COST
COUNCIL ON STATE TAXATION

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VIA EMAIL
Minnesota Legislature
Conference Committee on Taxes

Re: COST Opposes House Version of H.F. 2125 & Supports Most Tax Changes in Senate Version of H.F. 2125

Dear Co-Chairs Rep. Paul Marquart and Senator Roger Chamberlain, and Members of the Conference Committee:

On behalf of the Council On State Taxation (COST), we are writing to oppose the House version of H.F. 2125 (hereafter "House Version") that would retroactively couple Minnesota with some of the most significant and harmful corporate tax base expansion provisions of the 2017 federal Tax Cuts and Jobs Act (TCJA). Conversely, COST supports many aspects of the Senate version of H.F. 2125 (hereafter "Senate Version") which takes a more reasoned approach to addressing provisions of the TCJA and other tax changes unrelated to the TCJA.

Summary of TCJA Provisions Important to COST

At the federal level, the TCJA resulted in about a 10% corporate income tax cut. However, state conformity with the TCJA would result in about a 12% corporate tax increase in Minnesota since the state would not conform to the federal corporate tax cuts but would conform to the revenue raising corporate tax base expansion provisions.[1] Outlined in more detail below, several of the specific conformity measures in the House Version would impose unfair, harmful, and potentially unconstitutional retroactive changes. These include, on a retroactive basis:

- Imposing a tax year 2017 "transition tax" under IRC § 965;
- Conforming for tax year 2018 (and beyond) to several large revenue raising corporate tax provisions including broadening the domestic combined filing group to include controlled foreign corporations with global intangible low-taxed income (GILTI);
- Imposing the interest expense limitation under IRC§163(j); and
- Conforming to the net operating loss restrictions under IRC § 172.

[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/cost-studies-articles-reports/the-impact-of-federal-tax-reform-on-state-corporateincome-taxes.pdf.

In contrast, with the exception of conforming to the interest expense limitation under IRC section 163 (j), the Senate Version does not adopt these retroactive and harmful expansions of the state corporate income tax base; however, it can still be improved, as noted below.

Summary of Other Tax Provisions Important to COST

This letter also addresses some proposed tax changes outlined in more detail below. In general, COST supports the following provisions in the Senate Version:

- Sales tax changes to include audit restrictions and vendor allowance (which COST recommends expanding to all sellers), and to omit the House Version's unnecessary and onerous quarterly filing requirements for marketplace facilitators;
- The federal audit provisions, which in contrast to the House Version, apply an equitable statute of limitations and address concerns with tiered partnerships; and
- Requiring the Minnesota Department of Revenue to provide private letter rulings.

About COST

COST is a nonprofit trade association consisting of approximately 550 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*.[2] The study, conducted by Ernst & Young LLP, determined that state tax conformity 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. For purposes of this estimate, the study assumed that states would update their conformity dates to link with the Internal Revenue Code as of January 1, 2018 (including the changes under the TCJA) but remain decoupled from specific federal provisions as they have in the past. The study concluded that Minnesota would also experience an approximately 12% annual increase in its corporate income tax base if it conformed to the TCJA. This increase is averaged over the next 10 years, and the estimated corporate tax base increase for each year varies depending on the timing of the various federal changes.

Retroactive Imposition of Transition Tax – IRC § 965

Because the House Version would retroactively impose a tax on IRC § 965 income, the measure raises serious Due Process and other tax policy concerns. The TCJA changes to IRC § 965 impose a "transition tax" on certain deferred foreign source income – the result of the U.S.

[2] *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/cost-studies-articles-reports/the-impact-of-federal-tax-reform-on-state-corporateincome-taxes.pdf.

federal government moving from a worldwide to a quasi-territorial system of taxing multinational businesses. Repatriated income under IRC § 965 is taxed by including all of the post-1986 previously untaxed earnings of certain foreign subsidiaries of a US shareholder as a special classification of Subpart F income. The transition tax allows the netting of the earnings and profits of foreign corporations owned by a US shareholder. The amounts are reportable on the last return of the foreign corporations for tax years beginning before January 1, 2018. Importantly, the tax rate at the federal level on this income is at a reduced rate: 15.5% for a foreign cash position and 8% for the remaining amount, and payment of the tax can be made in installments over eight years. While the House Version would allow installment payments with a catch-up payment that would apply to tax year 2018, retroactively imposing this tax raises serious constitutional concerns, may lead to protracted litigation, and will negatively impact Minnesota as a fair state to conduct business. The Senate Version wisely would not impose a tax on the 2017 tax year federal transition deferred income—avoiding the inequitable inclusion of that income and protracted litigation over the very troubling Due Process concerns with imposing a retroactive tax on income back to tax year 2017.

Retroactive Imposition of Global Intangible Low-Taxed Income (GILTI)

Over the last 30 years, states have generally limited their corporate income tax base to the water's edge (*i.e.*, to only income earned in the U.S.). With federal tax reform, the federal government is moving from the taxation of all foreign source income primarily on a "deferred" basis to taxing a more limited range of foreign source income – including GILTI – primarily on a "current" basis. However, federal taxation of GILTI is very different than state taxation of GILTI from both a policy and a practical outcome perspective. Additionally, GILTI is not the traditional subpart F income that Minnesota has previously partially included in its corporate income tax base.

