates now on the books for taxing corporate income, gross receipts, sales on intermediate inputs, and the like. These low rates reflect the much broader basis of taxation implied by using value added as a tax base. Using value added would go a long away toward avoiding the skewness of the present system of state-local business taxation which tends to assess many service firms lightly (even though the service sector has become a much larger share of nominal output).

We would expect these low rates to mitigate state-local concerns over competitive fiscal disadvantages arising for certain capital-intensive industrial sectors. Remaining rate

TABLE 3

Taxes as a percentage of nongovernment gross state product

Region	Current business taxes	Hypothetical business taxes
U.S.	**3.1%**	**1.8%**
New England	2.9	1.6
Mid-Atlantic	3.4	1.9
East North Central	3.2	1.7
West North Central	2.8	1.8
South Atlantic	2.7	1.9
East South Central	2.5	1.6
West South Central	3.3	1.6
Mountain	3.1	2.1
Pacific	3.1	1.9
Seventh District	**3.4**	**1.8**
Illinois	3.6	1.8
Indiana	2.9	1.3
Iowa	3.5	2.2
Michigan	3.3	1.8
Wisconsin	3.2	2.3

Note: Gross state product (GSP) is net of government GSP.
Source: Staff calculations based on data provided by the U.S. Department of Commerce, Bureau of the Census, Governments Division and state fiscal agencies.

differences would become smaller as the tax burden is spread over more industries. The tax rates would need to be cut in half if the state-local sector were to bring business expenditures into line with public expenditures directly benefiting the business sector. More importantly, remaining tax rate differences would come to reflect differing public service needs among states as reflected by industry mix. Remaining tax rate differences might also reflect different regional approaches to development policy as some states and local communities, perhaps acting in partnership with their business communities, choose to offer differing levels, mix, and delivery of public inputs to private production.

Conclusion

It should be acknowledged that our approach to business location neutrality departs sharply from the rate-of-return approach in recent studies of state business tax climates.[20] These studies examine how the financial returns on investment are influenced by state and local tax structures. As such, they inherently deny the value of government services that may accrue to businesses at different sites. Also, they focus almost exclusively on taxes on business capital and profits taxes, overlooking important differentials in taxes paid by business firms on their intermediate purchases and on their payroll.

By incorporating all taxes directly affecting business and taking into account the costs of government services offered to the business community, our approach offers a more comprehensive measure of the business tax climate. It also enables us to detect important disparities in the business tax base. While it is true that other properties of a state's fiscal system, such as personal taxes and expenditure on education, may influence business profitability, without a complex general equilibrium model, such effects are difficult to quantify. The absence of such a complete model also rules out the accurate assessment of the marginal fiscal climate. Given these limitations, the best we can do is compare the average fiscal climate of competing states.

Because of their relative simplicity and transparency, our measures offer a useful alternative to complex cost-of-capital models for tax analysts in state capitols, whose job it is to enlighten legislators on the possible consequences of alternative business tax policies. With regard to competitive tax climates in particular, firms may prefer regions that offer a level and mix of business services for which the business community pays a proportionate price and where household expenditures are not subsidized by general business taxes. Taxing business in line with business services can also help the voting public choose the best levels and mix of publicly provided goods and services. Voters and their elected representatives will be able to perceive the accurate price signals for these goods. A dynamic dialogue between the business community and government services providers can develop which can, in turn, stimulate income creation or quality of life improvements in those regions that choose to follow the benefits principle.

APPENDIX

Methodology for business taxes and expenditures

Taxes

Unemployment insurance tax—Taxes are imposed by both the federal and state governments on the basis of payroll of those workers covered by unemployment insurance. We report state collections only, as reported by the Governments Division, Bureau of the Census, U.S Department of Commerce.

General sales tax collected from business—The hybrid nature of the sales tax as consumer-business tax presents formidable obstacles in distinguishing the business sector's share of revenues from that of consumers. State revenue departments typically report data by type of store or vendor from which the sale takes place, with no information about the buyer. The existence and variety of exemptions and partial exemptions for business purchases further complicates the matter, as does the varying exemption and coverage of certain consumer items, such as food, clothing, and prescription drugs.[1]

One estimation method has been to survey vendors within a state as to their thoughts on who purchases their taxable sales (Fryman 1969; ACIR 1981). Another method applies sales tax rates to government-reported data of consumer expenditures; the residual represents an estimate of business and tourist payments of the sales tax (Ring 1989; Blume 1983). Other studies use interindustry relationships, perhaps as reported in input-output models, to estimate the volume of business purchases subject to states sales taxation (DeBoer 1992; KPMG Policy Economics Group 1993), while other estimates are derived from reported collections by type of vendor (DeBoer 1992; Oakland 1992).

Our estimates take a decidedly conservative approach, based on the Fryman and ACIR estimates. We adjust and update those earlier estimates by examining changes in tax-base coverage that have occurred over time. For these changes, the business share of the sales tax intake is adjusted by regression elasticities, which capture the sensitivity of sales tax revenues to specific tax exemptions, such as that on industrial machinery and equipment in Illinois during the 1980s.

Estimates of the business sector's share of state sales tax revenue collections are applied to Census Bureau figures of general sales tax collections at the state-local level for fiscal 1991–92 to arrive at estimates of sales tax paid by businesses. By our estimates, the sales tax comprised 14.4 percent of state-local business taxes in the U.S. in fiscal year 1992. The corresponding share in the Seventh District lies close to this estimate at 11.6 percent, with Indiana's 20.2 percent share being the highest among District states. Michigan's relatively low 7.8 percent share for 1992 has increased since that year; Michigan raised its state sales tax from 4 percent to 6 percent in 1994.

Corporate income tax—These collection figures are reported by the Census Bureau for fiscal 1991–92 and, within the Seventh District, all collections derive from state taxes. Michigan imposes its single business tax on the business activity or value added of businesses operating within the state, rather than on corporate net income. Indiana is one of only three states in the nation that taxes gross receipts of corporations rather than net income. The Indiana tax is levied on the greater of tax due from gross receipts or an alternative tax on corporate net income. In some 22 states, taxes are also levied on capital stock or net worth, and then sometimes under a corporate franchise tax. Illinois imposes corporate levies on capital stock or net worth, which may be termed corporate franchise taxes.

Property tax—Beginning with a 1963 study, the U.S. Advisory Commission on Intergovernmental Relations began estimating property taxes paid by commercial, industrial, and agricultural enterprises. These estimates are based on tables of assessment and collection values reported at five-year intervals by the *Census of Governments*. We depart from that practice and instead use property tax collections as reported by individual state fiscal agencies for business classes of property in the Seventh District. For Michigan only, such collections by class must be estimated.

Taxation of real property is predominantly imposed by local governments rather than by state governments. Because tax rates are usually applied in an even fashion to classes of property, and because business property comprises a substantial portion of real estate, a sizable share of the local property tax falls on business property.[2] The gross assessed value of commercial, industrial, and acreage combine to account for one-third of all value (commercial and industrial combined account for one-fourth).[3]

The practice of taxing personal property (non-realty tangible property) of business firms can also be a great concern for those firms making heavy use of industrial machinery and equipment, and firms that own significant stocks of tangible inventory. Over time, most states have moved toward exempting tangible personal property of both firms and households, as Illinois did across the board in 1979.[4] Most district states liberally exempt business personal property or are moving in that direction.

Business licenses and fees—We follow the ACIR practice of including fees and taxes imposed on the right to do business, at the state or local level. These data are collected and grouped by the Governments Division of the Bureau of the Census.

Taxes on broad-based inputs to production—We exclude selective taxes such as those levied on tobacco, alcohol, and amusement. Presumably, these are intended to be shifted forward to consumers, or their taxation is intended to discourage the activity rather than to act as a broad-based payment for government services rendered. Likewise, taxes on specific industries, such as motel/hotel or severance taxes, are not broad-based business taxes but are intended to discourage or compensate for damages imposed on the state or local community. In contrast, we *do* include the following selective sales taxation of items which are broadly purchased as intermediate inputs by the business community:

Insurance—Most states tax the premiums on insurance sold in the state. Since businesses broadly purchase insurance, we estimate the business sector's share of such purchases in allocating total insurance premium tax collections. The sector's share is calculated for reported premiums sold by in-state companies to other businesses in each of the respective states. Such estimates are provided courtesy of the Regional Economics Applications Laboratory, which is a joint venture between the Federal Reserve Bank of Chicago and the University of Illinois at Urbana-Champaign. We average the latter estimates with groupings of insurance premiums sold by type for each state, making reasonable assumptions concerning likely types of insurance purchased by the business sector versus the household sector. In contrast, ACIR estimates typically include total insurance premiums, including those sold to households.

Motor fuels taxes—Following DeBoer (1992), we estimate motor fuel purchases by the business sector as opposed to households in allocating revenues collected. These data are collected and grouped by the Governments Division of the Bureau of the Census.

Public utility gross receipts taxes—The business portion of revenues is allocated using data on investor-owned public utilities. The *Statistical Yearbook of the Electric Utility Industry* reports gross receipts derived by sector, household versus commercial and industrial sector. These data are collected and grouped by the Governments Division of the Bureau of the Census.

Expenditures

Expenditures by function are reported annually by the Governments Division of the Bureau of the Census, U.S. Department of Commerce. Total direct expenditures by function include all payments to employees, suppliers, contractors, beneficiaries, and all other final recipients of government payments. Intergovernmental expenditures—payments and grants to other governments between state and local—are excluded. Such expenditures become expenditures of those governments where the funds come to rest. Since we are interested only in those expenditures made by state-local government, federal grant monies by function are netted out of these same functional expenditures. Similarly, revenues derived from user charges and fees (such as college tuition and roadway tolls) are netted out of appropriate expenditures made by state-local government. The remainder represents those direct expenditures by function that are funded by state-local own-source tax revenues.

Two categories of expenditures must be allocated. "Shared" expenditures are those for which little information on benefits to business versus households are available, for example, police, fire, transit, sewerage, sanitation, and parking. For these, a liberal 50 percent is allocated to the business sector.

Those expenditures representing general government overhead, such as all financial administration services, all general public buildings, all other miscellaneous government, interest on general debt, all legislative, and other-unallocable, are assigned to the business sector on a prorated basis. The proration reflects the share of business expenditures, plus shared business expenditures to total direct expenditures (net of prorated expenditures).

Other categories of spending are allocated directly to the business or to the household sector.

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[1]For state-by-state coverage of consumer items in the sales tax base, see ACIR (1994).

[2]The practices under which tax rates and/or property assessment ratios vary by type of property is called classification. Only a handful of states authorize classification. Among the five district states, classification is authorized only for Cook County, Illinois. There, commercial and industrial property is assessed at a rate more than double that for single-family residential properties.

Of course, there are many selective tax abatements that can be applied (usually on commercial properties) at the discretion of local governments (which may be acting on economic development concerns). So too, state property tax systems often contain "circuit breakers" and "exemptions," which exclude assessed value or offer tax reductions to classes of residential taxpayers, such as the elderly, the poor, or veterans. See ACIR, ibid.

[3]See table 4, U.S. Department of Commerce, Bureau of the Census (1987).

[4]U.S. Department of Commerce, Bureau of the Census (1988) reports in table 2 (p. 4) that personal property comprises 10.3 percent of locally assessed property (not all of which is business property). State-assessed property also includes personal property in some states, especially that belonging to public utilities. However, in total, state-assessed property (real and personal) comprised only 5 percent of overall state-local gross assessed value in 1987.

APPENDIX TABLE A

Seventh District share of state-local expenditures allocated to businesses and households, FY1992
(millions of dollars)

Spending category	Households	Prorated household	Shared household	Business	Prorated business	Shared business	Total
Education	$35,968						**$35,968**
Libraries	753						**753**
Welfare	8,706						**8,706**
Health	4,011						**4,011**
Hospital	803						**803**
Veteran services	17						**17**
Natural resources (fish + forestry)	155						**155**
Parks and recreation	1,729						**1,729**
Housing and community development	1,120						**1,120**
Unemployment insurance	4,467						**4,467**
Water transport				7			**7**
Natural resources - agriculture				341			**341**
Natural resources - n.e.c.				434			**434**
Financial administration		1,775			285		**2,060**
General public buildings		645			103		**749**
General interest on debt		4,988			799		**5,787**
Other government administration (L+CS)		1,313			210		**1,523**
All other and unallocable		3,072			492		**3,564**
Air transportation			26			26	**52**
Transportation subsidies			9			9	**19**
Highways			3,619			3,619	**7,238**
Parking			56			56	**113**
Fire protection			891			891	**1,782**
Police			2,185			2,185	**4,370**
Corrections			1,553			1,553	**3,106**
Judicial			859			859	**1,717**
Protective inspection and regulation			276			276	**553**
Sewage			626			626	**1,252**
Solid waste management			542			542	**1,084**
Miscellaneous federal grants			(555)			(555)	**(1,111)**
Total	**57,729**	**11,794**	**10,087**	**782**	**1,890**	**10,088**	**92,370**
Share of total	**62.5%**	**12.8%**	**10.9%**	**0.8%**	**2.0%**	**10.9%**	**100.0%**

Total household share 86.2% **Total business share 13.8%**

Note: Columns may not add up due to rounding.
Source: Staff calculations based on data from U.S. Department of Commerce, Bureau of the Census, Governments Division.

APPENDIX TABLE B

Business taxes: A comparison of measurements, FY1992

ACIR method	Total	Property	Sales	Corporate income	Insurance	Utility	Unemployment	Motor fuel
	(----------millions of dollars----------							)
Illinois	7,945	3,285	1,135	970	198	1,171	922	0
Indiana	3,200	1,461	642	755	123	0	180	0
Iowa	1,382	6374	204	193	97	6	150	0
Michigan	6,934	3,111	550	1,730	178	44	1,113	0
Wisconsin	2,478	939	241	438	69	254	359	0
Seventh District	21,939	9,433	2,772	4,086	665	1,475	2,724	0

Oakland/ Testa	Total	Property	Sales	Corporate income	Insurance	Utility	Unemployment	Motor fuel
	(----------millions of dollars----------							)
Illinois	9,670	5,284	1,135	970	83	649	922	480
Indiana	3,191	1,305	642	755	64	0	180	217
Iowa	1,819	1,003	204	193	50	3	150	133
Michigan	5,994	2,063	550	1,730	92	23	1,113	298
Wisconsin	3,142	1,532	241	438	36	131	359	228
Seventh District	23,816	11,187	2,772	4,086	324	806	2,724	1,355

Note: Figures may not add up due to tax categories omitted from this table.
Source: Staff calculations based on data from U.S. Department of Commerce, Bureau of the Census, Governments Division.

NOTES

[1]If the tax cannot be shifted forward, then this procedure is flawed. For example, if a state levies a sales tax on petroleum products refined in a particular state, and the price of refined products are determined in world markets, the tax would have to be added to the firm's cost of doing business within that state. Fortunately, such situations are not commonly the case.

[2]For small states, however, this point is more telling. Business owners in the New York metropolitan statistical area may have the option of relocating their businesses in several states, making the issue of personal income taxes a relevant factor in the location decision. However, this is mitigated by the common practice of crediting taxes paid by host states.

[3]These issues are dealt with at greater length in Oakland (1992).

[4]Indeed, the motor vehicle fuels tax could be treated under either rubric. It could be viewed as a user charge for the wear and tear and highway congestion associated with business transportation. However, fuel consumed is not a good measure of general environmental costs, such as congestion and other nonpriced costs. Accordingly, we choose to treat motor fuels tax revenues as part of general business taxation.

[5]In many instances the administrative cost advantages are exaggerated because they include costs shifted from government to the taxpayer.

[6]A substantial body of empirical studies provide evidence that voters respond to the perceived cost (that is, "tax price") in making public expenditure decisions (see Rubinfeld 1985).

[7]Typically a three-factor formula is employed for such purposes: payroll, capital investment, and sales. States with few production facilities often put heavy, sometimes exclusive, weight on the sales factor to capture a larger share of the profits of multistate corporations. Multistate corporations in Iowa can use sales by destination as the sole factor in apportioning taxable income.

[8]Now, the main objective may be to stem the outflow of gambling money to other jurisdictions or, in effect, to reduce tax importing.

[9]One might think that if all states adopt the practice, there will be no such "other" market; hence the firm will have to absorb the tax. However, from the taxing state's vantage point, the policies of other states are irrelevant. In the case under discussion, local residents would enjoy lower prices than consumers elsewhere if the tax were not imposed.

[10]If the superior resource provided competitive advantages to all production activities within the jurisdiction, a general tax might be in order. This might be true for certain local governments—for example, cities with outstanding harbors. However, even here the ubiquitousness of the advantage is questionable.

[11]While the business community can exert political influence, only individuals can vote. Therefore, support for desirable business services requires that voters not perceive a fiscal loss.

[12]Of course, if other jurisdictions do not implement the benefit principle, this neutrality would be vitiated.

[13]For details see Greco, Oakland, and Testa (forthcoming).

[14]Our finer measurements are carried out, not for each region, but only for the states in the Seventh District.

[15]The state of Michigan has since reduced its reliance on property taxes and hiked its reliance on general sales taxes for funding elementary and secondary education in the state. However, we do not believe that overall reliance on taxes imposed on the business sector has changed; property tax reductions, if any, have probably been offset by increased business tax payments made under the state's now-higher sales tax rate. See Courant, Gramlich, and Loeb (1995). A reduction in property taxes in Wisconsin is also imminent, but the sources of revenue compensation have not yet been decided.

[16]States may be implicitly changing the nature of their corporate taxes away from "profits or capital" taxes and toward a type of sales or import tax. Specifically, states have been changing the formulas by which they allocate the tax base of multistate companies. By "double-weighting" the allocation factor which counts the proportion of the firm's sales that are in-state, the corporate income tax implicitly taxes the sales of out-of-state firms that are being sold in the home state. That is, the tax liability correlates, not with firm profits, but with sales of imports into the home state. To the extent that the firm sells to a national market, such a tax would tend to raise the price of the goods sold in the home state.

[17]The single business tax (SBT) is levied on a tax base of value added for firms in the state, calculated by adding factor payments including interest paid, business income, depreciation, and labor compensation. The tax base deviates from value added by origin in that multistate firms are allowed to apportion business activity according to a formula that gives 50 percent weight of the taxable base to the firm's Michigan share of sales to total sales nationwide, and 25 percent weight each to the Michigan location of firm property and payroll. Other reductions or credits involve small firms, low-profit small firms, and all firms characterized by labor compensation bills which exceed 63 percent of the tax base. See Citizen's Research Council of Michigan (1995). The state previously imposed another form of the tax, the business activities tax, from 1953 to 1967.

[18]Value-added taxes are used by many countries, and a lively debate is now under way in the U.S. over whether to impose the tax at the national level. Such a tax would likely differ in intent and structure from that envisioned herein for state governments. A national tax in the U.S. is often envisioned as a "consumption-type" value-added tax, a national sales tax which would be imposed on consumption and might be designed to replace some existing revenue sources to encourage national savings behavior. In contrast, the tax base for state value-added taxation could include capital consumption, thereby relating more closely to business benefits received as reflected in total business activity in a state.

In many other countries, value-added taxes were enacted to eliminate significant imbalances in "turnover" type taxes, which tended to tax the gross receipts of firms at each stage of production.

[19]These value-added data by industry sector are derived by both the addition method and the substraction method. See U.S. Department of Commerce, Bureau of Economic Analysis (1985). Gross state product is equivalent in concept to national gross domestic product (which included capital consumption and indirect taxes in its definition).

[20]Such studies often follow the "rate-of-return" approach developed by James Papke. For example, see Tannenwald (1993).

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APPENDIX II

"Alternative State Business Tax Systems:
A Comparison of State Income and Gross Receipts Taxes"
(by Laura Wheeler and Edward Sennoga, dated August 20, 2007)

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ABSTRACT: Laura Wheeler and Edward Sennoga of the Andrew Young School of Policy Studies at Georgia State University compare gross receipts taxes with corporate income taxes; they say the gross receipts tax is not necessarily an improvement.

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* * * * *

I. Introduction

Nationally, there has been increased attention at the state level in a gross receipts tax as a replacement for the standard state corporate income tax./1/ Washington state has imposed a gross receipts tax since 1935. In 2005 this tax structure was also adopted in Ohio. And in May 2006, Texas lawmakers voted to replace their franchise tax with a gross re-

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ceipts tax. The reasons given for such a move include tax simplification and increased economic competitiveness; very much the same forces that are fueling the discussions of a federal sales tax, for example the Fair Tax proposal. The expected gains associated with a move to a gross receipts tax are relative to the original tax system being replaced. Both Ohio and Texas replaced a franchise tax/2/ with the gross receipts tax. In most other states, the main form of state corporate taxation is a modified version of the federal corporate income tax. Because there are differences between an income tax and a franchise tax, it is not clear that states taxing corporations according to their corporate income would benefit by moving to a gross receipts tax.

This report compares a gross receipts tax with the standard state corporate income tax. The basis for comparison involves several criteria such as the relative tax burdens, efficiency, the degree of progressivity, revenue stability and adequacy, complexity, and administrative costs. A general discussion of the criteria of a sound tax system is followed by a discussion of both the common form of the state corporate income tax and the gross receipts tax. The report then presents and explains the analytic results from the evaluation of both taxes using firm-level data from Compustat's industrial dataset and aggregate IRS Statistics of Income data. The report concludes with a side-by-side comparison of the two tax systems, using the criteria of a sound tax system.

II. What Is a Good Tax?

To provide a benchmark for our comparison of the different features of the state corporate income tax and gross receipts tax, this section discusses the characteristics of a good tax system. The attributes discussed here provide the basis of our comparison. The American Institute of Certified Public Accountants developed 10 guiding principles of good tax policy; principles that aid the evaluation of proposals to adjust or change tax rules and tax systems (AICPA, 2001). Those principles include equity or fairness, certainty, convenience of payment, economy of collection, simplicity, and neutrality. Other principles include economic growth and efficiency, transparency and visibility, minimum tax gap, and adequate government revenue. A description of some commonly accepted definitions follows.

Equity or Fairness

Simply stated, this principle requires that similarly situated taxpayers are taxed similarly. A tax based on ability to pay is viewed as fair by most policymakers if taxpayers with the least ability to pay have the lowest tax burdens. That principle therefore encompasses both horizontal equity (how similarly situated individuals and companies are treated) and vertical equity (how the tax burden varies with income). The former principle favors a tax system in which taxpayers with equal abilities pay similar amounts in taxes, while the latter calls for a tax system in which people with greater ability to pay taxes shoulder a heavier tax burden. For a tax on income, fairness or equity can be demonstrated by a tax that is relatively progressive in nature; taxpayers with higher incomes paying taxes at higher rates than lower income taxpayers. Equity can also be demonstrated by a tax that does not exclude some types of income or economic activity from taxation because those exclusions can lead to situations in which similarly situated taxpayers are not treated equally. For taxes based on benefits received, an equitable tax is one for which the tax burdens vary with the benefits received from the services financed by the tax.

Certainty and Convenience

The AICPA (2001) notes that "tax rules should specify when a tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined." That is, a taxpayer's tax liability should not be ambiguous. The rules governing the imposition and collection of a tax should enable the taxpayers to determine the tax base, tax rates, and tax liabilities with certainty based on the form of business activity or transaction.

Also, a tax should be payable in a manner or at a time that is convenient for the taxpayer. The AICPA (2001) observes that for taxes imposed on the purchase of goods, the tax should be imposed at the time of purchase when the person still has the choice of whether to purchase the goods and pay the tax. Convenience of payment enhances compliance with the tax, especially because the more difficult a tax is to pay, the higher is the likelihood that it will not be paid at all.

Economy of Collection, Simplicity, and Transparency

Yet another principle states that a tax should impose only minimal administrative costs on the government and taxpayers. Simple and unambiguous taxes are less costly to administer and comply with because taxpayers are fully aware

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of the effect of their transactions on their tax liability. Simplicity and transparency enhance tax compliance, subsequently reducing the cost of tax administration.

Economic Neutrality and Efficiency

Tax laws should not influence a taxpayer's decision to engage in one transaction or business activity versus another. The influence of tax laws on taxpayers' decisions should at least be kept to a minimum. A tax should be used primarily to raise revenue for governmental activities, rather than to influence business and personal choices (AICPA, 2001)./3/

Revenue Reliability and Stability

Governments should be able to determine, with some level of predictability and reliability, the amount of revenue likely to be collected from a given tax base. Tax revenue directly affects, the level of government expenditures because most state governments operate under a balanced budget constraint. Because economic changes affect tax bases in different ways, reliance on a mix of taxes, as opposed to a single tax, typically leads to more revenue stability for the levying government.

Many challenges arising from the desire to extend the influence of tax laws beyond that of simple revenue generation to such areas as distribution of income and economic development have, at times, hampered the integration of those principles of good tax policy into the federal and state tax systems. Frequent changes in the tax law have also reduced the certainty of tax systems, consequently challenging the principles of simplicity and economy of collection. The AICPA (2001) said that the real challenge is that not all the "good tax principles" can be achieved to the same degree for all proposed tax changes: "to exclude a particular type of economic benefit from taxation may satisfy the simplicity principle, but not the equity or neutrality principles." That suggests that legislators should carefully balance the principles of a good tax system to design optimal tax laws.

III. Gross Receipts Taxes

A gross receipts tax, sometimes referred to as a turnover tax, is levied on the value of products sold, the gross proceeds of sale (or total revenue), or the gross income of the business. The specific definition of a gross receipts tax base is decided by state legislators when designing the tax. There are two gross receipts tax systems operating in the United States -- one in Ohio and one in Washington state./4/ Both bases include gross receipts from the sale of goods and services and from the operation of a business. The Washington base includes all revenue to the firm, including interest income, sales of assets, dividend income, rental and royalty income, and short- and long-term capital gains. In that way, the Washington tax is actually a gross income tax because all forms of income are subject to tax. The Ohio tax base, however, includes gross receipts from the sale or operation of the business as well as rental and royalty income but excludes from the base interest earnings, dividends received, and capital gains./5/ Thus, the Ohio version of the gross receipts tax bears more resemblance to a business sales tax or consumption tax because it does not tax the return to capital.

The following section compares various aspects of the traditional state corporate income tax with a Washington-style gross receipts tax. Some discussion is given to the Ohio version of the tax but our data do not allow for a formal analysis of that tax base./6/

Table 1. Business Classification for the
Washington State Business and Occupation Tax

Business Activity Classification	Tax Rate
Manufacturing, wholesaling, and certain other activities such as extracting, commission of insurance agents, child care, radio and TV broadcasting, and others	0.484%
Retailing, environmental cleanup, and radioactive waste cleanup for the United States	0.471%

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Manufacturing/selling commercial aircraft and components	
Oct. 1, 2005 - June 30, 2007	0.4235%
July 1, 2007 - July 1, 2024	0.2904%
Travel agents, tour operators, stevedoring, freight brokers, licensed boarding homes, repair of aircraft, manufacturing of semiconductor materials, international investment management services	0.275%
Processing meat (at wholesale), soybeans, canola, and dry peas; manufacturing raw seafood, and wheat into flour; warehousing/reselling of prescription drugs, manufacturing of biodiesel/alcohol fuel, and manufacturing fresh fruit, vegetables, and dairy products	0.138%
Disposal of low-level radioactive waste	3.3%
Services, public/nonprofit hospitals, and all other activities	1.5%

Source: Washington State Department of Revenue, RCW 82.04.

Washington's Business and Occupation Tax

In Washington, the gross receipts tax is referred to as the business and occupation (B&O) tax and is calculated on gross income or gross receipts derived from business activities conducted within the state./7/ Businesses report gross income under one of eight tax classifications with varying tax rates. These are listed in Table 1.

According to the Washington State Department of Revenue, B&O tax collections in fiscal 2004 totaled just over $ 2 billion, representing almost 16 percent of state tax revenue./8/ Almost all businesses, including corporations, limited liability companies, partnerships, sole proprietors, and nonprofit organizations, are subject to the state B&O tax. Businesses with annual gross income of $ 28,000 or less do not have to file. Also, many small firms have their liability reduced through a small-business credit.

There are generally no deductions from the B&O tax for labor costs, materials, taxes, or any other costs of doing business./9/ Businesses can reduce their taxable incomes by taking advantage of deductions not related to the costs of doing business, including bad debts and interstate and foreign sales. The most common B&O exemptions include incomes from farming, the sale and rental of real estate, some nonprofit and social service organizations,/10/ government, and credit unions. Some businesses also qualify for tax credits based on the size (payroll), nature (high technology), and the location (distressed area) of the business. Further, businesses that perform more than one taxable activity for the same product can take advantage of the multiple activities tax credit to reduce the risk of multiple taxation. For instance, manufacturers that also sell finished products as wholesalers are required to report each activity under the appropriate B&O classification. That credit ensures that the B&O tax is paid only once on the same amount.

