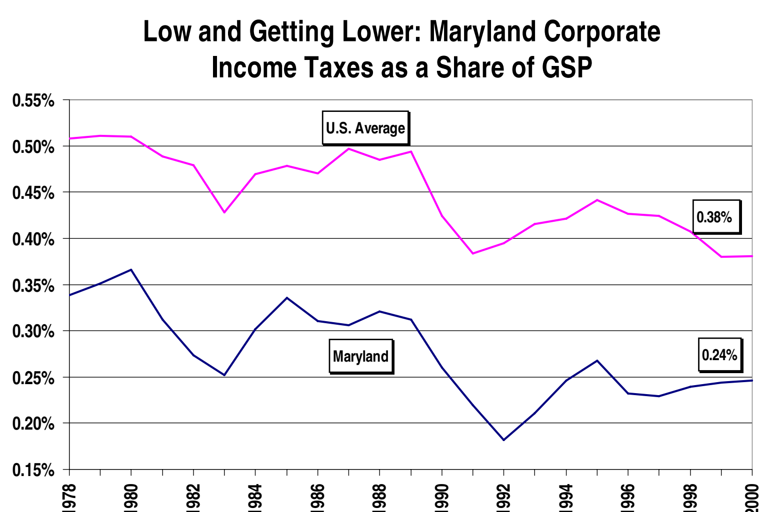
Testimony of Matthew Gardner, State Tax Policy Director
Institute on Taxation and Economic Policy
Regarding Senate Bills 403 and 748
March 9, 2005

Thank you for the opportunity to discuss the important changes in Maryland's corporate income tax proposed in Senate Bills 403 and 748. I am Matthew Gardner, State Tax Policy Director for the Institute on Taxation and Economic Policy (ITEP). Founded in 1980, ITEP is a nonprofit tax policy research group focusing on federal and state tax policy issues, with an emphasis on tax fairness and adequacy.

My testimony today focuses on a trend in the Maryland corporate income tax that is becoming increasingly visible—the emergence of profitable "zero-tax corporations"—and on two effective and complementary solutions to this problem, mandatory combined reporting and a gross-receipts-based minimum corporate tax. Requiring combined reporting of the income of multi-state corporations would help ensure the long-term viability of the Maryland corporate income tax. This reform would also make the corporate tax more equitable by eliminating the incentive for multi-state corporations to avoid state income taxes by artificially shifting income from one taxing jurisdiction to another. And an alternative tax base would mean an important backstop to the regular corporate tax, to help ensure that every large corporation pays some minimal amount of tax.

The Problem: "Zero-Tax Corporations"

The reason we're discussing corporate tax reform today is simple: the U.S. corporate income tax is in decline. At both the federal and state levels, governments now collect far less in corporate income taxes, as a share of the economy, than they did just a quarter century ago. Maryland's corporate tax collections have mirrored the nationwide decline in the corporate tax. And the problem is exacerbated in Maryland because the state's corporate



tax has historically been well below the U.S. average. As the chart on page 1 shows, Maryland's corporate tax has remained between 30 and 40 percent below the national average throughout the past 25 years.

This decline is troublesome for two reasons. First, it appears to be at least partially the result of tax avoidance strategies by corporations rather than the conscious design of federal and state policymakers. The growing use of tax loopholes at the federal level has meant that Fortune 500 corporations have been able to use tax breaks to reduce their corporate tax substantially despite being hugely profitable. Second, the decline of the corporate taxes paid by the biggest, most profitable companies inevitably means that taxes paid by smaller businesses and taxes paid directly by individuals must make up a bigger share of the tax pie.

There is growing evidence that the corporate income tax is nearing collapse from the sheer weight of these loopholes. A September 2004 ITEP analysis of 275 of the largest and most profitable corporations in America found that 82 of these corporations—almost a third of the total—managed to pay zero or less in federal corporate income taxes in at least one year between 2001 and 2003.[1] In other words, almost all of these companies actually received net tax rebates from the federal government in at least one year during this period despite being hugely profitable in all three years.

If these large, profitable corporations were this successful in reducing their tax liability through completely legal tax loopholes on the federal level, it seems plausible that the same corporations may be using these loopholes to reduce their Maryland corporate income taxes as well. After all, Maryland's corporate income tax rules are based on federal definitions of taxable profits—so any leakage in the federal tax base is likely to be passed directly through to the state level. Unfortunately, neither federal nor Maryland laws require corporations to release detailed information on the tax loopholes they have claimed. As a result, it's not currently possible to measure the precise extent of corporate tax avoidance in Maryland.

