ITEP Institute on Taxation and Economic Policy
1616 P Street, NW • Washington, DC 20036 • (202) 299-1066

TESTIMONY OF JEFF McLYNCH
Institute on Taxation and Economic Policy
before the Maryland Business Tax Commission
July 9, 2009

Chairman Wacks, Delegates, Senators, Members of Commission, thank you for the opportunity to appear before you this afternoon. My name is Jeff McLynch and I am the State Policy Director for the Institute on Taxation and Economic Policy (ITEP). Founded in 1980, ITEP is a non-profit, non-partisan research organization, based in Washington, DC, that focuses on federal and state tax policy issues with an emphasis on tax fairness and adequacy.

In reviewing and evaluating recent developments in state business taxation, due to the nation's economic diversity, the decentralized nature of tax policy in the federal system of government, and the breadth and depth of the ongoing recession and related fiscal crises, there are, quite obviously, a number of events that warrant the commission's attention. In the past several years, a handful of states, including Ohio and Texas, have completely revised the means by which they tax businesses operating within their boundaries. Others, such as California, have added to the list of states that have modified their basic apportionment formulas, while still more continue to offer a variety of tax credits and inducements with the aim of luring or retaining employers.

Rather than strive for an exhaustive description of these recent changes, I will instead focus on one particular trend in state taxation: the move to incorporate combined reporting into states' corporate income and similar taxes. Since 2004, seven states have adopted combined reporting, meaning that a majority of the states that levy a corporate income tax of some kind now use this approach to determining the tax liabilities of multi-state businesses. A number of other states, including Maryland, have given serious consideration to this reform and it seems quite likely that, as state fiscal woes persist and as new information about the extent of corporate tax avoidance becomes available, such consideration will only intensify. In the time that has been allotted to me today, I'd like to briefly summarize states' objectives in enacting combined reporting legislation, the conditions that prompted them to do so, and the gains they expect to realize from enactment. I'll also touch upon some of the objections that critics of combined reporting have raised in the past and will likely raise again in the future.

As the members of the commission are likely aware from prior testimony or from past debates here in Maryland, states can use one of two approaches in levying their corporate income taxes. They may, as Maryland currently does, use what is known as separate entity reporting, a method of accounting under which a corporate group reports the income – and determines the tax liability – of each of its separate entities taxable in the state independent of each other. This approach leaves the states that utilize it vulnerable to tax planning techniques that aim to shift income from an entity taxable in the state to a subsidiary in another state in which such income will either be taxed at a lower rate or perhaps not taxed at all. However, the majority of states that levy some form of corporate income tax no longer use this approach; rather, they employ what is known as combined reporting. Under combined reporting, a multi-state corporation calculates its income for tax purposes by adding together the income of all its subsidiaries – without regard to their location – into one total. That total is then apportioned to the state using the combined apportionment factors of the entities that comprise the corporation.

Consequently, combined reporting represents the most comprehensive option available to states seeking to halt the erosion of their corporate tax bases and to curtail corporate tax avoidance. It ensures that form – specifically, the form in which corporations choose to organize themselves, which may be manipulated to reduce their tax liabilities – does not triumph over substance – namely, the true level of economic activity in which a corporation may be engaged in particular state. Moreover, it is wholly consistent with and, indeed, a necessary complement to, formulary apportionment. States do not simply leave it up to businesses to decide the extent to which in-state operations contribute to their overall profitability – and by extension, to decide the amount of income subject to taxation in a given state. Rather, through their apportionment formulas, states require corporations to use objective factors, such as payroll, property, or sales, to make those determinations. States that continue to use separate entity reporting, in effect, cede such decisions back to corporations doing business within their boundaries, allowing them to define what their operations are for tax purposes. Combined reporting, on the other hand, restores the role that objective factors, such as those embodied in states' apportionment formulas, play in determining corporate tax liabilities. Richard Pomp of the University of Connecticut summarized this situation quite well, when he noted over a decade ago that, "A state that does not require related corporations conducting a unitary business to file a combined report is at the mercy of its corporate taxpayers."[1]

Since 2004, seven states have recognized the inferiority of separate entity reporting and incorporated combined reporting into their corporate income taxes. Vermont did so in 2004, followed by Texas in 2006, when it moved to its new "margins tax"; West Virginia, New York, and Michigan in 2007; Massachusetts in 2008; and Wisconsin earlier this year. (In each of these states, combined reporting will be in effect for tax year 2009.) These actions, as noted at the outset, brings the total number of states using combined reporting to twenty-three – or more than half of the states that levy some kind of corporate income tax.

