COST
COUNCIL ON STATE TAXATION

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Maryland General Assembly
House Ways and Means Committee

Re: COST's Opposition to House Bill 295, Mandatory Unitary Combined Reporting

Dear Chair Kaiser, Vice Chair Washington, and Members of the Committee:

Thank you for the opportunity to provide testimony today on behalf of the Council On State Taxation (COST) in opposition to House Bill 295 (H.B. 295), Corporate Income Tax – Combined Reporting, which would impose mandatory unitary combined reporting (MUCR). MUCR arbitrarily assigns income to a State, negatively impacts the real economy, has an unpredictable effect on State revenue, and imposes significant administrative burdens on both the taxpayer and the State. Further, the Maryland Economic Development and Business Climate Commission, established at the request of the General Assembly's leadership, has expressed that Maryland should not adopt MUCR because it: (1) creates revenue volatility, (2) picks winners and losers among taxpayers, and (3) leads to additional litigation and administrative costs.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of approximately 550 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

COST's Position on Mandatory Unitary Combined Reporting

The COST Board of Directors has adopted a formal policy statement on MUCR. COST's policy position is:

> *Mandatory unitary combined reporting ("MUCR") is not a panacea for the problem of how to accurately determine multistate business income attributable to economic activity in a State. For business taxpayers, there is a significant risk that MUCR will arbitrarily attribute more income to a State than is justified by the level of a corporation's real economic activity in the State. A switch to MUCR may have significant and unintended impacts on both taxpayers and States. Further, MUCR is an unpredictable and burdensome tax system. COST opposes MUCR.*

Problems with Mandatory Unitary Combined Reporting

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and business taxpayers is how a state should determine the corporate income tax base. The first approach, "separate entity reporting," treats each corporation as a separate taxpayer. This is the method Maryland currently uses; it is also used by Maryland's regional competitor-states, including Delaware, Pennsylvania, and Virginia. The second approach, MUCR, treats affiliated corporations (parents and subsidiaries) engaged in a "unitary business" as a single group for purposes of determining taxable income.[1] MUCR has several serious flaws.

- **Reduces Jobs –** Proponents of MUCR have focused on the benefits in terms of reducing tax planning opportunities, but they fail to acknowledge the evidence that adopting MUCR hinders investment and job creation. Even if MUCR results in only a relatively small increase in net corporate tax revenue, there will be significant increases and decreases in tax liabilities for specific businesses. Depending on the industry distribution of winners and losers, adopting MUCR may have a negative impact on a state's overall economy. Moreover, economic theory suggests that any tax increase resulting from adopting MUCR will ultimately be borne by labor in the State through fewer jobs (or lower wages over time) or by in-state consumers through higher prices for goods and services.

  States that use separate entity reporting have experienced higher job growth than have states with MUCR. From 1982-2006, job growth was 6% higher in states without MUCR than in states with it (after adjusting for population changes).[2] Furthermore, MUCR has been found to reduce economic growth, especially when the tax rate exceeds 8%[3] (Maryland's rate is 8.25%).

- **Uncertain Revenue –** Implementing MUCR would have an unpredictable and uncertain effect on Maryland's revenue. The corporate income tax is the most volatile tax in every state in which it is levied, regardless of whether MUCR is employed. A study conducted by the University of Tennessee found no evidence that states with MUCR collect more revenue, and then in a later study found that MUCR may or may not increase revenue.[4] Maryland's own commission found similar uncertainty and volatility, with MUCR increasing revenue in some years and reducing it in others. Maryland presently has five years of data on combined reporting, and, depending on which type of apportionment is used, MUCR may have resulted in less revenue than the State's current corporate income tax structure in two or three of those years.[5] The Indiana Legislative Services Agency

[1] The concept of a "unitary business" is a constitutional requirement that limits the states' authority to determine the income of a multistate enterprise taxable in a state. Due to varying state definitions and case law decisions, the entities included in a unitary group are likely to vary significantly from state to state.
[2] Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Ernst & Young, May 30, 2008, p. 16.
[3] William F. Fox, LeAnn Luna, Rebekah McCarty, Ann Boyd Davis and Zhou Yang, "An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes," University of Tennessee, Center for Business and Economic Research, October 30, 2009, p. 39. Another study by the two lead authors commissioned by the National Conference of State Legislatures reached similar conclusions.
[4] *Ibid*. 3, p. 34.
[5] Andrew Schaufele, Director, MD Bureau of Revenue and Estimates, Report on Combined Reporting to Governor, President and Speaker, March 1, 2013.

conducted a study in 2016 finding that any potential positive revenue impact from adopting MUCR would be only short-term and would likely decline to zero in the long-term.[6]

- **Regional Outlier** – Most of the states that utilize MUCR are west of the Mississippi River or in the Northeast. Apart from the District of Columbia and West Virginia, none of Maryland's neighboring competitor states currently utilizes MUCR, not Virginia, North Carolina, Delaware, or Pennsylvania.

