Testimony in Opposition to Mandatory Combined Reporting

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1. Introduction

Thank you for the opportunity to offer this testimony on behalf of Comcast Corporation regarding Maryland's consideration of mandatory unitary combined reporting ("Combined Reporting"). Comcast Corporation appreciates the time and effort that the Maryland Business Tax Reform Commission (the "Tax Commission") has spent reviewing this important issue. As discussed more fully below, Comcast Corporation:

(1) Opposes the adoption of Combined Reporting in Maryland;

(2) Supports the enactment of rules which will enhance Maryland's current separate reporting regime; or, in the alternative,

(3) Supports a repeal of the income tax (decouple from the broken Federal income tax regime), and replacement with a modified gross receipts tax which applies to broader tax base and all forms of business (regardless of form as a C-Corporation, S-Corporation, LLC, partnership, or sole proprietorships).

Over the last several years many states have adopted, or considered adopting, Combined Reporting. Combined Reporting is a fundamental change to a state's tax regime – not merely a revenue raising or decreasing measure.

Comcast Corporation opposes Combined Reporting because it:

- Does not increase tax revenue and, in fact, Combined Reporting, adopted in this weak economy, likely would decrease tax revenues; and
- Increases the complexity and cost of Maryland tax compliance and;
- Most importantly, makes the Maryland economy less competitive.

In simple terms, assume a company owns two hotels, one in Maryland and one in Pennsylvania, each held in a separate subsidiary. The hotel in Maryland is profitable. The hotel in Pennsylvania runs at a loss. Under Maryland's current separate reporting regime Maryland will collect tax on the profits of the Maryland hotel, but exclude the losses of the Pennsylvania hotel.

Combined reporting advocates will argue that as a result of Maryland's separate reporting regime, Maryland will not receive any tax revenue because the Maryland hotel will use "accounting tricks" to shift the Pennsylvania losses into Maryland.

In fact, if these types of "accounting tricks" were in such wide spread use, and if Combined Reporting were the "silver bullet" it is advertised to be, then why does the Maryland Tax Commission's own 2007 data show that Combined Reporting would help nearly as many taxpayer as it hurts? If the separate accounting abuses were so prevalent, as advertised, the Tax Commission's data should have shown virtually no winners.

2. C-Corporations Are Paying Their Fair Share of Maryland Income Tax

Maryland State legislators have been besieged with claims that the separate reporting regime has loopholes and, therefore, Maryland should enact a Combined Reporting regime as a "loophole closer". Combined Reporting advocates attribute declines in corporate income tax collections to abuses of the separate reporting regime. They claim that C-Corporations are not paying their fair share.

But the objective tax collection data does not support those claims. For examples, as a percentage of all Maryland income taxes (personal and corporate), C-Corporations are paying in about 87% of what they contributed in the 1980s, but 115% vs. the 1990s.[1]

Over that same time period the number of C-Corporations in the United States steadily declined from an average of 2.4 million C-Corporations in the 1980s to 1.865 million today – over a 20% decline vs. 1980s and a 15% decline vs. the 1990s. More importantly, the profits reported by C-Corporations (as a percentage of all business profits) has steadily fallen – down 43% vs. the 1980s and down 25% compared to the 1990s. Logically, fewer corporations would likely mean less overall profits.

