Business Taxes in Massachusetts: Toward Fundamental Reform

James P. Angelini, PhD, CPA
Frank Conte, MSPA
Alfonso Sanchez-Penalver, MSF
David G. Tuerck, PhD

THE BEACON HILL INSTITUTE AT SUFFOLK UNIVERSITY
8 Ashburton Place
Boston, MA 02108
Tel 617-573-8750, Fax 617-994-4279
Email bhi@beaconhill.org, Web; www.beaconhill.org
April 2008

TABLE OF CONTENTS

TABLE OF TABLES

I. Executive Summary

Massachusetts business tax laws are a hodgepodge of poorly-conceived measures that violate the most fundamental principles of tax equity. They discourages business from locating in the Commonwealth and serve alternately as a target for revenue-hungry state government and a mechanism for dispensing largess to special pleaders. This study lays out a proposal for comprehensive business tax reform that is simultaneously fair, (approximately) revenue neutral and positive for its effect on economic growth.

Businesses in Massachusetts can choose to organize as C-corporations, S-corporations, partnerships, limited liability companies, limited liability partnerships, sole proprietorships or corporate trusts. To raise revenue, the Commonwealth levies taxes on all these entities, either at the entity level and/or through the individual income tax. Corporate tax laws, the focus of much recent discussion on Beacon Hill, are in particular need of serious reform. At 9.5%, Massachusetts levies the fourth highest statutory state corporate income tax rate in the United States.

BHI proposes comprehensive business tax reform that will broaden the base by eliminating credits and loopholes and lower the rate for almost all business entities to 5.3%.[1]

Specifically, the Institute proposes that the Commonwealth:

- set the tax rate at 5.3%, the same rate as for individuals;
- eliminate the $2.60 per thousand tax on tangible personal property or net worth, applicable to C and S-corporations only;
- eliminate the conduit concept by taxing entities at the rate of 5.3% at the entity level;
- eliminate the double taxation of C-corporation earnings (and large S-corporations) by taxing business entities (domiciled in MA or with nexus) at 5.3%

[1] Our proposal does not encompass certain corporations that have historically received special tax treatment. These include banks, insurance companies, securities corporations and utilities.

at the entity level (as apportioned if multi-state) and eliminating the tax on corporate dividends to C-corporation shareholders or flow-through income from conduits;

- eliminate the $456 minimum tax on C- and S-corporations;
- adopt combined reporting and unitary tax principles, without a "waters edge" election. This will apply to all types of entities, not just corporations;
- adopt single-sales-factor apportionment for all entities and industries, not just some;
- allow net operating loss carryover deductions by sole proprietors, corporate trusts and partnerships;
- eliminate all tax incentives; and
- allow a 100% dividends-received deduction for dividends received by corporations, regardless of the percentage owned.

Using Massachusetts STAMP (the Beacon Hill Institute's State Tax Analysis Modeling Program for Massachusetts), we estimated the effects of instituting these reform measures on the state economy.[2] In Table ES1, we present the estimates of the effects of the changes on state and local finances, as well as on key economic indicators, for calendar years 2009-13. These effects are measured against a "baseline economy" that would have prevailed in the absence of the implementation of our proposals.

The proposal is close to revenue neutral. Under our projections, the state would lose $85.89 million in the first year of implementation, or only about 0.4% of current revenues. Local tax revenues would increase by $6.78 million – as local governments gain property tax revenue from businesses increasing the local deployment of capital and labor. The net effect is that the proposals would cause state and local tax revenues to decline by $79.11 million in 2009. This miniscule loss in revenue is, we believe, a small enough price to pay in order to achieve equity in the taxation of both persons and business and to turn the state tax code into an engine for attracting, rather than repelling, business.

[2] Detailed information about the BHI STAMP model is available upon request and at www.beaconhill.org .

Table ES1: Dynamic Tax Revenue Changes, 2009-2013
($ million)

Tax	2009	2010	2011	2012	2013
Sales and use tax	4.16	4.25	4.33	4.42	4.51
Motor fuel taxes	0.19	0.19	0.19	0.19	0.19
Motor vehicle fees	0.10	0.10	0.10	0.10	0.10
Corporations excise tax	(106.48)	(106.53)	(106.58)	(106.63)	(106.68)
Personal income tax	4.38	4.39	4.39	4.39	4.39
Cigarette and tobacco taxes	0.25	0.26	0.27	0.27	0.28
Other taxes, fees and revenue	11.09	11.24	11.39	11.55	11.70
Unemployment insurance tax	0.42	0.42	0.42	0.42	0.42
State dynamic revenue change	**(85.89)**	**(85.69)**	**(85.49)**	**(85.29)**	**(85.09)**
Residential property	0.02	0.02	0.02	0.02	0.02
Business property	6.76	6.76	6.76	6.77	6.77
Local dynamic revenue change	6.78	6.78	6.78	6.79	6.79
Net dynamic revenue change	**(79.11)**	**(78.91)**	**(78.71)**	**(78.51)**	**(78.30)**

The tax changes would exert positive effects on key economic indicators. Table ES2 shows that, in 2009, the state would create 4,025 new private sector jobs. Investment would increase by $119.73 million and real disposable income by $255.31 million.

Table ES2: The Plan's Economic Effects, 2009-2013

	2009	2010	2011	2012	2013
Employment					
Private					
Jobs	4,117	4,217	4,259	4,300	4,342
Government					
Jobs	(92)	(93)	(94)	(95)	(96)
Total					
Jobs	4,025	4,124	4,165	4,205	4,246
Investment					
$ millions	119.73	126.38	133.39	140.79	148.61
Real disposable income					
$ millions	255.31	252.57	249.86	247.19	244.54

Most importantly, the proposal would put a permanent end to the Commonwealth's crazy quilt of business tax laws, along with its sky-high tax rate on corporations.

II. Introduction

Massachusetts has a history of trying to placate two competing interests: corporations that are among its largest employers and that seek relief from the high corporate tax rate imposed by the state and the ever-needful state government that seeks to close "loopholes" and otherwise capture more money for state programs. The result is the worst of all worlds: a reputation as a state with high business taxes and steady frustration over an inability to collect enough (as some would see it) in business taxes.

The Beacon Hill Institute proposes comprehensive business tax reform that will, if implemented, bring sense to this broken tax system. Our proposal would broaden the base, lower the rate, and make Massachusetts a competitive destination for business. It would attract business and bring workers into the state, while creating a level playing field for all types of business. It would help reverse the perception that Massachusetts is a high-cost, high-tax state and play to the strengths of the Massachusetts economy. With BHI's reform plan, small businesses can expect predictability and larger businesses a new opportunity to source their income, payrolls and property to the Commonwealth rather than to other states.

The Commonwealth has many economic advantages over other states. These include access to a highly-educated work force and an open, diverse economy that brings the resources of its financial enterprises to its many technology start-ups. According to the Beacon Hill Institute's 2007 *State Competitiveness Report,* Massachusetts ranks second among all states in its ability to sustain a high level of income for its citizens. However, even with this high ranking, Massachusetts needs to improve dramatically its substandard state and fiscal policy performance. One way to improve the prospects for the state's long term economic health is to expand the business tax base while cutting the statutory tax rate on corporations.

Sound tax policy requires that any tax should meet the test of horizontal equity; that is to say, the application of a tax to two equal individuals or entities treats them equally. Sound policy likewise requires a tax to meet the test of vertical equity, where the concept of "ability to pay" is applied to individuals or firms with different incomes. Other objectives are simplicity, transparency, stability, neutrality and economic growth. The current tax system and recent proposals fail to meet any of these tests of sound tax policy.

Massachusetts has a history of trying to placate two competing interests: corporations and the need to raise revenue. The result is the worst of all worlds.

