

State & Local Tax **Alert**

Breaking state and local tax developments from Grant Thornton LLP

Massachusetts Issues Proposed Regulation on Combined Reporting

On February 20, 2009, following months of anticipation, the Massachusetts Department of Revenue issued its proposed regulation on combined reporting.¹ The proposed regulation was promulgated to expand upon and clarify the provisions of House Bill 4904,² which introduced mandatory combined reporting for taxpayer's engaged in unitary business operations.³ The proposed regulation was also promulgated, as directed by statute, to provide guidance on the application of certain provisions on which the statute remained largely silent.⁴ ***This Alert highlights some of the most significant components addressed in the proposed regulations.***

Are We There Yet? History of the Combined Reporting Regulation

This was often the sentiment that was felt by the business and practitioner community during the months that followed the enactment of the law. Although the Department quickly responded by issuing "guidance" on the application of the new law, the Department's initial pronouncements provided little more than a summary of the new law and failed to adequately address or explain much of the new law's confusing and ambiguous provisions.⁵ On November 6, 2008, the Department issued a working draft regulation,⁶ which provided the first substantive clues as to how the Department intended to administer the new law, as well as the first substantive guidance on those specific provisions on which the statute remained largely silent. The Department solicited practitioner and public

Release date

April 7, 2009

States

Massachusetts

Contact details

Sylvia F. Dion
Boston
T 617.848.4997
E sylvia.dion@gt.com

Giles Sutton
Charlotte
T 704.632.6885
E giles.sutton@gt.com

Jamie C. Yesnowitz
Washington, DC
T 202.521.1504
E jamie.yesnowitz@gt.com

www.GrantThornton.com/SALT

¹ MASS. REGS. CODE tit. 830, § 63.32B.2, Proposed Regulation on Combined Reporting.

² Ch. 173 (H.B. 4904), Laws 2008, § 48, *An Act Relative to Tax Fairness and Business Competitiveness*, enacted July 3, 2008.

³ See GT SALT Alert, "Massachusetts Adopts Sweeping Tax Reform," July 22, 2008. <http://www.gt.com/staticfiles/GTCom/files/services/Tax%20services/SALT%20Alerts/SALT%20Alert%2007-22-08%20MA.pdf>

⁴ The statute directed the Commissioner to issue regulations explaining the application of the new law as it relates to four specific areas: the elimination of intercompany transactions; the sharing within the combined group of credits that may be validly claimed by a taxpayer and that are attributable to the combined group's unitary business; the application of any carryforwards, including the sharing of any net operating loss or tax credit carryforwards that are attributable to the activities of the combined group's unitary business; and the relationship of sections 31I to 31K, inclusive (the related-party expense addback rules), to newly enacted § 32B. MASS. GEN. LAWS ch. 63, § 32B(f)(i)-(iv).

⁵ On August 15, 2008, the Department issued Technical Information Release 08-11, *An Act Relative to Tax Fairness and Business Competitiveness*, which was largely a summary of the provisions of the new law. On September 25, 2008, the Department issued a *Statement of Anticipated Regulatory Positions Relating to the Implementation of Combined Reporting* which provided a first glance into the Department's position on certain provisions, but provided little in the way of substantive guidance.

⁶ MASS. REGS. CODE tit. 830, § 63.32B.2, Working Draft Regulation on Combined Reporting.

comment on the working draft regulation through December 5, 2008. During the fourth quarter of 2008, the Department informally communicated its intention to issue a proposed regulation by December 31, 2008. However, the Department did not anticipate the magnitude of comments that it would ultimately receive, both in terms of volume, and in terms of depth, nor did it anticipate that comments would continue to pour in well beyond the December 5th deadline. It was evident to the Department that much consideration would be required in the drafting of the proposed regulation. After much anticipation, the Department issued its comprehensive and lengthy, 70-page, proposed regulation on combined reporting. The Department, once again, accepted comments to the proposed regulation through March 31, 2009, the date of a public hearing on which the proposed regulation was discussed.

Expansive View of Entities Included in Combined Group

Perhaps the provision of the new combined reporting law that solicited the greatest amount of comments deals with the statute's comprehensive definition of entities subject to combination, including its focus on direct and indirect ownership, its use of a more than 50% voting control (versus value) threshold, and its inclusion of certain "foreign" entities in the definition of a water's edge group.