- **Administrative Complexity –** MUCR is, by definition, complex, requiring extensive fact-finding to determine the composition of the "unitary group" and to calculate combined income. This complexity results in unnecessary and significant compliance costs for both taxpayers and the State. Further, the bill inappropriately delegates many details of the administration of the tax that should be codified in Maryland's law. The bill does not clearly specify how the tax should be administered; instead, it gives the Comptroller broad authority to adopt regulations to enforce the collection of the tax using MUCR.

    - *Determining the Unitary Group*: The concept of a "unitary business" is uniquely factual and universally poorly-defined. It is a constitutional (Due Process) concept that looks at the business as a whole rather than individual separate entities or separate geographic locations. In order to evaluate the taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation's operational and tax staff to gather this operational information. In practice, however, auditors routinely refuse to make a determination regarding a unitary relationship on operational information and instead wait to determine unitary relationships until after they have performed tax computations. In other words, the tax result of the finding that a unitary relationship exists (or does not exist) often significantly influences, or in fact controls the auditor's finding. Determining the scope of the unitary group is a complicated, subjective, and costly process that is not required in separate filing states and often results in expensive, time-consuming litigation.

    - *Calculating Combined Income*: Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most MUCR states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In addition to variations in apportionment formulas among the states that apply to all corporate taxpayers, further compliance costs related to MUCR result from variations across states in the methods used to calculate the apportionment factors. From a financial reporting perspective, adopting MUCR is a significant change that requires states to consider ways to mitigate the immediate and negative impact those tax changes have

[6] A Study of Practices Relating to and the Potential Impact of Combined Reporting, Office of Fiscal and Management Analysis, Indiana Legislative Services Agency, October 1, 2016.

on a company's financial reporting.[7]

- **Arbitrary –** Although proponents of MUCR argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under MUCR create new distortions in assigning income to different states. The MUCR assumption that all corporations in an affiliated unitary group have the same level of profitability is not consistent with either economic theory or business experience. Consequently, MUCR may reduce the link between income tax liabilities and where income is actually earned. Many corporate taxpayers may conclude that there is a significant risk that MUCR will arbitrarily attribute more income to a State than is justified by the level of a corporation's real economic activity in the State.

The Comptroller's Entity Inclusion Discretion Fails to Provide Taxpayers with Necessary Certainty

H.B. 295 would also provide the Comptroller with rulemaking authority to determine the inclusion of: (1) a corporation that is not specifically included in the reporting group "to the extent of the corporation's income derived from or attributable to sources within the United States"; or (2) an affiliated corporation that is a controlled foreign corporation. These provisions would give the Comptroller considerable discretion regarding which foreign entities are to be included in the reporting group, allowing the Comptroller to cherry pick among foreign entities to be included. It creates ambiguity as opposed to certainty that businesses need to operate effectively and that is essential to any sound tax policy. It also increases the likelihood that businesses, especially those engaged in multinational operations, will be subject to double taxation.

Conclusion

Studies show that MUCR is the most costly way for the State to raise revenue because of its negative impact on job creation. In addition, the General Assembly's own commission, which was tasked with studying how to improve the State's economy, stated that MUCR should be expressly rejected because the legislature's continued consideration of MUCR discourages business investment in the State.[8] MUCR will not help Maryland attract jobs or investment and should not be adopted.

For all of these reasons, COST urges members of the committee to please vote "no" on H.B. 295.

Respectfully,

Stephanie T. Do

cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director

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[7] ASC 740 (formally FAS 109) requires a recordation of tax expense under certain circumstances that can negatively impact a company's stock price and value.

[8] Report of the Maryland Economic Development and Business Climate Commission, Phase II: Taxes, published January 19, 2016, p. 39.