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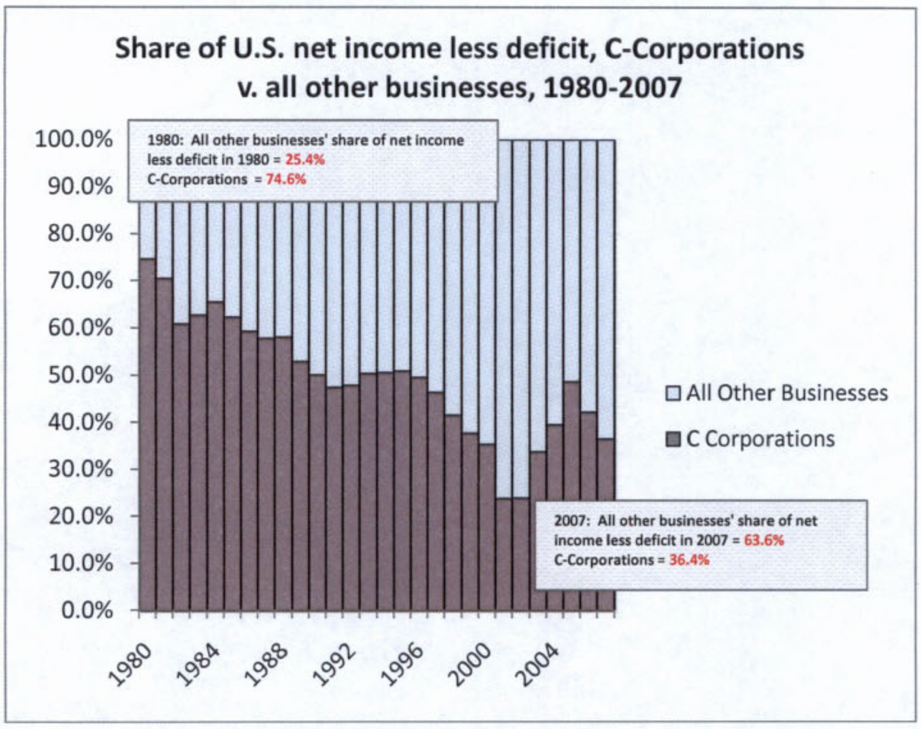
[1] The breakout of income taxes contributed by corporate net income tax ("CNIT") and personal income tax ("PIT") was: 1980s: CNIT 11.2% / PIT 88.8%. 1990s: CNIT 8.5% / PIT 91.5%; 2000s: CNIT 9.75% / PIT 90.25%. 9.75%/11.2% = 87%. Data Source: US Census data.



The profits earned by C-Corporations were 68% of all U.S. business profits in 1980. That figure fell to 38% in 2007. Consistent with this trend, data presented to the Maryland Business Tax Reform Commission shows that "Business Income/Loss Reported on Federal Tax Returns of Maryland Residents" exploded from \$9.971B in 2000 to \$16,138B in 2006 --- a 61% increase.[2] Thus, the data evidences a greater use of pass-through forms (such as LLCs or limited partnerships) of business in order to avoid the corporate double tax regime.

So, there are less C-Corporation taxpayers (down 15% compared to the 1990s); and, accordingly, less profits being reported by the C-Corporation taxpayers (down 25% compared to the 1990s). Yet, despite fewer C-Corporation taxpayers, C-Corporation's percentage of overall Maryland income taxes is at 115% of what it was in the 1990s.

Based on the aforementioned data, Maryland C-Corporations (those that remain) are contributing to the Maryland income tax pool at a greater rate.

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[2] At Page 7 of Overview of Maryland's Tax Structure, Presentation to the Business Tax Reform Commission, by David F. Roose, Andrew Schaufele (Comptroller of Maryland) and George Manev (Department of Management and Budget), presented May 13, 2009.
http://btrc.maryland.gov/MBTRCmeetings/documents/5_13_2009_Overview_of_Marylands_Tax_Structure.pdf

3. Maryland Combined Reporting Study

Maryland has issued the results of its analysis of the second year (2007) of the Combined Reporting information returns based on data evaluated from a more robust economic climate. The following are observations on the reported results:

- There are large numbers of winners and losers from Combined Reporting.
- As shown in the table, Maryland is estimating that in tax year 2007 Combined Reporting would reduce taxes by $182M, while increases taxes by $274M.

Maryland Combined Reporting Impacts,
Tax Year 2007 Information Reports

	Winners	Losers	Net Impact
Ag, Mining, Utilities, Const.	-$29.3	$4.3	-$25.1
Manufacturing	-$40.2	$57.5	$17.3
Wholesale & Retail Trade	-$17.6	$73.8	$56.2
Information	-$12.5	$26.9	$14.3
Finance & Insurance	-$31.1	$56.9	$25.8
Prof., Scient. & Tech. Ser.	-$21.0	$21.2	$0.2
Other Bus. Services	-$17.5	$16.8	-$0.7
Other Services	-$12.8	$16.9	$4.2
Total	**-$182.0**	**$274.3**	**$92.3**
Number of taxpayers	2,021	2,071	

Source: Comptroller of Maryland, March 2, 2010 Report

- The estimates, even if accurate for 2007, are not applicable to 2010 or 2011 because of the recession.
  - The latest U.S. Census Quarterly State and Local Tax Collections report shows that nationwide, corporate income tax collections for the 12 months ending June 2010 have fallen by 29% compared to the 12 months ending in June 2007. NOLs could also result in reduced corporate income tax collections for several years. The Comptroller's office noted in the 2007 report that they expect a large number of amended reports to be made for 2006 and 2007 due to NOL carrybacks. These amendments could substantially reduce the studies overall net looser tax impacts from Combined Reporting.
- Combined Reporting may raise little revenue, but instead may result in substantial redistributions of tax liabilities that may adversely affect Maryland's economy.

