Center on Budget and Policy Priorities

1275 First Street NE, Suite 1200
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

Testimony Of
Michael Mazerov, Senior Fellow, Center on Budget and Policy Priorities

Before the
Maryland Senate Budget and Taxation Committee

Hearing on S.B. 360, Corporate Tax Fairness Act of 2022
February 9, 2022

Chair Guzzone, and Members of the Budget and Taxation Committee, I am Michael Mazerov, a Senior Fellow with the State Fiscal Policy division of the Center on Budget and Policy Priorities in Washington, D.C. The Center is a non-partisan research and policy institute that pursues federal and state policies designed to reduce poverty and inequality and to restore fiscal responsibility in equitable and effective ways. We apply our expertise in budget and tax issues and in programs and policies that help low-income people to help inform debates and achieve better policy outcomes. I appreciate the opportunity to submit testimony in support of S.B. 360, Senator Pinsky's bill to mandate the use of combined reporting and adopt the throwback rule for the corporate income tax.

Combined Reporting Is Needed to Nullify Forms of Corporate Tax Sheltering to Which Maryland Remains Vulnerable

Combined reporting remains an essential tax policy reform for Maryland if it is to have a fair and robust corporate income tax. Year in and year out, the state suffers significant erosion of its corporate tax base because of corporate tax avoidance techniques that exploit the absence of combined reporting. Several of these strategies cannot be stopped at all — or in a sufficiently cost-effective manner for it to be realistic — through any policy reform other than combined reporting.

Let me give you one example, which goes by the name of "entity isolation." That strategy is used when, for example, an out-of-state manufacturer with Maryland sales needs to have some physical presence in Maryland (for example, to train its customers' employees how to use its products), but the manufacturing itself is done outside the state. The corporation forms a separate subsidiary to employ the people that must enter Maryland, but the profit on the sale in Maryland of the manufactured items themselves remains locked in the out-of-state manufacturing arm that Maryland cannot tax because of a federal law that bars the state from taxing companies that only solicit sales here (Public Law 86-272). Entity isolation is Corporate Tax Avoidance 101, it is perfectly legal, and it prevents Maryland from taxing profits that are earned through sales to Maryland customers. Maryland enormously increased the incentive for out-of-state manufacturers to shelter their income in this way when it enacted a single sales factor apportionment formula for them two decades ago.

We know that entity isolation is a widespread corporate tax shelter that is likely costing Maryland substantial revenues thanks to the data that the state compiled for several years from hypothetical (or "pro-forma") combined reporting returns mandated by 2007 legislation. Those data showed that the so-called "Finnigan" version of combined reporting would have raised substantially more revenue for the state than would the alternative, so-called "Joyce" approach. The Finnigan version of combined reporting embodied in S.B. 360 nullifies entity isolation, while the Joyce approach does so only partially.

Another example of a tax avoidance strategy to which Maryland remains vulnerable because it does not require combined reporting comes from a current tax case in Florida involving Target Corporation. Target has set up a subsidiary at it headquarters location in Minnesota that employs the people who engage in such activities as market research, promotional events, advertising development, brand strategy development and implementation, and community relations. The subsidiary charges the stores fees for all these activities, which are deductible and have the effect of siphoning income out Target's stores. In a combined reporting state, this strategy leads to no tax savings, because the profit of this subsidiary will be combined prior to apportionment with the profit of the parent, which owns the stores. However, because, like Maryland, Florida does not require combined reporting, it has been forced to engage in a convoluted strategy to try to tax the income of the marketing subsidiary directly (which is what is being challenged in court). The strategy may work, because, fortuitously, this subsidiary has some employees who telework in Florida. Maryland may not be so lucky and may well be losing revenue from every Target store in the state that are also presumably paying marketing fees to the same subsidiary. It is also important to note that Maryland's "intangible addback" law, which is often cited by combined reporting opponents as wholly adequate to protect the state's tax base, is completely ineffectual under this scenario because the Target subsidiary is charging the stores a fee for marketing services, not a royalty for the use of its trademarks.

Combined Reporting Will Help Level the Playing Field – Especially for Small Corporations

Needless to say, not many small businesses have the resources or sophistication to set up and operate the kinds of tax avoidance strategies just described that require multistate operations or the formation of subsidiaries in low- or no-tax states. But small corporations often compete with large corporations that can do this. Large corporations that are willing and able to engage in this kind of aggressive tax avoidance may be able to attract capital at a lower cost than their in-state competitors or use their tax savings to undercut the prices of smaller corporations. By nullifying many forms of tax avoidance, combined reporting can thus help smaller, locally based corporations compete on a more level playing field and thereby preserve more local jobs.

