MARYLAND BUSINESS TAX REFORM COMMISSION

Raymond S. Wacks, Chairman

Maryland Business Tax Reform Commission
Minutes of Meeting
October 1, 2009

A meeting of the Maryland Business Tax Reform Commission was held in the House of Delegates Office Building, Room 130 on Thursday, October 1, 2009 at 1:30 p.m.

Those present were:

Raymond S. Wacks, Chairman
Delegate Kumar P. Barve
Delegate D. Page Elmore
Senator Richard S. Madaleno, Jr.
Senator Nancy J. King
Senator Verna Jones
Delegate Sheila Hixson
Linda Tanton, Deputy Comptroller
Secretary T. Eloise Foster
Secretary Christian Johansson, Dept. of Business & Economic Development
Laura Kittel for C. John Sullivan, State Dept. of Assessments & Taxation
James F. Kercheval, MD Association of Counties
Paul Nolan, Manufacturers Alliance of Maryland
Steven J. Banks, Greater Baltimore Committee
Karen Syrylo, MD Chamber of Commerce
Martin Lobel, Public Member
Jennifer Japp

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

Speakers present were:

David Roose and Andrew Schaufele, Bureau of Revenue Estimates

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

Chairman Raymond Wacks opened the meeting at 1:35 p.m. Mr. Wacks made a motion to adopt the minutes of 9/10/2009. Paul Nolan made comment as to correctionS needed in minutes. Minutes will be corrected and adopted at next meeting.

Mr. Wacks introduced David Roose, Director Bureau of Revenue Estimates, who reported on the initial results from tax year 2006 corporate information report. Please refer to handout entitled Analysis of Tax Year 2006 Maryland Corporate Information Reports.

Stated Mr. Roose – View this as a starting point. Our analysis of tax year 2006 continues especially as we prepare the tax year 2007 report due next March. It is important to bear in mind that the estimates we'll be discussing are not directly relevant to what could be expected from combined reporting any time soon, but the estimates and issues we'll discuss today do represent the first concrete information we have about how the introduction of combined reporting would affect Maryland revenues and taxpayers.

- Paul Nolan - I understand 2006 was one of the highest years for corporate tax revenues. Is this correct?
    - On a tax year basis it was $868 million in 2006.
- Paul Nolan - Joyce 12.5% and Finnegan 19.5%; consider this in context rather than in a raw 100.
- Paul Nolan - What is the percentage that the corporate tax generally represents in terms of the full revenues?
    - 4 – 5%
- Paul Nolan - We are talking about 12, 19 or 20% increase on that number?
    - Right.

David Roose – Included in our March report were data covering 6,083 corporate groups with over 96,400 separate entities, over 14,700 of which had nexus in Maryland so about one-quarter of Maryland's taxpayers are members of a unitary group.

Unfortunately, we were unable to make sense of much of the data we received. Many adjusted for intercompany transactions within the reported data, though we had asked for those adjustments to be made explicitly and many reported data that were implausible if not logically impossible, such as different apportionment for Joyce and Finnegan, despite having no Finnegan companies, group data adjusted for intercompany transactions that was substantially greater than the sum of the data reported for the separate entities of the group, and simple (and obvious) typographical errors or data entered in the wrong fields. These issues precluded much of the intended analysis in March.

Over the early summer, we contacted 3,680 respondents and asked for clarification or correction of their reports. Of those respondents, 2,316 responded. Those responses as well as conversations with corporate tax people, practitioners, and other states helped us make sense of the rest of the responses. While we did not go line by line through the data, we did correct obvious typos and otherwise cleaned the data based on additional information received.

For tax year 2006, we now have 6,257 groups, 96,235 entities and 15,089 with nexus in Maryland. Before going any further, a quick review of combined reporting –

- Maryland is separate entity state; every legal entity with nexus files its own return.

- In combined reporting all intercompany transactions are effectively disregarded for tax purposes. Shifting income or expenses from one member to another generally has no bearing on tax liability.

- Income of the group is totaled, and then apportioned to Maryland.

- Generally, the apportionment factor is the average of the ratios of a company's property, payroll and sales in Maryland to total property, payroll and sales. The sales factor is given a double weight for most corporations.

- Two approaches to apportionment – Joyce and Finnegan

    - Under Joyce, the numerator of the apportionment factor only includes those companies with nexus in Maryland.

    - Under Finnegan, the numerator includes those companies, as well as all that make sales into the State – a broader reach.