But there is data available indicating that the "zero-tax corporation" problem has emerged in Maryland as well. Data released by the Comptroller's Office shows that two-thirds of the largest companies doing business in Maryland paid no corporate tax to the state in 2002.

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[1] *Corporate Income Taxes in the Bush Years*, Robert S. McIntyre and T.D. Coo Nguyen, Citizens for Tax Justice and Institute on Taxation and Economic Policy, September 2004.

How are these large companies managing to avoid paying corporate income taxes to Maryland? One widely recognized avenue for state tax avoidance is that some states permit companies to determine their in-state taxable income using separate accounting for each of their related subsidiaries. Separate accounting is a bookkeeping procedure that determines each company's taxable income by having companies keep separate accounts for their in-state and out-of-state business segments. Every transaction between the legally distinct subsidiaries of a company is supposed to have a transfer price (that is, the "sales price" at which these companies are essentially selling products to themselves) attached to it, which is supposed to be carefully scrutinized by auditors.

Not surprisingly, separate accounting is subject to abuse by large, multistate companies. In fact, it's an open highway for corporate tax avoidance. A large multistate company can use separate accounting to shift their taxable profits to low-tax jurisdictions. Here's how it works:

Consider a multistate company that has two subsidiaries, one in State A that permits separate accounting and one in State B, which has no corporate income tax. To reduce its taxable profits, the subsidiary in State A might say that it "pays" high transfer prices for the items it "buys" from the State B subsidiary. This shifts income out of State A (where it would be taxed) and into State B (where it's not).

For example, a furniture company might machine the metal parts for its furniture in State B, but assemble the furniture in State A. The company will, on paper, charge very high prices to its State A subsidiary for the metal parts. This makes the State B subsidiary look like it has very high profits (which are not taxed) and the State A subsidiary look like it has very low (taxable) profits.

Of course, except for tax considerations it doesn't matter to the parent company if its State B subsidiary has 80 percent of the total profits and its State A subsidiary has only 20 percent. Either way, the parent company gets 100 percent of the profits.

Another example of transfer pricing that has gotten more attention in recent years is the passive investment company (PIC) approach. In this variation on the transfer pricing scheme, a multi-state company will set up a subsidiary in a state that does not tax certain types of intangible income like royalties and interest—and make sure that this subsidiary receives all of the company's royalty income. The most infamous example of this practice is the Toys R Us corporation, which created a subsidiary in Delaware called Geoffrey, Inc. The subsidiary owns the Toys R Us trademark, and Toys R Us stores around the nation pay royalty fees to the Delaware subsidiary for their use of the trademark. This reduces the taxable profit of Toys R Us in two ways: stores in other states get to deduct their royalty payments as a cost of doing business, which reduces their taxable profit, and the Delaware subsidiary pays no tax on their royalty income because Delaware does not tax such income.

Trying to assure accurate transfer pricing under separate accounting creates huge enforcement problems. It is a time-consuming, complicated and often impossible job for state auditors to determine whether separate accounting methods accurately reflect a company's net business income in the state. The federal government, which tries to apply the same approach to multinational corporations, has had the same kinds of difficulties.

Solution #1: Combined Reporting

States seeking to prevent these income-shifting strategies have two options. They can close down these loopholes one at a time—as Maryland and a few other states have done in response to the PIC problem by enacting legislation that explicitly prevents the use of PICs—or they can adopt a comprehensive solution known as combined reporting. Combined reporting requires a multi-state corporation to determine its apportionable income by adding together the profits of all its subsidiaries into one total. Since the income of subsidiaries in the various states is added together in one sum, there is no tax advantage to income shifting between these subsidiaries under a combined reporting regime. While anti-PIC legislation can close down one particular path to tax avoidance, combined reporting is a better, more comprehensive approach to loophole-closing because it simply removes the incentive to shift income from higher-tax to lower-tax jurisdictions. If Maryland were to enact combined reporting legislation, it would join seventeen other states that require related companies to file a combined report.

Combined reporting is intuitively more fair than separate accounting because it ensures that a company's tax liability should not change just because its organizational structure changes. It also creates a level playing field between smaller and larger companies. Small companies doing business in only one state are at a competitive disadvantage because they can't use separate accounting to reduce their tax. This is simply because they have no business units in other states to shift their income to. Large, multi-state corporations will find it easier to avoid tax using separate accounting because they do have business units in multiple states.

