MARYLAND BUSINESS TAX REFORM COMMISSION

Raymond S. Wacks, Chairman

Maryland Business Tax Reform Commission

Minutes of Meeting
July 9, 2009

A meeting of the Maryland Business Tax Reform Commission was held in the House of Delegates Office Building, Room 130 on Thursday, July 9, 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
Linda Tanton, Deputy Comptroller
Secretary Christian Johansson, Dept. of Business & Economic Development
James Kercheval, MD Association of Counties
Michael Leszcz, Maryland Municipal League
Paul Nolan, Manufacturers Alliance of Maryland
Steven Banks, Greater Baltimore Committee
Karen Syrylo, Maryland Chamber of Commerce

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

Speakers present were:

Robert Cline, National Director of State and Local Tax Policy Economics, Ernst & Young LLP
Jeff McLynch, State Policy Director, Institute on Taxation and Economic Policy
Beverly Richard, CPA, State Taxation Committee, Maryland Association of Certified Public Accountants, Inc.

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 1:31 p.m. Mr. Wacks made a motion to adopt the minutes of 5/13/2009 and 6/4/2009. Delegate Kumar Barve seconded the motion to adopt the minutes. Minutes stand approved.

Mr. Wacks introduced the first speaker, Mr. Robert Cline, National Director of State and Local Tax Policy Economics with Ernst & Young LLP.

Mr. Cline gave a brief summary of what he was going to discuss and indicated that he is not to here to make recommendations for what Maryland should do but will be glad to answer questions regarding what other states are doing and what they are trying to accomplish. Mr. Cline went on to discuss the state and local business tax system; based on a study done for about seven (7) consecutive years in conjunction with COST.

- Question page 2, last bullet, and "excess of 47%."
    - "Mr. Cline indicated it could be the differences in the numerator and denominator, total level of state and local taxes paid by business in the state of Maryland. I have not looked at the details for the explanation. Delegate Barve requested a follow up on the information. Mr. Cline indicated that we do see that variation across states" stated Mr. Cline. *Information requested via e-mail 9/8/09.*

- How do you define benefits?
    - "Follow the methodology used by the Federal Reserve Bank in Chicago, we actually go through the governmental finances statement state by state of all the state and local spending by category, make assumptions about what percentage of those expenditures directly benefit business. Of course education, K-12 is the largest number that has to be dealt with, assuming about 25% expenditures accruing to business directly as a benefit. We do it expenditure item by expenditure item" stated Mr. Cline.

- Is there any study of the Tax gap issue as the state level?
    - "We have not dealt at all with the tax gap issue" stated Mr. Cline.

- Would it help the commission if we were to see more detail in terms of how you do the analysis on tax expenditures, how much is actually the Chicago Federal Reserves vs. economic analysis of what you are doing?
    - Mr. Cline stated he could certainly share that information. Raymond Wacks asked Mr. Cline to send that information to us. *Mr. Cline will forward. Information requested via e-mail 9/8/09.*

Mr. Cline continued by making a few more points about the overall dollar amounts of state and local taxes paid by businesses based on our estimates referenced on page 3 of handout. Mr. Cline pointed out that in FY 2008 we began to see the impact of the recession which really began in December 2007, notice that corporate income tax collections were already down 7% nationwide, property taxes were still going up in aggregate almost 5% , general sales tax had already started its slow down. The sales tax was really the first tax to go down, being affected by the recession.

- Do you correlate tax credits given to mitigate the impact of the taxes?
    - "The way it works in our study is we are taking the actual tax collection figures and they are almost without an exception after credits and refunds; actual cash in the door. The credits are showing up in the sense they reduce the level of before credit taxes but we don't have a separate estimate of what those credits are" stated Mr. Cline.

Mr. Cline went on to the Importance of non-taxable federal government activity in Maryland on page 7. Something very unique with Maryland; highest ratio of federal government activity in terms of personal income of any state we were able to measure. Latest data on personal income taxation on the state and local level; in Maryland State and local taxes, of that total 38% comes from the personal income tax. The U.S. average is 22%, which means Maryland relies extremely heavily on the personal income tax with all its volatility associated with it.

