MARYLAND BUSINESS TAX REFORM COMMISSION

Raymond S. Wacks, Chairman

BUSINESS TAX REPORTING SUBCOMMITTEE
Minutes of Meeting
November 5, 2009

A meeting of the Maryland Business Tax Reform Commission, Business Tax Reporting Subcommittee was held in the James Senate Office Building, Neall Conference Room on Thursday, November 5, 2009 at 10:00 a.m.

Those present were:

Raymond S. Wacks, Chairman
Delegate Page D. Elmore
Paul Nolan
Karen Syrylo
Martin Lobel
Steven Banks

David Roose, Bureau of Revenue Estimates
Marc Nicole, Department of Budget Management

Speakers present were:

Martin Lobel, Member
Andrew Schaufele, Bureau of Revenue Estimates

The meeting was open to the public and members of local government, state government and other interested parties were in attendance.

Chairman Raymond Wacks opened the meeting at 1:31 p.m. and announced today's meeting on Tax Philosophy. Mr. Wacks introduced Martin Lobel, member of the Maryland Business Tax Reform Commission as our first speaker.

Mr. Lobel started his presentation by giving a brief description of his background and making reference to web sites that may be useful to the commission: www.tax.org and www.tax.com. "So why do we tax business?" asked Chairman Wacks.

Tax Philosophy

"Taxes are the price for a civilized society," stated Mr. Lobel. "For analytic purposes, there are two separate boxes: economic and political. In the economic box you find two polar extremes: one believes the function of the tax code is to raise the revenue needed to run government. The political believes the function of the tax code is to assist American businesses compete more effectively. You can translate that into "we believe in the free enterprise system but we need protection from competition or a government subsidy." Economists call these provisions "tax expenditures." Between these two polar extremes there are many different philosophies: Do we help the rich? Do we help the poor? Do we help the corporations? Do we not help the corporations? These arguments tend to break down along party lines. It's a question of philosophy: do you believe that the function of the tax code is to raise the money needed to keep the government running with the least interference in the economy or do you believe the government should use the tax code to subsize various special interest groups?

"The best tax from a political standpoint is a tax people never see. Delaware's gross receipts tax is a perfect example which affects Maryland directly because consumers don't know they are paying it and businesses in Delaware advertise no sales tax to entice Maryland buyers.

"From a political standpoint you have two major problems: the tax code is so complicated that nobody really understands it, including the IRS, and two tax subsidies.

"Politically whatever the Maryland Business Tax Reform Commission does will have to be simple so the Legislature can understand what we are proposing and, more importantly, that media can understand when it is focused on the issue.

"One question is whether it makes sense to tax a corporation, because most of those taxes pass through to the consumer. We have created a situation where we treat corporations as if they are individuals; they have rights to free speech, due process and other rights. If you are going to treat a corporation as an individual for those purposes then you ought to treat a corporation as a taxable entity. Is it more efficient to eliminate the corporate subsidies? Yes. Is it realistically possible? I cannot answer that question. My experience in Congress is it probably isn't, although it would remove an enormous amount of pressure on the legislators. The way to do that would be to impose a tax on the profits big corporations report to their shareholders and under oath to the SEC. You could essentially eliminate all the corporate provisions in the tax code. Federally, nominal corporate tax rates are 35%, but you could raise a little more money by going to a flat 24% tax. Most businesses would be delighted not to have to go through the complicated tax forms" stated Martin Lobel.

- Isn't that the same justification for a flat income tax?
    - The flat tax really is not a flat tax; it is a very regressive tax. It's just like a social security tax. Who pays it? The poor people. I don't think that's what we want to do.

One of the real problems with the tax code is that domestic companies have to pay the full load and then they have to compete against the multinational corporations who don't pay taxes because they use transfer pricing to transfer income to foreign low tax countries.

"We don't have the authority to deal with that; the legislation was very specific about water's edge" stated Chairman Wacks. "Yes, but that doesn't mean we can't discuss it" stated Martin Lobel.

Essentially, those are the various tax philosophies. The one caveat I would make is that even Alan Greenspan admits that the efficient market theory doesn't work. Its real usefulness is telling you what you don't know. The uncertainty factor is one of the things to drive businesses to do what they do. We cannot predict what the future is going to hold. All we can do is make a best guess. From an economic standpoint, I think the answer about what we should do is clear. From a political standpoint I don't think the answer is quite so clear. This is the decision that the legislature is going to have to make.