    - In both cases, the denominator is the same – the sum of the total sales, property and payroll of all members of the group – those with nexus, those making sales into the State, and those with no direct business connection to Maryland.

Assumptions/simplifications required for this analysis:

- To minimize the burden on respondents, we only asked for major addition and subtraction modifications. In many cases, the smaller ones are Maryland specific and there's no reason that the corporations other than those with nexus would have that data readily available.

- The study also takes no account of tax credits.

- We tried to maintain current features as much as possible. The major impact is the single sales factor apportionment for manufacturers. Our calculations include a single sales factor for the entire group if the entity with the largest payroll is a manufacturer. In looking at many of the reports, in almost all cases the group is predominantly in the same industry as the entity with the largest payroll; there are some exceptions, and these generally seem to involve NAICS code 55, management or administrative support, which can include holding companies. There are other ways to do this, the most obvious being on an entity-by-entity basis within the group. How the single sales factor is treated can have a noticeable impact on the bottom line possibly by several million dollars which could have a substantial impact on any given taxpayer.

- We may not have covered all groups that would be subject to combined reporting. We have made efforts from the start to make sure everyone required to file was aware of that requirement. We sent out several rounds of e-mails to a wide variety of taxpayers. Continuing delinquency control to ensure compliance is as good as possible. Nonetheless, some may have slipped through; especially companies that are now out of business.

- All of these assumptions and simplifications are reasonable, and we believe that other than the treatment of the apportionment formula, none have a significant effect on the analysis.

As stated before, tax year 2006 revenues would have been $109 million higher under Joyce apportionment and $170 million higher under Finnegan apportionment.

Several general caveats which apply to all corporate income tax estimates:

- The corporate income tax is one of the State's most volatile revenue sources.

- Tax year receipts are received across fiscal years. Roughly 30% of tax year revenues are received in the first fiscal year, between 70% and 80% are received in the second fiscal year, small positive or negative amounts are received in the third year, in the fourth fiscal year and later, negative amounts are received due to amended returns; often NOL carrybacks. These adjustments will likely be larger for tax year 2006 due to expected large tax year 2008 NOL carrybacks. So of that $109 million estimated for tax year 2006, $33 million would have been received in fiscal year 2006, around $70 - $85 million would have been received in fiscal year 2007, and small amounts in 2008 and probably 2009. We can reasonably expect sizable negative amounts in fiscal year 2010 and 2011.

- The fundamental point is that with changes to the corporate income tax in particular, timing relative to business cycles and the natural lag of corporate income tax receipts are important when considering the fiscal year impact.

Specific reasons why these estimates do not translate directly to an estimate for a coming tax year:

- Most importantly, 2006 was at the end of one of the longest and strongest expansions of corporate profits in post-war history.

    - Profits grew by double-digits five consecutive years, 2002 through 2006;

    - Profits have since fallen two years in a row, including a 12% drop in 2008, and are expected to drop again this year;

    - In only one other period since 1947 have corporate profits dropped three years consecutively (1956 – 1958), and the current drop is much greater – about 23% compared to 12%;

    - Just on those raw numbers, we are in a vastly different climate;

    - As a rough comparison, the corporate income tax forecast for FY 2011 is almost 25% lower than tax year 2006, in spite of an increase in the rate of about 18% since then.

- Perhaps of even greater importance, the recession has affected different industries differently (as would be the case in all periods).

    - Pages 6 and 8 of the report indicate the effects of combined reporting by industry (industry determined by the federal business activity code of the entity with the largest payroll)

        - Under Joyce apportionment, more than 100% of the revenue increase – 112% – comes from just two industries; retail trade and finance and insurance;

- Those two industries have been affected by the recession more than most. In Maryland they have lost more jobs over the last 12 months than any industry except for construction;

- The disparity of the impact by industry has obvious implications for any future revenue estimates.

- More prosaically, as alluded to earlier, this study contained many assumptions as to the structure of combined reporting; any future proposals may or may not match our assumptions, with a resulting impact on the bottom line. Again, this is not an estimate of the fiscal impact of combined reporting if it were enacted in the near future.

Table on page 4: Joyce Method of Apportionment by Group Maryland Modified Income

- Impact by group size;

  - Group size measured by group Maryland modified income;

  - Generally speaking, the smaller a group is, the more likely it is that their tax liability will decline under combined reporting;

  - This makes intuitive sense, as larger groups are more likely to have far-flung operations;

  - About 10% more corporations pay more tax than pay less tax (2,220 to 2,033);

  - And 2,004 have no change in liability, most likely have no taxable income now;

  - I believe those in the nontaxable category shown as winners end up there as a result of losses being brought into the State, offsetting taxable income of the members of the group with nexus.

