Massachusetts Taxpayers Foundation

State Tax Expenditures: Less Than Meets The Eye

NOVEMBER 2012

MTF

The Massachusetts Taxpayers Foundation is a nationally recognized, independent, nonprofit research organization whose purpose is to promote the most effective use of tax dollars, improve the operations of state and local governments, and foster positive economic policies. The Foundation's extensive track record of high quality research and analysis has earned it a reputation for objectivity and credibility among legislators, policymakers, the media, and interest groups of all kinds. Over the past 15 years the Foundation has won 16 national awards for its work on health care access and costs, transportation reform, business costs, capital spending, state finances, MBTA restructuring, state government reform, and municipal health reform.

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We would like to recognize
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Overview

Each state has its own set of tax laws with a combination of personal income, sales, and businesses taxes, levied at rates that vary from state to state. A total of 41 states have a personal income tax on wages and salaries, 45 states impose a sales and use tax, and 47 states have a corporate income or similar business tax. In addition, some states levy a statewide property tax while others allow local governments to impose personal income and sales taxes. The Massachusetts constitution prohibits local income taxes and Massachusetts has no statewide property tax or local sales taxes.

Just as the federal government and each state has its own unique tax structure, they all have a series of exceptions to these taxes in the form of credits, deductions, deferrals, and exemptions. These exceptions are referred to as "tax expenditures" because they result in the state foregoing a portion of revenue that it otherwise would have received.

As a part of the Governor's budget proposal each year, the state Department of Revenue (DOR) compiles a tax expenditure budget. This budget estimates the amount of revenue the state foregoes for each of the scores of exceptions to tax law, as determined by DOR. Some of the state's tax expenditures are clear cut exceptions to the application of a tax, such as the sales tax exemption for groceries. Others are the result of DOR's interpretation of what constitutes a tax expenditure.

In general, Massachusetts applies an unusually broad interpretation in determining tax expenditures. As a result, the state's fiscal 2013 estimate of $26.6 billion in total expenditures is nearly 20 percent greater than the state's projected tax revenue collections for that same year. As shown in Table 1, exemptions from the sales and use tax represent the largest share, accounting for $18.4 billion or approximately 70 percent of the total. Personal income expenditures account for $6.8 billion or 26 percent, while corporate income tax expenditures are just $1.3 billion or five percent of the total.[1]

However, legislation signed in July 2012 changes tax expenditure reporting and, based on the Foundation's analysis, will slash the fiscal 2013 estimate by nearly half to $13.4 billion, also shown in Table 1.

In particular, the legislation narrowed the scope of expenditures by excluding the nontaxation of personal and professional services ($9.5 billion) and transactions involving real estate ($3.7 billion) from the sales tax expenditures. This change is discussed in detail on page 3.

In the revised budget, personal income expenditures account for $6.8 billion or approximately half of the total. With services and real estate no longer reported as expenditures, sales and use expenditures of $5.2 billion are 39 percent of the total, while corporate expenditures still account for the smallest share at $1.3 billion, or 10 percent.

[1] There are seven federally based deductions and eight state credits, totaling $102 million, that are exceptions to corporate tax law but used by individual taxpayers for their personal income tax liability.

Table 1
Original and Revised Tax Expenditure Estimates

Tax Expenditure Category	FY 2013 Original Estimate (millions)	FY 2013 Revised Estimate (millions)
Sales & Use	$18,397	$5,190
Personal Income	$6,842	$6,842
Corporate	$1,324	$1,324
Total	**$26,563**	**$13,356**

While eliminating the nontaxation of services and real estate from tax expenditure reporting is an important improvement, the Foundation's analysis concludes that the estimate is still overstated by several billion dollars. In addition, many other tax expenditures cover items that are already subject to a different tax, while others are a basic part of the tax code which directly benefit most or all Massachusetts residents. Further clouding the estimate are two elements that are not accounted for in the tax expenditure budget: exceptions to tax law that produce additional revenues for the state and the effects that eliminating exceptions would have on hiring, purchases, and other important economic factors.

The Foundation's analysis concludes:

- The revised estimate includes approximately $4.6 billion of questionable tax expenditures. Most of this total—$4 billion—is simply the result of the state's conforming with the federal tax code, expenditures that are rarely included in other states' totals. Another $600 million stems from corporate income tax expenditures that are not exceptions but rather established parts of the state's tax structure.

