HB 321
Uploaded by: Angela Pitale
Position: FAV

Madame Chair and Members of the Committee:

Thank you for the opportunity to express our support for House Bill 321, which would provide a technical amendment to allow certain companies impacted by the financial restatement of corporate tax liabilities due to the implementation of Single Sales Factor to reverse the unintended impact through Deferred Tax Relief.

Just a quick word about NextEra Energy Resources and our activity here in Maryland. NextEra Energy Resources is an affiliate of Juno Beach, Florida-based NextEra Energy, Inc., one of the largest clean energy companies in the country. NextEra Energy Resources, together with its affiliated entities, is the world's largest generator of renewable energy from the wind and sun and a world leader in battery storage. We've been a wholesale and retail energy supplier in Maryland for many years, selling a significant volume of energy primarily through the state's Standard Offer Service program, and we're presently developing several hundred megawatts of solar energy. We've always viewed Maryland as a positive place in which to invest and do business, and look forward to doing business here for many years to come.

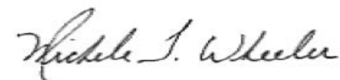
For certain companies with a significant volume of sales in Maryland, single sales factor apportionment results in a higher apportionment factor in Maryland which can expose them to higher taxation in two ways. First through a greater tax assessment itself – the amount that is reflected on the Maryland corporate income tax return each year. The second – an unintended consequence – requires publicly traded companies subject to Generally Accepted Accounting Principles (GAAP) to revalue their deferred tax assets and liabilities upon enactment of a change in tax law, like Single Sales Factor apportionment. It's this issue that the bill is specifically designed to address. To be clear, as the fiscal note states, there will be no immediate fiscal impact to the state.

This bill does not modify in any way the application of single sales factor apportionment, which is in effect today for corporate tax filers. The Maryland-based companies that benefit from single sales factor – the rationale behind implementing single sales factor – will continue to do so, and all taxpayers required to use single sales factor will continue to be required to do so. This bill does not attempt to re-legislate or modify the substance of single sales factor, nor carve anyone out of its application.

Rather, it provides companies that experienced that unintended financial statement impact with what is called "deferred tax relief". In essence, the state grants a deduction necessary to offset the negative financial statement impact, to be used in the future – at a time of the legislature's choosing. It's a relatively well known practice used in other states when a major change in corporate taxation occurs, the most recent being in New Jersey in 2018 and New Mexico in 2019.

This proposal is supported by the Maryland Chamber of Commerce, Council on State Taxation (COST), as well as other companies, including AT&T and Verizon. We also want to reiterate that the bill is to be scored by the Comptroller as having no fiscal impact.

We want to thank Delegate Luedtke (and Chairman Guzzone in the Senate) for their support and sponsorship. We thank the Committee for their consideration and look forward to answering any questions you might have.



Michele Wheeler
VP Regulatory and Political Affairs
NextEra Energy Resources

HB 321_MDCC_Corporate Income Tax - Single Sales Fa

Uploaded by: Maddy Voytek

Position: FAV

LEGISLATIVE POSITION:
Favorable
House Bill 321
Corporate Income Tax – Single Sales Factor Apportionment – Deferred Tax Relief
House Ways and Means

Wednesday, February 2, 2022

Dear Chairwoman Atterbeary and Members of the Committee:

Founded in 1968, the Maryland Chamber of Commerce is the leading voice for business in Maryland. We are a statewide coalition of more than 5,500 members and federated partners working to develop and promote strong public policy that ensures sustained economic recovery and growth for Maryland businesses, employees, and families.

HB 321 provides taxpayer relief for adverse financial reporting impacts resulting from the transition to single sales factor apportionment. Tax law changes such as this can have immediate and negative impacts on a taxpayers' financial reporting by creating new financial statement expenses and changing a company's tax liability. The modest deduction provided in HB 321 can help mitigate these negative impacts.

Any significant change in tax laws (such as the adoption of single sales factor apportionment), will require companies to re-calculate the value of tax assets or liabilities they had previously recorded. This recalculation requires a company to record additional tax expenses under the relevant financial accounting rules. Recognizing these expenses may result in an immediate adjustment of the company's stock price and value.

HB 321 provides these taxpayers with a deduction that is spaced out over ten years to help mitigate any negative effects that resulted in the adoption of single sales factor apportionment. This bill is a great example of Government being proactive and supportive of Maryland's many employers by ensuring that business owners do not suffer from both increased tax payments and a reduction in market value.

With these comments in mind, the Maryland Chamber of Commerce respectfully requests a **favorable report** on **HB 321**.

MDCHAMBER.ORG
60 West Street, Suite 100, Annapolis 21401 | 410-269-0642

STRI - June 2020 Paper (SSF).pdf
Uploaded by: Rob Garagiola
Position: FAV

Provided by: Rob Garagiola, Compass Advocacy
HB 321
Wedn. 2/2, W+M Committee
(301) 801-9678
RGaragiola@CompassAdvocacy.com

STRI
State Tax Research Institute

Mitigating the Impact of State Tax Law Changes on Company Financial Statements

PREPARED BY
LAUREN A. COOPER
WEST VIRGINIA UNIVERSITY
LAUREN.COOPER@MAIL.WVU.EDU

JOEL W. WALTERS
JWALTERS_97@YAHOO.COM

JUNE 2020

ABOUT STRI

The State Tax Research Institute (STRI) is a 501(c)(3) organization established in 2014 to provide educational programs and conduct research designed to enhance public dialogue relating to state and local tax policy. STRI is affiliated with the Council On State Taxation (COST). For more information on STRI, please contact Douglas L. Lindholm at dlindholm@cost.org. © STRI 2020

ABOUT THE AUTHORS

Dr. Lauren A. Cooper, Ph.D., C.P.A. is an assistant professor of accounting in the John Chambers College of Business and Economics at West Virginia University. Her primary research interests are in the areas of corporate taxation, robotic process automation, and corporate social responsibility. Dr. Cooper's research has been accepted for publication at *Accounting Horizons*, *Business & Society*, and *Review of Quantitative Finance and Accounting*. Her research has also been presented at various accounting research conferences, including the American Accounting Association Annual Meeting and the National Tax Association Conference on Taxation. Dr. Cooper earned a Doctor of Philosophy in business administration, an M.S. in accounting, and a B.A. in mathematics from Oklahoma State University. She is licensed as a Certified Public Accountant in the state of Oklahoma and was awarded the gold medal award by the Oklahoma Society of Certified Public Accountants. She is a member of the American Accounting Association and serves on the board of directors of the West Virginia Tax Institute.

Joel W. Walters, J.D., LL.M., C.P.A. most recently served as Director of the Department of Revenue of the State of Missouri, a role he held from April of 2017 until March of 2019. Prior to his stint in public service, Joel served as a partner at PricewaterhouseCoopers in Washington DC and New York City responsible for leading the Firm's tax practice serving foreign companies investing into the United States. Prior to PwC, Mr. Walters served in numerous senior finance roles in large multinational corporations over a twenty-year period. This included twelve years with Diageo plc (and its predecessor Grand Metropolitan plc), culminating as Group Tax Director in Diageo's global headquarters in London, UK. The remaining eight years included several senior finance roles with Vodafone plc in London, ultimately serving as Corporate Finance Director responsible for Vodafone's global tax and treasury functions. Mr. Walters specializes in finance strategy and operations, including tax, treasury and M&A. He has broad experience in corporate roles, professional service firms, and government. In these roles he has gained significant expertise in policy matters related to issues of importance to businesses (in particular taxation) from the perspectives of both the public and the private sectors. He has a BA in accounting from Gustavus Adolphus College, a JD from the University of Minnesota Law School, an LLM in Taxation from Georgetown University Law Center, and is a licensed CPA in the State of Minnesota.

