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THE TECHNOLOGY COUNCIL OF MARYLAND'S CASE AGAINST COMBINED REPORTING: A REBUTTAL

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Introduction and Summary

In a letter to State Senator Rona E. Kramer and Delegate Brian J. Feldman dated October 29, 2007, the Technology Council of Maryland (TCM) states its opposition to Governor Martin O'Malley's recommendation that Maryland adopt mandatory "combined reporting" under its corporate income tax. Combined reporting is a tax accounting practice that effectively treats a business composed of a parent corporation and its separately-incorporated subsidiaries as a single corporation for tax purposes.

TCM makes a number of claims, including that combined reporting is not necessary, would be burdensome, and would lead to lengthy legal challenges. Similar objections to the Governor's combined reporting proposal are being raised by some major multistate corporations doing business in Maryland and the trade associations that represent them. Accordingly, the rest of this report addresses each of the individual claims being made by TCM and demonstrates that they have little validity.[1] To summarize this report's conclusions:

- Adopting combined reporting is essential to nullifying a wide variety of aggressive tax-sheltering strategies that large multistate corporations are uniquely able to implement to reduce or even eliminate their income tax payments. Targeted measures like the 2004 anti-Delaware Holding Company law cited by TCM can neither address nor keep ahead of the array of tax shelters that sophisticated multistate corporations can put in place.

- As long as large multistate corporations can avoid paying taxes on their profits that small, in-state corporations must continue to pay, the state's corporate tax structure cannot be fair.

- Regardless of the amount of new revenue generated by the adoption of combined reporting, the state cannot reasonably ask individual taxpayers and small businesses to pay higher personal income and sales taxes while allowing large corporations to escape paying their fair share.

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[1] In the same letter, TCM also stated its opposition to the Governor's proposal for the imposition of new, higher income tax rates on high-income individuals. The Center's analysis of this proposal and its rebuttal of arguments that this would disproportionately affect Montgomery County and harm the state's economic development may be found in Nicholas Johnson, "Testimony on Maryland Income Tax Rate Restructuring" before the Senate Budget and Taxation Committee and the House Ways and Means Committee, November 1, 2007 (www.cbpp.org/11-1-07sfp-testimony.htm).

- Combined reporting is not difficult to administer; 16 states have been doing it for decades, including states like New Hampshire and Idaho that are much smaller than Maryland. Many of the corporations complaining about the alleged burdens of combined reporting are already filing on this basis in numerous other states.

- The potential for additional complexity, unpredictability, and litigation to arise from the adoption of combined reporting has been substantially mitigated by a provision of the proposed legislation that directs the Comptroller to adopt a regulation modeled on one developed by the Multistate Tax Commission, a joint agency of state revenue departments. The regulation will spell out which members of a multi-corporate group are and are not to be included in a Maryland combined report, the only significant source of potential disagreement.

Rebutting the Technology Council of Maryland on Combined Reporting

Claim: "Combined reporting, which is a method of computing state taxable income of a related group of companies, is a proposal that needlessly complicates Maryland's corporate tax structure."

Response: Far from being "needless," combined reporting is essential to having a fair and effective state corporate income tax, as a growing number of states are recognizing. Twenty-one of the 45 states with corporate income taxes have implemented or are phasing-in combined reporting. Five states have adopted it in the last three years. Without combined reporting, large, sophisticated multistate corporations that can afford to hire the best tax-avoidance advice that money can buy are able to avoid paying their fair share of income taxes. (A recent *Wall Street Journal* story revealed that Wal-Mart paid the Ernst & Young accounting firm $2.5 *million* for a 35-page cookbook of tax-avoidance strategies.) Small, often family-owned, corporations that do all their business within Maryland and cannot game Maryland's loophole-ridden corporate tax, as well as average citizens, make up the difference when large multistate corporations do not pay what they should.

Nor is combined reporting complicated. From an accounting standpoint, combined reporting is little different from the consolidated reporting that the vast majority of large corporations use when they report their profits to stockholders and the Internal Revenue Service. Most of the large corporations that are complaining most loudly about Maryland's adoption of combined reporting are undoubtedly filing on a combined reporting basis in other states. For example, Northrop-Grumman has facilities in nine other combined reporting states and Lockheed-Martin has facilities in six combined reporting states; the additional effort for them of filing on a combined reporting basis in Maryland would be minimal.