- More than $1.1 billion of expenditures are for items that are taxed through another means. This includes the sales tax exemptions for gasoline, hotel rooms, and alcohol, as well as the corporate income tax exemption for real estate taxed by municipalities rather than the state. These items do not escape tax, they are simply taxed separately.

- Many tax expenditures are widely accepted features of the state's tax structure, most of which have been in place for decades. For example, the sales tax exemptions for food, clothing, and medicine account for $1.4 billion.

- The tax expenditure budget includes only exceptions that result in foregone revenues, not those that result in an increase in revenues, also known as "negative tax expenditures." For example, federal law has permitted individuals to deduct charitable contributions since 1917, but except for one year Massachusetts has not allowed residents to use this deduction for state income tax purposes.[2]

- As discussed by DOR in the introduction to the tax expenditure budget, each tax expenditure estimate is "static" rather than dynamic. In other words, the

[2] Massachusetts permitted the deduction in 2001. In 2002, the state changed the law to provide taxpayers the charitable deduction only if the tax rate was at 5.0 percent in the prior year.

estimates do not take into account any outside effects, such as changes in spending or employment decisions by businesses, that may result from eliminating any of the credits, deductions, deferrals, or exemptions.

Changes in Tax Expenditure Reporting

In July 2012, the Legislature adopted and the Governor signed a broad set of changes aimed at improving the state's finance operations. Included in the law is a new definition for tax expenditures, as well as new reporting requirements that should improve the clarity and accuracy of future estimates. These are key changes that will have an immediate and positive effect not only on the size and scope of future estimates but also on the policy discussions related to the state's foregone revenues.

Under the previous definition, a "tax expenditure" was broadly defined to include credits, deductions, exemptions, and exclusions from the sales, personal income, and corporate income taxes. These general terms allowed significant latitude in determining the scope of what was a tax expenditure, and DOR often used the broadest interpretation possible. In particular, the term "exclusions" opened the door to an aggressively expansive approach because it allowed DOR to assume that virtually everything is taxable. No other state uses as far reaching an approach in its estimate of tax expenditures.

While still broad, the updated definition eliminates some of the room for interpretation by removing the vague term "exclusion." In particular, the new definition eliminates from the state's tax expenditure estimate one of the most expansive interpretations of a tax expenditure, the $9.5 billion for exclusion of services from the sales tax, as discussed on page 4.[3] The new definition also eliminates $3.7 billion for the exclusion of sales and rentals of real estate from the sales tax.[4]

At the same time, the definition now requires that the corporate income tax section account for credits, deductions, deferrals, and exemptions available to financial institutions, utility corporations, security corporations, and insurance companies, which are subject to separate business excises. Beginning with the fiscal 2013 estimate, DOR included these under the corporate income tax section, so the legislative change formalizes this practice.

A second critical part of the new law makes important changes in the frequency and content of tax expenditure reports. In the past, DOR published an annual estimate of tax expenditures but rarely provided revisions, even if there were significant economic changes or legislative actions that impacted it during the year. Furthermore, despite the fact that DOR's compilation of tax expenditures in Massachusetts was far greater than in other states, DOR provided few details on the methodology or rationale behind the estimate.

DOR now will be required to provide annual evaluations, comparisons, and explanations of past estimates. It will continue to produce an annual tax expenditure estimate but now it must compare these estimates to previous years. At the end of each fiscal year, DOR is expected to revise its estimates for that year based on available information and data and to explain any major differences from the original estimates.

[3] Massachusetts technically taxes one "service" because the sales tax applies to telecommunications services.

[4] For purposes of taxation, the technical term that covers real estate is real property, which is defined as land and the building(s) on it. We refer to real property as real estate in this paper.

These changes should enhance tax expenditure reporting by improving the accuracy of calculations and adding accountability for annual estimates. With annual analysis and revisions, DOR can better gauge the accuracy of its estimates and make appropriate changes in its methodology to improve future estimates. By explaining discrepancies, DOR will provide more clarity on the data and assumptions behind its calculations. Policymakers will know if fluctuations from year to year are rooted in a changed interpretation of law, the result of new tax rules, or supported by data.

These changes will bring Massachusetts more in line with other states in the size of its tax expenditure budget. To be sure, the revised definition of tax expenditures still allows for debatable interpretation, particularly with corporate tax expenditures as discussed later. However, there is little doubt that historical estimates have enormously overstated the size of tax expenditures.