Industry table on pages 6 – 9: Joyce Method of Apportionment by Predominant Industry, Measured by Payroll of Group

- Retailers and finance/insurance companies pay all of the revenue increase under Joyce, and most under Finnegan;

- Some industries, such as information services and professional services are generally balanced, with roughly the same number of winners and losers paying or saving roughly the same average amount ;

- Some industries, such as utilities and health care and social assistance, have roughly the same number of winners and losers but the average savings outweigh the average increases, or vice versa

- Some such as the retailers and accommodation and food services have more losers than winners, and the average increase is greater than the average savings.

- Page 7 shows the distribution by industry of those that pay more and pay less.

  - Information services and manufacturers save disproportionately more than their numbers, while real estate and construction save disproportionately less;

- ❖ As implied by previous discussions, retailers and finance companies pay disproportionately more in dollar terms relative to their numbers;

- ❖ Those with no change pay no taxes now, and would pay none under combined reporting or theoretically, are a group of 100% Maryland entities.

Mr. Roose concluded his presentation. Mr. Wacks asked for questions/discussion.

- Martin Lobel – Is this all domestic combined reporting? Does it include profits of multi-nationals? Could you do this for multi-nationals and, if so, would you expect the results to be significantly different?

    - This is all domestic. No, I cannot include profits from multi-nationals and I do not know if it would be significantly different. We don't have the data.

- Delegate Page Elmore – 2006 figures with Delaware Holding Company, was the addback in effect then?

    - We effectively compared this with actual 2006 collections which would include the roughly $50 million from the Delaware Holding Company addback. The holding company addback relates to an issue where companies were, under prior law, able to shift income out of the state and escape Maryland taxation. The addback effectively brings that income back in and lets us tax it. Again, that is one the major arguments behind combined reporting it prohibits those sorts of maneuvers. Under combined reporting such an addback is unnecessary so we did not include it there. These amounts take into account the addback under current law, but it is disregarded under combined reporting.

- Delegate Page Elmore - This $109 and $170 million high, is this a figure that you subtracted $50 million from?

    - No.

- Delegate Page Elmore - So this is $109 million over the $50 million?

    - Right.

- Raymond Wacks: To clarify that because we were discussing this before the meeting--this is net increase, not gross increase, and you have already taken into account the corporate income tax you have already collected for TY 2006?

    - Right.

- Delegate Page Elmore – Will we have a comparison with 2007 by March?

    - Yes, we will have the same data for tax year 2007 this March.

- Delegate Page Elmore – How much more or how much less has the Delaware Holding Company brought in?

- We will have that information also.

- Delegate Page Elmore – The Delaware Holding Company addback was supposed to bring in that much revenue.

    - It has been my view that the holding company addback addressed much if not most of the issues related to these inter-company transfers. I've heard this discussed elsewhere. I think the question is; how can these estimates be so high? In other words, does it imply that there is $107 – $109 million dollars in tax planning going on. I think the answer to that is. "No. These are really two separate issues. Combined reporting does happen to make these maneuvers much more difficult if not impossible. I think what it fundamentally is, is a different way to measuring economic activity in the state than what separate entity reporting is. Moving from separate entity to combined reporting would result in a revenue change even if there were zero cheating going on under either scenario. We are dealing with hundreds and hundreds of billions of dollars, and changes in apportionment factors which for a lot of these companies is going from something like 1.5 –1.75% to 2 – 2.5% which doesn't sound like a big change in terms of a percentage change in the apportionment, factor, but in dollar terms the change in liability could be very, very large. I think all we are doing is measuring the economic activity differently, which happens to have a very sizable effect on the bottom line. This is analogues to changes in the apportionment factor that has nothing to do with cheating at all. But moving from the regular three factor apportionment to double weighted sales is going to have the same sort of effect. Measuring the economic activity in the state differently, some taxpayers will pay more because of that change, some would pay less.

- Delegate Barve – The Finnegan method is the more aggressive of the two, correct?

    - Yes, it could be characterized that way.

- Delegate Barve – What is it with the Finnegan method that is not in the Joyce method; out of state sales imported into Maryland?

    - Yes.