Ohio's Commercial Activity Tax

In June 2005 Ohio enacted a gross receipts tax referred to as the commercial activity tax (CAT). That tax is imposed on the taxable gross receipts of almost all commercial activities and business entities in Ohio, including C corporations, S corporations, partnerships, and LLCs./11/ The initial top rate of the CAT is 0.06 percent and is scheduled to increase to 0.26 percent when the tax is fully implemented. The tax is being phased in over a five-year period starting in 2005. Once fully phased in, the CAT will exclude gross receipts of up to $ 1 million annually from taxation. Businesses with at least $ 150,000 in Ohio taxable gross receipts in a calendar year must register for the CAT and pay a minimum $ 75 fee included on the CAT form (Wilson, 2006)./12/ Only a few deductions are associated with the CAT, including

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cash discounts, bad debts, and returns and allowances. However, several forms and sources of income are excluded from the base. Those include interest and dividend income and capital gains, as well as compensation, including benefits, for services for an employer. Also, nonprofit organizations, dealers in intangibles, financial institutions, and insurance companies are excluded from the CAT.

Pros and Cons of a Gross Receipts Tax

A gross receipts tax has some advantages over a corporate income tax. First, it is usually imposed on nearly all business entities, as is the case in Ohio and Washington. That is not necessarily a characteristic of the gross receipts tax, because it could be applied to only a select type of business entity, but in practice that has not occurred. Second, the wide tax base increases the stability of that revenue source. Third, because a gross receipts tax is not a tax on net income or profits, it does not penalize business entities for being profitable. Finally, many praise the simplicity of the gross receipts tax as an advantage over the corporate income tax. But tax simplicity, or conversely complexity, is not necessarily a function of the underlying tax base. Most often the complex nature of a tax structure stems from the use of the tax code to redistribute income, benefit specific taxpayers, and encourage specific types of activities. It is often the case that tailoring a tax system to increase equity is at odds with the goal of simplicity. Thus, even a tax that begins with a simple base can become quite complex. Although the gross receipts tax can be levied in a very simple form, Washington and Ohio make exceptions to the simple base, such as an exemption for farming activities in the case of Washington and an exclusion for interest and dividend income in the case of Ohio. The potential complexity of the gross receipts tax is addressed later in the report.

A major disadvantage of the gross receipts tax is that though it may not be passed on to consumers directly, it can be, and probably is, passed on to consumers indirectly via price increases. That effect can lead to tax cascading or pyramiding in which taxes are imposed on earlier taxes. For instance, consider the case of a business that buys computer parts. The producer of the parts makes a sale to a business. The producer is taxed on the sale by the gross receipts tax. The producer may increase the price to offset the impending tax. The business then assembles the computer parts and sells the computer to a home user. That transaction is also taxed. The tax is imposed on the sale price of the home computer system, which implicitly includes the tax paid by the business when it purchased the parts. In that way, the price of the home system is increased by the amount of the tax paid by the business and the tax levied at the final stage of production is levied on a retail price that includes a previous tax payment.

The potential cascading effect described in this example increases as the number of taxable transactions in the production process increase. Because of the cascading, gross receipt tax systems impose a lower burden on vertically integrated firms or production processes with fewer steps from beginning to end, such as services. Some economists argue that a gross receipts tax has all the defects of a sales tax imposed on business purchases, if not worse, because sales for resale and other commonly exempt sales to businesses are subject to tax under the gross receipts tax (McLure, 2005). That is especially the case when goods and services produced by one business entity are used as inputs of another business establishment. In such a case, a gross receipts tax could be paid multiple times on a good as it progresses through the production process./13/

Another disadvantage of the gross receipts tax is that firms can have a positive tax liability even when they do not make a profit. That is because a firm's tax liability under a gross receipts tax is not reduced for the cost of business inputs, labor, interest payments, or capital investments. That tends to be particularly burdensome for startup firms with low sales but high business costs. That issue has been addressed by the Washington and Ohio tax systems by imposing filing thresholds and exempting a base level of gross receipts.

IV. State Corporate Income Tax

In 2007, 46 out of 50 states levied some form of a corporate income tax./14/ In general, it's a tax on corporate income as defined at the federal level with several modifications imposed at the state level. For instance, the federal definition of corporate income allows for more generous depreciation deductions than many states do./15/ By the same token, some states offer deductions or credits that are not allowed at the federal level. After computing the state corporate income tax base, corporate income is apportioned to represent the percent of total income that is earned in the state. The tax rate, which is lower than the 35 percent federal rate, is applied to this adjusted, apportioned base to yield a firm's state tax liability.

It has long been argued that the traditional state corporate income tax is an inferior tax on several grounds. It is complex because of its many deductions and special rules. It is distortionary in that it strongly influences economic be-

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havior because of its many deductions and exclusions. The state corporate income tax discriminates against the corporate form of business organization because it taxes returns to capital at a relatively high rate compared with noncorporate businesses and also because it encourages debt over equity financing./16/ As a revenue source it is highly volatile from year to year and has been on the decline relative to gross state product in most states over the past several years./17/ Finally, corporate net income is probably a poor yardstick by which to measure any benefits received from the provision of state government services.

On the positive side, the cost of administration is mitigated by costs borne by the federal government. One can also argue that the corporate income tax base may be more inclusive than some forms of the gross receipts tax because the definition of corporate income includes income earned from nonbusiness- related activities, such as dividend and interest earnings./18/ Economists have long supported the notion of increased inclusion in the tax base. Generally, comprehensive bases lead to fewer distortions and less tax avoidance behavior. Finally, because the corporate income tax is a tax on net income (that is, profits), it incorporates a better measure of ability to pay than a gross receipts tax that does not distinguish between firms based on their level of business expenditures.

V. Data

The analysis presented in this report is conducted using aggregate corporate tax return data from the 2000 SOI and firm-level data from the Compustat Industrial Annual file available from Standard and Poor's. The Compustat dataset, while not a representative sample of all U.S. corporations, does provide detailed firm-level data on over 24,000 publicly held companies. The S&P's Compustat data are standardized across firms to minimize reporting variability in the data. That allows better comparability between companies./19/

Table 2. Descriptive Statistics of Compustat Data for 2000

Variable	Observations	Mean	Standard Deviation	Minimum	Maximum
Total Assets (millions $)	8,955	$ 3,311	$ 25,526	$ 0	$ 902,210
Net Sales (millions $)	8,958	$ 1,341	$ 6,906	-$ 0.7	$ 206,083
Nonoperating Income (millions $)	8,929	$ 5	$ 232	-$ 10,375	$ 5,625
Federal Corporate Income Tax Liability (millions $)	6,944	$ 24	$ 153	-$ 1,261	$ 3,809

Source: Standard and Poor's Compustat data.

Table 3. Comparison of SOI Corporate Returns and Compustat Data for 2000

Variable	SOI	Compustat
Number of Observations	5,045,274	8,955
	Mean SOI	Mean Compustat
Total Assets (millions $)	$ 9	$ 3,311

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Net Sales (millions $)	$ 3	$ 1,341
Nonoperating Income (millions $)	$ 0.6	$ 5
Federal Corporate Income Tax Liability (millions $)	$ 40	$ 24

Table 2 presents the descriptive statistics from the Compustat data for a selection of the sample used in this report. The data used in the analysis are drawn from 20,195 U.S. industrial companies, though the maximum number of observations containing all the necessary variables for this study is 6,903. That difference is the result of the sizable number of missing observations for many of the industrial companies. The standard deviations shown in Table 2 reveal a large degree of variation in the size and financial strength of the industrial companies included in the S&P's Compustat data.

Compared with the SOI corporate data, the Compustat data are skewed toward the high end of the corporate income distribution. Table 3 compares the data from the SOI corporate return sample with the Compustat data used in this analysis. As seen from the table, the Compustat firms have greater assets, net sales, and net nonoperating income than those in the SOI sample, which is designed to be representative of the U.S. corporate population. At the same time, the Compustat firms have, on average, a lower average federal tax liability than those in the SOI sample. That issue is explored in more depth later in the report. While we prefer to work with a more representative data set, the Compustat data is the only publicly available micro dataset of corporations with sufficient level of detail for this type of analysis.

VI. Comparison of a Gross Receipts Tax With a State Corporate Income Tax

The current gross receipts tax is levied in Washington and Ohio on both corporate and noncorporate firms. The dataset used here contains information on corporate firms only. Therefore, this analysis can compare the effects of a gross receipts tax and a corporate income tax only on corporate firms and not all business entities. Also, the Compustat dataset does not provide enough observations to accurately model the Ohio version of the gross receipts tax, which excludes interest and dividend income and earnings from capital gains. Our analysis is therefore focused on the comparison between the Washington version of the gross receipts tax and the traditional state corporate income tax. It is not our intent to hold the Washington B&O tax up as the standard-bearer for all gross receipts tax systems. The exercise undertaken in this report is not to diminish the B&O tax but to consider the effect of replacing an existing corporate income tax with a gross receipts tax. Because the B&O tax has been around so long, Washington has an established history and experience with that tax system. It is hoped others can learn from Washington's experiences.

Some explanation of our critical variables is necessary before proceeding further with the results of the analysis. The overall analysis consists of several comparisons. Two comparisons, the size of the tax bases and revenue volatility, are performed in this analysis using aggregate data from the 2000 SOI corporate file. Two additional comparisons require a firm-level calculation and comparison of the size and distribution of the tax burden under both the corporate income tax and the gross receipts tax systems. To construct a firm-level estimate of the tax liability under a Washington gross receipts tax, we use the sum of the net sales variable and the nonoperating income variable found in the Compustat database./20/ Taken together those two variables capture gross receipts from sales and services net of returns and net income from nonoperating sources. A preferred measure would be gross nonoperating income, which is the value included in the Washington gross receipts base, but that variable is not available. Therefore, the gross receipts base used in this analysis is smaller (because of the deduction of nonoperating expenses) than that reported by firms operating in Washington.

The Compustat file contains only an aggregate value for all state corporate tax liabilities. The amount owed to each state is not broken out. Instead, this analysis uses the federal corporate income tax liability as the point of comparison. The federal corporate income tax liability variable found in the Compustat database is income tax liability after federal credits have been subtracted out. The distribution of federal tax credits is highly skewed. Based on the 2000 SOI data, the ratio of the value of federal tax credits to after-credit tax liability is about 3 percent for firms with positive assets of less than $ 100,000./21/ That ratio rises to 8 percent for firms with assets between $ 100 million and $ 250 million and then jumps to 36 percent for firms with assets in excess of $ 250 million./22/ Because of the large value of credits at the upper end of the asset distribution and their uneven distribution, care must be taken when interpreting some of the results of this analysis. Further, to make an appropriate comparison between the distributional effects of the corporate income tax and the gross receipts tax, any credits associated with the gross receipts tax should be included in the com-

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putation of the gross receipts tax liability. Unfortunately, that information is not available, with one exception. The B&O tax allows a small business credit worth at most $ 420 per year per firm. The value of the credit is reduced by $ 5 for every $ 5 increase in tax liability. The credit completely phases out at tax liabilities of more than $ 841. The simulation incorporates that small-business credit.

Once computed for each firm, the two tax liabilities, one for each tax system, are then analyzed on a firm-by-firm basis to compare the tax burden and distribution of the two tax systems. Also, the tax systems are compared on the basis of the size of their tax base, revenue volatility, complexity, and administrative costs. The results of each comparison are presented and discussed in the remainder of this report.

VII. Economic Efficiency

A fundamental tenet of public finance theory is that preferred tax systems are those that induce the least amount of welfare loss to society while achieving the desired revenue goal./23/ That is, in general, tax systems that induce the least amount of change in economic behavior because of the imposition of the tax are preferred to systems that induce a larger change in consumption or production activity. Conceptually, we can identify several characteristics that tend to increase or decrease this welfare loss. Low rates and broad tax bases come to mind immediately as attributes of a tax system that result in lower welfare losses. To that end, relatively few deductions or preferences are characteristic of efficient or preferred tax systems.

One general measure of efficiency can be captured by measuring the size of the tax base. A broad base is considered more efficient because it captures all sources of income and creates fewer options for tax-induced behavior. The calculation of tax liabilities of both tax systems considered in this analysis begins with gross receipts, but the corporate income tax then subtracts from that the costs associated with earning income. The 2000 data from the SOI sample of Form 1120 returns reveal that the ratio of the corporate income tax base (before credits) to business receipts (a proxy for the gross receipts tax base) is on average 3.7 percent./24/ It varies from a low of 0.44 percent for firms with positive assets under $ 100,000 to a maximum of 5 percent for firms with assets in excess of $ 250 million. Therefore, the gross receipts tax that applies the tax rate directly to the base of gross receipts has a broader base than the base of the corporate income tax, implying a more efficient tax system.

Preferred tax systems tax all income, regardless of source or type, at the same rate. Under the corporate income tax, all corporations are taxed at the federal statutory rate of 35 percent./25/ However, many preferences exist for various industries and activities. For instance, small businesses are allowed greater depreciation deductions than larger corporations, and a tax credit is allowed for expenses associated with research and development activities but only a deduction is allowed for expenses associated with advertising or renting. Moreover, there are many provisions in the corporate tax code pertaining to the depreciation allowances for various kinds of capital assets. Those differences in deductions and depreciation allowances alter the effective tax rate imposed on a corporation and create preferential treatment of some industries or businesses through the tax code. Even in the absence of those deduction and depreciation issues, the corporate tax system discriminates against corporate-owned businesses. Because the corporate income tax does not apply to noncorporate businesses, it provides an incentive for business owners to organize as noncorporate entities so that their income is taxed under the individual income tax system at lower rates. Several authors have considered that aspect of the corporate income tax./26/ Applying a uniform gross receipts tax to all businesses eliminates that source of tax-induced behavior and will represent a gain in efficiency over the current state corporate income tax.

However, the Washington B&O tax has its own sources of inefficiencies. It deviates from its most "equal treatment" by applying different tax rates across industries. In the Washington tax system, income from wholesale agricultural production is completely exempt, while the manufacturing sector is taxed at a 0.484 percent rate and the services sector is taxed at a 1.5 percent rate. In fact, the B&O tax system includes eight different tax rates (Table 1). That unequal treatment of business receipts could increase the welfare losses over its purest form in which all business receipts are treated in the same manner. Also, the B&O tax includes several deductions such as a deduction for charitable contributions, investment income of nonfinancial businesses, and a temporary deduction for the expenses associated with processing beef. The B&O offers several credits as well, such as a jobs credit for software developers in rural counties and a credit for preproduction expenses associated with some aircraft.

Another distortionary effect associated with the gross receipts tax stems from cascading. Our analysis does not take into account the cascading effects of the gross receipts tax. Accounting for tax cascading results in a lower revenue-neutral tax rate for all firms by increasing the size of the tax base as the tax is passed along. That results in a smaller tax burden for those firms that are first on the production chain, such as wholesalers, or firms that use fewer raw materials.

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That smaller burden comes at the expense of firms further down the production chain, such as retailers or manufacturers, that face the same tax rate but whose tax base (gross receipts) has been expanded to incorporate the tax payments made by firms at previous stages of production. Therefore, the gross receipts tax creates a distortion between the economic returns faced by wholesalers and retailers and provides an incentive for firms to vertically integrate to reduce their tax exposure.

Based on a 2002 study by the Washington State Tax Structure Committee, the degree of pyramiding statewide in Washington was estimated to be 2.5./27/ That means that on average, the effective tax on the final sale of a product is 2.5 times higher than it would be if only the final sale is taxed. That degree of pyramiding was found to vary greatly by industry. The study found that the degree of pyramiding on services was 1.6 while the degree of pyramiding on manufactured goods was between 6.7 and 2.2./28/

The base of the Ohio gross receipts tax excludes several sources of income such as interest, dividends, royalties, and capital gains. Based on 2000 SOI data of corporate tax returns, the base of the Ohio gross receipts tax is estimated to be on average 86 percent of the Washington base./29/ For firms with positive assets of less than $ 100,000, the Ohio base is 98 percent of the Washington base. The ratio falls steadily as asset values rise. In the case of firms with assets in excess of $ 250 million, the Ohio-style base is 80 percent of the more inclusive Washington-style base. Although still much larger than the corporate income tax base, that version of the gross receipts tax provides an incentive to redefine business income as those other nontaxed forms. That introduces a different source of inefficiency that is not associated with the existing corporate income tax because the base of the corporate income tax captures those other sources of income. However, the exclusion of returns to capital may have positive implications for investment and employment in the state.

It is not fair or perhaps useful to hold the Washington B&O tax or any other specific state tax up as the standard for the gross receipts tax. States have the right to allow any deductions and credits they deem appropriate, so that it is conceivable that a state could levy a gross receipts tax without allowing any special credits or deductions. But experience shows that significant pressure is exerted on tax systems to allow for special treatment of particular businesses or industries. That special treatment is often justified in the name of fairness, such as special credits for small businesses or struggling industries. Those pressures will exist regardless of the form of the tax imposed on business. Thus, as is made clear from the discussion above, replacing a corporate income tax with a gross receipts tax may not eliminate the complexity and special rules associated with the current corporate income tax.

In terms of the more efficient tax, it is clear from the discussion above that both the gross receipts tax and the corporate income tax create opportunities to play favorites between industries and businesses. Neither system is immune from that pressure.

VIII. Tax Burden Size

Efficiency is only one characteristic of a good tax system. In this analysis we also consider the size of the tax burden associated with the gross receipts tax. We use the firm-level Compustat data to compute for each firm the corporate income and the gross receipts tax burden, which is defined for this purpose as the ratio of a firm's tax liability to its total assets. To make a fair comparison between the two tax systems, we determine a gross receipts tax rate that produces an amount of revenue equal to the federal corporate income tax paid by the firms in the Compustat sample./30/ For our Compustat sample, that revenue-neutral gross receipts tax rate is calculated to be 1.68 percent. That is, a 1.68 percent rate applied to the Compustat sample gross receipts base raises the same amount of revenue as these firms paid in federal tax in 2000./31/

The unweighted mean burden for the corporate tax, computed as the ratio of tax liabilities to total assets, is estimated to be 1 percent and the unweighted mean burden for the gross receipts tax as constructed is 1.7 percent./32/ Care should be taken when interpreting these results. Those values represent the mean values experienced only by the firms in this sample and may not be representative of all firms. Our results indicate that the gross receipts tax burden overall is approximately 70 percent higher than the corporate tax burden. That is not an unexpected finding given that the gross receipts tax does not allow for the deduction of expenses associated with earning income.

Table 4A shows the tax burden, computed as the ratio of tax liabilities to total assets, of the corporate income tax and the gross receipts tax by asset category./33/ For firms with assets less than $ 250 million, the tax burden is larger under a gross receipts tax than under the existing corporate income tax./34/ Only for firms with assets in excess of $ 250 million is the estimated corporate income tax burden greater than the estimated gross receipts tax burden.

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Table 4B shows the same tax burden calculation by industry sector. The results indicate a higher burden under the gross receipts tax for the service and manufacturing sectors. Under the existing corporate income tax, the service sector faces a lower burden than the manufacturing sector. That pattern is continued under the gross receipts tax system.

Distribution

Another critical characteristic of a tax system is its degree of progressivity or regressivity. As can be seen in Table 4A, in general, tax burdens under the gross receipts tax decline as asset value increases, indicating a larger burden for firms with a smaller asset base or a regressive tax system. Tax burdens under the corporate income tax increase slightly with asset size, indicating a relatively more progressive tax system./35/ (The gross receipts tax could be made more progressive by allowing a tax credit based on the asset size of the firm.)

Table 4A. Tax Burden by Asset Size

Asset Size (Number of Firms)	Corporate Tax Burden	Gross Receipts Tax Burden
$ 0<$ 100,000 (73)	0%	5.1%
$ 100,000<$ 250,000 (41)	0%	1.1%
$ 250,000<$ 500,000 (59)	-1.7%	2.2%
$ 500,000<$ 1,00,000 (82)	-0.3%	2.2%
$ 1,000,000<$ 5,000,000 (392)	0.3%	2.1%
$ 5,000,000<$ 10,000,000 (345)	0.3%	1.6%
$ 10,000,000<$ 25,000,000 (548)	0.5%	1.9%
$ 25,000,000<$ 50,000,000 (522)	0.8%	1.8%
$ 50,000,000<$ 100,000,000 (633)	0.9%	1.6%
$ 100,000,000<$ 250,000,000 (841)	1.2%	1.6%
$ 250,000,000 or more (1,959)	1.5%	1.4%

Source: Compustat Industrial File and authors' own calculations.

Table 4B. Tax Burden by Sector ($ in millions)

Economic Sector (Number of Firms)	Corporate Tax Burden	Gross Receipts Tax Burden
Manufacturing (2,718)	1.2%	1.7%
Service (2,777)	0.8%	1.6%

Source: Compustat Industrial File and authors' own calculations.

Although the Washington tax as modeled here reveals a regressive system, an Ohio version of the gross receipts tax would reveal a more regressive system. That is because the Ohio version of the gross receipts tax does not include

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income from dividends, interest, or capital gains. Those sources of income increase with firm assets and make up a larger portion of corporate income as firm assets increase. By excluding that income from taxation, estimates indicate the Ohio-style gross receipts tax will be more regressive than the Washington-style gross receipts tax with its more inclusive definition of taxable income./36/

Change in Distribution

In this measure of the tax burden, our aim is to determine the change in relative tax burdens when shifting to a gross receipts tax from a corporate income tax. That is, we seek to determine if the move to a gross receipts tax alters the distribution of tax burdens between firms from the baseline distribution of the standard state corporate income tax. We do not measure the absolute burden in that measure but only the change in a firm's status relative to other firms.

In the procedure, we organize the firms into quintiles by ranking them first by their corporate tax burden. We then rank the same firms into quintiles based on their estimated gross receipts tax burden. To determine the extent to which the move to a gross receipts tax alters the relative distribution of tax burdens, we compare the gross receipts ranking of firms relative to their corporate income tax ranking. The results are presented in Table 5./37/

Table 5. Change in Tax Burden Distribution

	Gross Receipts Tax Quintile				
Corporate Tax Quintile	1st (n=1,380)	2nd (n=1,381)	3rd (n=1,381)	4th (n=1,381)	5th (n=1,380)
1st (n=629)	10%	17%	25%	26%	22%
2nd (n=3,243)	35%	21%	15%	14%	16%
3rd (n=270)	14%	27%	20%	22%	17%
4th (n=1,381)	9%	23%	25%	22%	20%
5th (n=1,380)	1%	15%	25%	30%	30%

Source: Compustat Industrial File and authors' own calculations.

The results indicate a fair degree of reranking of firms when switching from a corporate income tax to a gross receipts tax. That is not unexpected given the difference in the distribution of the burdens shown in Table 4A. For example, of those firms ranked in the lowest (1st) quintile under a corporate income tax, only 10 percent remained in the lowest quintile under a gross receipts tax. Seventeen percent of the firms rose to the 2nd quintile, 25 percent to the 3rd, and 26 percent to the 4th, while 22 percent of firms that were in the lowest quintile based on a corporate tax regime were ranked in the highest quintile based on a gross receipts tax regime. All firms in the 1st quintile based on the corporate income tax had negative corporate income tax burdens. All firms in the 2nd quintile based on the corporate income tax had a zero tax burden./38/ Firms in the 3rd through 5th quintiles had positive tax burdens.

Although there is a fair amount of change for firms in the lower quintiles, in the 5th quintile we see a larger degree of stability. That is, 30 percent of those firms that are in the highest quintile under a corporate income tax are also found in the highest quintile under a gross receipts tax. That is probably because of the deductibility of expenses allowed under the corporate income tax. Firms with high gross receipts and low expenses do not look very different in terms of tax liability under the two systems. But firms with high gross receipts and high expenses have a significantly lower tax liability under the corporate income tax than under a gross receipts tax.

IX. Revenue Stability

In addition to issues of efficiency and equity, good tax systems provide a steady and predictable flow of revenue for the levying government. Predictable revenue streams are easier to forecast and allow state officials more confidence in their future budgets. To determine the stability of each tax system, we compute the coefficient of variation for each

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system over the 1995-2003 period using aggregate data from SOI to represent both tax bases./39/ The calculation uses aggregate total receipts as a proxy for the gross receipts tax base. That is compared with the variation in the aggregate net taxable income, which is the federal corporate income tax base. That comparison is also computed separately for the manufacturing industry. The results, shown in Table 6, indicate a higher level of variation associated with the corporate income tax when all industries are considered and also when computed specifically for the manufacturing industry. Figure 1 shows the annual rates of change for each of the revenue streams. As is seen in this graph, the corporate income tax revenues for all industries and for manufacturing are more volatile over that period than gross receipts for either all industries combined or manufacturing individually.

X. Complexity and Administration

One of the major factors driving tax reform at the state and federal level is simplicity. As discussed earlier in this report, less complex tax systems are typically associated with higher rates of compliance and lower administrative and compliance costs. Less complex tax systems may also be perceived as more transparent so that taxpayers have a better sense of the relationship between their tax payments and the provision of government services. In comparing two tax systems and holding all other factors equal, less complex tax systems are preferred to more complex systems. However, such simple tax systems may not be politically popular or even feasible. The simplest and most economically efficient tax system is a head tax or lump sum tax. In that tax system, every person is assessed a tax liability that they are unable to alter by changes in behavior. Although not very popular, that tax system is very simple. Tax systems become increasingly complex as they attempt to address issues of fairness and as they attempt to induce changes in taxpayer behavior. Much of the complexity associated with the federal corporate income tax is because of the inclusion of provisions designed to level the playing field between industries and firms. Examples of those provisions include special deductions for small businesses or special preferences for industries with high capital expenditures. Therefore, much of the stress of a tax system stems from the desire to balance the demands for equity with the demands for simplicity. As a further means of comparison between the corporate income tax and a gross receipts tax, we consider the complexity of the tax system and the cost of administration of each system borne by the levying government.

Table 6. Revenue Stability

Coefficient of Variation	1995-2003
Federal Corporate Income -- All Sectors	21%
Federal Corporate Income -- Manufacturing	30%
Gross Receipts -- All Industries	13%
Gross Receipts -- Manufacturing	7%

Source: 1995-2003 SOI corporate data, tables 14A and 14B.

Complexity

There seems to be a popular opinion among the public that any tax system is an improvement in terms of simplicity over the existing income tax. There is no doubt that the existing federal corporate income tax is far from a simple tax structure. The complexity stems from several general sources, a few of which are unique to the income tax and some of which are not. Some unique sources of complexity have to do with defining taxable sources of income and allowable deductions. Other sources of complexity, which could be associated with any tax system, stem from the attempt to either level the playing field between industries or to give advantage to one industry over another. To do either requires special provisions with complex rules to determine which firms may take advantage of the provisions. Between 1954 and 2005, there was a 615 percent growth in the number of sections of the federal tax code relating to the taxation of income./40/ Many of those changes were incorporated to address perceived unfairness in the tax code.

Although conceptually less complex than the income tax, the gross receipts tax used in Washington and Ohio has its own source of complexity. For example, there are eight different tax rates associated with the B&O tax in Washington. Because gross receipts are taxed at different rates, it is necessary to have an extensive and comprehensive list of definitions of various business activities, some of which may be open to debate. Also, the B&O tax contains several

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exemptions and deductions. Examples of exemptions include: income from the sale or rental of real estate, wholesale agricultural producers, fundraising activities of nonprofits, credit unions, and income of small timber harvesters. Examples of deductions include: interstate commerce income, membership dues and tuition fees, cash discounts taken by purchasers, credit losses incurred by taxpayers who use accrual accounting, interest from first mortgage residential loans and some agricultural loans, and a temporary deduction for income associated with beef processing. Also, several tax credits exist, such as small-business credits, R&D credits, various new job credits, and a fairly involved multiple activities credit to prevent the double taxation of firms engaged in two or more economic activities. So, although the gross receipts tax as levied in Washington may be less complex in terms of the calculation of income, it is not necessarily simple and it is just as susceptible to pressure to provide preferential industry treatment as the existing income tax. Also, as of 2006, the Washington tax system is subject to apportionment of multistate tax bases in the same manner as traditional corporate income tax systems.

Figure 1. Annual Change in Revenue

[Image Omitted]

Cost of Compliance and Administration

There are several nonrevenue costs associated with a tax system. Those consist of the cost to the taxpayer of complying with the code and the cost to the levying government of collecting the tax. Minimizing these costs are goals of any tax system. Estimates of the cost of compliance are difficult to obtain because firms do not report those statistics. Several studies, however, have surveyed firms about their compliance costs. Based on a survey of large firms, Slemrod and Blumenthal (1993) estimate the ratio of the cost of compliance with state and local taxes to firm state and local corporate revenue to be 5.6 percent. That is more than double their estimate for the ratio associated with federal taxes, which was estimated to be 2.6 percent. That estimate is best considered an upper limit on compliance costs since it is based on a sample of firms with disproportionally large compliance costs. The Slemrod-Blumenthal report attributes the high compliance costs in the case of nonfederal taxes to the lack of conformity among state tax systems, especially the differences in state apportionment and depreciation rules. Research by Gupta and Mills (2003) confirms this conclusion by finding increases in compliance costs as states move away from conformity with other tax systems and each other. Thus, given that most states use a corporate income tax, some firms may experience an increase in compliance costs because of a move toward a non-income-tax system, especially if those firms operate in multiple states. In a second study focusing on the compliance cost of small and midsize firms, Slemrod and Venkatesh (2002) find that compliance costs for those firms are much greater relative to their sales when compared with the larger firms. Results from this study indicate that the ratio of total compliance cost to tax revenue is about 28 percent in the case of midsize firms./41/ Another study by Hall (1993) of the Tax Foundation showed similar results, with the ratio of compliance cost to sales decreasing with the size of firms. Although none of these studies give us any insight into whether the gross receipts tax is any less costly in terms of compliance, it does emphasize the importance of compliance costs when considering the choice of a state tax system. Further, the findings do indicate that nonconforming tax systems may induce higher compliance costs for firms.