Impact of Changes on Tax Expenditure Estimate

The change in the definition of tax expenditures results in the elimination of half, or more than $13 billion, of the $26.6 billion in fiscal 2013 tax expenditures. This change, driven by the deletion of "exclusions" from the new definition, eliminates $9.5 billion for the nontaxation of personal and professional services and $3.7 billion for the nontaxation of real estate transactions, both under the sales tax, and brings Massachusetts's methodology more in line with every other state.

Historically, Massachusetts applied an exceptionally broad view to the term tax expenditure when it included sales tax exclusions in its tax expenditure estimate, resulting in the capture of an enormous range of transactions that are neither specifically included in, nor specifically exempt from, the sales tax base. There is an endless list of transactions that are excluded from the sales tax, so to count any transaction not involving the transfer of tangible personal property as an exclusion opens the door to the idea that anything could be taxed.

Most states only include sales tax expenditures for specific exemptions, rather than a broad-based expenditure for any service that is not taxed. For example, California excludes services entirely from its tax expenditure estimate. New York accounts only for services that are specifically exempted in state law, such as dry cleaning. While Maryland taxes some services, it does not include an estimate for the dozens of services that are not taxed. Similarly, New Jersey, which taxes more services than most states, does not include an expenditure for those not taxed.

In addition to the nontaxation of services, the nontaxation of real estate transactions will also be eliminated from the tax expenditure estimate. Since the sales tax only applies to tangible personal property—which for the purposes of taxation does not include sales or rentals of real estate—it was a stretch to include this as a sales tax expenditure in the first place.[5] The new law ensures that nontaxation of real estate transfers will no longer be reported in the state's tax expenditure budget by clarifying that expenditures apply only to tangible personal property exemptions, such as the specific exemptions for food, clothing, and medicine.

[5] The new definition of tax expenditure states that "[s]ales that do not involve tangible personal property shall not result in tax expenditures under this definition."

Personal Income Tax Expenditures

Personal income tax expenditures total $6.8 billion, accounting for half of the revised estimate. Unlike most other states, Massachusetts includes in this estimate approximately $4 billion of expenditures that simply reflect conformity with the federal tax code. Expenditures from aligning, or coupling, with the federal code are primarily exemptions for employer-provided benefits, totaling $2.05 billion, and exemptions for capital gains, which total $1.58 billion (both are discussed later in this section).[6]

Few states opt to include federally based tax expenditures in their total estimates because they are merely the result of conforming to federal tax laws. These federally based exemptions are found in virtually every state and for the most part have been in place for decades. For example, employer contributions to pension plans have been exempt from employee income for nearly as long as the federal income tax has existed. Similarly, the exemption from employee income for employer-provided health insurance benefits is a widely accepted tax policy that has been in place since 1943. With these exemptions so entrenched in the tax framework, including them in the state's tax expenditure total is misleading.

While DOR acknowledges that its decision to include federal expenditures may be questioned, it chooses to include them because the state has the power to decouple from federal law at any time. However, every state has the power to decouple, yet dozens do not include federal expenditures in their estimates. Many of the federally based expenditures are among the oldest offered by the state and Massachusetts has rarely broken from federal law on these exemptions. Furthermore, through legislative action, the state explicitly conformed to the federal code as of January 1, 2005.

Many states do not report on federal expenditures in any form. A small number, such as New York, provide estimates of federal expenditures but make a point of separating them from the state-specific expenditures. In the Foundation's view, the best approach would be to report these expenditures separately, such as in an appendix. This would allow policymakers to identify clearly the amount of revenues it foregoes as a result of federal, rather than state, policy decisions without skewing the expenditure budget.

Table 2 details the components of the $2 billion in employer-provided benefit exemptions and the $1.6 billion of capital gains exemptions. The remaining $407 million is composed of 18 different expenditures, including deductions and exemptions primarily intended for individuals who own or start a business, exemptions for certain veterans benefits, and deductions for higher education costs and health care expenses.

[6] In the tax expenditure budget, the Department of Revenue uses the term "exemption" to refer to exclusions from gross income. For consistency, we follow DOR's convention and use the term "exemption" in place of exclusions in this report.

Table 2
Federally Based Personal Income Tax Expenditures

Expenditure	FY 2013 (millions)
Employer-Provided Benefits	**$2,045.7**
Net Exemption of Employer Contributions and Earnings of Private Pension Plans	$958.5
Exemption of Employer Contributions for Medical Insurance Premiums and Medical Care	$943.1
Self-Employed Health Insurance Deduction	$44.2
Other Employer-Provided Benefits	$99.9
Capital Gains	**$1,580.7**
Nontaxation of Capital Gains at Death	$1,217.0
Exemption of Capital Gains on Home Sale	$239.6
Nontaxation of Capital Gains at Time of Gift	$124.0
Other	**$406.6**
Total	**$4,033.0**

Employer Benefits

For purposes of taxation, the federal government and most states do not treat the benefits that employees receive in addition to wages as personal income. The exemption of these benefits from the personal income of employees accounts for almost one-third of all personal income tax expenditures in Massachusetts.

