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STATEMENT

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MassBudget Recommends Against Decoupling from Internal Revenue Code Provisions Governing Business Interest Expense Deductibility (163(j)) and the Taxation of GILTI

In 2017, the federal government adopted the Tax Cuts and Job Act (TCJA), giving very large tax cuts to corporations. Nationwide, businesses had their annual federal taxes cut by some $140 billion. (Given the relative size of our state economy, this likely translates into a tax cut for corporations doing business in Massachusetts of around $4 billion a year.)

To hold down the total cost of the TCJA, several smaller adjustments were made to the federal code, ones that would limit some of the more egregious corporate tax avoidance strategies and resulting tax losses that TCJA clearly was going to make even worse. Given that states generally build their own tax codes on the framework of the federal code, these federal adjustments in the TCJA can affect corporations' state tax liabilities as well.

The TCJA changes to Section 163(j) of the Internal Revenue Code (IRC) are an example of attempts made to limit excessive loss of federal revenue. This section creates somewhat tighter limits on the amount of interest expenses that can be used to reduce a corporation's taxable income.

The Massachusetts House of Representatives has approved a proposal to decouple from the changes TCJA made to Section 163(j) of the Internal Revenue Code (IRC), removing the tighter limits that TCJA created on business interest deductibility. Not only would this decoupling result in a direct loss of revenue for the Commonwealth of a reported $37 million annually, there may well be other effects associated with decoupling. To the extent that Section 163(j) helps limit the amount of interest that can be deducted from taxable income, it reduces overall incentives to engage in aggressive "earnings stripping."[1] (For a brief description of "earnings stripping", see Endnote 1.) Given the uncertainty around the magnitude of these other effects, it is unclear what further revenue losses there might be if the state decouples from Section 163(j).[2]

Decoupling from Section 163(j) is not especially common among the states. Of the 46 states with a corporate income or similar tax (including DC), only 8 have actively decoupled. (Another 4 have not yet "rolled forward" their codes to conform with TCJA, so these 4 states are not yet coupled to the new limits.) If Massachusetts decouples, it will be an outlier.

If Massachusetts chooses to decouple from Section 163(j), it would not be the first time that legislators have voted to decouple from a TCJA provision, to the benefit of large corporations. Last year, Massachusetts decoupled from the new federal approach to taxing Global Intangible Low-Tax Income (GILTI).[3] (For a brief description of the taxation of GILTI, see Endnote 3.) As a result, the Commonwealth will tax a much smaller share of corporations' offshore income than the federal government does or than a number of other states - including our neighbor New Hampshire - do. Though a detailed estimate is not available currently, this approach to taxing GILTI could cost the Commonwealth several hundred million dollars a year in forgone revenue, revenue that otherwise would be collected from large, profitable, multinational corporations operating in Massachusetts. This highly consequential decision regarding state tax policy was adopted without subjecting the policy to review by the Joint Committee on Revenue. The proposed change to decouple from 163(j) likewise was not subject to any legislative debate at time of passage.

Corporations nationally are collecting a significantly larger share of total U.S. income than they did in the 1980s. During the same period, taxes on this corporate income have fallen markedly in Massachusetts as a share of total taxes collected by the Commonwealth, even as these same corporations are enjoying large federal tax cuts. (See MassBudget's most recent report in our corporate tax series, *Rising Profits, Falling Tax Shares: Fixing What's Broken*.) In terms of both earnings and taxes, corporations are doing very well.

The Commonwealth should not be seeking additional ways to reduce state-level income taxes on profitable multi-state and multi-national corporations operating in Massachusetts. This approach provides an unwarranted tax advantage to a subset of businesses: those with multi-state and/or multi-national subsidiaries and sophisticated accounting departments. Providing such corporate tax cuts also deprives the Commonwealth of much-needed revenue for investments in education, transportation and more – all of which allow both businesses and communities throughout the state to thrive.

For the many reasons outlined above, MassBudget recommends the Commonwealth remain coupled to IRC Section 163(j) and recouples to the federal rules governing taxation of GILTI.

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[1] Earnings stripping is a favorite corporate strategy for shifting income among related businesses in ways that reduce a corporation's federal and/or state tax obligations. One way to do this is for the corporation to arrange "borrowing", either from US affiliated companies that are outside the unitary combined group (like captive insurance companies) or from the corporation's offshore subsidiaries and affiliates located in low or no tax jurisdictions. The corporation then pays large amounts of interest to its subsidiaries on these "loans", thereby reducing or eliminating the profits it must declare for US tax purposes.

[2] While there are other, more effective mechanisms for preventing earnings stripping and similar tax minimization strategies (e.g., requiring that captive insurance companies be included in the unitary group for the purposes of combined reporting and/or adopting mandatory worldwide combined reporting), Section 163(j) acts as a backstop in the fight against certain types of aggressive corporate tax avoidance. Unless and until other, more effective provisions are added to the Commonwealth's corporate tax code, Massachusetts should remain coupled to Section 163(j).

[3] The federal approach to taxing GILTI is another example of how the TCJA attempts to limit excessive revenue losses associated with aggressive corporate tax avoidance. The federal government now will tax a portion of the income of off-shore subsidiaries of US corporations located in low- or no-tax jurisdictions, when that income is extraordinarily high relative to the size of the off-shore subsidiary. The rationale underlying this approach is that this income really is attributable to US-based activities, but that corporations are engaged in aggressive income shifting to remove this income from legitimate taxation by the federal and state governments. The TCJA's GILTI provisions seek to address this problem, at least in part.