In putting in place such reforms, state policymakers were almost certainly responding to a growing awareness, founded on analyses produced by national, non-partisan entities such as the Congressional Research Service and the Multi-State Tax Commission, as well as on reporting by media outlets like the *Wall Street Journal*, of the prevalence of corporate tax planning practices and the impact that such practices were having on the viability of state

---

[1] Pomp, Richard D., "The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer," in David Brunori, *The Future of State Taxation* (Washington: Urban Institute Press, 1998), p. 62.

corporate income taxes. These concerns were only confirmed as states undertook their own assessments of the impact that responses to such planning – namely, combined reporting – would have on state tax collections. In general, states that have produced official revenue estimates – whether by a department of revenue, a legislative fiscal office, or a similar agency – have found that enactment of combined reporting would raise corporate income tax revenue on the order of 5 to 20 percent per year, once fully implemented. Vermont, when it first began to consider incorporating combined reporting into its corporate income tax, found that it would yield an additional 13 percent in corporate tax revenue (i.e. $5 million on a base of $40 million for fiscal year 2006). More recently, Wisconsin estimated that its enactment of combined reporting would yield $187 million over the 2009-2011 biennium – also roughly 13 percent of its baseline projections for corporate tax revenue.

As an aside, I should note that states have not necessarily adopted combined reporting as a means solely to generate additional revenue. Rather, some states, notably Massachusetts and West Virginia, plan to use at least some, if not all, of the additional revenue that combined reporting is expected to yield to reduce tax rates for businesses generally. In the case of Massachusetts, the corporate excise tax rate will fall from its present level of 9.5 percent to 8.0 percent by 2012 (with similar reductions in the rates for S-corporations and financial institutions), while in West Virginia, the same legislation that instituted combined reporting will ultimately lower the state corporate income tax rate from 8.75 percent to 6.5 percent. Installing a broader base while lowering rates does, of course, entail some tradeoffs. After all, every dollar generated by the switch to combined reporting that is used to reduce rates is a dollar that can not be used to meet other priorities. Should Maryland move to combined reporting – as it ought to do – it will be up to the members of the Assembly to weigh those tradeoffs accordingly.

In enacting combined reporting, policymakers in Vermont, New York, and elsewhere were also almost surely reacting to the inadequacy of alternative approaches to combating tax avoidance. States can – and do – try to put a halt to specific tax planning techniques on an ad hoc basis. Maryland, for instance, has passed separate measures to stop corporations from using passive investment companies (also known as PICs or Delaware Holding Companies) or from using captive REITs (Real Estate Investment Trusts) to reduce their tax liabilities here. However, these "one-off" pieces of legislation have been subject to constant challenge across the country. To cite just two recent examples, the June 29 issue of *State Tax Notes* included an article entitled "Is Virginia's Addback Statute Exception Susceptible to Challenge?"[2] Its conclusion? Virginia's "addback statute" – which disallows the deduction for intangible expenses central to passive investment companies – has "particular vulnerabilities" which should spur taxpayers to "press forward and challenge" the Department of Taxation's interpretation of the statute. Still more recently, the July 5 edition of the Hartford *Courant* contains an article revealing that, despite Connecticut's adoption in 1998 of anti-PIC legislation similar to that in effect in Maryland, AT&T Connecticut sent $145 million in royalties to a subsidiary in Nevada between 2002 and 2004 and an additional $46 million in

---

[2] Smith, Scott D. "Is Virginia's Addback Statute Exception Susceptible to Challenge?", *State Tax Notes,* June 29, 2009, pp. 1039-1044.