- Delegate Barve – What are the philosophical pluses and minuses of doing it that way, setting aside the notion that it might produce more money? Advantage and disadvantage?

    - The whole idea of this is to look at the corporate group as one taxpayer. If you are looking at the corporate group as one taxpayer then it would make sense to include in the numerator each of these factors; sales, property and payroll. There can be some changes in the property and payroll factors also. It would make sense to include all of the activity that goes in Maryland and if that's logically the case then Finnegan would be the answer. The reason Finnegan has been challenged in a number of states is those other entities that we would be taxing entities that do not have nexus with the state and that it is unconstitutional. That argument has carried the day in some instances. The counter argument to that is that they do have nexus with the state but it's carried through the group, not directly.

- Steven Banks – California is one state that uses both Joyce and Finnegan and I do believe Finnegan has some constitutional issues associated with it in terms of whether or not it's fair to include companies that aren't doing business in the state at all or don't have any nexus or apportionment factors. Is there a sense that you have the increase in tax as a result of big corporate groups including other companies that weren't included, or is it a sense of just when you look at the entire organizations together, the mathematical apportionment percentage that is derived by looking at all companies is different than the sum of the parts? I think the answer to that question in my mind are increases attributable to tax planning, or what you refer to as cheating, or to simple mathematics. [I'm] also curious about whether we've included, or how we've included, this whole idea of all these new taxpayers that are coming into the state as a result of "FIN 48" that Martin sent the commission (*reference e-mail dated 9/21/2009 "Could FIN 48 Have Contributed to an Increase in Nonfilers' Compliance?")* and I think that was right on point in that area. I know there's activity through the VDA process where we are including new companies, multi-national organizations or multi-state organizations that likely will result in additional revenues either way, and in all likelihood because they are predominately out of state are going to give a bigger bang for the buck to the state of Maryland under the single sales apportionment factor than they would under a three factor. It's the kind of data that I think will be helpful going forward as we try to make some reasonable conclusions as a result of all this.

  - We are looking at tax year 2006 only, any changes in regulatory or other things that would cause an issue with taxpayers being brought into this state are obviously not accounted for here. I have to say I am not particularly familiar with this issue and so that the implications may or may not be under both current combined reporting; I don't know.

  - I guess you are asking how much of this change comes from more income being brought in and how much comes from apportionment factors being changed. Is that correct?

- Steven Banks – I think that is right. You could have ten companies that are filing separately, each with their own percentage and when you add them together you are going to get a different percentage than you would from the sum of the ten. That has nothing to do with any tax planning or any behavior at all. It's just a change in the way we look at things. Whereas, the other situation is you could have a group that has fifteen companies, twelve of which are filing in Maryland, and three that are not. By including the other three in Maryland, you could lower the overall percentage and still end up with more taxes.

  - This gives me an opportunity to correct something I said earlier, actually where I talked about effectively to have changes in the income and changes in apportionment. The income is not always going to go up because you can bring losses from other entities into the state. So the income of what we are considering the "taxpayer" under separate entity reporting is really the income of all members of the group who have nexus in Maryland. The income can go up or down; the apportionment factor can go up or down. There are examples of any combination of those in there. I am not entirely sure how you would go about breaking down the effect of more income or the changes of apportionment.

- Paul Nolan – In terms of the corporate taxes in 2006, if corporate taxes were say 5% of the revenues we collected, then we assume all of the 2006 data we have is correct, then we go with the higher number Finnegan basically with the 20% increase, 5% basically becomes 6%. That's what we are talking about; 1% of the state revenues by one measure in one year correct?

- Correct.

- Paul Nolan – I just want to make sure that is what the entire commission has that in their mind; that's what we are talking about by changing from one system to another. Where there are winners and losers. Is it true that since we are looking at a picture of 2006, if you were to revisit 2006 data in say a year or two, with people filing NOL, carrybacks, and amended returns, isn't it true the 2006 numbers might look different given the fact that in the financial services and other industries that have been dramatically impacted by the economic crisis the numbers might look different as well?

    - The numbers will look different. Certainly over the two weeks we will be getting a lot of returns for tax year 2008; it's very likely a lot of them will have substantial operating losses that will be carried back to tax year 2006. Under the reporting law, when a corporation amends their corporate income tax return, they are also required to go back and amend their information report. Within 60 days, I believe, with that we will have that in the records for whatever companies….