Because the taxation of legal business entities varies considerably from business to business, Massachusetts taxes do not achieve horizontal equity. Firms with similar business income face different tax burdens, depending upon the legal forms they may have chosen. Table 1 contains a comparison of income tax rates on the various entities allowable in Massachusetts and their owners, as well as property and other taxes. The table makes clear the wide disparity in taxation. Some businesses are subject to double taxation, taxes on tangible property, taxes on net worth, minimum taxes, annual report fees or some combination of the above.

Table 1: Comparison of Tax Rates on Massachusetts Business

	C-Corp	S-Corp < $6 million	S-Corp > $6 <$9 million	S-Corp > $9 million	Partnership	Sole Proprietor	Corporate Trust
Entity Tax Rate (%)	9.5	0.0	3.0	4.5	0.0	0.0	5.3
Owner Tax Rate-Individual (%)	5.3	5.3	5.3	5.3	5.3	5.3	0.0
Total Tax Rate (%)*	14.8	5.3	8.3	9.8	5.3	5.3	5.3
Minimum Tax ($)	456	456	456	456	None	None	None
Annual Report Fee ($)	125	125	125	125	500(LLC)	None	75
Tax on Tangibles or Net Worth ($ per thousand)	2.60	2.60	2.60	2.60	None	None	None

*Assumes that there is no federal tax effect and that dividend distributions are unaffected by state corporate taxes.

Massachusetts tax law also violates the principle of vertical equity, since large multi-state corporations (often with greater tax law expertise) have more opportunity than smaller firms to shift income to lower corporate tax states. This inequity distorts business decisions, driving smaller firms and their employees out of the state. It also diminishes the amount of revenue generated by other taxes, including the individual income tax, the sales tax, the meals tax, and property taxes.[3]

We next, in Part III, summarize current business tax law in Massachusetts and describe the tax treatment of corporate income. Part IV compares Massachusetts business tax law to competitor states. Part V presents a set of reform proposals, and Part VI examines the revenue and economic consequences of these proposals. A summary and conclusion comprise Part VII.

III. Current Business Tax Law in Massachusetts

Businesses in Massachusetts can choose to organize as C-corporations, S-corporations, partnerships, limited liability companies, limited liability partnerships, sole proprietorships or corporate trusts (also called "trusts with transferable shares"). An option to establish regular trusts is also available in Massachusetts but is rarely used since most businesses do not operate in the trust form. Each of these forms has unique characteristics which include tax and non-tax factors. The taxation of these forms in Massachusetts is due partly to federal tax policy and partly to the state's treatment.

Federal tax law, which presents its own inequities, often dictates the form of entity, since federal taxes are usually larger than state taxes. However, Massachusetts has a long tradition of steadfastly resisting the imposition of federal tax policy on state tax law — often adopting some, but not all, portions of the Internal Revenue Code. Therefore, Massachusetts tax law can still be driven by tax policies that benefit the Commonwealth, irrespective of the choice of entity for federal tax purposes. We next explore the tax differences between these business forms.

In Massachusetts, business entities are either taxpaying entities or conduit entities, or a combination of both. A conduit entity is one that passes all its income (or losses) through

[3] *State Business Tax Climate Index*, 2003-2008, Tax Foundation, October 10, 2007. This index indicates that in 2008 Massachusetts' overall business taxes rank 34th in the nation, which is a decrease from 26th best in 2003. Massachusetts ranks 46th for corporate taxes alone.

to owners. The entity itself does not usually pay taxes. Choice of entity is one of several important tax planning decisions a business must make, and mistakes are costly. Often the decision is influenced more by federal taxes than by state taxes; however, there is no good policy reason why a business's state form must be the same as its federal form. Businesses should have the ability to choose which entity, at each level of government, is appropriate for tax and other purposes. In Massachusetts, businesses that pay tax at the entity level include C-corporations, larger S-corporations, sole proprietors, limited liability companies (if taxes are paid at the federal level) and corporate trusts. S-corporations, partnerships, limited liability companies (if conduits at the federal level) and limited liability partnerships are conduit entities.

C-Corporations (Form 355)

C-corporations pay taxes on net taxable income at the rate of 9.5%, which is the fourth highest state corporate tax rate in the country. If the corporation has a loss, it pays a minimum tax of $456. C-corporations also must pay a $125 fee to the Secretary of State for filing their annual report. In addition to the corporate income tax, C-corporations pay a significant tax on tangible personal property located in Massachusetts (other than property which is taxed locally by a city or town). Or, if they do not have sufficient personal property, they pay a tax on net worth. The rate is $2.60 per $1,000 for both. The tangible property tax includes all property the company owns, such as machinery and equipment, trucks and automobiles, furniture and fixtures, leasehold improvements, construction in progress, inventory and supplies. If any of these assets is taxed by cities or towns it is exempt from the tangible property tax. The tangible property or net worth tax, as well as the minimum tax, are regressive, because they are not based on income; companies with losses still have to pay these taxes. The burden is especially heavy on companies with inventory, which usually increases during times of decreased sales. There is little incentive to store inventory or supplies in Massachusetts.

Massachusetts C-corporations are subject to double taxation. If a portion of corporate profits is distributed as a dividend, the distribution generally is taxed to the shareholder.

Corporate profits are thus taxed once to the corporation and again to the shareholder when they distributed as dividends (assuming the corporation has adequate earnings and profits per IRC §301, 312 and 316). A Massachusetts corporation that *receives* dividend income from another corporation is allowed to deduct 95% of the dividends received if it owns more than 15% of the corporation paying the dividend. Dividends from Massachusetts corporate trusts are not eligible for this deduction. The purpose of the dividend-received deduction is to prevent possible triple taxation. However, this goal is not met for dividends from corporations with less than 15% ownership.

As an example of corporate double taxation consider the following: John owns 100% of the stock in XYZ, Inc. ("a C-corporation"). XYZ, Inc. had Massachusetts net taxable income for the current year of $100,000 and paid dividends to John totaling $100,000. What is the Massachusetts tax treatment of XYZ's earnings?

- XYZ, Inc. pays Massachusetts corporate tax on the net earnings of $100,000. At 9.5% this would equal $9,500.
- In addition, John pays income tax on the $100,000 of dividends that he receives at a rate of 5.3%, or $5,300. Therefore, the $100,000 is taxed twice for a total corporate and individual tax of $14,800, a combined rate of 14.8%.[4]

C-corporations also pay twice on liquidation. At the point of liquidation, C-corporations pay tax at the corporate level on the gain on any appreciated assets, and then the shareholders pay tax again when they receive the liquidating dividend. This means that C-corporations are induced not to hold real estate, which tends to appreciate; since the appreciation will be double-taxed if the corporation liquidates (liquidation is common in an asset sale, which is preferred by buyers). Shareholders have an incentive to own the real estate separately or in a realty trust, where there is no possibility of double taxation.

There are various methods of avoiding the double tax on C-corporation earnings and these methods are employed in the Commonwealth as well as at the federal level

[4] This assumes no federal tax effect and that dividend distributions are unaffected by state corporate taxes.