TABLE OF CONTENTS

EXECUTIVE SUMMARY 4

INTRODUCTION 6

DIFFERENCES BETWEEN FINANCIAL AND TAXABLE INCOME 7

ACCOUNTING FOR INCOME TAXES IN THE FINANCIAL STATEMENTS 8

THE IMPACT OF UNANTICIPATED CHANGES IN STATE TAX LAWS ON DEFERRED TAX ACCOUNTS 9

FINANCIAL REPERCUSSIONS ON COMPANIES AND OTHER STAKEHOLDERS 11

- CORPORATE STOCK PRICES ARE DRIVEN BY EXPECTATIONS 11
- THE COMPLEXITY OF TAX ACCOUNTS 12
- STATE TAXATION IS PRONE TO UNPLANNED EVENTS 12
- THE SIGNIFICANCE TO COMPANIES AND OTHER STAKEHOLDERS 13

SEVERAL JURISDICTIONS HAVE PROVIDED A DEDUCTION FOR DEFERRED TAX CHANGES 14

CONCLUSION 15

APPENDIX 16

EXECUTIVE SUMMARY

- Major changes in state tax law enacted by a state legislature can have significant and unintended consequences on the financial statements of publicly traded companies operating in the state, which can result in a reduction in earnings and a failure to meet market expectations.
- Publicly traded companies are legally required to keep records and compile financial statements using two methods: 1) "book" reporting, based on Generally Accepted Accounting Principles (GAAP) mandated by the U.S. Securities and Exchange Commission (SEC); and 2) "tax" reporting, based on the Internal Revenue Code (promulgated by Congress and administered by the Internal Revenue Service) and state income tax statutes, which typically conform to all or a significant portion of the Internal Revenue Code.
- Book or financial reporting under GAAP is premised on the need to provide consistent financial information about the company that is useful and helpful to current and potential investors and creditors.
- Tax reporting relies on the calculation of "taxable income" which is used to calculate a company's income tax liability on its federal and state income tax returns. The objectives of tax statutes are generally two-fold: 1) generate sufficient revenue for the spending needs of government; and 2) influence taxpayer behavior and levels of economic activity by incentivizing current and future investment.
- Accounting Standards Codification (ASC) 740 under GAAP requires companies to calculate and report taxes payable for the current period and the cumulative impact of the amount of taxes the company is expected to report for future periods. These amounts are carried on the GAAP balance sheet as either deferred tax assets (DTAs) or deferred tax liabilities (DTLs) and result from differences between book calculations and tax calculations.
- Significant and unanticipated changes to state tax laws, such as a legislative change to adopt combined reporting or to modify the state's apportionment formula, will trigger an immediate revaluation of a company's deferred tax balance sheet accounts. This in turn will impact the current period reporting of company earnings on the company's book income statement.
- This cumulative adjustment relates to transactions and activities that occurred prior to the law change and therefore were not, and never will be, reported in the company's state tax returns. Thus the adjustment disproportionately impacts a company's earnings.
- The most immediate and significant effect of an unplanned negative adjustment to a company's deferred tax accounts is downward pressure on the trading value of the company's stock arising from a failure to meet market expectations.
- An unanticipated reduction in share price has far-reaching implications for a company and its investors, and in addition to value, may also impact debt covenants, performance targets built into contracts with partners and suppliers, and merger and acquisition transactions, among others.

- Numerous states which previously enacted significant state tax changes have mitigated the unanticipated downward impact on a company's share price by allowing affected companies a future tax deduction equivalent to the change in deferred tax balances. The deduction provides an offset to the unexpected financial reporting impact.
- Such a deduction ("ASC 740 deduction") allows a company to immediately neutralize the GAAP impact of the legislative change without immediately affecting taxable income or state tax revenues.
- Federal tax changes do not require similar treatment because they are typically factored into earnings projections by management and analysts during the drafting and tax-writing stages of the federal legislation.
- State tax law changes are much more difficult to predict and/or anticipate. The sheer number of jurisdictions, the frequency of legislative proposals, and the uncertainty surrounding actual enactment and scope make it much more likely that a change in state tax laws will be a surprise event to management, market analysts, and other stakeholders.
- State legislators should strive to build a tax system predicated on fundamental notions of sound tax policy, including such core principles as fairness, neutrality, and stability. Conversely, a state with a tax system that exacerbates uncertainty and unpredictability in its application is a poor candidate for public companies seeking to expand or relocate.
- Enactment of an ASC 740 deduction as an integral part of a significant state tax change is an appropriate and necessary response to mitigate the financial statement uncertainty for publicly traded companies generated by the tax law change.

INTRODUCTION

When a state overhauls its tax laws, the effects of the change often have significant and unintended consequences on companies that operate in that state, wholly separate from the revenue impact. In particular, publicly traded companies are legally required under U.S. GAAP to record an adjustment in their financial statements for the effect of the change in tax laws on their deferred tax accounts. This adjustment directly impacts the amount of earnings reported on company income statements in the period the change in tax law is enacted. When adoption of such legislation is unexpected, the resulting downward adjustment in earnings can impact company projections and potentially lead to a significant decline in share price for failing to meet market expectations. This fall in share price results in a real loss of value for the company and its shareholders.

Due to the significance of the financial effects that unanticipated changes in tax policy at the state level can have on companies, state legislators should include provisions that mitigate these unintended consequences in the form of a deduction in an amount that offsets the financial statement impact of the deferred tax adjustment. Much study has been devoted to the sound tax policy principles that should guide policy makers in developing tax laws within a jurisdiction.[1] Taxpayers and taxing jurisdictions are equally well-served when policy makers abide by these principles—and mitigation of the unintended financial effects on companies as described herein is a positive and welcome policy achievement.

[1] Refer to the Appendix for published examples of sound tax policy principles in tax policy development.

DIFFERENCES BETWEEN FINANCIAL AND TAXABLE INCOME

Rarely, if ever, are the dollar amounts that a public company reports as earnings on its income statement equal to the dollar amounts reported as taxable income on company tax returns over the same period. This disparity is driven by the fact that companies are legally required to compute income using two unique sets of rules, each designed to meet different underlying objectives. Financial (or "book") income refers to the earnings a company reports on its income statement for financial reporting purposes. Publicly traded companies in the U.S. must determine their financial income in accordance with Generally Accepted Accounting Principles (GAAP). The objective of GAAP is to provide financial information about the company that is useful to current and potential investors and creditors in making resource allocation decisions to the business.[2] Information is useful if it helps these stakeholders assess a company's future economic prospects.

In contrast, taxable income is the amount of income used to compute a company's income tax liability on its tax return. This calculation is based on tax laws enacted by governments at national, state, and local levels. The objectives of tax laws are twofold: 1) to provide revenue to governments to support their programs and operations, and 2) to influence taxpayer behavior. Tax policies for businesses are often structured to incentivize investment in the economy, leading to an increase in future tax revenue. These underlying motives for tax laws are quite different from the "useful information" objective of GAAP. As such, there are many instances in which specific business transactions and financial results are accounted for differently for tax and financial purposes. Additionally, research suggests that variances between financial and taxable income are increasing over time.[3] These growing differences are attributable to several factors, including changes in tax law. In recent years, taxing authorities have used tax reform, such as the Tax Cuts and Jobs Act (TCJA) of 2017, to either reduce the tax burden on companies to spur economic activity, or to levy tax increases to fund key spending priorities such as pensions, education, and health care.