- Paul Nolan – I know it's beyond the statutory charge the Comptroller's required to meet but for purposes of this commission, would it be possible to do a revisit to the 2006 numbers?

    - That is exactly what we are planning to do. The March report will be reporting the initial results for 2007 and what 2006 looks like at that point in time. Again, there's the issue of tax year versus fiscal year and the distinction needs to be kept in mind.

- Christain Johansson – You mention that you could bring in losses from other states if you adopt this kind of method that you have nexus with a company pay some to Maryland but had not been included before and apparently the partner group can report those losses. Is that correct?

    - Yes, you could bring in losses from an entity that has no relationship whatsoever with Maryland directly. If there's a manufacturing company in California that does nothing in Maryland and they have a separate entity that does distribution that is located in Maryland, under combined reporting the income of the entire group is brought in.

- Christian Johansson – So in a recession, for at least the first couple of years, wouldn't that effect magnify if you adopted combined reporting?

    - I think the answer to that gets into some transition issues. Yes, certainly in a case of a recession, if combined reporting would be in effect for a long period of time you would be bringing those losses in but of course your domestic taxpayers would likely be having commensurate losses anyway. But there are issues that we did not bring up today, a lot of issues the subcommittee will really dig into. There are a lot of transition issues about the move to combined reporting and how things like NOLs, tax credits, and other issues ought to be treated both for those entities paying tax under current law and those that are not paying tax under current law.

- Christian Johansson – Under Finnegan it looks like manufacturers paid substantially more than under Joyce.

    - I can only give you my off-hand answer to that. I think it's the case that there are plenty of manufacturers out there that make sales of tangible goods into the state but have no activity in Maryland. I think we see the bigger change from them probably than anybody else in percentage trends because of that.

- Linda Tanton – commented on the work done by David, Bureau of Revenue Estimates, IT staff, and corporate audit staff. "They spent an enormous amount of time on this project since legislation was enacted. David and the Bureau staff have spent an enormous amount of time analyzing the data to come up with a product that was meaningful for the commission."

- David Roose thanked Andrew Schaufele, Carol Novella, Keith Akers for their time spent on this project.

- Martin Lobel – Have you compared whether these companies have filed combined reporting for federal taxes as opposed to state taxes? Do you know if there is a difference?

    - No, we have not looked at that.

- Martin Lobel – My impression based on the California experience [is that] a lot of companies file combined federal because [it is] easier and less tax for them. It may be something you want to take a look at before the next report.

- Delegate Elmore – Was 2006 the first taxable year with the Delaware Holding Company addback?

    - I believe it was 2004.

- Delegate Elmore - Has it gone up each year?

    - It's been in the range of 45 – 55 million dollars for 2004, 2005, 2006. I have not actually looked at that issue recently, but only recently would we have gotten good numbers for FY 2007 to get the returns in that are relevant.

- Delegate Elmore – Including through even more in 2007 and probably dropped some in 2008 – 2009. I think it is imperative that we have 2008 numbers on what is coming from the addback.

    - We will make sure we have those numbers in the near future.

- Karen Syrylo – Also thanked David Roose and Linda Tanton and all the staff responsible from the Comptroller's Office for putting together the report. Also thanked the business community because in that process of working on this the Comptroller's reached out to the community for assistance.

  The charts that show us that there are winners and losers both under Joyce and Finnegan and the great detail by industry but it seems to confirm that combined reporting is not just a loophole closer. Yes, it eliminates intercompany transactions so anybody has been using intercompany charges to reduce Maryland tax, this zeroes that out. As you describe the arithmetic, a corporate group can either pay more tax or less tax under combined reporting regardless of whether the have any intercompany transactions. Is that right?

    - That is right.

- Karen Syrylo - Did you at least look at which of the reporting companies had filled in that line for the addback for 2006? Do we know how many?
    - No, we didn't. The reason for that is, we didn't ask for it. Addback is only applicable if you are a current taxpayer and we didn't ask for additions/subtractions from current taxpayers because we have that in our records.
- Karen Syrylo – You had it in your records but that's not something you pulled out of your records when you were doing this?
    - We did for purposes of calculating current tax.
- Karen Syrylo - But not in terms of numbers for the report. I think it suffices to say for combined reporting, these numbers show it's only arithmetic; a different way of measuring economic activity and even companies that are not using intercompany transactions are going to have a difference up or down.