- Paul Nolan: Is it a fair analysis or fair comparison to say that a gross receipts tax is more akin to the property tax in that it measures the general wealth of a corporation but not its income and that is why we have instituted a corporate income tax?
    - Historically, corporate income taxes were a question of political expediency because concentrations of great wealth weren't paying taxes.

"Just to go back to your original question and address it from a different perspective; why are business taxed at all? If you look at Maryland revenues and what gets collected from general revenues to fund the state and you look at the major sources, the big sources are the sales tax and the individual income tax. The corporate tax is in there but it's not really a big piece; but it's there and it's significant" stated Paul Nolan.

"It's a way of augmenting governmental revenue over a time; augmenting governmental revenue from other sources that are more indirect unlike sales or individual taxation in a way that does not hurt the voters as much. Economists can debate about the incidence of the corporate tax; how you tax and where to tax a company who ultimately pays it is a subject of debate but it is certainly not a voter paying it directly and the corporations can't vote, even though they are legal persons and they do have legal rights. So in some respect, [the corporate tax] probably serves as safety valve on the revenue collections system as the one other source of revenue. It's not the major source of revenue for any state. Look at the federal revenues – the same is true; the corporate income tax historically is never more than the teens (range 13, 14, 18) in terms of a percentage of overall revenue collected. Again it serves the same purpose at the federal level; different people will have different perspectives. There really was no corporate income tax in the 19th century; it's a 20th century beast, and it really was created in the teens in response to the trusts, the way businesses were being organized, a way of getting at a lot of economic activity and since then there's been a back and forth, a play between politics and economics, abuse and reform, to tweak the system and make it more complicated over time," stated Paul Nolan. "If you believe in the political system, you believe in change. The abuses of 2009 are not the abuses of 1984 and those are not the abuses of the 1970's.

"If you fast forward to where we are today, even with all of the history, businesses are thought about as the equivalent of an individual and there is some argument that businesses are separate from the individuals that work for them, [and they] do benefit from government services and therefore there is some logic to taxing the business itself, separate from the people who work for it or the people who own it. I personally don't know any business who doesn't agree with the concept that businesses should be paying some level of taxes. There are lots of economists out there who talk about the theory that businesses shouldn't be taxed; everything should trickle down to the consumers. But in the real world, I don't think any of us see that happening. However, one thing that we do need to remember is that although businesses agree some level of taxation [that is] fair and easy to administer, a business looks at tax expense just like any other input. Taxes to a business are the same kind of dollars as the dollars they have to pay their employees, as the dollars they have to spend to buy their equipment, dollars they spend to buy their raw materials to make their product so if the tax goes up something else has to change, maybe their salaries have to go down, payouts to their shareholders go down, etc.

- Karen Syrylo: I am not familiar at all with the GE writer who says that the main driver of the tax code is to help businesses.
    - "His statements are posted on www.tax.org under the discussion of International Tax Policies" stated Martin Lobel.

- Karen Syrylo: I've always heard of it and thought about it as the higher level discussion of that point and that is, yes we all agree that tax code goal function is to raise taxes to run government. The goal without a doubt is to raise revenue and then the subsidiary question is: Should the code also be used for incentivizing certain kinds of behaviors or activities of businesses. I had not heard that somebody thinks that is the main driver.
    - "That is why I used him as an example of the far right," stated Martin Lobel.

Paul Nolan: "The basic argument for not taxing corporations [is that] people have a choice when they form a business as to how to operate; they can operate as a corporation which is taxable or they could operate as a sole proprietor or pass through entity. If they operate as a sole proprietor or pass through entity, all that income just gets taxed one time at the individual level. If they operate at a corporate level, taxes are applied to the corporate income and when the net income after taxes is distributed to the shareholders in the form of a dividend, or liquidating distribution, it's taxed again. It's the concept of an inefficient way and unfair way to tax income differently depending on your choice of entity. I don't think it's true to say it's big versus small because there are many very big pass through entities out there. I think it is a debate, and whether it's for revenue collection or promoting business, our tax code redistributes wealth and favors low income people in many, many examples. SEC reporting simply is when a company is regulated by the SEC or an international body; they have to attest to their numbers under generally accepted accounting principles for that jurisdiction."