A primary cause of the variation between a company's taxable income and reported earnings is the difference in the timing of revenue and expense recognition for tax and financial reporting purposes. A typical example involves the cost recovery of tangible assets with a useful life of more than one year, referred to as depreciation. In order to encourage investment in capital assets and spur the economy, tax law requires companies to deduct the cost of depreciable assets over a shorter period on their tax returns than is permitted under GAAP. GAAP requires a capital asset to be depreciated over its "economic useful life" with the objective of matching the cost of the asset to the periods in which the asset contributes to earnings and operations. As such, the amount of depreciation taken for tax and financial purposes differs for each period of an asset's depreciable life. Overall, however, the total amount of depreciation taken on a long-lived asset is generally the same under tax law and GAAP. Thus, the divergence in rules impacts only the timing of when depreciation expense is recognized on tax returns versus income statements, not the total amount recognized over time. GAAP requires companies to incorporate these timing, or temporary, differences in the accounting for income taxes in their financial statements through the recording of deferred income taxes.

---

2 Financial Accounting Standards Board (FASB), 2018; Chapter 1, The Objective of General Purpose Financial Reporting, *Statement of Financial Accounting Concepts No. 8.* Norwalk, CT: FASB.

3 Mills, L.F., K.J. Newberry, and W.B. Trautman. 2002. Trends in Book-Tax Income and Balance Sheet Differences. *Tax Notes 96* (Special Report): 1109–1124. Gaertner, F.B., S.K. Laplante, and D.P. Lynch, 2016. Trends in the Sources of Permanent and Temporary Book-Tax Differences During the Schedule M-3 Era, *National Tax Journal* 69(4): 785–808.

ACCOUNTING FOR INCOME TAXES IN THE FINANCIAL STATEMENTS

Publicly traded companies in the U.S. account for income taxes in their financial statements following GAAP, namely ASC 740.[4] Under this provision, corporations are required to recognize in the current year the deferred tax consequences attributable to temporary differences between amounts reported in taxable income and financial (book) income. Companies use a balance sheet approach, which focuses on the difference in the tax basis of assets and liabilities and their reported amount in the financial statements.

Income tax expense reported on a company's financial income statement consists of two components: 1) current tax expense, which is the amount of income taxes payable for the period, and 2) the change in deferred income taxes, which represents the change in estimated future effects of temporary differences. Deferred tax consequences are initially recorded in the period that a temporary difference originates. Subsequently, the income tax effects are eliminated once the difference reverses.

The future effects of temporary differences on income taxes are represented by deferred tax liabilities (DTLs) and deferred tax assets (DTAs) on company balance sheets. DTLs result from revenues that are included in taxable income *after* being recognized in financial income, as well as expenses that are deducted on a tax return *before* being included in financial income. DTAs occur as a result of revenues that are included in taxable income *before* being recognized in financial income, as well as from expenses that are deducted on a tax return *after* being included in financial income. DTLs and DTAs are measured by multiplying the gross amount of the temporary difference by the applicable tax rate, which is the enacted tax rate that is expected to apply when the temporary difference is anticipated to reverse.

Assuming a consistent tax regime, book tax expenses and tax amounts paid on returns should be equal over time. Deferred taxes simply adjust the timing of when tax expenses are recorded in the financial statements so that the reported book tax expense aligns with reported book income rather than with taxable income. However, when a state enacts a significant tax law change, such as a switch to combined reporting or a change in apportionment method, the parity between book and tax no longer exists, and a "catch up" adjustment to deferred taxes is required to reflect historical transactions that were never reflected in prior tax returns in that state.

If tax laws change after a DTL or DTA has been recorded on a company's balance sheet, GAAP requires the company to recognize the effect of the change in tax law on existing DTLs and DTAs in the period the legislation is enacted, rather than in the period the new law goes into effect. The balance of recorded DTLs and DTAs must be revalued based on the new effective tax rate that is expected to apply when the differences reverse, and a corresponding adjustment to income tax expense must also be recorded on a company's income statement. As such, the amount of earnings reported on a company's financial statements is directly and immediately impacted by changes in tax law through their effect on deferred income taxes.[5]

---

4 ASC 740, Income Taxes.

5 Refer to the Appendix for a more detailed explanation of accounting for income taxes.

THE IMPACT OF UNANTICIPATED CHANGES IN STATE TAX LAWS ON DEFERRED TAX ACCOUNTS

An unintended consequence when a state enacts a change in its tax law is that companies operating in that state are required to immediately revise the balance of their deferred tax accounts for the effect of the change in the period of enactment. Revisions to the balances of DTLs and DTAs reported on a company's balance sheet require a corresponding adjustment to the amount of income tax expense recognized on the income statement. Whether this income tax expense adjustment is positive or negative depends on a specific company's deferred tax position (*i.e.*, whether an asset or a liability). This adjustment to income tax expense directly impacts the amount of earnings that a company reports on its income statement for financial reporting purposes. Such an adjustment is necessary, even if the change in tax law does not go into effect until future years, because deferred income taxes are accounted for based on the enacted tax rates that are expected to apply when temporary differences reverse. An example is provided below to highlight the impact of changes in state taxes on companies' deferred tax accounts. (More examples are provided in the Appendix.)

Example 1, Part A: At the beginning of period 1, ABC Corporation has one temporary difference relating to depreciation. ABC has taken $1.5 billion in excess tax depreciation over financial depreciation, resulting in a DTL in period 1. The DTL will reverse evenly over periods 2, 3, and 4. Focusing only on state-level tax effects, ABC expects a 4 percent effective tax rate. The computation of ABC's DTL computation in period 1 is presented in Table 1A.

Table 1A: State-Level DTL Computation for Period 1

	Book Basis	Tax Basis	Temporary Difference
Depreciable Assets	$3,000,000,000	$1,500,000,000	$1,500,000,000
x Tax Rate			x 4%
DTL			$60,000,000

As shown in Table 1A, ABC uses a 4 percent tax rate to measure the DTL because it is the state tax rate that is expected to apply in periods 2, 3, and 4 when the temporary difference reverses. Example 1 is continued to showcase the effect of a state-level tax change from separate accounting to combined reporting on a company's deferred tax accounts.

Example 1, Part B: On December 30th of period 1, one of several states where ABC operates enacts tax legislation changing from separate accounting to combined reporting. The new tax law goes into effect on January 1st of period 3. As a result of this change in state tax policy, ABC's effective tax rate increases by one percent. The required adjustments to ABC's DTL and income tax expense due to this change in state tax law are computed in Table 1B.

Table 1B: Deferred Tax Account Revisions Due to a Change in State Tax Law

	Period 2	Period 3	Period 4	Total
Amount of the Reversal	$500,000,000	$500,000,000	$500,000,000	$1,500,000,000
x Tax Rate	x 4%	x 5%	x 5%	
Revised DTL	$20,000000	$25,000,000	$25,000,000	$70,000,000
Revised DTL	$70,000,000			
Minus: Prior DTL	($60,000,000)			
Increase in DTL	$10,000,000			
Increase in Income Tax Expense	$10,000,000			

ABC is required to measure its DTL based on the enacted tax rates that are expected to apply. In Example 1, the change in state tax law is enacted in period 1, so ABC is required to adjust the balance of its DTL in this period. The tax policy requiring combined reporting goes into effect in period 3. Accordingly, ABC must compute the amount of the DTL that will reverse in periods 3 and 4 using the revised effective tax rate of 5 percent, rather than the 4 percent rate that was originally used. This revision increases the DTL balance from $60 to $70 million. ABC must also recognize a corresponding $10 million increase in income tax expense in period 1, which will result in lower financial income being reported on its income statement. Note that ABC incurs a negative effect on its reported financial income in period 1 even though the change to combined reporting does not go into effect in the state until period 3. This disparity arises because GAAP requires companies to recognize the effects of changes in tax laws in the year the new legislation is enacted.

