## Special Report / Viewpoint

# State Disclosure of Tax Return Information: Taxpayer Privacy Versus The Public's Right To Know

*by Robert P. Strauss*

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### 1. Introduction

The purpose of this article is to discuss the general effects of publicly disclosing state tax return information. The Massachusetts corporate reporting requirement of January 1993, which requires that certain business taxpayers provide portions of their state business tax returns to the Massachusetts secretary of state, who then is required to permit public inspection of this state tax return information, has created a precedent that is now being reviewed in several other states, and is being widely discussed by a number of business taxpayer organizations.[1]

The remarks below are organized as follows. Section 2 provides a summary of the January 1993 Massachusetts statutory business tax reporting requirement. Section 3 provides a historical review of the development of federal tax disclosure policies over the last century and a broader context in which to view the current Massachusetts statute. Section 4 analyzes the current Massachusetts corporate tax reporting requirements vis-à-vis the current federal tax disclosure rules to ascertain if federal rules are violated by it, and/or if the Massachusetts requirements run any risks of adverse federal-state disclosure interactions. Section 5 discusses the broader policy issues and objectives of general and corporate tax reporting and public disclosure requirements. Finally, Section 6 discusses the implications of strengthened corporate tax reporting requirements to state revenue departments as an alternative to public reporting of tax return information.

### 2. The 1993 Massachusetts Corporate Tax Reporting Requirement

The current Massachusetts corporate tax disclosure, passed in January 1993, requires that Massachusetts taxpaying corporations that file 10-k reports with the Securities and Exchange Commission, provide to the Massachusetts secretary of state certain items off their state tax return. In turn, the Massachusetts secretary of state must make such information available for public review. In particular, these corporations are required to report:[2]

- business taxpayer name;
- address of the principal office;
- Massachusetts taxable income;
- total Massachusetts excise or tax due;
- nonincome excise tax due;
- gross receipts or sales;
- either gross profit or credit carryovers to future years; and
- income subject to apportionment.

This initial reporting of corporate tax return information by corporations, on forms to be specified by the Massachusetts secretary of state, is due by the close of 1993..

This Massachusetts requirement is unusual not only vis-à-vis current tax disclosure laws and practices in other states,[3] but also vis-à-vis the current federal tax disclosure law (section

[1]Whether or not the Massachusetts statute should remain intact has been the subject of a Special Commission on Business Tax Policy which was authorized in the same statute as the new reporting requirement to examine the fairness of Massachusetts' business income taxes as well as to comment on the reporting requirement, per se. The matter has been actively discussed in the state's leading newspapers and been the subject of continuing public and legislative debate.

[2]Section 5 of Massachusetts House Bill No. 6348.

[3]*See* Apppendix 1 of Robert Tannenwald, "Corporate Tax Disclosure: Good or Bad for the Commonwealth?" *Draft Working Paper,* Massachusetts Special Commission on Business Tax Policy, May 28, 1993. [Editor's note: For text of this report, see this issue.] Wisconsin permits public inspection of a list of named individual, business, and other taxpayers and Wisconsin taxes paid; West Virginia requires the disclosure of state tax credits taken by corporations; and Arkansas permits the public review of various tax credits taken by business, and requires the notification of taxpayers of such public requests for review.

6103 of the Internal Revenue Code of 1986) and practice. A number of states have discussed or legislatively considered public disclosure of tax return information in the past several years; however, none has gone as far as the new Massachusetts statute.[4] Any reading of the evolution of the federal tax disclosure rules must fairly conclude that the issue of publicly disclosing taxpayer tax return information has oscillated between supporting taxpayer privacy and making federal tax returns available for public inspection to improve taxpayer compliance.

### 3. Historical Swings in Rules Governing Disclosure of Federal Tax Information

As Meade Whitaker, chief counsel to the IRS in the mid-1970s, pointed out just prior to the Congress's significant tightening up of federal disclosure rules in the Tax Reform Act of 1976, the issue of taxpayer privacy versus the right of the public to inspect tax returns is as old as income taxation in the United States. The debate over privacy versus the right of the public to inspect tax returns was an integral part of the debate over the Civil War income tax that culminated in enactment of the Revenue Act of 1862.[5]

Throughout the history of federal taxation of individual and business income, there have been legislative attempts to make the list of taxpayers publicly available, as well as legislative attempts to make further information about the taxpayers' tax returns, "tax return information," publicly available or accessible as well. Section 15 of the 1862 tax law provided for the list of taxpayers to be published; in 1866, Congress attempted to prohibit the publication of the list. Although this early attempt to withdraw public access to the list failed, in 1870 the commissioner succeeded in prohibiting publication of the list, but continued to permit public access to the list. This regulatory decision was confirmed in the Revenue Act of 1870. In 1872, the income tax law expired and the issue of public access to taxpayer lists became moot.

