



# MARYLAND BUSINESS TAX REFORM COMMISSION

Raymond S. Wacks, Chairman

## BUSINESS TAX REPORTING SUBCOMMITTEE

Minutes of Meeting

November 19, 2009

A meeting of the Maryland Business Tax Reform Commission, Business Tax Reporting Subcommittee was held in the Louis L. Goldstein Treasury Building on Thursday, November 19, 2009 at 10:00 a.m.

Those present were:

Raymond S. Wacks, Chairman  
Paul Nolan  
Karen Syrylo  
Michael Ettlinger

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

Speakers present were:

Keith Akers, Chief Auditor

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 10:08 a.m. and introduced Mr. Keith Akers, Chief Auditor, Comptroller of Maryland Compliance Division.

Each member was given Article – Tax – General 10-306.1 Holding Companies statute, enacted 2004; Article – Tax – General 10-306.2 Income Tax – Captive Real Estate Investment Trusts statute (Captive REIT), enacted 2007 and the fiscal notes for each statute. Each member also received the SYL, Inc. case diagram which started the whole ball rolling with respect to Delaware Holding Companies.

### **Delaware Holding Companies – Keith Akers**

Mr. Akers stated his intention was to give the members a law review with respect to Delaware Holding Companies; the case really revolves around SYL and Crown. The issues involved were SYL would buy a suit from SYM's. SYM's was paying a fee through SYL in Delaware for a percentage of their sales; SYL in Delaware would dividend it back to the parent corporation. In essence they were taking a deduction off the return and therefore Maryland taxes were less than what it should have been. In some cases what would happen they would take those dividends and lend them back to the parent corporation and create an interest expense on the same line; double deduction. In Delaware money is not taxable because Delaware does not tax income from intangibles.

royalties, interest, patents, trademarks and various intangibles.

- How many examples of this do you think were occurring?
  - Hundreds.
- Do you remember how many companies fest up in amnesty?
  - We had approximately 300 and some that settled with us during the amnesty; we collected about 244 million back in November.
- Did you have a sense of this scale prior to the legislation?
  - One of our hearing officers stumbled upon it at a seminar in Washington, D.C.; it was a company out of Delaware who was selling their product. At that time we had articles from the Wall Street Journal regarding the problem so we were aware of it. A lot of things that we find are the results of talking with other states and the issues they are dealing with.

We came across the Delaware Holding Company issue in the early 1990's; we had companies that settled with us all the way back in the 1980's. This is still an ongoing issue that we are dealing with. Well over 400 companies that we have identified that didn't take advantage of the settlement and are currently adding back right now.

- How many of those 400 companies are exactly like or at least significantly similar versus companies that say my facts are different?
  - "Very few are not like SYM's in a sense that there pure limited expenses and that type of thing" stated Mr. Akers. "They have gotten a lot smarter. We have instances where they took the royalty company and merged it out of business and put it into a manufacturing operation so they took their patents, and royalties and trademarks, transferred them to a manufacturing company and the manufacturing company didn't have the people on staff to handle the research and patents, royalties; it was still being done the same way it was just in a company now with substance" stated Keith Akers.
  - "In 2004 when this legislation passed there was also a bill passed to create a settlement period for this particular issue; very specifically focused" stated Mr. Roose. Keith referenced the ones making the addback after the legislation passed, the result is on a going forward basis; we've identified for audit; if they are adding back now, they didn't take advantage of the settlement" stated Mr. Roose.

"I would like to state some additional facts" asked Ms. Syrylo of the Chairman:

- "The Comptroller's Office had lost the SYM's case in the earlier levels" continued Ms. Syrylo. "It was only at the Court of Appeals where the judge agreed with the Comptroller that this situation Maryland tax liability should be increased. The circuit court judges held that there was economic substance; companies had done some real things. The Court of Appeals said no, they called it window dressing, it was nothing but paperwork, it was not a real business transaction, and it didn't have economic substance.

Up until the Court of Appeals decision, which by the way took almost two years for them

to make a decision, the lower courts had held in favor of the taxpayer.”