First, Congress is raising $324 billion over 10 years from the international tax reform provisions (including GILTI) to help pay for $654 billion over 10 years in other business tax reform cuts. Minnesota, by contrast, is not conforming to the federal corporate tax rate cuts. Therefore, Minnesota has no reason to expand its 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, at the federal level, the focus of the GILTI provision is to include in the federal income tax base "low-taxed" foreign source income – basically income that is taxed in foreign countries at less than 13.125 percent. To achieve this practical outcome the federal government imposes a tax rate of 10.5 percent (one-half of the federal statutory rate) on the GILTI income and allows a credit for 80 percent of foreign taxes paid on such income. However, state corporate income tax laws in Minnesota, and in other states, do not allow for foreign tax credits. Therefore, all the GILTI income, from low and high-tax countries, would be subject to state corporate income tax.[3] This would constitute a vast and unprecedented expansion of the state corporate income tax base to include previously untaxed foreign earnings.

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[3] Joseph X. Donovan, Karl A. Frieden, Ferdinand S. Hogroian, and Chelsea A. Wood, "*State Taxation of GILTI: Policy and Constitutional Ramifications*," State Tax Notes, October 22, 2018. For more detailed information on the

As a result, to date, at least 17 states have decoupled from the GILTI provisions including virtually all of the states in the Midwest. Among the states fully (or 95%) decoupling (by legislation or administrative action) from GILTI are Connecticut, Georgia, Hawaii, Illinois, Indiana, Kentucky, Massachusetts, Michigan, Mississippi, Missouri, New Mexico, North Carolina, Oklahoma, Pennsylvania, South Carolina, Virginia, and Wisconsin. Moreover, six additional states (including California) have not specifically addressed IRC conformity or GILTI conformity and thus GILTI does not apply in those states.

Moreover, the House Version 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. Rather than directly attempting to impose the tax on GILTI as calculated at the federal level, the House Version would require controlled foreign corporations (CFCs) that incur GILTI in a particular year to be included in the domestic combined filing group, subject to the CFCs being 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 worldwide combined reporting.*** The House Version also raises fairness concerns over complicated compliance (for both the government and taxpayers) when 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). The result of the House Version is to 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 House Version 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.

By contrast, the Senate Version takes a more reasonable approach by excluding GILTI from the Minnesota corporate tax base. COST strongly supports the Senate Version's exclusion of GILTI from the tax base.

apportionment concerns, *see* Karl A. Frieden and Joseph X. Donovan, "*Where in the World is Factor Representation for Foreign-Source Income*?" State Tax Notes, April 15, 2019.

[3] *See* Retail Sales Tax Compliance Cost, National Estimate (April 2006). The study estimated the cost of collection for all sellers to collect the states' sales/use taxes was around 3.09%; study available at: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/other-state-tax-studies-articles-reports/jccspartifinalreportvoli.pdf.

Retroactive Interest Expense Limitation under IRC § 163(j) & Immediate Expensing Limitation under IRC § 168(k)

The TCJA imposes a 30% limitation on net interest expense deductions under the revised I.R.C. § 163(j) and provides for immediate expensing of asset purchases under IRC § 168(k). Both the House and Senate impose a limitation on business interest expenses which would inappropriately expand the Minnesota corporate income tax base, especially when considering the legislation would not allow immediate expensing under IRC § 168(k). Once again, this corporate base broadener 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's selective conformity to the interest expense limitations and disallowance of the full "bonus" depreciation (that was coupled with the interest expense limitations at the federal level), would result in a substantial corporate income tax increase.

The state-specific outcomes of conforming to the TCJA are arbitrary and inconsistent with the goals of federal tax reform. For example, the IRC § 163(j) provisions limit interest expense across the board, for both intercompany and third-party borrowing, and thus will impact borrowing by Minnesota taxpayers for both business operations and investment/expansion. This result ultimately harms Minnesota's competitiveness, especially in light of decisions by other states in 2018 to decouple from these provisions (see, *e.g.*, Connecticut, Georgia, Indiana, South Carolina, Tennessee, and Wisconsin).

Retroactively applying the interest expense limitation to tax year 2018 as proposed by H.F. 2125 and SF 5 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 these provisions. 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. Few states have answered these questions to date (and answers to these questions will depend on analysis and further development of federal guidance). If this provision is adopted, we recommend the inclusion of language in the legislation that would require that the limitation be computed on a combined reporting basis similar to the federal consolidated return basis rather than potentially computing the limitation on a separate legal entity basis. Finally, COST strongly encourages this Conference Committee to decouple from the interest expense limitations under IRC § 163(j), but if it proceeds forward with that proposal, it should only apply IRC § 163(j) to tax years starting after the effective date of the tax bill.