(although a single method may not work for both federal and Massachusetts taxes). The following advice applies to a business entity that aims to minimize its tax liability:

- Elect to be taxed as an S-corporation if Massachusetts gross receipts are less than $6 million. Massachusetts S-corporations do not pay tax at the corporate level if their gross receipts are less than $6 million. A corporation must choose S status in the first 75 days (2.5 months) of its tax year for the S status to be applicable for that year. If it misses this deadline, it is a C-corporation for that year (it can ask the IRS for a late election, but there is no guarantee that the IRS will grant it). If there is appreciated property in the corporation, and if the corporation does not elect S status in the first year, it will have to wait ten years to liquidate its assets to avoid a corporate level tax, even though it is an S-corporation. This is called a "built in gains tax," preventing C-corporations that want to liquidate from electing S status just before the liquidation to avoid the corporate level tax. Another benefit of electing S status in the first year of the corporation's life is that losses, which are likely in the first year, will flow through and be potentially deductible by the shareholders. If a filing corporation misses the deadline and elects in the second year, the first year losses will be stuck in the C-corporation until the corporation liquidates, which may not be for many years. The shareholders will not be able to deduct the S corporate losses on their Massachusetts personal income tax returns.
- Don't pay out dividends, since they are taxed twice. Although the IRS has the Accumulated Earnings Tax, widely seen as a weapon against this strategy, there is no such penalty tax in Massachusetts. Accumulating income in a C-corporation is encouraged in Massachusetts.
- Pay out the dividend as deductible salary to shareholders who are also employees, instead of paying out non-deductible dividends. However, all deductions have to be reasonable in amount. So, for example, the salary must be reasonable for the duties performed by the shareholder/employee. This is not workable if the shareholder is not an employee. The Department of Revenue (DOR) will attack

"unreasonable" compensation and claim that part of it is disguised dividends, and therefore not deductible.

- Pay out deductible rent instead of non-deductible dividends, if the shareholder leases property to the corporation (another reason why real estate should not be in a C-corporation). Deciding which assets should be transferred to the corporation and which should be retained by the shareholders and leased to the corporation is one of the important decisions a corporation must make early on. In addition, the rental of real estate will generate depreciation deductions that do not require a cash outlay.
- Pay out deductible interest instead of non-deductible dividends to shareholders who are also creditors. Another decision to make when forming the corporation is how it will be capitalized. The shareholders can put the assets into the corporation in exchange for stock (equity) or stock and some debt (a note owed to them). Interest expense paid by the C-corporation to the shareholder/creditor is deductible if not usurious. Also, repayment of the principal is tax free. However, upon corporate formation, if the shareholders are transferring appreciated assets into the corporation, the receipt of debt will trigger a gain to the shareholder (§351).

These examples show how current law creates an incentive for businesses to use their resources on tax avoidance efforts rather than business investment. These tax avoidance strategies, which are more applicable to smaller business, permit some C-corporations to avoid paying the double tax.

S-Corporations (Form 355S)

Massachusetts S-corporations are hybrid entities. They are both taxpaying and conduit entities. The corporation pays no tax when gross income is less than $6 million.
S-corporations pay a tax of 3% on net taxable income when gross receipts are between $6 million and $9 million; and 4.5% on net income when gross receipts are above $9 million. This treatment is not mirrored at the federal level, where there is usually no

entity tax. Note that the determination of the tax rate is based on *gross* receipts or sales, before deductions, not *net* income. The tax, however, is based on net taxable income. Therefore, a Massachusetts S-corporation could pay income tax even though net taxable income is far less than $6 million. This treatment is inequitable because it favors companies with low sales and high profit margins as compared to companies with high sales and low profit margins.

Income or loss is passed through to S shareholders. At the federal level an S-corporation's income is not taxed twice, as it is with a C-corporation. However, without a special rule, a C-corporation faced with double taxation of earnings or liquidation, could easily avoid the double tax simply by making an election to become an S-corporation. To prevent this, federal law may impose a double tax on S-corporations that switch to S status after their initial year as C-corporations. These special S-corporation double taxes are called "built-in-gains" taxes or "passive income" taxes. In Massachusetts, the corporation usually does not pay tax below the $6 million gross receipts level, unless it was once a C-corporation and converted to S status after the first year of its life. In that case the Massachusetts S-corporation could pay income tax on built-in-gains or passive income, even if receipts are less than $6 million. The S-corporation also pays a tax on tangible property or net worth, the $456 minimum tax and the $125 annual filing fee, similar to C-corporations. Therefore, S-corporations in Massachusetts are subject to double taxation when gross income is above $6 million and possibly under $6 million if they were once C-corporations.

Partnerships (Form 3), Limited Liability Companies and Limited Liability Partnerships

A Massachusetts partnership never pays taxes. Therefore, there is no double taxation, as there is for C- or some S-corporations. They also do not pay the $456 minimum tax; nor do they pay the $125 annual report fee.

Massachusetts Limited Liability Companies (LLCs) are taxed in the same manner as they are for federal taxes, if they have at least two owners. At the federal level, a business can "check the box" on form 8832, which allows it to be taxed as a C- or S-corporation or as a partnership. Single member LLCs (allowed in Massachusetts) cannot be a taxed as partnerships but are taxed as sole proprietorships, or as a branch or division of the owner. Therefore, the tax form chosen at the federal level must be used for Massachusetts tax purposes.

Massachusetts Limited Liability Partnerships (LLPs) are not subject to the same restriction. They are always taxed as partnerships, regardless of how they are treated at the federal level. However, there is no policy justification for requiring conformity to federal treatment for LLCs but permitting non-conformity for LLPs. Both LLCs and LLPs pay a $500 annual report fee to the Secretary of State, which is four times the fee paid by corporations. Regular partnerships pay no annual fee. *There is no justification for these huge fee disparities, based on the entities' legal form, all of which violate horizontal equity.*

An important distinction in the tax treatment of conduits is that the income (or loss) of the partnership or the S-corporation flows through and is taxable to the partners or shareholders *regardless* of how much they have taken out as draw (partnership), or dividends (S-corporation) during the year. The income is taxable to the owners whether or not they actually get it. If partnership taxable income is $100,000 the partners will be taxed on $100,000 on their personal returns, even if they did not receive any money from the partnership in draw. And they are taxed only on $100,000 even if they took a draw of $150,000. The same is true for S-corporations. Therefore, it is a flow of income, not cash that is taxed. The cash paid out as "draw" (partnership) or dividends (S-corporation) is not taxable and is ignored, with rare exceptions.

This is not true for C-corporations. For C-corporations, if a shareholder receives dividends he pays tax. Otherwise he pays no tax. Any "guaranteed payments" paid to partners, and salaries paid to shareholders who are also employees, are deductible by the partnership or corporation and taxable to the partner or shareholder. These types of payments are not ignored and they reduce the amount that flows through. Guaranteed payments to a partner are like a salary to an employee but, technically, they are not a salary because a partner can never be an employee of the partnership.

When there are losses in a partnership or S-corporation, these also flow through and are potentially deductible. Again, these losses flow through to owners regardless of how much cash they have taken during the year as partner draw or employee salary to the S shareholder. This treatment can create cash flow problems for minority shareholders or partners. For example, a minority (<50%) shareholder in an S-corporation is taxed on his or her share of the income and has no power to force management to pay a dividend. In effect, the shareholder pays the corporation's income tax. However, when there are losses, those are potentially deductible by the S shareholder or partner, unless restricted by the passive loss rules or lack of basis.

> **Example.** Judy owns 10% of the stock in XYZ Corporation, an electing S-corporation. The corporation earned a net taxable profit of $50,000 for the current year, after deducting Judy's wages of $10,000 for various services to the corporation, and made cash dividend distributions to the shareholders of $30,000.
>
> - Judy includes in her income the wages of $10,000 and her share of the corporate income of $5,000 (10% of $50,000). The $10,000 is deductible to the corporation. The $5,000 increases her basis in her corporate stock.
> - Judy receives 10% of the dividend distribution, or $3,000. This distribution is tax-free, unless it exceeds her basis in her stock.

Therefore, the tax treatment of Massachusetts conduits varies dramatically from that of C-corporations and is due solely to the legal form chosen, rather than to sound policy considerations.

