COST
COUNCIL ON STATE TAXATION



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**VIA EMAIL**
The Honorable Paul Marquart, Chair
The Honorable Dave Lislegard, Vice Chair
Minnesota Legislature
House Committee on Taxes

**Re: COST Opposes Portions of Amended H.F. 991**

Dear Chair Marquart, Vice Chair Lislegard, and Members of the Committee,

On behalf of the Council On State Taxation (COST), I am writing to oppose portions of H.F. 991, as amended by A21-0146 (House Omnibus Tax Bill), which would require controlled foreign corporations (CFCs) that earn global intangible low-taxed income (GILTI) in a particular year to be included in the domestic combined filing group if they are unitary with the group, unless the unitary group elects to make a worldwide election. No other state utilizes this form of reporting to calculate its corporate income taxes. Just as Minnesota has rejected the inclusion of GILTI in its tax base, Minnesota should also reject this approach. Finally, we also recommend an equitable modification to the State's rules for processing federal tax adjustments, as noted below.

## About COST

COST is a nonprofit trade association consisting of over 500 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. COST has a significant number of members that own property, have employees, and make substantial sales in Minnesota.

## COST's Research on the State Corporate Tax Impact of Federal Tax Reform

In March 2018, COST, through its affiliated State Tax Research Institute (STRI), issued a study entitled The Impact of Federal Tax Reform on State Corporate Income Taxes.[1] The study, conducted by Ernst & Young LLP (EY), estimated that state tax conformity

[1] The Impact of Federal Tax Reform on State Corporate Income Taxes, by Ernst & Young LLP for the State Tax Research Institute, March 2018, available at: http://cost.org/globalassets/cost/state-taxresources-pdf-pages/coststudies-articles-reports/the-impact-of-federal-tax-reform-on-state-corporateincome-taxes.pdf.

with federal tax reform would result in an average annual state corporate income tax base increase of 12% over the 10- year period between 2018 through 2027. This state tax increase contrasted sharply with the overall 10% corporate income tax decrease at the federal level from the TCJA. The difference in outcome at the state level was attributable to state conformity with federal corporate tax base broadeners but not with federal corporate tax rate cuts.

The study also concluded that Minnesota would experience an approximately 12% annual increase in its corporate income tax base – the same as the national average - if it conformed to certain provisions in the TCJA. In fact, the EY study underestimated the positive revenue impact in Minnesota. Based on a recent annual tax burden study conducted by EY on behalf of STRI, Minnesota's corporate income tax actually increased 21% from FY 2018 to FY 2019 ($1.4 billion to $1.7 billion).[2] This is greater than the national average which reflected an overall 17% increase in state corporate income taxes in FY 2019.[3] The large corporate income tax increase in Minnesota occurred even without State conformity to the federal GILTI provision.

**Including Controlled Foreign Corporations with GILTI in the Minnesota Domestic Combined Filing Group Is Unsound Public Policy**

Amended H.F. 991, similar to H.F. 2114, takes an approach to the taxation of GILTI that is more onerous than virtually any other state that has included GILTI in its corporate tax base. This legislation would require the inclusion of controlled foreign corporations (CFCs) that incur GILTI in a particular year in the domestic combined filing group if the CFCs are unitary with the group. The practical impact of including CFCs with GILTI in the domestic combined filing group is to compel Minnesota corporate taxpayers into something that closely resembles mandatory worldwide combined reporting. For many multinational businesses, particularly those in the services, digital, and financial industries, or those selling tangible property with older (depreciated) facilities, GILTI will constitute all or most of their foreign source income.

