# MARYLAND BUSINESS TAX REFORM COMMISSION

Raymond S. Wacks, Chairman

December 15, 2010

Honorable Martin O'Malley
Governor of Maryland
State House
Annapolis, Maryland 21401

Honorable Thomas V. "Mike" Miller, Jr.
President, Senate of Maryland
State House
Annapolis, Maryland 21401

Honorable Michael E. Busch
Speaker, Maryland House of Delegates
State House
Annapolis, Maryland 21401

Dear Governor, President and Speaker:

The Maryland Business Tax Reform Commission has completed its work and is forwarding to you its recommendations. Created by Chapter 3 of the 2007 Special Session, the Commission was charged with reviewing and evaluating the State's current business tax structure in order to make specific recommendations for changes to "provide for fair and equitable taxation for all corporations and other business entities doing business in the State." The Commission was charged with reviewing and evaluating the imposition of combined reporting for the corporate income tax, the imposition of other types of business taxes, and improved methods for evaluating the effectiveness and efficiency of economic development tax incentives.

After thoughtful consideration and lengthy deliberations, we present to you the following three recommendations:

- that the Maryland General Assembly not implement combined reporting in the 2011 legislative session;

- that no substantive changes to economic development incentives be made at this time, but that a workgroup be created to work with the General Assembly, taxpayers, and other stakeholders to ensure that incentives are measurable and cost effective; and

- that we reaffirm the previous actions of the General Assembly that it is the policy of the State of Maryland to support the Streamlined Sales & Use Tax Agreement, and that the State should join the compact and make necessary legislative changes when Congress authorizes a national streamlined sales tax.

Two additional motions were considered and rejected by the Commission.

Attached is the report of the Commission, which is supplemented by the Commission's website, www.btrc.maryland.gov. All presentations, testimony, meeting minutes, related studies, and other relevant material is available on the website.

I would also like to take the opportunity to thank the members of the Commission who spent many long hours in meetings reviewing the issues. In addition, the Commission members would like to thank the staff of the Comptroller's Office and the Department of Budget and Management who worked hard to provide quality information.

We hope that you find our work helpful, and would be pleased to make ourselves available if you should have any questions.

Sincerely,

Raymond Wacks
Chairman

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# REPORT

# OF THE

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# TABLE OF CONTENTS

## Introduction

The Maryland Business Tax Reform Commission was created by Chapter 3, Tax Reform Act of 2007 during the 2007 Special Session of the General Assembly. The 19-member Commission includes legislators, State officials, and representatives of the business community, local governments, and the public. The Commission's charge was to "review and evaluate the State's current business tax structure and make specific recommendations for changes...to provide for fair and equitable taxation for all corporations and other business entities doing business in the State," and the statute provides that the recommendations "may include, without limitation, changes such as tax rate changes, tax base broadening measures, measures to address tax avoidance strategies, and elimination of ineffective or inefficient tax policies intended as economic development incentives." The Commission was explicitly directed to include a review and evaluation of the following:

- the imposition of combined reporting using the "water's edge method" under the corporate income tax for unitary groups of affiliated corporations;
- the imposition of other types of business taxes, in lieu of or in addition to the current taxes imposed, including gross receipts taxes, value added taxes, and alternative minimum taxes; and
- improved methods for evaluation of the effectiveness and efficiency of tax policies intended as economic development incentives.

Initially, the Commission was to provide its final report of findings and recommendations by December 15, 2011. Chapter 543 of the 2010 Session of the General Assembly changed the due date for the final report from 2011 to December 15, 2010.

The Commission first met on November 19, 2008, and has since met an additional 28 times, either as the full commission or as one of two subcommittees that were formed to look at several issues in more detail, the Business Tax Reporting Subcommittee and the Business Incentives in the Tax Code Subcommittee. Testimony was presented by a variety of experts on tax policy, including tax policy analysts, economists, tax administrators and Commission members themselves. A public hearing was held on November 9, 2010 to hear from the public on these issues.

Following a discussion of the motions adopted and rejected by the Commission is a summary of material presented to the Commission and the two subcommittees, upon which their deliberations were based. Detailed information, including all presentations, expert testimony, meeting minutes, related studies, public testimony, and other relevant material is available on the Maryland Business Tax Reform Commission website, www.btrc.maryland.gov.

## Committee Actions

Following two years of extensive meetings and discussion, and public input, the Commission met on November 16 to vote on recommendations. Ultimately, three recommendations were adopted.

### *Combined Reporting*

Much of the Commission's work focused on whether Maryland should adopt combined reporting. By a vote of thirteen to four, the following motion was adopted:

> **A motion that the commission recommend to the legislature to not implement combined reporting in the 2011 session.**

Members determined that several factors made the implementation of combined reporting at the upcoming session of the General Assembly inadvisable. Combined reporting is a complex change for taxpayers, tax preparers, and the Comptroller's office, introducing uncertainty at a time when the economy is struggling to recover from the recent recession. It would result in a shift of the tax burden, substantial in some cases, among industries and among taxpayers, resulting in winners and losers. Many of the tax avoidance measures which combined reporting is intended to prevent have already been addressed by the State through the Delaware holding company addback, the captive real estate investment trust (REIT) legislation, and other measures. Finally, members noted, the Comptroller's study of corporate information returns for tax years 2006 and 2007, and preliminary results for tax year 2008, indicates that combined reporting would lead to increased volatility in the corporate income tax, already one of the State's most volatile revenue sources.