Stephen Banks: "There are differences between tax and financial statements but not necessarily good, bad, up or down, they're just different. I don't see how you could lower tax rates and come up with the same amount of revenue because the income being reported is the same amount of income; there might be timing differences as to when that income is reported but ultimately at the end of the day it is the same. When corporations or individuals file tax returns, similar to the SEC, we are attesting that they are in fact true and swearing under oath that they are true and we are held accountable if we break the rules and don't file taxes in accordance with the rules."

Martin Lobel: "The argument here is the tax expenditures reduce the amount of taxes that are paid. If you just eliminated all those tax subsidies or loopholes you could raise more money by lowering rates."

"What is the definition of the loophole or the incentive?" asked Karen Syrylo.

Paul Nolan: "It's also what the definition of income is. The US federal level Bi-Partisan Tax Commission under the Bush Administration looked at this question; 'should we go to GAAP as the measurement'? And that group decided, "No." GAAP is determined by regulatory body called the U.S. Regulatory Standards Board, which corporations support. They determine what income is for GAAP. The tax code is enacted by Congress; if they were to ever adopt the kind of proposal you are suggesting, they [would be] giving up the ability to ever put their thumb on the scale in terms of creating incentives. I don't think it will ever happen."

"I think that is where we are," said Ms. Syrylo. "There are a lot of writings on a theoretical basis; get rid of the corporate tax, have a flat tax, have GAAP, but we are in reality and we should spend our time on the things that we think are real. There are a lot of arguments on the basic incentives; job creation credits and things like that. There are some purests who believe none of those things should exist to encourage things but in reality almost every state has them and we are stuck having to consider our competitive position."

"Transfer pricing," stated Mr. Banks, "is not inherently evil. It simply refers to the mechanism we all use when we have intercompany relationships. The rules are designed absolutely to make sure that companies who deal with their own affiliated companies are doing so at an arms length basis and treating their own related companies as if they were third parties, and Martin correctly points out that there certainly have been abuses to that over time, and to say that the IRS can't police it, I don't know. At the end of the day, if you are a multinational organization and you have operations in England and operations in Hong Kong, and England has decided to lower their tax rate to 28% and Hong Kong is either 15 or 16%, the multinational is going to have a lower effective tax rate than a U.S. company [who is] primarily doing all their work here, because our tax rate is 35% plus we add on a 8.25% Maryland. That's not the company's fault or the multinational; it's just because those countries/jurisdictions decided that they can attract business or that they can live with a lower or different rate than we have."

"There is something I would like the commission to understand about transfer pricing," added Karen Syrylo. "You mentioned the memos and the pressure internally. If you have a company with different divisions and each of the division heads is gauged for his/her salary on his/her division productivity; yes he is going to want to minimize his cost and that's what generates this kind of jockeying back and forth. The thing to understand about transfer pricing is there is a range of a right number that is the right price for a transaction."

Paul Nolan stated that from the perspective of a vice president of tax at a global multinational, all those commissioners who have expressed the frustration over time have been acting to change the rules in terms of requiring companies to develop contemporaneous documentation substantiating the transfer pricing methodology they use on all material intercompany transactions. This is not a black box; you have to have that information and you have to have it available within 30 days from the time the IRS asks for it on audit, and if you don't, you could be subject to penalties. That regime which was developed here is now cascading out to many other jurisdictions, so now the contemporaneous documentation requirements which used to be in 4 to 5 countries a decade ago is now in 27 countries, headed to 40 countries. China just adopted a contemporaneous documentation regime that is a hybrid, sort of, from best or worst, depending on how you look at it these reporting regimes all over the world. They cited every country's rule and picked the best for them, which is a tough set of reporting requirements because they too are convinced that they are getting the short end of the stick. In addition, the revenue administrators of the UK, Japan, Canada and the U.S. – because of the tax shelter activity – started a cooperative function where they are communicating on a constant basis called a JITSIC: Joint International Tax Shelter Investigatory Committee. Now they are expanding that kind of approach with more countries outside of the JITSIC framework into transfer pricing. The IRS just hired 700 – 800 new employees last year (2008) to do nothing but international, and particularly focusing on transfer pricing. From an enforcement perspective, the tax administrators around the world are responding to whatever perceived abuses there are here that may continue, even though the laws have changed from thirty years ago. Every major multinational has to invest a substantial amount of time and money in documenting what it does when it operates across border to make sure that it can show that whatever happens from a transactional perspective can be justified.