In addition to firm compliance cost, government administrative costs are an important factor in the design of a tax system. As a rough estimate of the administrative cost of taxes in Georgia, we divide the Georgia Department of Revenue expenditures by the total own-source receipts to the state. That figure represents the cost per dollar of revenue for all revenue sources, not only the state corporate income tax. That figure is 66 cents per $ 100 collected for fiscal 2005./42/ If we calculate a similar figure for Washington, we find a slightly higher collection cost of 88 cents per $ 100 for 2005./43/ Those estimates are not rigorous enough to use in a comparison between the two tax systems but are offered as a guide to the existing cost of administering those systems.

XI. Conclusion

Spurred by calls for improved compliance, increased fairness, and greater simplicity, states have begun to consider alternatives to the existing taxes on corporations. This analysis considers the potential effect of replacing a traditional state corporate income tax with a gross receipts tax. Washington has levied a gross receipts tax for several decades and both Ohio and Texas have or are in the process of implementing their own versions of that tax. Based on the results of the analysis presented in this report, the gross receipts tax is not a complete elixir for the woes of the state corporate income tax.

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Table 7. Summary of Measures

Measure/Tax System (Data Used in Analysis)	Corporate Income Tax	Gross Receipts Tax
Size of tax base (aggregate SOI data)	applies only to corporations; allows deductions for the cost of earning income; varies from 0.44 percent to 5 percent of gross receipts	is levied on all business entities, has fewer deductions and exclusions compared traditional CIT
Size of tax burden (firm-level Compustat data)	average burden for firms in sample=1.0 percent of total assets;	average burden for firms in sample=1.7 percent of total assets
Distribution of tax burden (firm-level Compustat data)	generally progressive in nature; higher estimated burden for manufacturing firms	generally regressive in nature; higher estimated burden for manufacturing firms
Revenue stability (aggregate SOI data)	coefficient of variation for all firms = 21 percent; for manufacturing firms = 30 percent;	coefficient of variation for all firms = 13 percent; for manufacturing firms = 7 percent;
Complexity (aggregate data from state Department of Revenue	very complex with considerable compliance costs for	conceptually less complex than the traditional CIT but not immune to

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offices)	firms; has a long history of special preferences for firms and industries	pressures to offer special treatment for firms and industries

The results of the analysis are summarized in Table 7. In some categories, the gross receipts tax comes out as an improvement over the traditional state corporate income tax. For instance, the tax base of the gross receipts tax is much broader and inclusive than that of the corporate income tax. Further, the gross receipts tax base is less volatile over time compared with the corporate income tax. However, this analysis suggests that the gross receipts tax burden is larger for many firms and more regressive relative to the traditional corporate income tax. Our last criteria of complexity found that while conceptually the gross receipts tax is less complex, it is not immune to the pressures to offer special preferences to firms and industries. The more any tax system gives in to those pressures, no matter how justified, the more complex the tax system becomes. Based on those findings, we cannot say that the gross receipts tax system is an improvement over an existing state corporate income tax: Any improvements will depend on the particular characteristics of the state and their priorities in setting tax policy.

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FOOTNOTES

/1/ See John L. Mikesell (2007) for a similar discussion of this topic.

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/2/ A franchise tax is a privilege tax imposed on each corporation and limited liability company chartered or organized in a jurisdiction (or state) or doing business in that jurisdiction. "Corporation" also includes (but is not limited to) banks and state limited banking associations, as well as savings and loan associations.

/3/ There are exceptions to that principle, such as taxing activities that create externalities for society.

/4/ Filing for the Texas gross receipts tax will begin January 1, 2008.

/5/ Interest on credit sales is included in the base. Gross receipts from the sale of real property located in Ohio are also included in the base.

/6/ The major reason for this is a lack of data. For instance, the Ohio gross receipts base includes rental and royalty income. The data for those items are available for only a fraction of firms in the Compustat data set.

/7/ Washington does not impose either a corporate income tax or personal income tax. By contrast, Georgia total tax collections represent about 4.4 percent of gross state product in 2000.

/8/ That represents 0.79 percent of gross state product for Washington. By contrast, Georgia total tax collections represent about 4.4 percent of gross state product in 2000.

/9/ Because Washington does not levy an individual income tax, the lack of an exemption of the labor costs from the B&O tax base does not lead to the double taxation on wages.

/10/ Some nonprofit organizations such as public and nonprofit hospitals are subject to the B&O tax.

/11/ Banks and other financial institutions, insurance companies, public utilities, and dealers in intangibles such as securities are subject to special taxes and are excluded from the CAT. Further, most affiliates of financial institutions and insurance companies are also excluded from the CAT.

/12/ Businesses with gross receipts of less than $ 150,000 are not required to register as CAT taxpayers.

/13/ See Washington State Tax Structure Study Committee (2002), "Tax Alternatives for Washington State" (2002) concluded that Washington's B&O tax pyramids on average 2.5 times, though this rate varies considerably across industries.

/14/ Federation of Tax Administrators, available at http://www.taxadmin.org.

/15/ Those deductions include the bonus depreciation and the qualified productions activity deduction. Those deductions were not adopted by all states, and, consequently, firms operating in some states have to add back that expense at the state level when determining their state corporate income.

/16/ As part of the traditional corporate income tax, dividends are taxed twice and capital gains are taxed at the corporate rate of 35 percent.

/17/ See Cornia, et al. (2005).

/18/ For instance, the Ohio CAT excludes dividends, distributions from corporations, and interest income other than interest on credit sales as well as capital gains income.

/19/ To increase the sample size of the Compustat data, this report uses data from active and inactive companies incorporated in all 50 states as well as the District of Columbia for calendar year 2000. All analyses were run on a subsample containing only active firms, and the original pattern of results was upheld.

/20/ Net sales (data12) is gross sales net of returns. The nonoperating income (data61) variable captures net income from dividends, interest, rent, royalties, and capital gains.

/21/ Figures are based on the authors' calculations from SOI corporate data. See Table 2 for 2000.

/22/ Id.

/23/ Welfare loss refers to the reduced well-being of society as a result of an artificial change in price such as occurs with the imposition of taxes or subsidies.

/24/ Statistics of Income for 2000 Corporate Income Tax Returns, Table 2 -- Selected Balance Sheet, Income Statement, and Tax Items by Asset Size.

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/25/ S corporations are not included in this analysis. These entities are taxed under the individual income tax system.

/26/ See Austan Goolsbee (1998) and Jane G. Gravelle and Laurence J. Kotlikoff (1989).

/27/ See supra note 13 at 8, p. 112 and Appendix C-12.

/28/ Id. Stated differently, value added from service firms was inflated by a factor of 1.6 because of tax pyramiding and value added from manufacturing firms was inflated by a factor of 6.7.

/29/ Supra note 24.

/30/ As explained earlier, we do not have data on the amount of state taxes paid by each firm to an individual state. Therefore, we model the gross receipts tax as a federal level tax and compare it to a federal level corporate income tax. Because we are concerned only with relative effects and not absolute ones, that should not distort our results.

/31/ A corporate income tax of 6 percent is equivalent to a gross receipts tax of 0.29 percent.

/32/ Because the rates of both taxes are set to raise the same amount of revenue, the weighted means will be equal.

/33/ An alternative version of this table based on aggregate SOI data was constructed. It shows a similar pattern of results.

/34/ That burden calculation incorporates the Washington rules for a small-business credit for the gross receipts tax.

/35/ The corporate income results reported for firms with assets of less than $ 1 million in Table 4A are not reliable. The Compustat sample contains only 1 nonzero corporate tax burden for those categories. In the case of the gross receipts results, all asset categories are well represented except for the lowest, in which only three firms have nonzero gross receipts data.

/36/ The Ohio CAT remedies this issue in part via gross receipts thresholds and exclusions, both of which seek to reduce the regressivity of the CAT.

/37/ Our analysis compares only the statutory tax burdens and we do not make any assumptions regarding the shifting patterns of these burdens. Therefore, "tax burden" and "tax liability" in this report refer to statutory tax burdens and liabilities only.

/38/ The number of firms in the 2nd quintile of the corporate tax ranking is larger than 20 percent. It represents 48 percent of the firms in the sample instead of 20 percent. That is because all firms in this quintile had a zero tax liability. Because they all had the same tax liability, the computer program placed them in the same quintile. An artifact of that is that each of the 1st quintile and the 3rd quintile contain less than 20 percent of the firms.

/39/ The coefficient of variation is a measure of dispersion computed as the ratio of the standard deviation to the mean. In this case, it refers to the value of the standard deviation of federal corporate revenue during the 1995-2003 period divided by the mean of federal corporate revenue during the same period. Higher values of the coefficient of variation are associated with greater volatility over the period.

/40/ Moody, et al. (2005), p. 6.

/41/ This figure represents the ratio of all tax (federal, state, and local) compliance costs to total revenue paid by all firms.

/42/ See Chart C, p. 7, and Chart A, p. 6 of the 2005 Statistical Report from the Georgia Department of Revenue. This calculation does not include administrative costs associated with the collection of user fees or the insurance premium tax.

/43/ See Table 6 Department of Revenue Expenses and Collections: Average Cost of Collection for Past 30 Years. Available at http://dor.wa.gov/content/statistics/2005/Tax_Statistics_2005/default.aspx.

END OF FOOTNOTES

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APPENDIX JJ

"Illinois' Proposed Gross Receipts Tax:
A Modified GRT Could Be Paired With Other Tax Changes"
(by Elizabeth C. McNichol and Iris J. Lav, dated May 3, 2007)

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May 3, 2007

ILLINOIS' PROPOSED GROSS RECEIPTS TAX

A Modified GRT Could Be Paired With Other Tax Changes

Elizabeth C. McNichol and Iris J. Lav

Summary

Governor Blagojevich of Illinois has proposed a new revenue source, a gross receipts tax (GRT), to provide funds for a major health care expansion, public education, property tax relief, and to help address the state's long-standing budget problems. A GRT is a low-rate tax on the receipts of all types of businesses. The governor's proposed GRT would exempt retail sales of food and drugs, Medicaid payments, and the receipts of non-profits and industries such as gaming and insurance already covered by other specialized taxes.

A GRT in Illinois has a number of significant advantages:

- its ability to raise substantial amounts of needed revenue and to provide a more stable revenue stream over the course of a business cycle than the corporate income tax;
- improved equity in tax payments among different forms of business organization (such as corporations and partnerships) and between goods-related and service-related industries; and
- a reduction in special-interest tax breaks.

There also are some drawbacks to a GRT. There are, however, relatively simple ways to modify the structure of a GRT to mitigate the problems and capitalize on the advantages. Specifically, this report discusses how a subtraction for the cost of inputs purchased from other businesses, coupled with a low-income credit, could mitigate most of the problems of the GRT.

One potential problem with a GRT is its impact on high-volume, low-profit margin businesses, for which the tax can represent a high percentage of potential profits. Another potential problem is that a GRT favors businesses that conduct most operations in-house over businesses that purchase intermediate goods and services from other firms, since the tax is imposed each time a business purchases inputs from an outside firm. (This latter problem is called "pyramiding.")

Illinois can address both of these problems, however, by allowing businesses to subtract the cost of goods purchased from other companies from the gross receipts subject to the tax. Texas and

Kentucky allow a similar, although broader deduction. If the cost of purchased inputs were deductible, a retail discount clothing store — an example of a high-volume, low-margin operation — would pay GRT not on its total receipts, but on its receipts *minus* the amount it paid the wholesaler for the clothes it sold. This would eliminate the disadvantage that such a store would have under a GRT compared to a boutique clothing store with much fewer sales but a high profit on each sale.

Similarly, the ability to subtract the cost of purchased inputs would eliminate most pyramiding, since the taxes paid during the intermediate stage of production would be included in the purchasing business's cost of purchased inputs and thus would not be taxed again. Modifying the GRT in this way would help level the playing field between companies that purchase goods and services from other companies and "vertically integrated" companies that include multiple stages of production and have in-house staff to provide legal, accounting, and other services.

Another potential problem with the GRT is the burden it can impose on low-income households. A GRT is initially paid by businesses but a substantial portion of the tax is likely to be passed on to final consumers through higher prices. Low- and moderate-income households generally would pay a larger percentage of their income in GRT than higher-income households. Low-income households spend rather than save a larger share of their incomes and also are likely to spend a greater share of their income in the state where they live.[1] This additional burden, however, could be offset by creating or expanding tax relief targeted to low- and moderate-income families.

It should be noted that these proposed changes — allowing a subtraction for the cost of inputs purchased and providing tax relief for families — would reduce the revenue gained from a new GRT somewhat below what the governor has estimated for his proposal. The modified GRT would likely raise 60 percent to 70 percent of the revenue that the Governor's proposal would raise. To reach the revenue level the governor has proposed, the modified GRT would have to be coupled with additional revenue sources. One possibility would be an increase in the income tax rate. It also might be desirable to retain and strengthen the corporate income tax, with the GRT allowed as a credit against the corporate tax.

The Governor's Proposal

In March, Governor Rod Blagojevich proposed the establishment of a gross receipts tax — a major new revenue source for the state. The GRT would be levied on Illinois businesses and would eventually replace the state's corporate income tax, according to the governor's plan.

A GRT is a tax on business receipts. It applies whenever a product or service — from the raw material through the finished product purchased by a consumer — "turns over" (i.e., is sold by one business to another) in the process of making products or providing services. For this reason, a GRT is sometimes called a "turnover tax."

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[1] For a discussion of the geographic profile on different household spending patterns, see, for example, Andrew Bernat and Thomas Johnson, "Distributional Effects of Household Linkages," *American Journal of Agricultural Economics,* 73(2) May 1991.

For example, the provider of steel used to make a car would pay the GRT on the sales price of the steel it sells to the automaker, and a firm providing legal services to the automaker would pay the GRT on the fees it charges. When the automaker sells the car, it would pay the GRT on the revenue it receives from the car's sale.

A business computes the amount of GRT it owes by multiplying the GRT rate by the amount of revenue received from its sales of goods or services. A GRT can raise significant revenue with a very low rate because its base is extremely broad; a pure GRT covers *all* types of businesses and applies to *all* business revenue, not just profits.

The proposed Illinois GRT is not a pure version of the tax, however. It would apply only to Illinois businesses with more than $2 million in receipts, and would exempt retail sales of food and drugs, Medicaid payments, and the receipts of non-profits and industries such as gaming and insurance already covered by other specialized taxes, as well as receipts from the sales of products that are shipped out of state.

Advantages of a Gross Receipts Tax

Illinois would derive a number of advantages from a GRT:

- **Infusing much-needed revenue.** When fully phased in, the tax would raise over $7 billion annually, or about 25 percent of the state's current general fund budget. The governor has said that this additional revenue would be devoted to providing funds for a major health care expansion, public education, property tax relief, and to help address the state's long-standing budget problems. The GRT would not immediately replace the corporate income tax; instead, businesses would receive a credit against their GRT liability for corporate income taxes paid. The governor has stated that the corporate income tax would be eliminated in the future.

- **Creating a more stable revenue stream.** The revenue stream from a GRT is significantly more stable than that of a corporate income tax because businesses' sales are not subject to the wide swings that characterize their profits. For example, corporate income tax collections dropped 20 percent in fiscal year 2002 and climbed 54 percent in FY2004. This is considerably more volatile than business activity in the state over the same period. In contrast, the portion of the state's economic output attributed to private businesses rose 1.9 percent in 2002 and 6.6 percent in 2004.

- **Promoting tax equity among businesses.** All businesses in Illinois rely on government services. The state's transportation infrastructure and court system make it possible for corporations to do business in Illinois, for example, while the state's education system provides a supply of trained workers for corporate operations. Yet a considerable number of businesses in the state pay *no* corporate income tax; Governor Blagojevich has noted that 37 of the Fortune 100 companies paid no Illinois state tax despite having $1.2 billion in annual sales in Illinois. He has further noted that on average from 1997 to 2004, nearly half of all corporations with at least $50 million in annual Illinois sales did not pay any state income taxes. Such businesses are contributing considerably less to the costs of the government services they use than businesses that do pay the corporate income tax.

Key Features of Proposed Illinois Gross Receipts Tax

Tax Base

The tax would be levied on business receipts from sales of products and services in Illinois.

Tax Rates

There would be two tax rates:

- ❒ 1.95 percent on sales of services
- ❒ 0.85 percent on sales of goods

Exemptions

The following sales would be exempt from the GRT:

- ❒ Sales of businesses with receipts of less than $2 million
- ❒ Retail sales of food and medicine
- ❒ Sales of goods for export out of state
- ❒ Receipts from Medicaid payments
- ❒ Receipts of non-profits
- ❒ Receipts of businesses covered by specialized taxes such as gaming and insurance

Other Features

- ❒ The amount of GRT owed would be reduced by the amount of corporate income tax paid
- ❒ The tax is projected to bring in over $7 billion in revenue per year once fully phased in

Many businesses are able to avoid Illinois' corporate income tax by structuring themselves in other than a classic corporate form, including as a partnership, subchapter "S" corporation, or a limited liability company (LLC). Businesses operating in these forms in Illinois pass their profits through to their owners, who may pay tax at Illinois' lower personal income tax rate — or may not pay tax to Illinois at all if they live in other states. Unlike most states, Illinois does not require that taxes be withheld before profits are distributed to out-of-state owners or even that these owners sign a statement acknowledging that they owe and will pay taxes to Illinois on these profits.

- **Ensuring that service industries contribute.** The increasing importance of the production and consumption of services in the state's economy has reduced the growth of sales tax revenues — a major revenue source for Illinois — because sales taxes are levied largely on tangible goods and not on services. This problem is particularly acute in Illinois as the state's sales tax base is one of the narrowest in the country. Illinois' sales tax base includes only 17 of 168 services identified by the Federation of Tax Administrators as potentially taxable. Service industries such as legal, technology, and accounting firms sell services that are not subject to the sales tax. Adding a broad-based tax like the GRT would help broaden the state's business tax base.

  A GRT has advantages over the expansion of the retail sales tax base to include services as a way to ensure that service industries contribute to the cost of government services. First, a

gross receipts tax is initially a tax on businesses. While a significant portion of the tax may be passed on to consumers, some of the tax will be absorbed by the business through reduced profits and paid by business owners who tend to have higher incomes than the average consumer. In addition, GRT rates are considerably lower than retail sales tax rates because the broader base includes many more types of service industries than could typically be included under a sales tax. Moreover, the GRT falls on all sales of services. By contrast, no state in recent years has expanded its sales tax to more than a relatively limited selected group of services. The GRT has the advantage of treating all services equally.

- **Eliminating tax loopholes.** A GRT would allow the state to make a fresh start in taxing businesses without losing revenue from the exemptions and credits that have proliferated over time in the corporate income tax and the sales tax. A GRT has a very broad base that covers both goods-producing and service-producing businesses of all types. As a result, it is not subject to some major corporate income tax avoidance mechanisms, such as methods of organization in non-corporate form. The experience of other states such as Washington suggests, however, that Illinois will have to be careful not to add exemptions and credits to the GRT in the future in response to pressure from specific industries. It would be important to retain this advantage.

Concerns With A Gross Receipts Tax

This section outlines the major concerns that have been raised about GRTs. The next section explains how these concerns can be addressed.

The first concern relates to high-volume, low-margin businesses. The GRT does not distinguish among businesses based on how profitable they are. Businesses with a high volume of sales but a low profit margin (such as gas stations or discount clothing stores) are taxed at the same rate as highly profitable companies such as jewelry stores, or boutique clothing shops, even though they may be less able than those latter companies to pay the tax.[2] For example, a discount clothing store might sell items at just 1 or 2 percent above the price it paid a wholesaler for them; a GRT of even 0.5 percent or 1 percent would reduce the store's net income substantially and could affect its ability to make a reasonable profit.

Another concern is "pyramiding," or the taxation of inputs as well as final products. The GRT is levied each time a product or service is sold — whether the sale is of a finished product to the end consumer or of an input to a firm that will use it to create the final product. As a result, the total amount of GRT paid on a final product may be significantly higher than the GRT rate levied on the final product's sale may suggest, because each of the raw materials or services "consumed" in the creation of the final product would have been taxed when it was purchased. For example, the steel and tires used to produce a car, as well as any outside legal, accounting, or other services involved in the car's production, would be taxed as they are sold to the automaker and the automaker may pass along this cost in the price of the final product.[3]

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[2] Other types of businesses could have difficulty paying the tax in years of low profitability.

[3] The lower the rate of the tax the less likely it is that companies would make decisions about their organization as a result of pyramiding of tax rates. Thus, lowering the rate of the GRT could also mitigate some of these problems. This would, in turn, lower the revenue that the tax raised, requiring reduced spending or the need to raise additional taxes.

Is the GRT a "Hidden" Tax and Is This a Problem?

A number of critics of the Governor's proposal argue that a Gross Receipts Tax will reduce the accountability and transparency of Illinois' tax system and could result in poor policy choices in the future.

The GRT is a tax on businesses rather than on individuals. Like other business taxes it will be passed on to individuals — either to owners of capital through reduced profits, to consumers through higher prices or to workers through lower wages. Most economists agree that a considerable portion of a GRT will be passed on to consumers like a retail sales tax but, unlike a sales tax, the amount of the tax will not be shown on the bill a customer receives.

Some argue that this will make it easier for future governors to raise the GRT rate without having a full discussion of the impact of the higher tax. In reality, history shows that any proposals to raise business taxes — all of which are paid only indirectly by individuals — are subject to considerable debate by the legislature and receive scrutiny in the media. Businesses and their trade organizations are well positioned to take note when changes to business taxes are proposed and are unlikely to let them slip through without adequate debate.

In one sense it is very appropriate that the GRT be reflected in the price of the products sold. The GRT should reflect the cost to a business of the government services that allow it to operate in Illinois just as other business inputs such as materials, compensation and privately provided services are reflected in the price of their product.

A gross receipts tax is not the only tax levied on businesses that is not seen on bills to consumers. Businesses also pay property taxes which are reflected in the cost of doing business and potentially in the price of products. One of the proposed uses of the GRT in Illinois would be to reduce property taxes – both directly through targeted credits and indirectly by providing additional state aid for schools. In total, the impact of the GRT on consumers will likely be considerably less than the total amount of revenue raised, when the reduction in this other "hidden" tax is accounted for as well as the likelihood that businesses will not pass along the full amount of the GRT.

Pyramiding can cause economic distortions by creating incentives for businesses to act in inefficient ways. For example, some larger companies may have a choice between buying their inputs from other firms or making the inputs themselves; if they buy the inputs, the purchases are subject to the GRT, but if they make the inputs themselves, the purchases are not. Thus, the GRT may push companies to "vertically integrate" — that is, to bring services and production of inputs into the company rather than buying them from outside firms — in order to avoid the tax, whether or not this would otherwise be the most efficient way to make the final product. (How much of a push towards vertical integration the GRT provides would likely depend on the GRT rate and the number of times inputs are turning over.) In addition, companies that can vertically integrate would have a price advantage — and thus a competitive advantage — over companies that cannot. Pyramiding also can magnify the problems of a GRT for high-volume, low-margin businesses if it results in increased prices for purchases from wholesalers.

The potential economic distortions caused depend on the amount of pyramiding that occurs. Studies of the Washington state Business and Occupation tax and the New Mexico GRT show a not

insubstantial amount of taxation of business inputs.[4] New Mexico estimates that 15 percent to 30 percent of GRT revenues result from taxation of business-to-business transactions.

Another potential problem with pyramiding may occur for businesses that sell products out of state. A GRT could put Illinois businesses at a disadvantage when selling products out of state because they would be competing with businesses than do not have to pay the GRT. The tax proposed by Governor Blagojevich would moderate this problem by exempting the revenue from final sales that are exported out of the state. However, these exported items might still have some tax costs embedded in them if, for example, the raw materials used to make them were purchased in the state.

Concerns have also been raised about a GRT's effect on individuals. A considerable portion of a GRT would likely be passed along to the buyers of the taxed firm's products through higher prices. As a result, a GRT is similar to a sales tax from the perspective of individuals. Like the sales tax, a GRT is regressive: lower-income people will pay a larger share of their income in GRT-related costs than high-income people, on average, because low-income families spend rather than save a larger share of their income. In addition, lower-income people are more likely to spend their money close to home, where the goods and services are subject to the GRT.

The governor partially addressed this concern by exempting retail sales of food and drugs — two necessities that make up a significant share of family expenses — from the GRT. However, sales of these items from a manufacturer to a retailer would be subject to the tax, and much of this tax would likely be passed along to consumers.

Finally, some are concerned that the GRT may reduce the transparency and accountability of the tax system by creating a "hidden tax." To the extent that a significant portion of the GRT is paid by consumers of finished products through higher prices, the GRT would be largely invisible to the purchaser of the end product — unlike the sales tax which is shown on a sales receipt. As a result there is concern that the rate of the Gross Receipts Tax would not be subject to full consideration and debate by the public. (See the box on page 6 for further discussion of this issue.)

Modifications to the GRT Can Address These Concerns

As noted above, the governor's proposal addresses several of the concerns traditionally raised about GRTs. It would help firms that sell products out of state by exempting from the GRT the revenue from those out-of-state final sales. It would help lower-income people by exempting retail food and drug sales from the GRT. And it would help start-up businesses that are not yet profitable, as well as "mom and pop" businesses with low profitability, by exempting firms with less than $2 million in receipts from the tax.

Nevertheless, Illinois could do much more to mitigate the potential problems with a GRT — as other states with GRT-type taxes, such as Texas and Kentucky, have done.

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[4] The base of the Washington State B & O tax — total receipts reported to the state's Department of Revenue — significantly exceed Washington's total gross state product. This is the result of the taxation of goods at more than one stage of the production process. An analysis for the Washington State Tax Structure Committee estimated an average pyramiding rate of 2.5.

PROVISIONS OF STATE GROSS RECEIPTS-TYPE TAXES					
State	**Items Taxed**	**Rate**	**Size of Business**	**Food and/or medicine exempt?**	**Exports exempt?**
Illinois proposed	Receipts of all non-exempt businesses	1.95% for Service producing businesses 0.85% for Goods-producing businesses	Businesses with less than $2,000,000 in receipts are exempt	Yes, retail sales of food and medicine	Yes
Delaware	Gross receipts of all non-exempt businesses	Selected rates: Manufacturers: 0.180% Wholesalers: 0.307% Retailers: 0.576% Food processors: 0.154% Occupational/Professional/General Services: 0.384% Additional rates for specific industries	Retailers and wholesalers can deduct $80,000 per month. Manufacturers can deduct $1 million per month.	No	In most cases.
Kentucky	Tax is an alternative minimum calculation coupled with the corporate income tax. Corporations can choose one of two bases: gross receipts or gross profits (gross receipts minus cost of goods sold.)	The lesser of: 0.095% of gross receipts or 0.750% of gross profits (gross receipts minus costs of goods sold)	Businesses with both gross receipts and gross profits of less than $3,000,000 are exempt.	No	No
Ohio	Receipts from commercial activity of non-exempt businesses	0.26%	Businesses with receipts under $150,000 are exempt; those with receipts between $150,000 and $1,000,000 pay $150	No	Yes
Texas	The lower of: 70% of revenue; revenue minus cost of goods sold; or revenue minus compensation cost	0.5% of sales of retailers and wholesalers 1% of sales for all other businesses	Businesses with gross receipts under $300,000 are exempt (may rise to $600,000)	No	Yes
Washington	Gross receipts as measured by gross sales, gross income or value of products produced in state	Retailing: 0.471% Wholesaling: 0.484% Manufacturing: 0.484% Services: 1.5%	Businesses with gross income of less than $28,000 are exempt	No	No

Note: This table does not include state taxes that are called gross receipts taxes but that function as retail sales taxes such as those in New Mexico and Hawaii. In addition to the taxes listed, Illinois, Delaware and Kentucky have corporate income taxes while Ohio and Washington do not. The Texas tax described here will replace the state's corporate franchise tax which includes a tax on corporate profits.

- **Ensure fair treatment for high-volume, low-margin businesses.** Illinois could significantly reduce the impact of the GRT on high-volume, low-margin businesses if it allowed businesses to subtract the cost of purchased inputs from the total receipts subject to the GRT. Allowing businesses to subtract the cost of purchased inputs would help high-volume, low-margin businesses, which would be able to subtract the amount they paid for their inventory from the amount of their final sales and pay GRT only on the difference.[5] Thus, businesses with different profit margins would be treated more fairly under the GRT. Texas and Kentucky allow a similar but somewhat broader deduction by allowing businesses to subtract the "cost of goods sold," — which means the cost to the company of the inputs used to make the final product — from the base of their GRT.[6]

- **Eliminate most pyramiding.** Allowing businesses to subtract the "cost of purchased inputs" also significantly reduces the problem of pyramiding. For example, if an automaker buys $10,000 worth of parts from another company to make a car that it sells for $25,000, its total receipts from the car sale for GRT purposes would be $15,000 ($25,000 in sales minus the $10,000 paid for parts). The GRT would not be paid twice on those parts.