- The above data suggests that there may be little additional revenue from Combined Reporting to address with current budget deficits. Legislators should understand the potential impact of the large redistribution of taxes on Maryland's economy and tax competitiveness.

- If separate accounting was so abused, why are there such large numbers of winners?

- The large swings in winners and losers evidences that Combined Reporting is no more accurate than separate reporting – it is merely a trade of one set of distortions for another.[3]

- The study does not address the tax impact from enhancement of the accuracy (perceived and real) of the current separate accounting regime and/or broadening of the base through a modified gross receipts tax.

- Combined Reporting also presents planning opportunities that are not reflected in the study.

- Other shortcomings in the Maryland study data:

    - The data reported by taxpayers is a static snapshot at a point in time. The estimates do not make any adjustment for changes in taxpayer behavior that will reduce tax collections.

    - Without detailed regulations and tax agency guidance, there is still a great deal of uncertainty about how Combined Reporting will operate (including which firms are members of the combined group).

    - There is also a continuing, significant inconsistency in how the data is being reported. As a result, research staff has had to make a number of adjustments to the reported figures in generating impact tables. As pointed out earlier, relatively small mistakes in determining tax increases and decreases can have a magnified impact on estimates of the net impact.

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[3] Because Combined Reporting is a fundamental change to a state's tax regime – and not merely a revenue raising measure – Combined Reporting adoption requires state policy makers to consider numerous versions of the regime. While some of these considerations may appear minor at first glance, they may impact taxpayers and/or the state in very significant ways. For example, states considering Combined Reporting must decide how a unitary group's sales factor is computed (the so-called Joyce and Finnigan distinction). In addition, a Combined Reporting regime must consider how tax attributes (credits and net operating losses) earned by separate members will be combined and used to offset the unitary group's combined income. These decisions will greatly impact a corporation's tax liability in a Combined Reporting state, depending on the structure of a corporation. However a state comes down on these issues, however, Combined Reporting will likely create disparities among competing businesses merely as a result of their respective organizational structures. Because of variances among corporations in similar business lines, Combined Reporting may give one corporation a competitive advantage over another. Therefore, Combined Reporting nearly always creates an unlevel playing field among Combined Reporting "winners" and Combined Reporting "losers."

- The change in the estimated impact of Combined Reporting (under Joyce) between 2006 and 2007, a drop of 36% (-$52M) in the net impact is a very large change in one year. It is unclear whether this decrease is due to inherent volatility in revenues under Combined Reporting, amended reports reflecting NOLs, or continuing problems with the data being reported?

4. Combined Reporting, Jobs & The Maryland Economy

More attention should be focused by the Tax Commission on how Combined Reporting would impact the Maryland economy. For example, Combined Reporting states run larger budget deficits and create less jobs. A recent January 2010 study by Ernst & Young shows that Combined Reporting states have, on average, substantially higher percentage general fund deficits, 41% higher in Combined Reporting states versus separate filing states.[4] A similar study found that job growth in separate reporting states was higher than in Combined Reporting states.

A more recent empirical study of the impact of Combined Reporting on state GDP was prepared for the Tennessee Comptroller of the Treasury by the University of Tennessee Center for Business and Economic Research.[5] The regression analysis in the study included estimating the impact of Combined Reporting on GDP for corporate income tax states (42 states) over the 1994 to 2009 period. The authors concluded that: "These regressions provide evidence that Combined Reporting lowers state GDP in cases where the corporate tax rate exceeds 8 percent. (p. 39.) The study did not find any statistical evidence that Combined Reporting increased GDP.

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[4] See *"Comparison of State Economic and Fiscal Performance During the Recession"* (E&Y January 12, 2010).

[5] William F. Fox, LeAnn Luna, Rebekah McCarty, Ann Boyd Davis and Zhou Yang, "An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes," University of Tennessee, Center for Business and Economic Research, October 30, 2009.

