Massachusetts Taxpayers Foundation

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The Commonwealth of Massachusetts boasts a robust economy with a well-paid and highly educated workforce, and maintaining both is critical to the long-term health and stability of our state. To do this, Massachusetts must ensure not only that it fosters the creation of new businesses, but also that it is an attractive place to expand and maintain existing businesses.

The state's corporate tax plays an important role in its attractiveness to business. When evaluating our corporate tax, it is important to keep in mind three principles that foster economic growth and job creation: competitiveness, predictability, and simplicity.

A competitive corporate tax is perhaps more critical than ever before because of the shift to a global economy. Long-distance communication and interaction between employees is getting easier almost by the day, and this makes it easier for businesses to move operations to other states. For these decisions, the tax environment can be a major influence in whether to stay or expand in Massachusetts. Businesses rarely react immediately to corporate tax legislation with large, headline-grabbing layoffs; instead, the shift occurs (and has occurred) over time as employers choose to expand in other locations.

Predictability is another important factor in the state's corporate tax, and this holds true for individuals as well as businesses. Continually revising the state's tax statute and regulations and administering the tax in a way that departs from established interpretations breeds uncertainty. Like individual taxpayers, corporate taxpayers want to have a clear understanding of what is expected of them. Massachusetts has a particularly poor reputation for predictability, especially when compared to other states.

Part of predictability is simplicity, so that fewer aspects of tax law and regulations are open to dispute. It is important that a corporate tax be clear and straightforward, with limited room for interpretation, in order for businesses to comply with it easily and for the state to administer it fairly and predictably. A state is not an attractive place to run a business if it places excessive burdens on taxpayers in order to comply with vague or unnecessary rules or if it applies haphazard interpretations of statute and regulations.

The Commonwealth, through legislation, administrative interpretations, and audits is increasingly fostering a tax environment that is not competitive, predictable, or simple. It is important to remember that the tax legislation heard today has implications beyond the static impact on state revenues, and the MTF asks the Committee to consider whether these impacts will contribute to a more competitive, more predictable, and simpler tax statute that will enhance the state's long-term fiscal health.

This testimony addresses three legislative proposals: *An Act closing a certain corporate tax haven loophole* (H2477, S1524) which the MTF opposes; *An Act to clarify the net worth tax* (S1546, S1565, H2548) which the MTF supports; and *An Act relative to excessive executive compensation* (S1509) which the MTF opposes. The MTF is available to provide additional background or answer any questions on any of these three proposals.

Tax Haven Legislation

The proposed legislation to close a so-called corporate tax haven loophole (*An Act closing a certain corporate tax haven loophole,* H2477 and S1524) is overly broad and rife with flawed logic. It provides vast authority to the state's Department of Revenue (DOR), while creating enormous burdens that penalize all multi-national corporations with a presence in Massachusetts.

First, and perhaps most importantly, this legislation includes a provision that has nothing to do with tax havens. It allows the Commissioner of Revenue to require corporate taxpayers using the water's edge election to submit the income reported, tax liability, and apportionment method used in each U.S. state for each of its U.S. affiliated corporations in the combined report. Such reporting would be required of any multi-national corporation electing water's edge reporting, regardless of whether they operate in one of the so-called tax havens. Put simply, this provision does not relate to international tax havens or address illegal tax evasion. It is egregious, unnecessary, and violates taxpayer confidentiality.

Second, this legislation assumes that any presence in a so-called tax haven is motived solely by tax avoidance which is simply not the case. Businesses may have acquired companies with a presence in these jurisdictions for any number of reasons, such as to access a business process or product design or to reach an expanded customer base.

There are numerous other factors that affect decisions on where to locate in the international market, including the stability of the government, strength of educational systems, quality of life for employees, and proximity to centers of commerce. Furthermore, the vast majority of consumption of goods and services takes place outside of U.S. borders, so there is a need for a business presence around the world.

Proponents of the tax haven legislation describe it as ensuring fairness; however, upon greater scrutiny it is clear that the list of tax haven countries was compiled for a different purpose and is arbitrary at best.

This list was developed several years ago by the the Organisation for Economic Co-operation and Development (OECD) with respect to transparency of tax laws in each of those countries and not for the purpose of measuring the sufficiency of their tax law. The OECD's Global Forum on Transparency and Exchange of Information – the international body charged with overseeing the implementation of international standards on transparency and information sharing in order to curb tax evasion – has since rated several of the so-called tax haven countries, including Singapore and Hong Kong, as "largely compliant," which is the same rating it gives to the United States. Furthermore, the exclusion of countries with similar tax rates and transparency standards indicates that there is no clear set of rules for deeming a country a tax haven.

This legislation also makes no distinction between no tax and a low tax rate. While all of these countries have a lower corporate tax rate than the United States – which has one of the highest in the developed world – many do in fact levy taxes on businesses, often at a rate higher than even the Massachusetts state corporate income tax.

