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Testimony to the Maryland Senate Committee on Budget and Taxation

In Opposition to Senate Bill 596,
New Deduction to Offset Financial Statement Effects of Single Sales Factor Apportionment

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Chair Guzzone, Vice-Chair Rosapepe, and Members of the Committee, the Center on Budget and Policy Priorities appreciates the opportunity to submit testimony in opposition to Senate Bill 596. The Center is a non-partisan, non-profit policy research institute that focuses on the impact of federal and state budgets, programs, and tax policies on low- and moderate-income people.

SB 596 would enact a new corporate income tax deduction that will eventually cause the state to forgo real revenue dollars needed to fund investments in education, health care, transportation, and other vital services in order to offset a purely paper "expense" incurred by a handful of large, predominantly out-of-state corporations. The corporate proponents of this new deduction claim that without it their stockholders will unfairly suffer a "double impact" from Maryland's switch in 2018 to a single sales factor apportionment formula for all corporations. The first impact is the actual increase in Maryland income tax liability an affected corporation will experience. (Many in-state corporations pay less income tax under single sales factor, but some predominantly out-of-state corporations pay more.) The second impact is an alleged drop in the corporation's stock value caused by an increase in the "deferred tax liability" reported on the corporation's financial statements. The proponents seek the new deduction to offset the alleged stock market effect while providing no evidence that it has or will occur – evidence that should be readily available if the claim were true given that some two dozen states have switched to single sales factor apportionment in the past twenty years and the single sales factor bill here was enacted almost four years ago.

While revenue losses from the enactment of SB 596 would not begin for ten years, its approval would establish a dangerous precedent encouraging identical tax break demands in the future by any publicly traded corporation whose effective Maryland corporate tax rate increased due to any type of tax legislation – even legislation that might be revenue-losing overall. This is not a hypothetical concern; the Council on State Taxation (COST), the trade association representing large multistate corporations on state tax policy matters, has adopted an official position that "When enacting significant corporate tax law changes, states must mitigate the immediate and negative impact of those changes on a company's financial reporting" by enacting measures like SB 596 (emphasis added). Indeed, a deferred tax deduction has also been included in the HB 457, this year's bill to mandate the use of unitary combined reporting.

SB 596 is without merit for the following reasons:

- The proposed new deduction is a narrow, special interest tax break for a handful of corporations that only a few other states have approved, and that no taxpayer has yet been able to claim.

- The fundamental rationale for the deduction – an adverse impact on stock values of increased financial statement tax expense – is implausible.

- Proponents of "deferred tax relief" have yet to provide any empirical evidence of a negative effect on stock prices.

- Congress does not include "deferred tax relief" in federal tax legislation with the same impacts on reported financial statement profits.

- Rather than compensating for an adverse "double impact," SB 596 would actually provide a double tax benefit to some companies

- Governments don't compensate corporations for negative financial statement impacts of other changes in public policy.

- "Transition rules" for major tax changes can sometimes be justified, but that is not what SB 596 represents

<u>The proposed new deduction is a narrow, special interest tax break that only a handful of states have approved</u>. According to the Fiscal and Policy Note on the bill, the Comptroller believes that fewer than five large multistate corporations will be able to claim the deduction. Ironically, these corporations suggest that the switch to single sales factor apportionment was uniquely unfair to them, because they alone must publicly report lower financial statement profits due to its effect on their deferred tax accounts. But the opposite is closer to the truth. Many corporations – we do not know how many, because the Fiscal and Policy Note on the single sales factor legislation didn't report it – will experience increased tax liability because of the switch. But only these few companies will be able to reduce that increased liability to some degree by claiming the SB 596 deduction once it becomes available.