- **Retain a corporate income tax to ensure that all businesses pay their fair share.** Some states, seeking both to ensure that businesses benefiting from state government pay their fair share of taxes and to continue tying business taxes to ability to pay, have retained their corporate income tax even while enacting a GRT-type tax. In Kentucky's case, the amount of GRT owed can be credited against the amount of corporate income tax owed, so businesses pay the larger of the two. Delaware levies both a GRT and a corporate income tax but does not link the two. New Hampshire, levies a value-added tax that shares characteristics with a gross receipts tax, which it also allows as a credit against its corporate income tax.[7]

  Illinois could choose to retain its corporate income tax and allow the GRT as a credit against it. This would insure that all types of businesses — including those with relatively low receipts but high profits — pay a fair share. This would be particularly effective if Illinois took the opportunity to repair some flaws in the corporate income tax. (See below.)

- **Protecting lower-income and moderate people.** The regressive impact of the GRT could be mitigated through the expansion or creation of tax credits targeted on low and moderate income families. An efficient way to offset the GRT's impact on low-wage working families would be to significantly expand the state's earned income tax credit (EITC). The Illinois EITC equals just 5 percent of the federal EITC. Only one other state with an EITC has a rate this low. Even absent a new GRT, there are many reasons to expand the current EITC. The GRT

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[5] Texas also allows businesses to subtract either the costs of the inputs purchased for production or the total amount spent on worker compensation; of course a rational business will choose to deduct whichever is greater.

[6] By "cost of purchased inputs" we mean the amount that one company pays to another company for goods and materials that are either purchased for resale or are used in the production process. It differs from "cost of goods sold", which also includes the labor and other costs required to produce a final product or prepare an item for resale.

[7] A value-added tax eliminates the problems of pyramiding by taxing only the incremental value added by businesses at each step of the production and wholesaling process. New Hampshire is the only state with a value-added tax. Most economists consider value-added taxes superior to gross receipts taxes in terms of their impacts on the economic decisions of businesses. However, VATs have proven politically unpopular in the United States. The only other state with a VAT — Michigan — has just repealed the tax, and attempts to institute VATs in other states have failed.

would make a major expansion even more important, since food and medicine would be taxed under the GRT at levels before the final sale. Additional tax relief could be targeted to low- and moderate-income families that do not qualify for the EITC.

Raising Sufficient Revenue

Exempting inputs from the GRT base would raise somewhat less revenue than the governor's proposed GRT. While a precise estimate of the reduction in revenue that would result from these types of changes is beyond the scope of this paper, examination of data on business-to-business sales and the experience of other states suggests that allowing the exemption of cost of goods sold would reduce revenues from the proposed GRT by 30 to 40 percent. Thus rather than raising $7.6 billion when fully phased in, the GRT would raise approximately $4.6 to $5.3 billion.

Some of the difference could be made up by raising the GRT rate, although GRTs generally work best when the rate is fairly low. As a result, achieving the goals in education, health, and property tax relief that the governor and the legislature are discussing would likely require additional revenue increases. These increases could be designed to fall on a wider range of residents than a GRT alone.

One option would be raising the income tax rate. Depending on the amount garnered from the GRT and other sources, the income tax rate increase could be relatively modest. A one percentage point increase in Illinois' personal income tax rate would raise approximately $3 billion.

Retaining the corporate income tax as described above — with businesses paying the larger of the GRT or the corporate income tax — could also bolster GRT revenues. The corporate income tax could be improved at the same time in order to make it a better candidate for retention with a modified GRT. For example, a return to a three-factor apportionment formula (sales, property, and employment) would spread the tax more broadly. In addition, the definition of businesses subject to the corporate income tax could be expanded to include Subchapter S corporations and some limited liability companies. Or, Illinois could require that taxes be withheld before profits are distributed to out-of-state owners or that these owners sign a statement acknowledging that they owe and will pay taxes to Illinois on these profits. These changes are described more fully in the Appendix to this paper.

Conclusion

Governor Blagojevich's GRT proposal is a constructive step toward making Illinois' tax system stronger and fairer while providing resources needed to help address state priorities. While concerns have been raised about the possible effects of a GRT, the most serious of these could be addressed by a few modifications to the governor's proposal.

Appendix: Some Options for Improving the Illinois Corporate Income Tax

(1) Eliminate the single sales factor formula and return to a three-factor apportionment. When a corporation produces and/or sells goods and services in more than one state, each state requires the business to pay tax on just a portion of its profit. The tax laws of the large majority of states determine the portion of the corporation's profit that is subject to tax in relation to the shares of the corporation's total property, payroll, and sales located in each state.

Under New Jersey law, for example, a widget manufacturer that had its only factory and all of its employees in Trenton but sold all of the widgets outside the state would have one-half of its total, nationwide profit taxed in New Jersey. (Like many states, New Jersey gives the same weight to the location of sales as it does to the location of property and payroll combined.) The remaining half of the corporation's profit could be subjected to tax by the states in which its products are sold. This result reflects a broad consensus that states that provide services to a corporation's property and workers and states that provide a market for the corporation's output should be empowered to tax roughly equal shares of the corporation's profit.

Illinois, on the other hand, has apportioned the income of multi-state corporations based only on the amount of sales they have in Illinois since 1998. This approach is called a single sales factor formula. Returning to a three-factor apportionment formula would raise additional revenue and ensure that multi-state corporations pay their fair share of corporate income taxes.

(2) Expand the definition of businesses subject to the corporate income tax to include Subchapter S corporations and some limited liability companies. Or, Illinois could improve personal income tax collections from out-of-state owners by requiring that taxes be withheld before profits are distributed to out-of-state owners or that these owners sign a statement acknowledging that they owe and will pay taxes to Illinois on these profits.

(3) Modify the statutory definition of the unitary group to include unregulated investment subsidiaries and captive insurance companies. Illinois is in litigation with Exxon and Waste Management right now over whether their captive insurance companies can be combined. In addition, the fact that Illinois' corporate income tax statute doesn't allow financial institutions to be combined with non-financial entities has been a recurring problem, with corporations setting up out-of-state investment affiliates and isolating income and assets in them as well in order to reduce taxes owed to Illinois.

(4) Switch to the so-called "Finnigan" approach to unitary combined reporting (named for a California court case in which the issue was first raised). This issue arises when on or more members of a multicorporate group are subject to the Illinois corporate income tax ("have nexus") and other members of the same group do not. Under this approach, any sales into the state by out-of-state corporations that don't have corporate income tax nexus in Illinois are deemed to be sales made by the parent or sister corporations that *are* taxable in Illinois. This change is particularly important if Illinois retains the single sales factor formula.

APPENDIX KK

"Ohio's Tax Reform and the Commercial Activity Tax"
(presented by Thomas M. Zaino to Subcommittee on Alternatives to the Corporate Excise on August 20, 2007)

Ohio's Tax Reform and the Commercial Activity Tax

Before: Subcommittee on Alternative Tax Structures

Commonwealth of Massachusetts
Study Commission on Corporate Taxation
Boston, Massachusetts
August 30, 2007

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Agenda

- Background on Ohio and its Tax Reform Efforts
- Ohio's 2005 Tax Reform
- Overview of the Commercial Activity Tax (CAT)
- Final Observations
- Questions & Answers

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Background on Ohio

Ohio . . . an Economic Powerhouse

	1964
Personal Income Tax Rate (HMR)	Zero
Corporate Income Tax Rate (HMR)	Zero
Sales Tax Rate (State Only)	3%
Tangible Personal Property Listing %	50%-70%
Number of Cities with an Income Tax	~130

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Ohio . . . 40 Years Later

	1964	2004
Personal Income Tax Rate (HMR)	Zero	7.5%
Corporate Income Tax Rate (HMR)	Zero	8.9%
Sales Tax Rate (State Only)	3%	6%
Tangible Personal Property Listing %	50%-70%	25%
Number of Cities with an Income Tax	~130	~540

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Declining Economic Performance

- From 1990 – 2001, Ohio ranked 9th lowest among states in the rate of growth of the overall economy
  - 20% below average for all states
- Growth in manufacturing (nearly 25% of Ohio's economy) was 40% U.S. average
- Job growth was 20% below national average

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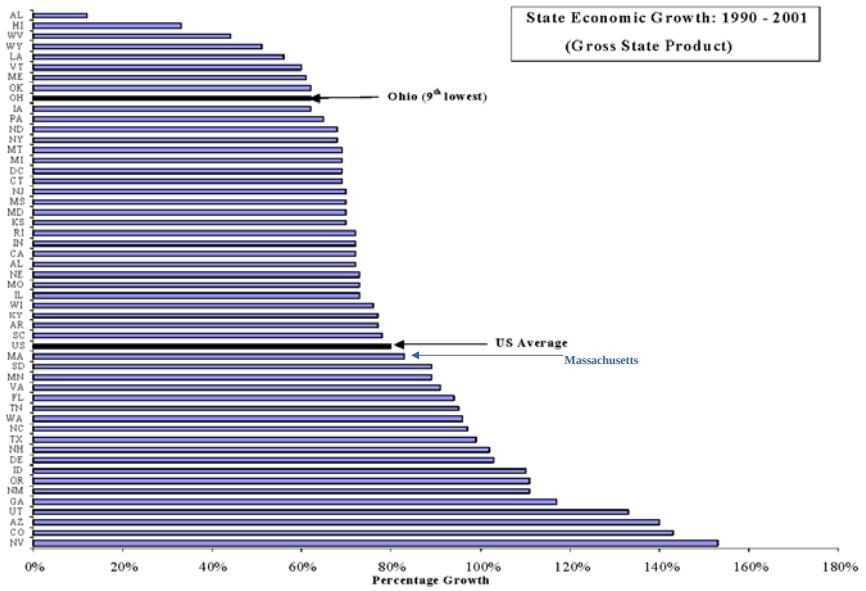

Source: Ohio Business Roundtable

How Did We Get from 1964 to Today?

Many aspects of the current system were derived by "Tax Studies"

- Examples:
  - Personal Income Tax
  - Corporate Income Tax
  - Estate Tax

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Ohio Tax Reform

1. Committee to Study State and Local Taxes (2002-2003)
2. *Ohio Business Roundtable* Study & Proposal (2004-2005)
3. Governor Bob Taft's Tax Reform Proposal (2005)

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40 Years Later . . . Plus 6

	1964	2004	2010
Personal Income Tax Rate (HMR)	Zero	7.5%	5.925%
Corporate Income Tax Rate (HMR)	Zero	8.5%	Zero
Sales Tax Rate (State Only)	3%	6%	5.5%
Tangible Personal Property Listing %	50%-70%	25%	0%
Number of Cities with an Income Tax	~130	~540	~540

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Six ways Ohio will *grow* – by 2010

1. Gross state product will increase by $5.6 billion.
2. Personal income will increase by $3.6 billion.
3. 78,500 new jobs will be created.
4. An additional $6.3 billion in real fixed capital investment will be injected into the economy.
5. $401 million in new state tax revenue will be generated.
6. Ohio will become a more attractive place to live and raise a family – and send a message to investors that Ohio is "open for business."

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Committee to Study State & Local Taxes (2002 – 2003)

- Issued Report & Recommendations March 1, 2003: http://tax.ohio.gov/channels/research/documents/CSSLT%20Final%20Draft.pdf
- Bi-Partisan, Legislative/Executive Branch
  - Three Senators (2R, 1D)
  - Three Representatives (2R, 1D)
  - Three from the Governor Taft's (R) cabinet (Budget, Development & Tax Dept.)

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Guiding Principles of a Quality Tax System

- Simplicity
- Equity
- Stability
- Neutrality
- Competitiveness

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Simplicity

- Tax system should facilitate taxpayer compliance by being easy to understand and easy to administer.
- Simplicity reduces a taxpayer's costs of compliance, thereby effectively reducing a taxpayer's overall tax costs.
- Simplicity also reduces the state's cost of administering the tax.

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Equity

- Horizontal Equity – Imposes similar burdens on similarly situated taxpayers.
- Vertical Equity – Recognizes differing abilities among taxpayers to afford and pay taxes.

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Stability

The tax system exists to fund essential government services and should provide adequate revenue to fund those services in both good and bad economic times.

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Neutrality

The tax system should not unduly influence economic behavior. The economy and the marketplace, not the government's tax policy, should drive business decisions.

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Competitiveness

The tax system is a meaningful part of a state's living, working, and business environment. It should not impose an excess burden on taxpayers, particularly as compared to the tax systems of other states and, more and more, as compared to other parts of the world.

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Hurdles to a Quality Tax System

- Corporation Franchise Tax
  - Anti-competitive, not stable, and low equity
- Tangible Personal Property Tax
  - Very stable, but very anti-competitive when compared with other states
  - Incentives hurt equity

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Hurdles to a Quality Tax System

- Personal Income Tax
  - Anti-competitive with a very high marginal rate of 7.5%, especially with 2% city rate and .75% school district income tax
  - Not simple or stable
  - Equity - mixed
  - Not neutral – snow-birds
- Municipal Income Tax
  - Not simple – no uniformity with over 540 jurisdictions
  - Anti-competitive

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Committee to Study State & Local Taxes – Concluding Theme

Broaden the Tax Base

and

Lower the Tax Rate

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2003 Budget Bill - Minor Tax Reform

- Of the 39 recommendations, 23 were enacted in some form, primarily to raise revenue, not true reform
  - Except municipal reforms
- Example: Did not adopt combined reporting for Corporation Franchise Tax
  - Viewed negatively by Ohio business
  - Would add to Ohio's "anti-business" environment
  - Unclear revenue impact
  - Not simple

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Ohio Business Roundtable (2004-2005)

- CEO-driven business organization, representing Ohio's largest companies
  - Tax reform was the #1 issue for 80 of Ohio's largest companies
- Project team included tax professionals from around Ohio and from member companies
- Developed economic models to evaluate tax changes and impact on the economy
  - Retained: Ernst & Young, LLP

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Key Tool – Economic Models

- Ernst & Young developed economic models capable of:
  - Weighing the revenue impact of tax policy changes
    - ODT capability
  - Weighing the economic impact of tax policy changes
    - Dynamic feedback

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OBRT & Ohio Political Leaders

- OBRT shared results of its study and its plan with Governor Taft and other Ohio political leaders.
- Governor Taft substantially adopted OBRT's tax plan.
- House and Senate improved the proposal.

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2005 Budget Bill – True Reform

- Commercial Activity Tax Phased-In
  - Over 5 Years
- Tangible Personal Property Tax Elimination
  - Over 3 Years
- Corporation Franchise Tax Elimination
  - Over 5 Years
- 21% Personal Income Tax Cut
  - Over 5 Years

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Business View

- Many businesses supported Governor Taft's tax reform package
  - Generally larger businesses with large Ohio base of operations or corporate headquarters
  - Generally businesses paying lots of corporation franchise tax and tangible personal property tax

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Business View

- Many businesses did not initially support the Governor's tax reform package
  - Some very large businesses with non-Ohio headquarters
    - Less CFT and TPP tax
    - Little PIT benefit
  - High-volume, low margin businesses
    - Market driven companies

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Business View

- Some reasons why some companies changed their minds
  - Added furniture and fixtures to phase-out
  - Retained the exemption for molds, jigs, dies and patterns
  - Accelerated phase-out of TPP
  - The CAT rate stayed low
  - Macro CAT cap put in place

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Commercial Activity Tax

Commercial Activity Tax

- Effective July 1, 2005
- A tax on the privilege of doing business in Ohio measured by gross receipts arising in Ohio
  - Phased-in over 5 years

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CAT Calculation

"Taxable Gross Receipts"
X 0.0026
Full CAT
X Phase-in Percentage
Phased-In CAT
- CAT Credits
CAT Due*

* Must add $150 Minimum Tax.

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Automatic Rate Adjustment

- Three possible automatic rate adjustments are built into the statute, triggered by revenue levels generated during pre-set time periods.
  - If >110% of targeted revenues
    - Rate decreases
    - Excess tax is refunded to all taxpayers

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Tax Rates

- 0.0026 x Taxable Gross Receipts
- Phase in of tax rate:
  - July 1, 2005 – March 31, 2006: 23%
  - April 1, 2006 – March 31, 2007: 40%
  - April 1, 2007 – March 31, 2008: 60%
  - April 1, 2008 – March 31, 2009: 80%
  - On or after April 1, 2010: 100%

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Rate Comparisons

State GRT Tax	Rate
Ohio (CAT - 2010)	.0026
New Hampshire (BET)	.0075
Texas (GRT portion)	.005 or .01
Michigan (GRT portion)	.00125
Illinois (Proposed GRT)	.005 or .018

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CAT Credits

1. Job Retention Credit (2008)
2. Job Creation Credit (2008)
3. Qualified Research Expense Credit (2008)
4. Borrower's Qualified R&D Loan Credit (2008)
5. Transitional Credit (2010)
6. Excess CAT Credit (perhaps in 2008, 2010 and 2012)

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Who is a Taxpayer?

Entities Subject to CAT

- Individuals
- Corporations
- S Corporations
- QSSS
- Partnerships
- LLCs and LLPs
- Firms
- Companies
- Estates
- Trusts
- Disregarded Entities
- Joint ventures
- Associations
- Societies
- Clubs

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Government Entities Are Not Subject to CAT

- The state
- State agencies
- State instrumentalities
- State political subdivisions

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Some Entities Not Subject to CAT

- Any person with $150,000 or less of taxable gross receipts.
- Certain public utilities
- Banks, other financial institutions, and their affiliates
- Domestic or foreign insurance companies.
- Nonprofit organizations

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Related Party Gross Receipts

- May exclude taxable gross receipts between related parties if make a special election.
- However, must waive any CAT nexus protection for all affiliates.

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Which Gross Receipts are Subject to CAT?

Gross Receipts Defined

- The total amount realized by a person that contributes to the production of gross income of the person.
- No deduction for cost of goods sold or other expenses.
- Includes:
  - FMV of any property or services received.
  - Debt transferred or forgiven as consideration.

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Some Exclusions from Gross Receipts

- Interest, except on credit sales.
- Dividends.
- Distributive shares of PTE income.
- Amounts received from sale, exchange or disposition of section 1221 or 1231 property.

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Some Exclusions from Gross Receipts

- Wages.
- Proceeds from sale of own stock.
- Gifts or membership dues.
- Property, money or other amounts received or acquired by an agent on behalf of another in excess of commission or fee retained by the agent.

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Four Deductions from Gross Receipts

1. Cash discounts allowed and taken.
2. Returns and allowances.
3. Bad debts.
4. Amount realized from sale of account receivables in limited circumstances.

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Taxable Gross Receipts

- "Taxable Gross Receipts" includes gross receipts sitused to Ohio.
- General Rule: Gross receipts earned from Ohio customers or related to Ohio.

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Problems with the CAT

"Bright-Line Nexus"

- $50,000 of property in Ohio
- $50,000 of payroll in Ohio
- $500,000 of taxable gross receipts in Ohio
- Has at least 25% of its total property, payroll and sales in Ohio
- Is domiciled in Ohio

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FAS 109 Adjustment – GAAP Earnings Reduction

- CAT is measured by gross receipts, not income.
  - Therefore, not treated as a FAS 109 tax.
- Accounting firms required any deferred income tax benefits or liabilities booked under FAS 109 for the legacy income tax to be adjusted all at once.
  - i.e., calendar year public companies had to report less book earnings for the second calendar quarter of 2005.

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Pass-Through Entities

- CAT is imposed on all entities, including pass-through entities.
  - Arguably, this places all business entities on a level playing field
- However, pass-through entities remain subject to personal income tax, while C corporations are not
  - Hurts "horizontal equity"

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Final Observations

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CAT Advantages

- Stability: Less Impact from Economic Fluctuations – High and Low
- Simplicity: More Simple – Reduces Compliance and Enforcement Costs
- Neutrality: Places All Business Entities on Level Playing Field
- Competitiveness: Exports Tax Burden – Relative to Property and Corporation Franchise/Income Tax

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CAT Problems

- Vertical Equity: Low-Margin Businesses – Heavier Burden
- Horizontal Equity: Pass-Through Entities – Double Taxed
- Neutrality: Pyramiding of Tax Could Drive Certain Behavior
- Competitiveness: FAS 109 Issues – Negative Book Earnings Impact
- Competitiveness: Nexus Position – Likely Unconstitutional

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Conclusion

- Ohio did "Economic Reform"
  - Not "Tax Reform"
- Ohio's Reform Resulted in a Tax Cut for most businesses and Ohioans
- CAT has Serious Issues, Offset in Ohio by:
  - Elimination of Tangible Property Tax and the Corporation Franchise Tax
  - Very Low Rate

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Senate-Passed Version of Ohio Reform (in millions)

	FY2006	FY2007	FY2008	FY2009	FY2010
Corporation Franchise Tax	($142.0)	($292.0)	($450.0)	($616.0)	($790.0)
Property Tax	$104.0	($153.0)	($500.0)	($848.0)	($1,146.0)
Personal Income Tax	($306.0)	($621.6)	($1,029.6)	($1,471.6)	($1,964.6)
CAT	$256.3	$539.9	$849	$1,079.6	$1,437.2
Sales Tax	$719.0	$751.5	$781.5	$813.0	$845.5
Excise Tax	$523.0	$445.0	$438.0	$429.0	$420.0
Other	$160.0	$156.0	$158.0	$160.0	$162.0
Total (vs. Current Law*)	$1,314.3	$825.8	$246.9	($454.0)	($1,035.9)

*Current law assumes 5% growth in spending after FY2006.

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Questions & Answers

APPENDIX LL

"The New Texas Margin Tax:
Overview, Pitfalls and Opportunities – Including 2007 Legislative Changes"
(by Ira Lipstet, dated August 21, 2007)

Texas Society of Certified Public Accountants
Fort Worth Chapter

Waco, Texas
August 21, 2007

THE NEW TEXAS MARGIN TAX
OVERVIEW, PITFALLS AND OPPORTUNITIES
INCLUDING 2007 LEGISLATIVE CHANGES

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TABLE OF CONTENTS

Page

BACKGROUND 1

THE FRANCHISE TAX IS CHANGED IN 2006 AND ALSO IN 2007 - OVERVIEW 1

HB 3928 MODIFIES HB 3 1

TAX COMPUTATION 3

Regular Margin Tax Computation 3

Computation of Taxable Margin 3

E-Z Tax Computation and Rate 4

Additional Tax Considerations 5

RETAILERS AND WHOLESALERS 5

TAXABLE ENTITIES 6

Small Business Exemption 9

Passive Entities 10

Active Trade or Business 12

Limitation on “Geoffrey” Structures 12

Separate Reporting Required – With Major Exception 13

REVENUE 13

Corporations 14

Partnerships 15

Entities Other than Corporations or Partnerships Subject to the Margin Tax 17

Revenue from Passive Entities 17

Other Adjustments to Revenue - Special Industry Provisions 18

Comptroller Rules will Interpret Revenue Provisions 21

Consistency Requirements – Revenue Exclusion and Corresponding Deduction Treatment 21

COST OF GOODS SOLD 21

Ownership Requirements for COGS Expense Deduction 22

Federal Government Contract Exception 22

Direct Costs 23

Indirect Costs 23

Exclusion from COGS 24

COMPENSATION 27

APPORTIONMENT 29

Sourcing Rules under HB 3 31

COMBINED REPORTING 32

UNITARY BUSINESS CONSIDERATIONS 33

Joyce v. Finnigan Approach – Treatment of Revenues for Entities Lacking Texas Nexus 34

Deduction on Combined Group Basis 34

Unitary Cases 37

TIERED PARTNERSHIP ARRANGEMENT REPORTING 37

TEMPORARY CREDIT, NET OPERATING LOSSES AND OTHER CREDITS AND DEDUCTIONS 40

EFFECTIVE DATES AND TRANSITION ISSUES 42

TRANSITIONAL RULE FOR ENTITIES NOT PREVIOUSLY SUBJECT TO FRANCHISE TAX 43

BACKGROUND

For almost 100 years, the state of Texas has imposed a franchise tax on certain business entities for the privilege of doing business in Texas.[1] Prior to changes made in 2006, the current version of the tax has, in essence, been levied upon the greater of the tax resulting from a base measured by apportioned taxable capital (at a rate of ¼ of 1%) or earned surplus (at a rate of 4.5%).[2] Taxable capital is a balance sheet, net worth measure,[3] and earned surplus is based upon modified federal taxable income.[4] Appended as Attachment A is an additional summary description of the franchise tax in place prior to the changes made in 2006 and 2007.

THE FRANCHISE TAX IS CHANGED IN 2006 AND ALSO IN 2007 - OVERVIEW

After numerous, repeated, failed attempts over a period of more than ten years, the Texas Legislature enacted extensive and significant changes to the franchise tax in May, 2006 by way of legislation frequently referred to as "HB 3"[5]. Subject to a number of exceptions, the effective date of HB 3 is for reports first due on or after January 1, 2008.[6] Because the Texas franchise tax (including the changes made resulting in the regime now frequently being referred to as the "margin tax") is based upon results of operations occurring in the calendar year prior to the year in which the report is due,[7] results of operation in 2006 (for some fiscal year taxpayers) and 2007 (for all taxpayers) affect margin tax computations, notwithstanding the general January 1, 2008 effective date.

HB 3928 MODIFIES HB 3

Shortly after passage of HB 3, it was apparent that there were numerous uncertainties, ambiguities and inconsistencies that were included in the new margin tax regime provisions. In order to address those issues (as well as a limited number of other matters), the 80th session of the Texas Legislature passed HB 3928 in June, 2007 (hereafter referred to as "HB 3928").[8] HB 3928 made numerous changes to the provisions of HB 3, even though the general effective date for HB 3 (January 1, 2008) had not yet occurred. Like HB 3, unless specifically provided to the contrary, HB 3928 is effective on January 1, 2008, and applies only to reports originally due on or after the effective date.[9]

> **NOTE**: This outline incorporates changes made in HB 3928 to the original HB 3 provisions. Unless pertinent to the discussion, original HB 3 provisions subsequently modified by HB 3928 will not be specifically addressed.

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[1] *See* Texas Tax Code § 171.001 et. seq. (Unless otherwise notes, references are to the Tax Code after changes made in 2006.)
[2] Texas Tax Code § 171.002 (in effect prior to 1/1/08).
[3] Texas Tax Code § 171.101.
[4] Texas Tax Code § 171.110.
[5] HB 3, 79th Leg., 3d Spec. Sess., §§ 2-26 (2006); also cited as Acts 2006, 79th Leg., 3rd L.S., Ch. 1 (hereafter cited as "HB 3").
[6] HB 3, § 26.
[7] Texas Tax Code § 171.1532.
[8] HB 3928, 80th Leg., Reg. Session. §§ 1-41 (hereafter cited as "HB 3928")
[9] HB 3928, §§ 38-40.

The new version of the franchise tax is also referred to as the "margin tax" because it changes the base of taxation from taxable capital or taxable earned surplus to a new concept of "taxable margin".[10] The margin tax is, in essence, a modified gross receipts tax, with some deductions allowed.

OBSERVATION: Questions have been raised as to whether the margin tax should properly be considered an income tax. The answer likely depends upon for what purpose the question is being asked. The Texas legislature has included a provision in HB 3[11] stating that the margin tax is not an income tax, and PL 86-272 does not apply to the tax. When contested, however, the question of PL 86-272 applicability based upon characterization of the tax is typically within the purview of the courts, rather than a legislative body. In addition, the Financial Accounting Standards Board (FASB) has apparently concluded that the margin tax is, for purposes of FASB Statement No. 109 (Accounting for Income Taxes) and financial accounting reporting purposes, an income tax.[12] The characterization of the nature of the margin tax can be important for both financial accounting and tax purposes.

Taxable margin is computed by determining the lesser of either 1) 70% of gross revenue, or 2) the total receipts from its entire business minus (at the election of the taxable entity) the greater of cost of goods sold or compensation.[13] The tax base is then apportioned using the single factor of gross receipts[14] and a tax rate of either 1/2 of 1% (for retailers and wholesalers) or 1% (for all other businesses) is applied to determine tax due before allowable deductions and credits.[15] Any future increase in the margin tax rate must be approved by a majority of registered voters in a statewide referendum.[16]

An alternative computation for determination of margin tax liability was added by HB 3928 provisions. The alternative (referred to as the "E-Z Computation") is applicable only to taxable entities where annual tax revenue from its entire business is not more than $10 million (annually).[17] The E-Z Computation imposes tax at a rate of 0.575% of total revenues from the entity's entire business, and does not permit any offsets of deductions or credits.[18]

In addition to the way the tax is computed, the margin tax is applicable to many more types of entities than was the prior franchise tax, including many partnerships.[19] In a significant change from the past franchise tax regime, combined reporting of affiliated entities will be

[10] Texas Tax Code § 171.101.
[11] HB 3, § 21.
[12] FASB Board Meeting, August 2, 2006. *See* www.fasb.org for materials related to the topic.
[13] Texas Tax Code § 171.101(a).
[14] Texas Tax Code §§ 171.101(a); 171.106.
[15] Texas Tax Code § 171.002(a), (b).
[16] Texas Tax Code § 171.003.
[17] Texas Tax Code § 171.1016.
[18] Texas Tax Code § 171.1016(b)(3); (c).
[19] Texas Tax Code § 171.0002.

required in certain circumstances.[20] Certain tiered partnership structures may also be taxed as a single entity.[21]

First reports reflecting the new tax will be due on May 15, 2008.[22] Because the franchise margin tax is based upon the results of operations ending in the year preceding the report year, the new tax will have applicability for operations ending during calendar year 2007. Consequently, calendar year taxpayers will be affected starting January 1, 2007.[23] Fiscal year taxpayers with year ends of May 31 or later that have not previously been subject to the margin tax will be affected starting with the beginning of their fiscal year in 2006 starting after June 1, 2006.[24] Additional transitional provision considerations are discussed in more detail in the "Effective Dates and Transitional Issues" section of this outline.

