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Tax reform? We got tinkering

By James P. Angelini and David G. Tuerck | April 16, 2008

THE MASSACHUSETTS House of Representatives has passed a \$392 million tax hike that provides for \$217 million in new corporation taxes. The tax hike is being interpreted as a political victory for Governor Deval Patrick, who faces a need to pay for an ambitious spending agenda.

The governor's victory is, however, a pyrrhic one. A year ago, he called for a Study Commission on Corporate Taxation that was to show how the state could "promote tax fairness and equity, encourage business growth and innovation, and strengthen the Commonwealth's global competitiveness."

However, the commission, and now the Legislature, did none of the above. The commission's final recommendations were aimed mostly at closing corporate "loopholes." A minority of commission members argued that the state should also cut the corporate tax rate - the fourth highest in the country - by enough to avoid further burdening business. But no one listened.

The trouble is that there were plenty of inequities for the commission to correct. Different business entities pay taxes at widely varying rates. C-corporations pay 9.5 percent, S-corporations pay up to 4.5 percent, and sole proprietors and partnerships 5.3 percent. Earnings by C-corporations and by some (but not all) S-corporations are taxed twice, first at the corporate level and then again when shareholders receive dividends or flow-through income. Other businesses, such as sole proprietors, partnerships, and "LLCs," are taxed only once. C-corporations and S-corporations pay a \$456 minimum tax and a .26 percent tax on tangible property or net worth, while other businesses do not. LLCs and LLPs pay an annual reporting fee of \$500, while corporations pay only \$125.

Furthermore, the tax code is shot through with preferences that are dished out to politically muscular special pleaders but denied to others. Some, but not all, businesses are permitted to use "single-sales-factor apportionment," which reduces the tax burden on corporations with large payrolls and investments in Massachusetts. Some, but very few, get to use the politically popular but economically dubious "film incentive credit."

The new law closes some loopholes by instituting combined reporting, which makes it harder to shift income to other states, and a check-the-box provision, which requires Massachusetts firms to choose the same tax status for state law and federal law. But it does nothing to improve compliance by nonresident shareholders or partners who don't pay taxes on flow-through income from Massachusetts S-Corporations or partnerships. Nor does it stop corporations from taking advantage of tax dodges such as paying salaries rather than dividends to shareholders or leasing property from shareholders.

As a sop to business, the House will cut the corporate tax rate first to 8.75 percent and eventually to 7.5 percent. But, at the end of the day, Massachusetts corporations will find themselves paying more in taxes and, as a result, looking for ways to move plant and payrolls out of the state.

If state leaders had really wanted to reform business taxes, they could have done so. In a recent report, the Beacon Hill Institute showed how the state could simplify the business tax code, restore equity, and make Massachusetts an attractive destination for investment, with almost no loss in revenue. It could cut the tax rate on corporate income all the way to 5.3 percent (the same as the individual rate). It could eliminate double taxation, the tax on tangible property, and the minimum corporate tax, and offer single-sales factor apportionment to all entities. This it could do by taxing business only at the entity level, adopting combined unitary reporting, and ending all tax incentives. The economic return would consist of thousands of new private-sector jobs and millions of dollars in new investment.

None of this was to be, however. Instead of tax reform, we got tax tinkering and another one percent in tax

revenue to spend. A poor showing, indeed, considering the opportunity that the state had to enact genuine tax reform.

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