

Massachusetts budget proposes significant law changes

January 25, 2013

In brief

On January 23, 2013, Massachusetts Governor Patrick submitted his budget recommendations for Fiscal Year 2014 to the Massachusetts Legislature. The bill contains tax proposals that include: adopting a market based approach for services and other receipts, along with a 'throw-out' rule; taxing security corporations and utility corporations like other business corporations; repealing the FAS 109 deduction for eligible corporations; increasing the personal income tax rate to 6.25%; lowering the sales and use tax rate to 4.5%; and extending the sales and use tax to computer and data processing services and custom software. [[House 1 - FY2014 Budget Recommendation, Outside Section 7](#), Deval L. Patrick (1/23/13), Outside Section 7]

In detail

The tax proposals in Governor Patrick's budget recommendation, contained in '[Outside Section 7](#)' of the budget, are summarized below.

Corporate excise tax proposals

Market-based sourcing for services

Under current law, Massachusetts sources sales of services to Massachusetts for sales factor purposes if: (i) the income-producing activity that gave rise to the sales is 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.

Effective for tax years beginning on or after January 1, 2014, under the governor's tax proposal, Massachusetts would source sales of services to Massachusetts for sales factor purposes if a corporation's market for the sale is in Massachusetts. With respect to determining a corporation's market, the proposed amendment provides that a corporation's market is considered to be in Massachusetts if and to the extent the services are "delivered" to a location in the state.

Specific sourcing rules

The following rules apply to the sales listed below:

- 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 Massachusetts.
- 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 Massachusetts.
- 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 Massachusetts.

- In the case of the sale of intangible property (other than 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.

Throw-out for sales other than sales of tangible personal property

The proposed legislation provides for a *throw-out rule* for sales other than sales of tangible personal property. The rule states that a sale should be excluded from the numerator and denominator of the sales factor if a corporation "is not taxable in a state to which a sale is assigned, or if the state or states to which such sales should be assigned cannot be determined or reasonably approximated."

Repeal of security corporation classification

Under current law, a 'security corporation' is a corporation that is engaged exclusively in buying, selling, dealing in, or holding securities on its own behalf and not as a broker, and has been so classified by the Massachusetts Department of Revenue. Security corporations are subject to a preferential tax rate on their *gross income* and are not subject to the non-income measure of the corporate excise. Specifically, a security corporation owned by business corporation is subject to a tax rate of 1.32% on its gross income

and a security corporation owned by a financial institution is subject to a tax rate of 0.33% on its gross income.

Effective for tax years beginning on or after January 1, 2014, under the proposed law, security corporation classification would be repealed and such corporations would be taxed as business corporations (where their net income would be taxed at 8% and the non-income measure of the corporate excise would also be imposed). In addition, security corporations would be potentially includible in a Massachusetts combined report (currently, security corporations are statutorily excluded from the Massachusetts combined group and required to file separate corporate excise returns).

Repeal of utility corporation classification

Utility corporations include those companies that are regulated by Massachusetts or other state law, such as those operating electric, gas, water, telephone and other similar businesses. Under current law, entities classified as 'utility corporations' are subject to a preferential 6.5% tax rate on their net income and are not subject to the non-income measure of the corporate excise.

Effective for tax years beginning on or after January 1, 2014, under the proposed law, utility corporation classification would be repealed and such corporations would be taxed as business corporations. While this would subject them to a higher rate of income tax (8%) and to the non-income measure, their new designation as business corporations presumably would make them eligible to carry forward net operating losses and be permitted to claim a less restrictive dividends received deduction.

Repeal 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 is entitled to claim a FAS 109 deduction over a 7-year period beginning with its 2014 tax year, provided that it had filed its FAS 109 deduction application on or before July 1, 2009. As originally enacted in 2008, the FAS 109 deduction was intended to come into effect in 2012, but its implementation was delayed twice by the Legislature ([click here](#) for our summary of the FAS 109 deduction).

The proposed amendment would repeal the FAS 109 deduction.

Sales and use tax proposals

Rate reduced from 6.25% to 4.5%

Under current law, Massachusetts imposes a 6.25% tax upon sales at retail of tangible personal property and telecommunications services. Similarly, Massachusetts imposes a 6.25% tax rate upon the storage, use or other consumption of tangible personal property or telecommunications services acquired within or without Massachusetts for storage, use or consumption within Massachusetts

Under the governor's tax proposal, the sales and use tax rate would be reduced from 6.25% to 4.5% effective January 1, 2014.

Taxation of computer and data processing services

Under current law, the only services subject to the sales and use tax are the provision of telecommunications services.

