# Maryland Business Tax Reform Commission

Minutes of Meeting
June 4, 2009

A meeting of the Maryland Business Tax Reform Commission was held in the House of Delegates Office Building, Room 130 on Thursday, June 4, 2009 at 1:30 p.m.

Those present were:

Raymond Wacks, Chairman
Delegate Sheila Hixson
Delegate Kumar P. Barve
Delegate D. Page Elmore
Senator Richard Madaleno
Senator Nancy J. King
Secretary T. Eloise Foster, Dept. of Budget & Management
Linda Tanton, Deputy Comptroller
Rhonda Ray for Secretary Christian Johansson, Dept. of Business & Economic Development
James Kercheval, MD Association of Counties
Michael Leszca, Maryland Municipal League
Paul Nolan, Manufacturers Alliance of Maryland
Steven Banks, Greater Baltimore Committee
Karen Syrylo, Maryland Chamber of Commerce
Jennifer Yang Japp, Public Member
Michael Ettlinger, Public Member

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

Speakers present were:

Michael Mazerov, Center for Budget and Policy Priorities
Douglas Lindholm, Council on State Taxation
Jim Eads, Federation of Tax Administrators

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 introduced the first speaker, Mr. Michael Mazerov, Senior Fellow, Center for Budget and Policy Priorities.

Mr. Mazerov spoke briefly on property taxes, sales tax, corporate income taxes, and gross receipts taxes, an overview of the different taxes that effect businesses and recent state issues. He touched on tax reduction strategies pursued by some corporations and the different methods states have adopted to restructure their corporate taxes, such as abandoning the income tax and adopting other tax measures, adopting additional taxes, enacting "addback" laws that disallow certain deductions, and adopting "combined reporting" for the corporate income tax. (Please see attached document.) Mr. Mazerov said that he sees this Commission's issues as the same as in other states, whether to take targeted measures or make systemic changes.

Questions asked after Mr. Mazerov's presentation:

- "With regards to the states that use alternative basis, is there any substantial difference in the tax burden for corporate income tax?"
    - "A number of states who use alternative taxes were enacted to explicitly be revenue neutral. But of course that doesn't mean they are revenue neutral in every individual corporation. Where they take the form of alternative tax they are effective because they do raise revenue relative to what the corporate income tax does" quoted Mr. Mazerov.
- "In my district I have a lot of biotechnology companies that don't pay profits so they don't pay corporate income tax right now. A lot of companies when they invent their vaccine they then become a target for acquisition by big pharmaceutical company from out of state. Let's take the case of a biotech company from Gaithersburg, Maryland; they don't make a profit, they're not paying corporate income tax, they've just invented a cure for cancer. Then a big pharmaceutical company in New Jersey buys the Gaithersburg, Maryland company. If we had combined reporting would the profits of that pharmaceutical company in New Jersey now be taxable in Maryland?"
    - "Eventually yes", stated Mr. Mazerov. "States take different positions on how soon a company is considered to be unitary with the rest of the company but eventually the odds are that it would be assuming that the operations of that company are going forward integrated into the operations of the New Jersey company."
    - Mr. Douglas Lindholm also answered the above question regarding biotech companies in Gaithersburg. Mr Lindholm stated, "If the company that invented the cure for cancer is still located in

Maryland, it will pay tax on all its profits to Maryland, they will still file as a company in Maryland. If that company from New Jersey moves the company; lock, stock and barrel, and assume it becomes part of the unitary group. two things will happen:

1. If there's combined reporting in MD and that unitary group was doing business here in Maryland, if that big company from New Jersey was not making money then that profit from Maryland would not bring any additional tax to Maryland because it was now combined as one.

2. If the New Jersey company was not doing business in Maryland before, if they were making profit, you would have to apportion using that company's factor. So depending on what the factor was, the apportionment factor and the tax could go up or down."

Chairman, Ray Wacks introduced the next speaker; Douglas Lindholm, President & Executive Director, Council on State Taxation.

Mr. Lindholm then began his presentation, speaking about the annual COST/E&Y estimate of the total state taxes paid by businesses in each state, statistics regarding Maryland's economy and business taxes, and COST's observations about combined reporting, alternative tax bases, and sales tax on business inputs. (Please see the attached handout.)