For both the S-corporation and the partnership there is the potential for non-reporting of the pass-through income to non-residents. Form SK-1 and 3K-1, indicating each owner's share of the entities net income, is sent to all owners. The non-resident shareholder or partner has the responsibility to file a non-resident Massachusetts income tax return (1-NR/PY) to report this income. Whether he actually does file is another matter. An out-of-state owner may not file, making it difficult to collect the tax he owes.

Sole Proprietorship (Schedule C and Form 1)

Massachusetts sole proprietorships are one-individual-owned firms. A sole proprietorship is not a separate legal entity and the owner has unlimited liability (i.e., personal assets are at risk). The income or loss is calculated on Massachusetts Schedule C and included on the owner's individual income tax return (Form 1). There is no double tax, minimum tax or annual report fee due.

Corporate Trusts (Form 3F)

A Massachusetts corporate trust (also called a "trust with transferable shares") is any partnership, association or trust where ownership is represented by transferable shares. Corporate trusts are taxed in the same manner as sole proprietorships, although many IRC provisions that apply to corporations also apply to corporate trusts. For federal purposes corporate trusts could be C- or S-corporations. They do not pay the $456 minimum tax but they do pay a $75 annual filing fee.

Apportionment and Unitary Tax Issues

An important question for Massachusetts (or any state) is whether Massachusetts has the ability to tax corporations incorporated in other states or countries ("foreign" corporations) when they do business in Massachusetts. The Supreme Court addressed this issue as it affects the Commerce Clause by stating that a state has the right to tax a foreign corporation when:

- The foreign corporation has sufficient "nexus" with the taxing state.

- The tax is fairly apportioned.
- The tax does not discriminate against interstate commerce.
- The tax bears a relationship to the services provided by the state.[5]

For our purposes, the first two prongs of this test are the most important.[6] The legal right to tax a foreign corporation in Massachusetts depends on whether there is sufficient nexus (i.e., a valid connection) between the corporation and Massachusetts. Adequate nexus includes physical presence, such as ownership or the leasing of property, offices, employment, and other tests, within Massachusetts. The existence of nexus, and hence the ability to tax a non-Massachusetts business, has been frequently litigated by the states.[7]

When a business entity has income both from business activity or ownership of any property in Massachusetts, and in another state, and the other state levies an income or franchise tax, then the entity must determine the amount of income that is taxable in Massachusetts by apportioning income on the basis of sales, tangible property and payroll located within Massachusetts. For a partnership, there must also be one or more corporate or non-resident individual partners.

The goal of fair apportionment is to prevent multiple taxation of the same income by the states where a company does business.[8] A similar goal exists at the federal level for multinational companies except that the approach is different. Federal law taxes all of

---

[5] See *Complete Auto Transit v. Brady,* 430 U.S. 274 (1977).
[6] The U.S. Supreme Court has not defined what constitutes discrimination in interstate commerce; however they have provided some guidelines. A state may not tax a transaction more simply because it is multi-state vs. entirely in-state. Interstate tax discrimination should not interfere with the economic decision of where to site one's business. The last test requiring the tax to bear a fair relationship to the services provided requires only that the tax is reasonably related to the amount of business the foreign business conducts in the state.
[7] Public Law 86-272, 15 USC 381-385 applies to state taxes based on net income and helps define when there is sufficient nexus. For example, the mere solicitation of sales orders of tangible personal property (but not real or intangible property), where the orders are sent out of state for fulfillment, does not constitute nexus. There are several questions not addressed by this law and there are many activities that will cause the loss of protection, and thus create nexus.
[8] Uniform Division of Income for Tax Purposes Act (UDIPTA) is a model law providing a standardized set of rules for the taxation of multistate corporations. Some states have adopted it as is and others have partly adopted it or modeled their own laws after it.

the income of U.S. companies doing business in several countries and then allows a deduction or credit for taxes paid to other countries, in order to reduce or eliminate the potential for multiple taxation. Foreign companies doing business in the U.S. are taxed only on income effectively connected in some way with the United States. States do not tax all the income of a foreign corporation, while allowing deductions or credits for taxes paid to other states, as a way to prevent multiple taxation. Rather, they apportion income using various formulas to approximate the economic activity in each state.

The Massachusetts apportionment formulas vary according to the type of industry or the type of legal entity. Only business income is apportioned. Massachusetts follows the rule whereby interest, non-business rents, royalties and some capital gains are not apportioned but are attributed 100% to the state where the property is sited.

The general formula for apportionment is to divide Massachusetts tangible property, payroll and sales by worldwide property, payroll and sales to yield percentages. The sales percentage is multiplied by two and added to the percentage for property and payroll. This total is then divided by four. The resulting apportionment percentage is multiplied by modified federal taxable income to determine Massachusetts taxable income. Oddly, partnerships use a single weighted sales factor and divide by three. Manufacturers and some mutual fund companies use only sales to determine their apportionment percentage (single-sales-factor apportionment).

The multitude of apportionment formulas employed by the states creates inefficiencies and inequities in income apportionment. Only ten states use a three-factor formula and 20 states double weight the sales factor. By 2008, Illinois, Nebraska, Iowa, Oregon, Texas, Georgia, Wisconsin and New York will use single-factor-sales apportionment for all entities. Other states are contemplating or moving towards single-sales-factor apportionment. Some states allow the business to choose among several formulas.

Single-sales-factor apportionment benefits companies that are headquartered in the single-sales-factor apportionment state, since they usually have large investments in property and large payrolls that would receive no weight in the formula. It likewise forces companies with high sales but small investment and small payrolls in the state to allocate more of their income to the state.

Under single-sales-factor, non-Massachusetts companies doing business in Massachusetts would allocate more of their income to Massachusetts than they do under the three-factor formula, because they usually have little property and only small payrolls in the Commonwealth. Single-sales-factor would induce the same companies to site more of their property and payrolls in Massachusetts. Massachusetts employs a "throwback" rule that does not allow a Massachusetts business to apportion income to a state that will not tax the income because of a lack of nexus or other reasons.

The potential for tax avoidance by businesses comprised of many different business entities is a major problem for states. Significant tax avoidance opportunities exist to shift income to subsidiaries or related companies located in low tax states, or countries. For example, a corporation in a low corporate tax state such as Texas can form a Massachusetts-related corporation and charge the Massachusetts company royalties for use of the company name or for other intangible assets. The royalties paid are an expense that is deductible by the Massachusetts company and not taxable to the corporation in Texas. Similar tax avoidance can be accomplished with the payment of interest on loans to related entities.[9]

The states approach this issue in various ways. Some states utilize separate entity reporting, where each legal entity is required to file a return and is taxed, *if* there is nexus. Some states allow the filing of a single consolidated income tax return if the entities are related and each has taxable income in the state. For the latter method, there are two approaches to apportionment of the income. Either the income is apportioned for each member of the group separately and then the taxable income is combined, or the

[9] See *Geoffrey, Inc. v. South Carolina Tax Commission*, 114 S. Ct. 550 (1993) and *K-Mart Properties, Inc. v. Taxation and Revenue Department* (Docket #21,140, New Mexico Ct. App., November 28, 2001.) These cases held that the licensing of intangible assets that are used in-state create sufficient nexus to tax the parent or related company.

apportionment formula is applied to the data of the combined group using a single formula.

Massachusetts allows corporations to elect to be taxed as separate entities or to file a consolidated return, if they are filing a consolidated return for federal purposes. Apportionment is applied to each corporation separately.