The reduction in financial income due to the deferred tax consequences of a state's change in tax policy creates an inequitable treatment of assets for tax purposes. In particular, accelerated depreciation deductions associated with long-lived assets were not previously included in computations of taxable income for the state, and as such, did not result in tax savings. Nonetheless, following the change to combined reporting, the income that is produced by these assets is included in taxable income within that state. Other changes in state tax law will have a similar effect on company financial statements. For instance, the enacted tax legislation in Example 1 could have also included a revision to an apportionment formula for allocating companies' income to that state. The increase in effective tax rate stemming from such tax law changes also reduces financial income through its increase in income tax expense. Capital-intensive companies are particularly affected in a negative manner by this type of change in tax law at the state level.

In sum, an unintentional, yet unfair, consequence of various types of changes in state tax laws is that companies are legally required under GAAP to record the effect of these changes in their financial statements to account for historical transactions that were not, and never will be, reported on their state income tax returns. The resulting one-time adjustment can significantly reduce the amount of earnings reported on company income statements in the period the legislation is enacted.

FINANCIAL REPERCUSSIONS ON COMPANIES AND OTHER STAKEHOLDERS

Corporate stock prices are driven by expectations: The stock (or share) price of a publicly traded company reflects the value that market participants place on the business based on its future economic prospects, including earnings, cash flows, and dividends. Stock prices reflect all information publicly available that helps investors assess the company's prospects.[6] As required by the SEC, publicly traded companies regularly communicate their financial performance through the issuance of periodic financial reports. A company's valuation is primarily built using this guidance, but investors will also look to additional information provided by management, news and research reports, and other sources. As relevant and unexpected information about a company becomes known, its share price changes accordingly based on the significance and magnitude of this new information.

Accordingly, the immediate market reaction to a company's reported earnings for the period is based less on its actual performance and more on how that performance differs from expectations, given that expectations have already been incorporated into its market value and thus its share price. Research literature documents significant market reactions to earnings surprises.[7] In particular, companies experience an increase in share price when earnings exceed expectations, and a decrease when earnings fall short of market expectations. Research data also suggests that the magnitude of the downward adjustment in companies' share price following a negative earnings surprise significantly exceeds the upward response to positive earnings surprises.[8]

This market response to earnings announcements is not well understood. Over many years one of the authors of this paper was responsible for communicating the financial results of a company to its employees and other stakeholders. Their reaction was often surprise when the company's performance looked extremely positive, yet its share price fell when the results were announced. This reduction in share price occurred because the company fell short of market expectations, despite its positive performance overall.

In an economic setting where the immediate market reaction is based on delivery against expectations rather than on actual performance, unexpected changes drive financial implications to a greater extent than the mathematical result of the change in current period earnings. Earnings surprises have a material impact simply because they are unanticipated by the market and other stakeholders, and this can ultimately drive the perception of a company and its value in the market. This is particularly the case when current year earnings are lower than expectations because of a cumulative adjustment that applies to many prior years all at once, as is the case with the deferred tax adjustment required by GAAP after changes in tax laws. The one-time adjustment that results from changing the tax treatment of many previous periods' worth of business activities and investments by its very nature has an oversized impact on the valuation of the company.

---

[6] Scott, W.R. 2014, *Financial Accounting Theory*, 7th ed., Toronto, ON: Pearson Education Canada Inc.

[7] Brown, L.D., R. Hagerman, P.A. Griffin, and M. Zmijewski, 1987, An Evaluation of Alternative Proxies for the Market's Assessment of Unexpected Earnings, *Journal of Accounting and Economics* 9(2): 159–193.

[8] Skinner, D.J. and R.G. Sloan, 2002, Earnings Surprises, Growth Expectations, and Stock Returns or Don't Let an Earnings Torpedo Sink Your Portfolio, *Review of Accounting Studies* 7(2-3): 289–312.

Example 1 above highlights this situation. A company operating in a state that has enacted tax legislation changing from separate accounting to combined reporting has a $10 million additional expense in period 1 that will flow through earnings and become a part of the calculation of the value of ABC Corporation and the underlying company share price. Additionally, in the case of ABC, the more it relies on capital assets, the larger the one-time adjustment will be and the more likely it will have a negative effect on the value of the company.

The complexity of tax accounts: The reported earnings and balance sheet amounts relating to taxation are generally not well understood by users of the financial statements. Analysts and other stakeholders interested in a company's performance and valuation rely more heavily on management to communicate the implications of tax-related items compared to other areas relating to operating performance. Accordingly, management communicates its expectations with respect to adjustments in the company's tax accounts to the market. Further material investigation by market participants is less prevalent for tax matters than other areas of a company's financial performance.

In conducting research for this paper, the authors contacted market debt analysts who follow publicly traded companies and discussed the impact of company tax accounts. One analyst indicated that deferred tax is the topic that most confounds analysts. In light of the difficulty in this sphere, it was suggested that other publicly available data is studied to gain as much information as possible; however, there is still significant reliance on management to explain changes in assets and liabilities. Without this guidance as to expected changes, it was suggested that tax is assumed to remain status quo and the models used to assess the position of the company are developed based on this assumption. Variations not built into the model therefore run contrary to this assumption and would cause a change in the expected income tax expense of the company.

State taxation is prone to unplanned events: The process of developing expectations with the guidance of management is effective to the extent that a company's leadership can anticipate and effectively communicate tax law changes that impact the financial statements. For example, as the TCJA was being developed and working its way through the U.S. Congress, companies expended significant efforts to assess its impact on their financial results and to communicate this information to their stakeholders. These efforts included identifying areas of uncertainty that were factored into earnings and valuation models if actual financial results varied from market expectations. Consistent with the idea that relevant information was communicated to stakeholders throughout the legislative process of enacting the TCJA, debt analysts indicated during discussions with the authors that the TCJA received sufficient media coverage to help them understand the associated balance sheet changes.

However, state tax law changes are much less manageable in this regard than federal tax reform or other tax-related items. Federal tax changes of greatest concern to management and analysts are typically limited to base broadening or rate increases, while state modifications can change whether companies are subject to tax altogether. It is often the case that a broad range of state tax changes are being considered in multiple states at any given point in time, without clarity in terms of the specific provisions that may be included in the final version of the legislation, or even if any tax policy changes with far-reaching consequences will ultimately be enacted. And if enactment does occur, it frequently occurs late in the legislative session, causing uncertainty until the actual adoption date. These factors make it difficult for company management to plan in advance for the financial

impact of changes in state tax law and to keep stakeholders' market analysts informed of the impact of the possible changes before enactment occurs. As such, changes in state tax law are much more likely to "fly under the radar" and therefore are not as well monitored and communicated, resulting in an earnings surprise.

One final point particularly relevant in the context of changes in state tax law involves the accounting periods impacted by the unexpected earnings surprise. If the concern is a change in value based on an adjustment in expectations of current period income, and that concern is magnified by volatility over time, mitigation of the type of event discussed in this paper becomes even more relevant. The adjustment to income tax expense on the income statement resulting from the revision of deferred tax accounts reflects a change in prior period results. In essence, the value of an item of income or expense on an after-tax basis is diminished from its original treatment with the consequences of that change flowing through in the current period. This suggests volatility over several accounting periods and is exactly the concern raised herein. This accounting period point can be seen in Example 1. Capital assets acquired under the previous state tax regime incur an adjustment at the end of period 1, and future periods are based on a new tax regime that was not in existence when the assets were acquired.