The Revenue Act of 1894 reinstated the income tax, but positively prohibited the publication of tax return information, going so far as to apply criminal sanctions for violations of the prohibition.

Debate over the 16th Amendment, which provided federal constitutional authority for income taxation, included prominent debates over who would be able to examine a taxpayer's return. Section II (G)(d) of the Revenue Act of 1913 provided that filed tax returns were public records that were "open to inspection only upon the order of the President, under rules and regulations to be prescribed by the Secretary of the Treasury and approved by the President." The practical effect of this was to allow the Secretary of the Treasury to promulgate regulations that stipulated that tax return information was essentially secret to all but federal tax administration officials.

In 1924, Congress dramatically changed this policy by legislating in the Revenue Act of 1924 that the amount of tax paid and the name and location of the taxpayer would be available for public inspection. The argument at the time in favor of this provision was that public inspection would improve compliance. Although Secretary of the Treasury Andrew Mellon opposed this provision of law, he upheld it before the courts. Furthermore, a federal district held in 1925 in *Hubbard vs. Mellon*[6] that there was no constitutional impediment to the public review of individual tax returns. This decision was consistent with an earlier U.S. Supreme Court decision, *Flint v. Stone Tracy Co.* that upheld the constitutionality of federal taxation of businesses, the requirement that business file returns pursuant to the tax, and the congressional designation that such business tax returns were public records.[7] The courts have found that such public review requirements do not violate constitutional assurances of unreasonable search or seizure, in good measure because no real property was at issue.

Public access to tax return information was quickly curtailed, however, as the Revenue Act of 1926 reduced public access to just the list of "each person making an income tax return," and eliminated access to numerical information on tax returns.

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Debate over public access to tax return information erupted in 1934 when section 55 (b) of the Revenue Act of 1934 was enacted; it provided that each taxpayer file an additional form, the so-called "pink slip," with the actual return; the "pink slip" contained the name and address of the taxpayer, total gross income, total deductions, net income, total credits against net income tax, and tax payable, and was to be available for public inspection.

The Congress repeatedly debated the "pink slip" provisions in January and February of 1935. Sen. Robert LaFollette of Wisconsin argued fervently in support of the provision, and pointed to Wisconsin's statute, that permitted public review of state tax returns in Madison. Opposition to the "pink slip" crossed party lines, and prominent Democrats from Massachusetts and New York questioned the wisdom of the provision. In March, 1935, the House Ways and Means Committee reported out HR 6359; the bill repealed the "pink slip" provision of the 1934 act before it had taken effect. On April 30, 1935, President Franklin Roosevelt signed the bill into law.

Section 6103 of the Internal Revenue Code of 1954 continued the public nature of tax returns whose review was to be guided by presidential order, and provided for state access to federal tax return information in conjunction with state tax

[4] *See,* for example, the working paper of the New York Legislative Commission on Modernization and Simplification of Tax Administration and the Tax Law, "Public Disclosure of Corporate Tax Information," Nov. 18, 1987.

[5] Meade Whitaker, "Taxpayer privacy vs. freedom of information: proposals to amend Sec. 6103," *The Tax Advisor,* April, 1975. For a much more complete historical treatment of the issue, *see also* Howard Zaritsky, Legislative History of the Tax Return Confidentiality: Section 6103 of the Internal Revenue Code of 1954 and its Predecessors, Congressional Research Service, American Law Division, December 4, 1974, CRS 74-211A.

[6] *Hubbard vs. Mellon,* 5 F2d 764 (CA-D.C., 1925).

[7] It should be noted that while the initial 1909 federal corporate income tax provided for public inspection of the tax returns, the public inspection provision was eliminated in June 1910. However, the Supreme Court commented that the initial public inspection provision did not violate the Fourth or Fifth Amendments to the Constitution.

administration needs. Shareholders composing more than 1 percent of the voting stock of a corporation were empowered to "examine the annual income returns of such corporation and of its subsidiaries." Finally, the tax committees of the Congress and the staff of the Joint Committee on Taxation of the Congress were empowered to "obtain data and inspect returns" in conjunction with their general oversight responsibilities.