TAX COMPUTATION

Regular Margin Tax Computation

The margin tax is imposed upon each taxable entity that does business in or is organized or chartered in Texas.[25] The regular computation for the margin tax is as follows:

Total Revenue (from Federal Form 1120, 1065 or other applicable Form)	
Minus:	Greatest of:
	Cost of goods sold, compensation or 30% of total revenue
Equals:	Taxable margin before apportionment
Times:	Apportionment factor (single factor of gross receipts)
Equals:	Apportioned margin
Minus:	Allowable deductions
Equals:	Taxable margin
Times:	Tax rate (1% or ½ of 1%)
Minus:	Allowable Credits
Equals:	Tax due on margin

A more detailed version of the tax computation is shown on the Texas Comptroller's website, and is included as Attachment B.

Computation of Taxable Margin

Taxable margin of a taxable entity is computed by :

(1) determining the taxable entity's margin, which is the lesser of:
  (A) 70 percent of the entity's total revenue[26]; or

[20] Texas Tax Code § 171.1014.
[21] Texas Tax Code § 171.1015.
[22] Texas Tax Code §§ 171.202; HB 3 § 22.
[23] HB 3 § 22. See also HB 3928 § 35, modifying HB 3 § 12 transition provisions. A bill containing identical provisions to those formed in HB 3928 § 35 was also passed by the 80th Legislature. See HB 1207.
[24] HB 3 § 22; HB 3928 § 35.
[25] Texas Tax Code § 171.001(a).
[26] *See* Texas Tax Code § 171.1011.

(B) An amount computed by:

(i) determining the taxable entity's total revenue from its entire business[27];

(ii) subtracting, at the election of the taxable entity (on an annual basis), either:

- Cost of Goods Sold[28]; or
- Compensation[29]; and

(iii) subtracting compensation (in addition to that set out at (i) and (ii) above) paid to an individual (as well as the cost of training a replacement for such individual) during the period the individual is serving on active duty as a member of the armed forces of the United States (if a resident of Texas at the time called to active duty).[30]

The taxable margin so determined is then apportioned to Texas based upon the single factor of gross receipts,[31] and allowable deductions subtracted.[32] The applicable tax rate is then applied to taxable margin to determine the tax liability.

E-Z Tax Computation and Rate

Otherwise taxable entities whose total annual revenue from the entire business is not more than $10 million may elect to bypass the regular tax computation imposed under Texas Tax Code § 171.002 in favor of a so-called "E-Z" computation.[33] The E-Z computation is essentially a flat gross receipts tax that does not allow for any offsets – either COGS, compensation or the 30% reduction available under the regular tax computation. Rather, the E-Z computation consists of determining the taxable entity's total revenues from its entire business, apportioning the amount of revenue attributable to Texas (typically using the single factor of gross receipts) to determine apportioned total revenue, and then applying a tax rate of 0.575%.[34] The tradeoff for utilizing the E-Z computation and rate is that a taxable entity making such election may not take any credit, deduction or other unauthorized adjustment.[35] The discounted tax rates and $300,000 revenue exclusion still apply to the E-Z computation.[36]

COMMENT: Taxpayers that fit under the $10 million annual revenue cap may conclude that paying a (possibly) slightly higher tax rate of 0.575% (versus a potentially lower rate to the extent the compensation or COGS deduction would have exceeded 0.425%) might be worth the greatly simplified method available under the E-Z tax computation method. For smaller entities (such as service entities) that have neither compensation nor COGS deductions that do not exceed

[27] *See* Texas Tax Code § 171.1011.
[28] *See* Texas Tax Code § 171.1012.
[29] *See* Texas Tax Code § 171.1013.
[30] Texas Tax Code § 171.101(a)
[31] *See* Texas Tax Code § 171.106.
[32] Texas Tax Code § 171.101(a).
[33] Texas Tax Code § 171.1016.
[34] Texas Tax Code § 171.1016(b).
[35] Texas Tax Code § 171.1016(c).
[36] Texas Tax Code § 171.1016(d), (e).

the 30% deduction otherwise allowable, the E-Z computation alternative would most certainly be the beneficial and preferred alternative.

Additional Tax Considerations

As was true under the earned surplus component of the old franchise tax, entities previously subject to the tax that, for whatever reason, are no longer subject to the tax are required to report and (potentially) pay an "additional" tax.[37] The additional tax is equal to the appropriate rate (i.e., either ½ or 1% if subjected to the regular margin tax, or 0.575% if the E-Z rate is applicable) of the taxable entity's taxable margin, computed on the period beginning on the day after the last day for which the tax imposed on taxable margin was computed and ending on the date the taxable entity is no longer subject to the tax levied under Chapter 171.[38] The additional tax imposed and corresponding report are due on the 60th day after the date the taxable entity becomes no longer subject to the margin tax.[39]

RETAILERS AND WHOLESALERS

As noted, those businesses engaged "primarily in the retail or wholesale trade" are subject to tax at only 1/2 of 1% as opposed to a full 1%.[40] (This assumes the taxpayer is not eligible for, and/or has not elected to calculate its tax based upon the "E-Z" computation method.)[41] For purpose of the margin tax, a taxable entity (discussed below) is considered to be engaged primarily in the retail or wholesale trade only if:

(1) the total revenue from its activities in retail or wholesale trade is greater than the total revenue from its activities in trades other than retail or wholesale;[42]

(2) with certain exceptions (total revenue from activities in a retail trade described in Major Group 58 SIC Manual – eating and drinking establishments), less than 50% of the total revenue from activities in retail or wholesale trade comes from the sale of products the entity produces or products produced by an entity that is part of an affiliated group[43] to which the taxable entity also belongs;[44] and

(3) the taxable entity is not in the business of providing retail or wholesale utilities, including telecommunications services, electricity or gas.[45]

For purposes of determining whether a taxable entity is a retailer or wholesaler, "retail trade" means the activities described in Division G of the 1987 Standard Industrial Classification (SIC) Manual published by the federal Office of Management and Budget;[46] "wholesale trade"

[37] Texas Tax Code § 171.0011(a).
[38] Texas Tax Code §§ 171.1011(b); 171.002(a), (b).
[39] Texas Tax Code § 171.1011(c).
[40] Texas Tax Code § 171.002(b).
[41] See Texas Tax Code §§171.002(b); 171.1016, and the discussion of the E-Z computation method in this outline.
[42] Texas Tax Code § 171.002(c)(1).
[43] *See* Texas Tax Code § 171.0001(1).
[44] Texas Tax Code § 171.002(c)(2).
[45] Texas Tax Code § 171.002(c)(3).
[46] Texas Tax Code § 171.0001(12).

means the activities described in Division F or the 1987 SIC Manual published by the federal Office of Management and Budget.[47]

Per the SIC Manual references, the chief functions of establishments included in Wholesale Trade are selling goods to trading establishments, or to industrial, commercial, institutional, farm construction, contractors or professional business users; and bringing buyer and seller together. In addition to selling, functions frequently performed by wholesale establishments include maintaining inventories of goods; extending credit; physically assembling, sorting and grading goods in large lots; breaking bulk and redistribution into smaller lots; delivery; refrigeration, and various types of promotion such as advertising and label designing.[48]

Retail Trade (per SIC Manual provisions) includes establishments engaged in selling merchandise for personal or household consumption and rendering services incidental to the sale of the goods. In general, retail establishments are classified by kind of business according to the principal lines of commodities sold (groceries, hardware, etc.), or the usual trade designation (drug store, cigar store, etc.). Some of the important characteristics of retail trade establishments are: the establishment is usually a place of business and is engaged in activities to attract the general public to buy; the establishment buys or receives merchandise as well as sells; the establishment may process its products, but such processing is incidental or subordinate to selling; the establishment is considered as retail in the trade; and the establishment sells to customers for personal or household use. Not all of these characteristics need be present and some are modified by trade practice. For instance, there are many types of retailers that sell primarily to businesses, such as lumber yards, paint, glass and wallpaper stores. These types of stores are classified in Retail Trade even if a higher proportion of their sales is made to other than individuals for personal or household consumption.[49]

TAXABLE ENTITIES

General definitions for many of the terms used under the margin tax are set out in Subchapter A of the Texas Tax Code.[50]

Subject to exceptions noted below, a "taxable entity" for purposes of the franchise margin tax is defined to include partnerships (including limited liability partnerships), corporations, banking corporations, savings and loan associations, limited liability companies, business trusts, professional associations, business associations, joint ventures, joint stock companies, holding companies, and "other legal entities."[51]

"Professional association" means an association, as distinguished from either a partnership or a corporation that is:

[47] Texas Tax Code § 171.0001(18).
[48] Standard Industrial Classification Manual Division F: Wholesale Trade summary.
[49] Standard Industrial Classification Manual Division G: Retail Trade summary.
[50] *See* Texas Tax Code §§ 171.0001-171.0004.
[51] Texas Tax Code § 171.0002(a).

(1) formed for the purpose of providing the professional service rendered by a doctor of medicine, doctor of osteopathy, doctor of podiatry, dentist, chiropractor, optometrist, therapeutic optometrist, veterinarian, or licensed mental health professional;. and

(2) governed by title 7 of the Texas Business Organizations Code.[52]

It is not entirely clear what is meant by the term "other legal entities" as one of the enumerated categories of taxable entities. It is possible that the definition could be extended to entities that are not specifically excluded from taxability by statute or otherwise (such as constitutional prohibitions). More guidance is need with respect to this vague, open ended definition.

Specifically included within the definition is a combined group of taxable entities.[53]

The inclusion of "joint ventures" presumably refers to entities which consist of two or more persons (not otherwise exempted from the margin tax) joined together for a particular project. Thus, a joint venture general partnership having as its partners two corporations would be a taxable entity for margin tax purposes. However, excluded from the definition of joint ventures (and therefore excludable from the margin tax) are joint operating or co-ownership arrangements that elect out of federal partnership treatment as provided by Internal Revenue Code (IRC)[54] § 761(a) and Internal Revenue Service ("IRS") Treasury Regulation § l.761-2(a)(3).[55]

NOTE: For margin tax returns first due on or after January 1, 2008, "Internal Revenue Code" means the IRC of 1986 in effect for the federal tax year beginning on January 1, 2007, and any regulations adopted under the code applicable to that period.[56]

Specifically excluded from entities subject to the tax are sole proprietorships, general partnerships (but only if the direct ownership of such general partnership is entirely composed of natural persons and the liability of which is not limited under the statute of Texas or another state, including by registration as a limited liability partnership), "passive entities" (as defined by § 171.0003, discussed below)[57] and (in continuation from prior franchise tax law) entities exempt from taxation under Subchapter B of Chapter 171 of the Texas Tax Code.[58] "Natural person" for these purposes means a human being or the estate of a human being. It does not include a purely legal entity such as a corporation, limited liability company, partnership or trust.[59] Entities exempt from taxation under Subchapter B of Chapter 171 of the Texas Tax Code would include,

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[52] Tex. Bus. Org. Code § 301.003(2).
[53] Texas Tax Code § 171.0002(a). *See also* § 171.1014 regarding combined reporting.
[54] For returns first due on or after January 1, 2008, "Internal Revenue Code" means the IRC of 1986 in effect for the federal tax year beginning on January 1, 2007, and any regulations adopted under the code applicable to that period. Texas Tax Code § 171.0001(9).
[55] Texas Tax Code § 171.0002(a).
[56] Texas Tax Code § 171.0001(9).
[57] Texas Tax Code § 171.0002(b).
[58] Texas Tax Code § 171.0002(b). See §171.051 *et. seq.* for other entities exempted under Subchapter B.
[59] Texas Tax Code § 171.00001(11-a).

for example, (among many others) nonprofit corporations organized for religious purposes,[60] educational purposes,[61] public charities,[62] and certain nonprofit corporations exempt from federal income tax.[63]

COMMENT: Subsequent to the passage of HB 3, but prior to passage of HB 3928, a question of some speculation was whether limited liability partnerships (LLPs) were subject to the margin tax. At first consideration, the answer might appear to be unequivocally yes, based upon the assumption that LLPs are limited partnerships. In fact, LLPs are included within the general partnership provisions under Texas law, and for that reason might not technically be limited partnerships.[64] It was arguable that notwithstanding the apparent intent to include professional service LLPs such as law firms as subject to the margin tax, the Legislature may not have accomplished that objective under the literal language of the HB 3 statutory provisions. That question was answered emphatically in the affirmative by HB 3928, when the Legislature made it quite clear that LLPs are subject to the margin tax.[65]

In addition to those entities set out as not taxable per § 171.0002(b), there are also excluded from the franchise margin tax the following types of entities:

(1) grantor trusts (per IRC §§ 671 and 770l(a)(30)(E)), all of the grantors and beneficiaries of which are natural persons or IRC § 501(c)(3) tax exempt charitable entities. Business trusts per Treasury Regulation § 301.7701-4(b) do not qualify as entities excluded from the tax;[66]

(2) estates of a natural person per IRC § 770l(a)(30)(D) (excluding business trusts per Treasury Regulation § 301.7701-4(b));[67]

(3) escrows;[68]

(4) real estate investment trusts (REIT) as defined by IRC § 856 and its "qualified REIT subsidiaries" (per IRC § 856(i)(2)), provided that the following types of REITs are not exempt from the tax: i) a REIT with any amount of its assets in direct holdings of real estate (other than real estate it occupies for business purposes) as opposed to holding interests in limited partnerships or other entities that directly hold the real estate, and ii) a limited partnership or other entity that directly holds the real estate as described in § 171.0002(c)(8)(A) (i.e., the immediately preceding part i);[69]

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[60] Texas Tax Code § 171.058.
[61] Texas Tax Code § 171.061.
[62] Texas Tax Code § 171.062.
[63] Texas Tax Code § 171.063.
[64] Texas Bus. Org. Code §§ 152.801-152.805.
[65] See Texas Tax Code § 171.0002(a), as modified by § 2 of HB 3928.
[66] Texas Tax Code § 171.0002(c)(1).
[67] Texas Tax Code § 171.0002(c)(2).
[68] Texas Tax Code § 171.0002(c)(3).
[69] Texas Tax Code § 171.0002(c)(8).

(5) real estate mortgage conduits (REMIC) per IRC § 860D;[70]

(6) a non profit self-insurance trust created under Chapter 2212, Insurance Code, or a predecessor statute;[71]

(7) a trust qualified under Section 401(a), Internal Revenue Code;[72] or

(8) a trust or other entity that is exempt under Section 501(c)(9), Internal Revenue Code (a voluntary employee benefit association, or VEBA).[73]

Another question raised prior to the passage of HB 3928 was what happens when an entity, all the partners (in a general partnership) or beneficiaries (in an exempt trust) of which are natural persons (and therefore previously exempt from the margin tax) has a partner or beneficiary die. In that case, the partner or beneficiary is no longer a natural person, but an estate. While estates are exempt from the margin tax, the literal definition of an exempt general partnership requires all such partners be natural persons – and "natural persons" (prior to the passage of HB 3928) only was defined to include human beings. The concern was that the general partnership would then become subject to the margin tax because not all of its partners were not natural persons? This issue was resolved by modifications made in HB 3928, which now specifies that a "natural person" means a human being or an estate of a human being.[74]

Small Business Exemption

An otherwise taxable entity is not required to pay any tax and is not considered to owe any tax for a period if the amount of tax computed for the entity is less than $1000 or the amount of the entity's total revenue from its entire business is less than $300,000 (as may be adjusted by subsequent consumer price indexing).[75] In addition, otherwise taxable entities having annual revenues from its entire business in excess of $300,000 but less than $900,000 are entitled to a discount from margin tax as follows:[76]

Total Revenue	Discount of Tax Percentage
Greater than $300,000, but less than $400,000	80%
Equal to or greater than $400,000, but less than $500,000	60%
Equal to or greater than $500,000, but less than $700,000	40%
Equal to or greater than $700,000, but less than $900,000	20%
$900,000 or greater	-0-

These discounted amounts are determined after determining taxable margin (per Tax Code § 171.101), applying the appropriate rate of tax (per Tax Code § 171.002(a) or (b)) and

[70] Texas Tax Code § 171.0002(c)(9).
[71] Texas Tax Code § 171.0002(c)(6).
[72] Texas Tax Code § 171.0002(c)(7)
[73] Texas Tax Code § 171.0002(c)(8).
[74] Texas Tax Code § 171.0001(11-a).
[75] Texas Tax Code §§ 171.002(d); 171.006.
[76] Texas Tax Code § 171.0021(a).

subtracting any other allowable credits.[77] The discounted tax computation also applies to those taxpayers that elect (and qualify) to calculate and pay their tax under the "E-Z" computation method.[78] The discount amounts are subject to adjustment (based upon consumer price index information) in even numbered years beginning in 2010.[79]

The comptroller may require any entity to file information reports as necessary to verify that the entity is not subject to the margin tax.[80]

An entity that can file as a sole proprietorship for federal tax purposes is not a sole proprietorship for purposes of § 171.0002(b)(1) and is not an exempt entity for purposes of the margin franchise tax if the entity is formed in a manner under the statutes of Texas or another state or another country that that limits the liability of the entity.[81] Because Texas does not follow federal check-the-box regulation for purposes of entity classification, a single member LLC would not be disregarded for margin/franchise tax purposes. Thus, a single member limited liability company whose sole member is an individual, the results of operations of which are reported on the individual's federal income tax return, is not exempt from the franchise margin tax per § 171.0002(d).

Passive Entities

As discussed above, passive entities may be excluded from the franchise margin tax. Tax otherwise imposed under Texas Tax Code §§ 171.001 (franchise/margin tax) and 171.0011 (additional tax) does not apply to those entities qualifying as passive entities.[82] Determination of whether an entity falls within the passive entity classification occurs on an annual basis.[83] An entity is only considered to be a passive entity if it meets all of the following requirements:

(1) the entity is a general or limited partnership or a trust (other than a business trust);[84]

(2) during the period on which margin is based, the entity's federal gross income consists of at least 90% of the following categories of income:
   (A) dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company;[85]
   (B) distributive shares of partnership income to the extent that those distributive shares are greater than zero;[86]

[77] Texas Tax Code § 171.0021(a).
[78] Texas Tax Code § 171.1016(d).
[79] Texas Tax Code § 171.006(a), (b).
[80] Texas Tax Code § 171.204.
[81] Texas Tax Code § 171.0002(d).
[82] Texas Tax Code § 171.001(c).
[83] Texas Tax Code § 171.001(c).
[84] Texas Tax Code § 171.0003(a)(1).
[85] Texas Tax Code § 171.0003(a)(2)(A).
[86] Texas Tax Code § 171.0003(a)(2)(B).

(C) capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, and gains from the sale of securities;[87] and

(D) royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests;[88] and

(3) the entity does not receive more than 10% of its federal gross income from conducting an active trade or business.[89]

In making the determination of whether an entity receives more than 10% of its federal gross income from conducting an active trade or business, the income described at § 171.0003(a)(2) (i.e., the passive type sources of income described in paragraph 2), above) may not be treated as income from conducting an active trade or business.[90] The passive type sources of income described at § 171.0003(a)(2) does not include i) rent[91] or ii) income received from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group[92] and another member of that group is the operator under the same joint operating agreement.[93]

OBSERVATIONS/QUESTIONS: The definitions relating to passive entities raise a number of questions. Some of these include:

- The phrase "income from a limited liability company" in § 171.0003(a)(2)(A) is of uncertain meaning. This could mean allocable share of an LLC that is treated like a partnership for federal tax purposes, or it could mean an actual distributive cash amount. Clarification is needed.

- If an item of income is included within the definition set out at § 171.0003(a)(2), is it necessarily excluded from being considered as having come from an active trade or business, irrespective of the nature of the activity? Would, for example, gain from the sale of real property conducted by a real estate developer in a limited partnership be considered passive income even if the developer was otherwise actively engaged in the development business? The literal language of §§ 171.0003(a)(2) and 171.0003(a)(3) in tandem suggests the answer could be yes, but the apparent intent evidenced by § 171.0003(a)(3) alone would indicate a contrary conclusion.

  NOTE: Changes made by HB 3928 added the requirement that a gain from the sale of real property be a "capital" gain before it could be included within the definition of passive income for these purposes.[94] The definition of

[87] Texas Tax Code § 171.0003(a)(2)(C).
[88] Texas Tax Code § 171.0003(a)(2)(D).
[89] Texas Tax Code § 171.0003(a) (3).
[90] Texas Tax Code § 171.0003(a)(3)(a-1).
[91] Texas Tax Code § 171.0003(a)(3)(b)(1).
[92] Texas Tax Code § 171.0001(1) defines "affiliated group."
[93] Texas Tax Code § 171.0003(a)(3)(b)(2).
[94] HB 3 § 3(a) (modifying Texas Tax Code § 171.0003(a)(2)(c)).

capital gain is not tied (by statute or otherwise) to the federal income tax definition of that term.

- Under the current language of HB 3, limited partnerships that are otherwise taxable are exempted from the margin tax to the extent they meet the 90% passive income requirements. Other pass-through entities (such as S corporations) which generate the identical types of income would not be exempted from the margin tax. Is this the result intended? If so, taxpayers could legitimately question the reason for such an arbitrary distinction.

Active Trade or Business

For purposes of determining whether an entity is conducting an "active trade or business" (so as to further determine whether an organization fits within the definition of a passive entity for purposes of § 171.0003(a)), an entity is deemed to be conducting an active trade or business if: i) the activities being carried on by the entity include one or more active operations that form a part of the process of earning income or profit[95] and ii) the entity performs active management and operational functions.[96]

Activities performed by persons outside the entity (such as independent contractors) are deemed to be performed by the entity itself, to the extent such persons perform services on behalf of the entity and those services constitute all or part of the entity's trade or business.[97] An entity is deemed to be conducting an active trade or business if intangible assets such as royalties, patents, trademarks, and other such assets held by the entity are used in the active trade or business of one or more related entities.[98]

For purposes of determining whether an entity is conducting an active trade or business, the ownership of a royalty interest or a nonoperating working interest in mineral rights is not deemed to be the conduct of an active trade or business.[99] Similarly, the payment of compensation to employees or independent contractors for financial or legal services reasonably necessary for the operation of the entity is not deemed to constitute conduct of an active trade or business.[100] In addition, holding a seat on the board of directors of an entity does not, by itself, constitute conduct of an active trade or business.[101]

Limitation on "Geoffrey" Structures

Some of the changes relating to the active trade or business requirements noted above result from the Legislature's response to the use by some taxpayers in recent years of so-called "Geoffrey" type structures in Texas. The structures were, in essence, companies set up to hold intellectual property assets (such as royalties or trademarks) which were than licensed to

[95] Texas Tax Code § 171.0004(b)(1).
[96] Texas Tax Code § 171.0004(b)(2).
[97] Texas Tax Code § 171.0004(c).
[98] Texas Tax Code § 171.0004(d).
[99] Texas Tax Code § 171.0004(e)(1).
[100] Texas Tax Code § 171.0004(e)(2).
[101] Texas Tax Code § 171.0004(e)(3).

operating companies in a specific state (such as Texas). The fees charged by the licensor company was deductible to the licensee operating company, reducing taxable earned surplus, and therefore, taxable income. The licensor (at least in some states such as Texas) was not deemed to be doing business in the state where the operating companies were located, and therefore not subject to tax at all.

"Geoffrey" is a reference to a South Carolina Supreme Court case decision which struck down the non-taxable result of such structures as described above.[102] ("Geoffrey" is the giraffe logo used by Toys R Us that was licensed by a royalty/trademark holding company to the Toys R Us operating company in South Carolina.) When the U.S. Supreme Court declined to hear the case, the Geoffrey decision was left intact in South Carolina, and other states adopted similar rationales. Texas never directly addressed the Geoffrey decision.

With the implementation of the HB 3 provision which specifies that the use of intellectual property is considered to be an active trade or business,[103] and therefore not excluded from the margin tax, the benefits of a Geoffrey type structure in Texas is significantly eroded.

Separate Reporting Required – With Major Exception

The general rule is that taxable entities are subject to the margin tax on a separate, stand-alone basis, with no consolidated return reporting allowed.[104] Under the margin tax, however, there is a major exception that has the effect of nearly consuming the general rule. To the extent the entity is a unitary enterprise that is part of an affiliated group, combined reporting of the affiliated group as a single entity is required.[105] In addition, certain entities that are considered to be part of a "tiered partnership structure" are also allowed to report as a single enterprise for purposes of the margin tax in certain cases.[106] Both of these changes are radical transformations of the traditional separate entity approach to franchise taxation, and will have a major impact on the use of planning structures (typically involving the use of limited partnerships) that have been used frequently in the past. Unitary reporting and tiered partnerships structures will be discussed in greater detail below.

REVENUE

The starting point in the computation of the margin tax is the determination of revenue. Unlike the earned surplus component of the prior franchise tax, the starting point for revenue for the margin tax is not federal taxable income as would be reported for corporate income tax purposes. Rather, the Texas legislature has come up with an entirely new definition of revenue which incorporates selected aspects of revenues reported for federal tax purposes. "Margin tax revenue" is based upon specifically identified amounts reported upon particular lines of federal tax returns, and varies depending upon whether the entity is a corporation, partnership, or some

[102] *See Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13, (S. Carolina 1993), *cert. den*. 114 S.Ct. 550 (1992).
[103] Texas Tax Code § 171.0004(d).
[104] Texas Tax Code § 171.1011(d).
[105] Texas Tax Code § 171.1014.
[106] Texas Tax Code § 171.1015.

other sort of taxable entity.[107] Subject to combined reporting requirements of unitary enterprises,[108] "revenues" for corporations and partnerships are as set out below:

Corporations

Total revenue for an entity treated as a corporation for federal tax purposes is computed by taking into consideration the amounts reportable as income on the following lines of Form 1120 (or corresponding federal forms such as the 1120S for S corporations[109]):

Add: (i) line 1c (gross receipts less returns and allowances);
(ii) lines 4-10 (interest, gross rents, gross royalties, capital gain net income, net gain from Form 4797, Part II, Line 17 and other income); and
(iii) any total revenue reported by a lower tier entity as includable in the taxable entity's total revenue under Section 171.1015(b) (i.e., tiered partnership reporting arrangements);[110] and

Subtract: (i) bad debts expense that corresponds to items of gross receipts included in Tex. Tax Code § 171.1011(c)(1)(A) (i.e., total revenues) for margin tax purposes;
(ii) foreign income (such as royalties and dividends) that has been included in total revenues for margin tax purposes;
(iii) to the extent included in the entity's total revenues for margin tax purposes, net distributive income from partnerships and from a taxable entity treated as a partnership or as an S corporation for federal income tax purposes;
(iv) allowable deductions from Form 1120, Schedule C (to the extent such dividend income is included in the entity's total revenue);
(v) to the extent included in the entity's federal gross receipts, items of income attributable to an entity that is a disregarded entity for federal income tax purposes; and
(vi) to the extent included in the entity's federal gross receipts, other amounts authorized to be subtracted from gross receipts per Texas Tax Code § 171.1011.[111]

OBSERVATION: Net distributable income amounts from two types of pass through entities (based upon the then treatment for federal income tax purposes) are (to the extent they have previously been included as a revenue amount) subtracted from the entity's valid revenue. Thus, to the extent an entity is a partnership or other entity that has elected to be treated as a partnership (such as an LLC) or an S corporation allocable shares of income from such entities previously included in margin tax revenues would be subtracted per this provision. The same treatment pertains to partnerships (discussed below).

[107] Texas Tax Code § 171.1011(a),(b).
[108] Texas Tax Code § 171.1011(c).
[109] There is no exclusion of S Corporations from the margins tax. *See* Texas Tax Code § 171.0002(a).
[110] Texas Tax Code § 171.1011(c)(1)(A).
[111] Texas Tax Code § 171.1011(c)(1) (B).

Partnerships

Total revenue for an entity treated as a partnership for federal income tax purposes is computed by taking into consideration the amounts reportable as income on the following lines of federal Form 1065 (partnership return) or Form 1065, Schedule K (as indicated):

Add: (i) Form 1065, line 1c (gross receipts less returns and allowances);
(ii) Form 1065, lines 4, 6 and 7 (ordinary income from other partnerships, trusts and estates, net gain from Form 4797, Part II, Line 17, and other income);
(iii) The amounts reportable as income on lines 3a and 5 through 11, Form 1065, Schedule K (other gross rental income, interest income, dividends, royalties, net short-term capital gain, net long-term capital gain, net Section 1231 gain from Form 4797, other income);
(iv) the amounts reported as income on line 17, IRS Form 8825 (total gross rents from rental real estate);
(v) the amounts reportable as income on line 11, plus line 2 or line 45, IRS Form 1040, Schedule F (gross income from farming operations);
(vi) any total revenue reported by a lower tier entity as includable in the taxable entity's total revenue under Tax Code § 171.1015(b) (dealing with tiered partnership reporting arrangements);[112] and

Subtract: (i) bad debts expensed by the entity for federal income tax purposes to the extent included as an item of gross receipts for margin tax purposes (in current or prior years);
(ii) foreign income (such as royalties and dividends) for federal tax purposes, to the extent included in gross receipts for margin tax purposes;
(iii) to the extent included in the entity's total revenues for margin tax purposes, net distributive income from a taxable entity treated as a partnership or as an S Corporation for federal income tax purposes;
(iv) to the extent included in the entity's revenues for margin tax, items of income attributable to an entity that is a disregarded entity for federal income tax purposes; and
(v) to the extent included in the entity's revenues for margin tax, other amounts authorized to be subtracted from gross receipts per Texas Tax Code § 171.1011.[113]

OBSERVATION: The definition of revenues for both corporate and partnership purposes is based upon specific line items on corresponding federal income tax returns. Prior to adoption of HB 3928, there were a number of inconsistencies and sums included in the treatment of corporate and partnership revenues. In a number of cases, this resulted in consequences that probably were not intended by

[112] Texas Tax Code § 171.1011(c)(2)(A).
[113] Texas Tax Code § 171.1011(c)(2)(B).

the drafters of the legislation. These errors (noted in the bullet points listed below) were, for the most part, corrected by specific provisions of HB 3928.

