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April 17, 2018

Senate Taxes Committee
Minnesota State Legislature

Re: COST's Support for Legislation to Decouple from Certain Corporate Tax Provisions in Federal Tax Reform

Dear Chairman Chamberlain and Members of the Committee:

On behalf of the Council On State Taxation (COST), representing approximately 550 corporations engaged in interstate and international business, I write in support of amending S.F. 3982 to decouple from certain provisions of federal tax reform (commonly referred to as the Tax Cuts and Jobs Act) that would negatively impact Minnesota businesses and place the State at a competitive disadvantage. These include, but are not limited to, new federal provisions imposing tax on "global intangible low-taxed income" (I.R.C. Sec. 951A) and limiting interest deductibility (I.R.C. Sec. 163(j)).

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

COST, through its affiliated State Tax Research Institute (STRI), has undertaken a study of *The Impact of Federal Tax Reform on State Corporate Income Taxes*.[1] The study, conducted by Ernst & Young LLP indicates that state tax conformity with federal tax reform will result in an average corporate tax base increase of 12% over the 10-year period between 2018-2027. This estimate assumes that states will update their conformity dates to link with the Internal Revenue Code as of January 1, 2018 (thus including the changes under the Tax Cuts and Jobs Act) but remain decoupled from specific federal provisions as they have in the past.

The study concludes that Minnesota would experience an approximately 12% increase in its corporate income tax base as a result of conformity to these I.R.C. provisions. This increase is averaged over the next 10 years and will vary depending on the timing of the various federal changes.

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[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-tax-resources-pdf-pages/cost-studies-articles-reports/the-impact-of-federal-tax-reform-on-state-corporate-income-taxes.pdf.

Global Intangible Low-Taxed Income

Over the last 30 years, states – including Minnesota – have generally limited their corporate income tax base to the water's edge (*i.e*., to income earned in the U.S.). With federal tax reform, the federal government is moving from the taxation of "deferred" foreign source income to the taxation of a portion of current foreign source income primarily to achieve two objectives that either do not apply to the states or cannot legally apply to the states.

First, Congress is raising $324 billion over 10 years from international tax reform to help pay for $654 billion over 10 years in other business tax reform cuts. The states, by contrast, do not conform to the federal corporate tax rate cuts and therefore have no reason to expand their tax base to make up for the lost revenue. Conforming to the GILTI provisions would represent a selective and arbitrary conformity that harms a segment of Minnesota businesses competing internationally, without advancing any compelling tax policy goal for the State.

Second, the new taxation of foreign source income and related provisions is intended to shift the U.S. tax laws toward favoring domestic commerce over foreign commerce. While this may be a permissible goal for the federal government, states are limited by constitutional provisions such as the Foreign Commerce Clause that make it impermissible to favor domestic commerce over foreign commerce. Further, GILTI represents income from active foreign operations and would need to be represented in apportioning taxpayers' income to Minnesota. Thus, while conformity to GILTI provisions may represent a modest short-term revenue boost (selective tax increase), this revenue would be subject to extensive litigation and may need to be refunded to taxpayers, in whole or in part, at a later date. In the meantime, the associated uncertainty and complexity of administration would distort business decisions and unduly burden the State Department of Revenue.

In the midwestern states, Wisconsin (A.B. 259, enacted on April 3) recently clarified that its corporate tax base does not include GILTI, and Illinois and Michigan do not include GILTI in their corporate tax base due to existing decoupling from the Internal Revenue Code.

Interest Expense Limitation

The federal provision with the largest impact on the Minnesota corporate income tax is the 30% limitation on net interest expense deductions under the revised I.R.C. Sec. 163(j). This limitation on business interest expenses would expand the Minnesota corporate income tax base by an average of approximately 7% over the next ten-year period.

All of the aforementioned corporate base broadeners at the federal level funded, in part, the substantial reduction in federal corporate tax rates to make the U.S. more competitive internationally. These rate reductions, of course, do not flow through to the states, and therefore Minnesota conformity would result in a substantial corporate income tax increase. This outcome is entirely inadvertent, as the Minnesota State Legislature did not enter its legislative session intending to limit legitimate business deductions for investing in the State.

The state-specific outcomes are arbitrary and inconsistent with the goals of federal tax reform. For example, the federal law provides for immediate expensing of capital assets, but Minnesota is already decoupled from federal "bonus" depreciation under I.R.C. Sec. 168(k). Therefore, this benefit, available at the federal level, is not available to Minnesota taxpayers for their capital investments, but Minnesota taxpayers also would be limited in their ability to deduct interest expense on financing such investments.

Moreover, the I.R.C. Sec. 163(j) provisions limit interest expense across the board, for both intercompany and third-party borrowing, and thus impact all borrowing by Minnesota taxpayers for both business operations and investment/expansion. This result harms Minnesota's competitiveness, especially in light of recent decisions by other states to decouple from these provisions (see Georgia H.B. 918, enacted on March 2, and Wisconsin A.B. 259, enacted on April 3).

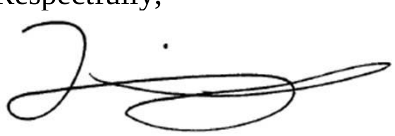
Applying the interest expense limitation in Minnesota would also significantly increase the complexity of corporate tax compliance, as much remains to be determined, both at the federal level and by the Minnesota Department of Revenue, on how to implement this provision. It is uncertain how the interest expense limitation will be computed and reflected in federal consolidated return filings, and commensurately how to determine if, and in what amount, the limitation applies at the state filing level. No state has answered these questions to date (and answers to these questions will depend on the details of federal guidance).

Conclusion

Minnesota should consider decoupling from provisions of federal tax reform that inadvertently expand the corporate tax base and harm Minnesota's competitiveness for business investment and growth, such as provisions including GILTI in the Minnesota corporate tax base and limiting interest expense deductions.

I am happy to answer any questions or provide further information regarding COST's research in this area.

Respectfully,



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