### *Tax Incentives*

The Commission closely examined current tax incentives and ways by which to improve measurement of their use and effectiveness. By a vote of fifteen to zero, with two abstentions, the following motion was adopted:

> **A motion to make no substantive changes to economic development incentives at this time, but to create a workgroup to work with the General Assembly, taxpayers, and other stakeholders to ensure that incentives are measurable and cost effective.**

Members noted the risks of making substantive changes to current incentive programs during a fragile economic recovery. In addition, members expressed concerns about the burdens additional reporting requirements would place on taxpayers, and the burdens additional reporting requirements would put on State agencies with extremely limited budgetary resources.

### *Streamlined Sales and Use Tax Agreement*

The Commission heard testimony on the Streamlined Sales and Use Tax Agreement (SSUTA) as part of its charge to examine broadening the State's tax base. By a vote of seventeen to zero, the following motion was adopted:

> **A motion that the commission reaffirms the previous action of the General Assembly and reaffirms the policy of the State of Maryland that we believe in the Streamline Sales and Use Tax Agreement and the legislature should join the compact and make the necessary changes when Congress authorizes a national streamlined sales tax agreement.**

Members recognized that the structural changes in the retail sector of the economy have had an impact on State revenues and that action is warranted. Accordingly, the General Assembly has positioned Maryland as an Advisory State, which means that Maryland agrees in concept with the SSUTA but has not made statutory changes required to conform with the agreement. A primary reason such changes have not been made is because conforming to the agreement would result in an immediate revenue loss of between $24 million and $28 million with little offsetting revenues from increased sales tax collections.

If Congress were to enact legislation requiring remote sellers to collect the sales tax for conforming states, Maryland would realize a significant increase in revenues. Maryland law currently provides that the State shall adopt the SSUTA upon enactment of such federal legislation, and also requires the Comptroller to submit proposed regulations and draft legislation that would bring Maryland into full compliance with the SSUTA within 90 days of the passage of the federal legislation.

### *Failed Motions*

Two motions introduced by members of the committee did not receive the necessary ten votes to be included as recommendations in the report.

The first failed motion, by a vote of six in favor and eight opposed, with three abstentions, was to recommend a need for flexibility for local tax incentives:

> **A motion that the report from this committee recommend a need for flexibility in both the local authority to provide tax credits as well as tax incentives on the state level and that we develop a workgroup to further investigate that and make recommendations to the legislature.**

Members expressed the concern that allowing individual counties to create their own incentive programs using State money would essentially cause the State to lose control over that money, making it difficult for taxpayers to hold the State accountable. Members also reiterated the concern that allowing each county to create its own tax incentives could cause a “race to the bottom,” with counties competing against one another to attract businesses. Additionally, it was suggested that counties do have some control over some local fees, and therefore can adjust these fees to reduce businesses’ local tax burden.

The second failed motion, by a vote of two in favor and fourteen opposed with one abstention, related to the issue of taxpayers not being able to claim a credit for taxes paid to other states against the local income tax:

> **A motion that the commission report recommend that the Maryland General Assembly study this issue and consider adopting a provision that allows the credit for taxes paid to other states on interstate business income to apply to both the state and local combined tax rate.**

Members were concerned that allowing a tax credit against both the State and local income tax would result in a significant reduction in county revenues at a time when counties are struggling with revenue shortfalls. In addition, members decided that the issue had not been discussed in sufficient detail to warrant inclusion as a recommendation.

## Maryland's Taxation of Business

Several broad-based taxes are imposed on Maryland businesses, including the corporate income tax, the individual income tax, the sales tax, and property taxes. Along with smaller, industry-specific taxes such as the public service company franchise tax and the insurance premiums tax, approximately $2.5 billion of Maryland's $13 billion in general fund revenues in 2008 were derived directly from business taxpayers.

The individual income tax is Maryland's largest source of general fund revenue, representing approximately one-half of general fund collections each year. While not generally thought of as a business tax, much of this revenue results from business activity. The income of most business entities other than C-corporations is reported on the individual income tax return of the owners of the businesses. These entities, known as "pass-through entities," include sole proprietorships, partnerships, limited liability corporations, subchapter S corporations, and others. The top marginal State tax rate of 6.25% applies to net taxable income above $1 million. The 6.25% rate is set to expire after tax year 2010, at which point a top State rate of 5.5% will be imposed on NTI greater than $500,000.

Maryland's 6.25% top rate is higher than in Delaware (5.95%), Pennsylvania (3.07% flat rate) and Virginia (5.75%), but lower than in New Jersey (8.97%), North Carolina (7.75%), West Virginia (6.50%) and Washington, DC (8.50%), although in all states except for New Jersey these rates apply to income well below $1 million. Maryland is unique in that each county also imposes an additional income tax that is administered by the State and distributed to the local governments. The county rates range from 1.25% to 3.20% of NTI. An additional nonresident tax of 1.25% is applied to the NTI of nonresidents. Business-related tax credits that can be claimed against the corporate income tax can also be claimed against the individual income tax, as well as a credit for taxes paid to other states, which is particularly relevant for taxpayers with business income as their business interests may cross state lines.