With respect to the *common ownership requirement*, the Department remained steadfast in its interpretation that the statute should be construed to the broadest extent possible. The proposed regulation states that "if the same person (and/or related person) holds more than 50% of the voting control of an entity (an "upstream entity"), that person shall be considered to hold indirectly, any stock or other interest in ownership or control in a lower tier entity (a "downstream entity") that is held by the upstream entity."⁷ ***For purposes of determining indirect ownership, the proposed regulation indicates that the constructive ownership rules of IRC Section 318 apply.***

As for the water's edge group, the statute requires inclusion of any member: (i) incorporated or formed in the U.S. (in a state, the District of Columbia, or U.S. territory or possession); (ii) incorporated or formed anywhere with at least a 20% average of its property, payroll, and sales factors within the U.S.; or (iii) any member which earns more than 20% of its income from intangible property or service-related activities the costs of which generally are deductible for federal income tax purposes against business income of other group members.⁸ Since the statute includes in its definition of an affiliated group (for purposes of the affiliated group election), any corporation which meets the water's edge description as described above,⁹ the distinction between filing on a default water's edge basis, or on an elected worldwide or elected affiliated group basis, will not always be significant. Although the proposed regulation provides additional guidance for determining whether a member has average property, payroll and sales factors within the United States of 20% or more,¹⁰

⁷ MASS. REGS. CODE tit. 830, § 63.32B.2(2)(a).

⁸ Ch. 173 (H.B. 4904), Laws 2008, § 48; inserting MASS GEN. LAWS ch. 63 § 32B(c)(3)(i)-(iii).

⁹ Ch. 173 (H.B. 4904), Laws 2008, § 48; inserting MASS GEN. LAWS ch. 63 § 32B(g)(i).

¹⁰ MASS. REGS. CODE tit. 830, § 63.32B.2(5)(b)2. In summary, the regulation indicates that the apportionment calculation is to be done by the corporation in question on a stand-alone basis, based

and guidance on the application of the more than 20% of income from the intangible or service-related activities requirement,¹¹ the regulation does not waver on the fact that companies, regardless of where incorporated or formed, which meet the conditions in the statute regarding water's edge entities, are required to be included in the water's edge group.

Determination of Combined Taxable Income

While the new law does not provide significant guidance on how to calculate taxable income,¹² the regulation goes into far greater detail on how to determine the taxable income of each taxable member of a combined group. The regulation makes clear that the separate identities of the taxable members of the combined group are not disregarded, and as such, each member is responsible for its own portion of the corporate excise based upon taxable income apportioned or allocated to Massachusetts.¹³ The components of income of a taxable member of a unitary combined group include the taxpayer's:

- Share of unitary business income apportionable to Massachusetts;
- Share of distinct business activity outside of the unitary business apportionable to Massachusetts;
- Intrastate income from business activity outside of the unitary business;
- Income or loss allocable to Massachusetts; and
- NOL carryforwards, including permissible shared carryforwards, offset against post-apportioned taxable net income.¹⁴

For members of an affiliated group, the income-based excise of each taxable member is based on its apportioned share of the combined group's affiliated group income prior to post-apportionment adjustments.¹⁵

Further, ***the regulation lists a series of rules required to determine a combined group's taxable income.*** For combined groups that are taxed on their unitary business, income and expenses derived outside the combined group are subtracted and added back, respectively.¹⁶ If the combined group has made an affiliated group election, no

on a three-factor formula, irrespective as to whether the corporation being tested would apply a single sales factor formula or a three-factor formula with a double weighted sales factor. The regulation also states that property, payroll and sales deemed to be within the U.S. includes items in any U.S. jurisdiction.

¹¹ MASS. REGS. CODE tit. 830, § 63.32B.2(5)(b)3. With respect to this provision, the regulation indicates that the Commissioner will take the position that this provision is implicated where a member earns more than 20 percent of its gross income, directly or indirectly, from intangible property or service-related activities, and that the amount of income to be included in the combined group's taxable income shall include said gross income as reduced by the deduction of any expenses that are directly attributable to such income.

¹² Ch. 173 (H.B. 4904), Laws 2008, § 48, inserting MASS. GEN. LAWS ch. 63, § 32B(d)(1).