New Operating Loss Restrictions

COST is concerned that neither the House Version nor the Senate Version in effect allow immediate expensing under IRC § 168(k) because both the House Version and Senate Version would require an add back of that immediate expensing under current Minnesota law to be taken over the next five years. Fortunately, the Senate Version does not impose the net operating loss limitations that mimic those imposed at the federal level to only allow an 80% utilization. Requiring an add back to the immediate expensing is not equitable given both the House Version and the Senate Version would apply the interest expense limitations under IRC § 163(j). However, the Senate Version, which would allow taxpayers to continue to fully utilize their net operating losses under Minnesota's current law, helps mitigate (but does not eliminate) this inequity and, therefore, is much preferred over the House Version which would impose a 20% restriction on the use of taxpayers' net operating losses.

Sales Tax Changes

Minnesota was one of the first states to enact a marketplace facilitator sales tax collection law and some cleanup over the next couple of years is likely needed to provide greater uniformity among the states. However, the proposed changes to require onerous quarterly reporting in the House Version is unwarranted and would unnecessarily increase compliance costs for marketplace facilitators. COST supports the Senate Version which does not contain this provision. In addition, the House Version would impose restrictions on the allowance of a sales tax refund for the purchase of software housed in data centers located in the state which would discourage businesses from continuing to operate and expand their operations in Minnesota. COST supports the Senate Version which does not modify this existing refund provision. This will encourage data centers to continue to make investments in the State. There is also an equitable provision in the Senate Version that would preclude a taxpayer from being assessed if the Minnesota Department of Revenue on a prior audit made no corresponding adjustment to reviewed transactions, absent a change in the State's law or notice from the Department. COST supports this provision. This is important because sellers are acting as collection agents for the state and should be able to rely on prior findings by the Department. A vendor allowance is also provided in the Senate Version, which COST supports; however, it could be significantly improved by increasing the amount of compensation (Senate Version proposes to allow 0.5% of tax collected) and expanding it to allow all sellers, as forced collection agents for the State, to offset some of their costs to collect and remit the State's sales tax.[4]

Federal Audit Adjustment Changes

The Multistate Tax Commission (MTC), working with state tax administrators and interested parties such as COST, has spent almost two years developing a model statute that addresses changes to how partnerships are audited and assessed at the federal level[5] and for taxpayers to report federal adjustments (*e.g.*, IRS audit adjustments) to the states in a manner efficient for both tax agencies and the taxpayers. The MTC formally approved its model on January 24 of this year. Unfortunately, the House Version incorporates language from H.F. 2169, which selectively incorporates some provisions of the MTC model legislation; however, it contains major deviations that would impede fair and efficient reporting of federal tax adjustments. One significant deviation is the impractical requirement for a partnership to know the residency status of all indirect partners (*e.g.,* a partner in a partnership that has an ownership interest in the audited partnership) in order for

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[4] *See* Retail Sales Tax Compliance Cost, National Estimate (April 2006). The study estimated the cost of collection for all sellers to collect the states' sales/use taxes was around 3.09%; study available at: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/other-state-tax-studies-articles-reports/jccspartifinalreportvoli.pdf.

[5] The MTC Model is available at: http://www.mtc.gov/getattachment/Uniformity/Adopted-Uniformity-Recommendations/Model-RAR-Statute.pdf.aspx?lang=en-US.

the audited partnership to remit the tax on behalf of its partners. Another significant provision of concern is the unfair statute of limitations provisions which would allow the DOR to make unrelated adjustments to a taxpayer's return when federal audit adjustments are being reported, but prohibit a taxpayer from making similar unrelated adjustments.[6] In addition, if the federal audit resulted in a refund, these provisions would prevent a taxpayer from receiving a refund if the federal audit was completed after Minnesota's regular statute of limitations had closed. The provisions in the Senate Version are aligned with SF 1522/H.F. 1486, which COST supports, and which treat the DOR and taxpayers fairly and equitably when federal audit adjustments are being reported, and more closely follow the MTC model. Additionally, the Senate Version addresses potential concerns over tiered partnership structures being used to evade tax following a federal audit adjustment. For these reasons, COST strongly recommends adoption of the federal audit adjustment and partnership audit provisions in the Senate Version by this Conference Committee.

Private Letter Rulings

The ability for taxpayers to request private letter rulings is addressed in the Senate Version, another provision which COST supports. Importantly, it would provide guidance for taxpayers on Department of Revenue positions because private letter rulings would be public (with confidential taxpayer information redacted). It is important for taxpayers to receive guidance from the Department on the application of the tax laws rather than learning about the Department's interpretation of these laws during an audit. Hopefully, the maximum fee of $1,000 would only be imposed for ruling requests that are extremely complicated.

Conclusion

For the aforementioned reasons, COST urges the Committee to oppose the tax provisions contained in the House Version and to support the majority of the provisions in the Senate Version.

Respectfully,

Karl Frieden

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Fred Nicely

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

[6] COST submitted written testimony in support of H.F. 1486 which more closely followed the MTC model and in opposition to H.F. 2169 on March 14, 2019 to the House Committee on Taxes; available at: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-comments-and-testimony/031419-cost-testimony-hf-1486-hf-2169---rar-final.pdf.