In the last few years, several states have considered adopting Combined Reporting while only a couple states have ultimately enacted Combined Reporting. A number of these states published highly speculative and suspect figures stating that revenue growth will increase dramatically under a Combined Reporting regime. For example, during the 2008 legislative session, New Mexico's Legislative Finance Committee estimated a twenty percent corporate tax revenue increase would result from Combined Reporting.[6] Just two years later, however, the New Mexico Legislative Finance Committee adjusted its methodology, stating: "recent econometric research using multiple years of data across states, indicates that Combined Reportinghas no effect on state corporate income tax revenues."[7]

5. Combined Reporting Brings Complications and Unintended Consequences

Administrative Costs Will Increase: Adoption Combined Reporting imposes a significant compliance burden on taxpayers and the state. In addition, Combined Reporting creates correlative enforcement problems for state tax administrators. Comcast Corporation, like other taxpayers doing business in Combined Reporting states, spends significant resources on corporate income tax compliance in Combined Reporting states. Likewise, tax administrators in Combined Reporting states expend scarce resources becoming familiar with such a major change to their respective state tax codes and regulations. For example, significant amounts of case law that clarified or preserved the integrity of the separate entity tax system may be rendered meaningless. States must publish new tax forms and other administrative guidance. Further, a state adopting Combined Reporting would have to invest significant time and money in educating auditors, legal counsel, and other department personnel about the audit and legal issues resulting from Combined Reporting.

Tax Litigation Will Increase: Defining a unitary business for combined group purposes remains the subject of litigation in states such as Illinois and California where significant guidance has been published. Published guidance only increases litigation in this area because the limits of the unitary business principle are contained within the Constitution and interpreted by the U.S. Supreme Court. Indeed, the most significant state tax case heard by the U.S. Supreme Court case over the last three years was a case defining the contours of what constitutes a unitary business.

Combined Reporting is a fundamental change to a state's tax regime – and not merely a revenue raising measure. While some of these considerations may appear minor at first glance, they materially impact a taxpayers and/or the state in very significant ways. For example, states considering Combined Reporting must decide how a unitary group's sales factor is computed (the so-called Joyce and Finnigan distinction). In addition, a Combined Reporting regime must consider how tax attributes (credits and net operating losses) earned by separate members will be combined and used to offset the unitary group's combined income. These decisions will greatly

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[6] *Compare* Michael Mazerov, *Corporate Lobbyist's Case Against Combined Reporting In New Mexico: A Rebuttal* (Dec. 1st, 2009), available at: http://www.cbpp.org/cms/index.cfm?fa=view&id=3012 *with* The Council On State Taxation, *Mandatory Unitary Combined Reporting: A Rebuttal to the Center on Budget and Policy Priorities* (February 12, 2010); available at www.cost.org.

[7] Fiscal Note, H.B. 215, Second Session, 49th Legis. (N.M. Feb. 11, 2010).

impact a corporation's tax liability in a Combined Reporting state, and undoubtedly lead to lead to litigation as the Combined Reporting "losers" work to minimize their losses and Combined Reporting "winners" work to increase their spoils.

6. Separate Reporting Does Work Today

Advocates of Combined Reporting claim that Combined Reporting will raise more revenue for the state by ignoring (eliminating) transactions with related parties. The simple complaint is that there is an abuse of the transfer pricing for the purchase of goods and services between affiliates.[8] This complaint ignores that separate accounting works today both inside and outside of tax.

Separate reporting is the regime used in the international tax community. There exist today robust transfer pricing rules which allow the international tax community, including the United States, to use separate reporting regime for national income taxes.

Separate Reporting is also the system used in the financial world to measure the income of minority shareholders and partners which invest in subsidiary units of a business. Separate reporting in the financial world comes with greatly enhanced controls – independent auditors, robust disclosure, and for public companies the SEC – all of which greatly increase the perceived and real accuracy of the separate company reporting.

We want to emphasize this point. Separate accounting works today in the financial community. Any large corporation which owns less than 100% of a subsidiary has a responsibility to that minority shareholder to properly and accurately account for the results of that subsidiary unit.