- Corporate revenues included amounts on lines 1c and 4-10 of Form 1120. Line 9 referred to net gain (or loss) from Form 4797. While all other corporate revenues would only include gross amounts, the 4797 transactions could be a net number.

- Partnership gross revenues included amounts from lines 1c and 4-7 on Form 1065. While line 1c is a gross number, however, lines 4-7 could be either a gain or a loss – clearly a net income (loss) concept. Except for line 6 (pertaining to Form 4797 totals) this was different from comparable corporate revenue treatment.

- Partnership revenues also included Schedule K lines 2-11. The same issues noted in the definition for Form 1065 are present in most of the line items here – they reflect net, rather than gross, income. As a result, while the starting point for the margin tax is supposedly gross revenues, many of the specifically identified totals are, in fact, net income (loss) amounts.

- Some glaring differences existed between corporate and partnership revenues. For example, gross rental amounts were included in corporate totals Form 1120, line 6), but net rental income (or loss) was the amount specified for partnership revenue purposes Schedule K, line 3c).

- Guaranteed payments to partners (Schedule K, line 4) were required to be added to partnership revenue, even though it is never subtracted out of the Form 1065 line item amounts. The result is that guaranteed payments are inexplicably added to partnership revenues.

Based upon subsequent actions of the Texas Legislature in HB 3928, it is doubtful that any of the above results were intended. Numerous changes were made under HB 3928[114] as reflected in the current version of Tax Code § 171.1011 dealing with how total revenues are to be determined for margin tax purposes. With very few exceptions, it is apparent that revenues for margin tax purposes are intended to be based upon gross, as opposed to net, revenues.

A reference to an amount reportable as income on a line number of an Internal Revenue Service form is defined as the amount entered – to the extent such amount entered complies with federal income tax law.[115] This will put a premium on determining whether the information contained on the margin tax report is consistent with federal income tax law. It is unclear at this point to what extent (if any) the Comptroller may challenge margin tax reporting based upon an additional interpretation of federal income tax law.

[114] See HB 3928 § 12.
[115] Texas Tax Code § 171.1101(b).

Entities Other than Corporations or Partnerships Subject to the Margin Tax

Entities which are subject to the margin tax that are treated for federal income tax purposes as other than a corporation or partnership (such as some trusts and S Corporations) are to determine their revenues in a manner substantially equivalent to that set out for corporations and partnerships. The Comptroller is to issue rules explaining how this is to be done.[116]

NOTE: The Comptroller issued draft forms and instructions in late October 2006 for preparation of information reporting required by the so-called 1000 largest taxpayers provided some guidance as to the reporting of various items of revenue and deductions. While much of the information contained in the draft instructions recited what was already contained in the HB 3 statutory provisions, there was some additional information provided with respect to reporting revenue and deduction amounts for entities other than C corporations and partnerships (including S Corporations and trusts). CAVEAT: None of the changes made in HB 3928 were (or could have been) included in the 2006 draft forms. More substantive guidance (including Comptroller rules and announcements) will likely not be issued until some time in mid to late 2007. As of the writing of these materials, the Comptroller has stated that draft rules would be out in August 2006, with comment and adoption likely coming in the next few months thereafter.

Revenue from Passive Entities

A taxable entity that owns an interest in a passive entity is required to exclude from the taxable entity's total revenue the taxable entity's share of the net income of the passive entity, but only to the extent the net income of the passive entity was generated by the margin of any other taxable entity.[117]

COMMENT: This provision requires including within a taxable entity's (such as a stand alone entity or a combined group) total revenue such taxable entity's share of the passive entity's net income – but only if (and only to the extent) the net income of the passive entity was not generated by the margin of any other taxable entity. It appears this provision could therefore require including within an upstream (with respect to the passive entity) parent taxable entity's total revenue any net income from the passive entity if the latter was solely responsible for generating its own net income. To the extent the passive entity net income resulted (in whole or in part) from (i.e., was generated from) the margin of any other taxable entity, this provision would not require such margin to be included in the net income of the passive entity which is allocated (presumably as a pass through item) to the upstream taxable entity (which holds an interest in the passive entity).

[116] Texas Tax Code § 171.1011(c)(3).
[117] Texas Tax Code § 171.1011(e).

Other Adjustments to Revenue - Special Industry Provisions

There are a number of specifically identified exclusions from revenue (to the extent such amounts would otherwise be included as revenues per Texas Tax Code §§ 171.1011(c)(1)(A), (c)(2)(A), or (c)(3)(A)), as follows:

OBSERVATION: Only a few specifically identified types of businesses are permitted to exclude pass through revenues (as set out at Tax Code § 171.1011(g)). There are numerous other types of business operations that do not get the benefit of revenues that pass through their accounting system (such as many service providers that are not engaged in construction or real property improvement activities). The non-favored taxpayer groups may well question why they are treated in a disparate manner.

(1) flow-through funds mandated by law to be distributed to other entities (including taxes collected and remitted to taxing authorities).[118]

NOTE: If the taxable entity belongs to an affiliated group, it may not exclude amounts that are received as payments from other members of the affiliated group. This is also true of certain other pass through payments received from members of affiliated groups, as identified at Texas Tax Code § 171.1011(g), (g-1),(g-2), (g-3) and (g-4) (discussed below).[119]

(2) certain flow-through funds mandated by contract to be distributed to other entities (such as sales commissions to non-employees and subcontracting payments handled by the taxable entity to provide services, labor or materials in connection with improvements to real property).[120] ("Sales commission" for this purpose means any form of compensation paid to a person for engaging in an act for which a license is required under Chapter 1101, Occupations Code; or compensation paid to a sales representative by a principal (as defined per Texas Tax Code § 171.1011(l)(2)) in an amount that is based on the amount or level of certain orders of the principal's product and that the principal is required to report on IRS Form 1099-MISC);[121]

(3) proceeds from the principal repayment of loans received by lending institutions;[122]

(4) proceeds relating to the tax basis (per the Internal Revenue Code) of securities and loans sold;[123]

(5) Legal services - proceeds received by entities providing legal services (and otherwise included in total revenues for margin tax purposes), including:

[118] Texas Tax Code § 171.1011(f).
[119] Texas Tax Code § 171.1011(h).
[120] Texas Tax Code § 171.1011(g).
[121] Texas Tax Code § 171.1011(l)(1),
[122] Texas Tax Code § 171.1011(g-1).
[123] Texas Tax Code § 171.1011(g-2).

(A) flow through-funds that are required to be distributed to the claimant (or other designated entity) by the claimant's attorney;[124]

(B) reimbursement of the legal entity's expenses incurred in prosecuting a claimant's specific matter (and which are not general operating expenses);[125] and

(C) $500 per *pro bono* services case handled by the attorney (if adequate records are maintained to support such expenses in accordance with how such expenses for those services are reported to the State Bar of Texas);[126]

(6) Pharmacy cooperatives shall exclude from total revenue, to the extent otherwise included as a margin tax revenue, flow-through funds from rebates from pharmacy wholesalers that are distributed to the pharmacy cooperative's shareholders;[127]

(7) Staff leasing companies - payments received by a staff leasing services company from a client company for wages (including payroll taxes and benefits associated with those wages) for the assigned employees of the client company;[128] For these purposes, a "staff leading services company" means a business entity that offers staff leasing services, as that term is defined by Section 91.001, Texas Labor Code, or a temporary employment service, as that term is defined by Section 93.001, Texas Labor Code.[129]

NOTE: In calculating the cost of goods sold or compensation deduction, a taxable entity that is a client company of a staff leasing services company shall rely on information provided by the staff leasing services company. The information can be provided on a Comptroller form or by an invoice.[130]

(8) dividends and interest received from federal obligations;[131]

(9) reimbursements received by a management company of specified costs incurred in the conduct of the active trade or business of a managed entity, including wages and cash compensation;[132]

(10) Health care providers - certain amounts received by health care providers,[133] (to the extent previously included as a revenue for margin tax purposes per Tex. Tax Code § 171.1011(c)(1)(A), (c)(2)(A) or (c)(3))[134] as follows:

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[124] Texas Tax Code § 171.1011(g-3)(1).
[125] Texas Tax Code § 171.1011(g-3)(2).
[126] Texas Tax Code § 171.1011(g-3)(3).
[127] Texas Tax Code § 171.1011(g-4).
[128] Texas Tax Code § 171.1011(k).
[129] Texas Tax Code § 171.0001(15).
[130] Texas Tax Code § 171.2125.
[131] Texas Tax Code § 171.1011(m).
[132] Texas Tax Code § 171.1011(m-1).
[133] *See* Texas Tax Code § 171.1011(p)(3) (and discussion below) for definition of "health care provider."
[134] Texas Tax Code § 171.1011(n)(1).

(A) the total amount of payments the health care provider receives under:
  (i) the Medicaid, Medicare, Indigent Health Care and Treatment Act (Chapter 61, Health and Safety Code), and Children's Health Insurance Program (CHIP);[135]
  (ii) for professional services proved related to workers' compensation claims (under Title 5, Labor Code);[136] and
  (iii) for professional services provided to a beneficiary rendered under the TRICARE military health system;[137] and

(B) the actual cost to the health care provider for any uncompensated care provided (if required records are kept to support such expenses;[138]

(C) for purposes of the exclusion from revenue, "health care provider" means a taxable entity that participates in the Medicaid, Medicare, CHIP, state workers' compensation or TRICARE military health system as a provider of health care services;[139]

(D) a health care provider that is a "health care institution" may exclude 50% of allowable exclusions specified at Texas Tax Code § 171.1011(n) from revenues (as opposed to the 100% exclusion that is permitted for health care providers that are not health care institutions).[140] "Health care institution" is defined to mean:[141]
  (i) an ambulatory surgical center;
  (ii) a licensed assisted living facility;
  (iii) an emergency medical services provider;
  (iv) a home and community support services agency;
  (v) a hospice;
  (vi) a hospital;
  (vii) a hospital system;
  (viii) certain intermediate care facilities (or other mental retardation programs);
  (ix) a birthing center;
  (x) a nursing home;
  (xi) a licensed end stage renal disease facility, or
  (xii) a pharmacy.

(11) revenue received by a taxable entity directly derived from the operation of a facility located on property owned or leased by the federal government and managed or operated primarily to house members of the United States armed forces;[142]

[135] Texas Tax Code § 171.1011(n)(1)(A).
[136] Texas Tax Code § 171.1011(n)(1)(B).
[137] Texas Tax Code § 171.1011(n)(1)(C).
[138] Texas Tax Code § 171.1011(n)(2).
[139] Texas Tax Code § 171.1011(p)(3).
[140] Texas Tax Code § 171.1011(o).
[141] Texas Tax Code § 171.1011(p)(2)(A)-(L).
[142] Texas Tax Code § 171.1011(q).

(12) Oil and gas producers - revenues received by a taxable entity from certain low producing oil and/or gas wells during periods when the price of crude oil and/or natural gas (as indexed) is below $40 per barrel or $5 MMBtu, respectively.[143]

Comptroller Rules will Interpret Revenue Provisions

The Comptroller has been directed by the Legislature to adopt rules as necessary to accomplish the legislative intent prescribed by the revenue provisions of Tex. Tax Code § 171.1011.[144]

OBSERVATION: Directing the Comptroller to issue interpretive (as opposed to legislative) regulations with respect to revenue matters indicates the Legislature has not given the agency broad based latitude to expand beyond the specific provisions included in the statute.

Consistency Requirements – Revenue Exclusion and Corresponding Deduction Treatment

Except as provided by Texas Tax Code § 171.1011(g) relating to certain allowable pass-through payments (discussed above), a payment made under an ordinary contract for the provision of services in the regular course of business may not be excluded from revenue.[145] Any amounts excluded from revenue per Texas Tax Code § 171.1011 may not be included in the determination of cost of goods sold[146] or compensation.[147]

COST OF GOODS SOLD

In determining taxable margin, one of the allowable alternative annual elective offsets to total revenue is the entity's cost of goods sold ("COGS").[148] The election (whether to use the COGS or compensation method) can be made on an annual basis by indicating the method to be used on its annual report.[149] The taxable entity is required to notify the Comptroller of its election not later than the due date of the report.[150]

NOTE: This is a change from the original HB 3 provision which would have allowed the taxpayer to change its election provision by way of an amended report.

"Goods" for this purpose means real or tangible personal property sold in the ordinary course of business of a taxable entity.[151] Tangible personal property for purposes of the COGS deduction is defined to mean personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any manner.[152] (This definition is almost identical

[143] Texas Tax Code § 171.1011(r),(s).
[144] Texas Tax Code § 171.1011(t).
[145] Texas Tax Code § 171.1011(i).
[146] Texas Tax Code §§ 171.1011(j); 171.1012.
[147] Texas Tax Code §§ 171.1013; 171.1011(j).
[148] Texas Tax Code § 171.101(a)(1)(B)(ii)(a).
[149] Texas Tax Code § 171.101(d).
[150] Texas Tax Code § 171.101(d).
[151] Texas Tax Code § 171.1012(a)(1).
[152] Texas Tax Code § 171.1012(a)(3)(a)(i).

to that which has been in place for sales tax purposes for many years.[153]) Specifically included within the definition of tangible personal property are also a number of items whose real value relates to their content (as opposed to the actual tangible property), such as films, sound recordings, videotapes, live and prerecorded television and radio programs, books and computer programs without regard to the means or methods of distribution or the medium in which the property is embodied.[154] Specifically excluded from the definition of tangible personal property for COGS purposes are items of intangible property and services.[155]

> **OBSERVATION:** Because services are excluded from the definition of COGS (at least for tangible personal property) many service providers will find themselves at a disadvantage relative to other taxpayers under the margin tax regime. This is particularly true for service providers that may not have much in the way of compensation expense (relative to total revenues), such as rental companies and some transportation operators. While the E-Z alternative tax computation will provide some relief for taxable entities with annual revenues of less than $10 million, service businesses with annual revenues over that amount will likely still be at a disadvantage.

The determination of COGS is not directly tied to the measure determined for federal income tax or financial accounting purposes; rather, it is specifically set out under the Texas Tax Code.[156] To the extent not specified pursuant to Texas Tax Code § 171.1012, however, COGS is required to be calculated in accordance with methods (as opposed to categories) permitted by federal statues and regulations.[157]

Ownership Requirements for COGS Expense Deduction

In order to deduct the expense associated with the COGS, the taxable entity must actually own those goods.[158] The determination of whether a taxable entity actually is the owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxable entity.[159] A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair or industrial maintenance (as the term "maintenance" is defined for Texas sales tax purposes[160]) of real property is considered to be an owner of that labor or materials, and may include the costs (consistent with the requirements of Tex. Tax Code § 171.1012(i)) in the computation of COGS.[161]

Federal Government Contract Exception

Solely for purposes of determining ownership of COGS, a taxable entity shall be treated as the owner of goods being manufactured or produced by the entity under a contract with the

[153] *See* Texas Tax Code § 151.009.
[154] Texas Tax Code § 171.1012(a)(3)(A)(ii),(iii).
[155] Texas Tax Code § 171.1012(a)(3)(B)
[156] Texas Tax Code § 171.1012.
[157] Texas Tax Code § 171.1012(h).
[158] Texas Tax Code § 171.1012(i).
[159] Texas Tax Code § 171.1012(i).
[160] *See* 34. Tex. Admin. Code § 3.357.
[161] Texas Tax Code § 171.1012(i).

federal government, including any subcontracts that support a contract with the federal government, notwithstanding that the Federal Acquisition Regulation (FAR) may require that title or risk of loss with respect to those goods be transferred to the federal government before the manufacture or production of those goods is complete.[162] Thus, even thought a contractor or subcontractor does not have legal title to particular goods due to the FAR provisions which they are required to adhere to when doing work for the federal government, those taxable entities will still be able to get the benefit of the COGS deduction for otherwise qualifying purchases.

Direct Costs

In summary, COGS for margin tax purposes includes many of the direct costs of acquiring "goods", including the following:[163]

(1) labor costs;
(2) cost of materials that are an integral part of property produced;
(3) cost of material consumed in the ordinary course of performing production activity;
(4) handling costs (including processing, assembling, repackaging and inbound transportation);
(5) storage costs;
(6) depreciation, depletion and amortization reported on the federal income tax return on which the margin tax report is based, to the extent associated with and necessary for the production of goods (including IRC § 197 assets);
(7) cost of renting or leasing equipment, facilities or real property directly used in the production of goods, including pollution control equipment and intangible drilling and dry hole costs;
(8) costs for repair and maintenance of equipment, facilities or real property directly used for the production of goods (including pollution control equipment);
(9) research, experimental, engineering and design activities directly related to the production of goods (including IRC § 174 expenditures);
(10) geological and geophysical costs incurred to locate property with the potential to produce minerals;
(11) production related taxes;
(12) cost of producing or acquiring electricity sold; and
(13) certain contributions to partnerships to the extent used to fund COGS activity of the partnership.

Indirect Costs

Also allowable as part of the COGS deduction are certain indirect costs for production-related facilities, land and equipment relating to goods, including the following:[164]

(1) deterioration of the goods;

[162] Texas Tax Code § 171.1012(i).
[163] Texas Tax Code § 171.1012(c)(1)-(13).
[164] Texas Tax Code § 171.1012(d)(1)-(10).

(2) obsolescence;
(3) spoilage and abandonment costs;
(4) preproduction costs of certain property held for future production;
(5) postproduction direct costs allocable to the property (including storage and handling);
(6) insurance on items used directly in the production of goods;
(7) insurance on produced goods;
(8) cost of utilities directly used in the production of goods;
(9) quality control costs incurred in the production, repair and maintenance of goods; and
(10) licensing and franchise costs incurred in the production of goods.

Exclusion from COGS

Specifically excluded from COGS are the following costs in relation to the taxable enitity's goods:[165]

(1) rental or leased equipment, facilities or real property not used in the production of goods;
(2) selling costs;
(3) distribution costs (including outbound transportation);
(4) advertising costs;
(5) idle facility expense;
(6) rehandling costs;
(7) bidding costs (relating to successful solicitation of contracts);
(8) unsuccessful bidding costs;
(9) interest;
(10) income taxes (federal, state, local and foreign) and franchise taxes based on income;
(11) strike expenses;
(12) officer's compensation;
(13) costs of operation of facilities located on federal government property used primarily to house United States armed forces members; and
(14) any compensation paid to undocumented workers.

Up to four percent of overhead and administrative costs may be deducted from COGS to the extent such costs are related to the production of goods.[166] To the extent that COGS are capitalized on the entity's federal income tax return pursuant to IRC §§ 263A, 460 or 471 such costs may also be capitalized (subject to specifically allowed deductions per Texas Tax Code § 171.1012(c), (d) and (f) and excluding those costs not permitted as part of COGS per 171.101(d)) for margin tax purposes; conversely, the entity may expense those costs.[167] IRC § 263A relates to capitalization of certain inventory costs; IRC § 460 pertains to special rules for

[165] Texas Tax Code § 171.1012(e)(1)-(14).
[166] Texas Tax Code § 171.1012(f).
[167] Texas Tax Code § 171.1012(g).

long term contracts, and IRC § 471 specifies certain federal tax requirements with respect to accounting for inventories.

If the taxable entity elects to capitalize expenditures (as set out in Texas Tax Code § 171.1012(g)) it must capitalize each cost allowed per Texas Tax Code § 171.1012 that it capitalized on its federal income tax return. If the taxable entity later elects to begin expensing a cost (consistent with Tax Code § 171.1012 provisions) as a COGS, the entity may not deduct any cost in ending inventory from a previous report. If the taxable entity elects to expense a COGS that may be allowed for margin tax purposes a cost incurred before the first day of the period on which the report may be based it may not be subtracted as a COGS. If the taxable entity elects to expense a COGS and later elects to capitalize the COGS, a cost expensed on a previous report may not be capitalized.[168]

A taxable entity is required to determine its COGS (except as specifically provided otherwise in Texas Tax Code § 171.1012) in accordance with the methods used on the federal income tax return on which the margin tax report is based.[169]

A "qualifying lending institution"[170] that offers loans to the public may subtract as a COGS an amount equal to interest expense.[171] Excluded from the definition of a qualifying lending institution for this purpose is an entity primarily engaged in an activity described by category 5932 of the 1987 Standard Industrial Classification Manual prescribed by the Federal Office of Management and Budget. The SIC category referenced relates to used merchandise stores. Within that Code section category are pawnshops – which may not avail themselves of the interest COGS provision for lending institutions. Included within the definition of lending institutions for this purpose are entities engaged in lending to unrelated parties solely for agricultural production.[172]

Expenses associated with certain leased motor vehicle, heavy construction equipment and railcar rolling stock rental or lease activities may be part of COGS.[173] This is a very narrowly allowed COGS deduction permitted with respect to rental activities that is not allowed to most other rental activity taxpayers.

A taxable entity (including a combined group) whose principal business activity is film or television production or broadcasting or distribution of tangible personal property (described in Tex. Tax Code § 171.1012(a)(3)(A)(ii)) which elects to subtract COGS may include (in addition to other allowable costs per Tex. Tax Code § 171.1012) depreciation, amortization and other expenses directly related to the acquisition, production or use of the property, including expenses for the right to broadcast or use the property.[174]

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[168] Texas Tax Code § 171.1012(g).
[169] Texas Tax Code § 171.1012(h).
[170] *See* Tax Code § 171.0001(10) for definition of "lending institution".
[171] Texas Tax Code § 171.1012(k).
[172] Texas Tax Code § 171.1012(k).
[173] Texas Tax Code § 171.1012(k-1).
[174] Texas Tax Code § 171.0001(8)(c).

A payment made by one member of an affiliated group to another member of the affiliated group that is not a member of the combined group (i.e., that does not fit within the unitary provisions) may be subtracted from (and therefore reduce) COGS only if the transaction between the affiliated group members is considered to be "at arms length".[175] For this purpose, "arms length" is defined to mean the standard of conduct under which entities that are not related parties and that have substantially equal bargaining power, each acting in its own interest, would negotiate or carry out a particular transaction.[176] "Related party" means a person, corporation, or other entity in which the person, corporation, or entity, or set of related person, corporations or entities, directly or indirectly owns or controls a controlling interest in another entity (including an those entities that are pass through or disregarded entities for federal tax purposes.)[177]

For corporations, a "controlling interest" means either more than 50% (directly or indirectly) of the combined voting power of all classes of stock, or more than 50% (owned directly or indirectly) of the beneficial ownership interest in the corporate stock.[178] For partnerships, associations, trust, or other entities, (other than a limited liability company) "controlling interest" means more than 50%, owned directly or indirectly, of capital, profits or beneficial interest.[179]

For a limited liability company, "controlling interest" means either more than 50%, owned directly or indirectly, of the total membership interest of the limited liability company or more than 50%, owned directly or indirectly, of the beneficial ownership interest in the membership of the limited liability company.[180]

QUESTIONS:

- The literal language of the related party transactions seems to indicate that if the transfers are not made at arms length, no COGS offset will be allowed, rather than just the excess of the amount charged over what is considered arms length. Is this is what was intended?

- What happens to the determination of "controlling interest" for partnership purposes when there are changes in profit or capital allocation amounts from year to year (as can result from partnership special allocations)?

- What guidance will be used to determine "direct or indirect" ownership for control testing purposes? There is no indication as to what attribution rule scheme will be applied. Furthermore, no additional provisions dealing with attribution rule definitions were included in legislation passed during the 2007 session.

[175] Texas Tax Code § 171.1012(l).
[176] Texas Tax Code § 171.1012(m).
[177] Texas Tax Code § 171.1012(n).
[178] Texas Tax Code § 171.0001(8)(A).
[179] Texas Tax Code § 171.0001(8)(B).
[180] Texas Tax Code § 171.0001(8)(c).

OBSERVATION: The addition of an arms length, related party transaction test for the determination of allowable COGS expenses in some cases is a major shift in thinking for the Texas tax system. Texas has traditionally been a very form oriented jurisdiction when construing its tax provisions. The introduction of the much more subjective "arms length" approach, while it is here applied just in the COGS area, may signal a significant change to Texas' approach to taxation. As can be seen by just a few questions regarding the applicability of these provisions, there are likely many areas that will need to be addressed in implementing this approach. It was thought some of these issues might be addressed during the 2007 legislative session. However, no such provisions were included in 2007 legislation passed.

COMPENSATION

As an alternative to COGS, a taxable entity may elect to deduct (on an annual basis) its compensation expense in order to determine taxable margin.[181] As is true for COGS, the taxpayer must make the election on its annual report by the due date of such report, and may not subsequently change its deduction election method by way of an amended report.[182] "Compensation expense" for this purpose means, in general, the sum of allowable wage and cash compensation payments and benefits amounts.[183] In general (subject to a number of exceptions and modifications), "wages and cash compensation" means the amount entered in the Medicare wages and tips box of IRS form W-2 (or any subsequent form that provides similar information).[184] Also included within the definition of wages and cash compensation for this purpose are distributions made to others who may not be employees. These amounts include:

(1) net distributive income from partnerships from a taxable entity treated as a partnership for federal income tax purposes, but only if the distributee is a natural person;[185]

(2) net distributive income from LLCs and corporations treated as S corporation for federal income tax purposes, but only if the distributee is a natural person;[186] and

(3) stock awards and stock options deducted for federal tax purposes;[187] and

(4) net distributive income treated as a sole proprietorship for federal income tax purposes, but only if the person receiving the distribution is a natural person.[188]

OBSERVATION: The statutory language dealing with compensation amounts deemed paid by partnerships is neither clear nor consistent. Drafters appear to have confused the concept of allocable shares of net distributive income from

[181] Texas Tax Code § 171.101(a)(1)(B)(ii)(b).
[182] Texas Tax Code § 171.101(d).
[183] Texas Tax Code § 171.1013.
[184] Texas Tax Code § 171.1013(a).
[185] Texas Tax Code § 171.1013(a)(1).
[186] Texas Tax Code § 171.1013(a)(2).
[187] Texas Tax Code § 171.1013(a)(3).
[188] Texas Tax Code § 171.1013(a)(4).

partnerships (a non-cash measure) with actual cash distributions. The statutory language as written would appear to allow a wage compensation deduction to the taxable partnership entity equal to net distributive income (up to the $300,000 annual limit), irrespective of the amount of actual cash distributed. This is an area that could use some clarifying language in technical corrections. Unfortunately, no such technical corrections were made during the 2007 legislative session.

QUESTION: Will professional partnerships having as partners professional corporations or professional LLCs be able to deduct compensation expenses allocated to such partners? (Such structures are fairly common among professional service firms.) Typically, the PC or LLC is the employer of the actual service provider/professional (as opposed to the operating partnership). The operating partnership that allocates the distributive share of income to the PC or LLC does not have as its distributee/partner/member a natural person. Does this mean that the distributor/partnership has no compensation deduction (at least with respect to those partner/member utilizing PCs or LLCs) even though allocable shares of distributive income of $300,000 per service provider may be present? No guidance has been provided indicating that would not be the result – and no changes were made during the 2007 legislative session addressing the issue.

Notwithstanding the actual wage and cash compensation amount paid, a taxable entity may not include more than $300,000 (as indexed) paid annually to any one person (including officers, directors, owners, partners, and employees).[189] In addition, a taxable entity may not deduct any amounts paid to an undocumented worker.[190]

In addition to wages and cash paid, "compensation" includes the cost of all benefits the taxable entity provides to its officers, directors, owners, partners and employees.[191] Among those items specifically included within the definition of benefits are workers' compensation benefits, health care, employer contributions made to employees' health savings accounts, and retirement (but only to the extent deductible for federal income tax purposes).[192]

OBSERVATION: Unlike the $300,000 cap on wages and cash compensation, there is no margin tax dollar limit placed on the amount of includable (and therefore deductible) benefit costs. This is true for allowable benefits for all workers (documented as well as undocumented). Taxpayers may question whether this was an intended distinction, or just an oversight. If intended, taxpayers may also question what the rationale is for the different treatment.

OBSERVATION: Conspicuous by its absence from the definition of an allowable compensation deduction are payments to independent contractors. Taxpayers who classify workers as independent contractors for federal employment tax purposes would therefore appear not to get the benefit of such payments as part of the compensation expense that will reduce gross revenues.

[189] Texas Tax Code §§ 171.1013(b)(1); 171.1013(c); 171.106.
[190] Texas Tax Code § 171.1013(c-1).
[191] Texas Tax Code § 171.1013(b)(2).
[192] Texas Tax Code § 171.1013(b)(2).

