



Massachusetts, unlike many other states, has a non-income measure of the corporate excise tax, often referred to as the net worth tax. The net worth tax is a separate component of the corporate excise tax, with its own set of rules. Businesses in Massachusetts have raised two separate but related concerns with the state's administration of this tax. The following sections detail these two issues:

- the first outlines the Department of Revenue's (DOR) inconsistent approach in determining what constitutes debt or equity when computing the net worth tax (Section 1 in this memo); and
- the second explains DOR's aggressive pursuit of foreign (non-U.S.) companies in collecting the net worth tax (Section 2 in this memo).

Already among a dwindling group of states with a so-called balance sheet tax, in both cases DOR's approach casts Massachusetts as an even more extreme outlier. A legislative proposal (Section 3 in this memo) is attached that would address these concerns.

Section 1: Determining Debt/Equity for the Net Worth Tax

Over the last several months, Massachusetts businesses have raised serious concerns about DOR's practices in administering the state's net worth tax, specifically as it relates to adjustments that are being made to taxpayer balance sheets to inflate a taxpayer's net worth and corresponding tax.

It is extremely important to AIM and MTF, and the scores of companies we represent, for Governor Baker to rectify this issue as soon as possible by including clarifying language—in an outside section of the fiscal 2016 budget—that reinforces the Legislature's original intent when it enacted the net worth tax. Swift action on this issue will avoid further negative effects on the state's current and prospective employers while making it clear that DOR has overstepped its authority in the administration of this tax.

A very common issue for taxpayers in the net worth tax regime is tied to centralized cash management; this is a common practice for complex businesses. Such arrangements can create intercompany debt, as recorded and reported in separate company financial statements. However, DOR asserts that such debt is instead equity. Once "reclassified" by DOR, a taxpayer's net worth tax base can be substantially inflated, subjecting the entity to a higher net worth tax. This approach ignores state law that requires using a taxpayer's books and records (i.e. financial statements) to determine the net worth tax liability and instead applies DOR-developed rules. By disregarding the books and records, DOR overturns 50 years of established practice and procedural application of the net worth tax.

Massachusetts repeatedly ranks among the worst states nationally for tax predictability, and DOR's administration of the net worth tax creates yet one more area of uncertainty. This practice will create unexpected, large tax liabilities for major employers within the state and make it more attractive for businesses to move out of state.

Sections one and two of the attached proposed legislation clarify that, for purposes of the net worth tax, DOR should treat debt and equity as they are accounted for in financial statements. The proposed

language affirms statutory authority and judicial precedent by stating that the standard accounting methods used in financial statements will also be the method by which DOR must determine the net worth tax liability.

Net Worth Tax Technical Background and DOR Approach

- The Massachusetts corporate excise tax is comprised of two separate taxes: (1) a net income tax; and (2) a property-based tax. At issue here is the tax based on property, as measured by a company's net worth.
- State statute requires net worth to be computed using book value, on a separate company (not combined or affiliated-group) basis. Our courts have construed the net worth tax statute as requiring the use of generally accepted accounting principles (GAAP) in computing net worth. Accordingly, intercompany obligations that are treated as debt under GAAP are to be treated as debt for net worth tax purposes. As the Supreme Judicial Court opined, this approach aims to "simplify" the tax and attract new industry "create(ing) a more favorable tax climate in Massachusetts."
- DOR is seeking to overturn longstanding rules through the audit and appeals process. It is now creating its own computation for computing the net worth tax and abandoning the use of book value. In so doing, DOR is departing from legislative intent, judicial precedent articulated by the Supreme Judicial Court, and 50 years of consistent practice and procedure.
- DOR is disregarding these valid, normal business transactions and creating its own accounting method and, by extension, a second set of financial statements for Massachusetts tax purposes only.

Implications of DOR's policy

- DOR's stance means that all companies, both Massachusetts-based and out-of-state, that have a significant physical presence in Massachusetts could be substantially harmed.
- The DOR position represents bad policy because the companies that provide thousands of jobs in Massachusetts could be severely punished.
- If this interpretation is applied broadly—and GAAP is no longer the controlling method for determining the net worth tax base—it would require businesses to re-create financial statements to suit DOR's specific demands. This is a tremendous undertaking and would add a substantial administrative burden on businesses.

Section 2: Net Worth Tax on Foreign Companies

The second issue of concern with the state's administration of the net worth tax relates to foreign (non-U.S.) corporations that have U.S. affiliates doing business in Massachusetts.

Under federal law and international treaties, states cannot require a foreign corporation to pay corporate income taxes if that business is not subject to U.S. income taxation. However, DOR has asserted that

foreign entities that receive royalties from affiliates doing business in Massachusetts have nexus in the state, and therefore must file the separate corporate non-income (i.e. net worth) tax.

While this application may be technically within the bounds of state law, it is undoubtedly an aggressive one. Massachusetts is in the minority as a state that still imposes a balance sheet tax on corporations, but extending its reach to foreign entities that do not do business in the U.S. under federal law certainly makes it an outlier. This undercuts the water's edge concept, which is a key aspect of Massachusetts combined reporting.

Section three of the attached proposed legislation would limit the state's ability to collect the net worth tax from foreign entities by modifying the sales factor calculation in the apportionment formula so that a foreign entity that is not subject to federal or state income taxes would likewise not be subject to the net worth tax as that entity would have a Massachusetts apportionment of zero for determining its net worth liability.

Section 3: Legislative Proposal

SECTION 1. Paragraph 8 of Section 30 of chapter 63, as amended by section 105 of chapter 165 of the acts of 2014, is hereby amended by striking out the last sentence and inserting in place thereof the following sentence:-

In determining whether an item shown on the books of a corporation is to be treated as reflecting debt or equity, the taxpayer's treatment of the item for accounting purposes shall be considered to be controlling, unless the commissioner establishes that such treatment is not in accordance with the accounting standards used by that taxpayer for making financial reports to shareholders, such as, without limitation, Generally Accepted Accounting Principles or International Financial Reporting Standards; and in determining the book value of any asset, the commissioner may disallow any reserve, in whole or in part, established with respect thereto which, in his judgment, is not reasonable and proper.

SECTION 2. By this act the general court clarifies its original intention that the treatment of an item on the books of a corporation shall be controlling in determining its net worth. This act shall be effective upon its passage, and shall be applicable to all open tax years.

SECTION 3. Section 38(f) of chapter 63 is hereby amended by inserting after the phrase "'sales' shall not include" by adding the following phrase:-

"an item of income of a corporation that is organized outside of the United States to the extent that such item is exempt from United States federal income tax either by virtue of a federal income tax treaty or otherwise, or"

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