MARYLAND BUSINESS TAX REFORM COMMISSION

Raymond S. Wacks, Chairman

Maryland Business Tax Reform Commission

May 18, 2010
Minutes of Meeting

A meeting of the Maryland Business Tax Reform Commission was held in the Louis L. Goldstein Treasury Building, Assembly Room on Tuesday, May 18, 2010 at 2:00 p.m.

Those present were:

Raymond Wacks, Chairman

Steven J. Banks, Greater Baltimore Committee
Michael Ettlinger, Public Member
Delegate Sheila Hixson
Senator Verna Jones
Martin Lobel, Public Member
Senator Richard S. Madaleno, Jr.
Paul Nolan, Manufacturer's Alliance of Maryland
Karen Syrylo, Maryland Chamber of Commerce
Linda Tanton, Deputy Comptroller
David Roose, Bureau of Revenue Estimates

Those also present were:

George Manev for Marc Nicole, Department of Budget and Management
Mark Vulcan for Christian Johannson, Department of Business and Economic Development

Speakers present were:

Jane Steinmetz, PriceWaterhouseCoopers
Joe Huddleston, Multistate Tax Commission

The meeting was open to the public and members of the local government, state government, media, as well as others, were in attendance.

Chairman Raymond Wacks opened the meeting at 2:04 p.m. by welcoming our guests and speakers.

Mr. Paul Nolan made a request to have the next Maryland Business Tax Reform Commission agenda reflect discussion regarding the process and procedure, subcommittee pros and cons, drafting reports for now and through December 15th.

Chairman Wacks introduced Jane Steinmetz from PriceWaterhouseCoopers to give an introduction about herself and about her presentation.

Jane Steinmetz: A partner at PriceWaterhouseCoopers, I run the Northeast state tax practice. In Massachusetts we had a legislative commission to study combined reporting and I was a member on that commission.

I am not going to make recommendations. I have clients on all sides of all issues. I am going to try an express to you very objectively the technical issues. I will relate to you a lot of the policy issues that we considered on the Massachusetts commission.

Topics:

- Concept of a Unitary Group
- Joyce/Finnigan
- Transitional Issues (move from a separate entity state to combined reporting)
- Single Sales Factor with Combined Reporting

Joe Huddleston: I am the Executive Director of Multistate Tax Commission. I have about 25 to 30 years experience in the area of state and local tax.

Jane Steinmetz: The unitary concept is one I usually think of in a very simplistic form which is the easiest to understand.

Let's suppose you have a business and it bought raw materials, made something of it and then sold it. Everyone says, "Ok we are going to tax that business as one." Then the business enterprise decided to break those operations into separate legal entities. At that junction the question becomes, "Do you respect the legal lines and tax them individually or do you continue to tax that business enterprise?" In its simplest format, that's really the question. The problem is, it's simple and we are not in a simple world. So when you fast forward it to modern day situations you have conglomerations' where they might be involved in banking, manufacturing and transportation. Then you ask "where is my business enterprise, where do I draw the lines?" I think that's where the complexity surrounding combined reporting that can come into the picture.

Combined reporting: a subjective analysis, it is based on facts and circumstances.

While on the Massachusetts commission one of the issues that were raised was that the subjective analysis can lead to prolonged litigation; it can also lead to uncertain tax positions for financial statement purposes. The taxpayer will say, "I'm going to drop my unitary relationship around these sets of corporations and the state different and then where does it end up.

With respect to the unitary group, the question is:

- where do you draw lines;
- it has to be a unitary relationship;
- look for that common business enterprise;
- Is there a way of assisting with analysis?

In Massachusetts while on the commission, we felt strongly for an affiliated group election which you can provide to taxpayers an election that's more objective; looking to a federal consolidated group as an election or something of that nature.

Joe Huddleston: While I agree with Jane that a unitary group is somewhat of a subjective analysis, it is not without guidance. There's been plenty of guidance on the structure of unitary over the years, not just with state regulations but from the federal courts and U.S. Supreme Court.