Over 20% of resident individual income tax returns report business income of one sort or another. In 2006, over $16 billion of business income was reported, although up to 30% of this income was earned in another state with an income tax and was effectively not taxed by Maryland under the State income tax. Conversely, nonresidents reported nearly $23 billion of business income in 2006, although only $1.5 billion on 35,600 returns was taxable. Unsurprisingly, business income is reported disproportionately on high-dollar income tax returns; residents with over $5 million of federal adjusted gross income, the top 0.1% of income earners, reported 11.0% of business income. Almost half of the business income was reported on only 2.7% of returns (those with federal adjusted gross income over $500,000).

The corporate income tax is generally Maryland's third largest source of general fund revenue each year. However, at around 5% of general fund revenues, it is substantially smaller than the individual income tax and the sales tax. The corporate income tax, paid only by C-corporations, is also traditionally Maryland's most volatile revenue source. Generally, every Maryland corporation and any other corporation that conducts business in Maryland is required to file a corporate income tax return.

Maryland taxes corporations on a "separate entity" basis–each separate legal entity is a taxpayer which files its own return based on its own federal taxable income and calculating its own deductions, apportionment and tax liability. A corporation's taxable income is apportioned to Maryland based on the amount of business carried out in the State. Most corporations are required to use the double-weighted three-factor apportionment formula, where the Maryland to total ratios of the three factors–sales, property, and payroll, with the sales factor doubled–are averaged. Manufacturing corporations are required to use single-sales apportionment, the ratio of Maryland sales to total sales; transportation, leasing and rental corporations and brokerage services also have special apportionment formulas. Maryland imposes a uniform rate of 8.25% on C-corporations, which is generally comparable with neighboring states. Maryland's rate is higher than in North Carolina (6.9%) and Virginia (6.0%), but is lower than Delaware (8.7%), New Jersey (9.0%), Pennsylvania (9.99%), West Virginia (8.5%) and Washington, DC (9.985%).

Roughly 65,000 corporations file an income tax return in Maryland each year. Over one-quarter of these corporations are classified in the real estate and rental and leasing industry and professional, scientific and technical services industry. Over 57% of Maryland modified income on taxable returns, however, comes from manufacturing firms (29% of income on 10% of returns), finance and insurance companies (18% of income on 9% of returns) and retail corporations (11% of income on 7.5% of returns).

The sales and use tax is Maryland's second largest source of general fund revenue, representing approximately 28% of general fund revenue annually. Generally thought of as a tax paid by consumers, the tax does have a substantial business component as it applies to the sale of most tangible personal property in the State–an estimated 28% of the tax is paid directly by businesses. Vendors who are engaged in business in the State are required to collect the tax from the purchaser, although Maryland generally cannot compel vendors with no physical presence in the State to collect the tax on sales made into the State. In those cases, the use tax is due from the purchaser. Maryland's 6% general rate is either higher or equal to the rate imposed by each of its surrounding states. Several exemptions from the sales tax directly affect business activity; major exemptions include those for sales of tangible personal property used predominantly in a production activity ($135 million); sales for agricultural purposes or of agricultural products ($83 million); and certain sales for research and development purposes ($21 million).

Businesses in Maryland are subject to a real property tax, and many are subject to a personal property tax. While there is a State component to the real property tax, it is small, as the rate is only 11.2¢ per $100 of assessed valuation; county rates range from 43.2¢ per $100 in Talbot County to $2.268 per $100 in Baltimore City. The weighted average local rate was roughly 97.2¢ in fiscal year 2010. Statewide, commercial property is roughly 18.4% of the real property tax base, although the range is quite wide. In Calvert and Queen Anne's counties, commercial property is less than 10% of the real property tax base, while in Baltimore City it is over 30% and in Allegany, Baltimore County, Prince George's, Washington and Wicomico counties, commercial property is over 20% of the total real property tax base. Given that Baltimore City has both the highest tax rate and the highest concentration of commercial property in the State; the share of the real property tax paid by businesses in Baltimore City is substantially higher than it is elsewhere in the State. There is no State personal property tax in Maryland. Twenty counties, however, impose a personal property tax; Frederick, Kent, Queen Anne's and Talbot counties do not.

Maryland also imposes a business franchise tax on public service telecommunications companies and electric and gas utilities, an insurance premiums tax on insurance companies, and an excise tax on alcohol, tobacco and motor fuel. However, collectively, these revenues make up only a small percentage of general fund revenues.

## Current Business Tax Issues

The Commission heard testimony from a variety of economists, tax policy experts, tax administrators and tax preparers regarding their perspectives on the positive and negative aspects of current state business taxation: COST, FTA, CBPP, E&Y, ITEP, and MACPA presentations. Broadly, the issues that the experts identified surrounding state taxation involve: identifying businesses' "fair share" and the optimal mix of taxation methods; adapting state taxation to changes in the economy over the past several decades; and whether or not economic development incentives are effective.

