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TESTIMONY OF MATTHEW GARDNER
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Before the Maryland Business Tax Reform Commission
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Thank you for the opportunity to appear before you this evening. My name is Matthew Gardner. I'm here on behalf of the Institute on Taxation and Economic Policy, a Washington-based nonprofit research group that focuses on federal and state tax policy issues with an emphasis on tax fairness and adequacy.

I'm here to talk about combined reporting, which ITEP views as a vital step towards ensuring the vitality of the Maryland corporate income tax going forward. I'd like to use my allotted time to discuss one important policy choice that Maryland policymakers must make in implementing combined reporting.

As you know, enacting combined reporting requires making a number of basic, but important, policy choices. One significant decision, and one that I know the combined reporting subcommittee has discussed at length, is whether to recommend the so-called "Finnigan" or "Joyce" approach to apportionment. As you know, these approaches are named for two California court cases that dealt with the question of how combined reporting and apportionment are applied when you have some members of a unitary corporate group that are subject to a corporate income tax in a state and other members of the group that are not.

In particular, what happens when you have one member of a unitary group that makes sales into Maryland without actually having nexus, but other members of the unitary group do have nexus with Maryland.

Under the *Finnigan* approach, the unitary group as a whole is effectively treated as "the taxpayer." If at least one member of a unitary group has nexus in Maryland, then the in-Maryland sales of all the non-nexus members are essentially attributed to the member that does have nexus. By contrast, under *Joyce*, the in-Maryland sales of non-nexus members are simply excluded from the sales factor.

The *Finnigan* approach also takes steps to prevent the state from over-reaching in its apportionment. If even one member of the group has nexus outside of Maryland, all of the non-Maryland sales of members that don't have nexus outside Maryland are nonetheless deemed to be non-Maryland sales. Under this scenario, even if Maryland had a "throwback rule," these non-Maryland sales would never be "thrown back", that is, treated as Maryland sales for apportionment purposes, under the *Finnigan* approach.

ITEP believes that the Commission should recommend the *Finnigan* approach to combined reporting, for two reasons. The first is that *Finnigan* is consistent with the fundamental conceptual goal of combined reporting. Simply put, that goal is to ensure that a corporation's tax liability to Maryland doesn't depend on whether it consists of a single legal entity or multiple entities. That result would not be fully achieved if Maryland were to enact combined reporting under a *Joyce* approach. Under *Joyce*, whether a company's sales to Maryland customers would be treated as Maryland sales for apportionment purposes would depend on whether the particular subsidiary making those sales itself had nexus in Maryland.

The second reason for preferring *Finnigan* is that it makes the most sense in light of Maryland's decision nearly a decade ago to mandate single sales factor apportionment for manufacturers. In taking this misguided step, Maryland policymakers were trying to maximize the amount of profits that in-state manufacturers could apportion out of Maryland and maximize the amount of profits that out-of-state manufacturers would have to apportion into the state.

The first difficulty is that in enacting single sales factor without simultaneously enacting combined reporting, Maryland lawmakers gave those out-of-state corporations whose taxes they were attempting to increase a huge loophole with which to avoid that outcome. Out-of-state manufacturers that have to have some physical presence in Maryland — say, to provide on-site servicing of what they sell — can now divide themselves up into multiple corporations in a way that completely zeroes out their Maryland tax. They can do this by putting all of their nexus-creating activities in a separate corporation from the one that actually sells products into the state, which means that the unit earning all the profits has no nexus in Maryland because it either has no physical presence in Maryland at all or just salespeople in Maryland, which isn't enough to establish nexus under Public Law 86-272. Adopting combined reporting under the *Joyce* approach would, to be clear, prevent a wide variety of tax avoidance that currently goes on—but it would not stop the particular instance of “nexus isolation” I just described.

Adopting *Finnigan*-based combined reporting nullifies this tax-avoidance strategy, by assigning Maryland sales of unitary group members that don't have nexus in Maryland to the members that *do* have nexus in the state. We know this sort of “nexus isolation” really does happen, by the way, by virtue of the fact that the Comptroller's data from 2006 and 2007 show that *Finnigan*-based combined reporting would have raised about \$50 million in additional revenue each year as compared with the *Joyce* approach.

There is one practical concern with taking the *Finnigan* approach: there is a lingering question as to whether it's constitutional. The U.S. Supreme Court could view it either as an illegal end-run around Public Law 86-272, or as unconstitutional under the Commerce or Due Process Clauses. But *Finnigan* has been challenged on exactly that basis in the courts of at least two states (California and New York), and it has been upheld. The small chance that it might someday be found illegal by the Supreme Court doesn't justify rejecting it in the face of the compelling policy arguments in favor of it. Maryland, like the other nine “*Finnigan*” states, could and should cross that bridge when it comes to it. To summarize, ITEP believes that when Maryland policymakers take the important step of enacting combined reporting, they

should maximize the effectiveness of this reform by adopting the *Finnigan* approach to apportionment.

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