The largest tax expenditure for employer-sponsored benefits, at $958.5 million, is the temporary exemption for investment earnings and employer contributions to private pension plans. Rather than a true exemption this expenditure is a tax deferral, meaning that the employee eventually pays a personal income tax—and the state receives revenue—once these contributions and earnings are distributed to the employee in retirement.[7]

Massachusetts also allows the virtually universal exemption for health insurance contributions from employers, accounting for $943.1 million. A companion deduction, also based on federal law, allows self-employed taxpayers to deduct the cost of health insurance from personal income, valued at $44 million.

The remaining $100 million is accounted for by exemptions for a handful of other employer-provided benefits, including life insurance coverage, workers' compensation, transit assistance, education assistance, and employer-provided child care.

[7] However, if a Massachusetts resident subsequently becomes a Massachusetts non-resident, federal law pre-empts Massachusetts from taxing distributions from a qualified pension plan. See 830 CMR 62.5A.1(4)(e).

Capital Gains
The $1.2 billion for the exemption of unrealized capital gains on property that is transferred upon death accounts for nearly all of the capital gains tax expenditures. Unrealized capital gains do not become subject to tax until there is a triggering event, such as a sale. Because the transfer of property at death is not a triggering event, the appreciated value of property passes to its recipients without the unrealized gain being recognized and subject to tax. While the state does not levy a capital gains tax at death—no state in the country does—there is an estate tax on estates worth $1 million or more.

DOR's fiscal 2013 estimate of $1.2 billion for the nontaxation of capital gains at death is puzzling because it spikes by 57 percent or almost $443 million over the fiscal 2012 estimate of $774 million. DOR estimates that it will drop by 40 percent to approximately $730 million in fiscal 2014.[8]

Driving the spike is DOR's assumption that, in anticipation of the federal tax law changes expected to occur in January 2013, people will find alternative ways to transfer assets and avoid the capital gains tax. DOR argues that because assets have been transferred through other vehicles—rather than through a bequest—they represent foregone capital gains revenues.

While that behavior may account for some increase, it is hard to believe that it will result in the large jump that DOR reports. By definition, this expenditure would only cover assets transferred by those taxpayers who died during the year—if a taxpayer transfers property but does not die in fiscal 2013, it is not part of this expenditure. There is also an expenditure for property that is transferred as a gift (rather than as a bequest), which accounts for an additional $124 million expenditure, but this a tax deferral rather than permanent loss of revenue.[9]

In addition to the capital gains exemptions for property transfers, Massachusetts aligns with the federal tax code to provide a separate exemption for home sales. Homeowners may exclude up to $500,000 of gain from the sale of a primary residence, the same as allowed under federal law.[10] This exemption has been expanded in recent years to apply to all homeowners for each sale, not just homeowners over age 55 or the sale of a first home, and totals approximately $240 million for fiscal 2013.

State-Specific Expenditures
As shown in Table 3, there are $2.8 billion in state-specific personal income tax expenditures, the lion's share of which are deductions and deferrals for retirement income and savings, which account for $1.7 billion.

[8] The fiscal 2012 estimate of $774 million is the state's revised estimate, as reported in the 2013 budget. The original estimate, reported in the fiscal 2012 budget, was $559.1 million.

[9] Property transferred by gift does not escape permanent taxation, but rather is a deferral because the appreciated value of the property is not transferred. In other words, property that was purchased for $100,000 but worth $300,000 will have a carryover basis of $100,000 if transferred as a gift but a stepped-up basis of $300,000 if transferred through a bequest.

[10] Homeowners may exclude from gross income capital gains of up to $250,000 for individuals or $500,000 for joint filers from the sale of a primary residence.