Some observers argue that because corporations are artificial entities and that their income ultimately flows through to stakeholders, that their income should not be taxed; doing so results in double taxation. Proponents of taxation at the corporate level counter that government provides the services and the structured environment that enable corporations to operate and make a profit, and that corporate taxation should be at a level that reflects these benefits provided by the state.

Proponents of combined reporting believe that the fact that state corporate income tax collections have been declining as a share of total state tax collections is primarily a result of aggressive corporate tax planning, especially the artificial shifting of income among corporations that operate in multiple states. Proponents in this camp believe that combined reporting is the tax policy solution which would level the playing field between large multistate corporations and small unistate businesses and would result in a fairer distribution of the tax burden to and among businesses.

Supporters of current law counter that many states, including Maryland, have enacted a variety of legislative solutions that minimize or prevent the illegitimate shifting of income.

Enacting combined reporting would therefore solve a problem that no longer exists while making the tax code more difficult to administer and comply with; the uncertainties and shifts in tax burdens may not be worth any increase in corporate income tax revenue. In addition, the fact that some taxpayers pay more tax under combined reporting while others pay less may support the argument that combined reporting does more than merely function as a means of addressing tax avoidance.

In recent years, some states have attempted to resolve perceived problems with the corporate income tax and address challenges brought by structural changes in the economy by moving to combined reporting, while others have recently moved away from or supplemented the traditional corporate income tax with various forms of value added or gross receipts taxes. Although this recent trend seems to be geared toward adapting state taxation to the new corporate environment, most experts agree that neither approach is a panacea.

Another frequently cited business issue in state taxation involves the sales and use tax. Despite the fact that businesses pay a sizeable share of the sales and use tax, many services, particularly those utilized by businesses, are excluded from the sales and use tax base. Some experts believe that, to reflect the decades-long trend in the United States' economy towards services away from production of tangible goods, the sales tax base should be broadened substantially to include services. Others argue that such an expansion results in tax pyramiding and difficulties in sourcing, and hence a tax structure that creates as many problems as it may resolve.

Aside from questions of the appropriate state business tax structure for the 21$^{st}$ century, there are varying viewpoints regarding the effectiveness of economic development incentives. Regardless of the types of incentives, supporters believe that they do create economic growth and that such incentives are necessary to compete with neighboring jurisdictions and others. Critics of economic development tax incentives suggest that it is very difficult if not impossible to accurately measure their effectiveness and that these incentives create a "race to the bottom" amongst state and local jurisdictions.

## Subcommittees

The Commission separated into two subcommittees, the Business Tax Reporting Subcommittee and the Business Incentives in the Tax Code Subcommittee in order to study more closely specific current business tax issues. The Business Tax Reporting Subcommittee was charged with studying (1) "the imposition of combined reporting using the 'water's edge method'" as well as (2) the imposition of other types of business taxes, in lieu of or in addition to, the current taxes imposed, including gross receipts taxes, value added taxes, and alternative minimum taxes." The Business Incentives in the Tax Code Subcommittee was charged with identifying "improved methods for evaluation of the effectiveness and efficiency of tax policies intended as economic development incentives" including the sales tax, tax credits and other tax expenditures. The work of the two subcommittees is discussed below.

## Business Tax Reporting Issues

The Commission explored several alternatives to and modifications of Maryland's current corporate income tax structure. Topics discussed included combined reporting, gross receipts taxes, value added taxes, alternative minimum taxes, throwback and throwout apportionment modifications, and the allocation of non-operational income. However, before these policy issues were addressed, members were presented with information regarding tax philosophy, current tax mechanics, the effect of recent statutory changes to the corporate income tax, and current issues realized in audit by the Comptroller's office.

### *Corporate Income Tax Avoidance*

The Commission heard from the Comptroller's lead corporate auditor regarding the effects of recently-enacted legislation addressing tax avoidance strategies and other such strategies that have since come to light. In 2004, the General Assembly passed legislation that restricted the ability of corporations to shift income to out of state shell companies to avoid taxation. Because of their large concentration in Delaware, these shell companies became known as "Delaware holding companies" (DHCs). Companies employing DHCs were able to reduce their Maryland corporate tax by transferring the corporation's trademarks, logos, patents, and other intangible assets to a shell company located in a state that does not tax income from intangibles. The Maryland corporation then pays the holding company for the rights to those various intangible properties, effectively diverting income from Maryland. The 2004 legislation also granted the Comptroller the authority to use powers under Section 482 of the Internal Revenue Code to reallocate income and deductions between related taxpayers.

Legislation enacted in 2004 provided a settlement period for taxpayers to come forward with liabilities related to this use of holding companies with penalties and half of interest due waived. Approximately 300 companies took advantage of this settlement, paying $198 million of tax and interest. Legislation was also adopted that addressed this issue on an ongoing basis. As a result, the State is getting more voluntary DHC-related disclosures, and has only recently neared the end of audits related to this issue.

