Massachusetts Enacts Expansive Combined Reporting Legislation

On July 2, 2008, Governor Deval Patrick signed Massachusetts House Bill 4904, a bill that makes sweeping changes to the state’s excise tax (the income portion) on business corporations. Most notably, and as foretold in a previous Sutherland Legal Alert, H 4904 will institute mandatory combined reporting. This Legal Alert summarizes some of the Act’s significant combined reporting provisions, including: the composition of a Massachusetts unitary group; the adoption of a Finnigan approach; a (delayed) net deferred tax liability deduction that mitigates the effect of FAS 109; an affiliated group election (instead of a unitary group filing); and the scope of the significant discretion afforded the Commissioner of the Massachusetts Department of Revenue.

Combined Reports and Unitary Groups

Destined to cause confusion, the Act includes extensive combined reporting rules that discard the previous “separate reporting” regime (whereby each company with Massachusetts nexus filed a separate tax return) and implement a combined reporting regime (whereby companies must calculate Massachusetts’ taxable net income based on a combined report if the companies are engaged in a unitary business and one or more of the companies in the group has Massachusetts nexus). Massachusetts has repealed the provision allowing a group of Massachusetts taxpayers that were included in the same federal consolidated return to elect to file on a combined (really consolidated) basis at the state level. The new combined reporting rules are effective for tax years beginning on or after January 1, 2009.

Composition of Massachusetts Unitary Group

H 4904 broadly defines “unitary business” as “activities of a group of two or more corporations under common ownership that are sufficiently interdependent, integrated or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them or a significant flow of value between the separate parts. The term unitary business shall be construed to the broadest extent permitted under the United States Constitution.” “Common ownership” as used in the definition of a unitary business requires more than 50% of voting control (directly or indirectly). The Act also addresses how partnerships are to be treated and adopts the aggregate theory. The Act also requires the following entities to be included in the combined report: (1) most financial institutions; (2) S corporations; (3) utilities; (4) captive insurance companies; (5) REITs; and (6) RICs, even if such entities are not subject to the Massachusetts excise tax.

Members of a Massachusetts combined group will generally file combined reports on a water’s-edge basis but may elect to calculate taxable net income on a worldwide basis. The election must be made on the original return. If the worldwide election is made, it is binding for that taxable year and for the next ten taxable years. For those taxpayers not making the worldwide election, Massachusetts has adopted a broad definition of “water’s-edge.” In addition to including the traditional companies incorporated in the United States in the water’s-edge group, H 4904 specifically includes the following non-U.S. entities in the water’s-edge group: (1) “any member, regardless of the place incorporated or formed, if the average of its property, payroll, and sales factors within the United States is 20 per cent or more;” and (2) “any member that earns more than 20 per cent of its income, directly or indirectly, from intangible property or service-related activities the costs of which generally are deductible for federal tax purposes, whether currently or over a period of time, against the business income of other members of the group, but only to the extent of that income and the apportionment factors related thereto.”
Calculation of Tax

The tax is calculated on an individual taxpayer (i.e., company) basis. Rather than determining a combined group apportionment formula and group taxable income (as most other unitary combined regimes require), the Massachusetts provision requires the creation of separate company apportionment formulas based on the combined group’s income and factors. Each Massachusetts taxpayer in the combined group (a company with Massachusetts nexus) uses the combined income of the group, the combined denominators of the group and its own adjusted (see below) numerators to calculate its Massachusetts taxable income.

One result of this approach is that the new regime includes an unusual Finnigan approach. The Massachusetts sales (numerators) of those members of the combined group that do not have nexus with Massachusetts are aggregated and then divvied up and included in the numerators of those combined group members that do have nexus based on the nexus companies’ percentage of overall Massachusetts sales. Thus, taxable members must directly include in their sales factor numerators a portion of the receipts of non-taxable members.

Another unusual feature of the new Massachusetts regime is the method by which the factors of members with different apportionment formulas are included in the tax calculation. The Act specifically provides that the combined group include unitary companies even if they use different apportionment formulas to apportion income. For example, a manufacturing company that qualifies for Massachusetts single sales factor treatment will be included in the combined group with affiliated companies that use the three factor (double weighted sales) formula. However, the manufacturer’s payroll and property will be included in its affiliates’ payroll and property factor denominators (even though it applies single sales factor apportionment to its income). The new law also has special provisions for determining the apportionment calculations for groups that include both financial and non-financial institutions because the items included in the factors differ.

Intercompany transactions, including dividends, are eliminated in calculating the apportionment factors. The legislation provides the Commissioner with the authority to promulgate regulations to prescribe the method for dealing with intercompany transactions. Such treatment will directly affect the application of the Massachusetts related party expense disallowance provisions. Depending on the Commissioner’s regulations, the related party expense disallowance provisions may no longer have an effect on taxpayer’s calculation of Massachusetts taxable income because of the elimination of intercompany transactions among members of the group.

