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To: The Honorable Donovan M. Dela Cruz, Chair
and Members of the Senate Committee on Ways and Means

Date: Friday, March 29, 2019
Time: 10:00 A.M.
Place: Conference Room 211, State Capitol

From: Linda Chu Takayama, Director
Department of Taxation

Re: S.C.R. 117 / S.R. 87, Requesting the Director of Taxation to Convene a Task Force to Consider Worldwide Combined Reporting of Corporate Income.

The Department of Taxation (Department) offers the following comments regarding S.C.R. 117 for the Committee's consideration.

S.C.R. 117 requests the Director of Taxation to convene and lead a task force to study the worldwide combined reporting and tax haven list methods of corporate income taxation and determine whether either is an appropriate option for Hawaii's income tax.

The Department notes that worldwide combined reporting was held to be constitutional in *Container Corporation of America v. Franchise Tax* Board, 463 U.S. 159 (1983). Following this case, worldwide combined reporting was increasingly used by states until being abandoned due to the threat of federal legislation constraining the states' authority to tax multinational businesses.

In addition, the Department believes the revenue gain will likely be smaller than the $38,000,000 estimated by the work cited by S.C.R. 117. Therefore, the realistic revenue gain may not justify the difficulty of imposing worldwide combined reporting.

In any case, the Department believes that the use of worldwide combined reporting should be studied thoroughly before being adopted. The Department is able and willing to convene and lead the task force as currently written, however, it may be more efficient for the Department to perform the study on its own as the revenue estimating portion of the study may require analyzing confidential tax information that may not be disclosed outside of the Department.

Thank you for the opportunity to provide comments.

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March 29, 2019

Hawaii State Legislature
Committee on Ways and Means

VIA EMAIL

Re: COST's Comments re SR 87 and SJR 117 (Worldwide Combined Reporting Study)

Dear Chair Dela Cruz, Co-Vice Chair Keith-Agaran and Committee Members:

We are writing on behalf of the Council On State Taxation (COST) to express our skepticism about the study topic proposed in SR 87 and SJR 117. These resolutions would establish a task force, headed by the Department of Revenue, to study the viability of imposing mandatory worldwide combined reporting on companies conducting business in the State of Hawaii. While we are typically in favor of conducting studies on complex tax issues, the issue of mandating worldwide combined reporting is particularly controversial and is not required for general businesses in any of the 44 States of the U.S. that impose a corporate income tax.[1] We also note that the projected revenue impact extrapolated for the State of Hawaii is particularly imprecise and is derived from recent global econometric studies attempting to quantify global profit shifting – admittedly a very uncertain exercise.

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 approximately 550 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Mandatory Worldwide Combined Reporting Was Previously Rejected and Discredited

Current state apportionment provisions allow taxpayers to elect to file their corporate income tax returns on a water's-edge basis, thereby limiting the determination of income subject to apportionment in the State to the income and apportionment factors of a group of unitary companies operating within the "water's-edge" of the United

[1] Alaska is the only state that mandates worldwide combined reporting today, but only on oil companies.

States. SR 87 and SJR 117 would convene a task force to study whether Hawaii should move away from the water's-edge filing methodology and require companies operating both in Hawaii and abroad to include non-U.S. corporations in their Hawaii corporate income tax filings (*i.e.*, implement mandatory worldwide combined reporting).

Mandatory worldwide combined reporting is not a new concept; nearly a dozen states imposed the filing methodology by the early 1980s. In a series of actions beginning in 1984 and accelerating over the next few years, however, all of those states had granted taxpayers an election 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 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 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.

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 methods to address international "base erosion and profit shifting." During their deliberations, the BEPS project considered, and rejected, the use of mandatory worldwide combined filing. 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.

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. Nevertheless, a recent report by a partisan think tank seized on the high point of these studies and has extrapolated that number to individual states through a series of assumptions and estimates. It then presents those numbers to the states as "money left on the table," and there for the taking if the state would only enact the thoroughly discredited and still-controversial filing method known as mandatory worldwide combined reporting. Accordingly, before determining whether a task force to study mandatory worldwide combined reporting is warranted, we would urge you to consider the validity of the information provided, and whether the state would really want to adopt a method of apportioning income that is an outlier, not just among all of the states, but also among all of the nations of the world.

Conclusion

Considering the checkered history of mandatory worldwide combined reporting discussed above, a move in that direction by Hawaii would not come without a price—both political and reputational. Before a technical study of worldwide combined reporting is undertaken, it might be useful to thoroughly examine the political history of worldwide combined reporting, whether the estimates provided are too good to be true, and the impact it might have on the State's business climate.

Respectfully,

Doug Lindholm Nikki Dobay

cc: COST Board of Directors