Table 3
Non-Federally Based Personal Income Tax Expenditures

Expenditure	FY 2013 (millions)
Retirement Income	**$1,123.7**
Exemption for Social Security Payments	$839.0
Exemption for Public Pension Payments	$284.8
Retirement Contributions	**$625.8**
Exemption for IRA Earnings on IRAs	$326.2
Deduction for Employee Contributions to Social Security and Public Pension Plans	$299.6
Other	**$1,060.2**
Total	**$2,809.7**

The largest of these expenditures, $839 million, is the state exemption for Social Security benefit payments. While the federal government subjects a portion of Social Security payments to the personal income tax when certain income thresholds are met, Massachusetts exempts the entire amount of these benefit payments from the state's personal income tax.

Twenty-six other states similarly exempt the entirety of Social Security payments, excluding the nine without a personal income tax. However, they only report tax expenditures for exemptions more generous than those offered by federal law. By comparison, Massachusetts includes two parts in this expenditure: the amount that results from the federal exemption and the amount that results from providing a greater exemption than federal law.

The state also exempts pension income that is received by state, local, and other public sector retirees, totaling $284.8 million. Since state and local employees in Massachusetts are not entitled to Social Security benefits for the time they worked in a state or local government position, this pair of exemptions ensures that both types of public retirement benefits—Social Security and public employee pensions—are treated equally for the purposes of state taxation.[11]

On the retirement savings side, tax deferrals for investment earnings in Individual Retirement Accounts (IRAs) account for $326 million of personal income expenditures. As with employer contributions to private pensions, these earnings are taxed years later when the benefit is drawn, so the state receives the tax revenue at a later date.[12]

Contributions to the Social Security system and other public pension systems can be considered another form of retirement

[11] State and local government employees in Massachusetts do not pay the Social Security payroll tax and do not receive Social Security benefits.

[12] However, if a Massachusetts resident subsequently becomes a non-resident, federal law pre-empts Massachusetts from taxing distributions from a qualified pension plan. See 830 CMR 62.5A.1(4)(e).

savings, and the state allows all taxpayers to deduct up to $2,000 from personal income to offset such contributions. Combined, these two deductions account for nearly $300 million.[13]

Approximately 30 other exceptions to state law compose the remaining $1.1 billion of personal income expenditures, with $614 million stemming from four items: the exemption for public assistance benefits, the child tax deduction, the earned income tax credit, and the rental deduction.[14] The other expenditures total $446 million, ranging from $99 million for the exemption for interest earned by residents who own Massachusetts state and municipal bonds to $400,000 for a credit for dairy farmers based on the amount of milk sold.

[13] These cover payments to Social Security, Medicare, or Railroad Retirement and the federal or Massachusetts retirement systems.

[14] Public assistance received as cash may be considered a federal expenditure. However, since the state's budget is not clear on precisely what is accounted for in this estimate, we have chosen to list it as a state expenditure.

Sales Tax Expenditures

As shown in Table 4, specific exemptions to the sales tax total $5.2 billion or 39 percent of the revised total. Several of the state's 34 exemptions, which are grouped into six broad categories in the table, are widely used and well known, such as the exemption for food, with the three largest categories, totaling $3.2 billion, primarily benefiting individuals. There are also a handful of narrower exemptions, such as the ones for motor vehicle purchases for paraplegics and meals served at churches, nursing homes, and hospitals.

Massachusetts does not provide any unusual sales tax exemptions, with every exemption offered in at least one other state and frequently in many states. Two of its largest exemptions, medicine and food, are rarely taxed in other states. Of the 45 states that have a statewide sales tax, only Illinois taxes prescription medicine while 31 states (including Massachusetts) do not tax food and seven tax it at a reduced rate. Other common exemptions include those for residential utilities, raw materials, non-profits, newspapers, textbooks, and funeral items. In fact, some states provide a much longer list of exemptions. Washington exempts alternative-fuel vehicles from the sales tax, California exempts linen rentals, New Jersey uses a reduced tax rate in one particularly distressed county, and Rhode Island does not tax floral arrangements. Many states also use exemptions for industries that are important to the state. For example, a number of Midwestern states have detailed lists of exempt agricultural products and equipment.

Food, Clothing, Medicine, and Utilities

Since it implemented the sales tax in 1966, Massachusetts, like many other states, has exempted basic necessities as a way to ease the burden, particularly for low-income residents. Accounting for $2.2 billion or nearly 17 percent of the revised total tax expenditures, these necessities include food ($683 million), medicine ($449 million), and clothing ($282 million). Exemptions for residential electricity, heating fuels, water, and landline telephone and Internet service make up the remaining $824 million.