- If you were to hypothesize, instead of the federal government; all those employees who are generating this personal income tax who are working for corporations that pay tax, where would that circle be on this chart?
    - "I can't speculate on that number but it certainly would be true that if more of the total economic activity in Maryland were private sectors subject to the full array of state and local taxes on business, you would get a much higher total number for taxes on the same basis of employees but you would have a larger percentage of the total state and local taxes paid by businesses. Another point from the tax policy perspective that comes out of this graph, there is danger in using simplistic ratios to compare across states. If you just use the ratios in our study about what percentage of total state and local taxes paid by business, Maryland looks relatively low or below average but that doesn't tell the story. You have to look deeper into the structure of the economy and really ask the question for the businesses that are subject to business taxes in Maryland are they over taxed or under taxed relative to some other benchmark whether it's surrounding states or national average?" stated Mr. Cline.
- Chart on page 7 states federal government activity in Maryland. Some local economist have taken using the phrase, "Maryland is driven by fed med and ed"; medical and educational institutions which are not in this chart, correct?
    - "It is strictly federal, personal income generated from the federal government sector, does not include state and local government activities" stated Mr. Cline.
- Medical institutions that also are not subject to business tax, educational institutional that are also not subject to business income taxes, and employee who are paying taxes in Maryland; I assume the chart would look even more drastic if you were to add not only the federal government activity but also the employees of the medical and educational institutions, do you know how much more would this show?
    - "We have not done this exercise. Certainly all the points on the diagram would move to the right. Maryland as well as other states, but Maryland would move further to the right in the percentage of personal income that is generated by non private sector activities" stated Mr. Cline.
- Individual income tax at 17% on growth page 6; is that just the LLCs and sub chapter S?
    - "Partnerships, proprietorships, and all pass through entities. Business income reported on individual income tax returns" stated Mr. Cline.

Mr. Cline went on to discuss the short-run business tax developments and longer-run perspective.

- Other states that are doing combined reporting; they have also cut their corporate taxes, have they not?

  - "Connecticut is an interesting example. The new budget bill in CT for FY 2010 has actually put a 25% surcharge on the corporate income tax and also increases the individual income tax rate and they are also considering the combined reporting. Massachusetts did adopt a phase in tax rate reduction on corporations in combination with combined reporting. There was a fairly serious discussion about delaying the phase out, phase down of the tax rate in Massachusetts but the phase down was defended and is still in place" stated Mr. Cline.

- What can you tell us about the status of Pennsylvania?

  - "I haven't been following Pennsylvania in detail. I think the combined reporting proposal is still on the table, it's been on the table for 3 – 4 consecutive years. I have been following their revenue estimates very carefully. They actually went back to Minnesota to gather some information to help augment their revenue estimate and what they found is that when they counted the number of company groups that would pay higher taxes and they counted the number of corporate groups that would pay lower taxes under combined reporting in Pennsylvania, they had a very large number in both buckets. They had 5200 (estimate) that were tax increases and 5000 (estimate) tax decreases in the aggregate they estimate on raised revenues. The important thing is they understand there are very significant redistributions of tax liabilities across different types of taxpayers; many winners and many losers. The winners pay less in corporate income tax; the losers pay more in corporate income taxes. Without a doubt there is a significant amount of redistribution. It's not loophole closing which sounds like you are going to raise revenue without loses; it's a combination of significant increases and significant decreases" stated Mr. Cline.

- Talk about the typical winner and typical loser in this redistribution. What kind of firms is paying more and what kind of firms are paying less?

  - "I am not prepared to talk about that composition but a few observations; it's difficult to generalize. I saw the internal analysis that was done in Minnesota when they adopted combined reporting in 1981, 1982 or maybe 1983. They looked at the returns that came in under combined reporting; they went back and disassembled those tax returns back into separate filing tax returns and looked at how much revenue they would have gotten from the combined reporting companies if they filed separately. They concluded they had lost money in Minnesota when they adopted combined reporting.   Remember it was 1982 – 1983 it was the perception coming out of the recession in 1980 -1981 what happened is that they were surprised by the size of the net operating losses that were unlocked through combined reporting when profitable companies, profitable subsidiaries were able to use the losses of subsidiaries; the offsetting effect reduced taxes about 9% in Minnesota. From a revenue perspective they concluded they did not raise short run revenue from that. Minnesota banks contributed a lot of loss to the disappearance of revenue under combined reporting because they were loosing money and when they combined their instate subsidiaries they reduced their in state liabilities" stated Mr. Cline.

- Does Pennsylvania have add back provisions like we do in Maryland?

  - "I'm not sure what the answer to that question is. In terms of tracking different revenue estimates in different states of combined reporting I concluded from looking at Maryland, it looked like after the adoption of expense add backs perhaps the revenue estimate had been reduced as much as 50%. I know a lot of different things were going on so that is probably too simplistic a conclusion but it looked like the add backs did affect the combined reporting estimates in Maryland" stated Mr. Cline.