Regarding Maryland's public and non-profit sectors, Mr. Lindholm felt Maryland is unique. He indicated that those sectors contribute 6.2% of Maryland's total personal income, surpassing all other states and nearly three times the national average of 2.2%. This is relevant to Maryland's high reliance on personal income tax revenue, because the employees in these sectors pay state taxes but the public and non-profit employers are generally exempt.

Mr. Lindholm concluded his presentation with an analogy. "Undertaking tax reform during a recession is a little bit like grocery shopping on an empty stomach. I think it is very tempting to reach for something that will bring you immediate gratification and not something that will be good for the long run."

- A question was asked during Mr. Lindholm's presentation; "What services in Maryland do businesses benefit from?" With regards to his comment that Maryland businesses paid $8.6 billion in state and local taxes while benefiting from only $5.9 billion in state and local expenditures.

- Mr. Lindholm referenced Footnote 5; *How Closely Business Taxes Conform to Benefits Principal* by William Oakland and William Testa (document attached). One of the issues there is, how do you recognize that cost of education, how much of that is attributable or directly benefits business? The authors of this study indicate that zero (0) dollars of educational cost is attributable to benefit business. The authors, from Ernst and Young, felt that was not reasonable. Previous studies have shown that anywhere from 0% or 50% of education cost could be attributable or traced as directly benefiting business. The authors then came to the conclusion that 25% of education was reasonable. The study goes into great depth.

- Mr. Lindholm stated that the $8.6 billion paid in state and local taxes comes directly from the Maryland study done by Ernst & Young, which is referenced in his testimony.

- Another question asked if it was assumed that unemployment insurance tax was 100% attributable to businesses.

    - Mr. Lindholm stated that he had not looked at that particular study in detail but would review it for the commission.

- What is the percentage of educated students in the State of Maryland that go on to be employed by businesses as opposed to the ones who work for state government, federal government and the educational institutions themselves such as Johns Hopkins?

    - "There is an argument over this. A difficult number to come to," stated Mr. Lindholm.

- What would you replace the corporate income tax with since obviously not a gross receipts tax?

    - "Maryland does well with its reliance on personal income tax; I would accept the corporate income tax for what it is. I would be happy if you repealed it and recognized that might bring in additional business that would then contribute to the personal income tax, sales tax, or the property tax. It is a tax that is imperfect but it has a function. It's also a tax that is used in an economic development sense; to help bring companies into Maryland" stated Mr. Lindholm.

- To summarize your position, you basically support income and sales taxation that is primarily paid by the end consumer?

- “That is correct and I think most economists will support that as well” stated Mr. Lindholm.

- A member observed that Mr. Mazerov indicated that there was a “trend” in terms of combined reporting. Can you comment what the trend with respect to the single sales factor for the states that have either adopted combined reporting or done this on their own?

    - “Yes. Just this year, Tennessee, New Mexico, Iowa, Missouri, Florida, Alabama have rejected combined reporting. Several states are pending but probably will not adopt combined reporting. With respect to the single sales factor; business income has been apportioned using three factors typically. The two factors of property and payroll tend to punish companies that are capital intensive in the state, so what states have done is they moved to the single sales factor as a way to export their tax base.”

Raymond Wacks thanked Mr. Lindholm for his time and then introduced Mr. Jim Eads, Executive Director, for Federation of Tax Administrators.

Jim Eads stated that the Federation of Tax Administrators is the association of State Tax Agencies of the 50 states, the District of Columbia and New York City. He also went on to say that what he will discuss today is his own views and not the views of the members. Mr. Eads continued with his presentation. He referenced a list of “principles of a “good” tax system,” and spoke about single sales factor apportionment, the “intricacies” of combined reporting, states that have adopted alternative tax bases, sales taxes, and good tax policy as good economic development policy. Please refer to the attached handout.

Mr. Eads observed that single factor apportionment is a trend; that “unitary taxation” is largely court-created law; that the state corporate income tax is only about 7% of state tax revenue but contributes a far greater percentage of litigation; that “revenue neutrality is like a poker game - same amount of money at the beginning and end of the game but in different pockets;” and that in his opinion “good tax policy is good economic development policy: if taxes are fair, it translates into good economic policy.”

