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FACTS AT A GLANCE July 6, 2010

New Corporate Tax Breaks Proposed in Economic Development Legislation

(Updated July 13, 2010)

In economic development legislation under consideration in the House, there are proposals for new corporate tax breaks. This *Facts At a Glance* provides information about the provisions.

WHAT ARE THE NEW CORPORATE TAX BREAKS?

ALLOWING 20-YEAR CARRY-FORWARD OF NET OPERATING LOSSES

Under current law, a company that has net operating losses in one year can carry-forward those losses and count them against profits during the next five years. This allows the company to pay less in taxes in subsequent years when it is profitable. This option is currently not available to financial institutions and public utilities. The proposed legislation would extend this opportunity to these types of companies (beginning in 2012) and extend the time period over which companies could carry-forward net operating losses to 20 years.

REDUCED CAPITAL GAINS TAX RATE FOR LONGER-TERM INVESTMENTS IN NEW MASSACHUSETTS COMPANIES

This proposal would reduce the tax rate to 3 percent (from 5.3 percent) on investments, held at least three years, in Massachusetts companies that are less than five years old and have less than $50 million in assets at the time of the investment. There are significant questions about whether such differential tax rates meet state and federal constitutional requirements.[1] If such differential capital gains tax rates are permissible, they could be implemented in a revenue-neutral way. To seek to encourage long-term investments in new Massachusetts companies, the state could modestly increase the capital gains tax rate on investments in other companies and use the revenue generated by such increases to pay for tax cuts for investments in Massachusetts companies.

ALLOWING MULTI-NATIONAL COMPANIES TO EXCLUDE FROM THEIR TAXABLE INCOME CERTAIN INCOME TRANSFERRED TO OVERSEAS AFFILIATES

An amendment added to the economic development legislation during floor debate allows multi-national companies to exclude from their Massachusetts taxable income certain income transferred to overseas affiliates. Specifically, it would exclude such income when tax treaties exclude federal taxation of such income. Those treaties, however, do not apply to state taxes. While there is some ambiguity in state law, the state does not interpret current law as allowing companies to exclude this income from their state taxable income. The

[1] See *"Economic Stimulus: What Can National and State Governments Do To Save and Create Jobs Quickly?,"* Massachusetts Budget and Policy Center, June 9, 2010, available at http://massbudget.org/doc/729/1233

provisions in this bill would exempt this income from state taxation. To the extent that there is ambiguity in the current law, the revenue could be protected by clarifying that this income should be included in the returns companies file in Massachusetts.

WHAT DO THESE NEW TAX BREAKS COST?

The net-operating-losses carry-forward changes would not have a cost in the first few years, but when the full costs hit the state in 20 years, the annual revenue loss is projected to exceed $100 million a year.[2]

The capital gains proposal also would not have an immediate cost, but would cost an estimated $14.5 million annually by tax year 2022.[3]

The amendment that allows multi-national companies to exclude certain income from their Massachusetts taxable income would cost the state an estimated $26 million to $28 million a year.

ARE THESE NEW TAX BREAKS WORTH THE COST?

There does not appear to be any clear evidence on whether these tax breaks are cost-effective. As has been the common practice, the Legislature and Governor[4] have produced no formal analysis about whether these new tax breaks are a more effective way to use resources -- ultimately over $100 million a year -- than other investments that could improve the productivity of the state economy. If the goal of these proposals is to strengthen the state economy, then it would be appropriate to seek to compare them to investments of a similar magnitude that could be made in the productivity of our people (such as workforce training, higher education and Pre-K-to-12 education) or in infrastructure that improves the productivity of our economy. Studies that seek to make these comparisons often find that specific corporate tax breaks are a less effective use of economic development resources than investments that improve the long-term productivity of the workforce.[5]

There is also no available state evaluation of whether these new tax breaks are more effective than already existing tax breaks. If there is evidence that these tax breaks may be more effective than previously enacted breaks, the state could reform the tax code in ways that would be revenue neutral by repealing less effective tax breaks as new ones are adopted. The proposals to adopt these provisions include no such effort to prioritize.

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[2] See Massachusetts Department of Revenue – Revenue Impact Analysis, available at http://massbudget.org/doc/735

[3] See DOR Revenue Estimate – Senate 2380, available at http://massbudget.org/doc/737

[4] As the Governor has not indicated whether he supports these proposals, the lack of formal analysis of the cost-effectiveness by his administration is significantly less of an issue than is the lack of such an analysis by the Legislature which is considering the proposals.

[5] Two reports that discuss studies which compare the effectiveness of tax breaks to other forms of economic investments are: *"Generating Jobs through State Employer Tax Credits: Is there a Better Way?,"* Jeff Thompson & Heidi Garrett-Peltier, Political Economy Research Institute, March 2010, available at http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_201-250/WP219.pdf, and *"Building a Strong Economy: The evidence on combined reporting, public investments, and economic growth,"* Economic Policy Institute and Massachusetts Budget and Policy Center, June 8, 2007, available at http://massbudget.org/doc/564