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A Washington National Tax Services (WNTS)
Publication

January 27, 2012

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Massachusetts proposed budget provides for market sourcing, addresses certain non-insurance income, delays FAS 109 fix, makes other changes

Authored by: Adam Weinreb

On January 25, 2012, Governor Patrick submitted his budget recommendations for Fiscal Year 2013 to the Massachusetts Legislature. [Outside Section 9](#) of the bill contains a number of provisions intended to:

- Adopt a "market-based" approach for sourcing service receipts (and certain intangible receipts) when determining the Massachusetts sales factor (along with a "throw-out" rule);
- Impose the corporate excise on the non-insurance income of a partnership or disregarded entity where an insurance company owns at least 50% of the partnership or disregarded entity;
- Delay the implementation of the FAS 109 deduction for corporations from the 2013 tax year to the 2014 tax year; and
- "Clarify" that the current room occupancy excise applies to Internet room resellers.



These proposed changes (as well as certain other miscellaneous provisions) are outlined in more detail below.

A. Market-Based Sourcing for Sales other than Sales of Tangible Personal Property

Under current law, Massachusetts sources sales, other than sales of tangible personal property, to Massachusetts for sales factor purposes if: (i) the income-producing activity that gave rise to the sales was performed wholly in Massachusetts; or (ii) the income-producing activity is performed both in and outside Massachusetts and a greater proportion of the costs of the income-producing activity is performed in Massachusetts than in any other state.

- **Market Based Approach** - Under the Governor's tax proposal, Massachusetts would source sales, other than sales of tangible personal property, to Massachusetts for sales factor purposes if a corporation's "market" for the sale is in Massachusetts. The Governor proposed a nearly identical amendment in his FY'12 Budget.
- **Definition of "Market"** - The proposed amendment provides the following guidance on when a corporation's market is considered to be in Massachusetts:
 - In the case of a sale, rental, lease or license of real property, a corporation's market is in Massachusetts if and to the extent the property is located in the state.
 - In the case of a rental, lease or license of tangible personal property, a corporation's market is in Massachusetts if and to the extent the property is located in the state.
 - In the case of a sale of a service, a corporation's market is in Massachusetts if and to the extent the service is "delivered" to a location in the state.
 - In the case of a lease or license of intangible property, including a sale or exchange of such property where the receipts from the sale or exchange derive from payments that are contingent on the productivity, use, or disposition of the property, a corporation's market is in Massachusetts if and to the extent the intangible property is used in the state.
 - In the case of the sale of intangible property (other than as referenced above), where the property sold is a contract right, government license or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area, the market is in Massachusetts if and to the extent that the intangible property is used in or otherwise associated with the state.
 - If a sale of intangible personal property is not described in the rules discussed above regarding when a corporation's market is considered to be in Massachusetts, then such sale is excluded from the numerator and the denominator of the sales factor.

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- **The "Throw-Out" Rule** - With respect to determining delivery location for services, the proposed legislation provides for a throw-out rule to the extent that a service provider is not taxable in the state to which the receipts are ultimately sourced. The proposed amendment specifically reads:
 - If the state of assignment cannot be determined, it shall be reasonably approximated, and;
 - If a corporation is not taxable in the state to which a sale is assigned, or if the state or states of assignment cannot be determined or reasonably approximated, such sale shall be excluded from the numerator and denominator of the sales factor (i.e., thrown-out).
 - **Broad Application of Market Based Sourcing Rules** - Based on the language of the proposed legislation in the framework of the current Massachusetts apportionment regime, the market-based sourcing rules should apply to all service providers, including those organized as corporations, S corporations, and partnerships. It does not appear, however, that the proposed amendment would apply to financial institutions.
 - **Commissioner's Authority** - The proposed amendment does not affect regulations previously adopted addressing the sales factor, nor does it restrict the commissioner's authority to adopt alternative apportionment methods for industries whose income is not otherwise reasonably apportioned under the proposed market-based sourcing.
 - **Effective Date** - The proposed amendment would be effective for tax years beginning on or after January 1, 2013.

B. Changes to Apportionment Rules Related to Mutual Fund Sales

Under current law, Massachusetts requires corporations deriving more than 50% of their gross receipts from mutual fund sales (i.e., "mutual fund service corporations" or "MFSCs") to source such sales based on the location of the shareholders in the mutual funds to which they provide services (i.e., "shareholder sourcing").

- **In General** - Under the Governor's tax proposal, it appears that all taxpayers with any level of mutual fund sales would source such sales using shareholder sourcing.
- **Application of Single Factor Test** - The proposed amendment appears to make the 50% test outlined above irrelevant as an eligibility requirement for using shareholder sourcing to source receipts from mutual fund sales as all taxpayers, irrespective of their level of mutual fund receipts, would use shareholder sourcing to source such receipts. However, under current law, only qualifying MFSCs (i.e., those meeting the 50% test) are eligible to use specialized single sales factor apportionment to apportion their mutual fund sales. The proposed legislation does not appear to change this rule. Therefore, we believe corporations with mutual fund sales that do not qualify as MFSCs would use the general three-factor apportionment formula, with a double weighted sales factor, to apportion such receipts.