- NOLs having a greater affect as what you saw in Minnesota holds true here in Maryland. Is that correct?

    - "You are certainly going to see NOLs having a very significant affect on current corporate income tax collections whether it's combined reporting or separate. It is possible that with the size of those NOLs at combined reporting in this environment you would lose more of your tax, larger percentage of the potential revenue that your expecting to see would be offset by unlocking those NOLs, then there are also the unused credits. In many states you have to consider whether they are carried forward credits that are not being used that somehow would be unlocked with combined reporting" stated Mr. Cline.

Mr. Cline continued with his presentation on longer-run perspective: tax changes to improve competitiveness.

- Question was raised on page 10, "reduce taxes on mobile capital, including property taxes." Aren't property taxes the most stable/immobile taxes?

    - "Many states that still have a significant personal property tax on business property and in some cases inventory. The majority of those dollars coming from real property taxes. I would put commercial property; office buildings, factory buildings I would put in the mobile capital category" stated Mr. Cline.

- With the exception of the automobile industry, what other industry has picked up and moved so quickly?

    - "Well we certainly see it in the support activities for example North Carolina has just passed a bill that provides a significant subsidy or incentive for the location of a DELL facility in the state. I assume they may have been doing some of those activities in Texas. The capital itself is very mobile across the state. More mobility of capital; real and personal then perhaps, is generally appreciated or understood" stated Mr. Cline.

Mr. Cline continued with his presentation on page 11; Taxonomy of new state business taxes.

- With all these states are they getting rid of other taxes or simply adding on?

    - "They tend to be getting rid of other taxes and so in Ohio they eliminated the personal property tax, corporate income tax, net worth tax and provided substantial overall deductions in business taxation. Michigan eliminated the single business tax provided some substantial property tax reductions to business and back filled the combination of the income tax and modified gross receipts tax. The single business tax was really a value added tax. The value added tax correctly handles the pyramid problem. It avoids taxing the same transaction or components over and over again; it does it by allowing a subtraction for purchases from other companies" stated Mr. Cline.

Mr. Cline mentioned that he has the details on Ohio, Texas and Michigan on the last three pages of his presentation.

- One more question was asked regarding New Hampshire; no sales or individual income tax, page 11.

- o "New Hampshire is a unique state. They have no individual income tax or sales tax. Legislators who looked at the issue of corporate income tax said that it was too volatile; concerned whether or not all businesses were paying their fair share. The indicated what they would do was to have a back stop to the corporate income tax which was an alternative base. It is almost the value added tax except the profits keep being taxed under the corporate income tax. You calculate your taxes both ways, and then pay the larger of the two. If you have a lot of profits and a high corporate income tax, you get a credit for the value added tax; you pay the difference which takes you up to the biggest number which takes you to your biggest number which is your profits. If your profits are small, you pay the larger of the business enterprise tax which is based on value added. New Hampshire has a very high property tax. You need to keep in mind the uniqueness of each state" stated Mr. Cline.

Mr. Raymond Wacks thanked Mr. Cline for his presentation. He reminded the committee members about the Business Tax Reform Web site. Mr. Wacks then welcomed Mr. Jeff McLynch, State Policy Director for the Institute on Taxation and Economic Policy.

Mr. McLynch thanked the commission for his opportunity to present. *Please note combined group does not include all subsidiaries because of the definition of unitary as per second page, first paragraph of handout.*

- In a recession regarding operating losses would you expect to see a decrease in revenue because of the tax advantages of combined reporting in the short term?
  - o "It will vary from state to state depending on net operating losses. Long term impact considering the depth of this recession" stated Mr. McLynch.
- What is MA doing in terms of declaring a business unitary and then denying them the use of NOLs?
  - o "No, they are not denying them the use of NOLs. MA used a different approach than Pennsylvania" stated Mr. McLynch.
    - ▪ *Additional clarification on information discussed requested via e-mail 9/8/2009.*
      - ✓ *"My recollection is that a point was raised about the impact that differing treatment of NOLs might have upon a given state's estimates for the amount of revenue that would be generated in the event that combined reporting were adopted. As for the differences between Massachusetts and Pennsylvania, my understanding is that, in Massachusetts (prior to the adoption of combined reporting), some entities already had the ability to use the NOLs of other related entities, whereas Pennsylvania had a greater restrictions".*

        "I believe that Howard Merkowitz, the Director of the Massachusetts Department of Revenue Office of Tax Policy Analysis, could provide you with more details about Massachusetts' treatment of NOLs, though you may have already been in touch with him" stated Jeff McLynch via e-mail 9/8/2009.
- I thought I heard you convey that a litigation issue is a transitional issue and your comments lead us to believe that would go away. Last month meeting Mr. Eads, Federation of Tax Administrators indicated that while corporate income tax represents about 70% of the state revenue across the country the litigation over combined reporting represents a multiple of that percentage in litigation. Can you reconcile that comment?