Furthermore, by no means do even all large corporations engage in aggressive income-shifting strategies. They may not be well-positioned to do so because, for example, they do not own significant valuable intangible assets, or because they are service businesses that are not covered by Public Law 86-272 and cannot easily engage in "entity isolation." Or it may simply be the case that the company's culture does not prioritize aggressive tax avoidance. Regardless, states simply should not maintain a tax structure that gives unfair advantage to those companies most willing and able to push the envelope, but that is precisely what not requiring combined reporting does.

Not Requiring Combined Reporting Is Inconsistent with States' Use of Formula Apportionment to Tax Multistate Corporations

Tax avoidance potential aside, not requiring combined reporting is fundamentally inconsistent with the way states tax multistate corporations. As you know, states do not seek to measure the profits realized on the sale of specific items within their borders. This would require the tracking of the receipts from the in-state sale of specific products and the specific expenses incurred in supplying those goods and services. Not only would that be an administrative nightmare for companies to comply with and for states to audit, it would also be fraught with conflict because there is no objective way to assign to a specific state overhead expenses that are shared among all production locations or the savings in expenses arising from economies of scale. That is why states use a formula to assign to themselves a reasonable share of the nationwide profit of a multistate corporation. But not requiring combined reporting is conceptually inconsistent with formula apportionment. As soon as a state recognizes for tax purposes the profit reported by geographically isolated entities merely because they are separately incorporated, it has nullified what it was trying to achieve through the use of formula apportionment.

As it did decades earlier with respect to formula apportionment, the U.S. Supreme Court twice upheld the constitutionality of combined reporting as a reasonable and fair means of determining the share of a multistate corporation's income a state may tax. The same cannot be said of some of the other approaches to preventing abusive interstate income-shifting that are sometimes put forward as alternatives to combined reporting – such as intangible addback laws.

A Growing Number of States Are Recognizing the Benefits of Combined Reporting

Whether or not to require combined reporting is a key policy choice that is relevant to the tax systems of 45 states plus the District of Columbia (all states except Nevada, Ohio, South Dakota, Washington, and Wyoming). More than three-fifths of those jurisdictions — 28 plus DC — have recognized the compelling case for combined reporting and now require it. Twelve states and DC have enacted combined reporting in the last 15 years – a rapid rate of adoption for such a significant change in state tax policy. Combined reporting has long been required and non-controversial in many generally Republican-controlled states, including Alaska, Arizona, Utah, Idaho, Montana, Kansas, and Nebraska. It was a Republican Governor, Jim Douglas, who started the post-2004 wave of combined reporting adoption with his (fulfilled) recommendation that Vermont switch. Combined reporting was enacted under Republican Governor Matt Bevin and a Republican-controlled Kentucky legislature in 2018.

Combined Reporting and State Economic Growth

Over the many years that the adoption of combined reporting has been considered in Maryland, members of this committee have undoubtedly heard claims that it would discourage corporations from investing in the state in the future and perhaps even cause corporations already here to leave. These claims should be given little credence. Between 2008 and 2010, I conducted research in four states to document all the states in which the largest private sector employers in those states maintained physical facilities, unquestionably subjecting them to those states' corporate income taxes. The most recent study I did looked at Maryland's largest 120 largest corporations (as measured by their Maryland employment). I found that a large majority of those companies quite willingly subjected themselves to combined reporting in other states:

- At least 108 of the 120 largest Maryland employers maintained facilities in at least one combined reporting state or were members of a corporate group that had a facility in at least one combined reporting state. The "compliance burdens" and additional tax liability arising from combined reporting could not be that unreasonable if these companies — or the parent corporation that controls their decision-making — willingly maintained a facility in one or more combined reporting states.

- A large majority of the corporations I examined maintained facilities in multiple combined reporting states. Three-fourths of them — 90 out of 120 — had facilities in five or more combined reporting states. More than half — 67 out of 120 — had facilities in ten or more such states, and more than one-fourth — 34 out of 120 — had facilities in 20 or more combined reporting states.

- Eighteen companies had facilities in all 23 states that mandated combined reporting at that time.

- Ninety-three had a facility in California, the state that pioneered combined reporting and — as any corporate tax manager will attest — enforces it most aggressively.

- Thirty-two of the companies maintained their headquarters in combined reporting states.