I would call your attention to the four to five cases out there that have over the decade have outlined fairly, clearly I believe, what parameters of a unitary group are. That doesn't mean that within this scope of these there is not room for discussion but there's some pretty clear historical outlines on what a unitary group is beginning with Brown Brothers that outline three unities back in 1942. You get a scope of just how long we have been talking about the discussion of a unitary group. The Butler Brothers outlined the unity of ownership, unity of operations and unity of use. Of course within that we can agree about what those things mean but again there somewhat narrowed over time by other U.S. Supreme Court cases. *Please refer to Mr. Huddleston's handout, "Will States Adopt a Model Combined Reporting Statute?" at the following link; http://btrc.maryland.gov/archive.asp*

Now what those mean within any factual content can be debated by at least it narrows the scope of what you are looking at so it's not completely blue skies as to what a unitary group is and the courts have given us some reasonable guidance?

Paul Nolan: Just to be clear for this group, some of us are tax professionals and some of us not; we're talking about how or what the definition of a unitary group is. In terms of the process, isn't it true that typically under the law, the taxpayer would have to make that determination first in their filings and that would be subject to review by the director of the department in the state?

Jane Steinmetz: In the field so to speak there is this theory that you go through to figure out what your unitary group is; how many corporations you include in the consultation of your tax liability. The way that typically happens is right now we are going to start preparing a 2009 calendar year returns.

Questions:

- Who is in/who is out?
- Unitary ties
- Foreign affiliates and whether there included
- Determination – I think these entities are included but you are going to have to put up a reserve on your financial statement because it's uncertain.

Michael Ettlinger: Technically, Massachusetts just adopted combined reporting. Typically the company's sort of settle in, you get to know it what your group is and it's the same every year; I understand companies change their structure.

Jane Steinmetz: That is a fair point; it depends with the changing of the structure. The other element we face is the states are different.

Joe Huddleston: The determination of unity is not something that is done in isolation from Maryland or for any given state. We are talking about multistate and multinational corporations who make these determinations routinely across the board and the jurisdictions that require those determinations. The unitary groups given the fact that there may be different rules in Maryland than there are in California, the general concept of the unitary group is not something that they are going to be determining for Maryland alone. They are going to make that determination then and they are going to make that determination beyond that based upon the particular rules in Maryland.

Karen Syrylo: Can you talk about separate from the statutory language the differences that the states have even when the language is similar in terms of the unities test and the different interpretations that State A and State B could have even though the standards that they are using are worded the same.

Joe Huddleston: Beyond the unities test and there are some different ones obviously that courts have looked out. From my perspective from the real differentiation between the states is not so much as the top line as to whether or not they were unity in that perspective. From my perspective I think most states are going to agree on whether or not they are not. The biggest differences are going to occur as you get down into the apportionment formula; what's in the formula, what's not. I'm not going to say there aren't differences at the unity level; I'm just saying they are much greater at the next level.

Karen Syrylo: I think in reality what a lot of us experience is that the standards that are in state statute or in regulations from the state can be and are in fact interpreted differently than at the court level. Therefore, you can have the same set of facts, with the same words in the statute and regulations and State A and here they're unitary and here there's a different group because in a different state the courts have a different interpretation. I think that needs to be considered when we are talking about the differences here.

Steven Banks: When you compare a subjective based combined reporting regime versus an objective separate company filing system; it's more than a company deciding what their unitary group is. As Jane pointed out you are going to be audited three years down the road and the auditors are going to make a decision on their own they think is appropriate. That doesn't even change it then because when they come in to audit again and they don't' review that particular item you are still left wondering each time you get audited. Facts always change, organizations always change, and you will have differences from one year to the next and you will be doing business a little differently.

By virtue of fact that there is such an amount of case law, I would argue that is doesn't have necessarily clarity it just points out that it really is a dicey issue that we continue to grapple with and would expect to. There are cases out there that are 15 years old that are still working there way through the system not only in California but other combined reporting states as well.

Joe Huddleston: I believe that business operations and business activities are in continuous state of flux and place the hands of each individual business the knowledge of how they operate and what they do. Clearly that is not going to change without regard to what the taxing structure in any jurisdiction is. Every one of those business has the opportunity and I would encourage them to make those contacts with their taxing authority and establish as they change what the rules are and what they aren't in each of the jurisdictions.

Paul Nolan: In terms of states that have been adopting combined reporting including Massachusetts, was any thought given to or an attempt made at developing guidance over and above the nuclear doctrine of unitary? Instructional guidance or procedural guidance in terms of advanced rule procedures?