  It's important for all of us when we are comparing the federal consolidated return methodology and the unitary combined return methodology at the state level to understand the requirements are significantly different. This definition of what is the unitary group is vastly different from the varying mechanical "Do you own 80% or more of the subsidiary?" which is the test for federal consolidated returns. So while yes, there are probably some consolidated groups who could be filing unitary at the state level, there are a lot of consolidated groups at the federal level who would have multiple unitary groups and multiple combined reports for a single state. We would need to keep those details in mind when we are talking about questions like that. While it would be interesting, it wouldn't answer all of the questions for looking at consolidated versus the state combined.
- Senator Mandaleno – Reference page 6 on the chart. Focus on the retail trade industry. What is it about the retail trade industry that has them paying so much more additional taxes?
    - A very good question, a very relevant question and unfortunately, I am not sure I have the answer right at the moment. For some industries some of the reasons we see what we see are pretty straightforward, but for the retailers and finance/insurance companies I'm not sure that I know why the characteristics of those industries appear to lead to the results we see. I think this is one of things we will be looking in to between now and the next report in March.
- Senator Madaleno – Putting the retail trade aside, take one of the trades you do feel comfortable with and walk me through why there is this swing.
    - Karen Syrylo – Retailing, because of the nature of the industry, is one of the industries that you most often see with not only dozens, but sometimes hundreds of subsidiaries; because for legal, operation, management reasons, it's not unusual for retail entity to have each store in it's own corporation or several stores within same geographic area within one corporation. A retailer selling the same product in different geographic areas is going to have different profit margins because of the makeup of the economy of that area where their stores are located. So (one) because you have multiple entities and (two) because of the arithmetic on different profit margins and different entities, you could end up with this arithmetic going up or going down.

- David Roose – And as was just pointed out to me, remote sales not from the sales tax perspective but all sales made into the state, for example L.L. Bean before they had any stores in Maryland.

- Karen Syrylo – Nexus under Finnegan would apply a lot to retailers because if they are shipping only by UPS and mail they don't have nexus with the state, but under Finnegan their sales into the state would be included in the numerator.

- Senator Madaleno – Does Finnegan somehow capture these sales into the state? Example; Amazon.com internet sales.

  - From a corporate income tax perspective, if Amazon had a related entity that had nexus with Maryland, their sales would have a bearing on their corporate income tax. From a sales tax perspective I am guessing it wouldn't have any effect. If it did, I don't know why it wouldn't under current law anyway.

- Senator Madaleno – What are the groups you feel more comfortable with explaining the difference?

  - I am guessing the structure of utilities is such that certainly until a number of years back, most of the activity of an entity was done was within defined geographic boundaries. Now some cross state lines, obviously, but some don't and so the effects on companies with structure like that and also heavily regulated [industries] may or may not be different. [They] would be very different than something like retailers, where they are spread all over the place and have limited regulation, very different industry structures. We are going to have to spend some time and talk with people that have familiarity with these industries as to why they are what they are.

- Senator Madaleno – How do you measure economic activity and is there something going on to suggest that the structure we have put in, although we have modified it over time, probably [goes] back several decades to a very different economy? Utilities for example, BG&E did very little outside the State of Maryland; Constellation is a very different entity right now. Is there something to be said about [the fact that] as the economy has changed, corporate structures have changed, that our tax policy needs to change to reflect the realities of the economy today?

  - States that have combined reporting have, until just recently, had it for decades, before the economy really changed. I think the argument is made for the sales tax all the time. We have a sales tax that is based on a manufacturing economy where goods are what are important, whereas goods are no longer as important as they once were. Services have become much more important. Many services can be performed literally from anywhere and so when you have taxes based on property and payroll – property especially – that sort of tax structure, one could argue, may not be quite as relevant now as it was when things were what was mostly bought and sold.

- Christian Johansson – Just to clarify; this is not a tax on Internet sales, but this is a tax on profits to companies that do Internet sales. Is that correct?

  - If they have a related entity that has a presence in Maryland.

- Christian Johansson - Ok, if you are selling into the state, according to Finnegan, you are subject to being considered to have nexus in the state.
  - But you have to have one member of the group that does have nexus. If there is no member that effectively has a physical presence in the state, then we still can't tax them.

- Christian Johansson – If you have a company that has whole offices, may happen to have a separate company but solely unrelated, but they have an interest some way or another, based in Seattle although they are selling into Maryland, we would be able to tax those Internet sales?
  - Yes, if one of their related members has an office in Maryland, right.