EXAMPLE: An affiliated group of entities may own controlling interests in many different businesses, but not 100% of those businesses. Thus, those businesses will have minority investors who have chosen which type of industries or companies to invest their money in. If an investor places funds in a company that owns a hotel in Maryland, the investor expects that the return on that investment will be solely dependent upon the success of the hotel in Maryland. If the affiliated group, of which the company owning the Maryland hotel is a member, also includes companies owning hotels in Indiana and New York, the minority investor in the Maryland business would not expect the returns on the investment to be affected by the success or failure of the other businesses in operating hotels in other states. In fact if the affiliated group tried to tie the investors returns to the returns of the entire group, this would run afoul of federal securities laws. The minority investor relies on the concept of separate accounting as the most accurate method to calculate the profits and losses of the company in which the investment was made.

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[8] As an aside, this is the same complaint leveled against the Federal international tax system. Yet, the statutory mandate of the Tax Commission expressly points to "water's edge method" Combined Reporting --- essentially allowing large multinational firms to retain this perceived benefit.

LESSON: The assault on separate reporting in the tax community appears to be driven by the perception that taxpayers' separate reporting is not accurate. Whether that perception is founded in reality is a matter for debate. As notes above, the sheer number of "winners" in the Tax Commission's own 2007 data is strong evidence that, in fact, separate accounting is not being abused.

But to quiet this debate, we are of the view that this negative perception must be addressed. Obviously, separate accounting in the financial world does not carry such a negative perception of inaccuracy. Why? Why is financial reporting perceived as more accurate than the income tax reporting? We believe that the answer is that in the financial world you have independent auditors and robust enforcement by State and Federal agencies. If similar appropriate accountability standards, modeled off the financial world, were in place for state tax purposes, states could be in the same position as the minority investor. Requiring some level of independent auditor review of separate tax reports for book income accuracy, paid for by the taxpayer, may very well accomplish this goal.

7. Recommendations

The first and foremost goal of any state income tax reporting system is "accuracy" – the accurate measurement of the profit and loss attributable to a corporate taxpayer's activity in the state. Claims of "loopholes" or that a system unfairly distorts income or losses are merely claims that the system does not accurately measure a taxpayer's income earned in the state.

With separate reporting and Combined Reporting as they exist today, both are somewhat flawed and causing inequities in the way companies are taxed. Options should be considered before legislatures decide they must choose one system or another. Two very different options are available – one currently in use by state tax authorities and the other used by the financial markets.

Option 1: Addback statutes. Studies have shown that addback statutes are effective in combating state tax planning abuses as well as in increasing revenue. While the scope of these addback statutes can result in some otherwise perfectly legitimate business expenses becoming non-deductible, they are a simple, efficient method for increasing revenue and closing some types of entity isolation tax planning.

Why do addback statutes work so well? Addback statutes typically include exceptions which allow the intercompany expense if the taxpayer can demonstrate that the expense is reasonable and/or traceable to a third party expenditure. In our view, the addback statutes work well to increase accuracy because they raise the enforcement bar and force taxpayers to substantiate their intercompany expenditures.

Option 2: Independent certification of state taxable income. The financial reporting system is essentially a separate return system which as an independent review of the profit calculations of each reporting entity. Today the only enforcement of tax separate company reporting is the Comptrollers auditors.

It is fair to say that the Comptroller's office may not have the resources needed to fully and fairly audit a taxpayer's separate company reports. As a side note, Combined Reporting and the associated complexities will also outstrip the Comptroller's resources.

So, what's the solution? Adopt the financial reporting model. The reporting system would be based on a separate return system, but companies would have to adopt transparent internal accounting that would accurately reflect the actual income producing activity of the reporting entity in the state. An independent third party, paid for by the taxpayer – such as an auditing firm – would review and certify the book figures on which the report is based, applying well know standards such as GAAP or IFRS. This would enhance both accuracy and trust in the state's separate reporting tax system.

More importantly for the Comptroller, companies which want to avail themselves of the separate reporting regime would foot the bill for audited statements to support their filings. Much in the same way as a subsidiary units of a large corporation today foots the bill for audited financial statements required to satisfy its minority investors.

Option 3: In recognition of the shrinking number of C-Corporations (as business continue to migrate to pass through entities such as LLCs) and in recognition of the reduced Federal income tax base created by permissive international tax rules, Comcast supports repeal of the income tax, decouple from the Federal income tax regime, and replacement with a modified gross receipts based tax which applies to all business regardless of their form as a C-Corporation, LLC, partnership or sole proprietorships.