Raymond Wacks thanked Mr. Eads for his presentation and then opened the floor for general discussion and questions.

- Question for Jim Eads – Taxing separate entity versus combined group.

    - “Businesses have to figure out where the “unities” are and how that translates into a unitary report. The Comptroller’s Office would have to consider a fairly comprehensive set of transition rules to get from a single entity report system to a combined unitary tax report system. A significant task to move from one system to another.”

- Question for Douglas Lindholm – Fairness in size. Have any other states addressed perceived leveling of playing fields with regards to the smaller business?

    - "I am sure there are states which have a progressive corporate income tax. I am not sure which ones. With the issue of small versus large, that is a bit false dichotomy. Sure, there is a dream for every small company to become a big company. If you are a small company any advisor you go to will tell you to operate as an LLC, S corp., partnership, something that passes through so you don't have to pay double tax on the distributions from the corporation. There still are some small businesses that are C corporations, but those are the ones that are typically growing and buying competitors and expanding, and those are the ones that are least able to deal with the combined reporting. Great frustration amongst some of the smaller, mid size companies that haven't the sophistication to deal with the reporting requirements that Maryland imposed upon them last year under great penalty and it was a great expense for them to have to calculate what their expense was going to be."

- Question for Michael Mazerov – Can you respond to this argument that state corporate income tax maybe isn't worth collecting; particularly in combined reporting, whether or not it will raise revenue and the complexities that it will introduce?

    - "You cannot have a fair tax system if you have a personal income tax and you don't have a corporate income tax. Someone who owns a business, they are not a manager, they live in the state, they own the business, they earn income from the business, and they're subject to income tax on that income of the business. How can their taxes be fair if someone with an out of state residence owns a business that is earning income in the state and cannot be subjected to tax directly, because they're a stockholder but they are equally earning income from the business? That is the fundamental rational for why we have a state corporate income tax, in my opinion," stated Mr. Mazerov.

    - "Combined reporting versus an effective corporate income tax under a separate entity system. To effectively impose a corporate income tax under a separate entity system is just as complex, just as much subjectivity, what comparable market base transfer prices are and so forth," stated Mr. Mazerov.

- Question for Michael Mazerov - single sales factor losing money for the state. Was that surprising to you?

- “No, it wasn’t at all surprising to me”, stated Mr. Mazerov. “I was quite active in testifying at the time Maryland was considering enacting single sales factor apportionment. A large part of the reason it was enacted in Maryland was up until that point, to my knowledge, Maryland was the only state where the legislative fiscal office had ever scored single sales factor as revenue neutral. I pointed out that it was highly unlikely to be revenue neutral and it turned out to not be revenue neutral. The states that have enacted single sales factor do not have that much to show for it in terms of economic development. Not long after Maryland enacted single sales factor apportionment, Black and Decker closed, GM in Baltimore closed and Tyson on the Eastern Shore closed. Businesses make their location decisions based on fundamental economics of the business. Corporate income tax, particularly after you take in account the deductibility from the federal income tax, it’s just too small of an expense for business investment location decisions. I would like to see this commission do an examination of what single sales have accomplished in the state and whether the businesses that have benefitted from single sales really have created additional jobs or maintained jobs at the same rate as the companies who haven’t benefitted from single sales.”

- Question for Douglas Lindholm – Comparing Maryland to Delaware; why is the perception that Delaware is so much better than Maryland from a tax standpoint?

  - “That’s a good question,” stated Mr. Lindholm. “There are a couple things going on there; one, Delaware has a very favorable corporate law which is why a number or companies incorporate there. Delaware taxes a lot of services, but at a small rate. That may be why their effective tax burden, which is how we are compared them, is lower than the state of Maryland. The controversy has been that Delaware does not tax passive investment income, so companies who want to manage their intangibles, their trademarks, have put a company in Delaware and have licensed that out to affiliates. That is the classic Delaware Holding Company, and again, has effectively been shut down in Maryland and in most separate filing states by the adoption of the add-back statute. The add back statute says, essentially, that if you are paying expenses for royalties or intangibles to related parties, you have to add that back to Maryland income and we will no longer give you that deduction. So, from that standpoint, combined reporting shuts that down as well, but it’s already shut down in Maryland and the fact is that controversy is lessened.”