The General Assembly proceeded in 2007 to close another tax avoidance strategy that had allowed corporations to deduct payments to "captive" real estate investment trusts (REITs) as expenses, therefore reducing their Maryland tax liability. Corporations could create and own a REIT that owned the real estate leased or rented by the corporation, which would then charge the parent corporation rent or leasing fees, shifting income from the parent to the REIT. The REIT would then pay a dividend to the parent corporation, a deductible transaction under federal law which would be reflected on its State income tax return, and since the federal treatment of REITs requires that the shareholders be taxed by their state of residence, not the location of the real estate, this income would essentially escape taxation by Maryland. The legislation passed to curtail these efforts, requiring that captive REITs add back their dividends paid deduction to their Maryland taxable income, has been successful.

In light of the successful closure of these tax avoidance strategies, some corporations have developed other tactics aimed at Maryland corporate income tax avoidance. Audits have revealed that, in methods similar to the DHC and REIT strategies, some corporations are using management expenses, costs of goods sold, self insurance strategies, and other expense items to effectively divert income from Maryland. These issues are addressed through audit using existing laws and regulations.

### *Policy Alternatives–Combined Reporting*

Because of the frequent assertion that combined reporting is a broad solution to many current corporate income tax issues and due to its complexity, discussion of combined reporting occurred over several meetings culminating in a staff report that identified the core issues for further discussion. A general discussion of combined reporting follows.

Under combined reporting, all members of a "unitary group" are generally treated as one entity for tax purposes. A unitary group is that group of corporations whose business activities are interdependent. Typically, some combination of centralized control, economies of scale, and a flow of goods, resources or services demonstrating functional integration are used to determine whether a collection of entities is a unitary group. Treating the unitary group as one entity eliminates any distortions caused by intercompany transactions. Defining the unitary group is widely regarded as one of the largest challenges in combined reporting taxation.

The income of the entire group is apportioned based on one of two methods, "Joyce" or "Finnigan." Under the Joyce method of apportionment, the denominator of the apportionment factor–typically payroll, property and double-weighted sales–is the total payroll, property and sales of all members of the group, regardless of whether they are subject to Maryland's corporate income tax (have *nexus* with Maryland). The numerator consists of the payroll, property and sales of all of the entities in the group with *nexus*. In general, under combined reporting intercompany transactions are irrelevant and the income subject to apportionment is much greater than under separate entity reporting, while the apportionment factor is much lower. The members of a group may pay more or less tax in the aggregate depending on whether the increase in income is relatively greater than the reduction in the apportionment factor.

Under the Finnigan method of apportionment, the denominator is the same as under Joyce–the total payroll, property and sales of all members of the group, regardless of whether they are subject to Maryland's corporate income tax. The numerator consists of the payroll, property and sales of all of the companies in the group that have *nexus* and all of the companies that make sales into the State (making sales into a state, with negligible other activity, does not create *nexus*). Again, intercompany transactions are irrelevant. Group income is the same under Joyce and Finnigan; except in extraordinary cases, the apportionment factor under Finnigan is equal to or greater than that under Joyce, as the addition of sales into the State from companies without *nexus* creates a larger numerator for the sales factor.

Along with several staff briefings, the Commission heard detailed testimony on combined reporting from Jane Steinmetz of Price WaterhouseCoopers, also a member of Massachusetts' Study Commission on Corporate Taxation, and from Joe Huddleston, Executive Director of the Multistate Tax Commission. Topics at that meeting included the concept of "unitary group," Joyce and Finnigan apportionment, single sales apportionment and combined reporting, and about transitional issues that would arise for taxpayers and tax administrators in making the change from separate entity reporting to combined reporting.

### *Corporate Information Reports*

In order to better understand the tax policy issue of combined corporate reporting, as well as other possible changes to the corporate income tax, the Maryland General Assembly imposed reporting requirements for certain corporations that are part of a unitary group, as set forth in Section 10 of the Tax Reform Act (Chapter 3, Acts of 2007, Special Session), and amended by Chapters 177 & 178 of 2008. The Comptroller is required to collect, compile, and analyze the reported corporate information for taxable years beginning after December 31, 2005 but before January 1, 2011.

Those corporations that comprise a corporate group are required to file a pro forma "water's edge" combined corporate income tax return that also separately reflects the dollar value of all property shipped from a facility within Maryland where the purchaser is the United States government or where the seller is not taxable in the state where the purchaser takes possession. The Comptroller satisfied the data collection piece of the reporting requirement by creating an online reporting system where corporate groups could either manually enter the required data or upload a file with the data in order to satisfy the reporting requirement.

The initial analysis of tax year 2006 corporate information reports indicated that under Joyce rules of apportionment, corporate income tax receipts would have been approximately $109 million higher than under existing law, and under Finnigan apportionment, approximately $170 million higher. These estimates assumed that a single-sales factor apportionment was used for manufacturing groups as a whole, with the industry of the group defined by the NAICS code of the member with the largest payroll. In addition, these estimates necessarily assumed that the introduction of combined reporting would not have caused any changes in behavior on the part of taxpayers. The above qualifications applied to all of the Comptroller's subsequent reports.

