

**Testimony of Matthew Gardner
Institute on Taxation and Economic Policy
Before the Maryland General Assembly
Regarding the Governor's "Combined Reporting" Corporate Tax Proposal
October 31, 2007**

Thank you for the opportunity to submit testimony regarding the important changes in Maryland's corporate income tax proposed by Governor O'Malley. My name is Matthew Gardner and I am the Executive Director of 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 examines a problem facing not just Maryland, but a number of different states – the erosion of the corporate income tax and the related emergence of profitable “zero-tax corporations.” I also will discuss the single best strategy available to lawmakers seeking to respond to the problem of corporate tax avoidance – mandatory combined reporting. Requiring combined reporting of the income of multi-state corporations would help ensure the long-term viability of the Maryland corporate income tax. It would also make the corporate tax more equitable – both among businesses and between businesses and individual taxpayers – by eliminating the incentive for multi-state corporations to avoid state income taxes by artificially shifting income from one taxing jurisdiction to another. Maryland is one of nine states in which combined reporting has been seriously considered as a strategy for shoring up the corporate tax base in 2007 alone. Two of these states (including neighboring West Virginia) have enacted combined reporting in 2007.

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: the state's corporate tax has historically been well below the U.S. average. As the chart on the next page shows, Maryland's corporate tax has remained between 15 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 avoid corporate

tax despite being hugely profitable. Second, a 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 February 2005 ITEP analysis of 252 of the largest and most profitable corporations in America found that 71 of these corporations – more than a quarter

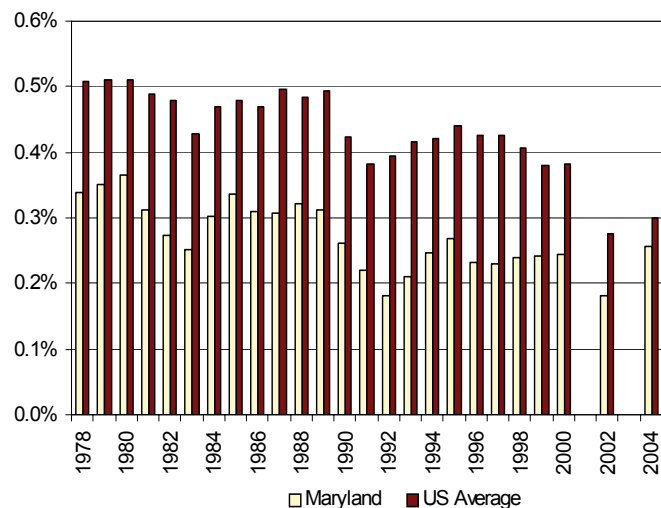
of the total – managed to pay zero state corporate income taxes in at least one year between 2001 and 2003.¹ Among these “zero tax” corporations was Maryland-headquartered Marriot International, which, despite profits of \$410 million in 2001, paid zero state corporate income taxes that year.

If the 252 corporations included in ITEP’s study had paid the 6.8 percent average state corporate tax rate on the almost \$1 trillion in U.S. profits that they reported to their shareholders, they would have paid \$67.1 billion in state corporate income taxes over the 2001-03 period. Instead, they paid only \$25.4 billion. Thus, these 252 companies avoided a total of \$41.7 billion in state corporate income taxes over the three years.

While these data look at state corporate income taxes in the aggregate, data released by the Maryland Comptroller in March 2004 demonstrate that the “zero-tax corporation” problem has certainly emerged here as well. These data indicate that two-thirds of the largest companies doing business in Maryland paid no corporate tax to the state in 2002.

How are these large companies managing to avoid paying corporate taxes to Maryland? One widely recognized avenue for 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.

Lower than the Rest of the Country
MD Corporate Income Taxes as a Share of GSP



¹State Corporate Income Taxes, 2001 - 2003, Robert S. McIntyre and T.D. Co Nguyen, Citizens for Tax Justice and Institute on Taxation and Economic Policy, February 2005

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 variation on this transfer pricing scheme that enables multi-state corporations to move income among states and, thus, to avoid taxation is what is known as "captive REITs." (REIT is short for Real Estate Investment Trust, an entity that is typically used by smaller investors to minimize risk when investing in real estate.) As a February 1, 2007 article in the *Wall Street Journal* revealed, Wal-Mart Stores used this stratagem to avoid upwards of \$350 million in state corporate income taxes between 1998 and 2001. Where transfer pricing schemes permit corporations to pay inflated prices to themselves for internal transactions, "captive REITs" essentially allow corporations to pay rent to themselves – and then to deduct that rent as a business expense – without that rent ever leaving the companies' ledgers.

Trying to prevent companies from using income-shifting techniques like transfer pricing or captive REITs 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.

Combined Reporting: A Simple Approach to Preventing Tax Avoidance

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 passive investment companies (PICs) by enacting legislation that explicitly prevents their use—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 – without regard to their location – 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 eighteen 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 only in Maryland 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 which to shift their income. 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 particular approaches to income shifting. The best known example of this is the "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 or similar, specialized 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.

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 simpli-

fying 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. One might expect that there would be even less of a relationship between corporate tax loopholes 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.

Third, 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. As Robert G. Lynch, the Chairman of the Department of Economics at Washington College found in his landmark study, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, "...after federal deductibility, all state and local taxes paid by businesses ... accounted for only 0.8 percent of their costs."¹ State corporate income taxes, in turn, constitute only a fraction of the state and local taxes businesses pay.

As a result, the other costs that businesses incur are far more important in determining a state's business climate. Lynch's research leads him to include in this set of costs:

the cost and quality of labor, the proximity to markets for output . . . access to quality transportation networks and infrastructure (e.g., roads, highways, airports, railroad systems, and sewer systems), quality-of-life factors (e.g., good schools, quality institutes of higher education, health services, recreational facilities, low crime, affordable housing, and good weather), and utility costs.²

Many of these costs can, in turn, be mitigated by state appropriations and other public policies, but only if states have the resources they require.

To its credit, the business community generally understands this – by and large, business leaders in Maryland know that an effective public sector can improve their bottom lines and that it is in the business community's long-term interest to have a corporate excise tax that is applied evenly and fairly. And that's really my final point – the overwhelming majority of corporations doing business in Maryland are good corporate citizens. As a result, relatively few businesses would be affected by combined reporting.

¹ Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, Economic Policy Institute, March 2004, p. 4.

² *Ibid.*, p. 6.

In the end, as New York City Mayor and long-time business leader Michael Bloomberg once put it, “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.”

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. Combined reporting – the single best reform available for closing such loopholes—would ensure the long-term viability of the Maryland corporate income tax and would have a salutary effect on tax fairness and adequacy in the state.

Thank you for the opportunity to provide the Joint Committee with this testimony.