Small employers (as defined by Texas Insurance Code § 1501.002) that have not provided health care benefits to any of their employees in the calendar year preceding the beginning date of the employer's reporting period are offered an incentive (by way of an increased compensation deduction) to provide such benefits. Such small employers (that have otherwise elected to deduct compensation) may deduct the regularly allowed compensation amount (per Tex. Tax Code § 171.1013). In addition, such small employers may also elect (as part of their margin tax compensation deduction):

(1) for the first 12-month period on which margin is based and in which the taxable entity provided health care benefits to all of its employees, an additional amount equal to 50 percent of the cost of health care benefits provided to its employees for that period; and

(2) for the second 12-month period for which margin is based and in which the taxable entity provides health care benefits to all its employees, an additional amount equal to 25% of the cost of health care benefits provided to its employees for that period.[193]

For purposes of this compensation deduction, "small employer" is defined to mean (in general) a person (including a partnership) who employed an average of at least two employees but not more than 50 eligible employees on business days during the preceding calendar year and who employs at least two employees on the first day of the plan year.[194]

Staff leasing company clients are authorized to include within the latter's determination of compensation payments made to the staff leasing company for wages and benefits of the assigned employees as if the assigned employees were actual employees of the client company.[195] Conversely, a taxable entity management company may not include as wages or cash compensation any amounts reimbursed by the managed entity; rather, those amounts are treated as though the reimbursed amounts had been paid to employees of the managed entity.[196]

APPORTIONMENT

Businesses that operate in multiple states are entitled to apportion their tax base among the various jurisdictions in which they do business. Most states use some variation of a weighted average of the three factors of property, payroll and sales to make a determination of the percentage of business done within the state. Unlike most other states, Texas has long used the single factor of gross receipts within the state as a percentage of gross receipts everywhere (excluding certain non-United States sourced revenues) to determine the percentage of the tax base apportionable to and taxable in Texas.[197] Single factor apportionment will continue to be used under the margin tax regime to determine the percentage of taxable margin that is subject to the tax.[198]

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[193] Texas Tax Code § 171.1013(b-1).
[194] Texas Insurance Code § 1501.002.
[195] Texas Tax Code § 171.1013(e).
[196] Texas Tax Code § 171.1013(f).
[197] Texas Tax Code § 171.106.
[198] Texas Tax Code § 171.106, as modified by HB 3, § 5.

"Gross receipts" (for Texas margin tax apportionment purposes) means all revenues reportable by a taxable entity on its federal tax return, without deduction for the cost of property sold, materials used, labor performed, or other costs incurred (unless otherwise specifically provided by Texas Tax Code chapter 171).[199] In general, a taxable entity is required to use the same accounting methods to apportion margin as used in computing margin.[200] A taxpayer may not change its accounting methods more than once every four years without express written consent of the Comptroller. A change in accounting methods is not considered justified solely because it results in a reduction in margin tax liability.[201]

Subject to certain exclusions noted below, the gross receipts of a taxable entity from its business done in Texas is the sum of the following:[202]

(1) each sale of tangible personal property if the property is delivered or shipped to a buyer in Texas regardless of the FOB point or another condition of the sale;
(2) each service performed in Texas, except that receipts derived from servicing loans secured by real property are considered to be Texas sourced if the real property is located in Texas;
(3) each rental of real property located in Texas;
(4) the use of a patent, copyright, trademark, franchise, or license in Texas;
(5) each sale of real property located in Texas, including royalties from oil, gas, or other mineral interests; and
(6) other business done in Texas.

Total revenue from the entity's entire business (the denominator of the apportionment factor) includes the following:[203]

(1) the sale of all tangible personal property less returns and allowances;
(2) interest and dividends;
(3) revenue from all services, rentals and royalties; and
(4) other business.

As was true with respect to prior law, only the net gain from the sale of an investment or capital asset is included in the taxable entity's gross receipts from its entire business.[204]

If a loan or security is treated as inventory of the seller for federal income tax purposes, the gross proceeds of the sale of that loan or security are considered gross receipts for apportionment purposes.[205] "Security" for purposes of Texas Tax Code § 171.106(f) (as well as Texas Tax Code §§ 171.1011(g) and (g-2)) has the meaning assigned by Internal Revenue Code § 475(c)(2), and includes instruments described by IRC §§ 475(e)(2)(B), (C) and (D). This is true irrespective of the provisions of Texas Tax Code § 171.1055 that otherwise would disallow

[199] Texas Tax Code § 171.1121(a).
[200] Texas Tax Code § 171.1121(b).
[201] Texas Tax Code § 171.1121(c).
[202] Texas Tax Code § 171.103(a).
[203] Texas Tax Code §§ 171.1011; 171.105(a).
[204] Texas Tax Code § 171.105(b).
[205] Texas Tax Code § 171.106(f).

taking into consideration receipts between individual members of a combined group for apportionment purposes when such revenues have been excluded from total revenues.[206]

COMMENT: A possible effect of the provision treating sales of loans or securities as gross proceeds for apportionment purposes (assuming such assets are treated as inventory for federal income tax purposes) could be to ultimately reduce the Texas apportionment factor, and thus the taxable margin amount. This can be the result when the location of a payor sourcing rule dictates that the sale of the loan or securities to non-Texas payors are not Texas sourced receipts, but the gross proceeds of the transaction are included in the denominator of the apportionment ratio.

The determination of gross receipts in Texas for apportionment purposes is similar, but not identical to that which existed prior to the changes to the franchise tax made by HB 3. One notable change is that the throwback rule will be eliminated under HB 3. That rule provided that sales of tangible personal property shipped from Texas to a purchaser in another state in which the seller is not subject to any tax on, or measured by net income (without regard to whether the tax was actually paid) would be 'thrownback' to Texas (i.e., included in the numerator of the single factor apportionment formula as a Texas sourced receipt). Such sales will not be considered Texas sourced receipts for purposes of the margin tax.[207]

Certain other receipts are excludable from margin apportionment pursuant to the provisions of HB 3. Receipts excluded from total revenue by a taxable entity per Texas Tax Code § 171.1011 may not be included in either the receipts of the taxable entity from business done in Texas or from receipts from its entire business (i.e., the denominator of the apportionment factor.)[208] There are also additional provisions dealing with apportionment of receipts for entities subject to combined reporting requirements, discussed below.

Sourcing Rules under HB 3

HB 3 is essentially silent on specifics as to the sourcing of gross receipts to Texas for apportionment purposes. ("Sourcing", for purposes of this outline, means the method by which one determines if a revenue is, or is not, a Texas receipt.) One may only assume that unless specifically modified (such as the elimination of the throwback provision noted above), the sourcing rules under the old franchise tax are largely intact. Those rules are set out at Tex. Admin. Code §§ 3.549 (with respect to taxable capital) and 3.557 (with respect to taxable earned surplus). While neither of those tax bases will continue to exist after the margin tax is phased in, the apportionment concepts will likely be quite similar. It will, however, be necessary to await Comptroller rules to determine exactly how the sourcing rules will be applied.

One of the more important sourcing rules has to do with the so-called "location of the payor" provisions. These rules (a result of both case law and Comptroller rule) specify that many types of income resulting from (among other things) the sales of intangibles, receipt of dividends and/or interest, or similar types of revenue streams are to be sourced based upon the "legal

[206] Texas Tax Code §§ 171.106(f); 171.1055(a), (b).
[207] *See* Texas Tax Code § 171.103(a)(1) prior to changes made by HB 3 § 5.
[208] Texas Tax Code § 171.1055.

domicile of the payor."[209] The determination of legal domicile can vary depending upon the entity status of such payor.[210] Thus, the legal domicile of a corporation is defined to be its state of incorporation. Alternatively, the legal domicile of a partnership or trust is the location of its day-to-day operations (or, if that is not easily ascertainable, its commercial domicile).[211] Absent any affirmative changes, there is no reason to believe the location of the payor rule will not continue to apply to margin tax computations.

By way of example of the applicability of the location of payor sourcing rules, a payment of a dividend by a Delaware incorporated entity, then, would be non-Texas sourced to the recipient payee, even if the payor corporation was physically located in Texas and had no other connection with Delaware at all (other than that being its state of incorporation).[212] These sourcing rules can be quite important for determining ultimate tax liability. This is especially true with respect to those cases under the margin tax when combined reporting (discussed below) will not apply, and the default separate entity reporting will be applicable.

Taxpayers need to be attuned to any rules or pronouncements that may be promulgated as to sourcing issues with respect to the margin tax regime.

COMBINED REPORTING

One of the major changes to the existing franchise tax structure effected by HB 3 and the margin tax is end of a longstanding history in Texas of separate company tax reporting. While the stated rule is that companies are required to report on a separate company basis, and it is clear that consolidated return reporting is not permitted,[213] the Texas legislature saw fit to impose combined reporting on members of an affiliated group that operate in a unitary manner.[214] Combined reporting is different from consolidated return reporting (in part) in that there is not the potential for offset of income, losses and other tax attributes from qualifying entities in a combined report as there is for federal consolidated income tax return purposes.[215] Combined reporting of unitary enterprises is a concept that has been in existence and utilized by numerous states for many years (with California being a lead state in that regard).[216] While a detailed discussion of unitary concepts and combined reporting is beyond the scope of this outline, following is a summary of the imposition of those requirements as part of HB 3 and the margin tax under the new Texas law.

Pursuant to HB 3, taxable entities that are part of an affiliated group engaged in a unitary business are required to file a combined group report (based on the overall group's business) in lieu of individual reports.[217] For this purpose, an affiliated group is defined as a group of one or more entities in which a controlling interest is owned by a common owner or owners, either

[209] 34 Tex. Admin. Code § 3.557(b)(9).
[210] 34 Tex. Admin. Code § 3.557(b)(8).
[211] 34 Tex. Admin. Code § 3.557(b)(8).
[212] *See* 34 Tex. Admin. Code § 3.357(e)(13)(E).
[213] Texas Tax Code § 171.1011(d).
[214] *See* Texas Tax Code § 171.1014.
[215] *See* Treas. Reg. §§ 1.1502-1 *et. seq.* for federal consolidated return regulation requirements.
[216] For a detailed discussion of unitary concepts, *see* Hellerstein & Hellerstein, *State Taxation*, par. 8.09-8.11 (Warren, Gorham & Lamont, 3rd Ed.).
[217] Texas Tax Code § 171.1014(a).

corporate or noncorporate, or by one or more of the member entities.[218] A "combined group" means taxable entities that are part of an affiliated group engaged in a unitary business and that are required to file a group report per Texas Tax Code § 171.1014.[219] "Controlling interest" means: (1) for a corporation, either more than 50%, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50%, owned directly or indirectly, of the beneficial ownership interests in the voting stock of the corporation[220]; and (2) for a partnership, association, trust, or other entity other than a limited liability company, more than 50%, owned directly or indirectly, of the capital, profits, or beneficial interest in the partnership, association, trust or other entity.[221] For a limited liability company, "controlling interest" means either more than 50%, owned directly or indirectly, of the total membership interest of the limited liability company, or more than 50%, owned directly or indirectly, of the beneficial ownership interest in the membership interest of the limited liability company.[222]

COMMENT: Prior to the changes made by HB 3928, the control test requirement for determining the existence of a unitary group was set at 80%, as opposed to a 50% threshold.[223] The decreased percentage for control purposes will necessarily result in more affiliated entities being subject to unitary tax, combined group requirements for Texas margin tax purposes.

UNITARY BUSINESS CONSIDERATIONS

"Unitary business" is defined for Texas margin tax reporting purposes to mean a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. In determining whether a unitary enterprise exists, the legislature has directed the Texas Comptroller to consider any relevant factor, including (presumably, among others) whether:

(1) the activities of the group members:
  (A) are in the same general line, such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation, or finance;[224] or
  (B) are steps in a vertically structured enterprise or process, such as the steps involved in the production of natural resources, including exploration, mining, refining, and marketing;[225] or

(2) the members are functionally integrated through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing.[226]

[218] Texas Tax Code § 171.0001(1).
[219] Texas Tax Code § 171.0001(7).
[220] Texas Tax Code § 171.0001(8)(A).
[221] Texas Tax Code § 171.0001(8)(B).
[222] Texas Tax Code § 171.0001(8)(c).
[223] See change to Texas Tax Code § 171.001(8) at HB 3928 § 1.
[224] Texas Tax Code § 171.0001(17)(A)(i).
[225] Texas Tax Code §171.0001(17)(A)(ii).

A combined group that is required to file a combined report is considered to be a single taxable entity for purposes of the application of the margin tax.[227] A combined group is also considered to be a single entity for purposes of applying the tax discount limitations based upon total revenues being less than $900,000.[228] A combined group's total revenue is determined by:

(1) determining the total revenue of each of its members (as provided by Texas Tax Code § 171.1011 as if the member were an individual taxable entity);[229]
(2) adding the total revenues of the members (as determined above) together;[230] and
(3) subtracting, to the extent included in revenue (per the stand alone provisions of Texas Tax Code § 171.1011) items of total revenue received from member of the combined group.[231]

Joyce v. Finnigan Approach – Treatment of Revenues for Entities Lacking Texas Nexus

As passed, a combined group's Texas receipts includes only the Texas receipts of those entities that have nexus in Texas (as opposed to lumping in revenues from combined group members that did not have any presence in Texas.)[232] This exclusion from Texas sourced receipts of entities that are part of a combined group, but which do not have nexus with the state, means that Texas has (at least for the time being) decided to follow the so-called "Joyce" rule (based upon a California State Board of Equalization decision of the same name).[233] An alternate approach, which would require inclusion of the non-nexus entity receipts in the numerator of the apportionment factor even though there is no nexus, was not adopted by the Texas legislature. (This alternate approach is often referred to as the "Finnigan" rule, also named after a California State Board of Equalization decision.[234])

Adopting the Joyce approach is beneficial to Texas taxpayers in that inclusion of the receipts of the non-Texas nexus entity in the denominator of the apportionment factor, but not the numerator, will result in a diluted apportionment factor. That, in turn, results in a smaller apportioned tax base and tax liability. There has been some discussion that the Texas legislature may revisit adopting the Finnigan (as opposed to the Joyce) approach in order to increase revenues. Taxpayers should monitor any such change as it could have a significant impact on the Texas margin tax liability of those entities filing combined reports.

Deduction on Combined Group Basis

In determining taxable margin, a combined group that elects to deduct either COGS or compensation must make the same election for all members of the combined group.[235]

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[226] Texas Tax Code § 171.0001(17)(B).
[227] Texas Tax Code § 171.1014(b).
[228] Texas Tax Code § 171.1014(b).
[229] Texas Tax Code § 171.1014(c)(1).
[230] Texas Tax Code § 171.1014(c)(2).
[231] Texas Tax Code § 171.1014(c)(3).
[232] Texas Tax Code § 171.103(b).
[233] *See Appeal of Joyce, Inc.*, Cal. State Bd. of Equaliz., Nov. 23,1966, Dkt. No. 66-SBE-070.
[234] *See Appeal of Finnigan*, Cal. St. Bd. of Equaliz., Aug. 25, 1988, Dkt. No. 88-SBE-022, on reh'g., Jan. 24, 1990.
[235] Texas Tax Code § 171.1014(d).

Regardless of the deduction election made, however, taxable margin of the combined group may not exceed 70% of the combined group's total revenue.[236]

COGS Deduction for Combined Group

A combined group that elects to deduct COGS in determining taxable margin is required to determine that amount by:

(1) determining the COGS for each of its members (as provided per Texas Tax Code § 171.1012) as if the member were an individual taxable entity;[237]
(2) adding the amounts of COGS determined above together;[238] and
(3) subtracting from the amount determined (in (2), above) any COGS amounts paid from one member of the combined group to another member of the combined group, but only to the extent the corresponding item of total revenue was subtracted in determining combined group revenue.[239]

A member of a combined group may claim as COGS those costs that otherwise qualify for margin tax purposes even though the costs are incurred by another member of the combined group.[240]

Compensation Deduction for Combined Group

For a combined group that elects to subtract compensation in determining taxable margin, that computation is done by:

(1) determining the compensation for each of its members (as specified by Texas Tax Code § 171.1013) as if each member were an individual taxable entity;[241]
(2) adding the amounts of compensation determined under (1), above;[242] and
(3) subtracting from the amount determined under (2), above, any compensation amounts paid from one member of the combined group to another member of the combined group, but only to the extent the corresponding item of total revenue was subtracted from combined group revenue.[243]

In apportioning margin, receipts from transactions between members of a combined group are, in some cases, subject to special rules. Receipts derived from such transactions between individual member of a combined group that are excluded (per Texas Tax Code § 171.1014(c)(3)) may not be included as a Texas sourced receipt of the taxable entity from the business done in Texas (per Texas Tax Code § 171.103), except in a situation where one member party to the transaction does not have nexus in Texas. In that case, such inter-company receipts ultimately derived from the sale of tangible personal property shall be included as a Texas

[236] Texas Tax code § 171.1014(d).
[237] Texas Tax Code § 171.1014(e)(1).
[238] Texas Tax Code § 171.1014(e)(2).
[239] Texas Tax Code § 171.1014(e)(3).
[240] Texas Tax Code § 171.1014(d-1).
[241] Texas Tax Code § 171.1014(f)(1).
[242] Texas Tax Code § 171.1014(f)(2).
[243] Texas Tax Code § 171.1014(f)(3).

sourced receipt to the extent that the member of the combined group that does not have nexus in Texas resells the tangible personal property without substantial modification to a purchaser in Texas.[244] For this purpose, "receipts ultimately derived from sale" means the amount paid for the tangible personal property by the third party purchaser.[245]

In addition, receipts derived from transactions between individual members of a combined group that are excluded receipts (per Texas Tax Code § 171.1014(c)(3)) may not be included in the receipts of the taxable entity from its entire business.[246] Otherwise, a combined group is required to include in its gross receipts from its entire business the gross receipts of each taxable entity that is a member of the combined group, without regard to whether the entity has nexus with the state.[247]

As noted above, there is no indication that (subject to the above provisions) any changes have been made to the "location of the payor" sourcing provisions. That rule specifies that certain revenues (from dividends, interest, and sales of certain intangibles) are sourced to the legal domicile of the payor entity.[248]

Even if a member of a combined group does not have nexus in Texas (and is excluded from including gross receipts in the combined group report per the *Joyce* rationale discussed above), there are Texas margin tax reporting requirements with respect to such non-nexus entity. The combined group must report for each member of the group that does not have nexus in Texas for taxation purposes:

(1) The gross receipts amount (that would otherwise be included as a revenue per Texas Tax Code § 171.103(a)), and

(2) The gross receipts computed under Texas Tax Code § 171.103(a) that are subject to taxation in another state under a throwback law or regulation.[249]

The information required with respect to combined group members that do not have nexus with Texas are identified as being for informational purposes only (although the Comptroller has been directed to adopt rules as necessary to enforce the reporting requirements).[250]

Each taxable entity that is part of a combined group is required, for purposes of determining margin and apportionment, to include its activities for the same period used by the combined group.[251]

Each member of the combined group is jointly and severally liable for the tax of the entire combined group.[252]

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[244] Texas Tax Code § 171.1055(b).
[245] Texas Tax Code § 171.1055(b).
[246] Texas Tax Code § 171.1055(c).
[247] Texas Tax Code § 171.105(c).
[248] *See*, e.g., 34 Tex. Admin. Code §§ 3.557(b)(8),(9);(e)(13)(E);(e)(21);(e)(25)(B).
[249] Texas Tax Code § 171.103(c).
[250] Texas Tax Code § 171.103(d).
[251] Texas Tax Code § 171.1014(h).

Unitary Cases

A detailed discussion of the background and evolution of unitary taxation principles is beyond the scope of this outline. There are literally hundreds of cases decided in many different jurisdictions throughout the United States, as well as numerous U.S. Supreme Court decisions pertaining to unitary taxation. The cases are typically very fact specific, and the courts' decision turn on the relevant facts.

Some of the leading unitary cases include the following:

Butler Bros. v. McColgan, 305 US 501, S. Ct. 701 (1942) ('three unities" (ownership, operation and use) acknowledged as acceptable basis for determination of a unitary enterprise);

Exxon Corp. v. Wisconsin Department of Taxation, 447 US 207, 100 S. Ct. 2109 (1980) ("functional integration" found to exist in an integrated oil and gas enterprise even thought only one activity (marketing) occurred in the state);

F.W. Woolworth Co. v. Taxation and Revenue Dept., 458 US 354, 102 S. Ct. 3128 (1982) ("functional integration" was not found to exist when a U.S. parent entity was not deemed to exercise centralized management control over foreign subsidiaries – therefore, no unitary enterprise);

ASARCO, Inc. v. Idaho Tax Commission, 458 US 307, 102 S. Ct. 3103 (1982) (no unitary enterprise deemed to exist between parent mining/smelting/refining company and its out of state subsidiaries which generated investment income unrelated to the taxing state; Court concluded that unitary tests of "functional integration, centralization of management, and economies of scale weren't sufficiently present to result in a unitary business);

Container Corporation of America v. Franchise Tax Board, 463 US 159, 103 S. Ct. 2933 (1983) (the Court concluded that a "flow of value," as opposed to a "flow of goods" was sufficient for a finding that a unitary enterprise existed);

Allied-Signal, Inc. v. Director of Taxation, 504 US 768, 112 S. Ct. 2252 (1992) (the taxing state attempted to apportion virtually all income, including investment type proceeds, from a 20% owned subsidiary; the Court disallowed this approach, concluding there was no unitary enterprise when there was not much more present between parent and minority ownership interest subsidiary than common ownership.)

For a good general discussion of unitary business principles, *see* Hellerstein & Hellerstein, *State Taxation*, par. 8.07 *et.seq.* (Third Edition, Warren, Gorham & Lamont, (2006 Supp.)).

TIERED PARTNERSHIP ARRANGEMENT REPORTING

Another significant change made by the legislature in enacting the HB 3 margin tax is in allowing so-called "tiered partnership arrangements" to be treated as a single taxable entity in

[252] Texas Tax Code § 171.1014(i).

some cases.[253] (In doing so, the legislature apparently got confused, and referred in HB 3 to what logically would be considered an "upper tier partnership" as a "lower tier partnership", and *vice-versa*.[254] The confusing "reversed" language was corrected by the legislature in HB 3928.[255]

As noted below, notwithstanding the reference to "tiered partnership arrangements," state law entities affected by these requirements include more than just partnerships. A "tiered partnership arrangement" means an ownership structure in which any of the interests in one taxable entity treated as a partnership, or an S corporation for federal income tax purposes (defined as the "lower tier entity") are owned by one or more other taxable entities (defined as the "upper tier entity"). A tiered partnership arrangement may have multiple tiers.[256]

OBSERVATION: "Tiered partnership arrangements" ("TPA") are essentially tax return reporting mechanisms that allow, in some circumstances, "lower tiered entities" (i.e., the "owned entity") to have their total revenues included in the report of the "upper tier entity" (i.e., the "owning" entity). The lower tier entity must be a taxable entity that is treated as either a partnership or S corporation for federal income tax purposes. It cannot be some other type of taxable entity that is classified otherwise for federal income tax purposes (such as a C corporation or a trust).

By contrast, an "upper tier entity" (i.e., the "owning" entity) can be any type of "taxable entity" – which would include e.g., C corporations, trusts and non pass through LLCs. "Upper tier entities" for TPA reporting purposes do not include non-taxable entities, however – such as an individual, or general partnership all of the partners of which are natural persons.

A tiered partnership arrangement may have two or more tiers.[257] In addition to the tax it is required to pay under Tax Code chapter 171 on its own taxable margin, the "upper tier entity" may include, for purposes of calculating its own taxable margin, the total revenue of a "lower tier entity" if the lower tier entity submits a report to the Comptroller showing the amount of total revenue that each "upper tier entity" that owns the "lower tier entity" should include in the "upper tier entity's" own taxable margin calculation (based upon the ownership interest of the "upper tier entity").[258]

OBSERVATION: Significant changes to the tiered partnership reporting arrangement provisions of Texas Tax Code § 171.1015 were made by HB 3928.[259] While those changes succeeded in eliminating the confusing "reversed" upper/lower tier language that had plagued the TPA provisions under HB 3, the revised TPA language leaves a somewhat curious provision in its wake. Whereas it was clear under the old provision that, to the extent the taxable margin of the "owned"

[253] Texas Tax Code § 171.1015.
[254] Texas Tax Code § 171.1015(a).
[255] HB 3928, § 18.
[256] Texas Tax Code § 171.1015(a).
[257] Texas Tax Code § 171.1015(a).
[258] Texas Tax Code § 171.1015(b).
[259] See HB 3928 § 18.

entity was included in the "owning entity," no margin tax would then be due from the owned entity, that result is not so clear subsequent to the HB 3928 changes. Texas Tax Code § 171.1015 now specifies that the upper tier entity "may" (not must) include the total revenue of a lower tier entity if the lower tier entity submits the proper report to the Comptroller. There is no corresponding statutory language stating that such total revenue would therefore be excluded from the lower tier entity's reporting, or that the lower tier entity is excluded from reporting (unlike the previous version of the TPA provisions). Although implied that there should be such an exclusion, there is no specific language in the statute dictating the result – that the lower tier entity would be relieved of margin tax liability on those revenues.

OBSERVATION: Unlike combined reporting requirements which are mandatory (assuming the affiliations and unitary aspects are met), TPA reporting appears to be elective. The TPA reporting election is made by the "lower tier entity" submitting a report to the Comptroller showing the amount of the taxable margin that each "upper tier" entity that owns it. While there is no apparent requirement that the "upper tier entity" acquiesce in the TPA, the specific statutory provision states that the upper tier entity "may" include the lower tier entity's revenues for purposes of calculating the upper tier entity's taxable margin. One may question what the result would be if an upper tier entity owning a minority interest in a TPA chooses not to include such total revenue in calculating its taxable margin (when the lower tier entity has submitted the requisite report).

OBSERVATION/QUESTION: Given the existence of mandatory combined reporting requirements that would result in a single tax return for the group when those requirements are met (i.e., the 50% affiliations and unitary business enterprise tests) one may ask when the TPA would have any applicability. The answer would appear to be when the TPA entities **do not** fit within the combined reporting requirements – either because the 50% affiliations or unitary business (or both) requirements are not met, but the literal statutory provisions of TPAs are so met. Thus, if there was multiple, unrelated party ownership of a lower tier entity such that none of the owners held in excess of 50% of the "ownership interests" of the lower tier entity, TPA reporting might apply. Similarly, if there was more than 50% common ownership, but no unitary enterprise, TPA reporting might be a possibility. Query: How is "ownership interest" determined when that measure might vary during the course of a year?

The tiered partnership reporting arrangement does not apply to that percentage of the total revenue attributable to an "upper tiered entity" by a "lower tier" entity if the "upper tier entity" is not subject to the franchise tax.[260] In that case, the "lower tier" entity is liable for paying the tax on its own margin (i.e., the owned entity pays the tax if the parent entity is not subject to the franchise tax).[261]

[260] Texas Tax Code § 171.1015(c).
[261] Texas Tax Code § 171.1015(c).

The exclusion of taxability for entities having annual revenues of less than $300,000 (or tax of less than $1000) does not apply to an upper tier entity if (before attribution of any total revenue from the lower tier entity) the lower tier entity could not itself meet the tax exclusion requirements.[262]

The Comptroller is charged with adopting rules explaining the tiered partnership reporting arrangement.[263]

TEMPORARY CREDIT, NET OPERATING LOSSES AND OTHER CREDITS AND DEDUCTIONS

There is no provision in HB 3 or the margin tax for the generation or utilization for business loss carryovers on a go-forward basis.[264] Because there are many taxpayers that will have unutilized business losses, a provision was included in HB 3 (at § 171.111) which attempted to provide a credit mechanism to mitigate the effect of the new law on those losses. The credit provision at Texas Tax Code § 171.111 was very poorly drafted, and consequently subject to a clarifying revision during the 2007 legislative session.[265] The modified temporary credit provision allows taxable entities to take a credit in the amount specified against the tax otherwise due on taxable margin. In order to do so, the taxable entity must notify the Comptroller, in writing, of its intent to take the credit on its first margin tax report due on or after January 1, 2008. The taxable entity may then claim the credit at or before the original due date of any report due after January 1, 2008 for a period of up to 20 consecutive privilege periods.[266]

The credit is computed in the following manner:

(1) Determine the amount of the unutilized business loss carry forwards of the taxable entity (per Texas Tax Code § 171.110(d)) in effect prior to January 1, 2008;

(2) Multiply the amount of unutilized business carry forwards by:
   (A) 2.25 percent for reports originally due on or after January 1, 2008 and before January 1, 2018; and
   (B) 7.75 percent for reports originally due on or after January 1, 2018 and before September 1, 2027; and

(3) Multiplying each annual amount by 4.5 percent[267] (the tax rate in effect on taxable earned surplus prior to the implementation of the margin tax).

The Comptroller may request that the taxable entity submit information with each annual report for which it is eligible to take the credit information relating to the business loss carryover.[268] The credit may not be conveyed.[269] In addition, the entity loses the right to claim the credit if entity changes combined groups after June 30, 2007.[270]

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[262] Texas Tax Code § 171.1015(d).
[263] Texas Tax Code § 171.1015(d).
[264] *See* current Texas Tax Code § 171.110(e), to be repealed by HB 3 § 5.
[265] See HB 3928, § 23.
[266] Texas Tax Code § 171.111(a).
[267] Texas Tax Code § 171.111(b).
[268] Texas Tax Code § 171.111(c).