- Ms. Syrylo continued, “Although many of us can look at this and say, “this look so obvious” there are a lot of company’s that did more than this. I am different from SYL because I do have economic substance, I did a real transfer of assets, I do have real people managing in Delaware and therefore these expenses are legitimate.”
- “Issues of the companies you are currently dealing with are they new issues or transactions that have happened since the law has passed” asked Michael Ettlinger.
  - “This is legacy” stated Mr. Akers. “Some of it is new to the extent that they have become more creative; we are finding it in different places like management fees and cost of goods sold.”
- “Does the current reporting structure; the requirement to report the addback, is that in your opinion giving you enough information as an auditor to go in to ask the right questions?” asked Paul Nolan
  - In some cases that are not being disclosed stated Mr. Akers. “They change the way they do business, they now say it’s a part of goods sold, not a royalty per se, not required to be added back.”
  - “These are new audit issues post 2004” stated Deputy Comptroller Linda Tanton.
- “Under current law, if the statutes were enacted that would broaden this kind of reporting and make it more robust in the ways you were talking about, were maybe people were pushing the envelope, that would then give you the information and tools to then follow up” stated Paul Nolan.
  - “Yes.”

“Obviously 2004 legislation was very effective in terms of the numbers of dollars and taxpayers the Comptroller has been able to investigate”, stated Mr. Nolan. “The question is, and other people who are proponents of combined reporting will see that there are new loopholes. There is no reason not to think about the current rules and what could be done to strengthen those to get to these. At some point we are going to run out of new ideas from a planning perspective to get around the rules.”

“If I could add to that in terms of more detail” stated Ms. Syrylo. What is the nature of the intercompany transaction? I think gets at the point of perhaps giving you more so you can more quickly and efficiently deal with “is this taxpayer doing something that is legitimate, a real business deduction.” I think it would also point to one of the things that companies are seeing; spending time with the auditors on things that ultimately are or should be deemed to be different that this, and the view that not every intercompany transaction is “sill kind of transaction.” “When companies are truly performing business services for each other the Internal Revenue code says; that you have to charge each other the same you way would charge an unrelated party. So if that’s the nature of the intercompany management fee or whatever they want to call it that should be a legitimate audit resolution” stated Ms. Syrylo.

“If the management fee is going to a state that is not Delaware, a state that has a high tax rate there’s a

way to see that information” stated Paul Nolan. “We talked about the addback statute that we have and the reporting under it versus other states that require a bit more information to be brought in; the Comptroller in those states has the ability using computer matching to start looking at statistics and not just human auditors. If you have disclosure with respect to related party transactions plus which states are being paid to then you are in a situation where you can see all those payments being made and to what state under an automated system” stated Paul Nolan.

- “How many of the 100 of audits you are doing are going to end up in tax court versus the ones you are settling before court?” asked Ms. Syrylo.
  - “Most of them are settling before court” stated Keith Akers. “We only have 4 – 5 going to court.”
- “Why are so many settling?” asked Chairman Wacks.
  - “Some of them feel they want to be heard and go forward with court” stated Mr. Akers. A lot of them are settling for FIN 48.

“If you are in a situation where it is an addback and you have a Delaware company that hasn’t reported, isn’t reporting or filing in Delaware, in Maryland under the statute there’s no return so there’s no statute of limitations that is running on an improperly filed return, there’s no return and so that statute can go on forever. If you set up a FIN 48 reserve with respect to that liability, which is a liability that never goes away” stated Paul Nolan.

“We are getting more voluntary disclosures without Keith’s auditors walking in their door” stated Deputy Comptroller Linda Tanton.

“A lot of our audits now could be where the taxpayer is in compliance from 2004 forward but they did not settle with us so we are conducting audits prior to that 2004 period because we have a statute of limitations on companies that did not file here” stated Mr. Akers. “Current audit period is not a problem, it’s prior to.”

“So to that extent the tax return form did your audit work because anybody who had that line filled in for 2005 but hadn’t filed for the amnesty was an automatic audit candidate” stated Mr. Syrylo.

“It helped us with our audit selection” stated Deputy Comptroller Linda Tanton. The first year those people created those tax returns and checked that box, we did a program match.