"In the United States, it's not even that the transfer pricing that you are using is justified," stated Steven Banks. "The IRS has over 500 pages on regulations on transfer pricing. In the United States, you have to not only prove that what you are charging is reasonable, you have to prove that it's the best way of charging, which is unheard of in any other country.

"I would like to go back to the comment that was made that the IRS can't police and there's this large temptation to cheat. We have a voluntary tax system – not only with corporations – but with transfer pricing as well as individuals. We have the highest voluntary filing success with any country in the commercialized world. With respect to transfer pricing, you have to remember if you charge or overcharge/undercharge on one side of that transaction in the United States, you are having the opposite impact on the other side. The last thing we want to do is be wrong with transfer pricing, because at the end of the day you can't be overly conservative or aggressive; there are substantial penalties involved with respect to transfer pricing. We spend more money each year on transfer pricing studies and contemporaneous documentation than we do on preparing our tax returns."

"A congressional committee is going to be holding hearings very shortly about the Delaware Blind Trust. The data they have developed indicates massive tax fraud through transfer pricing" stated Martin Lobel.

"What is a blind trust?" asked Paul Nolan.

"You can set up a blind trust; corporation or individuals, and no one can figure out who owns it" stated Martin Lobel.

"You are talking about an absolute fraud type situation and has nothing to do with what we are talking about," stated Steven Banks.

"The California commission report was politically dead. Conceptually, what was the commission trying to accomplish?" asked Chairman Raymond Wacks.

"Classical camel built by a committee," stated Mr. Lobel.

“Were they attempting to simplify the tax code and broaden the base?” asked Chairman Raymond Wacks.

“Yes, and address gross receipts versus income tax and what is the better measure of economic activity,” stated Paul Nolan.

Steven Banks: “California has increased their spending and cut their ability to raise taxes at the same time, and it is catching up with them. Although we are in bad shape, we don’t have the degree of issues as they do.”

“We have to take something else into consideration here” said Delegate Page D. Elmore: “What effect this commission’s decision will have on the State dealing with our neighbors: West Virginia, Pennsylvania, Delaware and of course Virginia. Are we going to sit here and let Virginia continue to get beat our clock with 5.75% income tax? Some in Maryland could be as high as 10% almost and to sit here, business-wise…same thing on our big corporations and raise that tax, or shift the burden or make new winners and new losers out of combined reporting. I think it is something the legislature has to seriously look at. We don’t know yet what effect rising taxes in November 2007 had: whether or not we have lost corporations or individuals and how many have we lost and what percentage of corporations, if any, have we lost.”

- Chairman Wacks: Isn’t there also a personal property tax on individuals in Virginia as well?
    - “It’s disappearing; being phased out” commented Karen Syrylo.
- Chairman Wacks: How does Virginia raise sufficient revenue to conduct business?
    - “They have a tremendous income tax” stated Delegate Elmore.
    - “They make it up in volume. They are one of the states that has a net increase and migration of individuals as well as businesses” stated Karen Syrylo.
    - “Their tax structure is also different. They have the sales tax on groceries at a reduced rate, they have a recordation tax for the state, [and] their corporate income tax is structured very similar to ours,” stated David Roose.

- “I am not saying what to do is perfect, but we better look south and not put ourselves out of competition,” stated Delegate Elmore.
- “One of the decisions we have to make is: Do we want to encourage small businesses, entrepreneurs with an attractive tax system? A lot of the small businesses cannot compete with the multinationals because of the diverse tax structure, and I think that is one of the things we should be addressing” stated Martin Lobel.
    - “I would agree with that,” said Karen Syrylo, “and we have to start with the basis that Maryland is already a small business state. Of roughly 150,000 businesses in Maryland, only 1,000 have more than 100 employees. With all due respect to the tremendous contributions that big businesses make in Maryland, we are predominately a small business state, and so things like the third highest personal income tax rate in the country hurts all of those small businesses who don’t pay the corporate income tax but flow through entities and things like that.”
    - “Keep corporate form in mind,” stated Paul Nolan. “If I was going to form a small business tomorrow with 15 people, I would not form a C-corp; I would be in a pass-through or Sub-S,

> and so there's not this big versus small in the C-corp. [It] is not quite right [that] we may be able to address it with graduated rates, which I think we should think about. What I think the real discussion [is is that for] small versus big, [they] have to take form into account too, and then you are back to those individual rates."