¹³ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(b)1.

¹⁴ *Id.*

¹⁵ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(b)2.

¹⁶ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(c)1.

modifications are allowed.¹⁷ The total income of the combined group is the separately determined sums of each member of the combined group.¹⁸ Separate taxable income begins with taxable net income as determined under the Massachusetts statute for members incorporated in the United States or included in a consolidated federal return.¹⁹ For members not incorporated in the United States or included in a consolidated federal tax return, such members may either prepare a special profit and loss statement that is translated into United States dollars, or use different procedures to determine taxable net income if approved by the Commissioner.²⁰

Special rules apply for direct and indirect distributive share of partnership income;²¹ dividends between combined group members;²² intercompany income;²³ federally deductible charitable expenses;²⁴ expenses of a member of a unitary group that are attributable to allocable income of another member of the unitary group;²⁵ and conformity to Treas. Reg. Section 1.1502-13.²⁶ The proposed regulation also advises that a member that previously did not have to file in Massachusetts will use its federal basis in its assets as its initial Massachusetts basis, although an election may be made to calculate a Massachusetts basis instead.²⁷

Finally, ***it should be noted that a member of the combined group, whether or not taxable on its income, will be subject to the non-income measure of the excise tax.*** Such non-income measure continues to be computed as it was prior to the law change and may require the computation of a stand-alone apportionment.²⁸

Apportionment Rules and Adjustments

The complexities of the new law are possibly best observed in the law's revision to the apportionment rules. Although the new law generally retains the existing apportionment rules for different types of corporations (*i.e.*, business corporations, manufacturers, financial institutions, mutual fund service corporations, and utilities), the new rules provide for

¹⁷ *Id.* Also see MASS. REGS. CODE tit. 830, § 63.32B.2(10)(a) which requires that all income of group members included in an affiliated group, by way of the election, shall be treated as apportionable, irrespective as to whether such income would be allocable to a particular state in the absence of an election.

¹⁸ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(c)2.

¹⁹ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(c)2.a.

²⁰ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(c)2.b.

²¹ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(c)3.

²² MASS. REGS. CODE tit. 830, § 63.32B.2(6)(c)4.

²³ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(c)5.

²⁴ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(c)6.

²⁵ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(c)7.

²⁶ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(c)9, 10.

²⁷ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(d).

²⁸ MASS. REGS. CODE tit. 830, § 63.32B.2(6)(b)3.

certain adjustments to the apportionment rules in an attempt to achieve a *Finnigan*-style apportionment.²⁹

The proposed regulation adds to the statutory apportionment provisions by addressing adjustments required to be made to the combined group apportionment, including: the flow-through treatment of pass-through entities' apportionment factors;³⁰ the exclusion from apportionment of gross receipts excluded from the federal gross income of a combined group member;³¹ the treatment of intercompany transactions;³² certain inclusions to the denominators of nonfinancial members;³³ the 80 percent reduction of intangible property values of financial institution members (when financial and non-financial entities are subject to combination);³⁴ the impact to mutual fund service corporations; and the potential availability of alternative apportionment.³⁵ Per the proposed regulation, where a combined group cannot apportion because no member is taxable outside Massachusetts, all taxable income is taxable in Massachusetts and each member's share of the group's taxable income is determined by application of a two-factor formula based on each member's total property and payroll, with various adjustments.³⁶

Special Net Operating Loss Rules

As directed by the combined reporting statute, the Commissioner addressed the application of any carryforwards and the sharing of any NOLs attributable to the activities of the combined group's unitary business through extensive guidance.³⁷ The regulation imposes a variety of limitations and the application of special ordering rules. ***For NOLs generated in tax years beginning on or after January 1, 2009, a taxable member of a combined group may carry forward its apportioned share of the group's loss to offset its post-apportioned taxable income derived from the combined group in a future year.***³⁸

Other taxable members of the same combined group are entitled to share the NOL carryforwards incurred in tax years beginning on or after January 1, 2009, but only if such a