I found comparable results in my Iowa, North Carolina, and New Mexico studies, as did two other organizations that conducted similar research in Connecticut and Wisconsin.

If corporations willingly subjected themselves to combined reporting in other states year-in and year-out, there simply is no reason to believe that they would shun Maryland as a place to invest were it to adopt combined reporting.

I have also looked at the record of combined reporting states in retaining manufacturing jobs. This may be a reasonable indicator of whether combined reporting has a negative impact on the attractiveness of a state for investment, since manufacturers in theory do not need to be as close to their customers as retailers, construction contractors, and other types of service businesses need to be and therefore can choose to locate where state and local tax policies are more to their liking. These data show that combined reporting states do no worse in manufacturing job retention and growth than separate filing states do. (I excluded from this analysis those states that do not levy a corporate income tax at all.)

Four of the five states with the highest rate of manufacturing job growth over the 10 years prior to the pandemic required combined reporting throughout the period, as did the state with the highest rate of manufacturing job growth – Michigan. Twenty-one states with corporate income taxes experienced at least 10 percent manufacturing job growth over the past 10 years. Eleven of the 21 had combined reporting in effect throughout the period, and a twelfth state had enacted but not yet implemented it. Thirty-six states had net positive manufacturing job growth over the past 10 years; 19 of them had combined reporting in effect throughout. In short, there is no obvious correlation between a state's adoption of combined reporting and its relative success in attracting or retaining the most potentially footloose firms and their jobs.

Nor does academic research demonstrate that combined reporting has an adverse impact on state economic performance. For example, a 2007 study concluded that "there is no evidence that these [combined reporting] requirements diminish economic activity in states." A 2012 study actually found that "States with more aggressive corporate income taxes, specifically those that include combined reporting requirements, tend to have higher entrepreneurship rates." A 2014 study concluded that "Combined reporting has no discernable effect on personal income, G[ross]S[tate]P[roduct], or employment after controlling for tax rates, apportionment, and throwback rules." A 2016 study found that "Other tax policy measures (the throwback rule, required combined reporting, the personal income tax, and corporate license fees) are typically statistically insignificant" in affecting corporate investment in states. As with many subjects, studies can be found on both sides of the question; a 2003 study found that "The effect of the income tax burden on [corporate investments in] property is more pronounced for states mandating [combined] unitary taxation" (although it should be noted that the analysis only covered a period up to 1996 and misclassified three combined reporting states as having not adopted the policy.)

There is a good explanation for why combined reporting does not appear to have a significant impact on state economic and job growth one way or the other. All state and local taxes paid by corporations represent on the order of 2-4 percent of their total expenses, on average. State corporate income tax generally represent less than 10 percent of that already small share. And most states that have prepared estimates predict that requiring combined reporting will boost corporate tax collections between 10 and 20 percent. It therefore should not be surprising that the evidence just cited suggests that combined reporting has not been a disincentive for corporations to continue investing and creating jobs in states that adopt it.

The Alleged "Complexity" of Combined Reporting

Corporate opponents of combined reporting also object that combined reporting is complex and burdensome to comply with, particularly because of the subjectivity entailed in determining which subsidiaries of a multi-corporate group are and are not engaged in a so-called "unitary business" with the parent and/or subsidiaries subject to corporate income tax in a state. Such a claim compares combined reporting to the current system under which the state is largely powerless to stop many forms of interstate income shifting. If the state actually had the resources and attempted to adjust the prices that one member of a corporate group located in Maryland charged and/or paid other out-of-state members for intra-corporate sales of goods and services to prevent such shifting, then the subjectivity, litigation, and compliance burden flowing from such an effort would exceed that of combined reporting many times over.

Corporations already file consolidated tax returns for federal tax purposes and consolidated financial statements for financial reporting purposes; they know how to do the accounting. The only potential complexity that arises from combined reporting is determining which corporations are and are not part of the unitary group. As discussed previously, most major corporations are filing combined reporting-based tax returns in numerous states, so they appear to be figuring out how to do that. That said, Maryland could consider emulating Massachusetts and several other states by allowing corporations to make a long-term election to determine the combined group strictly base on common ownership with no subjective determination of whether a particular subsidiary is part of a "unitary business." Such an election eliminates <u>any</u> argument that combined reporting imposes a significant or unreasonable compliance burden on corporations. (It must be offered as an election

because the courts have held that combined reporting can only be mandated when the related corporations are economically integrated or "unitary.")