In March 2010, the Comptroller released a revised analysis of tax year 2006 corporate information reports and an initial estimate of tax year 2007. The initial tax year 2006 estimates were revised upwards, indicating that under the Joyce method of apportionment, combined reporting would have generated approximately $144 million in additional revenue for that tax year, rather than the initially reported figure of $109 million in additional revenue, while under the Finnigan method of apportionment $197 million in additional revenue would have been received, rather than the initially reported figure of $170 million. This revision arose primarily from three factors–amended corporate reports, additional corporate reports, and the correction of data problems discovered after further detailed analysis. For tax year 2007, revenues would have increased approximately $92 million under Joyce, and $144 million under Finnigan, increases of roughly 13% and 20% over actual tax year 2007 liability.

Although the initial analysis of tax year 2008 is not due for submission until March 2011, the Comptroller's office was able to provide a preliminary analysis in November 2010, before the Commission's voting session. The preliminary estimate indicated that had combined reporting been in effect for tax year 2008, the State would have collected less revenue that it actually did under existing law. The State would have lost approximately $51 million or $13 million under the Joyce and Finnigan methods of apportionment, respectively. These corporate reporting requirements expire after tax year 2010.

### *Other Policy Alternatives*

Excluding industry-specific gross receipts taxes, the insurance premium tax and public service company franchise tax, gross receipts taxes are the most common broad based non-income tax measure employed by states to tax corporations. Some states, such as Kentucky and Delaware, impose both a broad based gross receipts tax and an income based tax. A generic gross receipts tax is exactly as it sounds, the gross receipts of a corporation are taxed at a relatively low tax rate. However, most states that employ a gross receipts tax do so with a variety of different deductions from total gross receipts. For instance, Delaware permits a flat $960,000 deduction to the corporation's gross receipts while Texas's tax, which is on a combined group basis, allows the group to deduct the greater of their costs of goods sold, compensation paid, or 30% of total receipts. Despite certain tactics available to mitigate a gross receipt's effect on low margin corporations, the burden that would be placed on low margin corporations and a substantial shift in the overall tax burden among industries were considered substantial drawbacks to gross receipts taxes.

Alternative minimum taxes (AMTs) were examined by the Commission as a possible supplement to an income tax. An AMT is a minimum amount that a corporation would pay if its calculated tax liability were less than a defined amount. An AMT can be structured so that any AMT paid in a given year could be claimed as a credit available in later years to reduce corporate income tax liability. In that case, the AMT essentially results in an acceleration of revenue rather than a revenue generator. While the AMT could offer some "smoothing" of revenues and perhaps enhance the perception the fairness of corporate taxation, economic, distributional, and timing arguments weighed against an AMT. Additionally, some members noted that Maryland's annual business filing fees currently serve as a form of an AMT.

A value added tax (VAT) is a consumption tax that is based on the value that a business adds to its product. That value is the difference between the sales price that the business receives for the product and the cost of its inputs. As a product continues through its production cycle, from raw material to end consumer, the VAT is applied at each transactional stage. As each business in the production stage remits the VAT that they have collected, they receive a credit for the VAT that had already been collected up to their production stage. Members showed very little interest in a VAT as it was deemed to be exceedingly difficult to administer at the state level.

Throwback and throwout are modifications to the sales factor of the apportionment calculation for entities or groups that make sales from Maryland into states where those sales are not taxed. Either modification may serve as an accompaniment to separate entity or combined reporting corporate income taxation. Under a throwback requirement, those receipts that were not taxed in their destination state would be "thrown back" and included in the numerator of the Maryland sales factor apportionment calculation. Alternatively, those same sales under a throwout requirement would be negated, or "thrown out" from the denominator.

Both throwback and throwout lead to a higher apportionment factor, and therefore a revenue increase. Aside from the benefits of higher revenues, these apportionment modifications are intended to increase the likelihood that 100% of an entity's income will be subject to state corporate income taxes. Throwback and throwout laws effectively require companies to pay tax in one state on income that another state has chosen not to tax or cannot tax under principles of jurisdiction or federal preemption (Public Law 86-272). Arguments against throwback and throwout included that they represent a tax on product originators, thereby discouraging investment in a state. Throwback and throwout can be perceived as unfair because apportionment should require any factor in the apportionment calculation to reflect how the income of a corporation is earned. Additionally, it may be considered uncompetitive since the majority of Maryland's neighboring states employ neither throwback nor throwout.

Certain corporate income is apportionable while some is allocable, with the differentiation derived from the income's source. Operational income is that income which is generated through the entity's core business operations, while non-operational income is that income which arises outside of the entity's core operations, e.g., investment profits, foreign exchange income, or capital gains realized from the sale of a plant. Generally, once income has been classified as non-operational, that income is sourced to the state in which the property was located (for tangible assets) or to the taxpayer's commercial domicile (for intangible assets). Many states apportion operational income and allocate non-operational income, although there are variations from state to state.

Currently, Maryland does not distinguish between the two, therefore apportioning away income that could be allocated 100% to Maryland. Altering Maryland's statute to require 100% allocation of non-operational income could provide a small boost to revenues, though the inherent one-time nature of these transactions makes budgeting for them all but impossible. The commission decided not to provide any recommendation related to non-operational income.