Another option is to allow combined reporting for a unitary business. The crucial difference between a consolidated return and a combined return for a unitary business is that under the unitary concept the income from all affiliated businesses are included in the apportionment calculation, even if a member of the unitary group does not have nexus in the state. Therefore, the income (or loss) of a company without nexus in the unitary group is included in the apportionment and a portion is allocated to a state even though the corporation does not operate in that state. The member of the unitary group that has nexus then reports its share of income based on an apportionment formula that includes the factors of the *entire* unitary group, rather than just those with nexus. This approach is constitutional and can include foreign subsidiaries of a U.S. multinational or a foreign multinational with U.S. subsidiaries.[10]

Of course, the important question is determining which entities are members of the unitary group; much like determining nexus. Under a unitary approach legal entities are ignored, and the rules apply to partnerships as well as corporations. The determination of which entities are included in the unitary group is difficult since there is no standard definition. The courts have applied various tests, including common ownership, common operations, centralized management, functional integration, interdependence among entities and other factors.[11] The objective of combined unitary reporting is to eliminate the tax avoidance potential of inter-company transactions. This is the same objective as

[10] *Container Corporation of America v. Franchise Tax Bd*., 463 U.S. 159, 103 S. Ct. 2933 (1983); *Barclays Bank PLC v. Franchise Tax Bd*., 512 U.S. 298 (1994). Some states allow a taxpayer to make a "waters edge" election which limits apportionment to only those entities within the U.S.
[11] For example, see *Butler Bros. V. McColgan*, 315 U.S. 501 (1942) and *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980).

for consolidated returns except that the unitary approach is more effective. Massachusetts has not adopted this approach.

IV. Comparison of Massachusetts Business Tax Laws vs. Competitor States

In Table 2 we present a comparison of the Bay State's business tax law with business tax law of other competitor states.[12] Specifically, we compare tax rates, double taxation, tangible property or net worth taxes, minimum taxes, unitary taxation, apportionment formulas and C-corporation dividend received deductions for C-corporations, S-corporations, partnerships and sole proprietors.

Table 2: Comparison of Tax Characteristics of Competitor States

State	C-Corp Tax Rate (%)	S-Corp Tax Rate (%)	Partnership Tax	Sole Proprietor Tax Rate (%)	Double Taxation (entity)	Tangible Property Or Net Worth Tax?	Minimum Tax (entity) ($)	Unitary Taxation?	Apportionment Formula (1)	Dividend Received Deduction ?[9]
California	8.84	1.50	No[4]	1.0 - 9.3	Yes (C & S)	No	800 (C, S, P, LLC)	Yes	SSPP	Yes (V)
Colorado	4.63	0.0	No	4.63	Yes (C)	No	None	Yes	SPP, SP	Yes (F)
Connecticut	7.50	0.0	No	3.0 – 5.0	Yes (C)	Yes	250 (C, S, LLC)	Yes	SSF, SSPP	Yes (V)
Delaware	8.7[1]	0.0	No	0.0 -0 5.95	Yes (C)	No	35 - 165,000	No	SPP	Yes (F)
Florida	5.50	0.0	No	None	No	No	None	No	SSPP	Yes(F)
Maine	3.5 - 8.93	0.0	No	2.0 - 8.5	Yes (C)	No	None	Yes	SSF	Yes(F)
Maryland	7.00	0.0	No	2.0 - 4.75[5]	Yes (C)	No	None	No	SSPP, SSF	Yes (F)
Massachusetts	**9.50**	**0.0, 3.0, 4.5**	**No**	**5.30%**	**Yes (C & S)**	**Yes**	**$456(C, S)**	**No**	**SSF,SSPP,SPP**	**Yes**
Minnesota	9.80	0.0	No[4]	5.35 - 7.85	Yes (C)	No	0 - 5,000 (C, S, P)	Yes	SPP	Yes (V)
New Hampshire	8.5 - 9.25	8.5 – 9.25	8.5 to 9.25	8.5 - 9.25	No	No	None	Yes	SSPP	No
New Jersey	6.5 - 9.00	0.0	No	1.4 - 8.97	Yes (C)	No	500 - 2000 (C, S)	No	SSPP	Yes (V)
New York	7.10	0.0	No	4 - 6.85[5]	Yes (C)	No	800 (C, S)	Yes	SSF	Yes(V)
North Carolina	6.90	0.0	No	6.0 - 7.75	Yes (C)	No	1.50[7] (C, S)	No	SSPP	Yes(F)
Rhode Island	9.00%	0.0	No	3.75 - 9.9[6]	Yes (C)	No	500[8] (C, S)	No	SPP	Yes(F)
Texas	0.50 - 1.00[2]	Same as C	Same as C	None	No	No	None	Yes	SSF	Yes
Utah	5.00	0.0	No	2.3 - 6.9	Yes (C)	No	$100	Yes	SPP,SSPP	Yes (V)
Vermont	6.00 - 8.50	0.0	No[4]	3.6 - 9.5	Yes (C)	No	250 (C, S, P, LLC)	Yes	SSPP	Yes(F)
Washington	0.015 - 0.484[3]	Same as C	Same as C	Same as C	No	No	None	N/A	N/A	N/A

1) SSF = Single Sales Factor; SSPP = Double weighted sales, property and payroll; SPP = Single weighted sales, property, payroll: SP=Sales & property. All factors evenly weighted unless otherwise noted. [1] plus .576 on gross receipts [2] X Gross revenue - (CGS or comp.)[3]on gross receipts [4]minimum tax applies [5]plus local taxes [6]or 7.0 flat rate [7]per $1000 of stock [8]or $2.50 per $10,000 of stock (SSF in 2013) [9] V=varies by % owned, F = same as Federal

[12] Compiled by authors from examination of tax forms, tax laws and The Beacon Hill Institute's *State Competitiveness Reports 2001-2007* as well as the Massachusetts Technology Collaborative as enumerated in its *The Index of Innovation Economy, 2006.*

The analysis indicates that Massachusetts has the second highest C-corporation tax rate and is one of the few that taxes S-corporations at the entity level. Massachusetts is one of 15 states out of 21 that double tax C-corporation income, but is only one of two states that also double taxes S-corporation income. Massachusetts is one of only two states with a tax on tangible property or net worth, in addition to the income tax. Massachusetts is not alone in imposing minimum taxes on corporations (C or S). Twelve states impose such a tax, and four states impose a minimum tax on other entities, such as partnerships or LLCs, which Massachusetts does not. Eleven out of 21 states have adopted unitary tax principles; Massachusetts is not one of them. Massachusetts has three different apportionment formulas, which apply to different industries and businesses, which is more than any other state. All states that tax corporate business income, except one, permit a deduction for dividends received from other corporations.

We conclude from this comparison that Massachusetts significantly lags other states in competitiveness with regard to tax rates, S-corporation entity taxation, tangible property and net worth taxation and unitary taxation. Whether Massachusetts is competitive with regard to apportionment formulas is difficult to say. However, applying different formulas to different businesses clearly violates horizontal equity principles. Massachusetts is competitive with regard to sole proprietor tax rates, double taxation of C-corporations (but not S-corporations) and somewhat competitive with regard to minimum taxes (13 out of 21 states impose lower or no minimum taxes).

V. Reform Proposals

In some quarters, Massachusetts has an image problem that may be hindering investment decisions. According to one report, Massachusetts ranks 46th out of all 50 states for corporate taxes, and 34th when other taxes, such as unemployment taxes and property taxes are included.[13] Other reports maintain that overall business taxes in Massachusetts

[13] Tax Foundation, *State Business Tax Climate Index*, 2008.

are low when compared to personal income.[14] This view, however, does not address the possibility that the state's poor record in creating new jobs may be attributable to its corporate taxes.

Clearly, other states have been competing more effectively than Massachusetts in lowering their business taxes. Not surprisingly, the growth of the Massachusetts' economy from 2003 to 2006 was almost the slowest in the nation.[15] To prevent further erosion of the tax base, including personal income, property, sales and meals taxes, Massachusetts should consider lowering the nominal business tax rate.