The significance to companies and other stakeholders: Opponents of ASC 740 mitigation have suggested that a decline in a publicly traded company's share price is simply a paper loss without any real ramifications. However, a reduction in share price has far reaching implications, especially when it is the result of an earnings adjustment that was not anticipated or communicated by the impacted company.

First, the negative movement in share price can have immediate implications for the company itself. The share price reflects the market's view of the value of the business. Publicly traded companies often have other agreements tied to share price, including debt covenants and performance targets built into contracts with partners, suppliers and participants in transactions such as mergers and acquisitions. When an unanticipated change is reflected in earnings and the share price drops, many of these other relationships can be affected in a negative and disruptive way. Further, numerous discussions with stakeholders are needed to communicate the implications of this change in stock price going forward to avoid more long-term negative repercussions through debt/equity analysts and debt rating agencies who can influence the value of the business and the cost of capital in a variety of ways. The investment of time and effort by management in this situation can result in a material cost of compliance arising from the changes in the tax policies in jurisdictions in which the business operates.

Beyond the company itself, other stakeholders can be significantly impacted by unexpected results. The actual owners of the company's shares that have lost value experience more than a paper loss; they experience a real loss in the value of a held asset. These owners include a broad and varied range of investors. A recent study issued by the Securities Industry and Financial Markets Association (SIFMA) found that in 2018, the majority of stock shares in the U.S. were owned by individuals either directly (37.6%) or indirectly through mutual funds (22.6%).[9] Another significant domestic class of owners was pensions (11.5%). Finally, the fall in share price can be directly felt by employees with share-based compensation plans as well as current and former employees holding the company's shares in their retirement accounts.

---

9 SIFMA. 2019. *SIFMA Insights. Q: Who Owns Stocks in America? A: Individual Investors. A Chart Book on Stock Ownership.* Available at: https://www.sifma.org/wp-content/uploads/2019/10/SIFMA-Insights-Who-Owns-Stocks-in-America.pdf

SEVERAL JURISDICTIONS HAVE PROVIDED A DEDUCTION FOR DEFERRED TAX CHANGES

Many states that have enacted significant corporate income tax changes have also included special provisions to mitigate the financial reporting impacts of these changes (*i.e.*, an ASC 740 deduction)—a clear signal that states understand the need to provide relief in this situation and are looking for legislation to achieve that result.

A common provision enacted by several states provides specific relief by creating what amounts to a phase in of the change by providing an offsetting deduction over a number of years. A summary of enacted ASC 740 deductions is provided in Table 2, below. Note that the ASC 740 deduction has the desired impact on financial reporting (and share price) even if the effective date is delayed or continuously postponed. A similar approach has been taken with respect to preservation of companies' net operating loss (NOL) carryforwards despite changes in state tax laws that would diminish the NOLs created under the prior tax regime. A summary of the states that have enacted mitigating provisions is provided in Table 3.

Table 2: Enacted State ASC 740 Deductions

State	Year of Enactment	Deduction Time Period
MI	2007	15-year deduction beginning in 2015
MA	2008	30-year deduction beginning in 2021
DC	2011	7-year deduction beginning in year 10
CT	2015	30-year deduction beginning in 2021
KY	2018	10-year deduction beginning in 2024
NJ	2018	10-year deduction beginning in year 5
NM	2019	10-year deduction beginning in 2026

Table 3: Enacted State Tax Provisions to Preserve NOL Carryforwards

State	Type of Mitigation Provided	Time Period of the Mitigating Provision
NY	Deduction	Ratable deduction over 10 years with a carryforward of up to 20 years
OH	Tax Credit	Credit carryforward for up to 20 years
TX	Tax Credit	Credit carryforward for up to 20 years

As more states continue to consider and debate significant state tax law changes as part of broad tax reform, legislation to mitigate the unintended impact on financial statements and share price—in the form of an ASC 740 deduction—should be a part of any serious and thoughtful state tax reform effort.

CONCLUSION

States considering broad and fundamental tax reform must be cognizant that significant changes in state tax laws will have material consequences on the financial statements of publicly traded companies by forcing a recalculation of deferred tax assets or deferred tax liabilities. This recalculation can cause collateral impacts on share price, financing, and contractual obligations for these companies. Accordingly, state policy makers should carefully evaluate all aspects of a significant change to state tax laws, including the unintended consequences on the financial statements of publicly traded companies. One way to mitigate unintended consequences is to incorporate into the tax statute a deferred tax relief provision in the form of a future ASC 740 deduction that grants affected taxpayers a meaningful and timely deduction. States should ensure that such ramifications are addressed to avoid imposing a detrimental impact on companies twice, first through actual tax payments, and second through a reduction in market value caused by tax law changes enacted by their legislatures.[10] Mitigation of the collateral impacts of a state tax law change does not alter the fact that publicly traded companies granted the deduction will still be subject to the revised tax law for all prospective periods, just like all other taxpayers affected by the change.

State legislators are entrusted with a difficult charge: to build a tax system predicated on fundamental notions of sound tax policy, including such core principles as fairness, neutrality, and stability. Conversely, a state with a tax system that exacerbates uncertainty, unfairness and unpredictability in its application is a poor candidate for public companies seeking to expand or relocate. Enacting an ASC 740 deduction as an integral part of a significant state tax change is an appropriate and necessary response to mitigate the financial statement uncertainty generated by implementing significant state tax reform.

[10] Council On State Taxation (COST) Policy Statement, 2016: *Consequences of Significant Tax Law Changes on Financial Reporting*, Tax Executives Institute, Inc., 2018: *State and Local Tax Policy Statement Regarding Financial Statement Impact of Tax Law.*

APPENDIX:

How do publicly traded companies account for deferred taxes in their financial statements under U.S. GAAP?

Publicly traded companies in the U.S. account for income taxes in their financial statements following ASC 740. Companies are required to recognize in the current period the deferred tax consequences attributable to temporary differences between amounts reported in tax and financial income as well as NOL carryforwards.[11] Companies use a balance sheet approach, which focuses on the difference in the tax basis of assets and liabilities and their reported amount on the financial statements.

Income tax expense reported on a company's income statement consists of two components, current tax expense and the change in deferred income taxes, as is shown in the following formula.

Income Tax Expense = Current Tax Expense ± Changes in Deferred Income Taxes

Current Tax Expense is the amount of income taxes payable for the period, while *Changes in Deferred Income Taxes* represents the change in estimated future effects of temporary differences and NOL carryforwards. Deferred tax consequences are initially recognized in the period that a temporary difference originates or an NOL occurs. These income tax effects are subsequently eliminated once these items reverse.

Focusing first on temporary differences, the future effects of these differences on income taxes are represented by deferred tax liabilities and deferred tax assets (DTLs and DTAs) on companies' balance sheets. A DTL recognizes that income taxes payable will be higher in subsequent periods due to temporary differences; for example, from revenues included in taxable income after being recognized in financial income, as well as from expenses deducted on a tax return before being deducted from financial income. Example 1 included an example of a DTL. Recall that ABC had a $1.5 billion temporary difference in period 1 due to accelerated tax depreciation. This DTL will reverse evenly over periods 2, 3, and 4 as the amount of depreciation expense recognized in financial income exceeds the amount of tax deductions claimed. Example 2 expands upon the depreciation example for ABC Corporation to demonstrate the computation of income tax expense and DTLs.

Example 2, Part A: Based on Example 1, ABC Inc. has a $1.5 billion temporary difference at the end of period 1 due to accelerated tax depreciation. The financial, or book, basis of its depreciable assets is equal to $3 billion while the tax basis of its assets is $1.5 billion. The computation of ABC's DTL and income tax expense for period 1 is computed in Table 5, assuming ABC has $10 billion of taxable income and a tax rate of 21 percent.

