STATE TAXES AFTER REFORM
PARTNERSHIP

September 21, 2018

VIA Email: rulesandregs@dor.state.ma.us

Re: Comments Regarding the Working Draft of Technical Information Release18-XX: Treatment of Deemed Repatriated Income Under General Laws Chapter 63

Dear Sir or Madam:

We represent the State Tax After Reform ("STAR") Partnership, a coalition of 24 companies that was formed to help the business community navigate the state legislative, executive, and regulatory reaction to federal tax reform.[1] We are writing to express our comments on the Working Draft of Technical Information Release 18-XX: Treatment of Deemed Repatriated Income Under General Laws Chapter 63 released by the Department of Revenue ("Department") earlier this month. The draft guidance does not entirely reach the correct result and we therefor recommend the Department either (1) allow factor representation of the deemed payor's factors to avoid unconstitutional distortion or (2) allow taxpayers to calculate their actual percentage of related expenses in addition to offering the 5% expense disallowance as a safe harbor.

The draft guidance provides that foreign earnings deemed repatriated under IRC section 965 are treated as a dividend income for purposes of computing the Massachusetts state tax base and, thus, that such earnings are eligible for the state's 95 percent dividend-received deduction. We agree with the Department's treatment of 965 income as dividend income that is eligible for the 95 percent dividend-received deduction.

With respect to apportionment, however, the draft guidance fails to consider that, because a portion of the 965 income is included in the state tax base, the receipts of the foreign subsidiaries that are the deemed payors of the 965 income must be considered in computing the apportionment factor. Under the Commerce Clause of the U.S. Constitution, as interpreted by the U.S. Supreme Court, a tax is not constitutional unless the apportionment formula is fair. *Complete Auto Transit, Inc. v. Brady*, 430 US 274 (1977). An apportionment formula will be considered fair only if the factor or factors used in the apportionment formula actually reflect a reasonable sense of how income is generated. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). 965 income represents earnings generated by a US shareholder's foreign subsidiaries. Thus, unless the factors of the foreign subsidiaries are included in the apportionment formula used to apportion the 965 income to Massachusetts, the apportionment formula does not accurately reflect how the 965 income is generated and is unconstitutional.

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[1] Please visit our website (www.star-partners.org) for more information about the STAR Partnership and our work.

We understand that in *The Gillette Company v. Commissioner of Reven*ue, 683 NE2d 270 425 Mass 670, 07/31/1997**,** the Supreme Judicial Court of Massachusetts determined that the factors of foreign subsidiaries from which the taxpayer received interest and royalty payments were not required to be included in the taxpayer's apportionment formula under the fair apportionment prong of the Commerce Clause test because the income (royalties and interest) was the *taxpayer's* income and was not the income of the foreign subsidiaries. Here, however, the federal government's taxation of 965 income is a tax on the earnings of the foreign subsidiaries. The draft guidance even implicitly acknowledges that 965 income is "a tax on the earnings and profits of the subsidiary corporation making the dividend." Unlike the royalties and interest in *Gillette*, which were derived from the licensing and lending activities of the taxpayer, the 965 income is wholly derived through the activities of the foreign subsidiary. In *Gillette*, the court acknowledged that "when a subsidiary's income is combined with the parent's income subject to apportionment, a taxing state must also combine the property, payroll, and sales figures of all members of a unitary business to calculate an apportionment formula." Thus, the only way to ensure that Massachusetts' tax is fair and constitutional is to include a portion of the receipts of the foreign subsidiary in the apportionment factor used to compute what portion of the taxpayer's income, including the 965 income, is subject to tax by Massachusetts.

The Department claims that the inclusion of 5 percent of 965 income in the tax base is an effective "disallowance of expenses" related to such income and, thus, is not the taxation of earnings of the foreign subsidiaries. However, if the Department is correct that the Massachusetts Legislature intended the inclusion of 5 percent of dividends in taxable income to be a "disallowance of expenses of the corporation reporting the dividend income rather than as a tax on the earnings and profits of the subsidiary corporation making the dividend," then it would further that legislative intent to afford taxpayers the opportunity to use the *actual* amount of expenses attributable to the 965 income as the disallowed expense rather than the 5 percent safe-harbor. Said another way, if the Department is going to assert that the inclusion of 5 percent of 965 income in the tax base is the disallowance of related expenses in order to avoid constitutional apportionment issues, then it must give taxpayers the election to use actual expenses related to 965 income as the disallowed expense.

We appreciate the Department's consideration of our comments. Please contact us at if you would like to discuss further.

Sincerely,

Stephen Kranz
Partner
McDermott Will & Emery LLP