State governments are not alone when facing the problem of complex, inefficient tax codes. A parallel can be seen at the federal level. The United States has the second highest effective corporate tax rate in the developed world.[16] Not long ago, the United States could boast of having one of the lowest corporate tax rates. But this has changed. Other countries are aggressively competing by lowering their corporate tax burdens. Declining corporate tax revenues, combined with a slowing economy and decline in the value of the dollar are related to our lack of international tax competitiveness.

BHI's reform proposals seek to meet the following objectives:

- Broaden the tax base by increasing the number of businesses that are taxed.
- Increase both horizontal and vertical equity.
- Eliminate double taxation.
- Increase compliance by non-resident entities and owners.
- Decrease tax avoidance.
- Attract business to Massachusetts.

---

[14] Massachusetts Budget and Policy Center, "Business Taxation: Isolated Statistics Versus a More Complete Picture," *MassBudget Brief*, 10 January 2008: http://www.massbudget.org/BizTaxBrief.pdf.

[15] Based on BHI calculations, Massachusetts ranked 48th ahead of Ohio and Michigan. Data are available upon request.

[16] Tax Foundation, "New Ranking: Major U.S. Trading Partners Cut Corporate Tax Rates While U.S. Stands Pat with Second-Highest Rate," 27 July 2007; Internet; available from http://www.taxfoundation.org/news/show/22504.html.

.

- Increase tax revenues of all types in the long term while maintaining current business tax revenue.

Specifically the Institute proposes the following:

- *Set the statutory business tax rate on almost all entities at 5.3%, the same rate as for individuals*.[17] Currently, C-corporations pay 9.5%. S-corporations pay nothing if gross receipts are less than $6 million, 3% of taxable income if gross receipts are greater than $6 million but less than $9 million and 4.5% if gross receipts are over $9 million. Partnerships pay no tax; corporate trusts, and sole proprietors pay 5.3%. The varying tax rates violate horizontal equity, in that two business taxpayers with the same income will pay very different income taxes (see Table 1).
- *Eliminate the tax of $2.60 per thousand dollars on tangible personal property or net worth, applicable to C and S-corporations only*. This tax is regressive and not uniformly applied to all businesses. Partnerships, sole proprietors and corporate trusts do not pay this tax. Because it bears no relationship to the ability of the business to pay, the tax is regressive. In fact, it often increases when a business is doing poorly and when inventories, which are included in the tax base, are growing. The tax does not make Massachusetts an attractive place to invest capital.
- *Eliminate the conduit concept by taxing all entities at the rate of 5.3% at the entity level.* All entities, regardless of the legal form, would pay tax at the entity level. This proposal would tax businesses organized as partnerships or S-corporations under $6 million in gross receipts which currently are not taxed. The major benefit of this proposal would be to increase compliance by non-resident partners and shareholders, who often fail to file non-resident personal income tax returns for the flow-through income from these entities. This would also eliminate the need to adopt "check the box" rules. If tax considerations are removed, Massachusetts should allow any choice of entity that the taxpayer

[17] Our proposal does not encompass certain corporations that have historically received special tax treatment. These include banks, insurance companies, securities corporations and utilities.

desires and the choice could be different than the form chosen at the federal level. Taxpayers should be allowed to choose the form in which they wish to conduct business to accomplish business goals, other than tax avoidance.

- *Eliminate the double taxation of C-corporation earnings (and the earnings of large S- corporations) by taxing all business entities (domiciled in MA or with nexus) at 5.3% at the entity level (as apportioned if multi-state) and eliminating the tax on corporate dividends to C-corporation shareholders or flow-through income from conduits*. Dividends from Massachusetts corporations would not be taxable to resident or non-resident shareholders. Dividends to Massachusetts residents from corporations not subject to Massachusetts taxation would continue to be taxable. Flow-through income to partners or S shareholders would not be taxable, if from entities taxable in Massachusetts. Dividends would continue to be non-deductible by the corporation. This eliminates the problem of collecting tax on non-resident owners. It also eliminates double taxation on liquidation and discourages the use of debt vs. equity capital structures, excessive compensation and rent, as double-tax avoidance schemes. Of course, taxpayers may still employ these techniques to avoid federal tax, which would affect Massachusetts, and compliance could still be a problem for reporting of compensation, interest income and rental income by non-resident shareholders, as it is now. The solution to this problem is to deny the corporation a deduction for wages, interest or rents paid to non-resident shareholders. Also, we propose elimination of the 9.5% built-in gains and passive income taxes of S- corporations that were once C-corporations.
- *Eliminate the $456 minimum tax on C and S-corporations. This tax is regressive and horizontally inequitable*. The minimum tax is not assessed on partnerships, sole proprietors or corporate trusts and has no bearing on the ability to pay tax. The largest multi-national corporation with a loss and the smallest new corporation with few assets pay the same tax. It is an impediment to business formation in Massachusetts and discourages businesses from choosing the corporate form. It has been justified as a fee for the privilege of using the corporate form and the benefits it confers, such as limited liability; however,

corporations already pay $125 ($500 for LLCs) to the Secretary of State when filing their annual report, which is exorbitant and without merit. Furthermore, LLC's enjoy limited liability yet do not pay the minimum tax if they choose to be taxed as partnership.

- *Adopt combined reporting and unitary tax principles for all business entities, without a "waters edge" election. This will apply to all types of entities, not just corporations.* Currently, Massachusetts does not employ unitary or combined reporting. Doing so would capture some of the income of affiliated (unitary) out-of-state corporations, without direct nexus in Massachusetts, that now escape taxation, including income in other countries. This income escapes taxation via a number of tax avoidance schemes, such as transfer pricing; establishing nexus in low tax states and shifting income out of state; avoiding the Massachusetts business property tax by investing in low tax states; and utilization of inter-company transactions such as management fees, interest and royalties. Eliminate "throw-back" rules, which seek to assert Massachusetts tax on income, properly allocable to another state, if the other state imposes no tax. This tax cannot be defended on equity grounds and is simply a revenue raiser.
- *Adopt single-sales-factor apportionment for all entities and industries, not just some.* Why discourage payroll and property investments in Massachusetts by including these factors in the formula? Single-sales-factor apportionment would make Massachusetts more competitive and attract more business to the state. The apportionment factors utilized in Massachusetts depend on the industry the taxpayer is in, which is not horizontally equitable. Single-sales-factor apportionment would also simplify apportionment calculations under combined reporting.
- *Allow net-operating-loss-carryover deductions by sole proprietors, corporate trusts and partnerships.* Currently, only corporations are allowed to carry over their losses to future years. Allowing only some businesses to take these loss deductions violates horizontally equity. It also punishes the taxpayer whose earnings vary considerably from year to year and rewards those with steady

earnings. This is consonant with the proposal to tax all businesses at the entity level.

- *Eliminate all tax incentives*, such as: the 3% Investment Tax Credit; the Economic Opportunity Area Credit; the Vanpool Credit; the Research Credit; the Harbor Maintenance Tax Credit; the Full Employment Credit; the Brownfields Credit; the Low-Income Housing Credit; the Historic Rehabilitation Credit; the Home Energy Efficiency Credit; the Solar Heat Credit; the Film Incentive Credit; and the Medical Device Credit. All of these credits decrease the tax base and reward targeted industries and/or taxpayers and are, therefore, not horizontally equitable.

- *Allow a 100% dividends-received deduction for dividends received by corporations, regardless of the percentage owned.* Currently, only corporations that own more than 15% of the dividend paying corporation are allowed this deduction. There is no equitable rationale for this arbitrary percentage cutoff. This will eliminate double or triple taxation of dividends.