Table 4
Sales Tax Expenditures

Expenditure	FY 2013 (millions)
Food, Clothing, and Medicine Exemptions	$1,413.5
Utilities Exemptions	$824.0
Items Covered Under Another Tax (motor vehicle fuel, alcohol, motel rooms)	$994.9
Exemption for Production Materials, Fuels & Equipment	$894.8
Tax-Exempt Organizations (non-profits and governments)	$657.2
All Other Exemptions	$405.1
Total	**$5,189.5**

Items Covered Under Another Tax

Another category of sales tax exemptions includes three items—motor vehicle fuels, hotel rooms, and alcohol—that are taxed under separate levies. These exemptions account for nearly $1 billion in expenditures.

In Massachusetts, drivers pay a tax of 23.5 cents per gallon for gasoline, included in the price at the pump, which produced $662 million of revenues in fiscal 2012. Since the state does not levy the sales tax on top of the gasoline tax, DOR estimates the state foregoes $726 million of revenue.

Hotel rooms in Massachusetts are taxed at 5.7 percent, slightly less than the 6.25 percent sales tax, which provided $121.6 million in state revenues for fiscal 2012. However, as a result of not applying the sales tax on top of the hotel tax, the state estimates that it foregoes $155 million.

The state also taxes alcohol at the distributor level, ranging from 11 cents per gallon on beer to $4.05 per gallon for distilled spirits, which generated $76 million in fiscal 2012. By not adding the 6.25 percent tax on the sale of alcohol, the state foregoes $114 million.[15]

Exemption for Production Materials

Another sales tax exemption covers purchases of materials, fuels, tools, and machinery, including spare parts, used in manufacturing, research and development by certain corporations, the furnishing of power, newspaper publishing, agricultural production, commercial fishing, and commercial radio and television broadcasting, which accounts for a total of $894 billion. Like most other states, Massachusetts exempts the components used to produce a final good, as well as the inputs to these other industries.

This is an important exemption for consumers as well as corporations manufacturing in Massachusetts. If the 6.25 percent sales tax were applied to every item added during production, the final prices of goods would be much higher. It is important to note that Massachusetts-based manufacturing corporations pay an eight percent corporate tax imposed on apportioned net income, a state-level excise imposed on tangible personal property not subject to local tax, and local property taxes on buildings and land.

Tax-Exempt Organizations and Other

An additional $1.1 billion comprises the exemption for non-profits and governments ($657 million), which is commonly seen in other states, and $405 million in miscellaneous expenditures, the largest of which is the exemption for containers ($158 million), followed by the exemption for the trade-in value of a vehicle when buying a new one ($96 million), both of which are offered by several other states.

[15] Alcohol was also subject to the sales tax for a short period beginning on August 1, 2009. A referendum vote in 2010 repealed the sales tax on alcohol, effective January 1, 2011.

Corporate Tax Expenditures

Despite the public focus on so-called corporate tax "breaks," they actually comprise the smallest share of tax expenditures. At a total of $1.3 billion, corporate expenditures account for only five percent of the 2013 total estimate of $26.6 billion and 10 percent of the revised $13.2 billion. In the revised estimate, personal income expenditures are five times as large and sales and use expenditures are nearly four times as large as corporate expenditures.

Furthermore, based on the Foundation's analysis, close to half of the $1.3 billion are not legitimate tax expenditures and should not be included in the state's tax expenditure budget. Specifically, DOR includes three questionable items under corporate expenditures—adjustments to the apportionment formula ($262.2 million), the net operating loss deduction ($90.6 million), and a series of depreciation deductions ($242.5 million).

Apportionment

For the purposes of calculating tax expenditures, DOR assumes that multi-state corporations should apportion income based on an outdated, infrequently used formula that weighs payroll, property, and sales equally.

Most multi-state business corporations subject to tax in Massachusetts apportion their income to Massachusetts by applying a three factor, double-weighted sales formula that weighs the sales factor at 50 percent and the property and payroll factors at 25 percent each.[16] Defense companies, manufacturers, and mutual fund companies that are doing business in more than one state apportion their share of income to Massachusetts using a "single sales factor" apportionment formula which weighs sales at 100 percent. With no corporate taxpayer in Massachusetts apportioning its taxable net income (or combined group income) using an equally weighted, three part formula since the mid-1970s, the double-weighted sales and single sales apportionment formulas are a central part of the state's tax structure rather than an exception to it.[17]

The movement away from the equally weighted three factor apportionment formula is a national phenomenon that has accelerated over the past two decades. Double- and single-weighted apportionment formulas are now the accepted standard for apportioning multi-state corporate income. Of the 47 states with a business income tax, only six—Alaska, Delaware, Hawaii, Kansas, Montana, and North Dakota—require universal use of a three factor, equally weighted formula.[18] Fourteen states use the single sales formula to apportion corporate income for all industries, including retail and professional services, with Pennsylvania and California set to start in 2013.[19]

[16] Income refers to "combined group income" of the larger "unitary business" corporate group in which they are a member. Stand alone corporations that are operating on a multi-state basis also apply a three factor, double-weighted sales formula to apportion their taxable net income.

