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## **FISCAL YEAR 2009 TAX REFORM PROPOSALS**

Recently, both the Governor and the Speaker of the House have announced their support for tax policy reforms aimed at reducing corporate tax avoidance. Both have also proposed using revenue raised by reducing tax avoidance to pay for a corporate tax rate cut. The rate cut proposed by the Speaker would be significantly larger and would begin sooner than that proposed by the Governor. This *MassBudget Brief* describes these two proposals and some alternatives.

### **Tax Reforms in Both Proposals**

- ***Combined Reporting.*** Combined reporting would change the way Massachusetts taxes multi-state companies. Currently, if a company operates as a large number of separate subsidiaries, Massachusetts taxes each subsidiary separately. This allows companies to shift income among subsidiaries so that it appears that the Massachusetts subsidiaries have little or no profit (and thus little or no tax due) and that profits are earned in subsidiaries that are in states that don't have corporate income taxes. With combined reporting, Massachusetts would treat a company with many subsidiaries as one single company, making tax avoidance much harder. Twenty-one other states have combined reporting or have passed laws to start combined reporting. The Department of Revenue estimates that combined reporting would ultimately save the state about \$313 million per year. Because current proposals would implement this reform on January 1, 2009, not all of the revenue would be available in the coming fiscal year (the budget now being developed is for Fiscal Year 2009, which runs from July 1, 2008 to June 30, 2009). Because approximately 60 percent of corporate taxes each year are paid in the first six months of the year, \$188 million of the revenue would likely be available for the FY 2009 budget.
- ***Check-the-Box Conformity.*** Under existing federal laws, some companies can choose what type of entity they will be considered for tax purposes (as a corporation or a partnership, for example). In states with check-the-box conformity, once a company makes a choice for federal purposes, they are treated the same way for state purposes. Unlike other states, Massachusetts does not require this conformity. As a result, companies can be treated as one type of entity in Massachusetts and as another in other states and federally. This creates openings for tax reduction strategies. By joining other states with check-the-box conformity, Massachusetts could save \$169 million per year (and \$101 million in FY 2009).

### **Differences Between the Governor's and Speaker's Proposals**

The two proposals differ in the size and timing of the corporate rate cut.

- The Governor proposes cutting the corporate tax rate by 12.6 percent (from 9.5 percent to 8.3 percent) over three years, from 2010 to 2012. This rate cut would cost the state approximately \$210 million when fully implemented.

- The Speaker proposes cutting the corporate tax rate by 26.3 percent (from 9.5 percent to 7 percent) over three years, from 2009 to 2011. This rate cut would cost the state approximately \$438 million when fully implemented.

Both of these cost estimates assume current economic conditions. Actual revenue will be affected by changes in the economy and inflation over the next four years. These estimates also assume the enactment of the other proposals included in both plans. As those other proposals increase the tax base, changes in the corporate tax rate will have a larger revenue effect after those reforms are implemented than they would otherwise.

The Governor proposes two additional tax reforms that are not in the Speaker's plan:

- Requiring companies that resell hotel rooms over the Internet to charge the room occupancy tax on the full retail price of the room (rather than the lower price that the reseller may have paid). This is estimated to save the Commonwealth \$5.6 million in the first year and \$9.6 million a year after that.
- Reforming the earned income tax credit so that it is not paid on certain income not earned in the state. This is expected to save the state \$2 million a year.

	<b>Governor's Proposal</b>	<b>Speaker's Proposal</b>
<b>FY 2009</b>		
Reducing Tax Avoidance	\$296.6 million	\$289.2 million
Rate Cut	n/a	(\$105.2 million)
<b>Net Effect</b>	<b>\$296.6 million</b>	<b>\$184.0 million</b>
<b>FY 2010</b>		
Reducing Tax Avoidance	\$493.6 million	\$482.0 million
Rate Cut	(\$42.1 million)	(\$280.6 million)
<b>Net Effect</b>	<b>\$451.5 million</b>	<b>\$201.4 million</b>
<b>FY 2011</b>		
Reducing Tax Avoidance	\$493.6 million	\$482.0 million
Rate Cut	(\$140.2 million)	(\$403.0 million)
<b>Net Effect</b>	<b>\$381.3 million</b>	<b>\$44.0 million</b>
<b>FY 2012</b>		
Reducing Tax Avoidance	\$493.6 million	\$482.0 million
Rate Cut	(\$210.5 million)	(\$438.0 million)
<b>Net Effect</b>	<b>\$283.1 million</b>	<b>\$44.0 million</b>

### **Corporate Tax Cuts and Other State Priorities**

Proposals to spend some or most of the revenue generated by closing corporate tax loopholes on a rate cut should be examined in the context of the overall long and short term fiscal and economic challenges facing Massachusetts. A recent study by the Congressional Budget Office found that cutting corporate tax rates is not a cost-effective strategy for providing immediate economic stimulus at the national level.<sup>1</sup> Furthermore, extensive economic evidence suggests that corporate tax rate

<sup>1</sup> Congressional Budget Office, "Options for Responding to Short-Term Economic Weakness," January 2008, pp. 20-21, available at <http://www.cbo.gov/ftpdocs/8916/type=1>. In addition, economic stimulus is generally more efficiently achieved at the national level.

cuts do less in the long term to strengthen an economy than can be achieved by effective investments in worker training, education, and public infrastructure.<sup>2</sup>

There are other strategies that might be more efficient and effective in benefiting the people of the Commonwealth and the state economy than a corporate tax rate cut, including the following:

- ***Assisting low and middle income taxpayers who are paying a disproportionately large share of their incomes in property taxes.*** The lost revenue due to corporate tax avoidance is one of several reasons why the state has not been able to provide larger amounts of local aid. As a result, communities have had to raise revenue by relying more on the local property tax. Using money raised by reducing corporate tax avoidance, the state could provide tax credits to people with disproportionately high property taxes by expanding our property tax circuit breaker law. The property tax circuit breaker, which currently provides a tax credit to any senior citizen who pays more than ten percent of his or her income in property taxes, could be expanded to younger taxpayers (as the Governor proposed last year), or it could be reformed in other ways to help others whose property taxes are a large share of their income.
- ***Investing in the maintenance of the state's infrastructure.*** The state Transportation Finance Committee concluded that Massachusetts faces a transportation funding gap of \$15 to \$19 billion over the next twenty years (or between \$765.7 and \$978.9 million per year). Safe and efficient roads, bridges and mass transit are among the underpinnings of a productive state economy, and the money saved by reducing corporate tax avoidance could cover a substantial share of the funding gap.
- ***Investing in education.*** The Legislature is three years into a five year plan to reform and increase funding for local schools. In addition, the Governor's "Readiness Project" is examining several ambitious proposals to improve public education, including dramatically expanding access to early education and care, funding a longer school day in more districts, and making sure that everyone can afford to attend community college. Money raised from reducing corporate tax avoidance could be used to improve public education.
- ***Improving the structural balance of the state budget.*** The state continues to rely on money from its Stabilization Fund (the "Rainy Day" fund) because ongoing revenues are less than the cost of current services. That is a fiscally dangerous strategy in the long term. Restoring structural balance to the state budget could help to provide the fiscal stability the state needs to meet its commitments to expanding access to health care, protecting the environment, providing local aid, and meeting the other essential obligations of our government.

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<sup>2</sup> Massachusetts Budget and Policy Center and Economic Policy Institute, "Building a Strong Economy: The evidence on combined reporting, public investments, and economic growth," available at <http://www.massbudget.org/BuildingStrongEconomyJune07.pdf>.