- “I am not trying to deny that there will be litigations surrounding the issue of what constitutes a combined group. Businesses that will be affected by this will litigate to the extent that they are able to and to the extent that it benefits them to do so” stated Mr. McLynch. If you look commission report from the state of Massachusetts, their department of revenue testified that some substantial fraction of the litigation which they are currently engaged add back statues would be resolved if that state had combined reporting.

Mr. McLynch continued with his presentation on page 5. Mr. McLynch referenced research by Michael Mazerov of the Center on Budget and Policy Priorities; Most Large North Carolina Manufacturer are Already Subject to “Combined Reporting” in Other States, January 15, 2009.

- Discussion of the additional costs and burdens describes the preparation of the return itself? What is your view of my prior point that many businesses say that the cost in complexity as well as the unpredictability in lack of certainly comes from the litigation issues and audit issues? What is your view of the costs of litigation?

  - “There are trade offs in terms with the cost of litigation. States right now that have add back statues are routinely litigating the defense of those particular statues. It’s an administrative cost to the state at a time when they do not have the resources available to them to try and to defend their particular statue. Combined reporting because it is more comprehensive, nullifies those particular transactions, removes the need to litigate those add back statues. It’s either a matter of administrative burdens for departments of revenue or burdens that are placed on business. I think that once it’s been established, in most cases that combined reporting exist that litigation will dissipate” stated Mr. McLynch.

Karen Syrylo stated that the complexities that adds to the litigation and the cost of litigation, it is a judicially oriented concept; that the statues can only be so clear but the interpretation of what is the unitary group, which subsidiaries belong in the group, which transactions are to be combined, creates so much litigation that has been going on for decades. *“I would like to make sure that the commission focuses on this topic at a later time.”*

- Biotechnology firms lose money until they have their breakthrough and then their business model usually involves being purchased by an out of state corporation so you have a biotech company burning through capital, basically no profits on the books, and suddenly they have their breakthrough they have their patent and a big pharmaceutical company wants to buy them. Under combined reporting wouldn’t that company have to export some of its corporate income to be taxed in Maryland?

  - “I think to the extent they have their operations here, over time that entity is going to operate as a whole so that each portion is contributing to the profitability that is why you want to have a more comprehensive definition of income” stated Mr. McLynch.

- Clarification on page 3 regarding Virginia’s add back statue.

  - “The Department of Revenue interpretation of exceptions to be vulnerable to attack. In the case of Maryland, add backs and REIT’s those particular approaches have not been sanctioned in the way that combined reporting has by the Supreme Court. States like Alabama states are already beginning to lose their defenses of these premier statues. It is clear you want to have something that will withstand the challenge” stated Mr. McLynch.

- I assume we would pick up a whole lot of revenue once we went back to add back?
    - o "Yes, you saw changes in the combined reporting estimate in Maryland as a result of the add back category" stated Mr. McLynch.

- If we went to combined reporting, would we need the Delaware Holding Company?
    - o "It will neutralize" stated Mr. McLynch.

- Majority of the states have moved towards combined reporting. How is it that other states adopt a policy that will bring about the end of capitalism but other states have managed to do it? How is it?
    - o "California was one of the states to begin using combined reporting in 1937. Other states have begun using it for some time now. Oregon, Mexico have seen a number of critical "new economy investments" along the lines of retail. I understand your concerns about whether biotech companies or high tech companies are going to move from one state to another. I do think that states that they do wish to foster the economic growth can make certain investments need to have the resources to make those investments therefore they need to have the tax policy available to them" stated Mr. McLynch.

Mr. Wacks introduced Beverly Richard, Maryland Association of CPAs. Ms. Richard thanked Mr. Wacks for the ability to speak today.

Ms. Richard explained her position and the position of the Maryland Association of CPAs. Her background is that she is the tax manager for a public accounting firm located in Sparks, Maryland.

Ms. Richard's went on to summarize, the very broadest overview of what she would say the biggest challenges are as a taxpayer and tax practitioner would be the complexity of what we deal with is state and local taxes, lack of certainty, and a lack of transparency. I will touch on those aspects. Ms. Richard's went on to discuss the "10 Criteria for Evaluation Proposed Tax Legislation." This was information that was handed out to the Maryland Association of CPAs as ideals to be strived for in terms of tax policy and tax legislation.