Commission staff provided members with analyses of the revenue and distributional effects of various implementations of many of the above policy options and others. Further detail related to the Comptroller's corporate information reporting study was also provided.

## Business Tax Incentive Issues

The Commission heard extensive testimony on Maryland's 23 business-related tax credits and other State and local tax incentives. The Department of Business and Economic Development provided the Commission with a detailed overview of Maryland's current business tax credits, and placed them in the context of the State's economic development strategy—the State's efforts are focused on the biotechnology industry, the health care and education sectors, and the hospitality industry along with the federal government and related activities. Several examples of businesses that located and created jobs in the State as a result of the tax incentives offered were provided, as well as information regarding the amount of credits authorized by DBED over the past several years for various tax credits.

The Commission heard from directors of the economic development offices of several counties and from several business promotion organizations regarding their desire for more flexibility at the county level when offering businesses incentives. Because many State tax credits are general economic incentives, those that may work in one county do not necessarily work in another. Thus, incentives counties can provide are limited not only in resources, but also in authority. With more flexibility in the use of State funds, they argued, counties could more effectively craft incentive programs to fit the individual needs of businesses that are considering locating in a certain county and the economic development policies of each county.

The Commission also heard testimony from several site location consultants regarding the role of tax incentives in a business' decision to locate in a particular state. Jay Biggins, Executive Managing Director of Biggins, Lacy, Shapiro & Company, noted that tax incentives generally play a role in refining a company's search once a list of possible locations has been narrowed to two or more "finalist" locations and cost has become the driving factor for location. Businesses weigh incentives in terms of the return on investment as a result of the incentive and the amount of time required to take full advantage of the incentive. He noted that at this point, in many cases, Maryland may be competing directly with its neighboring states when businesses look at the most lucrative and appropriate incentives. Mr. Biggins also pointed to recent surveys ranking Maryland on different measures of business climate, which rate the State very highly to relatively poorly, depending upon the specific measure surveyed.

Measuring the effectiveness of State tax incentives was discussed in detail at several Commission meetings. There are both administrative difficulties with measuring the effectiveness of tax incentives, as well as empirical questions regarding whether certain business activity would have taken place in the absence of the incentives. Excluding the credit for income taxes paid to other states, Maryland currently offers 22 different business tax credits to incentivize job creation, capital development, certain environmental goals and investment in the local community. Representatives of the Comptroller's office explained a number of difficulties with tracking the use of business tax credits, including following the carryforward of credits, tracking credits claimed by pass through entities, and the prioritization of credits for taxpayers who claim more than one credit in any given year but who do not have sufficient liability to offset the full value of the credits claimed. All of the above issues make it difficult to get an exact number and amount of each of the State's credits claimed each year and to determine the difference between when certain economic activity took place and when a credit is actually claimed by a taxpayer. Solutions to these problems were discussed, including capturing more data from tax forms or integrating the Comptroller's reporting system with the systems of the State agencies administering each of the credits. All potential solutions, however, would require legislation and would impose additional burdens on taxpayers, the Comptroller's office and other administering agencies.

In addition to obtaining accurate data regarding the tax credits when they are claimed, the Commission discussed methods of studying the State's business tax credits to determine the effectiveness of any incentives offered. Several states currently require such analyses. Several issues were raised in regard to these studies, including when and how often credits are studied, who performs the studies, and what the outcomes are desired from the studies.

Finally, although not specifically a tax incentive like those described above, the commission did discuss the issue of the individual income tax credit for taxes paid to other states. Under current Maryland law, taxpayers may claim a credit against their Maryland tax liability for any income taxes paid to other states on income that is taxable in both Maryland and the other state. The credit is the lesser of the tax paid to the other state or the reduction in Maryland tax resulting from the exclusion of income in the other state. Currently, taxpayers may only use this credit to offset Maryland State income tax liability; it cannot be claimed against local income tax liability. This treatment, it was argued, amounts to double taxation of income.

In addition to the above tax incentives and credits, the Commission discussed the issue of the Streamlined Sales and Use Tax Agreement (SSUTA), a voluntary agreement among many states that requires full member states to conform their individual sales and use tax statutes to those set forth in the SSUTA. The primary goal of the SSUTA is to require uniform statutory definitions and practices, thereby demonstrating to Congress that the administration of the sales tax can be simplified for remote sellers, those doing business in a state from without who cannot currently be required to collect the sales tax. By doing so, member states hope to prevail upon Congress to adopt legislation requiring remote sellers to collect and submit the sales tax for transactions in states where they do not have a physical presence.

Both the Comptroller's office and the Council on State Taxation (COST) gave testimony regarding the SSUTA. The Comptroller's presentation was an overview of the purpose of the agreement and the complexities that have limited Maryland's conformity to the agreement. Maryland is considered an "Advisory State," which means that Maryland agrees with the SSUTA in concept but will not conform with the agreement until federal legislation imposing collection responsibilities on remote sellers is enacted. A recent study from the Comptroller's Office estimated that the statutory and regulatory changes necessary to conform Maryland's sales and use tax structure to that set forth in the SSUTA would cost the State between $39.5 million and $51.1 million in revenues in fiscal year 2011 (in the absence of any federal provision requiring remote sellers to collect and remit sales and use taxes).