COMMENT: The prohibition on the ability to claim the credit carryover if the entity changes combined groups effectively restricts the use of such loss carryovers from being used as assets that can be conveyed in order to offset taxable margin of different affiliated groups of taxable entities.

There is also a prohibition on the ability of a stand-alone taxable entity to claim a credit for loss carryovers unless the taxable entity was subject to the franchise tax as of May 1, 2006 (i.e., corporations and limited liability corporations).[271] Thus, stand-alone entities that were not subjected to the franchise tax prior to the implementation of the margin tax (such as limited partnerships) would not be able to claim a credit for loss carryovers.

A taxable entity that is a combined group may claim the credit for each member entity that was subject to the franchise tax as it existed on May 1, 2006.[272] By implication, members of combined groups that were not subject to the franchise tax as it existed on May 1, 2006 (such as limited partnerships) would not be eligible to take the loss carryover credit.

In no event may the amount of the credit claimed (including any unused credit carried forward) exceed the amount of franchise tax due for the report. Any unused credits expire, and may not be carried forward to any margin tax reports due on or after September 1, 2027.[273]

Previously existing tax credits will be eliminated when the margin tax goes into effect.[274] New credits (other than those specifically authorized by HB 3 or other Tax Code provisions) will not be obtainable after the margin tax provisions go into effect. That repeal, however, will not affect a credit that was established under Texas Tax Code Chapter 171 (Subchapter L-U) prior to the effective date of HB 3.[275] Companies with accumulated economic development credits (as a result of a written agreement with the Texas Department of Economic Development or is successor, effective before June 1, 2006) will continue to be able to claim and accumulate the credits.[276]

Additional deductions are also allowable for certain Solar Energy Devices and Clean Coal Projects.[277] The taxable entity may deduct from its apportioned margin 10% of the amortized cost of the qualifying device or equipment if the required qualifications are met.[278] A "Clean Coal Project" has the meaning assigned by Texas Water Code § 5.001.[279]

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[269] Texas Tax Code § 171.111(d).
[270] Texas Tax Code § 171.111(d).
[271] Texas Tax Code § 171.111(d-1).
[272] Texas Tax Code § 171.111(d-1).
[273] Texas Tax Code § 171.111(d-2), (e).
[274] HB 3, § 18(a).
[275] HB 3, § 18(b).
[276] HB 3, § 19.
[277] Texas Tax Code §§ 171.107; 171.108.
[278] Texas Tax Code §§ 171.107(b); 171.108(b).
[279] Texas Tax Code § 171.108(a).

EFFECTIVE DATES AND TRANSITION ISSUES

The general effective date of the margin tax is January 1, 2008, and applies to reports first due on or after that date.[280] The first tax payment based upon the new tax will therefore be payable with the report due May 15, 2008. Because the franchise tax continues to be based upon a company's financial activity that ends in the calendar year in the year preceding the report year, the new law will have an impact on activity well before January 1, 2008.

In no event will the new law apply to activity prior to June 1, 2006. For calendar year taxpayers, the 2008 report will be based upon operations for calendar year 2007 (i.e., January 1, 2007 – December 31, 2007). For fiscal year taxpayers, the earliest impact will vary. For those with a fiscal year ending after January 1, 2007 but before June 1, 2007, the first (i.e., 2008) report will be based upon a partial year's worth of activity (starting after June 1, 2006 and ending prior to June 1, 2007. Those with fiscal years ending after June 1, 2007 will file their 2008 report based upon a full year of activity (e.g., a June 30th taxpayer will report for 2008 based upon results from July 1, 2006-June 30, 2007.

The 1000 largest entities doing business in the state as of early 2007 (as measured several different ways) were required to file an information report. The report had to contain the same information that an entity required to file the report would have submitted in its report due to the Comptroller in 2006, if the changes made by HB 3 had been in effect January 1, 2006.[281] The information report was also required to contain the total of maintenance and operation school property taxes paid by the entity to Texas school districts in 2005. The Comptroller was to identify and notify these taxpayers of the their obligation, as well as send them appropriate forms and instructions, between November 15 – December 2, 2006. The information reports were required to be submitted on or before February 15, 2007.[282] The Comptroller has the authority to revoke the charter of taxpayers that did not comply with the information return reporting requirements.[283] Similar information reporting requirements initially mandated by HB 3 for the 1000 largest taxpayers pertaining to 2006 and 2007 financial information were eliminated by HB 3928 provisions.[284]

For purposes of HB 3, an existing partnership is considered as continuing (and therefore subject to the margin tax) if it is not terminated.[285] A partnership is considered terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.[286] For a merger or consolidation of two or more partnerships, the resulting partnership is, for purposes of the transitional rules, considered to be the continuation of any merging or consolidating partnership whose members own an interest of more than 50% of the capital and profits of the resulting partnership.[287] For a division of a partnership into two or more partnerships, the resulting partnerships, other than any resulting

[280] HB 3, §§ 22, 26.
[281] HB 3, § 23(b).
[282] HB 3, § 23(f).
[283] HB 3, § 23(c).
[284] See HB 2938, § 36.
[285] HB 3, § 22(c).
[286] HB 3, § 22(d).
[287] HB 3, § 22(e).

partnership the members of which had an interest of 50% or less in the capital and profits of the prior partnership, are, for purposes of the HB 3 transitional rules, considered a continuation of the prior partnership.[288]

TRANSITIONAL RULE FOR ENTITIES NOT PREVIOUSLY SUBJECT TO FRANCHISE TAX

Entities not previously subject to the franchise tax as it existed prior to the implementation of the margin tax by HB 3 (such as limited partnerships) which terminated their existence (e.g., by liquidation into non-successor entities or as non-surviving merger parties) prior to July 1, 2007 are not subject to margin tax filing, reporting or payment requirements.[289]

Conversely, if an entity that was not previously subject to the franchise tax prior to its amendment by HB 3 was in existence and doing business in Texas at any point after June 30, 2007, it will (or would) be subject to some sort of margin tax reporting and/or possible tax liability. For those entities not previously subject to the franchise tax which continue in existence as of and after January 1, 2008, the entities will be subjected to margin tax as discussed in this outline.

If an entity not previously subject to the margin tax (prior to implementation of HB 3) existed and was a going business in Texas after June 30, 2007, but terminated its existence after June 30, 2007 and prior to January 1, 2008, the entity is required, for the privilege of doing business in Texas at any point during the July 1, 2007 – December 31, 2007 period, to file an additional report and pay an additional tax. The additional tax amount is equal to the appropriate rate (under Texas Tax Code § 171.002 as amended by HB 3928) on the entity's taxable margin beginning on the later of January 1, 2007, or the date the entity was organized or started doing business in Texas,[290] and ending on the date the entity became no longer subject to the tax. (The effective date of the transitional provisions was June 15, 2007.[291])

COMMENT: Subsequent to the passage of HB 3928 on June 15, 2007, there was a short period of time (ending June 30, 2007) during which entities such as limited partnerships that would otherwise become subject to margin tax as of January 1, 2008 could terminate their existence and avoid margin tax that would be due on activity occurring up to June 30, 2007. This was due to the operation of the transitional rule provisions adopted by HB 3928, § 35(b-1) and (b-2) (discussed above). As a result there was a brief flurry of activity in June 2007, where a number of entities considered and/or did, terminate their existence to avoid tax on amounts that would otherwise have been due on activity through June 30, 2007. The Comptroller, acknowledging the existence of the transitional provisions, provided guidance as to how it would treat varying types of these transactions. Copies of the Comptroller guidance are attached as Attachment C.

[288] HB 3, § 22(f).
[289] HB 3928, § 35(a) (amending HB 3, by adding § 22(b-1)).
[290] HB 3928, § 35(a) (amending HB 3, by adding § 22(b-2)).
[291] HB 3928, § 35(b).

Subject to the transitional provisions discussed above, an entity becoming subject to the franchise tax under margin tax provisions that is part of a combined group is required (for purposes of determining margin and apportionment) to include its activity for the same period used by the combined group.[292]

[292] HB 3928 § 35(a) (amending HB 3, by adding § 22(g)).

Attachment A

Texas Franchise Tax Summary Prior to HB 3 Changes

The Texas franchise tax is levied upon each corporation that does business or is chartered or authorized to do business in Texas. The definition of "corporation" for franchise tax purposes includes limited liability companies, but excludes partnerships. While the franchise tax is imposed upon corporations for the privilege of doing business in Texas, it operates no differently from a corporate income tax for the substantial majority of entities subject to the tax.

The franchise tax is levied upon the greater of an amount measured by (1) a corporation's taxable capital apportioned to the state or (2) taxable earned surplus apportioned to the state. The tax on capital is imposed at a rate of ¼ of 1% [or $2.50 per $1,000] of taxable capital, while earned surplus is taxed at a rate of 4½%. Taxable capital is defined as the sum of a corporation's "stated capital" and "surplus." While there are a number of statutorily required exceptions, taxable capital is (very roughly speaking) equal to the excess of a corporation's assets over its liabilities. True debt is excludable from taxable capital, but estimated or contingent liabilities are not. Only that part of the corporation's capital which is apportionable to the state is subject to the franchise tax.

The earned surplus component of the franchise tax is based primarily upon the amount of the corporation's federal taxable income apportionable to the state. A corporation's federal taxable income for franchise tax purposes is defined as its taxable income after taking into account federal Form 1120 Schedule C special deductions and before considering net operating loss (NOL) deductions. Federal NOL's resulting from years ending before January 1, 1991 cannot be used for Texas franchise tax purposes. Business losses occurring in Texas after that date may reduce taxable amounts for franchise tax purposes. Prior to apportionment, the corporation's federal taxable income total is adjusted by subtracting from it certain types of foreign *(i.e.,* non U.S.) sourced income, and adding back to it any corporate compensation received by officers and directors that has been deducted for federal tax purposes. However, corporations that do not have more than 35 shareholders are not required to add back the compensation of corporate officers and directors. Consolidated return reporting is not permitted for franchise tax purposes.

There is no minimum franchise tax. If there is less than $100 in tax that would result from the preceding computations, no tax is due. This translates into no franchise tax amounts due from corporations having apportioned taxable capital of less than $40,000 and apportioned taxable earned surplus of less than $2,222. In addition, entities having total gross receipts of less than $150,000 annually are not subject to the franchise tax.

Apportionment

Apportionment of taxable capital and/or net earned surplus to Texas is based upon the single factor of the corporation's gross receipts. Unlike many other states, Texas does

not allow any alternative measure of apportionment other than the mandated single factor gross receipts method. The gross receipts apportionment ratio is calculated by dividing the gross receipts of the corporation attributable to Texas by its gross receipts earned everywhere. The method of determining the gross receipts apportionment factor for taxable capital purposes is typically based upon generally accepted accounting principles (GAAP). However, a corporation whose taxable capital is less than $1 million may report *its* surplus *(i.e.,* the cumulative earnings component of total capital) according to its most recently used federal income tax method. The apportionment of earned surplus to Texas is also based upon the single factor of gross receipts; however, unlike the measure used for taxable capital purposes (which is based upon GAAP) the earned surplus gross receipts factor is based upon the methodology used for federal income tax purposes.

Included in the computation of gross receipts from business done in Texas is the sum of the corporation's receipts from:

1) sales of tangible personal property if the property is delivered or shipped to a buyer in Texas, as well as each sale of tangible personal property shipped from Texas to another state in which the seller is not subject to taxation;

2) each service performed in the state;

3) each rental of property situated in the state;

4) each use of a patent, copyright, trademark, franchise or license in the state;

5) each sale of real property located in the state, including royalties from oil, gas or other mineral interests; and

6) other business done in the state.

Sales of Texas companies not subject to tax elsewhere may be "thrown back" to Texas and included as a Texas sourced receipt, depending upon a number of different factors. (Note: the throwback provision of the earned surplus component of the franchise tax has been declared unconstitutional in the 2005 court case of *Home Interiors & Gifts, Inc. v. Strayhorn.* It is currently being appealed to the Texas Supreme Court.) There are also special rules for allocation of certain types of passive income (such as dividends and interest) to the state of incorporation of the payor of such income.

Reporting Requirements

The franchise tax is paid based upon an initial period, a second period, and a regular period. The initial period begins on the date a corporation is incorporated in Texas, is granted a certificate of authority to do business within the state, or begins doing business in the state, whichever is earlier, and ends on the day before the first anniversary of that date. The second period begins on the first anniversary date (as outlined above) and ends on the following December 31. The regular periods are thereafter based upon a calendar year (the privilege period).

The first report after a corporation starts operating in the state is due on the month ending date closest to 90 days after the corporation's first anniversary date in Texas (*i. e.*, about 15 months after the corporation first starts doing business in Texas.) Thereafter, franchise tax returns are due on May 15 of each year, with a 6 month extension of time to file available. As noted, no tax is due if the franchise tax liability is calculated to be less than $100, although an information report must still be filed.

The regular period franchise tax reports due on May 15 relate to the calendar year privilege period in which the returns are due. The franchise tax report for the regular period is based upon the corporation's accounting period ending in the year before the report year. By way of example, a calendar year corporation's 2006 franchise tax report due on May 15, 2006 is based upon the entity's accounting year ending December 31, 2005. The 2006 franchise tax report and tax paid relate to the privilege period of calendar 2005. A corporation reporting on a non-calendar fiscal year is subject to the same rules. For example, the 2006 franchise tax report for a September 30 year end corporation would be due on May 15, 2006. The franchise tax report would pertain to the privilege period of calendar 2006, but would be based upon the results of operation for the 12 month period ending September 30, 2005.

As consolidated tax return reporting is not permitted, each component member corporation of a federal consolidated return group that has nexus with Texas is required to file a franchise tax report on a stand-alone basis.

Attachment B

RESET CALCULATION

NEW FRANCHISE TAX CALCULATION

The worksheet below calculates taxable margin on a separate entity basis. The worksheet will calculate an amount of tax due based upon the amounts that are entered, HOWEVER :

If your total revenue is less than or equal to $300,000, or your tax due is less than $1,000, you will owe no tax. All taxable entities must file a report, even if no tax is due.

SPECIAL NOTE TO TAXABLE ENTITIES THAT ARE PART OF AN AFFILIATED GROUP: Each taxable entity that is part of an affiliated group engaged in a unitary business shall file a combined report in lieu of individual reports, without regard to the $300,000 limitation on revenue. All members of a combined group must use the same method to compute margin (i.e. cost of goods sold, compensation or 70%). See instructions for additional information. However, each member of a combined group may use the worksheet below to provide an estimate of the individual member's portion of the combined group's tax liability before eliminations.

See instructions below calculator.

STEP 1. MARGIN

1a. TOTAL REVENUE	_____
1b. COST OF GOODS SOLD - Unless otherwise provided in HB3, taxable entities that provide only services will not have a cost of goods sold and must use the compensation deduction or 70% below.	_____
1c. COGS MARGIN - Line 1a minus line 1b.	_____
2a. TOTAL REVENUE	_____
2b. WAGES AND CASH COMPENSATION - W2 Medicare wages and tips plus stock awards and stock options deducted for federal income tax *(may not exceed $300,000 for any single employee)*.	_____
2c. EMPLOYEE BENEFITS - Employer's Cost of retirement contributions, employee health insurance and worker's compensation.	_____
2d. COMP MARGIN - Line 2a minus (lines 2b and 2c).	_____
3a. TOTAL REVENUE	_____
3b. % MARGIN - Equals 70% of line 3a.	_____
4. **MARGIN** - Enter the least of lines 1c, 2d or 3b.	_____

STEP 2. APPORTIONMENT

5. TEXAS GROSS RECEIPTS	_____
6. EVERYWHERE GROSS RECEIPTS	_____
7. **APPORTIONMENT FACTOR** - Line 5 divided by line 6.	_____

STEP 3. TAXABLE MARGIN

8. **TAXABLE MARGIN** - Line 4 multiplied by line 7.	_____

STEP 4. TAX DUE

9. TAX - Multiply line 8 by ☐ 0.5% for wholesalers and retailers or ☐ 1% for other taxable entities.	_____
10. CREDITS	_____
11. TAX DUE - Line 9 minus line 10. *(If less than $1,000, you owe no tax. Cannot be less than zero.)*	_____

Overview – House Bill (HB) 3 was passed during the 79th 3rd Called Session of the Texas Legislature. This bill amends Texas Tax Code Chapter 171 to revise the existing franchise tax by changing the tax base, lowering the rate, and extending coverage to all active businesses receiving state law liability protection. Changes made by HB3 are effective for franchise tax reports originally due on or after January 1, 2008.

Entities Subject to Tax – The tax applies to partnerships (general, limited and limited liability), corporations, limited liability companies, business trusts, professional associations, business associations, joint ventures and other legal entities with statutory liability protection. Sole proprietorships, general partnerships directly owned entirely by natural persons, entities exempt under Subchapter B of Chapter 171, passive entities, grantor trusts, estates of natural persons, escrows, passive investment partnerships, certain family limited partnerships, REMICs, and certain REITs are not subject to the tax. Additionally, entities with revenues of $300,000 or less or who calculate their tax due to be less than $1,000 will owe no tax. However, all taxable entities, including those who will owe no tax, must file a return. Texas Tax Code 171.0002.

Lines 1a, 2a, and 3a. Total Revenue – Total revenue is determined based on federal income tax reporting. Total revenue for a taxable entity filing as a corporation for federal tax purposes includes amounts entered on line 1c of its federal tax return (Form 1120) plus the amounts entered on lines 4 through 10, Form 1120. A taxable entity filing as a partnership for federal tax purposes includes in total revenue the amounts entered on line 1c, Form 1065, the amounts entered on lines 4 through 7, Form 1065, and the amounts entered on lines 2 through 11, Form 1065, Schedule K. From these amounts a taxable entity may subtract, to the extent included in revenue, bad debt expense, foreign royalties and dividends under Section 78 and Section 951-964, Schedule C dividends and income from a related entity. Specific exclusions from revenue include flow-through funds mandated by law, fiduciary duty or contract, such as sales tax, sales commissions to nonemployees, the tax basis of securities underwritten and a general contractors flow through payments to construction subcontractors. A lending institution may exclude the principal repayment of loans. An entity that provides legal services may exclude the following flow-through funds: damages due the claimant; funds subject to a lien or other contractual obligation arising out of the representation, other than fees owed to the attorney; fees paid to another attorney; reimbursement of case expenses and actual out-of-pocket expenses, not to exceed $500 per case, for providing pro bono legal services. Dividends and interest from federal obligations are excluded. A staff leasing services company shall exclude payments received from a client company for wages, payroll taxes and employee benefits for the assigned employees. A health care provider may exclude 100% of revenues from Medicaid, Medicare, CHIP, workers' compensation claims and TRICARE, and actual costs for uncompensated care (healthcare institutions may only exclude 50%). For purposes of this calculator, total revenue cannot be less than zero. Texas Tax Code 171.1011.

Line 1b. Cost of goods sold – "Goods" are defined as real or tangible personal property sold in the ordinary course of business and includes a computer program. Taxable entities that provide only services are not eligible for a cost of goods sold deduction. A taxable entity renting motor vehicles, heavy construction equipment or railcar rolling stock may use cost of goods sold for costs related to the property rented. Cost of goods sold includes all direct costs of acquiring or producing the goods such as labor; materials; handling costs including processing, assembling, and inbound transportation; and storage costs. Cost of goods sold also includes cost related to production related equipment and facilities such as depreciation, rental and repair and maintenance. Research, insurance, utilities, quality control and licensing costs directly related to the production of goods are also included. A taxable entity may deduct up to 4% of overhead costs allocable to the production of goods. Lending institutions that make loans to the public may deduct interest as a cost of goods sold. Cost of goods sold does not include renting or leasing costs that are not production related; selling costs; distribution costs including outbound transportation costs; advertising cost; interest; income or franchise taxes; and officer compensation. Payments for undocumented workers are not deductible. Any amounts excluded from line 1a may not be included in the determination of cost of good sold. Texas Tax Code 171.1012.

Line 2b. Wages and Cash Compensation - Wages and cash compensation include amounts reported for Medicare wages and tips on Form W2; net distributive income from partnerships, limited liability companies and S corporations to natural persons; and stock awards and stock options deducted for federal income tax purposes. Includes wages and cash compensation paid to officers, directors, owners, partners and employees. The deduction for wages and cash compensation is limited to $300,000 per person. A taxable entity that is a staff leasing services company should include only payment for the entity's own employees that are not assigned employees. A client company that contracts with a staff leasing services company may include wages for assigned employees but may not include an administrative fee or payroll taxes. Payments for undocumented workers are not deductible. Any amounts excluded from line 1a may not be included in the determination of compensation. Texas Tax Code 171.1013.

Line 2c. Employee Benefits - Benefits provided to officers, directors, owners, partners and employees, including workers' compensation, health care and retirement benefits to the extent deductible for federal income tax purposes. Texas Tax Code 171.1013.

Line 5. Texas Gross Receipts - Gross receipts in Texas include sales of real property located in Texas, sales of tangible personal property when the property is delivered or shipped to a purchaser within Texas, services performed within Texas, rentals of property situated in Texas, royalties from use of patents or copyrights within Texas, revenues from the use of trademarks, franchises or licenses within Texas and all other business revenue within Texas including dividends and interest from Texas payors. Any amounts excluded from line 1a may not be included in the determination of Texas Gross Receipts. Texas Tax Code 171.103.

Line 6. Everywhere Gross Receipts - Gross receipts everywhere includes all sales of real property, all sales of tangible personal property, all services, all rentals, all royalties from use of patents, copyrights, trademarks, franchises or licenses and all other business revenue including dividends and interest. Any amounts excluded from line 1a may not be included in the determination of Everywhere Gross Receipts. Texas Tax Code 171.105.

Line 9. Tax Due - The tax rate is 0.5 percent for entity's primarily engaged in retail and wholesale trades as well as those businesses under Major Group 58 (eating and drinking establishments). The rate is 1 percent for all other taxable entities. Texas Tax Code 171.002.

Line 10. Credits - A taxable entity that previously qualified for a research and development credit, capital investment credit, or job creation credit may claim unused carryovers and installments to offset the tax on margin. Each credit is limited to 50% of the tax due before using the credit. No additional credits for research and development, capital investment, or job creation may be created. In addition, a corporation may take a credit based on business losses accrued under Tax Code Section 171.110(e) that were not expired or exhausted on a report due prior to January 1, 2008. The credit is 10 percent of the business losses multiplied by the appropriate margins tax rate and expires September 1, 2016. Texas Tax Code 171.111.

Combined Reporting

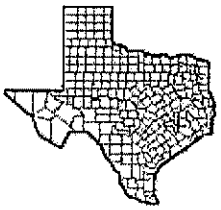
Taxable entities that are part of an affiliated group engaged in a unitary business shall file a combined group report in lieu of individual reports, without regard to the $300,000 limitation on revenue. All members of a combined group must use the same method to compute margin (i.e. cost of goods sold, compensation or 70%).

An affiliated group is a group of one or more entities in which a controlling interest (80%) is owned by a common owner or owners, either corporate or noncorporate, or by one or more of the member entities. A unitary business is defined as a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.

Margin for the combined group is calculated by adding the total revenue for each entity, subtracting the cost of goods sold/compensation for each entity and then subtracting items of revenue and cost of goods sold/compensation from one member of a combined group to another member of the combined group.

For apportionment purposes, Texas Gross Receipts of a combined group should include only receipts for entities within the group that have nexus in Texas. Receipts from transactions between members that are excluded from revenue may not be included in Texas Gross Receipts except for receipts from the sale of tangible personal property between members where one member party to the transaction does not have nexus in Texas.

Everywhere Gross Receipts for a combined group should include receipts for all entities within the group, regardless of whether the entities have nexus in Texas. Receipts from transactions between members that are excluded from revenue may not be included in Everywhere Gross Receipts. Texas Tax Code 171.1014.



Texas Franchise Tax
Frequently Asked Questions - Transition Provisions

The guidance provided below is contingent upon House Bills 1207 and/or 3928, passed by the 80th Legislature, becoming law.

In dealing with transition issues, we will look to the legal formation of an entity. The results below apply regardless of whether the entity is treated as a partnership or is disregarded for federal tax purposes. We will also continue to follow our policy that an entity converting into another entity will be a continuation of the original entity.

Example 1 - A limited partnership converts before July 1, 2007, into a new corporation or limited liability company.

Result - The post-conversion entity will file an annual report on May 15, 2008, using the margin calculation. The post-conversion entity will include in its calculation of margin the activity of both the pre-conversion and post-conversion entity for the period upon which the report is based. In other words, if the entity is a calendar year taxpayer for federal tax purposes then the activity for both the pre-conversion and post-conversion entity for the entire calendar year 2007 should be included on the 2008 annual report.

Example 2 - A limited partnership merges into a newly formed corporation or limited liability company before July 1, 2007.

Result - The limited partnership will not file a final franchise tax report based on the margin calculation on the activities up to the merger date. The newly formed corporation or limited liability company will be subject to franchise tax based on the margin calculation from the date of formation. It will file an initial franchise tax report as prescribed by Tax Code 171.1532.

Example 3 - A limited partnership merges before July 1, 2007, into an existing corporation or limited liability company where the surviving entity did not have nexus for Texas franchise tax prior to the merger.

Result - The limited partnership will not file a final franchise tax report based on the margin calculation on the activities up to the merger date. The corporation or limited liability company will be subject to franchise tax based on the margin calculation from its first date of business in Texas. It will file an initial franchise tax report as prescribed by Tax Code 171.1532.

Example 4 - A limited partnership merges before July 1, 2007, into an existing corporation or limited liability company and the surviving entity had nexus for Texas franchise tax prior to the merger.

Result - The limited partnership will not file a final franchise tax report based on the margin calculation on the activities up to the merger date. The surviving entity will file an annual report on May 15, 2008 using the margin calculation. The surviving entity will not include in its calculation of margin the activity of the non-survivor for the period prior to the merger.

Note: This presumes that the surviving entity's 2008 report is an annual report. If the surviving entity's 2008 report is an initial report, the entity will include only its activity for the period upon which the initial report is based.

Example 5 - A limited partnership merges into a general partnership owned directly and entirely by natural persons before July 1, 2007.

Result - The general partnership will be considered a continuation of the limited partnership. However, since the general partnership is owned directly and entirely by natural persons, it is not a taxable entity. The limited partnership will not file a final franchise tax report based on the margin calculation on the activities up to the merger date. The general partnership does not file a 2008 franchise tax report as it is not a taxable entity.

Example 6 - A limited partnership owned by natural persons merges into a limited liability company newly formed by

the partners of the limited partnership before July 1, 2007.

Result - The limited partnership will not file a final franchise tax report based on the margin calculation on the activities up to the merger date. The newly formed limited liability company will be subject to franchise tax based on the margin calculation from the date of formation. It will file an initial franchise tax report as prescribed by Tax Code 171.1532.

Example 7 - A limited partnership is owned by two corporations. The partnership and both partners are part of a combined group of affiliated taxpayers. Before July 1, 2007, the limited partnership merges into a newly formed limited liability company that is owned by a corporate member of the combined group.

Result - The limited partnership will not file a final franchise tax report based on the margin calculation on the activities up to the merger date. The activity of the limited partnership prior to the merger is not included in the combined group's 2008 franchise tax report.

Example 8 - A limited partnership is owned by two corporations. The partnership and both partners are part of a combined group of affiliated taxpayers. Before July 1, 2007, the general partner merges into the limited partner and immediately following the merger the partnership is liquidated into the limited partner.

Result - The limited partnership will not file a final franchise tax report based on the margin calculation on the activities up to its liquidation date. The activity of the limited partnership prior to the liquidation is not included in the combined group's 2008 franchise tax report.

Susan Combs
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BACKGROUND, EDUCATION AND PRACTICE

Ira A. Lipstet is a partner with the Austin law firm of DuBois, Bryant & Campbell, LLP. He engages in a broad ranging tax and business practice.

Mr. Lipstet's experience involves federal and state tax and business planning and controversy work including: ad valorem property tax issues, including transactional as well as controversy work from appraisal review board proceedings through litigation; tax litigation in State District Court, U.S. Tax Court, State and Federal Appellate Courts; representation in administrative proceedings before the Internal Revenue Service, the Texas Comptroller of Public Accounts and other government agencies; negotiations with taxing authorities; consulting regarding state and local tax incentives and abatements; federal and state tax planning and structuring activities, especially involving Texas franchise, sales and use, property tax and multi-state corporate tax issues; tax exempt organization tax issues, including planning and structuring considerations for federal income and state franchise, income, sales and property tax purposes; and qualification for and maintenance of exempt status and unrelated business taxable income issues; merger and acquisition issues including exempt entities.

Prior to joining DuBois, Bryant & Campbell, Mr. Lipstet was a Director with Ryan & Company, a shareholder with Jenkens & Gilchrist, and a Senior Tax Manager with Touche Ross in Houston. He received his B.A. and M.B.A. from the University of Texas at Austin and his J.D. from the University of Houston. Mr. Lipstet is board certified in tax law by the Texas Board of Legal Specialization. Mr. Lipstet is a certified public accountant and a member of both the Texas Society of CPAs and State Bar of Texas State Tax Committees. Mr. Lipstet is a frequent lecturer to professional groups on tax and related topics.