Joe Huddleston: I believe that every state has done that as part of the process. Where they are in that process probably differs but every state tries to develop a set of rules and instructions that advise the taxpayers exactly what happens and how to file.

Senator Madaleno: How much of it is set in statute and how much of it is set in regulation by the taxing authority?

Jane Steinmetz: As originally drafted in Massachusetts very salient points were left in the discretion of the Department of Revenue. One of the issues we discussed; "Can you say in theory combined reporting is the way to go?" In my view it's very hard to say theoretically I think yes or no. With that depth of detail, I would impress upon you to put as much in the statute as possible. In Massachusetts we were going back and forth as to what was intended. On the commission there was a lot of debate about whether it should be in the statute or regulations.

Joe Huddleston: Often there is a great deal of responsibility that falls onto the administrative body to write the regulations.

It is a policy determination on the front end as to how you want to do that. The argument is if you put everything in the statute, as we have already heard, the evolving nature of what it means to do business in Maryland or Massachusetts can change pretty quickly at least over the term of years. Some would say you are better off and much more flexible in terms of being able to respond to business activity by having that done in the regulations.

Senator Madaleno: Is there anything from your prospective inheritably unstable likely to have more audits under combined reporting?

Linda Tanton: There will likely be more audits; in some ways it would reduce the number of audits because we would not be auditing each single affiliate within a group. Audits will probably take more time to do. If Maryland were to go to combined reporting we would be going through a hefty transition period. We would continue to do audits for a certain period based on current law and at the same time we would be educating our auditors on how to do audits for combined reporting. We would also be educating our taxpayers in the state which some of our auditors would actually be doing that also and how to deal with combined reporting. We would very much be involved in drafting regulations and administrative releases. Would we start auditing for combined reporting the following year? No.

Jane Steinmetz: Massachusetts has done a great job at putting out announcements; ninety page regulation, approximately 180 pages of forms and instructions.

Raymond Wacks: From your perspective, who is making the decision as to what the entity is? Is it basically an accounting decision made by the finance people and are there any national accounting standards that help to inform that decision?

Jane Steinmetz: As to who is included?

Raymond Wacks: Yes.

Jane Steinmetz: There really are two parts to that question. First there is the legislative determination as to who is in and who is out; one of the issues we had to face on the commission. What types of entities are included; banks, insurance companies, S corporations, and the like. Once you decide what corporations are included in the group, then you have to look for an intricate tendency among them. It's really the tax department advisors trying to figure out are there sufficient independencies between the corporations that one is contributing to the business operations of the other and there are centralized management and other types of ties that you would look at and at the end of the day you would say this is one enterprise.

It would be the tax department that would decide that.

Steven Banks: I have a follow up question for Linda Tanton. Maryland like many states, primarily audits income; making sure the correct amount of income and allocating the correct amount of income to the state.

Linda Tanton: We are auditing expenses, net income, correct.

Steven Banks: In Maryland your starting point is your federal taxable income number and then Maryland makes modifications. In large part, most companies are audited by the IRS and this is a very extensive process. By law, when a company is audited by the IRS we are required to report to Maryland the findings of the audit. In large part Maryland reaps the benefit of the federal audit because in many cases there's an adjustment on the federal return and Maryland return.

If we were to introduce combined reporting, it's an auditable question that has nothing to do with federal. It's a whole new area that would result in a lot more work for the Comptroller's Office. Would you hire additional people just for this issue or would you pull the emphasis from other aspects of audits you are currently performing?

Linda Tanton: We have had some preliminary discussions on this as we educate ourselves. It would be a huge learning curve for us and so we would incur some expense in training our current auditors on how to do these kinds of audits. At the same time I am assuming that the state would expect us to continue auditing and bringing in revenue under the current law. If we were to do that we would probably ask for some additional audit resources at least to get us through the transition period. Then we would have to see how it shakes out after we did that whether we could go back to the number that we currently have or in order to have sufficient audit coverage for the state whether we need to increase that number permanently.

Martin Lobel: Most large oil companies report to the SEC on a unitary basis. They have refineries, they have production and marketing operations so they can shift their profits from refinery in Maryland and they can shift all their profits if they want to marketing or they might shift it offshore where they pay a very small royalty and no severance tax. The experience in California has been it's much easier to audit a unitary company than it is to try and figure out which chunk to tax and then to add back out of state income.