- “I am still curious with your estimate of how many of those several hundred audits are actually being settled” stated Ms. Syrylo “either less liability than the auditors thought or with no liability because at the end of the day it was agreed that these intercompany transactions were valid, valid management fees or interest expense.”
  - “We don’t keep track of that” stated Mr. Akers.
- “The audits that were done that closed with no liability?” asked Ms. Syrylo.
  - “During the audit if we found that issue was not issue for us, we didn’t assess it” stated Mr. Akers. We don’t have a record of what we didn’t assess, have a record of what was assessed and what they paid us. As far as the hearing process we have a record of that” stated Mr. Akers.
  - “One of the big issues we have that is really difficult for us to do upfront is to validate the 4% federal tax rate” stated Keith Akers. “In general we have to go to them and actually

look at the documents and have them send us their justification and that generally requires them to provide us with copies of state tax returns, analysis of the tax rate, apportionment factor, etc to see if actually meets that 4% rate” stated Mr. Akers.

- “Do you feel the lack of resources is causing your auditors to miss good audit candidates?” asked Mr. Ettlinger.
  - “I don’t think so” stated Mr. Akers. “It takes about two years for the auditors to become proficient enough to do their job on their own and handle these types of issues.

“Right now we have more audit candidates than we can cover” stated Deputy Comptroller Linda Tanton.

“It’s also worth noting that we have had to divert some of our audit resources to other issues like corporate reporting” stated David Roose. “They also had to handle the call center as well as e-mails with taxpayer issues regarding corporate reporting” stated Mr. Roose.

- “In terms of resources, if the statute were to be changed, the reporting had to be different, had to be more robust, had to disclose it on their returns, etc. would you go about resourcing your audits different or casting more broadly?” asked Mr. Nolan.
  - “I would think so” stated Mr. Akers. “I think if you were able to narrow the issues down a little bit better in that process, one of the things we are looking at with the new computer system is the data warehouse. Having the capability to put that information into a system that you could do all types of sorting and gather specific information would be helpful” stated Keith Akers.
- “Is that a regulatory or statutory change?” asked Mr. Ettlinger.
  - “Statutory” stated Karen Syrylo.
- “What are your perspectives in terms of the law and the Maryland court system in terms of interpretation?” asked Paul Nolan. “Do you think that with the SYL case and the cases that followed it, do you think the judiciary system is supportive of the efforts of enforcement or more taxpayer friendly” asked Mr. Nolan.
  - We feel that we have a strong basis of what we are doing” stated Keith Akers. The Court of Appeals agreed with SYL and that has been kind of an unusual basis from the past” stated Mr. Akers.
  - The cases that are going through the courts now are tweaking those issues and they are a little different” stated Deputy Comptroller Linda Tanton. “We still think that they ought to be subject to tax and we have not received a higher level court decision on any of those yet. It may be premature for us to say that the courts are sympathetic to those issues” stated Deputy Comptroller Linda Tanton.

- “The Supreme Court does not want to take these cases on” stated Deputy Comptroller

Linda Tanton.

- “We are winning the cases” stated Deputy Comptroller Linda Tanton.

“The issues with these kinds of transactions” stated Karen Syrylo is:

- Are these sham transactions? Do they lack economic substance? Were they not real?;
- If they were real, do the transactions still have nexus with the state?

“Even in cases where the legal issue was brought by the taxpayer was clearly about nexus; a bank that was issuing credit cards in the state; is that enough nexus, or is that a intangible transaction like this” stated Karen Syrylo. “The Supreme Court has chosen not to take on any of those cases on nexus” stated Karen Syrylo.

### **Captive REITs – Keith Akers**

The process for Captive REITs, a retailer in the State of Maryland who owns their stores, they set up a trust outside their consolidation, that captive REIT is required to have 100 shareholders and they will have ninety nine corporate offices having 1% share in the business, corporation located in Delaware who has 99% share of the Captive REIT, retailer shifts income to REIT through rental income, REIT avoids state income tax liability because of the dividends paid deduction for REITS. The purpose of the legislation is to treat the dividend as the feds do in a sense that basically makes the REIT taxable where its properties are located.

“One of the things we found with this particular issue, the stores are still in the name of the company that is paying the money to the REIT” stated Mr. Akers. “Walmart is an example.

- “Unlike the Delaware Holding Companies where there are some taxpayers out there who might still believe in there substance and might try to pursue it, in terms of defending and not settling in the Captive REIT area, so far your experience is taxpayers are folding” asked Mr. Nolan.
  - “Once we find them” stated Deputy Comptroller Linda Tanton.
- “Is there something we can recommend to put on the returns or disclosure that would help that to be disclosed” asked Chairman Wacks.
  - “We are dealing with companies that file in Maryland and paying the rents” stated Keith Akers. “We have to go back and disallow it, we can only go back in years in statute” stated Keith Akers.