"In terms of complexity; state taxation is much more complex than most people would anticipate. Each state has different types of state taxes and all the different places that the state receives revenue from. From the business perspective there are a lot of different taxes that we are trying to delving to understand. In regards to each one of those taxes, each state, and each jurisdiction has their own rules, calculations, rates, and forms, exemptions, there own interpretations of the exact same wording. Within each state there are different sub jurisdictions; counties impose taxes, cities impose taxes, there are police jurisdictions, school districts, parishes; sometimes each one of these there is a single tax and each one has their own rate recorded on a single form, sometimes there is multiple forms for recording in different jurisdictions and reporting requirements; a huge level of complexity. Speaking about combined reporting is another level of complexity. Step one is preparation of the separate company returns, step 2 is working on combining that; each state there own way of doing combined reporting. Because of the lack of consistency from jurisdiction to jurisdiction it does allow for tax planning opportunities which also the states strive for also because the states want to be different in some way to attract the business into their state. Economic development purposes for having a lack of uniformity but it also does cause complication, it also causes a complexity which is the reason I am employed" stated Ms. Richard.

"Maryland has some advantages; a single state sales tax at one rate across the state, we have no city returns, we don't have different levels of tax, we have one form to file; all are advantages that Maryland has. Maryland strives to keep things relatively stable and simplified as possible. Even in the case of our county piggy back tax; Maryland has tried to make that as streamlined as possible from a taxpayer perspective. It's allowed to be recorded on our state income tax return, the calculation is based on state calculation, it doesn't have a separate calculation with its own rules" stated Ms. Richard.

"The second issue I would like to address is the issue of certainty or transparency which kind of goes hand in hand" stated Ms. Richard. For taxpayers there is a need to know exactly what the proper amount of taxes, who it's owed and to be certain of those things. I am often called to answer the question, "where do I need to file", "what state/jurisdiction do I have nexus in and for which type of tax?" The connection to a state it has to rise from certain level to be subjected to that states tax and that is different for taxes say a sales tax than it is for income tax. It is not as simple as you might think. We actually have to do studies and go in depth to someone's business and help them determine where do they need to file and what type of taxes do they need to file in each of these jurisdictions" stated Ms. Richard.

"Businesses want to avoid double taxation. They want to structure things so that the sale is going to Maryland or Virginia but not both. Questions asked by taxpayers:

Is an item or transaction taxable?
Is their an exemption?
Is their an incentive?
How do I properly qualify to get that exemption?
How do I meet those requirements so I'm not going to be taxed on something?

Most taxpayers understand that the cost of living is that we pay taxes; there not trying to cheat the system. Most taxpayers the bigger issue is getting the knowledge to know that what they are paying is their fair tax, is the right amount of tax. They don't want to pay extra just to be sure. Taxpayers struggle to understand the law completely too properly comply is an everyday struggle" stated Ms. Richard.

"The primary way that businesses and tax practitioners find certainty is through information and obviously the law is published. The law tends to be the outline. Rulings, interpretations, hearings, court cases; these are what provide taxpayers with the information needed to determine their tax situation under their specific circumstances. Some states, example would be in Virginia; they offer an extreme amount of guidance, they provide guidance, they publish all their rulings and cases and they also give their taxpayers very easy access to this information directly on their own web site. You don't have to pay for high level tax research software to be able to find the answer to a tax question. This transparency of information helps also improve taxpayer compliance through examples of similarly situated taxpayers and the eventual outcome of their circumstance. It also provides taxpayers the knowledge that the state is applying the law fairly to all taxpayers" state Ms. Richard.

Ms. Richard went on to talk about combined reporting and stating that as a representative of the Maryland Association of CPAs they are not for or against combined reporting.

"It is simply a different tax methodology; another way of calculating things. Maryland taxes each legal entity separately so that form of legal existence is the filing enemy and under combined reporting; your taking a group that you determine is unitary; it functions as one true taxpayer and reporting that on one tax return as if it is only one entity" stated Ms. Richard. "However, combined reporting does have its own unique set of issues. In the states those are west of the Mississippi where they've always had combined reporting these things have been worked out over a time. East of the Mississippi we have other things that we have worked out over time such as the related party add back rules, capital REIT rules.

