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TESTIMONY OF MICHAEL MAZEROV SENIOR FELLOW, STATE FISCAL PROJECT BEFORE THE MARYLAND SENATE BUDGET AND TAXATION COMMITTEE REGARDING SENATE BILL 269 — COMBINED REPORTING

Chairman Kasemeyer and members of the Committee, I am Michael Mazerov, Senior Fellow with the State Fiscal Project of the Center on Budget and Policy Priorities in Washington. The Center is a non-profit, non-partisan research institute that focuses on federal and state budgets, programs, and tax policies, with a particular emphasis on how they affect low-income families. I appreciate the opportunity to present testimony this afternoon regarding Senate Bill 269, which would require the use of combined reporting for Maryland's corporate income tax.

Combined Reporting Is Needed to Nullify Forms of Corporate Tax Sheltering to Which Maryland Remains Vulnerable

Combined reporting remains an essential tax policy reform for Maryland if it is to have a fair and robust corporate income tax. Year in and year out, Maryland suffers significant erosion of its corporate tax base because of corporate tax avoidance techniques that exploit the absence of combined reporting. Those strategies go well beyond the so-called "Delaware Trademark Holding Company" and "captive REIT" (Real Estate Investment Trust) tax shelters that the General Assembly addressed several years ago with legislation specifically aimed at them. Most of these other tax avoidance techniques cannot be stopped at all — or in a sufficiently cost effective manner for it to be realistic — through any policy reform *other* than combined reporting.[1]

Let me give you a couple of examples. The first tax avoidance strategy can be called "asset isolation." There are many types of corporations that own valuable assets that earn income from payments by independent companies. For example, drug companies often develop and retain ownership of patents that they license other drug companies to use in their manufacturing processes in exchange for royalty payments. Similarly, banks buy mortgage-backed securities that earn interest income. Such corporations can easily transfer these assets to subsidiaries that Maryland has no legal authority to tax located in states without corporate income taxes. If these drug companies and banks are subject to corporate income tax in Maryland, the state has probably been allowing them to deduct from their Maryland taxable income all the expenses associated with creating those assets — for example, the salaries of the scientists that developed the drugs, the investment officers who traded the securities, and the depreciation of the buildings where those activities occurred. The state has also been providing services to those facilities, like maintaining the roads that employees use to get to them every day. And then, when those activities result in the creation of an income-producing asset, the assets are transferred to an out-of-state subsidiary that Maryland can't tax. That deprives Maryland of its fair share of income tax revenue from those companies.

Under combined reporting, the profits of whatever part of the corporation is taxable in Maryland will be added to the profits of the subsidiary in the tax haven state that owns the patents or securities and is receiving royalty and interest income from them. Then, Maryland will tax a share of that combined income. The share will be determined as it is under the existing system, based on the share of the nationwide sales, property, and payroll of the combined group that are actually located in Maryland. The royalty and interest "addback" legislation that the General Assembly enacted in 2004 cannot shut down this tax-avoidance scheme because that law only applies when those payments are being made from one member of the corporate group to another. Here, in contrast, the payments are coming from outside the corporate group. Only combined reporting can ensure that Maryland receives its fair share of revenue under this scenario.

Similarly, only combined reporting can nullify a tax-avoidance strategy that can be called "entity isolation." That strategy is used when, for example, an out-of-state manufacturer with Maryland sales needs to have some minimal physical presence in Maryland — for example, to install the products it sells — but the manufacturing itself is done outside the state. The corporation forms a separate subsidiary to employ the people that have to be in Maryland, but the profit on the sale in Maryland of the manufactured items themselves remains locked in the out-of-state manufacturing arm that Maryland can't tax because of a federal law that bars the state from taxing companies that only solicit sales here (Public Law 86-272). Entity isolation is Corporate Tax Avoidance 101, it's perfectly legal, and it prevents Maryland from taxing profits that are earned through sales to Maryland customers. Maryland enormously increased the incentive for out-of-state manufacturers to shelter their income in this way when it adopted a single sales factor apportionment formula for these companies back in 2001.

We know that entity isolation is a widespread corporate tax shelter that is costing Maryland substantial revenues thanks to the data the Comptroller has compiled from the hypothetical (or "pro-forma") combined reporting returns mandated by 2007 legislation.[2] Those data show that the so-called "Finnigan" "flavor" of combined reporting would raise substantially more revenue for the state than would the alternative, so-called "Joyce" approach. The Finnigan version of combined reporting completely nullifies entity isolation, while the Joyce approach does so only partially.