While first-year tax revenues will decrease due to the lowering of the rate, elimination of double taxation and minimum taxes, we expect this decrease to be largely offset by revenue increases due to the following:

- Single-sales-factor apportionment will decrease taxes on businesses that have payroll and property in Massachusetts but increase taxes on non-Massachusetts businesses with little payroll or property in Massachusetts.
- Taxing all entities, including partnerships and small S-corporations, will decrease loss of revenue due to non-compliance of out of state partners and S-corporation shareholders.
- Unitary or combined reporting will increase revenues due to elimination of many of the tax avoidance schemes presently employed by multi-state corporations. This will broaden the tax base by capturing income from entities in low tax states, or countries, without nexus in Massachusetts.
- The elimination of all targeted tax credits will increase revenues.

- There will be an increase in the first year tax base due to new business formation in Massachusetts created by improvements in equity and lowering of tax rates and elimination of double taxation.

VI. Estimated Static and Dynamic Revenue Effects

We provide both "static" and "dynamic" revenue estimates. Static estimates assume that there is no change in underlying economic activity in response to a change in tax law. For example, under a static estimate, a fall in the corporate income tax rate, as here, from 9.5% to 5.3%, would be predicted to cause corporate tax revenue to fall by 44.2% (= (9.5-5.3)/9.5).

The evidence shows that state and local level tax changes have significant effects on state economic activity.[18] A dynamic estimate shows a smaller drop in revenue because it captures the positive effect on the tax base of the reduction in the corporate income tax.

In order to analyze the sweeping changes in the way in which business entities are taxed in Massachusetts, The Beacon Hill Institute (BHI) built a "Computable General Equilibrium" (CGE) model of the Massachusetts economy, called Massachusetts-STAMP (for State Tax Analysis Modeling Program). The purpose of the model is to answer questions about what would happen to the Massachusetts economy under a variety of hypothetical tax changes. [19]

Table 3 presents our estimates of the static revenue effects of these tax proposals. [20] Here we assume that our proposals are adopted, effective January 1, 2009.[21]

---

[18] Timothy Bartik, *Who Benefits from State and Local Economic Development Policies?* (Kalamazoo, MI: Upjohn Institute, 1991).
[19] Detailed information about the Massachusetts CGE STAMP® 07 model can be obtained by sending an email to fconte@beaconhill.org or by visiting www.beaconhill.org
[20] All data are 2004 Massachusetts Department of Revenue data. The estimate for Combined Reporting and the estimate for Unitary Tax Principles were obtained from Commonwealth of Massachusetts, *Study Commission on Corporate Taxation, Final Report*, (December 28, 2007): 120. The estimates were inflated to 2009-2013 using the following methodology: We first calculated the ratio of the change in revenue due to the individual reform proposal to the total revenue collections for the appropriate tax (corporate, personal, and business property) in 2004. This ratio was applied to the BHI projections of total revenue

Table 3: Static Revenue Estimates, 2009-2013
($ millions)

C-Corporate Income Tax Changes	2009	2010	2011	2012	2013
Rate Reduction to 5.3%	(323.13)	(328.92)	(334.96)	(341.28)	(347.88)
Minimum Tax Elimination	(21.55)	(21.93)	(22.34)	(22.76)	(23.20)
Combined Reporting & Unitary Tax Principles	182.24	185.5	188.91	192.47	196.19
Incentive Tax Credits	135.80	138.23	140.77	143.42	146.20
Subtotal	(26.65)	(27.13)	(27.62)	(28.15)	(28.69)
S-Corporation Tax Changes					
S-Corp Tax Collections Expansion	47.16	48.01	48.89	49.81	50.78
Minimum Tax Elimination	(39.55)	(40.26)	(41.00)	(41.77)	(42.58)
Combined Reporting & Unitary Tax Principles	94.33	96.02	97.78	99.62	101.55
Incentive Tax Credits	76.90	78.27	79.71	81.22	82.79
Subtotal	178.84	182.04	185.39	188.88	192.54
Business Property Tax Change	(264.45)	(268.99)	(273.62)	(278.32)	(283.10)
Total Net Change	(112.26)	(114.08)	(115.85)	(117.58)	(119.25)

In 2009, the state loses $323.13 million from lowering the C-corporation tax rate from 9.5% to 5.3% and $21.55 million from eliminating the minimum corporate tax payment. However, the state gains $182.24 million from adopting combined reporting and unitary tax principles and $135.80 million from the elimination of incentive tax credits. The state would lose a net of $26.65 million from the reforms to the taxation of the businesses registered as C-corporations.

The corporate tax reforms effects on firms incorporated as S-corporations also impact state tax collections. The expansion of the S-corporation collections produces an additional $47.16 million in tax revenue. The adoption of the unitary tax principles and

collections for corporate, personal and business property taxes in FY 2009-FY 2014. This provided the basis for our calendar year estimates in Table 3.

[21] We could not obtain static revenue estimates for all of our proposals. It is our judgment that the revenue gains not captured by our estimates roughly offset the revenue losses.

the elimination of incentive tax credits would increase tax collections by a total of $171.23 million dollars. These gains are offset by the elimination of the minimum tax collection, which would reduce collections by $39.55 million. On a net basis reforming the corporate tax laws that apply to S-corporations would increase state coffers by $178.84 million in 2009.

The state would also lose $264.45 million in 2009 from the elimination of the tax on tangible property and net worth levied on both C and S corps. On a net static basis the state would lose a total of $112.26 million under the reforms outlined above. However, as stated above, these static estimates fail to account for the economic and behavioral effects of the reforms solutions, thus we need to estimate the dynamic revenues.

Table 4 presents dynamic tax revenue estimates. As expected, the tax changes affect the revenue collection of both state and local taxes. Under the plan, combined state and local tax revenues would decline by $79.11 million in 2009. The decrease is caused primarily by the $106.48 million reduction in corporate excise tax collections. However, the economic stimulus created by the reforms would boost revenue collections for the sales and income taxes by $4.16 and $4.38 million dollars, respectively, and other revenues and fees by almost $11.09 million. The remaining state taxes would undergo gains of almost $1 million dollars combined. These estimates imply a difference of $26.37 million between the static and dynamic state revenue estimate, with the static estimate overstating the decrease in revenue collections.

Local government would see an increase in their property taxes of $6.78 million dollars, as businesses chooses to locate more capital and labor in the state.

The dynamic tax revenue estimates are predictably smaller than the static estimates. In 2009, total tax revenue collections, including both state and local government would decrease by $79.11 million, $33.15 million less than the static estimate.

Table 4: Dynamic Tax Revenue Changes, 2009-2013
($ million)

Tax	2009	2010	2011	2012	2013
Sales and use tax	4.16	4.25	4.33	4.42	4.51
Motor fuel taxes	0.19	0.19	0.19	0.19	0.19
Motor vehicle fees	0.10	0.10	0.10	0.10	0.10
Corporations excise tax	(106.48)	(106.53)	(106.58)	(106.63)	(106.68)
Personal income tax	4.38	4.39	4.39	4.39	4.39
Cigarette and tobacco taxes	0.25	0.26	0.27	0.27	0.28
Other taxes, fees and revenue	11.09	11.24	11.39	11.55	11.70
Unemployment insurance tax	0.42	0.42	0.42	0.42	0.42
State dynamic revenue change	**(85.89)**	**(85.69)**	**(85.49)**	**(85.29)**	**(85.09)**
Residential property	0.02	0.02	0.02	0.02	0.02
Business property	6.76	6.76	6.76	6.77	6.77
Local dynamic revenue change	*6.78*	*6.78*	*6.78*	*6.79*	*6.79*
Net dynamic revenue change	**(79.11)**	**(78.91)**	**(78.71)**	**(78.51)**	**(78.30)**

The above analysis shows how the push and pull of economic activity affect the revenue collections of the different taxes in place. We now consider the effects of the proposed tax changes on seven different economic indicators. These effects are presented in Table 5.