This would make Minnesota an extreme outlier, as no other state currently mandates this type of worldwide combined reporting. Amended H.F. 991 also raises fundamental fairness concerns because CFCs are included in the unitary group when they have GILTI but excluded from the group when they have no GILTI or have losses in their CFCs. Furthermore, CFCs would be included in the group whether they have small or large amounts of GILTI and regardless of whether the GILTI is subject to tax at the federal level (after the allowance for foreign tax credits). As a result, this legislation would arbitrarily (and perhaps unconstitutionally) allow the State to bring in income from CFCs when they have net GILTI, but exclude them, absent the 10-year election to use worldwide reporting when the CFCs have overall losses. Moreover, the bill would include CFCs in the Minnesota combined returns in years when the CFCs pay no federal tax on GILTI because of the utilization of foreign tax credits to offset the GILTI amounts.

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[2] "Total State and Local Business Taxes" business tax burden study for FY 2018 is available at: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/fy18-state-and-local-business-tax-burden-study.pdf. The FY 2019 business tax burden study is available at: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/2020-business-tax-burden-study---final.pdf.

[3] *Supra*, FY 2019 tax burden study.

## Problems with Mandatory Worldwide Unitary Combined Reporting

Mandatory worldwide combined reporting is not a new concept; nearly a dozen states imposed the filing methodology by the early 1980's. In a series of actions beginning in 1984 and accelerating over the next few years, however, all of those states granted taxpayers the right to file (or elect to file) using the water's-edge methodology, a position that has held fast in the states ever since. Pressure against mandatory worldwide combination had been building through the 1970s and early 1980s among both foreign governments and foreign and domestic multinational business enterprises, threatening to instigate an international tax war. The British and Japanese governments in particular, threatened retaliatory taxing measures against the U.S. to counter the trend toward mandatory worldwide combined filing. Although the U.S. Supreme Court upheld California's imposition of mandatory worldwide combined reporting in 1983, pressure from the international community continued to build, spurring President Ronald Reagan to convene the Worldwide Unitary Taxation Working Group in 1984, led by Treasury Secretary Donald Regan and comprising representatives of the federal government, state governments, and the business community.

Although the Working Group found it difficult to reach an agreement on several issues, it did agree on a set of principles designed to guide the formulation of state tax policy. Among those principles was a recommendation that states only enact "water's-edge" unitary combination for both U.S. and foreign-based companies. As noted, under the water's-edge method, only the income and the apportionment factors derived from operations within the domestic United States (i.e., up to the "water's edge") are used to calculate state corporate income tax liability. That principle has held to the current day. No state has returned to a mandatory combined reporting regime for all business corporations, and even the Multistate Tax Commission's model combined reporting statute includes a water's-edge election.

In addition to the international geopolitical reasons, states have also rejected the worldwide combined reporting approach because of the inequities and imbedded complexities. These include the potential for double taxation of foreign source income; the complexities of determining which foreign entities -- sometimes numbering in the hundreds -- are "unitary" with their U.S. affiliates; and the accounting difficulties resulting from different exchange rates, foreign accounting methodologies and technology platforms utilized by foreign affiliates. Minnesota's existing water's-edge filing regime is consistent with the regimes adopted by other combined reporting states, and there is no rational public policy reason for adopting a different approach for determining the tax base and apportionment factors for Minnesota's corporate income tax.

## Questionable Estimates of Global Profit Shifting and State Corporate Tax Revenues

Over the last twenty years, many countries lowered their corporate income tax rates to incentivize businesses to locate and expand there. As the disparity between corporate tax rates imposed by various countries grew, policy makers at the international level became concerned with the increased use of global profit shifting – the artificial shifting of income and activity from high-tax jurisdictions to low-tax jurisdictions. Efforts to combat global profit shifting have been underway at the Organization for Economic Cooperation and Development (OECD) for many years, culminating in its BEPS project recommending measures to address international "base erosion and profit shifting." During its deliberations, the OECD considered and rejected the use of mandatory worldwide combined filing. Similarly, the current OECD Pillar 1 and 2 proposals for reforming international taxation steer clear of any consideration of mandatory worldwide combined filing.[4] Finally, the U.S. Government, which adopted sweeping tax reform with the passage of the Tax Cuts and Jobs Act (TCJA) in 2017, moved away from its prior worldwide tax filing regime to a quasi-territorial tax system that includes a more limited taxation of foreign source income principally through the inclusion in the corporate tax base of 50 percent of global intangible low-taxed income.