Combined Reporting Will Help Level the Playing Field for Small, In-State Corporations

Needless to say, not many small businesses have the resources or sophistication to set up and operate the kinds of tax shelters I've just described that require multistate operations or the formation of subsidiaries in states like Delaware and Nevada. They don't have a million dollars lying around with which to hire Ernst & Young to develop a tax minimization strategy cookbook, as Wal-Mart did several years ago.[3] But small corporations often compete with large corporations that are able to do this. Large corporations that engage in aggressive tax avoidance may be able to attract capital at a lower cost than their in-state competitors or may use their tax savings to undercut the prices of smaller corporations. By nullifying many forms of tax avoidance, combined reporting can thus help smaller, locally-based corporations compete on a more level playing field and thereby preserve more local jobs.

Now, representatives of multistate corporations often respond to this argument by saying that it's the big multistate corporations that are actually at the competitive disadvantage. They assert that they're subject to "double taxation" of their profits at both the corporate and the individual level (when individuals receive corporate dividends), while most small businesses aren't subject to the corporate tax. In fact, there's considerable research to show that business income received by non-corporate businesses is taxed at the federal level at an effective tax rate roughly comparable to corporate businesses despite this so-called double taxation.[4] This is due to the much greater ability of big corporations to finance their activities with tax-deductible debt and the fact that much corporate stock is owned by tax-exempt entities like pension funds. In any case, many small businesses are, in fact, organized as taxable corporations. A recent Treasury Department study classified 95 percent of all taxable "C" corporations as small businesses.[5] In short, there is little doubt that many small businesses in Maryland are organized as taxable corporations and are at a competitive disadvantage vis-à-vis large multistate corporations because of the disproportionate ability of the latter group to engage in aggressive tax avoidance strategies like those I've described. For those small businesses, combined reporting will help level the playing field.

Combined Reporting Will Raise a Meaningful Amount of Revenue

When Maryland was considering combined reporting in 2006 and 2007, representatives of multistate corporations doing business here argued that the state had already reaped most of the potential revenue gain from combined reporting by enacting addback and anti-captive REIT laws. They asserted that any potential additional revenue wasn't worth the alleged disruption of the corporate tax structure that the adoption of combined reporting would entail.[6] As the oft-heard saying went: "The juice isn't worth the squeeze." Thanks to the requirement for pro-forma combined reporting that the General Assembly enacted in 2007, we now that that this emphatically is not true. The Comptroller's compilations of these data found that even *after* the adoption of the addback and anti-captive REIT laws, combined reporting under the so-called "Finnigan" approach would have boosted corporate income tax collections in tax years 2006 through 2008 by an *additional* 14.6 percent. The so-called "Joyce" approach would have boosted corporate tax receipts by 8.2 percent. And this is even after taking into account that corporate tax collections in the third year, 2008, would have actually been somewhat less under combined reporting than they would have been under the existing system.[7] Needless to say, the corporate community has been hammering on that last result even though it is easily explained by the fact that other states' economies were much harder hit than Maryland by a recession of once-in-a-century severity. But again, overall, combined reporting resulted in a significant net revenue gain for the three years taken together. This is entirely expected, given the prevalence of corporate tax avoidance strategies that exploit the absence of combined reporting. Of course, the fiscal note on SB 269 verifies this.[8]

To summarize my arguments so far, mandatory combined reporting remains essential if Maryland is to have a viable corporate income tax that supplies essential revenues, that doesn't reward with the lowest tax liability those corporations most willing to push the legal envelope, and that doesn't unfairly disadvantage smaller corporations that don't have the resources to set up out-of-state subsidiaries to avoid taxes. A slight majority of states with corporate income and similar taxes — 23 out of 45 plus the District of Columbia — have recognized this and mandated combined reporting. Seven states have enacted combined reporting since 2004.[9] It was a Republican Governor, Jim Douglas, who started the post-2004 wave with his recommendation that Vermont switch to combined reporting. Last year, another Republican Governor, Rick Snyder of Michigan, spearheaded reform of the state's business tax structure and retained combined reporting. Republican Governor Scott Walker campaigned on repealing combined reporting but chose to retain it after he was elected. If combined reporting is "anti-business," then there have been a lot of anti-business Republican governors over the years. Ronald Reagan did not make an effort to repeal combined reporting while he was governor, and neither did Sarah Palin.