You can look at the history of tax law and cases and you can see that these things take time to develop. One of the things with the move to combined reporting; because you have an objective way of determining whose the taxpayer under separate reporting; it's a separate legal entity. In combined reporting one of the complications is who is the group, who is the taxpayer, what entities make up the combined report?" stated Ms. Richard. "In terms of looking at the taxpayer group, you've gone from objective criteria who file the return to a subjective determination on who's included in the unitary group. That subjectivity also breeds the need for guidance, guidance, and more guidance. A lot of that is developed through case law; what is the interpretation on the states side of centralized management; how much centralization, how much functional integration pulls taxpayers into the group?" stated Ms. Richard. Subjective determinations are often worked out in court and as you develop a body of case law, and you can reference the court laws. This takes time to develop. There is increased litigation, increased questions, increased need for guidance, increased need for transparency, but that transparency and guidance does then allow for taxpayer buy in. If the taxpayer knows that they are being treated the same way that the state treated another taxpayer; then the taxpayer does have the buy in from that.

Raymond Wacks thanked Ms. Richard for her presentation and asked committee members if they have any questions.

- Litigation issue resulting from combined reporting isn't that combined reporting itself apparently bring more litigation, it's the change.

    - "You're moving from objective criteria to a subjective criteria; a question that is easily answered, who files a tax return? The legal entity, to a subjective determination based on the specific facts and circumstances of your taxpayer group. Who buys the pencils? Who does the accounting? Details. All of those things are open to interpretation even if the law was written exactly the same way; the interpretation of how much is needed, where is that threshold? Those questions have to be answered and ultimately you end up answering it through case law" stated Ms. Richard.

- Winners and losers of going on this path. Constellation has come in and supported combined reporting. Obviously they've made the determination this is a better tax system for them as a group than our current system. They have figured out that they will pay less. We file a unitary tax return to the federal government.

    - "No, it's a consolidated return we file to the federal government. It's more of a mathematical difference. Combined and consolidated are similar in the fact that they both file a group return. At the federal level it's a little more simplified, because at the federal level you don't have apportionment that you're dealing with. With consolidated you are only adding together your income and losses and those types of tax attributes and eliminating intercompany adjustments. At the state level there are actually two different options; combined and consolidated. It's more two different differences; one is mathematical; which numbers do you add first. Consolidated filings generally speaking you calculate each entity separately then get to the state number at the bottom and add them across. In combined reporting you are going to add the taxable income; add each apportionment figure and come up with a total taxable income and then a total state apportionment factor and then you are going to apply that" stated Ms. Richard.

- "I am a lawyer, not an accountant so I view things a little different. I would say the difference is the constitution. Basically the federal government thanks to the amendment to the constitution has the power to impose an income tax on a corporation that is a resident of this country. Whether it's a foreign corporation or domestic corporation and so there is a complex set of rules called the consolidated return regime. Each state whether it's Maryland, New Hampshire, Vermont, Texas can only really reach as far as it can reach with it's own constitution and it cannot reach beyond the state without some other connection; nexus concept. Without going into the depths of that; a state like Maryland or California just can't simply enact the same kind of statue that the federal government did because the state of California does not have that reach legally under the constitution and it's own power obviously we have the federal system as our constitution but its that distinction we cannot impose that upon a constellation. You couldn't just say, "we hear by enact the exact same statue as the federal government; you now give us a copy of your consolidated return we will go by from that, we'll somehow apportion the income" that is the key difference stated Mr. Paul Nolan.

- "At the federal level, the threshold for filing consolidated return, the only question is, do you have the required level common ownership? At the state level you have to impose, because of constitutional issues, this question of which of those subsidiaries that has common ownership is unitary and not all of the subsidiaries, even if there 100% owned meet all of these tests to be unitary and that's how you get a difference between the ownership test of who is included in the consolidated group at the federal level versus what is this definition of unitary to identify what subsidiaries are in a state combined return" stated Karen Syrylo.

- "I was under the impression that under combined reporting that a wholly owned subsidiary was automatically part of a unitary group. What is generally speaking treatment the difference between wholly owned subsidiary and partially owned subsidiaries? If a corporate parent owns 60% of a subsidiary in Massachusetts but 25% of the subsidiary in Texas, what are the differences or the factors involved in deciding:"

    A. In or out of the group?
    B. Is there such a thing as a partial membership in the unitary group?

    - "No, there is no such thing as a partial membership in the unitary group. You can have consolidated states, Virginia has separate filing, consolidated, combined; it's a mathematical difference. The other difference with consolidated and combined is usually the consolidation requires objective criteria, 80% ownership. For unitary your qualification for ownership is usually is the much lower ownership percentage say 50% but that you also have to meet the other criteria. For example, does that business function with your business? If the subsidiary is a completely different line of business, they don't interact with you, there is not centralized management; just because you are owned by the parent doesn't mean you are the same unitary group. If however, you have just 50% common ownership, your 50% common owned by another parent but yet you integrate together, one true business operating as one despite these legal lines, you really truly are operating as one, even though you only have 50% common ownership, you are together in a unitary group" stated Ms. Richard.