[11] Taxable income and pretax financial income may also differ due to permanent differences, which result from transactions that are recognized in taxable income but are never included in financial income, or vice versa. An example of a permanent difference is the payment of political contributions, fines, and penalties. Companies recognize an expense on their income statement for these expenditures but are not allowed a corresponding deduction on their tax returns. Permanent differences only impact the period in which they occur. As such, companies do not recognize any deferred tax consequences associated with permanent differences in their financial statements.

Table 4A: DTL and Income Tax Expense Computations for Period 1

Period 1	Book Basis	Tax Basis	Temporary Difference
Depreciable Assets	$3,000,000,000	$1,500,000,000	$1,500,000000
x Tax Rate			x 21%
DTL			$315,000,000
	Amount	Supporting Calculation	
Current Tax Expense	$2,100,000,000	$10,000,000,000 x 21%	
Plus: Increase in DTL	$315,000,000	See above	
Income Tax Expense	$2,415,000,000		

As is illustrated in Table 4A, the DTL in period 1 is computed by multiplying the gross amount of the temporary difference, which is the difference between the book and tax basis of the depreciable assets, by the applicable tax rate. Income tax expense is then equal to the sum of the current tax expense and the change in deferred income taxes, which is equal to the amount of the DTL for period 1. Example 2 is continued to see how the income tax effects of the temporary difference reverse in future periods.

Example 2, Part B: ABC Corporation has a $1.5 billion temporary difference at the end of period 1 that will reverse evenly over the next three periods. The computation of ABC's income tax expense for periods 2, 3, and 4 are computed in Table 4B, assuming ABC has taxable income of $10.5 billion and a tax rate of 21 percent in each period.

Table 4B: DTL and Income Tax Expense Computations for Periods 2, 3, and 4

Period 2	Book Basis	Tax Basis	Temporary Difference
Depreciable Assets	$2,000,000,000	$1,000,000,000	$1,000,000,000
x Tax Rate			x 21%
DTL			$210,000,000
	Amount	Supporting Calculation	
Current Tax Expense	$2,205,000,000	$10,500,000,000 x 21%	
Minus: Decrease in DTL	(105,000,000)	$315,000,000 – $210,000,000	
Income Tax Expense	$2,100,000,000		
Period 3	Book Basis	Tax Basis	Temporary Difference
Depreciable Assets	$1,000,000,000	$500,000,000	$500,000,000
x Tax Rate			x 21%
DTL			$105,000,000
	Amount	Supporting Calculation	
Current Tax Expense	$2,205,000,000	$10,500,000,000 x 21%	
Minus: Decrease in DTL	(105,000,000)	$210,000,000 – $105,000,000	
Income Tax Expense	$2,100,000,000		
Period 4	Book Basis	Tax Basis	Temporary Difference
Depreciable Assets	$0	$0	$0
x Tax Rate			x 21%
DTL			$0
	Amount	Supporting Calculation	
Current Tax Expense	$2,205,000,000	$10,500,000,000 x 21%	
Minus: Decrease in DTL	(105,000,000)	$105,000,000 – $0	
Income Tax Expense	$2,100,000,000		

Table 4B demonstrates how temporary differences reverse in future periods. By the end of period 4, the book and tax basis are the same, and the DTL is equal to $0. As the balance of the DTL declines over periods 2 through 4, the amount of income tax expense reported on the company's income statement is also reduced to account for the change in deferred income taxes.

In contrast to a DTL, a DTA recognizes a decrease in taxes payable, or an increase in taxes refundable or saved, in future periods resulting from temporary differences attributable to future deductible amounts existing at the end of the current period. DTAs occur as a result of revenues being included in taxable income before being recognized in financial income as well as from expenses being deducted on a tax return after being included in financial income. Corporations recognizing a DTA are also required to evaluate, based on all available evidence, whether it is "more likely than not" (a greater than 50 percent likelihood) that a portion or all of the DTA will not be realized. The amount that is determined to not be realized based on this threshold is recorded in a valuation allowance, which reduces a corporation's DTA. An example of a DTA is provided in Example 3.

Example 3, Part A: During period 1, XYZ Co. estimates that it has warranty costs of $3 billion related to the sale of its products, which it will pay in period 2. For financial purposes, XYZ recognizes warranty expense and a corresponding warranty liability in its financial statements in period 1. However, under the warranty payment rules, the deduction is not recognized in XYZ's income tax return until period 2, when the warranty payments are made. Accordingly, XYZ has a $3 billion temporary difference in period 1 resulting in a DTA. The computation of XYZ's DTA and income tax expense for period 1 is computed in Table 5A, assuming XYZ has $15 billion of taxable income and a tax rate of 21 percent. For simplicity, also assume that XYZ determines that it will more likely than not realize all of this DTA.

Table 5A: DTA and Income Tax Expense Computations for Period 1

Period 1	Book Basis	Tax Basis	Temporary Difference
Warranty Liability	$3,000,000,000	$0	$3,000,000,000
x Tax Rate			x 21%
DTA			$630,000,000
	Amount	Supporting Calculation	
Current Tax Expense	$3,150,000,000	$15,000,000,000 x 21%	
Minus: Increase in DTA	($630,000,000)	See above	
Income Tax Expense	$2,520,000,000		

A comparison of Tables 4A and 5A shows that DTLs and DTAs are calculated in a similar way. The DTA in period 1 is computed by multiplying the gross amount of the temporary difference, which is the difference between the book and tax basis of the liability associated with the warranty costs, by the applicable tax rate. Income tax expense is then computed as the difference between the current tax expense and change in deferred income taxes, which is equal to the amount of the DTA for period 1. This example is continued to see how the income tax effects of the temporary difference reverse as XYZ recognizes a tax deduction associated with the warranty costs in period 2.

Example 3, Part B: XYZ Co. has a $3 billion temporary difference at the end of period 1 that will reverse as the company pays $3 billion in warranty costs in period 2. The computation of XYZ's income tax expense is computed in Table 5B, assuming XYZ has taxable income of $12 billion and a tax rate of 21 percent in period 2.

Table 5B: DTA and Income Tax Expense Computations for Period 2

Period 2	Book Basis	Tax Basis	Temporary Difference
Warranty Liability	$0	$0	$0
x Tax Rate			x 21%
DTA			$0
	Amount	Supporting Calculation	
Current Tax Expense	$2,520,000,000	$12,000,000,000 x 21%	
Plus: Decrease in DTA	$630,000,000	$630,000,000 – $0	
Income Tax Expense	$3,150,000,000		

As shown in Table 5B, the book and tax basis of the warranty liability are the same by the end of period 2, and the DTA is equal to $0. As the balance of the DTA is eliminated, the amount of income tax expense reported on the company's income statement is increased to account for this change in deferred income taxes.

Companies are also required to recognize DTAs associated with NOL carryforwards, which exists when a net loss occurs for tax purposes. U.S. tax law allows companies that experience an NOL to use, or carry forward, this loss to offset taxable income in the future.[12] The use of an NOL carryforward results in future tax savings through the reduction in future taxable income. Companies record a DTA and the corresponding effect on income tax expense in the period that the NOL occurs. The DTA is subsequently reduced and the income tax effects eliminated as the company uses the NOL carryforward to offset taxable income in future periods.

Is there evidence to suggest that market participants misprice the deferred tax consequences associated with changes in tax law?