- Delegate Barve – Is there any way to really assess to what extent this is because of uncaptured intercompany transactions and to what extent this is a result of simply a different methodology? The reason I ask this that unfortunately every tax issue is going to be seen through the lenses of good and evil. I guess the question we have to deal with as policymakers is what extent is this us catching cheating and to what extent is this us merely changing the rules of the game? Is there a way to objectively come to an analysis of which is truer?
  - The short answer to that would be the revenue effect of the Delaware Holding Company addback. I should say that for reasons I won't go into, we don't know what the full effect of that was, but the $55 million almost certainly is most of the impact of that. And then the Captive REIT issue, those two changes, relates specifically to address these sorts of transactions. Right, there is $60 millionish that is as a result of these sorts of transactions. That means the remainder of it is measuring things differently. Of course, the whole income, addback, captive REIT issues…those are not cheaters anymore, not saying that they were before but there certainly not now. They are doing exactly what the law says and paying the taxes that the General Assembly has said they owe to the state.

- Delegate Barve – Has anyone else in any other state undertaken this kind of analysis?
  - To my knowledge nobody has done anything to this extent. Some of the states that have recently moved to combined reporting have looked at samples of 1000 to 2000 returns, and got tax data from other states that have combined reporting then tried to piece all that together.

- Steven Banks – The conclusion to be drawn, since we do have the addback provisions in place and [they] have been in place before 2006…none of these numbers are related to holding companies or Captive REITs. It's impossible for companies that are multi-national or multi-structured not to have intercompany transactions. They all have them because companies are ultimately managed by a board of directors and a management team with a pyramid. In any organization ultimately you are going to have intercompany transactions and related transactions. The transfer pricing rules not only internationally on the federal level but at the state level as well including Maryland require companies to in fact treat their affiliated companies as if they were third parties. We have to go through and make entries for intercompany transactions. If we didn't, then you could really manipulate things.

  The Senator's point…I think he really touches a nerve there. I think really it's the essence of what we are talking about. There are constitutional tax attorneys who spend all their time thinking about these big tax issues. One of the seminal questions is whether or not our society and the way we tax business is dramatically different than what is in the 1950s and 60s when we came up with these rules. Truthfully, in my view, the answer is probably "no," because it's true the Internet is new and it allows companies to get customers that they couldn't get before, but twenty to thirty years ago the same conversations were being had and the same discussions took place because we had catalogs. All these sales tax and income tax issues [that] were out there, as to whether or not you need a physical presence to capture tax liability, were based on the same lines. The form of capturing the customer or reaching the customer is different, the Internet versus direct mail catalog or Wall Street Journal ad, Super Bowl ad, is different but the concepts are the same. We haven't wrestled with economic nexus, we haven't talked about things like that, but at the end of the day, capital and labor really does drive revenues and if we let ourselves get to a point where you can start taxing companies just because you have customers in that state which is a step some states have attempted to go down and some that have successfully gone down ultimately, you really do run into situations that have significant impact on your ability to attract and maintain businesses. If a Maryland, West Virginia or a New Jersey company can go out and capture and require a company to pay the tax in your state just because they have a customer, you could literally have a substantial burden on interstate commerce. There are literally thousands of taxing jurisdictions within this country, starting at the federal level and then state….

- Paul Nolan – California is the paragon of progressivity in terms of development of tax codes. [It is] the one that is the most prominent in terms of combined reporting and worldwide, a couple of developments there recently. First, they adopted elective single sales factor apportionment last year. Second, the commission released its recommendations, eliminating their corporate income tax, eliminating the sales tax, reducing the individual income tax and replacing it with modified gross receipts tax system. We should change our reference just a bit.

- Martin Lobel – Every IRS commissioner who has never testified on transfer pricing assistance has admitted they cannot police it. When you have two entities, say a company here in Maryland and a company in the Cayman Islands. One of which is a drug company. They expense all the cost of developing a new drug, and then when the FDA is on the verge of approving it they transfer the patent to a separate affiliate in the Cayman Islands and they pay royalties to the Cayman Islands, which is a deductible expense in the United States. The deduction is for the "transfer price" which is supposed to reflect a fair market value. The IRS has estimated that multinational corporations' transfer pricing means we have lost approximately $300 million in taxes.

  We have a lot of multi-national corporations in Maryland who are using transfer pricing. How much more revenue could we raise if we use combined reporting worldwide?