- If a parent group has a 75% stake in a subsidiary is in the same line of business and therefore should be considered together with that, what becomes of the 25% of profit of the subsidiary that the parent is not legally entitled to because the parent does not own that portion of the subsidiary?

    - "First let me address minority interest; what you are speaking to is a financial reporting concept which goes to the financial statements that are created for the investors of those companies, the banks, stakeholders so that they have a true picture of the business and those rules for financial reporting are very different from tax reporting even at the federal level. When you deal with minority interest, you are dealing with a different calculation" stated Ms. Richard.

- "The situation you described is very real. Illinois had to adopt add back provisions under combined reporting. Well you ask why they would do that. It's one or the other; you wouldn't need both. What happened in Illinois is true with other states. The unitary concept is not leading to all the affiliates being a part of the unitary group in the combined reporting state like Illinois. There tax planning among the members of the combined group and the subsidiaries that aren't unitary with the combined group even though there under the same ownership. You put add back provisions into your combined reporting system because the battle has just moved to a different arena. The battles between those affiliated companies in the unitary group and the unaffiliated companies that are owned by the same owners in that group. You may see that combined reporting state will adopt add back provisions because the problem is broader than you think will be solved by combined reporting" stated Mr. Cline.

- "The other question I would like to come back to is why there are such strong positions? Why are there two camps? If you think that the problem in the corporate income tax is the Delaware Holding Company, and that you have a Maryland company that simply transfer intellectual property to a Delaware Holding Company and did it with a $1,000 expenditure, you would look at that and say that's not real economics, that's tax planning pure and simple. We don't want that to happen that's not consistent with the administration and the intent of the corporate income tax. On the other extreme there are taxpayers who say, according to your example in Maryland of the research and development company, that's real economics, they did lose money, they were losing money but they were doing real things in Maryland. Now they are purchased by a manufacturer of pharmaceuticals that makes money in manufacturing now you look at it and say let's combine real economic entities and ignore the fact that there different from an economic perspective; one loses big bucks and the other makes big bucks. Combine the two, take their total income, divide it by all their sales, and that's the dollar amount of profits that Maryland would say under combined reporting belongs in Maryland because they combined reporting equalizes the profits per dollar of factors regardless of the profitability of the different subsidiaries and regardless of what kind of factors are creating these sales. Then suppose you have 100% sales factor apportionment into Maryland you say, and by the way, a dollar of sale brings with it the same dollars of profit in every state from any affiliate regardless of the true relationship between sales and profitability. So what happens is that to solve that one extreme which is paper transactions that move profits from one state to another, you adopt a new system that creates new tensions, and that is the tension over real economic activity being attributable to Maryland that doesn't belong in Maryland. Partly because your average in profits over all these different subsidiaries that everyone knows do not have the same amount of profits and your apportioning them to a state assuming that everybody dollar sales brings in the same profitability, it just isn't true. The taxpayers start to think that combined reporting is an attempt by the states to grab economic activity and profitability that doesn't belong in the state. It's overreaching from a real economic perspective.

  Other extreme camps say, no were just going after the cheats, were going after tax planning that's only artificially redistributing profits and you have some pretty strong positions in both of those extreme camps. The way I kind of close the discussion is to say is there a way to get the benefits of preventing the paper transfer of profits without creating the distortions that you are going to get from reallocating real economic activity on an arbitrary basis called combined reporting? Maybe that is where add backs come in.

Maybe there are alternative ways to reach the objective of getting rid of the paper transactions without creating the economic distortions of combined reporting but there are strong positions in both camps" stated Mr. Cline.

- Why shouldn't a wholly owned subsidiary be a part of a unitary group?

    - "Let's say you ran a very successful accounting practice in your county. Wholly in the state of Maryland, you paid all your taxes in the state of Maryland. A company in California decided to purchase you out; you made enough money to buy a nice beach house. You continued to do all your work in Maryland and pay your taxes and profits in Maryland; you're doing business for Maryland people, why would California be due any of those taxes" stated Mr. Steven Banks.

- That just seems to be a very cut and dry situation. I don't think a lot of business situations are not that cut and dry. Over time when one company owns another company those distinctions are going to tend to money.