For the next 20 years, federal tax return information was governed by section 6103. However, various events now known as "Watergate," which threatened the impeachment of President Nixon, and brought about his subsequent resignation, brought to light extensive use of IRS tax return records by various federal agencies for the surveillance and harassment of various groups. Investigations also revealed the use of federal tax returns by the Nixon White House against political opponents of the administration. It was determined that the IRS Ideological Organizations Audit Project and Special Service Staff targeted more than 8,000 individuals and 3,000 groups for tax investigation by the IRS because of their political activities. It was learned that the White House maintained an "Enemies List" and obtained their tax return information from the IRS to use against them.

The *General Explanation of the Tax Reform Act of 1976* observed:

> Questions were raised and substantial controversy created as to whether the extent of actual and potential disclosure of returns and return information to other Federal and State agencies for non-tax purposes breached a reasonable expectation of privacy on the part of the American citizen with respect to such information. This, in turn, raised the question of whether the public's reaction to his possible abuse of privacy would seriously impair the effectiveness of our country's very successful voluntary assessment system, which is the mainstay of the Federal tax system.[8]

Prior to the 1976 amendments to section 6103, various congressional committees investigating the abuse of such private information concluded that there was no meaningful procedure for the IRS to use in determining the legitimacy of requests for tax return information from the White House or any federal agency.[9]

The 1976 amendments to section 6103 dramatically clarified and severely limited the circumstances under which federal tax return information could be provided to other federal agencies for law enforcement purposes. Access by the Congress and by the states for tax administration purposes was essentially continued; however, a significant number of states, that had historically permitted some public review of state tax returns and thus indirect public review of federal tax return information, had to amend their own confidentiality statutes to prevent such indirect review of federal tax return information by the close of 1978 to be able to continue to receive, for state tax administration purposes, federal tax return information from the IRS.[10, 11]

In reading the congressional debate and editorial opinions expressing outrage over the use of tax return information for essentially political purposes, one can not help but be struck by the determination in the 1970s that tax return information be made strictly private, and the debates in 1935 when the positive effectiveness of the "pink slip" provision was actively debated. It seems unreasonable to presume that continued public access to federal tax return information could have prevented or precluded the sort of persecution of individuals and organizations that took place in the late 1960s and 1970s as a consequence of the abuse of presidential authority. Indeed, one might speculate that public access to partial or complete tax return information might have created more widespread political use of such information as well as hindered voluntary compliance.

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This essentially historical review of the privacy status of federal tax return information indicates that the United States has gone through periods in which public scrutiny was thought to aid the voluntary compliance effort and periods during which such public scrutiny was thought to be unduly intrusive vis-à-vis the private financial affairs of individuals and organizations. The current federal posture toward public access to federal tax returns is quite restrictive, and, in my view, it is unlikely that this will change. Over time, governmental access to federal tax returns for various law enforcement purposes has been broadened; however, at each stage the issue of taxpayer privacy and the excesses of the late 1960s and 1970s have been raised by the Congress as of paramount concern in maintaining the essential secrecy of federal tax returns vis-à-vis public review.

### 4. Interaction of Section 6103 of the Internal Revenue Code and Massachusetts Corporate Tax Reporting Requirements

With this background, let me now turn to discuss the recently enacted Massachusetts business tax disclosure requirements in conjunction with federal nondisclosure rules. First, the structure of the federal (section 6103) disclosure prohibitions does

[8] *General Explanation of the Tax Reform Act of 1976* (H.R. 10612, 94th Congress, Public Law 94-455, prepared by the Staff of the Joint Committee on Taxation, Dec. 29, 1976), p. 314.

[9] *See,* for example, statement of the American Civil Liberties Union before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, 96th Congress, 2nd Session, July 30, Serial 96-112.

[10] It should be pointed out that Wisconsin permitted public review of entire tax returns until 1953, when it amended its disclosure statutes to permit public review to simply the state tax liability and the identity of the taxpayer. It has been observed by those knowledgeable with Wisconsin that the persistent use of complete tax return information by Sen. Joseph McCarthy for essentially political reasons finally led the Wisconsin legislature to limit severely what the public could access.

[11] *See* Appendix, which contains the state safeguards section of 6103.

not *directly* impact those in Massachusetts HB 6348, because the federal prohibition is structured to prevent state tax administration authorities from making public or giving to other state or local government officials federal tax return information. Under HB6348, the Massachusetts Department of Revenue does not provide federal tax return information to the secretary of state for publication, nor does it provide state tax return information to the secretary of state for public review. Instead, the secretary of state obtains this information directly from taxpayers under state law. Were the Massachusetts Department of Revenue to permit public review of federal tax information that it received either from the taxpayer or the IRS, it would violate the federal prohibition, and also violate its own nondisclosure statute which governs how the Massachusetts Department of Revenue is to maintain confidentiality of federal and state tax return information.