Raymond Wacks: Let's get back to the presentation.

Senator Jones: I want to hear what Massachusetts experience was in talking about transition issues at this time.

Jane Steinmetz: I think the Massachusetts Department of Revenue has done a great job in trying to get information out.

Massachusetts issues are right now under separate entity reporting:

- Is it at arms length?
- Does it involve a transaction that might be subject to add back?

Under combined reporting what we are finding is a lot of discussion moving to more of a multi-national flavor so now it was all about across the border transactions.

Joe Huddleston: As you calculate all of these independent entities that might be affiliated into a unitary relationship, it's true that almost all states rarely ever audit above the line calculations. They take the federal return and that's the number by which they break out and make sure the numbers are correct for their sake. In a similar fashion if you combine affiliated entities you still wouldn't be going above the line to audit, really you could, states have that authority to independently audit above the line if they wish to but in most cases it's just too complicated, too hard to do for states so they rarely if ever do that.

Steven Banks: They go with the assumption that the IRS does a pretty good job.

Joe Huddleston: Yes, they begin with that assumption and then once the IRS is done with their audits. In a combined group they rarely take that same line off of multiple affiliates' and add it together and then begin the apportionment.

Senator Madaleno: On the transition issue in Massachusetts, what was the period of time between the legislative enactment and when the law went into affect?

Jane Steinmetz: In Massachusetts the bill was signed into law on July 3, 2007 and it became effective for tax years beginning on or after 1/1/2009 so basically it became effective for calendar year 2009 returns. Once the law is signed that is when it affects your financial statement. You also have to consider your estimates.

Karen Syrylo: So the department had about six months to write regulations, and develop forms. Can you give us a sense of how many attorneys and CPA's the department had working on those and was it all internal? What was the manpower in the department and how much did they engage the outside community?

Jane Steinmetz: I can't speak to the internal resources that were brought to bear on that. My understanding is they sought internally to develop these policies. We went through the department and business community probably three or so iterations of back and forth comments.

Jane Steinmetz: Some of the pros and cons we have heard about combined reporting.

Pros

- Combined reporting as a fair approach;
- One that curtails the amount of planning;
- Provides predictable revenues to the state;
- Simple.

Cons

- Unpredictable revenues;
- Having the tendency to arbitrarily assigning it to a state;
- Complex.

Apportionment

- Issue is whether you have one apportionment formula or several;
- Whether you do want apportionment which the trend has been single sales factor or multiple.

In Massachusetts mutual fund service providers and manufacturer's have single sales factor. Then there are banks, and utilities that have their own regime. There was a sentiment that single sales created for certain industries were a mechanism through which the state tried to entice companies to locate and remain in Massachusetts and the reason being is the mechanics of single sales factor. A single sales factor formula basically says I am going to apportion income into the state by looking at your sales and your sales in the state relative to everywhere sales. Sales are apportioned based on where your customer is. Single sales factor does not apportion income based on a company's investment, property and apparel in the state.

So at the end of the day, the debate was in Massachusetts certain promises were made through a single sales factor formula to industries and they wanted to preserve that.

There was talk about buying wholesale single sales factor and where it ended up in Massachusetts was to preserve the separate regimes so what we have now is a regime where every entity is looked at individually to determine what its apportionment factor is; it could be three factor which is based on sales, property, and payroll, it could be single sales factor. In addition you look at every entity and determine what its tax rate is.

Joe Huddleston: Perhaps it would be helpful to walk through Joyce and Finnigan at this point.

Senator Madaleno: Before you go into Joyce and Finnigan, I don't know if I understood you about the apportionment issue. By leaving the different apportionment factors with the different industry groups, it's more complex. Was there talk about going to the three factor apportionment for everybody or was there talk about going to single sales for everybody?

Jane Steinmetz: It's not in the commission report but there was talk about going to single sales factor. The thought was within the Massachusetts commission we had issues that we needed to address. There was debate as to whether you should go one apportionment factor or retain the individualized factors. At the end of the day I don't think there is enough time to address it; to make an educated recommendation.

Senator Madaleno: Do either of you know if other states have gone in a different direction? Of the states with combined reporting is there a standard approach?

Joe Huddleston: There is a clear trend. I don't think you can say there is a standard but there is a clear trend over the last few to move in the direction of multi weighted sales and then ultimately single sales.