Karen Syrylo: Once we get away from the overall philosophy of what to tax and who to tax, the question is then, how do you tax? Some of the reports may be viewed online, like the statistical studies like the Ernst & Young reports that show the dollars of total state and local taxes that businesses have paid, and the charts show that businesses in Maryland pay the corporate income tax [and] the personal income tax for flow-through businesses. The biggest tax is the property tax. Businesses in Maryland pay 40% of our sales tax revenues on the things that they buy; not the tax they charge at the cash register, but the tax on the things that they buy. Businesses were paying almost $9 billion dollars in state and local taxes and some of the reports [provide] breakdowns. In the real world, our delegates and senators have the issue that we are going to continue business taxes and we are not going to get rid of the corporate income tax. The question is, "What are some of the characteristics of a good tax policy system?" There are several documents from the American Institute of CPAs [and] from the Tax Executives Institute as well as the National Conference of State Legislatures and the characteristics each of those organizations are very similar in deciding how to structure your overall tax policy:

- Taxes need to be simple;
- Taxes need to be easy to understand for the taxpayer as well as the tax administrator;
- Taxes need to be fair, and;
- The tax structure needs to focus on economic growth and efficiency.

All of these documents talk about transparency; the taxpayer sees and knows what he is paying and when he is supposed to pay it. A structure should minimize non-compliance. [It should] have things like withholding, clear rules on the forms and when the taxes are supposed to be paid. You make it easy for people to comply and [make it] cost effective for collection. 'Just tell me what the rules are, make them clear and make them certain' is what I hear from our business members.

Del. Elmore: Out of our four border states, only one has combined reporting and that is West Virginia. Our primary competition is to the south, east, to the north and now, West Virginia.

Steven Banks: A 1,000 page Internal Revenue Code sounds ridiculous and very complicated. The reason it is so long is not because politicians have spent time creating loopholes or creating subsidies, it is really the other way around. People are darn creative and they understand the rules and look for ways to use them to their advantage to minimize their taxes, which is perfectly legal. And then politicians look for ways to close those loopholes down. It's not because we have created opportunities, it's because they are shutting them down. The law of unintended results is very appropriate as we've discussed items like gross receipts taxes or getting rid of corporate income tax directly. In these difficult times when you look at other states who have done major shifts in their tax policy (Ohio, Texas, Michigan), the jury is absolutely out as to what the unintended consequences are going to be. In Texas it looks like the revenues are down. Ohio has decided they have constitutional issues with respect to the way their taxes are being administered. We have to go in with our eyes wide open.

Chairman Raymond Wacks: I think this has been valuable and highlights the difficulty of our task ahead of us. If it was easy, someone would have done it already.

Corporate Tax Forms

Andrew Schaufele, Bureau of Revenue Estimates presented and discussed the Maryland corporate income tax return (Form 500), decoupling modifications (Form 500DM), and Maryland's pass-through entity income tax return (Form 510).

- Paul Nolan: Regarding the addback section, comparing this compliance to other states like New Jersey…[There is a] choice to have the kind of disclosure rather than the mechanics of the math. I would like this committee to have a discussion around that.

  - David Roose: At the next meeting of this subcommittee we will be going over the Captive REIT and the holding company addback in more detail, and we will take a look at New Jersey's form to see what it does and what it allows them to do.

- "David, did we get the total number that showed up for Line D?" asked Karen Syrylo.

  - David Roose: $76 million of add back, a related subtraction that Andy will be talking about here shortly that was $13 million for TY 2006. We will have 2007 numbers and updated TY 2006 at our next meeting. Roughly $63 million of revenue, effectively, because of net addback.

  - Steven Banks: Line 1-Federal Taxable Income, based on the federal tax return, is the starting point for Maryland's return. Whenever companies are audited by the IRS, the companies are required to notify the state when their audit is complete and any adjustments that have been made. In effect, Maryland and other states that start with the federal numbers rely on the federal government or are subsidized by the federal government in the audit process. A good amount of the audit process is taken care of at the federal level which is nice and allows us to maintain staff level much differently.