²⁹ Ch. 173 (H.B. 4904), Laws 2008, § 48, inserting MASS. GEN. LAWS ch. 63, §32B(d). *Finnigan* is a California State Board of Equalization (SBE) decision, currently followed by several states, that held sales made to a taxing state's customers by a unitary group member that is not subject to tax in the state are includible in the numerator of the group's sales factor in the state, as long as at least one member of the unitary group is subject to tax in the taxing state. *Appeal of Finnigan*, Dkt. No. 88-SBE-022 (Cal. State Bd. of Equal. Aug. 25, 1988). In contrast, many states, including states that have adopted the Uniform Division of Income for Tax Purposes Act follow the *Joyce* rule, another California SBE decision, whereby sales made to the taxing state's customers by a unitary group member that is not subject to tax in the state are not includible in the numerator of the group's sales factor in the state, even though other members of the unitary group are subject to tax in the taxing state. *Appeal of Joyce Inc.*, Dkt. No. 66-SBE-070 (Cal. State Bd. of Equal. Nov. 23, 1966).

³⁰ MASS. REGS. CODE tit. 830, § 63.32B.2(7)(e).

³¹ MASS. REGS. CODE tit. 830, § 63.32B.2(7)(f).

³² MASS. REGS. CODE tit. 830, § 63.32B.2(7)(g).

³³ MASS. REGS. CODE tit. 830, § 63.32B.2(7)(h)2.

³⁴ MASS. REGS. CODE tit. 830, § 63.32B.2(7)(h)1.

³⁵ MASS. REGS. CODE tit. 830, § 63.32B.2(7)(j).

³⁶ MASS. REGS. CODE tit. 830, § 63.32B.2(7)(k).

³⁷ Ch. 173 (H.B. 4904), Laws 2008, § 48; inserting MASS GEN. LAWS. ch. 63 § 32B(f)(iii).

³⁸ MASS. REGS. CODE tit. 830, § 63.32B.2(8)(a).

taxable member was also a member of the same combined group in the year in which the combined group loss was generated.³⁹

Pre-2009 NOL carryforwards can be utilized only by the taxable member who generated the loss on a post-apportionment basis and thus, are not available to be shared with other taxable members of the combined group. Therefore, any NOL carried over from a taxable year beginning prior to January 1, 2009, must be converted to a post-apportionment basis by applying the taxable member's 2008 apportionment percentage (as calculated under prior law) and applying this percentage to the 2008 pre-apportioned NOL. Any remaining (unused) NOL carryforward generated in 2007 and prior tax years, must be similarly converted to a post-apportionment basis using the taxable member's apportionment percentage from the year in which the loss was generated.⁴⁰ As noted above, any pre-enactment NOL carried forward must be applied first to reduce the member's taxable income, before any combined group NOL carryforward is applied.

Generally, where a taxable member that was not previously a member of a combined group enters a pre-existing combined group or becomes part of a new combined group, the member can continue to deduct any NOL carryforward that the member has from prior taxable years against its apportioned share of the combined group taxable income, subject to certain limitations.⁴¹ ***Where a taxable member leaves a group, any NOL carried forward from year to year separately by the individual taxpayer that originally incurred the underlying loss remains a tax attribute of the taxable member.*** Consequently, if a taxable member of a combined group ceases to be a member of the group, any NOL carryforward owned by such taxpayer is no longer available for use by the other taxable members of the combined group with which the taxpayer was previously affiliated. ***If the taxpayer enters a new combined group, the taxpayer may not share the NOL carryforward with the taxable members of its new combined group unless one of the taxable members of the new combined group was also a member of the taxpayer's combined group during the year the loss was incurred.***

Credit Carryforward Rules

The proposed regulation's provisions related to tax credits are similar to those discussed above for NOLs. ***In general, a tax credit generated by a taxpayer belongs to that taxpayer and can be applied against the excise of that taxpayer.***⁴² ***Limited sharing of credits with combined group members is allowed for tax years beginning on or after January 1, 2009 under certain conditions.***⁴³ Pre-2009 credit carryforwards generally may not be shared with other combined group members.⁴⁴ Similar to the NOL provisions, when a member leaves the combined group, the member maintains the tax attribute and the

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ MASS. REGS. CODE tit. 830, § 63.32B.2(8)(f).

⁴² MASS. REGS. CODE tit. 830, § 63.32B.2(9)(a).

⁴³ MASS. REGS. CODE tit. 830, § 63.32B.2(9)(a), (b).