- Above question also asked to Jim Eads.

  - “My perception is also that Delaware taxes a lot of services.”

- Mr. Mazerov also commented stating that Delaware has a very low rate general gross receipts tax, even though they don't collect sales tax.

- In the broader category of alternative tax base, gross receipts tax, whether we're talking about a Delaware type gross receipts tax or Washington type business occupation tax, or some of the new gross receipts taxes like Ohio, Michigan and Texas have adopted: my understanding is that several of the new taxes are a result of commissions such as ours, where those states did other things to their taxes; Ohio removed their franchise tax and other taxes, Texas had to redo their property taxes, etc. The phrase was used earlier, "revenue neutrality." In looking at how much tax is being raised in those other states, we've heard that many businesses are paying significant additional taxes while other businesses are paying significantly less, is it revenue neutral? Is the bottom line that the state is going to get the same amount of $$. Does anyone have the information, statistics or results from those relatively new gross receipts taxes from other states?

    - Jim Eads commented that although he does not have any specific information. He heard from Texas that the margin stats are not producing what they expected and the same with Ohio. Part of that can be attributed to the economy, but whatever tax system you devise is not going to be a perfect tax system.

    - Douglas Lindholm also commented on the above question by stating that each of those states was really backed into a corner. Texas has constitutional prohibition against an income tax which is why they went with a margins tax. Michigan was struggling with their auto industry and the auto industry was paying a single business tax which is the value added tax, things like compensation, depreciation, interest, which are added in and perceived to be a punitive tax. In Ohio part of the business community went along with adoption of the gross receipts tax because they eliminated the franchise tax and the property tax on inventories so again a deal was struck there.

- Question asked to Michael Mazerov regarding the single sales factor – U.S. Supreme Court views single sales apportionment as being acceptable correct?

    - "Yes."

- Single sales factor as being a trend in many states. Doing something good for their state. What do you think we can do but adopt the single sales factor when it is a trend and accepted by the U.S. Supreme Court? Balance between reality and theory? Based on Comptroller's Office staff, we had a reduction in revenue as a result of single sales factor, which is hard to understand since Maryland has lost many in-state manufacturing operations and single factor should result in the out-of-state businesses paying more Maryland tax on their Maryland sales. Assuming that the numbers are really at least neutral, how can you recommend that Maryland not follow the national trend? Why is that?

- Michael Mazerov again stated that he would like to see the commission do a retrospective examination of what single sales factor has accomplished.

- Question of Doug Lindholm – Reference the Tennessee study. Asked to go into detail regarding the study.

  - "The study was conducted over a length of two years. A great deal of interviewing companies and states and took statistical analysis of states that recently adopted combined reporting. They then evaluated what was the most effective way to predict whether combined reporting would bring in money. They decided statistical regression analysis, which I have no idea what that is, was the most effective way to do that. They conducted an extensive regression analysis and found there was no correlation between raising revenues between a combined reporting state and a state that had adopted combined reporting."

  - Mr. Mazerov replied, "The authors of the Tennessee study recommended, from a policy standpoint, that combined reporting would be an appropriate tax policy. In terms of the revenue analysis, they did do a statistical regression analysis; there is very good reason to believe that the particular methodology they used is quite flawed. Over the period, they examined only 1 or 2 states that had switched to combined reporting at the very end of the period which they modeled in regression. The revenue gained from combined reporting that would be necessary under that scenario, when you are running a regression over 20 years and only 2 or 3 states have switched at the very end of the period, the revenue gain that would be necessary to find statistical significance or the switch to combined reporting would have to be much, much greater than anyone who believed that combined reporting would generate additional revenue would ever argued it would be. Methodology was such that it would be virtually impossible to find statistical significance for the adoption of combined reporting."

  - "Tennessee does not have an add back statute. They have an add back reporting statute."

Raymond Wacks adjourned the meeting at 3:36 p.m. The next Business Tax Reform Commission meeting will be on Thursday, July 9, 2009 @ 1:30 p.m.

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