More than two dozen states have switched to single sales factor apportionment, but none of them have ever enacted this kind of deduction simultaneously or subsequently. Maryland itself mandated single sales factor apportionment for manufacturers in 2001, but no such corporation experiencing a tax increase due to the switch was granted this break. Six jurisdictions enacted an analogous tax deduction when they adopted mandatory combined reporting, and its effective date was moved back multiple times in three – Connecticut, the District of Columbia, and Massachusetts. (In the other three states, Kentucky, New Jersey and New Mexico, the deduction may not yet be claimed.) A seventh state, Michigan, enacted a similar provision in 2007, but the tax to which it was attached was repealed before the deduction took effect, and proposals to attach the deduction to the replacement tax were rejected.

The rationale for the deduction is implausible. It cannot be emphasized enough that SB 596 will eventually rebate real dollars to eligible corporations to offset the impact of the switch to single sales factor apportionment on how much profit they report – "on paper" – to their stockholders and the public. The "double-impact" justification for the tax break effectively posits that the stock market is incapable of rationally distinguishing between the effect of the tax change on the amount of profit actually retained by the corporation after paying its Maryland corporate income tax and the effect on the corporation's financial statement profit. But there are scores of highly-skilled and highly-compensated stock market analysts whose job is to do precisely that – to make adjustments for the many arbitrary line-drawings entailed in preparing financial statements under Generally Accepted Accounting Principles and thereby develop an accurate picture of the recent and likely future economic performance of the corporation. Individual investors may not have access to this kind of sophisticated analysis, but institutional investors certainly do, and their buying and selling activity in the stock market drives stock pricing.

The claim that the stock valuations of corporations reporting an increase in deferred tax liabilities (or a decrease in deferred tax assets) due to state corporate tax increases are harmed is even more implausible when one considers the magnitudes typically involved. In testifying in support of SB 458, the 2019 predecessor to this bill, the representative of NextEra Energy – the corporation that seems to have taken the lead in pushing for this tax break nationally – stated that the adjustment to the company's deferred tax asset/liability accounts resulted in a reduction in reported Maryland profits of "millions of dollars." Yet NextEra reported $4.3 billion in profit from current operations nationally in 2018. Given that the current stock value of the company is driven overwhelming by its future earnings prospects – which in turn depend on the vagaries of the world economy and world energy markets and a host of other idiosyncratic factors – it is hard to believe that an additional financial statement expense in the "millions of dollars" could have any discernible impact on the stock value of a company this large.

Proponents of "deferred tax relief" have yet to provide any empirical evidence of a negative effect on stock prices. Roughly two dozen states have switched to single sales factor apportionment in the past two decades without enacting the type of deduction included in SB 596. Roughly a dozen have switched from separate-entity corporate taxation to combined reporting without enacting the deduction. If the stock market value claim were true, surely these shifts in tax policy would provide evidence that proponents of deferred tax relief would be citing. In its testimony in support of SB 458, NextEra stated that upon the enactment of single sales factor legislation in Maryland in 2018 it did, in fact, report an immediate additional tax expense in the "millions of dollars." Yet it has not provided any evidence that that expense negatively affected its stock value in the four years since.

Congress does not include "deferred tax relief" in federal tax legislation. Center staff and other experts consulted are unaware of Congress ever having been lobbied for "deferred tax relief" in connection with federal tax policy changes that can have the same kinds of effects on corporate deferred tax accounts and financial statement tax expense as those created by state tax policy change. Nor are we aware of any official policy statements from organizations of private sector federal tax practitioners comparable to COST's asserting that corporations are entitled to such relief. This is despite the fact that federal tax policy changes can result in increased tax expense on corporate financial statements many times larger than those resulting from changes in state tax policies. Indeed, following the enactment in late 2017 of the federal Tax Cuts and Jobs Act, several articles appeared describing how the law forced multi-billion- dollar reductions in reported financial statement profit for some companies -- $22 billion in the case of Citigroup, for example ("Trump's

Tax Cuts Will Play Havoc with Reported Earnings," Mondaq, April 19, 2018). Perhaps federal tax lobbyists for corporations perceive that Congress has more tax policy staff familiar with the nuances of tax calculation and financial statement tax accounting than states do and therefore anticipate a more skeptical reception to demands for a federal tax break analogous to the one in SB 596.