The adoption of combined reporting will not affect the tax filing of businesses organized as Subchapter S corporations, Limited Liability Companies, or partnerships; the owners of such businesses will continue to be subject to personal income taxes on the businesses' "passed-through" profits. Nor will regular, taxable "C" corporations be affected by combined reporting if they are organized as single legal entities. Multi-entity corporate groups are the only ones affected by combined reporting, and the very small increase in complexity is well-justified by the need to stop abusive corporate tax sheltering in Maryland.

Claim: "TCM believes that Maryland's current corporate tax structure is fair, especially after legislation in 2004 prohibited the use of Delaware Holding Companies."

Response: Notwithstanding the targeted legislation enacted by Maryland to nullify the use of Delaware Holding Companies, the state's corporate income tax structure still includes many loopholes and opportunities for tax avoidance. Delaware Holding Companies (and captive Real Estate Investment Trusts, which Maryland also attacked with targeted legislation earlier this year) barely scratch the surface of the tax-avoidance techniques to which non-combined-reporting states like Maryland are vulnerable. These other techniques, which include "transfer pricing and the use of "captive insurance companies," are described at length in a number of recent reports.[2] Under transfer pricing, for example, a South Carolina manufacturer could reduce its taxable profit in Maryland by setting up a "wholesaling" subsidiary to sell its goods in Maryland and charging the subsidiary an artificially-inflated price for them. This would reduce the profit of the Maryland subsidiary and shift it into South Carolina, where it would be taxed at a lower corporate tax rate.

Contrary to TCM's claim, Maryland's corporate tax structure will not be fair until it mandates combined reporting and shuts down the wide array of tax shelters that large multistate corporations can implement to reduce their taxes but that small businesses cannot. If Maryland increases its corporate tax rate, as the Governor has proposed, without simultaneously adopting combined reporting, the unfairness of the existing corporate tax structure to small businesses will be increased even further. Small businesses will pay more, while their large multistate corporate competitors will continue to shift their taxable profits into out-of-state affiliates.

Claim: "It is misleading to say that because a corporation pays little or no corporate tax one year that they are taking advantage of tax 'loopholes.' The true tax liability of a corporation depends on a variety of issues, including profitability (or lack thereof), corporate restructuring and other factors."

Response: It is certainly true that there are a number of reasons other than the use of aggressive tax-avoidance strategies that a corporation can owe little or no corporate income tax to Maryland in a particular year. For example, the corporation may truly be unprofitable in that year, it may be using past losses to offset its current profits (perfectly legal and legitimate under Maryland law), or it may be taking advantage of certain tax incentives which, while perhaps questionable from a policy standpoint, nonetheless are also legal and were consciously enacted by the legislature.

Nonetheless, it is suspicious and disturbing that data released by the Comptroller over a number of years show a persistent pattern of a high proportion of the largest for-profit corporations in Maryland having zero corporate income tax liability — even in years in which the economy is doing well and in which it is highly likely that the vast majority of them are reporting positive profits to stockholders. These data strongly suggest that aggressive tax planning, which exploits the absence

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[2] See: Center on Budget and Policy Priorities, "State Corporate Tax Shelters and the Need for Combined Reporting," October 26, 2007 (www.cbpp.org/10-26-07sfp.pdf). See as well a memorandum prepared in early 2007 by the Massachusetts Department of Revenue, "Examples of Tax Planning Strategies Addressed by Combined Reporting" which is available as Appendix A to Massachusetts Budget and Policy Center, "Building a Strong Economy: The Evidence on Combined Reporting, Public Investments, and Economic Growth," June 8, 2007 (www.massbudget.org/BuildingStrongEconomyJune07.pdf). See also: Ernst & Young State and Local Tax Services, "Wal-Mart Ideas for State and Local Tax ETR [effective tax rate] Reduction," memorandum dated August 2002 (online.wsj.com/public/resources/documents/wsj071023-walmart-tax_reduction.pdf)

of combined reporting in Maryland, is indeed a major reason that many large corporations are paying little or no income tax to the state.