⁴⁴ MASS. REGS. CODE tit. 830, § 63.32B.2(9)(c)(i), (ii).

remaining credit is no longer available for use by the other taxable members of the group.⁴⁵ Credit recaptures generally will be based on the regular statutory provisions, but will be determined based upon the total credit previously taken by the taxpayer and any member of the combined group that shared in the credit.⁴⁶

Principal Reporting Corporation

The regulation introduces the concept of a “principal reporting corporation.” The principal reporting corporation is required to report the income of the combined group, and acts on behalf of the combined group on all tax matters.⁴⁷ Generally, the principal reporting corporation is the taxable member that is the combined group’s common parent corporation, or where no common parent exists (or is not taxable), the taxable member that the group reasonably expects will have the largest amount of Massachusetts taxable net income on a recurring basis.⁴⁸

Application of Related-Party Expense Addback Rules

The regulation states that the related-party expense addback rules put into effect during the Massachusetts separate reporting regime are not applicable to members in the same combined group as long as transactions between the related members are deferred or eliminated under combined reporting.⁴⁹ ***Where the taxpayer does not make an affiliated group election, the addback rules apply to transactions between commonly owned corporations that are members of separate combined groups, or corporations filing a combined return but the transaction does not relate to the unitary business.***⁵⁰

Commentary

The adoption of mandatory combined reporting represents a dramatic change to the Massachusetts corporate taxation scheme. Upon enactment, it was anticipated that the new combined reporting law would likely produce complexities and ambiguities not previously seen in the Massachusetts tax law. For some in the Massachusetts business community, there were serious concerns that the statute would allow the Department excessive discretion in administering the statute. Although the proposed regulation is comprehensive, and contains explicit examples, especially in the areas of apportionment, NOLs and credits, it undoubtedly supports the Department’s position in certain key areas. Perhaps this is why the Department, in its history of publishing regulations, has never seen a regulation solicit such a voluminous response and why a technical corrections bill has already been submitted for consideration. Special attention should be paid to the: calculation of group income; utilization of corporate tax attributes within the combined reporting group; and apportionment rules applicable to combined reporting groups.

⁴⁵ MASS. REGS. CODE tit. 830, § 63.32B.2(9)(d).

⁴⁶ MASS. REGS. CODE tit. 830, § 63.32B.2(9)(e).

⁴⁷ MASS. REGS. CODE tit. 830, § 63.32B.2(11)(a).

⁴⁸ *Id.*

⁴⁹ MASS. REGS. CODE tit. 830, § 63.32B.2(13).

⁵⁰ *Id.*

Whether the Department will consider the comments received in response to the proposed regulation, and incorporate further modifications into the final regulation, remains to be seen. What can be anticipated, however, is that the adoption of combined reporting in a state that has largely adhered to separate reporting will undoubtedly require a significant educational effort to be undertaken by the Department in order to properly apply the new statute, and administer combined reporting at the audit level.

The information contained herein is general in nature and based on authorities that are subject to change. It is not intended and should not be construed as legal, accounting or tax advice or opinion provided by Grant Thornton LLP to the reader. This material may not be applicable to or suitable for specific circumstances or needs and may require consideration of nontax and other tax factors. Contact Grant Thornton LLP or other tax professionals prior to taking any action based upon this information. Grant Thornton LLP assumes no obligation to inform the reader of any changes in tax laws or other factors that could affect information contained herein. No part of this document may be reproduced, retransmitted or otherwise redistributed in any form or by any means, electronic or mechanical, including by photocopying, facsimile transmission, recording, re-keying or using any information storage and retrieval system without written permission from Grant Thornton LLP.

Tax professional standards statement

This document supports the marketing of professional services by Grant Thornton LLP. It is not written tax advice directed at the particular facts and circumstances of any person. Persons interested in the subject of this document should contact Grant Thornton or their tax advisor to discuss the potential application of this subject matter to their particular facts and circumstances. Nothing herein shall be construed as imposing a limitation on any person from disclosing the tax treatment or tax structure of any matter addressed. To the extent this document may be considered written tax advice, in accordance with applicable professional regulations, unless expressly stated otherwise, any written advice contained in, forwarded with, or attached to this document is not intended or written by Grant Thornton LLP to be used, and cannot be used, by any person for the purpose of avoiding any penalties that may be imposed under the Internal Revenue Code.