<u>Rather than compensating for an adverse "double impact," SB 596 would actually provide a double tax benefit to some companies</u>. Evidently believing that the stock market is, in fact, irrational, corporate managers often try to boost the near-term profits they report to stockholders by calculating the income tax expense reported on their financial statements as if they were writing off ("depreciating") their plant and equipment investments evenly over time while calculating their actual tax liability using "accelerated depreciation" that allows them to "bunch" depreciation deductions in the years immediately after the asset is purchased. (This up-front bunching of depreciation expense of course means that they end up deducting less annual depreciation in later years than they otherwise would have.)

The ability to claim accelerated depreciation in calculating tax liability is a valuable tax break that provides a real economic benefit to the company – the additional taxes saved up front are like an interest-free loan from the government. They are more valuable than the higher taxes paid later because of the time value of money.

The divergence between "book" and "tax" depreciation is probably the most common reason a corporation would have to report a one-time increase in its tax expense when a state tax policy change increases its effective state corporate tax rate. Thus, it is ironic that corporate representatives are claiming that SB 596 is needed to compensate for an adverse double impact on corporate profitability. The reality is closer to the opposite. Corporations elected to receive the real economic benefit of claiming accelerated depreciation in calculating their taxes, and then, when the combination of that choice and a change in state tax policy forces a reduction in reported financial statement profitability, they are demanding an additional offsetting tax deduction that will also reduce their real tax liability.

<u>Governments don't compensate corporations for negative financial statement impacts of other changes in public policy</u>. Corporations run numerous risks that real-world conditions will change in ways that will reduce their profitability. Consumers can decide they prefer one of their competitor's products to theirs. A flood or fire can wipe out access to a key production input. A court can rule that a flaw in their product design harmed customers. Or, as we have seen recently, ports can become overwhelmed by a surge of demand for products manufactured overseas – delaying their ability to obtain crucial production inputs.

Another risk that corporations run is that public policies affecting them will change in an adverse way. Congress can impose more stringent pollution control requirements. The Federal Reserve can increase their borrowing costs. If these changes are large enough, they can impose not only direct costs on the companies but also force them to write down the value of certain assets on their financial statements. Although the direct costs incurred as a result of the changes would typically be deductible in calculating income tax liability, governments don't compensate the corporations for the secondary financial statement impacts. Accordingly, it is unclear why states should compensate corporations for the financial statement impact of a corporate tax increase as SB 596 would do.

"Transition rules" for major tax changes can sometimes be justified, but that is not what SB 596 represents. A legitimate case can sometimes be made that major corporate tax policy changes justify certain kinds of transition rules to mitigate inequities created when corporations that made investment decisions under one set of tax rules now confront a different set of tax rules. For example, a corporation can make a major facility investment where the depreciation deductions will be so large as to put the company into a loss situation for a number of years. The company makes the investment in anticipation that it will be able to use those losses to offset profit in later years, but then the state repeals its corporate income tax and substitutes a gross receipts tax. A legitimate argument can be made that a transition rule should perhaps allow the corporation to carry back the losses instead or be able to deduct them against the gross receipts tax going forward.

But the new tax deduction that SB 596 would grant is not a transition rule. If it were, it would be made available immediately (rather than with a 10-year delay) to all corporations that will experience a higher tax liability due to the switch to single sales factor apportionment rather than just publicly-traded corporations with the financial statement impacts discussed previously. It should be seen for what it is – a special interest tax break being justified on dubious conceptual grounds and with no empirical support being offered for its central claim of an adverse stock value impact.

For all these reasons, I respectfully request an unfavorable report on SB 596. Although it has been structured to avoid an immediate adverse impact on Maryland's revenues, its enactment would set a precedent for attaching the same tax break to any future legislation that increases the effective tax rate for any publicly-traded corporation with net deferred tax liabilities. With the precedent established, future sessions of the General Assembly would be hard-pressed to justify not granting it in all similar circumstances – perhaps with much more immediate and serious revenue impacts.

Thank you.