Moreover, "corporate restructuring" is *not* a legitimate explanation for low or zero corporate tax payments to Maryland. The tax avoidance techniques that combined reporting is meant to nullify are almost always based on some form of corporate restructuring — such as setting up subsidiaries in other states beyond the legal reach of Maryland taxing authorities to which income-earning assets are then transferred. It is a fundamental goal of combined reporting to ensure that a corporation's tax liability to a state is the same *regardless* of the parent/subsidiary legal structure the corporation adopts.

Claim: "It is also important to keep in mind that instituting combined reporting in Maryland does very little to solve Maryland's structural budget deficit."

Response: The Department of Legislative Services has estimated that the enactment of combined reporting will raise approximately $40 million in additional revenue annually. That is a very conservative estimate relative to what other states considering adoption of this policy have estimated, even taking into account that Maryland has already reaped part of the potential revenue gain from adopting combined reporting through previously-enacted, targeted legislation aimed at nullifying the Delaware Holding Company and captive REIT tax shelters. In any case, the revenue that would be raised by combined reporting is a significant contribution to the budget.

More importantly, the enactment of combined reporting is essential to ensuring that the state does not continue to suffer budget deficits in the future. Without it, corporations will have free rein to engage in ever more aggressive and creative tax-avoidance techniques, and the corporate income tax will continue to erode.

In the final analysis, however, the fundamental case for combined reporting is based on fairness, not revenue. Individual taxpayers cannot avoid paying their personal income taxes by "leasing" themselves to their employers, and corporations should not be able to avoid their fair share of Maryland taxes by "leasing" their workers from an out-of-state affiliate — as Ernst & Young advised Wal-Mart to do. (That is just one of many examples.) The Governor's tax package asks many Maryland citizens to make additional financial sacrifices to ensure that they continue to enjoy the excellent local school systems, state universities, parks and recreational facilities, high-quality transportation networks, and all the other amenities that make Maryland a good place to live. If the state does not adopt combined reporting as part of the package, then many large multistate corporations will avoid making additional contributions to the support of the state despite receiving direct benefits from these same public services.

Claim: "Combined reporting is difficult to administer. . ."

Response: Combined reporting has been used successfully for decades by 16 states, many of them — like Idaho, New Hampshire, and North Dakota — with much smaller economies than Maryland and smaller revenue department staffs. Combined reporting would be a new approach to taxation for Maryland, and like anything new, there would be transition issues to face and a need to educate taxpayers and state personnel alike in how combined reporting differs from current law. But the

successful use of this system by even very small states for decades demonstrates that combined reporting is eminently administrable by the Comptroller's office.

Claim: "Combined reporting . . . invites a great deal of unpredictability to the corporate tax system."

Response: The only significant "unpredictability" even hypothetically added to the corporate tax system by the adoption of combined reporting is the initial uncertainty entailed for a corporation in knowing which of its affiliated corporations belong in the Maryland combined report because they are part of the "unitary business" that is conducted in Maryland.[3] That "unpredictability" has been substantially solved by a provision of the proposed combined reporting legislation directing the Comptroller to adopt a regulation defining the contours of a unitary business that is based on a very detailed model regulation carefully developed over the course of several years by the Multistate Tax Commission — a joint agency of state revenue departments. Again, for the large number of corporations that are already filing on a combined reporting basis in other states, that uncertainty has already been resolved; they have conducted a self-evaluation of their operations to determine how many different unitary businesses they are engaged in (if more than one) and which affiliates are part of which ones.

This determination of the boundaries of a corporation's "unitary business(es)" falls into the category of transitional issues in implementing combined reporting. While some businesses will have some transitional uncertainty, the need to end tax avoidance by some large multistate corporations doing business in Maryland suggests that it is reasonable to tolerate some temporary uncertainty.