Sutherland Observation: The interplay of existing and new tax calculation rules could lead to some interesting results. For example, Massachusetts has had a throwback rule for quite a while. Now that it is a Finnigan state and imposes combined reporting, sales by Massachusetts taxpayers that previously might have been thrown back to Massachusetts may now be excluded from the Massachusetts sales factor numerator if another member of the group is taxable in the destination state. Other interesting results will occur as a result of including companies with differing apportionment formulas in the combined group, yet calculating taxable income on an entity-by-entity basis. For example, a retailer that is a Massachusetts taxpayer may see its property and payroll factor decrease because it will include the property and payroll attributable to a unitary manufacturing company in its property and payroll denominators.

Net Deferred Tax Liability (FAS 109) Deduction

To alleviate the potential financial statement impact resulting from these tax law changes, H 4904 allows a combined group to deduct an amount equal to the “net deferred tax liability” created as a result of the
implementation of combined reporting. A taxpayer is limited to \( \frac{1}{7} \)th of the computed deduction in each year beginning in the 2012 tax year for seven tax years.

The total deduction is calculated as the lesser of: (1) the amount necessary to offset the increase in net deferred tax liability resulting from the new combined reporting regime; and (2) the Massachusetts Tax Basis Modification (as defined by the legislation). The deduction cannot exceed the increase in net deferred tax liability resulting from all of the provisions of the Act (not just the combined reporting provisions). The Massachusetts Tax Basis Modification is the combined group's non-taxable members' aggregate adjusted book basis less the aggregate adjusted tax basis on its eligible assets (non-taxable member's tangible or intangible assets that are subject to depreciation, amortization or other cost recovery that was placed in service before the combined reporting legislation became effective).

Taxpayers must file a statement with the Commissioner by July 1, 2009, that specifies the total amount of the deduction which the taxpayer will claim. The Commissioner retains the authority to review or redetermine the proper amount of such deduction when it is taken on a return.

*Sutherland Observation:* The Massachusetts Tax Basis Modification captures the amount of depreciation, amortization or other cost recovery that a non-taxable member would have been able to deduct, if Massachusetts had a combined filing regime which included such non-taxable member in the earlier tax periods during which the depreciation, amortization or other cost recovery deduction would have been permitted.

**Affiliated Group Election**

The Act permits a taxpayer to elect to include all members of its “affiliated group” as its combined group. The affiliated group is defined by reference to Internal Revenue Code § 1504 but subject to a 50% (rather than 80%) common ownership test and must include all commonly owned corporations incorporated in the U.S. whether or not such corporations would be part of an affiliated group under § 1504. This election must be made on an original return filed by any member of the combined group and is binding on all members of the affiliated group for the taxable year in which the election is made plus the next nine years. (Oddly, this time period is one year less than the time period for the water's-edge election). Any corporation entering an electing affiliated group is deemed to have waived any objection to its inclusion in the combined group. If a group revokes its election after the 10 year period, a new election cannot be made during the next three taxable years. It is not clear whether failure to do anything at the end of an election period is deemed to continue the election or to be a revocation.

A significant feature of this affiliated group election is that members of the group must characterize all of their income as apportionable income, “whether or not such income would otherwise be subject to apportionment or would be allocable to a particular state in absence of [this] election.” Finally, a taxpayer making the affiliated group election must submit any information requested by the Commissioner for use in drafting a report describing the impact of the affiliated group election. In connection with this report, the Commissioner may request data related to an electing taxpayer's filings in other jurisdictions.

*Sutherland Observation:* The requirement that acquired corporations are subject to the affiliated group election requirements (e.g., the acquired corporation is required to be included in the group regardless as to whether it is unitary, and it waives its right to allocate income) could create planning challenges in mergers and acquisitions – particularly if one group is acquiring another unitary group of corporations. For example, if an electing group acquires a non-electing group, careful consideration will be needed to determine when to dispose of unwanted non-business assets – before or after the acquisition.
Discretion of Commissioner

H 4904 grants the Commissioner substantial discretion regarding implementation and interpretation of the combined reporting provisions. In general, the Commissioner is authorized to adopt regulations controlling the calculation of Massachusetts taxable net income derived from a unitary business. More specifically, the Act also provides that the Commissioner must adopt regulations addressing: (1) elimination of intercompany transactions; (2) the sharing of credits attributable to the activity of a unitary business; (3) the application of carryforwards, including NOL and credit carryforwards; and (4) the relationship of various other credits to the combined reporting rules. Once promulgated, state courts may afford these legislative regulations greater weight than so-called interpretive regulations.

Rate Reduction

In a mild taxpayer victory, the Act consolidates the Massachusetts tax rates by repealing the surtax and increasing the general business corporate tax rate resulting in a tax rate of 9.5% for 2009. Thereafter, the tax rate on net income is reduced as follows: for tax years beginning on or after

- January 1, 2010 – 8.75%
- January 1, 2011 – 8.25%
- January 1, 2012 – 8.00%.

Other Changes

H 4904 makes many other changes to the Massachusetts excise tax law, including:

- Full check-the-box conformity (previously Massachusetts partially conformed to the federal entity classification rules).
- Formation of several “study committees” that will address, among other issues, Streamlined Sales Tax conformity and continued use or expansion of single sales factor apportionment.

If you have any questions regarding this alert, or the services we provide, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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