Combined Reporting and State Economic Growth

During this hearing you will undoubtedly hear from a number of witnesses who will claim that adopting combined reporting will harm Maryland's economy by discouraging corporations from investing in the state in the future and perhaps even causing corporations already here to leave. These claims should be given very little credence. A report I prepared in late 2010 substantially undermines the claim.[10] It identifies the other combined reporting states in which the 120 largest corporations doing business in Maryland (as measured by Maryland employment) have physical facilities and therefore are unquestionably subject to mandatory combined reporting.

I found that the vast majority of the largest corporations here are quite willingly subjecting themselves to combined reporting in other states:

- At least 108 of the 120 largest Maryland employers maintain facilities in at least one combined reporting state or are a member of a corporate group that has a facility in at least one combined reporting state. The "compliance burdens" and tax liabilities arising from combined reporting cannot be that unreasonable if these companies — or the parent corporation that controls their decision-making — willingly maintain a facility in one or more combined reporting states.

- The vast majority of the corporations examined maintain facilities in multiple combined reporting states. Three-fourths of them — 90 out of 120 — have facilities in five or more combined reporting states. More than half — 67 out of 120 — have facilities in ten or more such states, and more than one-fourth — 34 out of 120 — have facilities in 20 or more combined reporting states.

- Eighteen companies have facilities in *all 23* combined reporting states.

- Ninety-three have a facility in California, the state that pioneered combined reporting and — as any corporate tax manager will attest — enforces it most aggressively.

- Thirty-two of the companies maintain their *headquarters* in combined reporting states. These companies include Bechtel, Berkshire-Hathaway (parent of GEICO), Hewlett-Packard, Target, and Wells Fargo.

If these corporations willingly subject themselves to combined reporting in other states year-in and year-out, there is no reason to believe that they would shun Maryland as a place to invest were it to adopt combined reporting.

I have also looked at the record of combined reporting states in retaining manufacturing jobs. This may be a reasonable indicator of whether combined reporting has a negative impact on the attractiveness of a state for investment, since manufacturers in theory don't need to be as close to their customers as retailers, construction contractors, and other types of service businesses need to be and therefore can choose to locate where state and local tax policies are more to their liking.

In the last 10 years, every state except Utah and North Dakota has experienced a net loss of manufacturing jobs. And yet there is no indication that the presence of combined reporting has played a role in a state's relative success in retaining such jobs. Of the 15 states with corporate income taxes that had the best record in retaining manufacturing job in the last decade, 10 were combined reporting states. (This group of 10 includes Utah and North Dakota.) Conversely, of the 15 corporate income tax states that lost the greatest share of manufacturing jobs, only two were combined reporting states, and only for a few years at the end of the decade. There appears to be no correlation between a state's adoption of combined reporting and its relative success in retaining what are theoretically the most potentially footloose firms and their jobs.

And there is a good reason for this. All state and local taxes paid by corporations represent no more than 2 percent to 4 percent of their total expenses, on average. On average, the state corporate income tax represents less than 10 percent of that already small share.[11] And combined reporting will boost corporate tax collections on the order of 10 percent to 20 percent in most states. It thus should not be surprising that the evidence I've just cited suggests that combined reporting has not been a disincentive for corporations to continue investing and creating jobs in states that adopt it.

The Alleged "Complexity" of Combined Reporting

Corporate opponents of combined reporting also object that combined reporting is complex and burdensome to comply with, particularly because of the subjectivity entailed in determining which member subsidiaries of a multi-corporate group are or are not engaged in a so-called "unitary business" with the parent and/or subsidiar(ies) subject to corporate income tax in Maryland. Such a claim compares combined reporting to the current system under which the state is, for all practical purposes, powerless to stop many forms of interstate income shifting. If the state actually had the resources and attempted to adjust the prices that one member of a corporate group located in Maryland charged and/or paid other out-of-state member for intra-corporate sales of goods and services to prevent such shifting, then the subjectivity, contentiousness, litigation, and compliance burden flowing from such an effort would exceed that of combined reporting many times over.

Corporations already file consolidated tax returns for federal tax purposes and consolidated financial statements for financial reporting purposes; they know how to do the accounting. The only potential complexity that arises from combined reporting is determining which corporations are and are not part of the unitary group. As discussed previously, most major corporations are filing combined reporting-based tax returns in numerous states, so they appear to be figuring out how to do that. The state could consider emulating Massachusetts and allowing corporations to make a long-term election to determine the combined group strictly on the basis of common ownership with no subjective determination of whether a particular subsidiary is part of a "unitary business." Such a rule eliminates *any* argument that combined reporting imposes a significant or unreasonable compliance burden on corporations.