Jane Steinmetz: As far as apportionment does anyone need me to take a step back as to what we mean by apportionment three factor versus single sales?

Raymond Wacks: It would be helpful.

Jane Steinmetz:

- Apportionment is a mechanism through which a state determines its share of the business enterprises income that it gets to tax. Historically, the standard formula which made its way through the system was a formula based on three factors:
  - Property
  - Payroll
  - Sales

  That would measure the companies' relative property, payroll, sales in the state to total property, payroll, and sales. That involves an era where there were a lot of bricks and mortar type operations. As the economy trended in different directions, different formula's started to pop up; one for transportation companies, one for banking, and of course the single sales.

- Single sales factor does not measure a companies income based on necessarily their property or payroll but only on where there sales are. When done on a destination basis basically what the state is saying is; "I will tax a company to the extent they are unveiling themselves on my marketplace through their customers in the state but, I am not going to tax a company based on their level of investment in the state.

Joe Huddleston: I think it would be helpful to begin to understand Joyce and Finnigan. I prepared something in advance and I am going to read to you.

<u>Joyce and Finnigan Apportionment:</u>

All members of a combined group that have property or payroll in a state will likely have nexus and subject to tax here.

Combined groups that includes affiliate that have sales into the state yet are not subject to tax there either because the state requires a physical presence for nexus or because the state is prohibited from taxing under Section 86-272 Federal Code are those non nexus sales reflected in the sales factor numerator for the state. The answer depends on whether the state follows Joyce or Finnigan.

Jane Steinmetz: If you have A, B, and C entities, A is in Maryland, B is in Massachusetts and C is in California and you are trying to measure this combined groups income apportioned to Maryland. The question becomes A must contribute to the sales factor; Maryland sales to total sales, A has a physical connection with Maryland therefore it is going to presumably contribute to the sales factor. The question becomes is whether B, no connections to Maryland, C, no connections to Maryland contributes to that sales factor.

Joe Huddleston: The answer is if the state follows Joyce, the answer is no.

Jane Steinmetz: B and C would not contribute to the Maryland side.

Joe Huddleston: Each member of the combined group that has nexus in the state will figure its own share of unitary business income attributable to the state using its own property, payroll and sales or sales only. If the member does not have nexus in the state that member won't file and any sales it has into the state simply won't be reflective in the attribution of the unitary business income arising from the unitary business sales in the state.

If the state follows Finnigan, the answer is yes. Even sales from non nexus members will be reflective in apportioning unitary business income for the state. Under Finnigan the combined group is essentially treated as a single tax payer for apportionment purposes. The factor numerators; payroll, property and sales attributable to the state reflecting payroll, property and sales for the group as a whole because this calculation includes sales from members who don't file in the state a second calculation is sometimes required to spread those non nexus sales among the group members that do file in the state. For example, if there are two group members, one in state, and one PL86-272 protected, all the sales of the protected member will be attributed to in state member. If there are three group members, two in state and one PL86-272 protected some formula will be used to split all the sales of protected member among the two in state members. In these states the Finnigan approach is essentially an apportionment workaround of 86-272 and nexus restrictions. In other states group is treated as a single apportioning entity for apportioning purposes and no second step calculation step is required.

Most combined reporting states follow Joyce. The Joyce result concerns states because it does not fully reflect the sales activity in the state.

Steven Banks: Singles sales versus three factor is not a combined reporting versus completely separate. I think the acknowledgment that there is a trend here recognizes the fact that under a single sales factor regime you are not penalizing your in state companies. Under a three factor formula (if surrounding states have single sales) under three factor where you are required to consider your payroll and property most in state companies have a lot of payroll and property so as they expand their workforce and expand their facilities, every time they add another body in the State of Maryland under a three factor, they pay more taxes.

Whereas, if it was a single factor you wouldn't be paying more, again whereas the out of state companies that are filing in state would be paying more. Under single sales factor I think it's been looked at by state government when they adopted it as being perhaps revenue neutral but helping the in state companies at the expense of the out of state filers.

Karen Syrylo: Let me add that you are talking about income tax neutral and the income tax benefits of the in state who folks because they have the payroll and property in the state are supporting the personal income tax because their employees are here and are paying property tax so the benefit that he is talking about is corporate income tax only.