The COST presentation provided detail on the genesis of the agreement, current federal legislation that would require remote sellers to collect sales and use taxes, and the recent estimates of the impact of remote sales on Maryland revenues. Congressional legislation has in fact been proposed several times which would require remote sellers to collect state sales and use taxes. The most current legislation, titled the Main Street Fairness Act (H.R. 5660), was introduced in July 2010. This act would grant the consent of Congress to the SSUTA and require all remote sellers that do not qualify for the small seller exception to collect and remit sales and uses taxes in accordance with the SSUTA. As of November 2010, the bill has 6 cosponsors but has yet to receive any major action.

A recent study by William Fox and others, authorities on issues related to taxation of online and other remote sales, estimated that Maryland sales tax collections were about $140 million (4%) lower than they otherwise would have been in fiscal year 2010 due to the inability to compel remote vendors to collect the tax. This figure is in line with earlier work done by Fox, as well as by the Comptroller's Office. Changes proposed by the SSUTA, if ratified by Congress, would not result in a net revenue increase of this amount, due to the changes to current Maryland law that would be required. These include changes to how Maryland rounds sales tax calculations, the possibility of higher vendor discounts, as well as exemptions for small remote retailers and other requirements of the agreement. Nevertheless, if Maryland conformed to the SSUTA and if Congress were to require remote sellers to collect the tax, Maryland sales tax revenues would increase.

## Conclusion

The Business Tax Reform Commission's charge to "review and evaluate the current business tax structure to provide for fair and equitable taxation for all corporations and other business entities doing business in the State" has been completed. The Commission recommends (1) that the General Assembly not implement combined reporting in the 2011 session; (2) that no substantive changes to development incentives be made at this time, but that a workgroup should be created to work with the General Assembly, taxpayers, and other stakeholders to ensure that incentives are measurable and cost effective; and (3) that the previous action of the

General Assembly and policy of the State of Maryland that we believe in the Streamlined Sales and Use Tax Agreement are reaffirmed, and that the legislature should join the compact and make necessary changes when Congress authorizes a national streamlined sales tax agreement.

## Minority Report

We dissent from two recommendations of the Maryland Business Tax Reform Commission:

### *Tax Expenditures (aka tax incentives, tax subsidies, and special interest provisions)*

There really is no reason to delay cutting tax expenditures or treat them any different than appropriated expenditures. Tax expenditures have been studied by the Presidential Commission and numerous economists, conservative and liberal. Every one of them concluded that from an economic standpoint there is no difference between a tax expenditure and an appropriated expenditure. The only difference is that, once a tax expenditure is enacted, it tends to remain long after it can be justified and tax expenditures tend to help the wealthy and sophisticated while appropriated expenditures tend to benefit the lower and middle income taxpayers. Rather than cutting only appropriated expenditures which tend to benefit the middle and lower income taxpayers, we vote to oppose all tax expenditures that do not have a formal cost benefit analysis justifying them before being enacted and a sunset provision that would require such provisions to be eliminated unless a cost benefit analysis justifies their continuation on a regular basis, say every 5 years. The states of Oklahoma and Washington have such systems which have saved taxpayers millions of dollars in unjustified spending.

### *Combined Reporting*

We vote to recommend that Maryland adopt world wide combined reporting as the fairest way to balance the corporate tax burden between domestic and multinational corporations operating in Maryland while maintaining enough tax revenue to supply the things that attract business to Maryland. If the Commission does not adopt world wide combined reporting, as a fall back, we would support water's edge combined reporting.

Why the majority of the Maryland Business Tax Reform Commissions wants to continue to discriminate against domestic companies in favor of the multinational companies by continuing the current tax system makes no sense. We can understand why the multinational corporations want to continue the current system – it is so easy to shift profits out of state and thereby avoid paying the taxes that the domestic companies must pay, which gives them a great competitive advantage. Tax Notes and The Wall Street Journal have reported numerous times on multinational companies who, apparently legitimately, have shifted literally billions of dollars of profits overseas, along with the jobs that go with these profits.

There is nothing particularly complicated about combined reporting. Companies have used it for years in reporting profits to their shareholders and, as the US Supreme Court has determined more than once, it is as least as accurate as other methods and probably more so in allocating profits.

We understand why elected officials want to continue to attract businesses to Maryland. But almost every survey shows that the education system and infrastructure are far more important than taxes in determining where businesses locate. And, without sufficient taxes to pay for those things that do attract business, Maryland stands to lose its current advantage of having one of the best educational systems in the Nation. The alternative is to shift the tax burden to individual taxpayers who are already hurting from the economic downturn.

From an intellectual and economic standpoint, Maryland should adopt world wide combined reporting. It would raise more money from the multinationals, eliminate the discrimination against domestic companies and provide the funds needed to provide the education and infrastructure that does attract business. There is no real reason for delaying such a decision.

Martin Lobel, Commissioner
Public Member

Carey E. Butsavage
Public Member