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To be sure, the coexistence of a state tax return, which must be kept secret under Massachusetts nondisclosure statutes in the Massachusetts Department of Revenue, and simultaneous public access to the essential parts of that return in another government agency must be viewed as contradictory (if not confused) state policy toward taxpayer privacy. However, the new Massachusetts statute that requires business taxpayers to provide specified state tax return information to the secretary of state for public inspection does not appear to be any direct violation of section 6103 by the Department of Revenue which might trigger, say, the criminal penalties of section 6103 against state revenue officials.

In any case, the public access requirement through the Massachusetts secretary of state violates the spirit if not the intent of the federal prohibition in section 6103 to restrict access of federal tax return information solely to state and local tax administration officials or other state and local officials pursuant to state law, and to insure such information's essential privacy. The indirect disclosure of federal tax return information from the taxpayer to the Secretary of State would ultimately seem to put at risk the ability of the Massachusetts Department of Revenue to continue to obtain information from the IRS to administer the state's tax system.

Several points are germane to reaching that conclusion. First, it is likely, if not necessary in many cases, that the information being required of a taxpayer under this new state reporting requirement will be federal tax return information protected by section 6103, since the state tax information required to be sent to the secretary of state could readily be identical to that filed for federal purposes (e.g., taxable income, income subject to apportionment, gross receipts, etc., are measured through the application of the rules of the Internal Revenue Code), and in many cases will be copied from the federal Form 1120 to the appropriate state tax return, and then to the form supplied by the secretary of state. This will be the case for single-entity business taxpayers and for multistate business taxpayers who file on the same basis for state purposes as for federal purposes.[12]

Second, it is difficult to read the state law requirements, safeguards section, of section 6103 (e.g. see section 6103 (p)(8)(A) of the IRC) without concluding that Massachusetts' now contradictory policy toward privacy automatically stops further state access to federal tax return information from the Internal Revenue Service. In particular, it is difficult not to conclude that the new state disclosure law indicates that the state no longer has in force "provisions of law which protect the confidentiality of the copy of the Federal return (or portion thereof) attached to, or the Federal return information reflected on such State tax return."

The mere transference of federal *qua* state information to another form would not seem to adequately hide the nature and origin of such information as being fundamentally federal tax return information. Indeed the statutory language of HB 6348, which requires taking certain information off the state return at certain points in the calculation of Massachusetts tax due, and the (prior) statutory requirements of Massachusetts tax law, which critically link the definition of Massachusetts taxable income to federal taxable income, using line 28 of federal Form 1120, seem to create a very strong, precise relationship between what originates as federal tax return information and what becomes information reported to the secretary of state, who makes the information publicly accessible.

The *General Explanation of the Tax Reform Act of 1976* observes (p. 333) that state requirements to submit both a state and federal tax return to the state are permissible under section 6103 only to the extent that the state adopts by the close of 1978 confidentiality statutes acceptable to the secretary of the treasury. Moreover, "the policy underlying this requirement is that the attached copy of the [federal] return and the included information should be treated by State and local governments as confidential rather than effectively as public information."

The contradictory requirement of Massachusetts state law — secrecy of income and tax information if sent to and maintained by the Department of Revenue and public access to some of the same information if sent to the secretary of state — appears to facially contradict the continuing federal requirement that the state have in place laws ensuring the confidentiality of federal tax return information. Public access to federal tax return information, indirectly obtained by a state nontax official, would seem to directly contradict the federal requirement that a state maintain the confidentiality of federal tax return information in order to have continued access to federal tax return information. It seems reasonable to conjecture that the federal character of the information required to be publicly disclosed by the Massachusetts secretary of state would be noticed in a federal court were the matter litigated.

Whether or not the IRS will administratively deny the Massachusetts Department of Revenue further access to federal

[12]It is somewhat anomalous, at least to me, that subchapter S, sole proprietorships, and partnerships are exempted from the new Massachusetts public reporting requirements. My recollection of the federal history of aggressive tax planning and congressional response or "loophole closing" over the last quarter century suggests that these organizational forms required more repeated attention and active amendment of the Internal Revenue Code than the activities of incorporated business.

tax return information is not a theoretical question, and presumably one of more than passing interest to the Department of Revenue, or, for that matter, any business taxpayers who find the disclosure requirement offensive.