    - "We see it in many different forms; some companies are very centralized in how they manage their multi-state or multinational organizations and some are not. Extreme examples are easy to see and a very objective case of single filing is easy to see; that is one of the issues with combined reporting we do have to start making those determinations and there is all kinds of variances" stated Mr. Banks.

    - "I would like to give you a challenging example; how broad this concept of unitary is. It's not ownership, solely prerequisite necessary but not sufficient to determine who's the taxpayer. In Minnesota after they adopted combined reporting, there was an internal discussion in the Minnesota Department of Revenue about an audit for a very large taxpayer. The auditor wanted to set the rate out to visions of a single entity, so subsidiaries involved, the auditor said that a conviction of this major company that was loosing very large dollars should not be part of the unitary taxpayer entity. The auditor was going to carve out pieces of the single entity operation arguing that the division was not unitary with the rest of the company and they were willing to push it off the tax return so that the net operating losses associated with that division would not dilute or reduce the positive incomes created being other divisions.

The concept of unitary really is that big in terms of its uncertainties the controversy, the theory of what you are trying to do. The auditors decided that if you understand the argument and the rationale because its consistent with the concept of unitary but you have to do it consistently so you have to allow a taxpayer to throw out a division if they argue that it's making a lot of money but it's not unitary with the rest of the single company business and they weren't willing to go that far so that ended the discussion. The idea of unitary could be within a single entity as opposed to the relationship across multiple affiliates" stated Mr. Cline.

- "If you think of unitary in terms of can you break up the single company into two different taxpayers, you get some appreciation of how complex this is. It's not a simple loophole closing exercise. It's a fundamentally different way of thinking about who a taxpayer is. If Maryland decides to adopt combined reporting and your deciding that the large number of taxpayers almost as many as there are losers who are being overtaxed in the current system and almost equal number but not in dollar amounts are being under taxed, you should understand which industries are affected, what types of businesses and what their characteristics are. That is a fundamental change in the way you tax business, I think in order to make that decision you need a lot of pretty important information about the winners and losers. That's why it is so important" stated Mr. Cline.

- "Please keep in mind there is going to be variation among the states, what is true in Pennsylvania may not necessarily be true for the state of Maryland" stated Mr. McLynch.

- Which states should we look out as benchmarks, how their corporate economies are set up and what impacts our tax structure is going to have? Are there certain states that are similar in nature?

  - "Maryland is on its own is my conclusion" stated Mr. Cline. "You have to find out where the sore thumbs are in Maryland. What's broken, what isn't working? You have to think about what the impact of any tax policy changes on the competitiveness of the private sector in Maryland, a really critical question" stated Mr. Cline.

    "Do tax changes make a difference in the private sector in terms of jobs and income? The one change that had the greatest negative affect on Maryland's economy was combined reporting. Greatest number of jobs lost per one million dollars of increases in business taxes. The one with the lowest negative impact on the state was an increase in the sales tax rate. You need to spend time thinking about how it fits into your economic development policy whether or not there are some changes that are better than others" stated Mr. Cline.

- As an individual CPA, knowing what you know about the two systems, if we ere to adopt combined reporting for the state of Maryland, would your individual workload increase if combined reporting were passed?

  - "There are different tax planning opportunities because you have to work with who is in the unitary group. It's a whole new world. As far as new workload; combined reporting we charge much more for combined reports, we charge a lot more for a new combined report, as far as combined report planning, yes each business is going to want to examine it's impact. It's one thing they do ask us to study; study where should I expand into to, where should I open my next manufacturing plant, what incentives are available" stated Ms. Richard.

Raymond Wacks thanked the speakers for their discussion and reminded everyone that there is no meeting in the month of August. Our next meeting will be September 10th at 1:30 p.m.

Mr. David Roose briefly discussed the upcoming report from the Comptroller's Office on combined reporting, and said it will include transition issues which will be very important but will not include an estimate of what combined reporting would bring if it were enacted this coming session. What we will be doing is saying here is what combined reporting would have brought for this state for TY 2006; using that to illustrate a lot of these issues and recognizing fully that the circumstances for TY 2010 and 2011 are going to be very different than they would have been for TY 2006. Then we have to make the determination as to what is different and how will that affect the bottom line but that is not what we will be doing in this report.

Ms. Syrylo asked Mr. Roose about the add back which Maryland has; add back was in effect in TY 2006, will your presentation have numbers broken out on what the state has generated from add backs knowing that monies already coming into the state? "We will be taking into account of that" stated Mr. Roose.

Meeting adjourned the meeting at 3:45 p.m.

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