Steven Banks: And to take it a step further, why I think it's been a trend in the combined reporting regime is that it's been looked as an appeasement to a certain extent because combined reporting as we all know has not been supported by the business community. Combined reporting provides a very wide spectrum of consideration but Joyce versus Finnigan is just one of them.

Joe Huddleston: Joyce/Finnigan is the big one because you have to make a determination as to which of the affiliates are included in the apportionable base.

Steven Banks: Yes and the bottom line is Finnigan in all likelihood is going to result in additional tax revenues to the state from out of state companies.

Joe Huddleston: I think it also important to note as you talk about single sales factor, I think it is important to keep this calculation in mind. With in almost every jurisdiction, the number of businesses that are apportioning their income are dwarfed in comparison to the number of businesses who are not apportioning their income because their in state businesses exclusively and they do all their activities in the state. The result is those businesses pay on all their property, their entire payroll, and all their sales; they pay on all of these factors every single time. They pay on 100% of their income every single time.

Karen Syrylo: For our colleague from Tennessee, we do need to look at the Maryland specifics about the point you just made because we are in a state where we're no more than forty miles from another state of large number of our businesses are multi state and are not 100% apportioned in Maryland. I understand your general point but it may not be as reflective here in Maryland.

Jane Steinmetz:

- Finnigan attempts to treat the group as one.

  The nexus of one entity in a state is conferred upon the other members as one.

- Joyce looks at each entity separately.

  Nexus of one entity is only that companies nexus. That has a bearing on the receipts factor; measuring what receipts is in the numerator, in state receipts over total receipts.

  - What members contribute to the numerator and what happens with the throwback issue?

Throwback example: Company A selling goods into a state where it's not subject to tax – you have to throwback those sales into Maryland.

Senator Madaleno: To take you're A/B – A is a retailer in Maryland and B is the online affiliate of that retailer based in another state that is selling into Maryland. Under Joyce all of the sales that occur within the stores of the retailer in Maryland uses single sales factor. So you would combine the income off A & B but you would only get what is sold in physically in Maryland in the stores, whereas under Finnigan you would also capture the sales coming in to Maryland through that online affiliate.

Jane Steinmetz: That is correct. Joyce – A – retailer with the storefronts contributes to the numerator over combined denominators. Finnigan – B – also contributing to the numerator as well as the denominator.

When you have online retailers, there are many instances where there found to have nexus in the state where the retailer is.

Joe Huddleston: Exclusively in my opinion only, I think you will find which has been pointed out before the nature of business activities and the structure of how those people do business over time changes. The reasons combined reporting will get a check mark really don't have anything to do with revenue because what you will find is the snapshot of your numbers this year, next year and on down the road is nothing more than that. As business activities change and evolve their relationship with your state's economy can change over time too. The winners and losers will change in this environment. What that will mean is over time the trends of whether there is money or not is an evolving kind of thing.

Raymond Wacks: Ms. Steinmetz, do you sense in your practice are more corporations becoming multi state in order to survive or is that not really changing much?

Jane Steinmetz: I would say all my clients are multi state/multi national.

Joe Huddleston: Businesses have much smaller economic scale are able to transact business across state lines.

Jane Steinmetz: Combined reporting is an apportionment methodology. That is all it is. The theory behind combined reporting is, I have a Maryland taxpayer and I need to figure out its apportioned share of income from a business enterprise in which it operates.

In order to have a right to apportion, you have to have taxable presence outside the state.

Senator Madaleno: A small company that does web design, they have no presence anywhere, and under our current rules all of their income would be apportioned in Maryland?

Steven Banks: I think the answer to your question is if New York or Pennsylvania or one of the states that your web designer has clients in, if they believe you have a taxable presence in their state and they are correct, then you are a multi state in Maryland.

Martin Lobel: *Referenced members to an article from Bloomberg; U.S. Companies Dodge $60 Billion in Taxes with Global Odyssey.*

Does unitary eliminate transfer pricing abuse?

Jane Steinmetz: I think transfer pricing with respect between domestic companies, intercompany transactions are eliminated, transfer pricing with respect to U.S. companies to foreign affiliates that still exists.

Steven Banks: And that is where the bulk of the transfer pricing issues are unfortunately.

Martin Lobel: Nothing that says we couldn't tax it. California did it until campaign contributions

Interruption.