- Karen Syrylo – While this commission is looking at the present as well as into the future, I do think it is important that we keep in mind history, and learn from history. We can talk for a day about the history surrounding the Container case, Barclay case and what President Reagan went through with the international backlash that happened that almost led to federal congressional legislation precluding the states from using worldwide combined reporting. There is a lot of history that we need to think about and there some things we certainly don't want to relive and make the same mistakes and get foreign partners to say they won't do business with our state if we do certain tax things. We also have to remember that closer to home, [it was specified] that this commission is to look at combined reporting on water's edge basis. The worldwide combined reporting has a lot of history that needs to be thought about; a lot that is very negative.

- Jennifer Japp – Referenced table 4 and 5. Characteristics of companies which would capture the bulk of the profit.

- Steven Banks – The ultimate amount a company/organization pays in Maryland state tax is a reflection of the taxable income, multiplied by a measure of what's taxable in the state - the apportionment percentage. If by going through this exercise and assuming we are not capturing any tax planning or cheating, it's just simply refiguring mathematics.

  Combined reporting is simply an alternative method, there's no right or wrong answer. Both are legitimate and both are accepted by the Constitution.

- Senator Madaleno – Seems to be that combined reporting allows us to reflect the realities of corporate options that are available today that weren't available forty years ago. I don't remember when the nation went to interstate banking and when we changed our laws but we would have had a situation, where at some point in the past, Maryland National Bank never had business outside of Maryland. Now they have gone from Maryland National Bank to Nations Bank to Bank of America. [They are] now a part of this global institution which provides services in every state and therefore leaves our tax structure. To deal with it is not just a change in the structure and there's not a right or wrong answer, but there is one that is more relevant.

- Karen Syrylo – I have to agree with you in a context of a business. Every dollar of investment, every dollar of expense that was spent in each of their offices generated the same dollar of profit. In a magical world where all of the services were exactly the same, all of the customers were exactly the same and all the expenses in every state or country were exactly the same and therefore the relativity of gross receipts to net profit was the same…but that is very rare in the business world today. One of the problems that Congress talks about with respect to combined reporting is exactly that. Take a very easy example; if you have a really vertically integrated set of companies, a manufacturer and a retailer. The manufacturer is making products and if they were selling it directly they would have XX number of dollars of profits, but with added costs of more employees at the store, advertising, etc. The retail store has additional expenses and has a different profit margin. When those two companies are filing separate returns, their exact profit is reflected on an income tax return. When you glob them together in a combined return, you are now doing a mathematical exercise that ends up with an assumption that every dollar of gross receipts created the same percentage of that profit. Economically, that is an invalid assumption in a lot of industries today. So I would agree with you, if we had a series of businesses where the mathematics worked out that putting everybody together makes the most sense and was the easiest and the best tax policy…but there is a lot of combined reporting that can result in the state being said to be taxing activity that wasn't generated in the state because of this arithmetic assumption, and that too is another topic that could take another day.

- Martin Lobel – I have some personal knowledge in this. I was part of a team from California that litigated the Long Beach antitrust case. Everybody knows that the major oil companies are very integrated in production; they have pipelines, refineries and gas stations. Each segment was always fighting as to who was going to get what percentage of the profit because they could shift their profits up and down the vertical chain. It really didn't make any difference to the final result, but it made a lot of difference as to who got what bonus; the refinery end of the business, or the pipeline end of the business or the gasoline end of the business. So when you're talking about economics, but the realities are [that] these vertically integrated companies fight to maximize their tax savings by shifting profits up and down the chain. So combined reporting in that case clearly made a big difference.

Raymond Wacks congratulated the commission on having completed the easier part of their test. “We are now going to move into subcommittees and dig into details of these issues. Hopefully, next spring or summer after this session is over, we will report back the results of our subcommittee work and start the debate regarding what kind of recommendations or questions we still have to answer as we start to prepare our interim report for almost a year from now, December 2010” said Mr. Wacks.

“At the last meeting, we broke down two subcommittees: Business Tax Reporting and Business Incentives in the Tax Code. These are open meetings any member of the commission can feel free to attend either one or both of these meetings as we move forward. I think the next step in the process is for the subcommittees to get together and hold organizational meetings to figure out how we are going to approach our task and what tasks we are going to look at and complete in order to try to report back to the Commission as a whole next spring/summer.”

One subcommittee will meet on October 22nd and one on the 29th in an informal setting.

The Maryland Business Tax Reform Commission adjourned at 3:22 p.m.

CN, MC, SB, ML/liv