2008.[3] In other words, simply because Maryland has put such measures in place does not mean that the issue is completely resolved. The constitutionality of combined reporting, in contrast, has already been twice upheld by the U.S. Supreme Court.

Moreover, attempting to respond to corporate tax avoidance on an ad hoc or piecemeal basis simply leaves state policymakers and state tax administrators continually one step behind, racing to keep up with corporate attorneys and accountants and the immense resources at their disposal. More specifically, while Maryland may have protected itself against PIC's and REIT's, it remains exposed to other schemes designed to shift income, or to move income generating activities, out of state, such as captive insurance companies, nexus isolation strategies, and transfer pricing. Combined reporting, since it, in effect, nullifies all of the various intra-corporate transactions that transfer income in this fashion or that allow businesses to organize themselves in such a way that major portions of their activities are not subject to taxation in a given state, provides a broader, more forward-looking response to tax avoidance.

Finally, in passing combined reporting into law, state legislators presumably understood that they would be achieving greater economic neutrality and reducing the tax-related advantages that large multi-state corporations previously enjoyed over locally-owned and operated companies. As the Speaker of the Wisconsin State Assembly, Michael Sheridan observed this past spring, enacting combined reporting "[closes] corporate loopholes that shift tax burdens to families and small businesses [and gives] Wisconsin businesses a level playing field with out-of-state competition."[4] Small businesses operating solely within a given state's boundaries simply cannot avail themselves of the complex tax planning techniques that large multi-state corporations pursue; thus, neutralizing those techniques through the adoption of combined reporting restores some competitive balance between large and small businesses. In fact, a 2006 study on state tax policy and entrepreneurship finds that, "States with more aggressive corporate income taxes, specifically including combined reporting…tend to have higher entrepreneurship rates," reflecting the contributions that small businesses can make to economic growth and innovation.

Data presented to the Commission at its initial meeting in May certainly seem to hint at the disparate impact that combined reporting would have on small businesses as opposed to large corporations. For instance, of the roughly 64,000 corporations filing income tax returns in Maryland, just over 60 percent – or nearly 39,000 – appear to operate solely within the state and would presumably be unaffected by combined reporting; of the approximately 13,800 of these "unistate" corporations that have taxable income, virtually all – 97 percent – were small businesses (i.e. they had Maryland modified incomes below $500,000). Similarly, of the total number of small businesses with taxable income, more than two-thirds had operations solely in Maryland.

---

[3] Doan, Lynn "Like AT&T, Other Conn. Corporations Using Tax Loopholes," Hartford *Courant*, July 5, 2009.
[4] Sheridan, Michael J., *Speakers Column: Grow the Economy and Balance the Budget,* March 5, 2009.

To be sure, combined reporting has not become law in these seven states without opposition. In particular, opponents of combined reporting typically make three claims about the consequences of enacting this vital corporate tax reform.

First, opponents of combined reporting frequently maintain that corporate tax avoidance occurs to such a small extent, that combined reporting reduces the taxes of less profitable entities to such a degree, and that those corporations experiencing tax increases from combined reporting will litigate to such lengths that states will not see any revenue gains in the short-run – and possibly the long-run as well.

Yet, this notion is counter to the research that other states that have recently adopted – or have considered adopting – combined reporting have conducted. As noted earlier, the state departments of revenue or other fiscal agencies that have completed rigorous analyses of the impact that combined reporting will have on corporate income tax collections typically find that, over the long-run, enactment will boost collections by 5 to 20 percent. Here in Maryland, the Department of Legislative Services (DLS) has previously estimated that the enactment of combined reporting would increase corporate income tax revenue by approximately $45 million annually, while a recent press account suggests that the Comptroller's Office may produced an updated estimate later this year, one that could be as much as $100 million.[5] While the initial DLS estimate may be conservative relative to those published in other states, either figure suggests that corporate tax avoidance is sufficiently widespread in the state that curtailing it could have a positive impact on Maryland's balance sheet. Moreover, any state concerned about the short-run revenue impact from litigation by affected businesses can draft its initial combined reporting legislation in such a way that it provides for a transition period in which the amount of tax that would have been paid under the previous separate entity regime serves as an alternative minimum tax.