The obvious response to the above analysis is to counter that the separate reporting requirement to the secretary of state satisfies the state safeguard requirement of section 6103 because the Department of Revenue is not disclosing the tax return information and because the federal tax return information is not an attachment, per se, to the state return, but provided to the secretary of state under a separate state law. That is, the argument would be that because there is a "Chinese Wall" between what the Massachusetts Department of Revenue and the secretary of state do with federal tax return information, there could be no federal objection.

Several responses to this line of reasoning seem in order. First, the *General Explanation* language discusses a "policy . . . of confidentiality," that is a broader concept of privacy than simply noting the manner in which the private federal information gets transmitted.

Second, the identical nature of the information for most business taxpayers could not be attributed to chance or bad luck since there are distinct and operational legal and regulatory requirements in Massachusetts law regarding how state business returns are to be prepared and filed, and because the dependence of the various state definitional and accounting standards on the Internal Revenue Code are clear. Were Massachusetts not to rely on the IRC (currently only Arkansas is "decoupled"), this "chance" argument would be more plausible.

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Finally, consider the converse situation in which the secretary of state would be require and obtain state tax return information, but was required not to make it available for public review. (I am positing here an alternative state disclosure statute.) Suppose now that the secretary of state were required to provide this information to the Massachusetts Department of Revenue. Would the provision of state tax return information to the Department of Revenue, merely because it went through an intermediary, cease to maintain its essential character as tax return information? Would the Department of Revenue be obligated to maintain its confidentiality (e.g., not permit public review) because the information received was not directly covered by state nondisclosure statutes? I suspect that the revenue commissioner would choose to keep this information confidential, because of possible federal penalties should the state tax return information also be federal tax return information.

Even if the indirect nature of the public disclosure of what is likely to be federal tax return information is viewed administratively by the IRS to overcome the state law requirements of 6103, and/or if a federal court were to reach the same conclusion as the IRS, a question remains as to whether 6103 would remain in its current form. The earlier discussion of the historical evolution of legislative policy in this area suggests that the U.S. continues to be in a "secrecy" era, rather than a "public review" era vis-à-vis federal tax return information. If my reading of the current federal mood is correct, it seems likely that the Congress could easily amend 6103 (p)(8)(A) to strictly prohibit the IRS from providing federal tax return information to state tax administrators in states that fail to ensure the confidentiality, directly or *indirectly,* of federal tax return information.

If the reporting requirements of HB 6348 were structured to ensure that the information provided to the secretary of state would be federal tax return information but purely state tax return information, then the risk of the IRS vacating its information exchange agreement with the Massachusetts Department of Revenue would disappear. To achieve this, Massachusetts would have to "decouple" its income tax definitions from the Internal Revenue Code. This decoupling could easily create a massive source of additional ambiguity in their revenue statutes with likely substantial (adverse) revenue consequences.

### 5. Observations on the Broader Issues of Privacy, Compliance, Confidence in the Tax System and Accountability of Elected Officials

Irrespective of the possible risks created by HB 6348 to Massachusetts' continuing access to federal tax return information from the IRS to administer its own tax laws, there remains a series of difficult issues surrounding tax reporting and disclosure that deserve a separate discussion. Any fiscal system that empowers the government to extract taxes from its citizens must deal with the following conflicting objectives:

- protecting taxpayer privacy;
- ensuring taxpayer compliance with the tax laws;
- ensuring public confidence in the uniform administration of the tax laws; and
- ensuring political accountability of our elected representatives that these conflicting objectives are reasonably adjudicated both in the written law (and its regulations) and the practical administration of the law.

The above historical review of the U.S. federal experience indicates that the order of importance of these objectives, at least at the federal level, has shifted over time. The question I wish to examine now is how one might balance these objectives at the state level.

First, I should observe that opinions (and perhaps empirical evidence, although I am not aware of any systematic studies) vary considerably about the effect that public disclosure might have on voluntary compliance. Some argue that public scrutiny and pressure will force recalcitrant or reluctant taxpayers to be more complete in their tax filings, and that this in turn will reduce taxpayer fraud and reduce the amount of underpayment of taxes in gray areas where interpretation of the statutes permits taxpayers some leeway in determining their tax liability. Others argue that such publication will simply increase the reluctance of taxpayers to complete their returns and generally encourage their noncompliance with the tax laws. Under this view, the prediction is that public disclosure of tax returns would undermine the voluntary compliance system that is a major underpinning of our federal and state income taxes.