Proponents also argue that corporations conducting legitimate business in these countries may opt to pay the state's corporate tax using worldwide reporting rather than using the water's edge election. However, this ignores the great complexity and burden that worldwide reporting presents, both for business and the DOR. Countries have starkly different tax regimes and different definitions of income, among other differences. Furthermore, returns that are submitted in different languages would need to be translated by the taxpayer in order for DOR to verify information. In short, worldwide reporting is not a practical option for any stakeholder.

The problems with this legislation are numerous, and our testimony addresses only a few. The MTF is available to discuss this issue in depth with any members of the Committee.

Net Worth Legislation

The MTF strongly supports a full repeal of the net worth tax, as proposed by several legislators, however, this testimony deals solely with S1546/S1565/H2548, *An Act to clarify the net worth tax*, which the Foundation also strongly supports.

Massachusetts, unlike most other states, has a non-income measure of the corporate excise tax, often referred to as the net worth tax. In addition to paying an eight percent tax on their corporate income, corporations pay another tax to the Commonwealth on their property or net worth. This separate component of the corporate excise tax has its own set of rules. Already among a dwindling group of states with a so-called balance sheet tax, DOR's approach on two net worth issues casts Massachusetts as an even more extreme outlier.

The first concern pertains to DOR's inconsistent approach in determining what constitutes debt or equity when computing the net worth tax. Over the last several months, Massachusetts businesses have raised serious concerns about DOR's practices in administering the state's net worth tax, specifically as it relates to adjustments that are being made to taxpayer balance sheets to inflate a taxpayer's net worth and corresponding tax.

It is extremely important to rectify this issue as soon as possible with clarifying language that reinforces the Legislature's original intent when it enacted the net worth tax. Swift action on this issue will avoid further negative effects on the state's current and prospective employers while making it clear that DOR has overstepped its authority in the administration of this tax.

A very common practice for taxpayers in the net worth tax regime, particularly complex businesses, is tied to centralized cash management. Such arrangements can create intercompany debt, as recorded and reported in separate company financial statements. However, DOR asserts that such debt is instead equity. Once "reclassified" by DOR, a taxpayer's net worth tax base can be substantially inflated, subjecting the entity to a higher net worth tax. This approach ignores state law that requires using a taxpayer's books and records (i.e. financial statements) to determine the net worth tax liability and instead applies DOR-developed rules. By disregarding the books and records, DOR overturns 50 years of established practice and procedural application of the net worth tax. This practice will create unexpected, large tax liabilities for major employers within the state and make it more attractive for businesses to move out of state.

Sections one and two of the proposed legislation clarify that, for purposes of the net worth tax, DOR should treat debt and equity as they are accounted for in financial statements. The proposed language affirms statutory authority and judicial precedent by stating that the standard accounting methods used in financial statements will also be the method by which DOR must determine the net worth tax liability.

The second issue of concern with the state's administration of the net worth tax relates to foreign (non-U.S.) corporations that have U.S. affiliates doing business in Massachusetts.

Under federal law and international treaties, states cannot require a foreign corporation to pay corporate income taxes if that business is not subject to U.S. income taxation. However, DOR has asserted that foreign entities that receive royalties from affiliates doing business in Massachusetts have nexus in the state, and therefore must file the separate corporate non-income (i.e. net worth) tax.

While this application may be technically within the bounds of state law, it is undoubtedly an aggressive one. Massachusetts is in the minority as a state that still imposes a balance sheet tax on corporations, but extending its reach to foreign entities that do not do business in the U.S. under federal law certainly makes it an outlier. This undercuts the water's edge concept, which is a key aspect of Massachusetts combined reporting.

Section three of the proposed legislation would limit the state's ability to collect the net worth tax from foreign entities by modifying the sales factor calculation in the apportionment formula so that a foreign entity that is not subject to federal or state income taxes would likewise not be subject to the net worth tax as that entity would have a Massachusetts apportionment of zero for determining its net worth liability.

Executive Compensation

The MTF opposes S1509, *An Act relative to excessive executive compensation*. This bill would levy an additional two percent tax on corporate taxpayers and financial institutions for which the highest paid employee earns more than 100 times the median compensation for all employees in that business, including contract employees.

Such legislation would create a clear disincentive to locate in Massachusetts. It also could have the unintended consequence of eliminating important jobs, rather than automatically increasing low salaries or reducing executive compensation. As the MTF has argued in the past, tax policy will not solve the very real problem of income inequality.

Executive compensation is a decision for businesses, and the state should not try to regulate it with legislation. Shareholders, many of whom are sophisticated institutional investors, have the authority to reject executive compensation packages which they believe to be inappropriate. They routinely exercise that right and the Legislature should continue to allow this self-regulation.