Second, opponents of combined reporting routinely assert that it will impose new and onerous administrative burdens on businesses. In particular, they contend that determining which entities within a corporate group are part of a unitary business for tax purposes is exceedingly complex and will lead to thousands of hours and millions of dollars in wasted effort as businesses seek to comply with the new reporting regime.

Such claims ignore the very trend that I have sought to highlight here today. As the majority of states now use combined reporting in some fashion, it seems increasingly unlikely that a multi-state business (that is, a business that would be affected by combined reporting) operating in Maryland will have its operations solely in separate entity states. Consequently, a multi-state business operating in Maryland is already likely complying with combined reporting in another state and will therefore have some experience in defining a unitary business and in complying with the requirements of combined reporting generally. For example, research by Michael Mazerov of the Center on Budget and Policy Priorities indicates that 60 of the 75 largest manufacturers in North Carolina and 31 of 34 large manufacturers in

[5] Tallman, Douglas, "Accounting change could net state $100M", July 3, 2009 (downloaded from www.gazette.net)

Iowa – both of which are separate entity states – have operations in states that use combined reporting.[6] It seems unreasonable to think that businesses operating in Maryland differ in such a fundamental fashion from businesses in these states that the same will not be true to some degree. Of note, Northrop-Grumman and Lockheed-Martin, two major enterprises with operations in Maryland, conduct business in multiple states currently using combined reporting. Similarly, one would be hard pressed to name a state in which Bethesda-based Marriott or one of its many affiliated brands does not have at least one hotel.

Third, opponents of combined reporting argue that it will impair economic growth, deterring companies from entering any state that adopts it and encouraging others to leave. While this argument is perhaps the most prominent of the three claims made against combined reporting, it does not have any more basis in fact. Rather, serious economic analyses of the relationship between corporate income taxes 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 incomplete. One might expect that there would be even less of a relationship between corporate tax avoidance and economic development, since – unlike tax incentives, which may at least be tied to some economically productive investment – tax avoidance has no real economic substance.

This basic finding of the economic literature really should come as no surprise. State and local taxes are a very small part of the costs that most businesses face, while corporate income taxes comprise a very small share of the state and local taxes businesses typically pay. More specifically, the latest research suggests that state and local taxes amount to just 2.5 percent of businesses' total costs and, for the average business, corporate income taxes come out to just 10 percent of that 2.5 percent.[7] Costs that are far more substantial for the vast majority of businesses include the cost of labor and the cost of transporting either inputs to production facilities or finished goods to market, costs that state and local governments can help to reduce through strategic public investments, but only if they have the revenue necessary to do so.

In closing, the past several years have been marked by a number of major developments in state and local tax policy. One of the most notable of those developments – and, indeed, the one most essential to the long-term viability of states' corporate income taxes – has been the move towards combined reporting. The seven states that have enacted combined reporting since 2004 – Vermont, Texas, New York, West Virginia, Michigan,

---

[6] Mazerov, Michael, *Most Large North Carolina Manufacturers are Already Subject to "Combined Reporting" in Other States,* Center on Budget and Policy Priorities, January 15, 2009; Mazerov, Michael and Lira, Katherine, *Almost All Large Iowa Manufacturers are Already Subject to "Combined Reporting" in Other States,* Center on Budget and Policy Priorities, April 3, 2008.

[7] Mazerov, *Most Large North Carolina Manufacturers…,* p. 6.

Massachusetts, and Wisconsin – have done so both in recognition of the impact corporate tax avoidance was having on their budgets and in an effort to restore some measure of competitive balance between small and large businesses operating within the state. These moves have given rise to a variety of claims about the deleterious affects of combined reporting, but, when those claims are examined on their merits, it becomes clear that the adoption of combined reporting in Maryland would be an entirely positive development.

I again thank you for the opportunity to speak here today and would be happy to answer any questions you may have.