Many economic papers have contributed to these efforts by attempting to quantify the global impact of profit shifting. Not surprisingly, the results of these studies vary dramatically, and each study contains disclaimers regarding the complexity, difficulty, and uncertainty of its conclusions. The process is made even more difficult because of the fluid nature of international taxation, with many nations such as the United States making or considering significant changes to their corporate income tax laws relating to global commerce. Nevertheless, a recent report by a partisan think tank seized on the high point of these studies and extrapolated that number to individual states through a series of assumptions and estimates. It then presented those numbers to the states as "money left on the table," and there for the taking if the state would only enact the discredited and still-controversial filing method known as mandatory worldwide combined reporting. These estimates (and the report) should be viewed with great skepticism. Not only does the Institute on Taxation and Economic Policy report rely on highly generalized and problematic global tax data, but it makes no effort to customize its estimate to reflect the laws of particular states or make adjustments to reflect changes in national corporate income tax laws.[5]

**Improvements to Minnesota's Rules for Reporting Federal Tax Adjustments**

COST, for the past two years, has raised concerns with the Minnesota Department of Revenue's approach to addressing the new federal audit procedures for partnerships, which also contain rules for reporting federal tax adjustments to the State.[6] We fully support adoption of the MTC's model legislation, jointly developed by COST and other interested parties (including state tax administrators).[7] However, one unresolved issue remains: any State and/or taxpayer adjustments arising from the taxpayer's federal tax adjustments that are otherwise beyond the Minnesota statute of limitations should be limited to the specific issues referenced in the federal changes. We recommend amended H.F. 991 address this by incorporating the following limitation in Section H of the MTC model:

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[4] At the subnational level, only one country other than the U.S. among the world's 49 largest economies imposes a corporate income tax on any portion of foreign source operating income. See "Survey of Subnational Corporate Income Taxes in Major World Economies: Treatment of Foreign Source Income," prepared by PricewaterhouseCoopers LLP for the State Tax Research Institute, November 2019.

[5] Institute on Taxation and Economic Policy and U.S. PIRG, "A Simple Fix for a $17 Billion Loophole: How States Can Reclaim Revenues Lost to Tax Havens", January 17, 2019, pp 17-18.

[6] See for example comments filed by COST last year on H.F. 3389 available at: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-comments-and-testimony/03042020-cost-testimony-re.-hf-3389-final.pdf.

[7] MTC model legislation is available at: https://www.mtc.gov/MTC/media/AUR/Proposed-Model-RAR-Statute-Technical-Corrections-(10-25-20).pdf.

> Scope of Adjustments and Extensions of Time. Unless otherwise agreed in writing by the Taxpayer and the [State Agency], any adjustments by the [State Agency] or by the Taxpayer made after the expiration of the [State's normal statute of limitations for assessment and refund] is limited to changes to the Taxpayer's tax liability arising from Federal Adjustments.

This provision applies equitably to taxpayers and the State to limit the scope of adjustments solely to the federal tax adjustments after the State's general statute of limitations for assessments/refunds has expired.[8]

## Conclusion

Minnesota's current water's-edge filing provision serves not only as a practical limitation on combined reporting that reduces the incidence of double taxation and economic distortion, but it also keeps the State within the conventional norms of business taxation. The adoption of the required combination provisions in this bill would place Minnesota at huge competitive disadvantage among states and would send a warning flag to multinational businesses that the state is a hostile environment for business expansion and relocation. Finally, the scope of any State or taxpayer adjustments after the State's normal statute of limitations has expired should be limited to only those issues responsible for the federal tax changes.

Respectfully,

Fredrick J. Nicely

cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director

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[8] This position is also addressed in a COST Policy Statement, State Reporting Requirements for Federal Tax Changes, available at: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-policy-positions/cost-federal-tax-changes-rar-policy-oct-2019.pdf.