“They are acting as a tenant on property they own” stated Paul Nolan.

- “What can we do regarding the REITs filing requirements” asked Ms. Syrylo.
  - “The REITs are filing” stated Mr. Akers. “The problem we have in my opinion is, the REIT has a name of “John Doe”, the company in Maryland that is paying the rent is “Mary Smith” there is no way you can tie them together to see that the REIT is reporting” stated Mr. Akers.

- “Is there something that the commission could recommend to SDAT’s filing that they should be

gathering more information so that it is accessible to the Comptroller outside of your office” asked Ms. Syrylo.

- “I don’t think I am adverse enough to be able to make that decision” stated Mr. Akers.
- “Going back to this loophole discussion, even if it is a legitimate REIT is that a loophole we think is a problem” asked Chairman Wacks.
  - “Let me answer that question” stated Ms. Syrylo. “Let me remind the commission that the Maryland Chamber of Commerce supported this legislation in 2007. We felt that unlike a taxpayer who was taking advantage of something in another state’s law and is going all the legitimate things, the reason that the REIT entity was created under the federal statute was being abused and not followed in this use of it for a state tax plan. The REIT was created with the intention of allowing lots of little investors to participate in the real estate market. When you have one entity using a REIT because all of the 100 shareholders are in the same group, it is automatically contrary to the basic intention of why a REIT was set up” stated Ms. Syrylo.

“So the real REITs that we are talking about are the ones that do have hundreds or thousands of shareholders” stated Ms. Syrylo, and often those shares are traded on some public exchange and you don’t have the relationships of the hundred shareholders all being owned by the same entity” stated Ms. Syrylo.

“Which is why we call it a Captive REIT” stated Deputy Comptroller Linda Tanton.

- “We didn’t talk numbers, how much tax revenue have you received from this?” asked Ms. Syrylo.
  - “I would say we are in the twenty million range in two years with 4 – 5 audits that settled” stated Keith Akers. “The big issue there is dealing with the statute issue to the extent that we can only go back two years that are open” stated Karen Syrylo.

“In terms that it’s only a few audits, I should add a fact that the nature of this type of planning is so complicated that it’s probably only usable by big, big companies” stated Karen Syrylo.

“I would have to agree based on the companies we have identified and actually dealt with” stated Keith Akers.

“If we could ask you to think about any recommendations you would have for the commission to consider on what kind of data would make your job easier to find the people who are using this abuse” stated Ms. Syrylo.

“Transfer property reporting might be an interesting trigger if you change the disclosure rules where at any conveyance you are making a conveyance to a person who is a related party” stated Mr. Nolan. “It creates data point that could be found and measured” stated Mr. Nolan.

“There’s been a change in that law too, to provide more data when there is a transaction” stated Mr. Ettlinger.

“That would help the transactions where the people who are actually transferring the property to the

REIT, it's still up to the auditors to find the ones that were outright fraud" stated Ms. Syrylo.

"I have a question for you about the 2004 legislation that was passed and I don't see on the agenda" stated Ms. Syrylo.

- "Granting the Comptroller Section 482 powers" stated Karen Syrylo.
  - "I was planning to get to that later" stated Keith Akers.

## **Current Audit Issues – Keith Akers**

### **Captive Insurance Companies**

The other issue we are dealing with is Captive Insurance companies. We have about a hand full of them and we have one in the hearing process right now. A Captive Insurance company is a company within the consolidated group who was set up to handle the insurance needs of the corporate group. In some cases we are finding that they are transferring their royalties, patents, trademarks to captive insurance company instead of Delaware Holding Company and paying for the use of those royalties. The insurance company is in turn lending back that money to the parent company and so we are back to the Delaware Holding Company scenario. The difference is the insurance company by law is not required to file a corporate income tax return because they are subject to the gross premiums tax.

They don't pay premiums on royalties and interest because there not insurance related. We are also finding that these insurance companies are doing business in a lot of states but they're only filing insurance premiums in the state they are incorporated in. The argument we get is "your law exempts us from filing; we are an insurance company."

The Captive Insurance is issues that happened before the addback legislation. The addback legislation did take care of the issue; what we are dealing with is prior to the 2004 session.