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[3] The U.S. Supreme Court has ruled that in order for a state to require an otherwise non-taxable out-of-state corporation to be included in a combined report with a related corporation that *is* taxable in the state, the out-of-state corporation must be part of the same "unitary business" as the in-state corporation. A unitary business is the set of the corporation's or corporate group's activities that constitute an integrated economic enterprise in which economies of scale or other economic synergies are present. For example, a typical "vertically integrated" oil company — in which one subsidiary explores for and pumps crude oil, which it sells to a refining subsidiary that converts the crude oil into gasoline, which the second subsidiary then sells to a third, wholesale marketing subsidiary — is likely to constitute a single "unitary business." The same is true of a multistate retail store chain in which each individual store is separately incorporated but in which a nationwide network of warehouses operated by the chain supplies all the stores and nationwide advertising is conducted on behalf of all the stores. In contrast, a business that that owned one subsidiary that manufactured jet airplanes and another that operated a cattle ranch might comprise two different "unitary businesses" if the two subsidiaries were independently managed, borrowed money independently, and so forth.

The "unitary business principle" also applies to a business comprised of a single corporation. That is, if a single corporation is engaged in two distinct unitary businesses, and all the activities of one of the businesses are conducted out of state, the state *must* allow the corporation to treat the out-of-state activities as a separate, non-taxable business. In actuality, a corporation that would pay less tax in a non-combined reporting state like Maryland if it could establish that its out-of-state activities really constituted a second, non-taxable unitary business would seek to bolster its case by forming a separate subsidiary to "house" them. In contrast, a corporation that would pay less tax in a non-combined reporting state if it were treated as a *single* unitary business always has the option of keeping all the activities within a single corporation; state tax authorities would find it almost impossible to prove that such a corporation really was engaged in two distinct unitary businesses. Thus, whatever "unpredictability" and "complexity" allegedly arises from requiring combined reporting really flows from the universally-applicable unitary business principle — which applies to single corporations and multi-corporate groups alike. The fact that disputes about the applicability of this principle only arise when a state has mandated combined reporting is the artificial result of the one-sided ability a multistate corporation has to control how many "unitary businesses" it appears to be engaged in. Again, that control flows from the corporation's power to decide whether it will organize itself legally as a single entity or a multi-corporate group.

Moreover, any new *targeted* approaches to stopping abusive tax planning will *also* lead to "unpredictability." It is interesting that the business community is touting as a better alternative to combined reporting new authority that was given to the Comptroller in 2004 to make ad hoc adjustments to the taxable income of corporations whenever he perceives that such adjustments are needed to "reflect clearly the income of such organizations" that is earned in Maryland. If such authority were actually used by the Comptroller, it would cause endless "unpredictability" for corporations about their final tax liability because it could potentially be applied to every single interstate transaction a Maryland corporation engages in during a particular year. In short, the claim that combined reporting would add to the "unpredictability" of Maryland's corporate tax system is another red herring to distract policymakers from the need to address the inherent weakness and manipulability of the current structure.

Claim: "Combined reporting . . . may end up in court for years to come. . ."

Response: Combined reporting has been sustained in two separate U.S. Supreme Court decisions as a fair and legal means of taxing multistate corporations. Maryland's adoption of combined reporting will therefore be absolutely immune to any *fundamental* legal challenges. In contrast, many of the fallback approaches to combined reporting that are aimed at attacking individual tax shelters are very vulnerable to legal challenge. Indeed, the state tax press is full of articles by private attorneys advising corporations about how they can challenge the kind of anti-Delaware Holding Company legislation that Maryland enacted in 2004; a test case in Alabama has already gone against the state in the initial trial court. It should be of little surprise then that the business community is urging the state to continue to use the limited — and legally-vulnerable — case-by-case approach to addressing any future corporate tax shelters that the state may uncover.

The only practical legal route corporations that find their tax-avoidance strategies nullified by combined reporting can pursue is to challenge the state's determination as to which of their out-of-state affiliates do and do not belong in the Maryland combined group. Their ability and incentive to attempt such litigation will be substantially reduced if the General Assembly adopts Governor O'Malley's proposed legislation, which, as noted above, directs the Comptroller to adopt a detailed regulation on this issue developed by the Multistate Tax Commission. The state cannot, of course, stop corporations that find their tax-avoidance strategies shut down from bringing court cases, but it must not be deterred by the threat of litigation from enacting a necessary reform to the state's corporate income tax structure.