[17] Financial institutions and utility corporations still apply three factor, equally weighted apportionment formulas, though in the case of financial institutions the rules for determining and sourcing the receipts (sales) and property factors vary considerable from the apportionment rules for business corporations.

[18] Oklahoma uses a three factor apportionment formula, but companies with total in-state investments of more than $200 million may use a weighted apportionment formula.

[19] Double- and single-weighted sales factor apportionment formulas are used to ensure that a multi-state company which has significant operations in the state—employing many residents, owning or leasing large amounts of property, and otherwise supporting the state's economy—is not penalized with a higher relative tax burden than businesses with little presence in the state.

Net Operating Loss Deduction

The state's decision to include $90.6 million for the NOL carry-forward is also open to question. The carry-forward allows all businesses except financial institutions and utility companies to use a net operating loss deduction at any point during a 20-year period. For the purposes of determining tax expenditures, DOR assumes that the carry-forward period would be eliminated altogether and therefore these companies would forfeit unused deductions.

Yet NOL carry-forwards have been a fixture of the U.S. tax code for decades, reflecting the reality that a calendar year does not account for business cycles and other external events that can cause fluctuations between profits and losses from year to year. The carry-forward period strikes a fair balance that ensures that profits and losses are treated equally for tax purposes.[20] Without a carry-forward period, businesses with swings in income would be penalized, paying more in taxes over time than a company with the same total earnings but without the volatile swings. NOL carry-forward periods are particularly critical for new companies in planning for the long term.

NOL carry-forwards are so integral to the tax code that they are excluded from the Joint Committee on Taxation's (JCT) federal tax expenditure budget because they "represent normal income tax law."[21] Not only is a carry-forward period standard in the federal government's eyes, it is also a universal practice among the states. Every state permits corporations at least a five-year carry-forward period, while the federal government and 26 states, including Massachusetts, use a 20-year period.[22]

In fact, rather than reporting the NOL carry-forward as foregone revenues, the state should report on the revenue gain that results from less favorable treatment for banks and utility corporations in Massachusetts. The state disallows these businesses a carry-forward period, resulting in a break from normal tax law that works in the state's favor, referred to as a "negative tax expenditure."

Accelerated Deductions

The third category of questionable corporate tax expenditures is the $243 million for eight deductions mostly related to the depreciation of tangible property, such as equipment. Referred to as "accelerated deductions" in the tax expenditure budget, these allow taxpayers to deduct the costs of equipment and other assets over a shorter time frame than the useful life of the asset. Most of this expenditure—$172 million—stems from a single depreciation deduction, referred to as the accelerated cost recovery system, which covers an enormous list of tangible property used by businesses, ranging from cars to computers.[23]

[20] The Joint Committee on Taxation (JCT) notes that carry-forward periods help limit the asymmetrical treatment of losses: "[t]he treatment of income and loss under the Code is asymmetrical in the sense that income is taxed in full when realized, while losses are frequently limited, deferred, or disallowed."

[21] Joint Committee on Taxation, *Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates*, JCX-15-11 (Washington, D. C.: U.S. Government Printing Office, February 28, 2011), 8. In the JCT analysis, only deviations that are more favorable than the 20-year carry-forward period are counted as tax expenditures.

[22] In recent years, California, Illinois, and Maine have temporarily suspended the carry-forward period for a short period of time. This does not mean that taxpayers forfeit their deductions. Rather, taxpayers postpone the use of deductions until the carry-forward period is reinstated.

[23] Other accelerated deductions allow for the immediate deduction of certain research and experimental expenditures and the amortization of certain capital costs.

DOR views accelerated deductions, as opposed to non-accelerated deductions, as an exception to tax law despite their nearly universal use by the federal government and the states. For example, 46 of the 47 states with business taxes follow the federal accelerated cost recovery system identically. Nearly all business taxpayers use accelerated deductions for most of their equipment, with the few exceptions limited to items such as equipment used primarily overseas.