### **482 Issue**

"During the 2004 legislation the Comptroller's Office was given the 482 authority; transfer pricing issues" stated Mr. Akers. "We had an audit, we did a 482 adjustment on them on intercompany loans, we assessed them based on the feds rates; it ended up in court; the courts ruled that we did not have the authority to make that adjustment; only the IRS could. So in the 2004 legislation we were given the 482 authority" stated Keith Akers. If you have a corporation with multiple you may have one of the companies within the group that does all the accounting work within that group. Under IRS rules you are required to pay an arms length transaction price for that particular service from whoever you received the services from. Transfer pricing is a difficult area to get into; even the IRS struggles with it; offshore issues, etc. Our main goal with the 482 has been to look at things like management fees to see if they look exorbitant compared to the business; issues with products being sold; manufacturer sets up a sales company in another state, they transfer all their products to that distributor in the other state, what kind of rate are they paying to for that product, is it a fair price? These are things we can look at but again, is it a fair price is the difficulty.

- "Can you give us a sense of how many audits you have raised 482 issues in?" asked Karen Syrylo.

- "Probably no more than 5 or 6 with respect to the 482 issue itself" stated Keith Akers. "In a

round about way, Delaware Holding companies are 482 issues also because we are looking at royalty rates, industry standards, etc.” stated Mr. Akers.

- “Has the FIN 48 had any appreciable impact in this area, have any taxpayers come forward for VDAs?” asked Mr. Nolan.
  - “I only see the Delaware Holding Company voluntary disclosure” stated Mr. Akers. I think the answer to that is yes; our volume has picked up considerably with regards to voluntary disclosures and I can only attribute that to FIN 48 issue. It certainly puts a notice on CEO’s of corporations to make sure they have a clean balance sheet when they do their annual reports” stated Mr. Akers.
- With regards to the Pinsky letter that comes out every year listing the corporations who have not paid taxes; those companies that are on that list, has there ever been any focus as to why they haven’t paid tax” asked Mr. Nolan.
  - Because of the notoriety surrounding the letter and the publicity and the political aspect, we have in the past looked for our own point of view looked at some of them to see what was going on in a particular industry” stated Deputy Comptroller Linda Tanton. “In our letter we have tried to say that there are certainly legitimate reasons why a corporation doesn’t owe taxes in a particular year” stated Deputy Comptroller Tanton.
  - “We understand the issues and know why in general companies may not be paying their tax” stated Mr. Roose. “The production of that list has generated no work that wouldn’t be done anyway” stated Mr. Roose.

## Current Audit Issues

“I do not think there is anything out there currently now other than the issues I have discussed above” stated Mr. Akers.

- “What are the issues surrounding combined reporting?” asked Chairman Wacks.
  - “Intercompany eliminations” stated Mr. Akers.
  - “Initial analysis we ran into all sorts of problems because information was reported to us on that page in three different ways and it wasn’t clear to us at first what exactly what was going on” stated David Roose. “Even after we spoke with a lot of people and knew it was still difficult to deal with the data itself and as you recall we sent out approximately 2600 letters trying to get clarification, so for tax year 2008 we asked for the information in a different way so I am hoping that people were paying attention when entering the information in the system. We will know in a few months whether or not that was successful. This year has been much smoother with fewer questions” stated David Roose.
  - “As far as issues with combined reporting, we are really not in a position to develop what the audit issues are going to be” stated Mr. Akers. “I can tell you that combined reporting is just another way of taxing and you are going to have audit issues as with the same as you have with single entities, it’s just a different taxing scheme” stated Keith Akers.

“One thing the commission will want to take a look at is in the event combined reporting were enacted

what would it take to get the auditors up to speed, transition rules, etc. next year” stated Mr. Nolan.

- What sort of issues can you comment on with respect to non corporate audit issues?” asked Ms. Srylo.
  - “Non resident owners we are trying to identify” stated Mr. Akers.
  - “Pass through entities are a little more difficult for us to get our arms around, they tend to be more complex these days” stated Deputy Comptroller Linda Tanton. “We are hoping with the data warehouse technology will help us get our arms around this issue.”

### **Next Meeting**

December 3, 2009 is the Business Tax Incentives subcommittee; January 7, 2010 is the full commission, January 11, 2010 for this subcommittee. The subcommittee agreed that the 2:00 p.m. time would work better. All meetings will take place in the Assembly Room in the Louis L. Goldstein Treasury Building.

/liv