Most of this sort of discussion (e.g., the 1935 congressional debates) has taken place in the context of considering the publication of an individual's income tax details, rather than the particular circumstances in Massachusetts that require that only business taxpayers make public certain aspects of their state taxes. Several derivative issues arise. First, is it appropriate or compelling to have different public disclosure standards for individuals and for profit and nonprofit organizations? Second, does Massachusetts' apparently unique disclosure requirement for business taxpayers create other adverse consequences beyond withdrawal of access to federal tax return information or possibly reduced compliance with Massachusetts tax laws?

***Is it appropriate or compelling to have different public disclosure standards for individuals and for profit and nonprofit organizations?***

With respect to public reporting requirements for individuals versus organizations, one can distinguish among three policy positions:

Policy 1: The public reporting requirements are the same for individuals and organizations (at any level deemed appropriate, from zero public reporting to publicly putting returns in every known mailbox);

Policy 2: Organizations are required to publicly report more than individuals, e.g., Massachusetts HB 6358; or

Policy 3: Individuals are required to publicly report more than organizations.

I find it peculiar that Massachusetts decided to pursue Policy 2, rather than Policy 1, with a high level of required public disclosure of all taxpayers' information, or pursue Policy 3 with greater public disclosure of individual tax information vis-à-vis that of organizations. Certainly, most of the population is more familiar with the mechanics of filling out individual income tax returns and the implied issues of equity and tax avoidance that accompany various deductions and sources of income. That greater knowledge and understanding should improve the enforcement value derived from such public review, since the general public would more readily understand this sort of information.

The circumstances of many business tax returns, especially those of multistate businesses, are inherently more complicated. It is unlikely that the general public understands Massachusetts business tax rules or those of other states as well as it understands the tax rules governing individual income taxes. Furthermore, I doubt that the public understands the broad latitude that the federal courts have ceded to the states over the years in allowing them to define their own geographic attribution rules (the single-factor approach of Iowa, or the double-weighting of sales in the three-factor apportionment formula by other states) and the latitude in allowing each of the states to define the filing unit and nexus standards. Also, I doubt the public appreciates the considerable ambiguity in many state business income tax statutes. I would guess, overall, that public understanding of state business tax rules is in fact quite weak.

Further, given that the tax circumstances facing a multistate business in other states is not to be reported to the secretary of state for subsequent public inspection, the possibilities for misunderstanding and/or misinformation appear to be significant. One can only see a portion of the overall picture of a multistate business's tax situation by looking at Massachusetts' data, and one cannot readily conclude from one piece of the overall picture whether Massachusetts is under-, over-, or fairly taxing a company.

One might also conjecture that the likelihood of public misunderstanding or misinformation about the correctness or propriety of any business tax return would be quite great. Whether or not business taxpayer compliance would thus improve from a poorly informed or misinformed public review then seems to be more problematical than in the case of the review of individual income tax returns.

There are, of course, those who are expert in understanding business tax returns and for whom the public disclosure of tax return information serves other, nontax purposes. Those most knowledgeable are the domestic and international competitors of a particular company. Public disclosure in this instance could disadvantage the individual company as competitors learn the private details of the company's activities. For small public companies, and for companies with foreign competitors this problem is most pronounced, because for small companies there will be a close relationship between their state and federal return and what they provide to the Massachusetts secretary of state for public review. They would now have their private financial affairs subject to competitive scrutiny. Foreign competitors of a domestic firm would not have to disclose the financial circumstances of their offshore parent companies, while now gaining access to information about the financial circumstance of the domestic firm.

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I do not think these competitive considerations are merely theoretical but that they constitute an unwelcome byproduct of the newly enacted public reporting requirements. Given that other states do not require such public reporting and that businesses prefer to keep such matters private, it would appear that Massachusetts disadvantages itself vis-à-vis other states as a place in which to do business, or to locate or expand in to do business. Certainly holding constant other considerations that affect the business location decision (cost and quality of labor, transportation costs and proximity to markets, the tax cost and quality of various public services, the regulatory environment, etc.), the public reporting requirements are a distinct disadvantage.

Further, viewed in conjunction with a series of contentious fights over the state's budget, the revelations about the prior administration's very large budget deficit in the course of a presidential campaign, the passage and subsequent repeal of portions of the sales tax on services, and the earlier arguments

and ultimate constitutional curtailing of the size of Massachusetts' public sector (because of property tax limit initiative Proposition 2½), one can conclude that the newly enacted public reporting requirement is part of a history and tradition in Massachusetts of general political and fiscal instability, and that the legislative process often finds it convenient to target business taxpayers.

