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June 26, 2017

Chair Michael D. Brady
Chair Jay R. Kaufman
The General Court of the Commonwealth of Massachusetts
Joint Committee on Revenue

Via E-mail

Re: COST's Opposition to S.B. 1548 ("Accurate Reporting of Corporate Profits"/Mandatory Worldwide Combined Reporting)

Dear Chair Brady, Chair Kaufman, Vice Chair Creem, Vice Chair Campbell, and Members of the Committee:

On behalf of the Council On State Taxation (COST), I am writing to oppose legislation that would repeal the Commonwealth's current corporate excise tax provisions that provide for "water's edge" filing by unitary corporate groups. In its place, the bill would make mandatory the election to subject the worldwide unitary business group to combined Massachusetts corporate excise tax filing.

Mandatory worldwide combined filing is contrary to the approach to taxing corporate profits employed by virtually all U.S. trading partners and was rejected by the U.S. states over 30 years ago. Repealing the water's-edge filing method would make Massachusetts an outlier among states utilizing unitary combined reporting. Senate Bill 1548 not only significantly increases the likelihood that businesses engaged in multinational operations will be subject to double taxation, it sends a signal to our international trading partners that Massachusetts does not value them.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of nearly 600 major 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.

The Water's-Edge Election

Generally, Massachusetts' water's-edge provision limits the determination of income subject to apportionment to the income and apportionment factors of a group of unitary companies operating within the "water's-edge" of the United States. Senate Bill 1548 would eliminate the water's-edge provision and make mandatory the current election to include non-U.S. corporations in the determination of the Massachusetts corporate excise

tax liability (*i.e*., mandatory worldwide combined reporting). If S.B. 1548 were enacted, Massachusetts would be the only state in the nation to employ mandatory worldwide combination, and the only state to apply such a method since Alaska adopted water's edge legislation for most companies in 1991.

Although multi-national corporate affiliations existed well before the turn of the century, it wasn't until sometime in the late 1960s and early 1970s that certain states began to require foreign affiliates to be combined as part of a unitary group. This method (worldwide combination) became the subject of much international attention because of its implications for taxing foreign-earned income.

Although California ultimately prevailed before the United States Supreme Court on the constitutionality of its worldwide combination scheme, it became clear very quickly that worldwide combination was not simply a domestic tax issue. Some of our nation's most important trading partners vociferously objected to its use as well. From the perspective of foreign nations, worldwide combination was seen as an attempt to tax activities occurring overseas, and to place on their companies doing business within the U.S. a burden that was not placed on U.S. companies operating abroad. In fact, in 1985, the United Kingdom approved legislation that would have allowed the U.K. Treasury to penalize multinational groups of companies with operations in any U.S. state that employed worldwide unitary combination. Similarly, many Japanese businesses announced that they would not locate or expand operations in any state that applied worldwide combination.

As a result, worldwide combination was thoroughly investigated in the 1980s by the Department of the Treasury's Worldwide Unitary Taxation Working Group, commissioned by then President Ronald Reagan. The Working Group included representatives of the federal government, the states (both the legislative and executive branches), and the business community.

In the Working Group's final report to the President (July 31, 1984), Treasury Secretary Donald Regan noted that the Working Group agreed on three principles that should guide the state taxation of the income of multinational corporations. The first principle was that a water's-edge election be provided by states for both U.S. and foreign based companies. Secretary Regan recommended that federal legislation be enacted to that effect if the states failed to resolve the issue on their own. Indeed, such federal legislation was introduced in Congress that would have precluded the states from adopting mandatory worldwide combination.

Fortunately, both the need for federal legislation and the potential for retaliation by some of our nation's closest trading partners were averted when the states that employed combined reporting adopted water's-edge elections and have maintained them ever since. Even the Multistate Tax Commission's model combined reporting statute includes a water's-edge election.

The elimination of the water's-edge approach is also out of sync with the approach taken by the rest of the world—including the U.S. Currently, the U.S. Congress and the Trump administration are proposing major tax reform, and both proposals move the U.S. away from its current worldwide tax filing regime towards a territorial tax system. Further, the current U.S. tax system is based on international transfer pricing principles, the deferral of foreign earnings, and application of a foreign tax credit upon repatriation, none of which are respected by state unitary formulary apportionment. Thus, state efforts to apportion and tax worldwide income are contrary to both the current U.S. approach and current federal tax reform proposals to improve U.S. competitiveness.

At an international level, the vast majority of industrialized nations use a territorial tax system. Moreover, the recent Base Erosion and Profit Shifting (BEPS) project, spearheaded by the

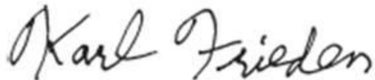
Organization for Economic Cooperation and Development (OECD), affirmed the territorial approach for international taxation by rejecting a worldwide tax base and instead prescribing a series of policy initiatives within the territorial system to address the issue of profit shifting.

In addition to being out-of-step with other states, the federal tax reform efforts, and the international tax community, Massachusetts would be putting its foreign direct investment and jobs at risk. During the 1980s worldwide reporting debacle, discussed above, foreign nations did authorize retaliatory tax treatment against U.S. multinationals, forcing federal involvement. Such actions would almost certainly recur with the passage of S.B. 1548. This would undoubtedly affect Massachusetts's economic development and ability to attract foreign direct investment.

Conclusion

Massachusetts' water's-edge provision serves not only as a practical limitation on combined reporting that reduces the incidence of double taxation and economic distortion, it also removes a significant barrier to trade with our nation's leading trading partners. Senate Bill 1548's proposed repeal of the water's-edge provision would not only signal the necessity to revisit federal legislation, but would also raise an unfortunate warning flag for those foreign investors considering direct investment in Massachusetts. COST respectfully opposes S.B. 1548 and urges the Members of the Committee to reject it.

Respectfully,



Karl A. Frieden

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