Combined reporting is not the only option available to states seeking to prevent income shifting. A second-best approach is legislation that explicitly bars corporations from using some particular approach to income shifting. The best known example of this is the so-called "anti-PIC" legislation that has been passed by half a dozen states, including Maryland.

The main drawback of this approach is that it amounts to putting a finger in a dike. It can be an effective way of plugging one particular leak. But inevitably, the dam will leak elsewhere. Anti-PIC legislation does nothing to deter multi-state companies from seeking other income-shifting avenues. In fact, the only limitation faces these companies is the imagination of their accountants.

Solution #2: A Strengthened Minimum Tax

All states with corporate income taxes use corporate profits to define the tax base. This ensures that the corporate tax reflects a business' ability to pay the tax: if a corporation loses money in any year, they don't pay the tax. But, as I've already mentioned, the growing use of tax avoidance strategies means that many profitable corporations are now able to report artificially low (or negative) profits for tax purposes even when they've done quite well financially. In other words, reported taxable profits are no longer always an accurate measure of a company's ability to pay.

A growing number of states have adopted an alternative corporate tax that acts as a backstop to the regular profits-based tax, using some measure of business activity other than profits as a backstop to the corporate profits tax. The gross-receipts based tax under consideration today would act as such a backstop in Maryland.

A minimum tax can help eliminate the "zero-tax corporation" problem—and can also help states to get around the problem of corporate nexus, which says that companies must have a substantial presence in a state to be taxable by that state. Some nexus rules only apply to taxes that are based on profit. So a company that does business in a state and benefits from Maryland public services, but doesn't have enough physical presence in the state to satisfy the nexus rule, cannot be reached by a profits-based taxed, but can be reached by an alternative tax.

Taxes and Economic Development

Virtually every state legislature that has entertained options for closing corporate tax loopholes has heard apocalyptic predictions of the dire economic consequences that would result from these changes. There are several brief points I would like to make on this topic.

First, these anti-tax arguments are generally based on anecdotal arguments or threats by footloose corporations, rather than hard empirical evidence.

Second, serious economic analyses of the relationship between tax incentives and economic development generally find little or no relationship between tax levels and economic outcomes. Studies that do purport to show such a relationship typically make simplifying assumptions that do not apply in the real world. For example, such studies will frequently estimate the negative impact of tax increases on a state's economy, but will not estimate the positive economic impact of increased state spending. In today's political climate, lawmakers raise taxes in order to fund services that improve the quality of life for individuals and businesses. Any analysis that does not attempt to quantify this positive effect is basically assuming that lawmakers take the gains from tax increases and throw them down a hole in the ground.

Third, this basic finding of the economic literature really should come as no surprise. Corporate income taxes are a small part of the total taxes that most businesses pay. And state and local taxes overall represent a very small part of the cost of doing business for Maryland firms. Other costs of doing business are far more important in determining a state's business climate. As New York City Mayor and long-time business leader Michael Bloomberg put it recently, "Any company that makes a decision as to where they are going to be based on the tax rate is a company that won't be around very long. If you're down to that incremental margin you don't have a business."

Finally, it's important to note that the overwhelming majority of corporations doing business in Maryland are good corporate citizens. And to their credit, the business community generally recognizes that it's in their long-term interest to ensure that the corporate tax is applied evenly and fairly. The experience of New Jersey with their alternative gross receipts tax is a testimony to this. When New Jersey lawmakers passed the 2002 legislation creating this tax, they also created a tax review commission, staffed largely by representatives of the business community, that was given the general task of assessing the implementation of the tax reforms and the specific task of offering a recommendation about whether the new minimum tax should be sunsetted or made permanent. Given this option, the commission did not recommend repealing the tax, and instead recommended a variety of minor changes to improve its functioning.

Conclusion

There is no legitimate rationale for preserving tax loopholes whose only effect is to encourage companies to devote their resources to accounting shenanigans that minimize tax liabilities but add no economic value to a company or to a state's economy. Both of the proposed tax reforms I've touched on in my testimony would have a salutory effect on tax fairness and adequacy in Maryland. Mandatory combined reporting is, quite simply, the single most important step states can take to ensure the long-term viability of their corporate income tax. And a strong alternative tax can provide an important backstop to the regular corporate income tax to help ensure that all large companies contribute some minimal amount to support the cost of providing the public services that allow them to do business in Maryland.

Thank you for the opportunity to testify.