Effective January 1, 2014, under the proposed amendment, the provision

of computer and data processing services would become subject to the sales and use tax. Massachusetts would define 'computer and data processing services' as services that include but are not limited to programming, code writing, modification or testing of existing programs, feasibility studies and design and installation of computer systems that integrate computer hardware, software, and communication technologies. Other proposed changes relating to computer and data processing services include:

- For purposes of imposing the sales and use tax, it would be immaterial whether the computer and data processing services are rendered in connection with: (1) the development, creation or production of standardized or custom software; (2) provision of access to software; or (3) the storage of data on the seller's or a third party's server including disaster recovery services.
- In the case of bundled charges, where the value of computer and data processing services is the predominant portion of the bundle, the entire charge for the services would be subject to the sales and use tax. Under this circumstance, tax would be imposed on the bundled charge regardless of whether any report that is furnished or made available is unique to a particular customer.
- Computer and data processing services would include provision of data or access to data that are sold together with a computer or data processing service, unless the purchase of the data or access to data is optional to the customer and the cost to the customer of the data or access to data is stated

separately from any charge for computer or data processing service on the invoice provided to the customer at the time of purchase.

- Computer and data processing services would not include the provision of (1) downloaded books, music, videos or ringtones; or (2) computer facilities management services.

Taxation of custom software

Under current law, the retail sale of standardized computer software, irrespective of how it is delivered, is subject to the sale/use tax. The sale of custom software is not subject to the sales and use tax.

Effective January 1, 2014, under the proposed amendment, the retail sale of custom software would also become subject to the sales and use tax as a transfer of tangible personal property. The term 'custom software' is defined by the amendment as a software program prepared to the special order of a customer that is not standardized software, including modifications or enhancements to standardized software.

Personal income tax proposals

All of the following personal income tax proposals would be effective for tax years beginning on or after January 1, 2014.

Uniform personal income tax rate of 6.25%

Under current law, Massachusetts divides gross income into three classes:

- interest (other than Massachusetts bank interest), dividends, and short-term capital gains (Part A income)
- long-term term capital gains (Part C income)

- all other income (Part B income).

For 2012, the tax rate on Part B and most other types of income is 5.25%. However, a 12% tax rate is applied to short-term capital gains and long-term gains on collectibles. In addition, filers may voluntarily pay tax at a rate of 5.85% on income that is otherwise taxed at 5.25%.

Under the proposed amendment, Massachusetts would retain the gross income classification structure (that is, the Part A, B, and C designations will remain), but all income would be taxed at a uniform tax rate of 6.25%. In addition, filers would no longer be able to elect to pay tax at 5.85% under the proposal.

Changes to the tax base

Under current law, Massachusetts generally conforms to the Internal Revenue Code, which means that for most filers there are few modifications made in arriving at Massachusetts gross income. The governor's proposal includes 19 modifications (so that Massachusetts will no longer conform to the federal rules) that will increase Massachusetts gross income. Significant departures from federal conformity include:

- The inclusion in Massachusetts gross income of certain employer-provided benefits (e.g., amounts paid by employers for premiums on accident and accidental death insurance, amounts paid by employers for premiums on group-term life insurance, amounts paid by employers in providing adoption or education assistance and qualified retirement planning assistance, and amounts provided by an employer through a qualified transportation fringe benefit program).

- The inclusion in Massachusetts gross income of gain from the sale of a principal residence.
- The inclusion in Massachusetts gross income of the value of meals or lodging furnished to an employee at the convenience of an employee.

The governor's proposal doubles a filer's personal exemption amount. For example, under current law, the personal exemption for a joint filer is \$8,800. Under the proposed amendment, the personal exemption would be increased to \$17,600.

The governor's proposal provides for the elimination of numerous deductions, including:

- the ability to deduct up to \$2,000 in capital losses against Part A dividends and interest income
- the ability to deduct up to \$2,000 against Part B income for contributions to social security, railroad retirement and public pension plans

- the ability to deduct the net amount of Part A, B and C income of trustees, executors and administrators that is set aside for charitable purposes
- the deduction for dependents under 12 years of age
- the deduction for contributions to Health Savings Plans and Archer Medical Savings Accounts
- the deduction for adoption fees.

Other notable provisions

Other tax related proposals in the governor's budget include:

- *State tax credits* - Effective for tax years beginning on or after January 1, 2014, the proposal repeals state tax credits for renewal energy source property, lead paint removal, and replacement of a failed septic system. In addition, the proposals limit the amount of aggregate film credit that can be claim by all taxpayers (including corporate) in a given year to \$40 million.

- *Indexing of the gasoline tax* - Under current law, the tax on the sale of gasoline is 21 cents per gallon. Under the proposal, the tax per gallon would be adjusted at the beginning of each fiscal year by the percentage, if any, by which the Consumer Price Index for the preceding year exceeds the same for the calendar year that ends before such preceding year. This amendment would be effective on July 1, 2013.
- *Cigarette tax increase* - The governor's proposal would also increase the excise imposed by a package of cigarettes by one dollar and also increases taxes on other tobacco products effective as of January 1, 2014.
- *Sales tax imposed on 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 this sales and use tax exemption effective January 1, 2014.

Let's talk

If you have questions about the Massachusetts Governor Patrick's tax proposals, please contact:

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