Steven Banks: Our commission charter does not allow us to do that.

Martin Lobel: Well you can make recommendations.

Will unitary eliminate transfer pricing?

Jane Steinmetz: No. In part with respect to domestic entities but you still have foreign affiliate considerations.

Combination of entities:

- Worldwide – tax on a worldwide basis;
- Water's Edge – bring in the domestic affiliates;
- Objective standard – example; an affiliated group election.

Some states will default to worldwide but have water's edge election. The problem with that is majority chose water's edge so rather than make an election Massachusetts decided to make that the default. The default would be domestic grouping and then you could elect worldwide or media elect objective grouping, federal consolidated type group.

- o With respect to the election, what would be the obvious decision point, how long is it binding for?
  - Some would say eight years, I think California; Massachusetts it is ten years.
- o Can they be disturbed on audit?
  - Once the taxpayer makes the election that should be a sacred cow.

Joe Huddleston: As you look at the rules in combined reporting and separate entity reporting, in most states they have provisions embedded in their statute to be able to review the filing circumstance and make a determination as to whether that filing circumstance adequately represents the actual business activity within in a state or not and then the revenue department has the authority to go in and force the business entity and change the way they file if they can support their argument. Nothing is ever written in stone as your business activity evolves.

We have pointed out this distinction and how difficult it can be for your revenue department to write rules and the transition period that is apparent in that. If it is that you decide to go down this road there's a few areas that I would strongly encourage you consider putting in your statute.

- o Joyce and Finnigan determination;
- o NOL's, credit carry forwards, and how you deal with them;
- o Dividends; intercompany transfers and intercompany dividends, external dividends;

Senator Madaleno: Are you suggesting that this be addressed legislatively?

Joe Huddleston: Let's assume you are going to adopt a combined reporting structure, I would recommend these items be a part of the statutory framework of the combined reporting.

Michael Ettlinger: Is there some principal reason for allowing the election? I assume it is just a numbers game. Is there any particular reason why you would want to allow companies to sort of pick from three different inconsistent, abstractly inconsistent ways of calculating their taxes.

Joe Huddleston: I think that in most jurisdictions that have allowed these elections are done under a strong consideration or strong understanding that business enterprises dramatically differ on how their carry on operations and they differ dramatically in their relationship even between affiliates. If you have selected a methodology that does not represent your business activity and there is dramatic distortion in your receipts, then states almost always have the authority to make adjustments.

Jane Steinmetz: That point was definitely debated Landon, Massachusetts. The reason was some taxpayers cannot figure out their unitary group. There needs to be a level of certainty for both the state and the taxpayer with respect to what the revenues are.

I do agree with the point that Joe made; six ancillary issues we thought was important to cover;

- Joyce and Finnigan;
- Who is included in the group; who is in, who is out
- What type of entities;
- Use of discretionary authority;
- Apportionment;
- World wide water's edge type of elections
- Utilization of NOL's, credits, charitable contributions.

Michael Ettlinger: What were the parameters of the commission of Massachusetts? What was it supposed to look at; the whole corporate tax system?

Jane Steinmetz: The charge was to look at several things:

- Net worth taxes, minimum taxes, streamlined sales tax;
- 2006 and 2007 combined reporting was proposed; approximately 85% was spent on combined reporting issues.

Steven Banks: How did combined reporting score from a revenue perspective in Massachusetts?

Jane Steinmetz: I wish I knew that. We had two pretty big changes in Massachusetts; conforming to the federal classification of entities and the other was combined reporting and I recall the scoring was done together.

Steven Banks: So it was done as a revenue generator per se?

Jane Steinmetz: No, in fact, well the recommendation of the commission was coupled but there was a reduction of tax rate to try to get to a neutral position.

Martin Lobel: Did anyone compare any gross receipts tax as opposed to the tax on combined reporting?

Jane Steinmetz: On the Massachusetts commission that was studied and the recommendation was not to move forward with the gross receipts tax.

Joe Huddleston: Gross receipts are a completely different inspection.

David Roose: Didn't you also have issues with combinations of gross receipts taxes?

Jane Steinmetz: I agree with Joe, it is a discussion for another day but it's a Para mining affect so you have companies that sell from A to B and might be intra companied and B to C and they are hit with gross receipts tax so it depends on how you structure them in your business system.