Opponents of combined reporting sometimes argue that combined reporting will be burdensome and should not be enacted in Maryland because other combined reporting states have divergent laws concerning which kinds of corporate subsidiaries are included in the combined group and other fine points of the policy. This is a red herring and, quite frankly, a disingenuous argument. Maryland cannot be responsible for divergent policy choices that other states have made nor should it reject an otherwise sound tax policy change because of those choices. The multistate corporate tax community is free at any time to encourage combined reporting states to harmonize their combined reporting law to reduce their compliance burdens, but there is no evidence of their having made any real attempt to do so. Indeed, it opposed the promulgation by the Multistate Tax Commission of a model combined reporting law several years ago.

Now Is the Time

As you know, the Maryland Business Tax Reform Commission recommended that combined reporting not be adopted in 2011. It is now 2012, however, and whatever reticence the Commission may have had is no longer justified given that corporate profits have reached an all-time high. Corporations can afford to contribute somewhat more to the state services from which they benefit. According to the Council on State Taxation, a business organization, Maryland imposed the second lowest overall business tax burden of any state in 2010 (tied for second).[12] Another COST study showed that Maryland imposes the twelfth-lowest effective tax rate on new business investments.[13]

The enactment of combined reporting can make an important contribution to preserving Maryland's tax base from further erosion and ensuring that sufficient revenues are available with which to finance critical public investments in education, worker retraining, and physical infrastructure. These kinds of investments are critical to Maryland's economic future, and they benefit Maryland businesses as well as Maryland families. The state continues to struggle with a substantial structural budget gap that puts these investments at risk. In light of Maryland's quite low business taxes, it is entirely reasonable that Maryland finally require large multistate corporations that are continuing to shelter their quite-healthy profits from taxation with aggressive tax planning techniques to help to close that gap. Maryland's adoption of combined reporting is long overdue.

Addendum: The NCSL Combined Reporting Study

I would like to respond to what I anticipate will be the citation by business witnesses of a recent National Conference of State Legislatures report that used statistical techniques to determine whether combined reporting generated revenue for states that adopted it and had an adverse impact on their economies.[14] The study was unable to find a statistically significant revenue impact and concluded that combined reporting states with above-average corporate income tax rates had slightly lower rates of economic growth as a result. However, a study co-authored by the principal author of the NCSL report reached precisely the opposite conclusion:

> [I]f policymakers decide that restoring, or at least maintaining, the corporate income tax base is desirable, evidence suggests that combined-reporting requirements are often effective in partially achieving this goal. At the same time, there is no evidence that these requirements diminish economic activity in states.[15]

An earlier study co-authored by the authors of the NCSL report and published in a peer-reviewed economics journal reached the exact opposite conclusion as the NCSL study with respect to the revenue impact of adopting combined reporting:

> [The statistical results support] the notion that combined reporting partially closes a potential loophole that otherwise allows multistate corporations to shift income to low-tax states. The point estimate suggests that adopting combined reporting increases corporate tax revenues by $95.7 million in the average state.[16]

The NCSL report did not acknowledge, let alone reconcile, the contrary conclusions of its authors' prior research. Any time the updating of a statistical analysis with a few years of additional data leads to a different conclusion concerning the issues being studied, significant questions arise concerning the robustness of the theoretical model underlying the analysis.

In addition, the NCSL report acknowledges that its statistical methodology inherently involves drawing conclusions only from a few years' experience of just two recent adopters of combined reporting, Vermont and New York.[17] In other words, if combined reporting were, in fact, generating significant revenue in the 16 states that have required it for decades, and if, in fact, those states were *not* experiencing any negative economic effects, the NCSL study would be incapable of incorporating those results.

Finally, it is worth noting that the NCSL report also found that the type of anti-Delaware Holding Company legislation that Maryland has already enacted actually had a more negative impact on state economic growth than combined reporting.[18] That finding is dubious because most of the companies affected by this law are retail store chains, and they obviously don't close stores in states that enact these laws. In any case, however, by the logic of this result Maryland would actually improve its economic outlook by repealing its royalty addback law and *substituting* combined reporting.

In sum, significant questions can be raised about the validity of the statistical analysis contained in the NCSL report, and until it can incorporate more years of data from more states adopting combined reporting in recent years, it should be given little weight in evaluating the economic and revenue impact of this policy. For now, the best evidence on the revenue impact of combined reporting in Maryland is that provided by the fiscal note on this legislation and the very specific data developed by the Comptroller's Office over the past three years. And the best evidence on its benign economic development impact is the willingness of major multistate corporations to maintain their operations in numerous combined reporting states on an ongoing basis.