Excluding the three questionable expenditures, the balance of corporate tax expenditures totals only $728.7 million, made up largely of 12 specific credits and the exemption for property that is taxed locally, as shown in Table 5.

Credits

Twelve tax credits, which account for $416 million of tax expenditures, are intended to lure and retain businesses, stimulate economic growth, and create jobs. While the specifics may differ among states, at least one other state offers a similar credit, subsidy, or incentive for 11 of Massachusetts' 12 credits.[24]

- The research credit, which accounts for $111 million of expenditures, aims to encourage innovation and discovery by allowing businesses to recoup 10 percent of their research and development expenses.[25] This credit supports several key industries in Massachusetts, allowing biotechnology, pharmaceutical, medical device, and technology firms to defray some of the high costs associated with research. The federal government, 39 other states, and even other countries also offer a research credit.

- The film tax credit accounts for $83 million in tax expenditures, and recent analyses by DOR have shown that there is an extremely high cost for the jobs created. Film production companies are eligible for credits on 20 percent of payroll costs and 25 percent of production expenses. In its November 2011 report analyzing the film tax credit, DOR estimated that the cost of the credit translated to an astounding $300,000 per job created in the state in 2009 and averaged nearly $175,000 per in-state job over a five-year period. Since many of the jobs are short-term positions with salaries far lower than the cost of creating the job, the film tax credit is strikingly inefficient.

- The investment credit, which totals $56.5 million, provides corporations engaged in research and development, manufacturing, agriculture, and commercial fishing a three percent credit on the cost of property, buildings, and other large equipment. The credit has been offered in Massachusetts since 1970, and 39 other states have a similar credit.

[24] The Foundation was not able to find a comparable program for the harbor maintenance tax credit, which provides a state tax credit for federal harbor maintenance fees paid by companies.

[25] The 10 percent credit is for expenses over a base amount that is determined by provisions in the Internal Revenue Code. The research credit also provides a credit for 15 percent of any payments received by an organization for the purposes of conducting research.

Table 5
Corporate Tax Expenditures
(excludes Adjustments for Apportionment, Accelerated Deductions, and Net Operating Loss Carry-Forward)

Expenditure	FY 2013 (millions)
Credits	$416.1
Research Credit	*$110.9*
Film Credit	*$82.6*
Investment Credit	*$56.5*
All Others	*$166.1*
Exemption for Property Subject to Local Taxes	$191.0
All Other	$121.6
Total	**$728.7**

- Eight other credits comprise $166 million in tax expenditures, ranging from $47.5 million for the historic building tax credit to $500,000 for the conservation land tax credit. For the brownfield, economic development, historic rehabilitation, and low income housing credits, if the property is no longer used for the purpose the credit was intended, the state may require the company to repay its credits. Similarly, for the life sciences incentives, if a corporation's job targets are not substantially met, a portion or all of the credit must be repaid to the state.

It is important to note that the fiscal 2013 corporate credits include a shift in methodology. Historically, credits claimed by financial institutions and insurance companies were not included in corporate income tax expenditures because these companies pay different taxes specific to their industries (referred to as the financial institution excise and the insurance premium tax).[26] However, starting with fiscal 2013, the state expanded its estimate to account for financial institutions and insurance companies in the corporate tax expenditures category.

Exemption for Property Taxed Locally
The state's estimate includes $191 million stemming from exemptions for property that is subject to local taxes. Massachusetts imposes a non-income measure of the corporate excise that is based on either taxable net worth or taxable tangible property, depending on whether the corporation is classified as an intangible property corporation or a tangible property corporation.[27] In determining the tax base, corporations are allowed a deduction for the book value of the tangible and real property located in Massachusetts that the corporation owns and which is subject to a local property tax. The tax expenditure is

[26] To strengthen historical comparisons, in the fiscal 2013 tax expenditure budget, DOR also revised its previous estimates for fiscal 2011 and 2012 to reflect this change.
[27] Taxable net worth and taxable tangible property are taxed at $2.60 per $1,000 of value.

based on the deduction afforded corporations so that the tangible and real property located in Massachusetts is not subject to tax twice, once at the state level and again at the local level. In other words, the tax expenditure contemplates the double taxation on this property.

The remaining $121.6 million of corporate expenditures includes $71 million for the special taxation of S corporations (businesses with 100 or fewer shareholders that are taxed at the shareholder level on their corporate income), $46.5 million for deductions for charitable contributions, and $4 million for the exemption for credit union income, as well as a tax deferral provided to shipping companies, and a deduction for businesses using alternative energy sources.