Joe Huddleston: If you want to encourage vertical integration, which would be one way to do it.

Senator Madaleno: Moving just one step away from combined reporting is there something else we should be looking at from a business tax standpoint?

Raymond Wacks: Is there things happening in other states that you are aware of?

Jane Steinmetz: You know there are fifty jurisdictions that have evolved

Interrruption.

Joe Huddleston: Right now the overriding trend is this discussion.

Steven Banks: We have talked about VAT, gross receipts, sales tax and services for sales tax, and at depth we have talked about this issue.

Joe Huddleston: I would say that over the last 5 – 6 years the movement toward combined reporting has been greater and more momentum than preceding 25 years.

Steven Banks: You made a comment earlier that you didn't think in your personal view combined reporting had much to do with revenue; it has to do with all of these policies; in terms of preference. In Maryland we have 482 powers, we have add back provisions.

Combined reporting versus separated filing both are viable reasonable solutions and under either situation you can go after the aggressive transfer pricing regime. If you are a company that is following the rules it shouldn't matter because if you are following the rules you are already subject to transfer pricing rules and requirements and if you are not you are already exposed.

Joe Huddleston: I guess I would have to disagree with you. One of the overriding reasons for combined reporting is that under the separate entity structure it actually invites game playing. The result we have seen over the last thirty years is massive structuring and game playing in the reporting process. From my perspective I would say that combined reporting is a reasonable, fair methodology for reducing the ability of corporations to avoid paying their fair share of taxes.

Steven Banks: What game playing could be going on in Maryland right now that the 482 powers, transfer pricing, add back for interest, captive REIT rules could not capture?

Martin Lobel: I would just like to point out that every IRS commissioner and the IRS I suspect has a few more enforcers than we do here in Maryland has testified under oath before Congress that they could not police transfer pricing, period. That it was more of an honor system than anything else.

Steven Banks: Our whole tax system is an honor system.

Martin Lobel: Not if the auditors can catch it.

Laughter.

Martin Lobel: The problem is that transfer pricing results in a loss of revenue. That is real money even to the federal government. I don't know what it is to Maryland but I suspect its real money here too. The Supreme Court stated in its decision that combined reporting was as accurate of an accounting method as separate accounting.

Steven Banks: I am not arguing with that and I am not saying there is anything inherently wrong with combined reporting but the BP argument that you keep bringing up, transfer pricing in the international context is probably right, but we are not talking about that here; we are talking about state, multistate issues.

Martin Lobel: I can tell you from my personal experience that I was involved in the Long Beach antitrust case and I have seen Exxon memos with the executives of the refineries were fighting with the production guys as to who was going to get what profit because their bonuses depend on it and that was all domestic.

Karen Syrylo: That doesn't mean that what they end up with is wrong; it might mean that they were picking between ranges of correct numbers.

Debate continued with several members involved.

Paul Nolan: In terms of states which have adopted combined reporting, I assume there are transition issues with the backlog and prior pieces Linda Tanton described before.

Have any states adopted approaches to that like amnesty or any other ways of clearing out the pipeline so the administration can move on with the system and spend less time on the sunset or the old?

Jane Steinmetz: Massachusetts has had amnesty but it is typically on nexus issues.

Joe Huddleston: I am really not aware of one that I can tell you. The general calculation is that right now multistate businesses are making these calculations all the time and it is not that difficult for a fifty state company to tell you what their unitary group is.

Karen Syrylo: Do you have information or can you guess what percentage of time, percentage of issues that are spent on audit, accounting, and legal bills specific to combined reporting versus all other issues?

Joe Huddleston: No, I don't. It's obviously substantial but all of the others are equally substantial.

Karen Syrylo: I recall one of our earlier meetings where we had representative from the FTA talking about the small percentage of state revenues that come from corporate income tax versus the much larger percentage of audit time and expense that is spent just on combined reporting. That is always something that is in my members interest and why the complexity issues that are out there because if does cost money.

I would love to know what your members think of that, the percentage of their time spent on combined reporting.

Joe Huddleston: I would be happy to know that question.

Raymond Wacks: Our next meeting we will take the first part of that meeting to figure out how we are going to bring this process to completion.

Our next meeting will be May 27th.

Request for subcommittee meeting on June 3rd @ 2:00 p.m. to have it moved to 2:30 p.m.

liv/SB/ML/PN