Del. Elmore: This is just another example of how we chase businesses out of here. You can go to Virginia and write it off. Look at what we did with the Inheritance tax. Virginia just abolished theirs and they accept the federal 3.5. Maryland no longer agrees with that so we decouple from that and only allow the $1 million. I have not heard much here over the course of these meetings that is going to change their philosophy.

David Roose: There are certainly other states that have done the same thing as Maryland has done. I am not sure what Virginia has done with regard to this. I thought several times how Maryland could undo this and what would it take, and I think it would be difficult to undo unless somebody was willing to give up a lot of money one way or the other. It is a perfect example of the complexities that are introduced into the tax system, both for the taxpayer and the tax administrators for a benefit for the state.

"This was as a consequence of action by the General Assembly, correct?" asked Paul Nolan.

David Roose: No, there's the provision in law that requires the automatic decoupling if the Comptroller makes the estimate [that] the revenue effect will be $5 million for that tax year. [If it is $5 million or more,] the changes in federal law don't apply to Maryland. One of the miscellaneous additions is G: an amount is required to nullify the impact of federal tax changes as determined by the Comptroller. That is the placeholder for 'just in case' we have to do something at the end of the tax year.

"The answer to your question, Paul, is that it's all legislatively driven," stated Karen Syrylo.

Andrew Schaufele continued with the corporate income tax return discussion.

"What is the difference between apportionment and combined reporting?" asked Chairman Wacks.

Karen Syrylo: Apportionment is taking a single corporation – its total income – and if that corporation is doing business in a bunch of other states, you take that one corporation's net income to figure out how much of that is taxable in each state. Combined reporting is an apportionment mechanism; instead of looking at each company, you first look at the top line and add all the companies together. Then you do a spreadsheet with all of the companies' receipts, property and payroll to come up with a single apportionment factor that you then multiply times the total of all the consolidated companies. It's a different way of measuring how much income goes to a given state, but it's on a combined basis.

"In the case of McCormick, what is the difference for you between apportionment and combined reporting?" asked Chairman Wacks.

Paul Nolan: Exactly what Karen just stated. We have a series of U.S. corporations and under separate reporting today there would be a schedule 500 for each of those companies doing their report; you would look at their receipts, property, payroll, etc. then repeat that for as many companies as you have. In combined reporting, there would be one form and I would have a spreadsheet behind that where I would have combined all the information, use the apportionment method we're using, that would factor into a single form Of course there are several different complexities with Joyce versus Finnegan, but I won't get into that.

Steven Banks: Combined reporting just refers to whether or not it's one company or ten you are filing a tax return for. Regardless, in both cases, whatever income you are reporting, you still have to apportion that income. Apportionment simply refers to how much of that income is taxable in your state.

Karen Syrylo: An Apportionment methodology is an area that a lot of states are looking at [and] a lot of states have changed their methodologies. There is a huge inclination towards changing to single sales factor and ignoring the property and payroll or to even more than double weight the receipts.

Pass Through Entities Tax Form

"Pass through entitities is essentially another way of taxing business income. Form 510 serves as both a reporting function and a tax withholding function" stated Andrew Schaufele.

Andrew went on to discuss the form and went over a couple different examples due to the forms complexity.

"The pass through entity return is basically a withholding mechanism to get at the non resident owners of a business that is doing business in Maryland," stated Karen Syrylo.

Asked Paul Nolan: Thinking about the addback provisions: Is there still a loophole here, that if you had corporations that formed a partnership and the partnership had royalty payments to the Delaware entity, that it might somehow be related, but they work the 306 carefully with regard to the attribution rules, how would Maryland even see it?

"We looked at this and came to the tentative conclusion that it is not a problem. Why that is I don't recall, but we would look at this in about two weeks" stated David Roose.

Paul Nolan: Again if there is an opportunity there to apply the addback provisions more uniformly on business forms that is certainly something we would want to think about…an existing rule/enhancement that may be easily implanted.

The next meeting of the Business Tax Reporting Subcommittee is on November 19, 2009 at 10:00 a.m. The committee will be discussing Captive REIT's, Delaware Holding Companies, add backs and audits.

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