Notes

[1] See: Michael Mazerov, "State Corporate Tax Shelters and the Need for 'Combined Reporting'," Center on Budget and Policy Priorities, October 26, 2007; http://www.cbpp.org/files/10-26-07sfp.pdf .

[2] These data are available at http://www.marylandtaxes.com/finances/revenue/combined.asp . The tax year 2007 data indicate that implementation of the "Joyce" approach to combined reporting would have increased corporate income tax revenue in that year by $92 million, while the "Finnigan" approach would have increased revenue by $144 million. "Joyce" and "Finnigan" refer to two California court cases describing alternative approaches to implementing combined reporting when some members of the combined group are taxable in a combined reporting state and others are not.

[3] See: Jesse Drucker, "Inside Wal-Mart's Bid to Slash State Taxes," *Wall Street Journal*, November 23, 2007.

[4] See: Congressional Budget Office, "Taxing Capital Income: Effective Rates and Approaches to Reform," October 2005, p. 8; http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/67xx/doc6792/10-18-tax.pdf .

[5] See: Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce, and Richard Prisinzano, "Methodology to Identify Small Businesses and Their Owners," Office of Tax Analysis, U.S. Department of the Treasury, August 2011, Table 4, p. 26; http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf .

[6] Indeed, some business representatives argued that combined reporting would likely generate no revenue whatsoever. See, for example, the official statement of legislative position of the Maryland Chamber of Commerce on SB 393, February 28, 2007: "It is highly likely that Maryland would see no revenue gain, and will likely suffer a loss of income tax revenues from combined reporting for the foreseeable future."

[7] See the source cited in Note 2.

[8] See the fiscal note on SB 269 at http://mlis.state.md.us/2012rs/fnotes/bil_0009/sb0269.pdf .

[9] See: Michael Mazerov, "A Majority of States Have Now Adopted a Key Corporate Tax Reform — "Combined Reporting," Center on Budget and Policy Priorities, April 3, 2009; http://www.cbpp.org/files/4-5-07sfp.pdf .

[10] See: Michael Mazerov and Mark Enriquez, "Vast Majority of Large Maryland Corporations Are Already Subject to "Combined Reporting" in Other States," Center on Budget and Policy Priorities, November 9, 2010; http://www.cbpp.org/files/11-9-10sfp.pdf .

[11] See Note 4 of the source cited in the previous Note.

[12] See: Andrew Phillips, Robert Cline, Thomas Neubig, and Julia Thayne (all Ernst & Young), "Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2010," Council on State Taxation, July 2011, Table 5, p. 9; http://www.cost.org/WorkArea/DownloadAsset.aspx?id=79162 .

[13] See: Robert Cline, Andrew Phillips, Thomas Neubig (all Ernst & Young), "Competitiveness of State and Local Business Taxes on New Investment," Council on State Taxation, April 2011, Table 2, p. 9; http://www.cost.org/WorkArea/DownloadAsset.aspx?id=78442 .

[14] William F. Fox and LeAnn Luna, "Combined Reporting with the Corporate Income Tax: Issues for State Legislatures," National Conference of State Legislatures, November 2010; http://www.ncsl.org/documents/standcomm/sccomfc/CombinedReportingFinalDraft.pdf .

[15] Donald Bruce, John Deskins, and William F. Fox, "On the Extent, Growth, and Efficiency Consequences of State Business Tax Planning," in Alan J. Auerbach, James R. Hines, Jr., and Joel Slemrod, Editors, *Taxing Corporate Income in the 21st Century*, Cambridge University Press, 2007.

[16] William F. Fox and LeAnn Luna, "Do Limited Liability Companies Explain Declining State Corporate Tax Revenues?" *Public Finance Review*, November 2005.

[17] See pp. 35-36 of the source cited in Note 14: "Statistical analysis of this type identifies the effects by looking at how the economy is influenced in states where a change in policy takes place. Thus, we cannot measure the effects in states that imposed combined reporting throughout our period of analysis, which spans from 1993 through 2009. As a result, we are primarily measuring the effects arising from the recent adoption of combined reporting in Vermont and New York. . . Other adopters have implemented the policy too recently for the effects to be measured in the data. This suggests that additional study is warranted as years pass, and it is possible to study New York and Vermont for more years and to examine other adopting states." In other words, this analysis cannot measure the revenue and economic effects of combined reporting in the 16 states that implemented it prior to 1993 and maintained it through 2009.

[18] See Table 7, p. 34, of the source cited in Note 14.