Whether or not this is good short-run or long-run politics is difficult to judge; however, given the generally poor state of New England's economy, sluggish economic growth, high levels of unemployment, and soft property values, it is difficult to see how these new, differential reporting requirements can be viewed as attracting business to Massachusetts, or at the margin, retaining businesses currently within Massachusetts. Given Massachusetts' recent history of fiscal instability, it would be prudent for firms considering moving into the state or expanding in the state to ascertain what else, in the areas of corporate tax disclosure or tax policy, lies in store for them.

Public concern over the extent of compliance by Massachusetts' business taxpayers has probably grown in recent times; however, it should not be surprising that as the recession deepened more firms wound up paying the minimum tax, and that business tax revenues decelerated or actually declined. Data to date indicate that by the late 1980s, the New England economy experienced an economic collapse of the relative magnitude that California is now experiencing. The demise of commercial real estate was especially difficult in New England, and this affected local and regional banks. Furthermore, international competition in various areas of technology and the slowdown in world demand for computer products adversely affected some of Massachusetts' largest companies. As business in New England declined faster than in other parts of the country, income attributable to Massachusetts fell and operating losses were generated. Tax receipts suffered at the state level, and the softness, or nominal decline, in property values adversely affected local property tax receipts.

It seems likely that these economic pressures have shifted at least the relative incidence of taxation from business to households, which in turn has created political discontent. Unfortunately, if this analysis is correct, the slowness of the economic recovery in New England means that such political conflict will continue. Moreover, to the extent that markets are inherently more competitive than before, the ability of companies to pay state taxes and pass them on to consumers through higher prices, or back to labor in the form of lower wages, is reduced.

### 6. Ways To Enhance Public Confidence in State Business Taxes: Improving Corporate Tax Reporting to the Massachusetts Department of Revenue

If I am correct in my earlier analysis that the public has a relatively poor understanding of state business taxes, especially as they are defined by the states and applied to multistate businesses, it seems likely that public review of such information for one state could easily lead to misinformation and more political conflict that would be detrimental to the state or region. There remains one outstanding question: How might one improve public confidence in any state's business taxes without resorting to public disclosure of them?

The primary challenge for any tax collector is to develop ways to enhance public confidence in a tax in terms of compliance and the uniformity of its application, and at the same time protect the privacy rights of taxpayers.

Public confidence in taxation requires at a minimum the confidence that the tax collector, in this case the Massachusetts Department of Revenue, operates in a uniform manner in the application of the tax statutes and is immune to political or other undue influence in the collection of taxes and the adjudication of disputes. Such confidence can be enhanced by extending civil service protection to the employees performing the collection and audit functions, and compensating employees at a level that continues to attract quality individuals. These are not just matters of executive branch leadership, but also matters of legislative interest and oversight. Unfortunately, it is all too common in periods of economic recession to cut the budget of the revenue agency when that function, collecting revenues to meet a constitutional requirement to balance the budget, becomes more important. Public confidence in the tax collection process is enhanced during difficult economic times if elected officials forgo this temptation to cut back on resources devoted to tax collection.

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Public confidence in a tax structure is also enhanced when the statutes enacted and the regulations promulgated are clearly written. Unfortunately, it is often the case that state revenue statutes are ambiguously written, and, as a result, litigation is required by taxpayers and the revenue authority to achieve sufficient clarity to administer parts of the tax law. Here, the legislative branch of government must claim primary responsibility, for it writes and passes the laws.

Public confidence in the tax system can also be enhanced by requiring taxpayers to disclose sufficient information to the tax authority so that the public can believe that audits can be performed by the tax authority without undue delay. My own preference in trying to balance the conflicting objectives of taxpayer privacy, taxpayer compliance, and public confidence in the administration of the tax system is to first ensure that the tax authority, here the Massachusetts Department of Revenue, has sufficient information to readily make a determination that the taxpayer has complied with the laws.

In the case of complex, multistate business tax returns, the state can be at a distinct disadvantage vis-à-vis the business taxpayer, because it does not have independent information available to determine if the entity claimed to be subject to tax in Massachusetts is a fair representation of the firm's overall activity; cannot readily independently check the various items of revenue and cost in getting to taxable income, and cannot readily independently check the denominators of the apportionment fractions to determine if the business is properly apportioning income to Massachusetts. In my judgment, the public reporting requirements contained in HB 6348 do not add to the information that the department has available in the examination of complex returns to aid in its compliance efforts, yet they sacrifice the essential privacy of the taxpayer.

One approach to improving compliance and public confidence while maintaining the essential privacy of the taxpayer is to require, through state statute, that each business taxpayer (i) submit to the Massachusetts Department of Revenue when filing its state tax return a copy of its bona fide federal corporate tax return as signed and filed with the Internal Revenue Service, and also (ii) submit to the Massachusetts Department of Revenue when filing its state tax return a signed, written explanation of the relationship between the bona fide federal return and underlying statement of consolidation, and the state business tax return.