Yes. Our research indicates that investors and analysts have mispriced previous changes in tax law at the federal level. While evidence suggests that analysts updated their earnings forecasts for less complex provisions of the Tax Reform Act of 1986, such as the reduction of corporate tax rates, analysts did not accurately incorporate complex changes, including the new foreign tax credit rules, into their forecasts.[13] Additionally, researchers found a positive association between analyst forecast errors and the revaluation of deferred tax accounts resulting from the Omnibus Budget Reconciliation Act of 1993, which raised the corporate tax rate from 34 to 35 percent.[14] Research also suggests that analyst forecast accuracy declined surrounding the expiration of the previously temporary R&D tax credit provision, while investors mispriced the retroactive extension of the R&D tax credit. These findings suggest that market participants have failed in certain instances to fully understand the effects of changes in federal tax law on adjustments to income tax expense and reported earnings.

What are the policy principles of a high-quality system of taxation?

Many organizations and practitioners have proposed tax policy principles for use by policymakers when designing and evolving tax policy within a jurisdiction. For example, The National Conference of State Legislatures (NCSL) promulgated the following list of principles in 2007:

Principles of a High-Quality State Revenue System[16]

- *A high-quality revenue system comprises elements that are complementary, including the finances of both state and local governments.*

---

[12] IRC §172, Net Operating Loss Deduction

[13] Plumlee, M. 2003. The Effect of Information Complexity on Analysts' Use of that Information. *The Accounting Review* 78(1): 275–296.

[14] Chen, K.C.W. and M. P. Schoderbek, 2000, The 1993 Tax Rate Increase and Deferred Tax Adjustments: A Test of Functional Fixation, *Journal of Accounting Research* 38(1): 23–44.

[15] Hoopes, J.L., 2018, The Effect of Temporary Tax Laws on Understanding and Predicting Corporate Earnings, Working Paper, University of North Carolina; Bratten, B. and D.S. Hulse, 2016, Retroactive Tax Legislation, Reported Earnings, and Investors' Responses to Earnings "Surprises", Evidence from R&D Credit Extensions, *The Journal of the American Taxation Association* 38(2): 87–109.

[16] National Conference of State Legislatures, 2007, *Principles of a High-Quality State Revenue System*, 4th ed.

- *A high-quality revenue system produces revenue in a reliable manner. Reliability involves stability, certainty and sufficiency.*
- *A high-quality revenue system relies on a balanced variety of revenue sources.*
- *A high-quality revenue system treats individuals equitably. Minimum requirements of an equitable system are that it imposes similar tax burdens on people in similar circumstances, that it minimizes regressivity, and that it minimizes taxes on low-income individuals.*
- *A high-quality revenue system facilitates taxpayer compliance. It is easy to understand and minimizes compliance costs.*
- *A high-quality revenue system promotes fair, efficient and effective administration. It is as simple as possible to administer, raises revenue efficiently, is administered professionally, and is applied uniformly.*
- *A high-quality revenue system is responsive to interstate and international economic competition.*
- *A high-quality revenue system minimizes its involvement in spending decisions and makes any such involvement explicit.*
- *A high-quality revenue system is accountable to taxpayers.*

As another example, the American Institute of Certified Public Accountants (AICPA) developed a framework of 10 guiding principles of good tax policy to help evaluate changes in tax rules.[17]

- ***Equity and fairness.*** *Similarly situated taxpayers should be taxed similarly. This includes horizontal equity (taxpayers with equal ability to pay should pay the same amount of taxes) and vertical equity (taxpayers with a greater ability to pay should pay more taxes). Note: Equity is best measured by considering a range of taxes paid, not by looking just at a single tax.*
- ***Certainty.*** *Tax rules should clearly specify when and how a tax is to be paid and how the amount will be determined. Certainty may be viewed as the level of confidence a person has that a tax is being calculated correctly.*
- ***Convenience of payment.*** *A tax should be due at a time or in a manner most likely to be convenient to the taxpayer. Convenience helps ensure compliance. The appropriate payment mechanism depends on the amount of the liability, and how easy (or difficult) it is to collect. Those applying this principle should focus on whether to collect the tax from a manufacturer, wholesaler, retailer or customer.*
- ***Economy of calculation.*** *The costs to collect a tax should be kept to a minimum for both the government and the taxpayer.*
- ***Simplicity.*** *Taxpayers should be able to understand the rules and comply with them correctly and in a cost-efficient manner. A simple tax system better enables taxpayers to understand the tax consequences of their actual and planned transactions, reduces errors and increases respect for that system.*

---

[17] AICPA, 2017, *Tax Policy Concept Statement No. 1—Guiding Principles of Good Tax Policy: A Framework for Evaluation of Tax Proposals.*

- *Neutrality. The tax law's effect on a taxpayer's decision whether or how to carry out a particular transaction should be kept to a minimum. A tax system's primary purpose is to raise revenue, not change behavior.*

- ***Economic growth and efficiency.** A tax system should not impede productivity but should be aligned with the taxing jurisdiction's economic goals. The system should not favor one industry or type of investment at the expense of others.*

- ***Transparency and visibility.** Taxpayers should know that a tax exists, and how and when it is imposed on them and others. Taxpayers should be able to easily determine the true cost of transactions and when a tax is being assessed or paid, and on whom.*

- ***Minimum tax gap.** A tax should be structured to minimize noncompliance. The tax gap is the amount of tax owed less the amount collected. To gain an acceptable level of compliance, rules are needed. However, a balance must be struck between the desired level of compliance and the tax system's costs of enforcement and level of intrusiveness.*

- ***Appropriate government revenues.** A tax system should enable the government to determine how much tax revenue it likely will collect and when—that is, the system should have some level of predictability and reliability.*

STRI

STATE TAX RESEARCH INSTITUTE

Council On State Taxation

122 C Street, NW | Suite 330

Washington, DC 20001 | (202) 484-5222

020222 COST Testimony in Support of HB 321 (ASC 74

Uploaded by: Stephanie Do

Position: FAV

Officers, 2021-2022

Robert J. Tuinstra, Jr.
Chair
Corteva Agriscience

Michael F. Carchia
Vice Chair
Capital One Services, LLC

Mollie L. Miller
Secretary & Treasurer
Fresenius Medical Care North America

Arthur J. Parham, Jr.
Immediate Past Chair
Entergy Services, LLC

Amy Thomas Laub
Past Chair
Nationwide Insurance Company

Douglas L. Lindholm
President
Council On State Taxation

Directors

Madison J. Barnett
The Coca-Cola Company

Barbara Barton Weiszhaar
HP Inc.

C. Benjamin Bright
HCA Healthcare, Inc.

Lani J. Canniff
Ameriprise Financial, Inc.

Sandra K. Cary
LKQ Corporation

Susan Courson-Smith
Pfizer Inc.

Karen DiNuzzo-Wright
Walmart Inc.

Jamie S. Fenwick
Charter Communications

Kurt A. Lamp
Amazon.Com

Stephen J. LaRosa
Alexion Pharmaceuticals, Inc.

Toni Mincic
Lumen Technologies

John H. Paraskevas
Exxon Mobil Corporation

Robbi Podrug
Best Buy Co., Inc.

Michael R. Raley
VF Corporation

Patrick A. Shrake
Cargill, Incorporated

Kyle Snedaker
Conagra Brands, Inc.

Beth L. Sosidka
AT&T Services, Inc.

Archana Warner
Exelon Corporation

Emily T. Whittenburg

Stephanie T. Do
Senior Tax Counsel
(202) 484-5228
sdo@cost.org

February 2, 2022

Delegate Vanessa E. Atterbeary, Chair
Delegate Alonzo T. Washington, Vice Chair
House Ways and Means Committee
Maryland General Assembly

Re: In Support of H.B. 321, Relief for Detrimental Financial Statement Effects of Single Sales Factor

Dear Chair Atterbeary, 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 support of House Bill 321 (H.B. 321), a measure to provide taxpayer relief for adverse financial reporting impacts of transitioning to single sales factor apportionment. Significant tax law changes such as this can inadvertently have immediate and negative impacts on taxpayers' financial reporting, creating new financial statement expenses in addition to changing a company's actual tax liability. Providing a deduction over time for detrimental effects on deferred tax assets and liabilities can help mitigate inadvertent detrimental financial statement impacts of such tax changes.

