ORGANIZATION FOR INTERNATIONAL INVESTMENT
GLOBAL INVESTMENT GROWS AMERICA'S ECONOMY

OFII Testimony on Governor's FY 2014-2015 Budget Proposal to Strike the Tax Treaty Exception from the Add-Back Statute

Joint Legislative Public Hearing on 2014-2015 Executive Budget Proposal: Topic "Taxes"

February 10, 2014

On behalf of the Organization for International Investment (OFII), I appreciate the opportunity to comment on Assembly Bill 8559 and Senate Bill 6359, legislation to implement the Fiscal Year 2014-2015 Budget. OFII's comments will address the budget's proposal to strike **§208.9(o)(2)(B)(iii)** from current law – to be known as the "tax treaty exception" for purposes of this comment letter. This provision allows corporations to claim an exception from the state's add-back requirement for royalties paid to affiliates based in countries that have a comprehensive income tax treaty with the United States. Our comments also address amending §208.9(o)(2)(B)(ii), another add-back exception that if changed could prevent double taxation of legitimate cross border royalties should the tax treaty exception be struck from law.

OFII supports the budget's aim to position New York as a more competitive location in attracting business investment, particularly to the upstate region. However, OFII strongly urges legislators maintain the tax treaty exception in current law. Striking this section from the add-back statute would undermine the Governor's stated goal to create jobs and grow the economy. In particular, removing this exception would result in double taxation on multinational groups and significantly hinder New York's ability to retain and attract foreign direct investment (FDI). New York would in fact stand alone in requiring an add-back for legitimate royalty payments to foreign affiliates resident in treaty countries without having other add-back exceptions to protect against such double taxation.

OFII is a business association based in Washington, D.C., which represents over 160 U.S. subsidiaries of companies headquartered abroad (membership list is attached). We aim to help position our country as a competitive location to attract FDI. We continually work with federal and state policymakers to ensure nondiscrimination in U.S. law and regulation to encourage global businesses to invest and create jobs in this country.

Foreign direct investment is vital to New York's economy and workforce

U.S. subsidiaries of global companies generate precisely the types of high-value jobs and economic activities that states are looking to attract. These firms represent less than 0.5 percent of all U.S. companies with payrolls yet they employ 5.6 million Americans, including 17 percent of the U.S. manufacturing workforce.[1] With a combined annual payroll of $438 billion and an average employee salary at over $77,600 these companies provide well-paying U.S. jobs at salary levels substantially higher than the economy-wide average.

[1] All statistics in this testimony are the latest data from the Department of Commerce's Bur[...] Analysis released August 2013 regarding the U.S. [...]

Overall, these companies generate 6.3 percent of U.S. private sector GDP, underwrite 16 percent of U.S. research and development activities, produce 20 percent of U.S. exports, and pay 14 percent of federal corporate income taxes.

New York communities have long benefitted from FDI. Approximately 410,500 state residents are employed by a U.S. subsidiary of a global company. This accounts for 5.7 percent of the state's private sector workforce. Additionally, Governor Cuomo has recognized the important contributions FDI brings in the state and has initiated efforts to attract it to New York through initiatives like Start-Up NY and Global NY.

OFII's concerns with striking the tax treaty exception from the add-back statute

All states with an add-back requirement currently allow an exception for legitimate cross border royalty payments. New York's tax treaty exception provides for this norm. In summary, the exception would preclude the addition of cross border royalties to taxable income if:

1. The royalty is paid to an affiliate located in a foreign country.
2. The affiliate is located in a country that has an comprehensive income tax treaty with the United States.
3. The royalty is subject to tax in the foreign country.
4. The effective tax rate of the tax paid abroad is equal to that imposed by New York.
5. The royalty is pursuant to a transaction undertaken for a valid business purpose and uses terms that reflect an arm's length relationship.

This tax treaty exception allows U.S. subsidiaries of global companies to license technology or brands from their foreign affiliates and pay royalty fees overseas in the normal course of conducting legitimate business activities without the burden of double taxation. A tax treaty exception has been part of New York's add-back statute since its inception in 2003. It was amended by last year's Fiscal Year 2013-2014 budget agreement to provide more restrictions to qualifying for the state's addback exception.

Striking the tax treaty exception from the state's add-back statute would completely distort traditional norms of add-back methodology. Companies would now have to add back cross border royalties when calculating taxable income, leading to a concern of extraterritorial double taxation of royalties received by non-U.S. companies because this income is already taxed by the foreign jurisdiction where the recipient is located.