- **Treatment of MFSC's Non-Mutual Fund Sales** - With respect to receipts from non-mutual fund sales (e.g., brokerage sales and sales to retirement accounts), such receipts should be sourced using a market-based approach. As noted above, under the proposal, the market for such sales should be in Massachusetts if the sales are delivered to a location in the state. In the context of these sales, it is not clear whether Massachusetts would interpret the "delivered" to location to be the ultimate customer or beneficiary location or something else.
- **Application of Throw-Out Rule** - In the context of both shareholder sourcing and market-based sourcing, the proposed throw-out rule has the effect of diluting both the numerator and denominator of a MFSC's sales factor. The extent of dilution and overall effect on a MFSC's Massachusetts tax liability will depend on the interpretation of delivery location and on whether a MFSC is located in-state or out-of-state.

C. Taxing the Non-Insurance Business of Insurance Companies

Under current law, the income that an insurance company receives from the non-insurance business of a partnership or disregarded entity in which it is a partner or member is not subject to tax under either the corporate excise (because insurance companies are not subject to the corporate excise) or one of the insurance excises (because this type of income is not included in the tax base).

- **Corporate Taxation of Non-Insurance Businesses** - The proposed amendment would treat certain partnerships and disregarded entities as if they were corporations, subjecting the income of such entities to the corporate excise. Specifically, if an insurance company owns 50% or more of the capital or profits interest in a partnership or disregarded entity that is engaged in a non-insurance trade or business, then the income from such non-insurance trade or business would be taxed to the partnership or disregarded entity as if it were a corporation.
 - Partnerships and disregarded entities so treated as corporations will file returns as if they were business corporations and, if applicable, would be included in a Massachusetts combined report.
 - For purposes of this proposed amendment, the term "partnership or disregarded entity" includes real estate investment trusts ("REIT"). To the extent that a REIT's income is subject to tax under the proposal, Massachusetts would not recognize a dividends paid deduction on the distribution of such income.
- **Effective Date** - The proposed amendment would be effective for tax years beginning on or after January 1, 2013.

D. Delay in the Implementation of the FAS 109 Deduction

Under current law, if the enactment of combined reporting rules for a unitary combined group would result in an increase to the combined group's "net deferred

tax liability,” then the combined group would be entitled to claim a FAS 109 pro-rated deduction over a 7-year period beginning with its 2013 tax year, provided that it had filed its FAS 109 deduction application on or before July 1, 2009.

- **Proposed Change** - The proposed amendment would postpone the tax year in which the deduction could first be claimed to the 2014 tax year. The FAS 109 deduction has already been delayed a year since the original legislation allowed eligible corporations to begin claiming their pro-rated share of the deduction in 2012.

E. Amendments to Room Occupancy Excise

- **Proposed Change** - Under the Governor's proposal, the Room Occupancy Tax would be expanded to require registered "room resellers" (e.g., retail agents reselling hotel/motel rooms to consumers on-line) to collect and remit tax upon the difference between the amount paid by the consumer to the reseller and the amount paid by the reseller to the operator. It is our understanding that the Department of Revenue was only receiving the tax based on the wholesale price of the room (and not that price ultimately charged by the agent to the consumer). However, the Department of Revenue views this proposed statutory amendment as a clarification to existing law.
- **Effective Date** - These provisions would be effective for transfers of occupancy taking place on or after August 1, 2012. The Governor proposed a nearly identical amendment in his FY'12 Budget.

F. Miscellaneous Provisions

- **Taxation of Candy and Soft Drinks** - Under current law, candy and soft drinks are exempt from the sales and use tax as food products for human consumption. The Governor's proposal would repeal the sales and use tax exemption for the sale of candy and soft drinks. The proposed changes would be effective August 1, 2012.
- **Cigarette Tax Increase** - The Governor's proposal would increase the excise imposed on a package of cigarettes by 50 cents. If enacted, the Massachusetts excise on a package of cigarettes will be \$3.01 per pack. In addition, the Governor's proposal increases taxes on other tobacco products, e.g., cigars, smokeless, roll-your-own, etc. and contains provisions that affect the administration of the cigarette excise. The proposed changes would be effective as of August 1, 2012.
- **Taxation of Lottery Winnings** - The Department of Revenue's current position is that individuals cannot apply their wagering losses or gambling related trade and businesses expenses as offsetting amounts that reduce the amount of any lottery winnings subject to Massachusetts tax. The Governor's proposal codifies this position. The proposed amendment would be effective for tax years beginning on or after January 1, 2012.
- **Proposed Appropriations** - The Governor's Budget generally proposes a 3.3% increase in spending for FY'13 over the projected spending for FY'12 for Department of Revenue operations.

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For more information, please do not hesitate to contact:

<i>Jon Muroff</i>	<i>(617) 530-4573</i>	<i>jon.muroff@us.pwc.com</i>
<i>David Sheehan</i>	<i>(617) 530-4872</i>	<i>david.sheehan@us.pwc.com</i>
<i>Adam Weinreb</i>	<i>(646) 471-4409</i>	<i>adam.weinreb@us.pwc.com</i>

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