Regarding the issue of state enforcement burdens, it is only necessary to observe that small population states with small revenue department staffs – states like Alaska, Idaho, Montana, New Hampshire, and Maine – have managed to successfully administer combined reporting-based corporate income tax structures for decades.

Finally, opponents of combined reporting sometimes argue that combined reporting will be burdensome and should not be enacted in a state because other combined reporting states have divergent laws concerning which kinds of corporate subsidiaries are included in the combined group and other fine points of the policy. This is a red herring and a disingenuous argument. Maryland cannot be responsible for divergent policy choices that other states have made nor should it reject an otherwise sound tax policy change because of those choices. The multistate corporate tax community is free at any time to encourage combined reporting states to harmonize their combined reporting laws to reduce business compliance burdens.

Adoption of Combined Reporting Is Long Overdue

The enactment of combined reporting can make an important contribution to preserving Maryland's tax base from further erosion and ensuring that multistate and multinational corporations compete on a level playing field with their counterparts that do not seek to push the tax-avoidance envelope and with wholly in-state corporations. It will generate additional revenue with which to finance public investments in education, as confirmed by the fiscal note for this bill. Additional investment in education is critical to Maryland's economic future, and it will benefit Maryland businesses as well as Maryland families. Maryland's adoption of combined reporting is long overdue.

Maryland Should Also Enact a "Throwback Rule"

S.B. 360 would also incorporate the "throwback rule" into Maryland's corporate tax code. The rule deems sales of goods ("tangible personal property") made by Maryland manufacturers, wholesalers, and retailers to be Maryland sales for corporate income tax apportionment purposes if they are delivered from Maryland into a state in which the seller does not have enough physical presence to be subject to its corporate income tax. As noted in passing above, a 1959 federal law, Public Law 86-272, decrees that a seller of tangible personal property cannot be subjected to a state's corporate income tax if it has no physical presence in the state or if its physical presence is limited to salespeople who do no more than solicit orders.

The goal of the throwback rule is to prevent corporations from having "nowhere income" – profit that can't be taxed by any state. Under Maryland's current apportionment formula, a Maryland manufacturer organized as a corporation with all its property and employees in Maryland but no physical presence in any other state would pay no taxes anywhere on any of its profit.

Public Law 87-272 enshrines bad public policy. Just as the Supreme Court finally recognized in the 2018 *Wayfair* decision that physical presence shouldn't be a requirement for sales taxation, it shouldn't be a requirement for income taxation either. Nonetheless, states are stuck with Public Law 86-272 for now. The creation of the throwback rule and its inclusion in the "Uniform Division

of Income for Tax Purposes Act" reflected an agreement among the states to collectively address limits on their ability to impose income taxes on corporations with no physical presence within their borders and the "nowhere income" that results from those limits. States essentially said: "Let's make a deal. You'll tax the profits of your corporations selling into my state without a physical presence, and I'll tax the profits of my corporations selling into your state. We should roughly get the same amount of revenue, and corporations won't avoid taxes they should legitimately be paying to one of us." More than half the states with corporate income taxes honor that deal; Maryland should join them.

Individual taxpayers subject to personal income taxes can't have "nowhere income." I live in Maryland but earn my entire salary in the District of Columbia. Congress has enacted a law that says that the District is not allowed to tax my income. Do I have "nowhere income?" Of course not; Maryland taxes my entire salary. So how can it be fair that, thanks to Congress's enactment of Public Law 86-272, a Maryland manufacturer earning all its income by selling to customers located in DC can have all its income be untaxed by either Maryland or DC? Clearly, it isn't fair. I and other Maryland taxpayers pay higher taxes or experience reduced services to compensate for the revenue lost due to corporations' nowhere income. This bill eliminates this unfairness with a few simple sentences of statutory language.

Now, if the state adopts the Finnigan approach to combined reporting included in this bill, the throwback rule will be somewhat less necessary and will generate less revenue. Under Finnigan, there is no throwback if *any* member of the corporate group has nexus in a state in which it makes sales. Nonetheless, even with Finnigan-based combined reporting in effect, there can still be some states in which none of the combined group members have nexus, and throwback of sales from those states is appropriate. Likewise, under combined reporting there will still be corporations that are a single legal entity that may not have nexus in one or more states in which they have sales, and throwback is still needed to eliminate nowhere income of such corporations.

In conclusion, I respectfully urge the Committee to favorably report S.B. 360. I thank the Committee for the opportunity to submit written testimony. I may be reached at mazerov@cbpp.org if committee members have any questions.