Table 5: The Plan's Economic Effects, 2009-2013

	2009	2010	2011	2012	2013
Employment					
Private					
Jobs	4,117	4,217	4,259	4,300	4,342
Government					
Jobs	(92)	(93)	(94)	(95)	(96)
Total					
Jobs	4,025	4,124	4,165	4,205	4,246
Investment					
$ millions	119.73	126.38	133.39	140.79	148.61
Real disposable income					
$ millions	255.31	252.57	249.86	247.19	244.54

The first economic indicator we consider is employment. The number of private sector jobs that otherwise would have been in place increase, while the public sector loses jobs.

The decrease in the public sector jobs results from the decrease in the total revenue collected by the state government. With less revenue, the state would have to reduce expenditures. Under the reform, we estimate that in 2009 this would lead to the elimination of 92 government jobs in Massachusetts. However, the private sector would gain jobs. This is caused by the reduction in the tax rate on C and S-Corps and business property taxes. We estimate that the private sector would employ 4,117 more people in 2009 under our plan. The employment gains would lead to an increase in total real disposable income in the state to be higher, by $255.31 million in 2009.

A 5.3% business tax rate on a broader base would increase investment by $120 million in 2009.

Investment would increase by $119.73 million in 2009 under the plan because the reduction in corporate taxation and the preferential treatment of capital goods would increase the funds available for investment within the state and attract more investment to Massachusetts from outside the state.

VII. Summary and Conclusions

The Massachusetts business tax code cries out for reform. If they are expected to become viable sources of revenue, business taxes must be reformed in a manner that promotes stability, economic growth as well as simplicity and transparency. Both the Governor and the House Speaker have released plans that, in some respects, move the state in the right direction. However, both focus on raising new revenue without considering long-term economic effects. Firms will continue to engage in tax avoidance strategies as long as rates remain high.

Massachusetts should strive for a predictable and competitive business tax policy that serves firms, investors, workers and government in the most optimal manner. A uniform rate covering a broader base would provide a stable source of revenue and promote economic growth. All businesses would be treated with consistent, equitable tax policies that recognize that the investments these companies make in Massachusetts are catalysts for economic and job growth.

Adopting a business income tax rate of 5.3%, applied to all business entities, would represent the kind of bold move that will attract new businesses and thus benefit all taxpayers of the Commonwealth of Massachusetts.

SELECTED WORKS

Aaron, Henry J and Joseph A. Pechman, ed. 1981. *How Taxes Affect Economic Behavior*. Washington D.C.: Brookings Institution.

Bartik, Timothy. 1991. *Who Benefits from State and Local Economic Development Policies?* Kalamazoo, MI: Upjohn Institute.

Beacon Hill Institute at Suffolk University. 2003. "Wishful Thinking about Corporate Tax Breaks." (June) available from http://www.beaconhill.org

Berck, Peter, Elise Golan and B. Smith, with John Barnhart and Andrew Dabalen. "Dynamic Revenue Analysis for California." 1996. University of California at Berkeley and California Department of Finance.

Brunori, David. 2001. *State Tax Policy*. Washington, DC: Urban institute Press.

Bonnett, Thomas. 1998. "Is the New Global Economy Leaving State/Local Tax Structures Behind?" *Public Management* 80, no. 4 (April).

Brunori, David. 2003. *Local Tax Policy: A Federalist Perspective.* Washington: Urban Institute Press.

Cline, Robert. 2002. "Can the Current State and Local Business Tax System Survive the New Economy Challenges?" *State Tax Notes* 241. (April 15): 241.

Edwards, Chris. 2004. "State Corporate Income Taxes Should Be Repealed." Tax and Budget Bulletin 19. Cato Institute. (April).

Fox, William F. and LeAnn Luna. 2002. "State Corporate Tax Revenue Trends: Causes and Possible Solutions" *National Tax Journal* 55, no. 3 (September).

Grace, Martin F. 1998. "Should the Corporate Income Tax be Repealed?" Georgia Public Policy Foundation. (May).

Gruber, Jonathan. 2005. *Public Finance and Public Policy.* New York: Worth Publishers.

Massachusetts Budget and Policy Center. 2008. "Business Taxation: Isolated Statistics Versus a More Complete Picture," *MassBudget Brief* (January): http://www.massbudget.org/BizTaxBrief.pdf.

Muehlmann, K. Heinz. 1989. "Do Massachusetts Corporations Pay Their Fair Share of Taxes? Yes, and Then Some." Needham, MA: Foundation for Economic Research (May).

Raimondo, Henry J. 1992. *Economics of State and Local Government*. New York, Praeger.

S.H. Brooks Co., Inc. 1993. “Report to the Massachusetts Special Commission on Business Tax Policy.” (May).

Study Commission on Corporate Taxation. 2007. “Interim Report” Commonwealth of Massachusetts. (June).

Study Commission on Corporate Taxation. 2007. “Final Report.” Commonwealth of Massachusetts. (December).

Tax Foundation. 2007. *State Business Tax Climate Index*, 2003-2008. (October).

Wilson, Daniel. 2006. “The Mystery of Falling State Corporate Income Taxes.” Economic Letter 35. Federal Reserve Bank of San Francisco. (December).

About the authors

James P. Angelini is an Associate Professor of Accounting and Taxation, and Director of the Master of Science in Taxation Program at the Sawyer School of Business at Suffolk University in Boston, Massachusetts. Dr. Angelini teaches both undergraduate and graduate courses in taxation. A CPA in Massachusetts, Dr. Angelini has over 30 years of public accounting experience and has published numerous articles on various topics in federal and state taxation. Dr. Angelini is a member of the American Accounting Association, the American Institute of Certified Public Accountants, the Massachusetts Society of Certified Public Accountants, and the American Taxation Association. He is a resident scholar at the Beacon Hill Institute.

Frank Conte is Director of Communications and Information Systems at BHI. He holds a Master of Science in Public Affairs from the University of Massachusetts-Boston and a Bachelor of Science from Suffolk University. He assists in the management of the institute's research projects and media outreach efforts including all aspects of the institute's computer infrastructure.

Alfonso Sanchez-Penalver is an Economist at the Beacon Hill Institute. He holds a Master of Science degree in Finance from Boston College and a BSBA in Finance from Suffolk University. He is currently enrolled in the PhD program in Economics at Suffolk University. He has an extensive career in web programming and project management, as well as in accounting and financial analysis.

David G. Tuerck is Executive Director of the Beacon Hill Institute for Public Policy Research at Suffolk University where he also serves as Chairman and Professor of Economics. He holds a Ph.D. in economics from the University of Virginia and has written extensively on issues of taxation and public economics.

The authors would like to acknowledge the assistance of Suffolk University students James A. Nolet (Class of 2011) and Michael Head (Class of 2008) as well as interns Ashley Mowatt of Simmons College (Class of 2008) and Ian Finn of Boston College (Class of 2008).

The Beacon Hill Institute at Suffolk University in Boston focuses on federal, state and local economic policies as they affect citizens and businesses. The institute conducts research and educational programs to provide timely, concise and readable analyses that help voters, policymakers and opinion leaders understand today's leading public policy issues.

THE BEACON HILL INSTITUTE
FOR PUBLIC POLICY RESEARCH
Suffolk University
8 Ashburton Place
Boston, MA 02108
Phone: 617-573-8750 Fax: 617-994-4279
bhi@beaconhill.org
http://www.beaconhill.org