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 over 500 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. Many COST members have operations in Maryland.

COST's Position on Consequences of Significant Tax Law Changes on Financial Reporting

The COST Board of Directors has adopted a formal policy statement on consequences for financial reporting resulting from significant tax law changes. COST's policy position is:

When enacting significant corporate tax law changes, states must mitigate the immediate and negative impact of those changes on a company's financial reporting. While it is evident that companies may experience a change in their actual tax liability as a result of some tax law changes, the financial impact of having to immediately recognize additional tax expense for financial reporting purposes is not always evident.

State Mitigation of Unintended Financial Reporting Effects of Tax Policy Choices

The Internal Revenue Code and associated state rules for recording income and expenses are often different from the Generally Accepted Accounting Principles (GAAP) publicly traded companies follow for recording income and expenses. The difference between the GAAP and tax accounting methods typically result in the creation of deferred tax assets and tax liabilities on the financial statement balance sheets of companies. Significant tax law changes, such as a transition to single sales factor apportionment, typically require companies to re-compute the value of tax assets or liabilities they had previously recorded, and the cumulative effect of that re-computation often requires companies to immediately record additional tax expenses under the relevant financial accounting rules. The recognition of these expenses, in turn, may result in an immediate market adjustment of the company's stock price and value.

States should ensure that such ramifications are addressed to avoid detrimentally impacting companies twice—once through actual tax payments and a second time by a reduction in market value—by tax law changes enacted by their legislatures. States can mitigate these detrimental effects by allowing a deduction to be claimed in the future that can be spread equally over a specified period of time. By providing a reasonable schedule to allow the future deduction of the additional expenses triggered from any book/tax differences, a state can eliminate any financial reporting impact that may be required under financial accounting rules.

H.B. 321 would further sound tax policy in Maryland by providing those taxpayers experiencing detrimental financial statement impacts from the enactment of single sales factor apportionment during the 2018 legislative session a deduction, spaced out over ten years, to mitigate the loss of deferred tax assets and creation of deferred tax liabilities that were not intended by the General Assembly's tax policy decision.

Conclusion

For the reasons set forth above, we encourage you to vote in support of H.B. 321.

Respectfully,

Stephanie T. Do

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

HB321_MD Center on Economic Policy_UNF.pdf

Uploaded by: Kali Schumitz

Position: UNF

MDCEP
MARYLAND CENTER ON ECONOMIC POLICY
FEBRUARY 02, 2022

Tax Policy Should Reflect What is Best for Maryland, not Individual Corporations

Position Statement in Opposition to House Bill 321

Given before the House Ways & Means Committee

Prudent tax policy should ensure the state has the resources it needs and that we have a balanced tax code asking everyone to pay their fair share for the public investments that form the foundation of thriving communities. House Bill 321 takes the state down a risky path by adding another special interest carve-out that only benefits a handful of large, multistate corporations, at the expense of the revenues we need to make our state function. For these reasons, the Maryland Center on Economic Policy opposes House Bill 321.

A few years ago, the General Assembly passed legislation that phases in a single sales factor formula for calculating corporate income taxes. This approach means the amount of a company's business income that is subject to Maryland taxation is calculated using its percentage of sales in the state. This policy allows large, multistate corporations to calculate their taxes based only on the sales they make in Maryland, without considering their operations here. In many cases, this absolves corporations' responsibility to pay for public services that make their businesses possible—from schools to train their workforce to fire protection for their facilities.[i]

House Bill 321 attempts to use real dollars to offset revenue losses that exist only on paper, which some companies have claimed could hurt their stock prices. Corporate managers often try to boost the near-term profits they report to stockholders by claiming accelerated depreciation when calculating tax liability, meaning they end up deducting less annual depreciation in later years than they otherwise would have. House Bill 321 would grant corporations that received the benefits of claiming accelerated depreciation an additional offsetting tax deduction that will also reduce their real tax liability.

Further, there is no evidence that Maryland's adoption of single sales factor has had any negative effects on the corporations asking for special treatment. More than two dozen states have switched to single sales factor apportionment, but none has enacted this kind of deduction. Maryland also did not use such a policy when it enacted single sales apportionment for manufacturing businesses.

According to the Comptroller's office, House Bill 321 would benefit fewer than five large, multistate corporations.[ii] This approach to policy sets a dangerous precedent of providing special tax breaks to individual companies following any change in corporate tax policy, building on the many other tactics large, profitable, multistate corporations can already use to minimize their tax liability in Maryland.

1800 North Charles Street, Suite 310 Baltimore MD 21201 | mdcep@mdeconomy.org | 410-412-9105

While the revenue losses from the enactment of the bill would not begin for 10 years, Maryland will need sufficient tax revenue to support the investments in education, transportation, healthcare, and other aspects of our community that will improve Maryland in the long term.

For these reasons, the Maryland Center on Economic Policy respectfully requests that the Ways and Means Committee make an unfavorable report on House Bill 321.

Equity Impact Analysis: House Bill 321

Bill summary

House Bill 321 adds an additional special interest policy that benefits less than five large, multistate corporations, at the expense of vital revenue needed to address the needs of the state of Maryland as a whole.

Background

Large, multistate corporations have used a number of tactics to minimize their tax liabilities in Maryland over the years and House Bill 321 would only add to these strategies.

- A few years ago, the General Assembly passed legislation that calculates corporate income taxes using a single sales factor formula. This means that the company's business income that is subject to Maryland tax is only the sales that are made in the state of Maryland. The policy disregards the company's operations in the state of Maryland that they profit on elsewhere, removing their responsibility to pay for the public services that enable their business to be profitable.
- Corporate managers often try to increase their short-term profits they report to stockholders by claiming accelerated depreciation when calculating tax liability, which means they end up deducting less annual depreciation in later years than they would have otherwise. House Bill 321 would grant these corporations an additional offsetting tax deduction that will also reduce their real tax liability.

Equity Implications

- Corporate tax loopholes primarily benefit the small number of wealthy households who hold the bulk of corporate stock and other financial assets. Household wealth in the United States has been lopsided as a result of historically racist policies. Implementing policies that will enable huge, multistate corporations to reduce their tax liabilities will come at the expense of Marylanders who are financially less well-off. This is the case, as these corporations' reduced tax liabilities, put greater responsibilities on people who derive their income from work than on those whose income comes from wealth, growing the barriers that hold back Marylanders of color
- Implementing another policy that will relieve large multistate corporations of their taxation responsibilities will reduce the funds that could be used to invest in things like better schools, reliable transportation, and improved healthcare. Investing in these vital needs strengthens our economy and can dismantle the economic barriers that too often hold back Marylanders of color.

Impact

House Bill 321 would likely **worsen racial and economic inequity** in Maryland.

[i] Michael Mazerov and Michael Leachman, "State Job Creation Strategies Often Off Base," Center on Budget and Policy Priorities, February 2016. http://www.cbpp.org/research/state-budget-and-tax/state-job-creation-strategies-often-off-base

[ii] Fiscal and Policy Note for Senate Bill 458 (Revised for Third Reader), Maryland Department of Legislative Services, 2019. http://mgaleg.maryland.gov/2019RS/fnotes/bil_0008/sb0458.pdf