***For large companies, there can often be a significant difference between the entity on the pro forma federal corporate tax return and the entity on the bona fide federal corporate tax return.***

For many multistate businesses, only a portion of their multistate business, as reported to the Internal Revenue Service, is properly subject to tax in Massachusetts (the balance has no nexus in Massachusetts), and, consequently, they comply with Massachusetts' current information requirement to include their federal return by creating and providing to Massachusetts a pro forma federal return which is what their federal corporate income taxes *would have been* had only the entity subject to Massachusetts tax filed at the federal level. For large companies, there can often be a significant difference between the entity on the pro forma federal corporate tax return and the entity on the bona fide federal corporate tax return. The latter is audited by the IRS, and the signatory does so under a set of quite certain responsibilities; the former is purely informational in nature and is not audited (and if different from the actual return, never filed with the IRS). Since the entity on the bona fide return will be different than the entity that has nexus in Massachusetts, the written explanation is necessary to relate the two sets of figures (revenues, costs, etc.).

Given Massachusetts' existing tax confidentiality rules for information provided by the taxpayer to the Department of Revenue, the essential privacy of the relationship between taxpayer and tax collector is maintained. At the same time, public confidence in Massachusetts business taxes should increase, because the Department of Revenue will have available much better information, which is independently reviewed by the Internal Revenue Service, about the overall business as well as an initial positive affirmation by the business taxpayer about how its activities in Massachusetts relate to its overall economic activities.

This information requirement was part of business tax reform legislation enacted in West Virginia in 1985.[13]

As noted earlier, if the public reporting requirements passed in January 1993 were limited to items other than federal tax return information, then the risks identified earlier to the Department of Revenue of losing access through the IRS to federal tax return information would disappear. Irrespective of these risks, there remains the public policy question of how the aforementioned objectives would be served, given greater corporate tax reporting to the Department of Revenue, by continued information requirements of nonfederal information.

Several observations are relevant here. First, the related requirement in Massachusetts HB 6348 that the Department of Revenue continue to analyze and publish more detailed aggregate statistics about state business taxes should ensure that the public can continue to be informed about the nature of various tax expenditures contained in Massachusetts business tax law. Second, the provision of additional federal information to the Department of Revenue will enhance this requirement for better aggregate statistics and further inform the public of the nature of Massachusetts' business taxpayers. Third, the legislative tax policy process will be increasingly informed and accountable through public debate as these aggregate statistics are refined and made annually available.

The remaining issue for Massachusetts involves whether or not state tax return information should be required to be disclosed, given that it is not directly or indirectly federal tax return information. There is some merit in requiring that companies which benefit from various tax credits be asked to report to the Department of Revenue on the economic and social benefits (e.g., increased employment) that have resulted from these incentives. Whether or not the company-by-company use of such credits and statements about economic impact should be a matter of public record is a difficult issue. One approach to resolving this would be first to require that the Department of Revenue collect such state information and statistically report the results of that effort. If public and legislative interest in the nature and benefits of such tax incentives is satisfied, then there would be no further need to make such information publicly available. Then, if such aggregate information were found to be deficient, the state could take the last step and require that it be made public through the Department of Revenue or secretary of state.

## 7. Appendix: Section 6103 (p) (8) (A) and (B) of IRC of 1986 as amended

(8) State Law Requirements. —

(A) Safeguards. —Notwithstanding any other provision of this section, no return or return information shall be disclosed after December 31, 1978, to any officer or employee of any State which requires a taxpayer to attach to, or include in, any State tax return a copy of any portion of his Federal return, or information reflected on such Federal return, unless such State adopts provisions of law which protect the confidentiality of the copy of the Federal return (or portion thereof) attached to, or the Federal return information reflection on, such State tax return.

(B) Disclosure of Returns or Return Information in State Returns. — Nothing in subparagraph (A) shall be construed to prohibit the disclosure by an officer or employee of any State of any copy of any portion of a Federal return or any information on a Federal return which is required to be attached or included in a State return to another officer or employee of such State (or political subdivision of such State) if such disclosure is specifically authorized by State law. ☆

[13] I have also suggested this as an alternative to the spreadsheet suggested by the Unitary Working Group after the *Container* decision, and in conjunction with federal collection of state corporate income taxes. *See* "Considerations in the Federal Collection of State Corporate Income Taxes," *State Tax Notes,* 1, 3 September 16, 1991, 81-89.