In addition, taxing income protected from federal tax by bilateral income tax treaties would undermine the integrity of the U.S. treaty network and risk unnecessary disputes with key trading partners. Furthermore, no other state employs such an extraterritorial add-back approach with regards to cross border royalties. In contrast, within the last four years, Massachusetts, New Jersey, Washington D.C., Connecticut, and West Virginia took steps to prevent double taxation of cross border royalties.

We believe striking the tax treaty exception is inconsistent with the Governor's stated goal of making the state a premier destination for FDI and ensuring that it remains competitive in the

global economy. An extraterritorial tax policy that causes double taxation could act as a hurdle for important pro-growth initiatives like Start-Up NY and Global NY and would unequivocally undermine the state's credibility as a competitive and attractive market for global businesses across all industry sectors to invest and create jobs.

Negative effects of striking the tax treaty exception

- **Hurts competitiveness:** States do not tax income attributable to legitimate cross border transactions and no state has an add-back requirement without protecting against double taxation of legitimate cross border royalties. New York would stand alone in striking the tax treaty exception without having other protections against double taxation. This unilateral action would endanger the state's ability to attract and retain FDI.

- **Increases costs:** Striking this provision would cause extraterritorial double taxation for multinational groups that operate in New York as cross border royalties would be taxed in two jurisdictions. This double taxation could make local investments substantially more expensive, undermining the state's attractiveness as a location to create future jobs and grow business.

- **Violates spirit of federally negotiated tax treaties:** Bilaterally negotiated tax treaties have long recognized the importance of the free flow of royalties across borders. Parties agree to tax this income just once by the country in which the payment is received. Pursuit of this income by the state would undermine the U.S. treaty network and this perceived encroachment could lead to retaliation by our trading partners.

- **Establishes NY as a regional outlier:** A removal of the tax treaty exception by New York would be contrary to actions taken by other states to prevent double taxation of cross border royalties. Within the last four years, Connecticut, Massachusetts, New Jersey, Washington, D.C., and West Virginia took steps to preclude the taxation of cross border royalties.

- **Undermines Governor's efforts to attract investment:** This provision would directly counteract efforts by Governor Cuomo to attract additional FDI to New York through initiatives like Start-Up NY and Global NY. A discriminatory tax environment acts as a clear hurdle in attracting global firms.

- **Targets legitimate business activities:** Striking the tax treaty exception would penalize U.S. subsidiaries simply because they license technology and brands from their foreign affiliates – business norms necessary for these firms to grow and invest in the U.S.

Amending §208.9(o)(2)(B)(ii) to alleviate concerns

OFII believes that if lawmakers strike the tax treaty exception from the add-back statute, the state is able to insert legislative language to another exception of the add-back requirement to alleviate concerns of double taxation for multinational groups. Specifically, OFII would urge lawmakers to adopt the following language to §208.9(o)(2)(B)(ii):

> (ii) The adjustment required in this paragraph shall not apply if the taxpayer establishes by clear and convincing evidence of the type and in the form prescribed by the commissioner, that: (I) the related member was subject to tax on or measured by its net income in this state or another state or possession of the United States or **a foreign country or** some combination thereof; (II) the tax base included the royalty payment paid, accrued or incurred by the taxpayer; and (III) the aggregate effective rate is no less than eighty percent of the statutory rate of tax that applied to the taxpayer under section two hundred ten of the this article of the taxable year.

Inclusion of "foreign country" would ensure that cross border royalties taxed by a foreign jurisdiction are not also subject to tax by New York. This legislative fix would align with bilaterally negotiated tax treaties and not hinder New York's competitiveness in attracting FDI.

Conclusion

In summary, striking the tax treaty exception conflicts with commonly understood international and domestic taxation norms, which protect against double taxation. Thus, New York would create a discriminatory tax environment for U.S. subsidiaries of global companies and undermine its competitiveness in attracting FDI and the jobs that follow. For these reasons, we respectfully ask that the state maintain the tax treaty exception as part of the add-back statute. If it is struck from law, then OFII urges lawmakers to amend the exception described by §208.9(o)(2)(B)(ii) to ensure that New York does not hinder its competitiveness in attracting FDI.

Thank you for your consideration. If we can be of further assistance, please contact George McElwee, OFII's Vice President of Public Policy and Government Affairs, at 202-659-1903 or gmcelwee@ofii.org.

Sincerely,

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