SB0576 Combined Reporting FAV.pdf
Uploaded by: Cecilia Plante
Position: FAV

TESTIMONY FOR SB0576
CORPORATE INCOME TAX – COMBINED REPORTING

Bill Sponsor: Senator Lewis Young
Committee: Budget and Taxation
Organization Submitting: Maryland Legislative Coalition
Person Submitting: Cecilia Plante, co-chair
Position: FAVORABLE

I am submitting this testimony in favor of SB0576 on behalf of the Maryland Legislative Coalition. The Maryland Legislative Coalition is an association of activists - individuals and grassroots groups in every district in the state. We are unpaid citizen lobbyists and our Coalition supports well over 30,000 members.

Our members believe that there is no better time than the present to take a hard look at how Maryland receives revenue from taxes. Specifically, how skewed taxes are skewed in favor of large corporations and away from low-income earners.

We all remember the giant tax giveaway that the Trump Administration passed in 2017. The idea, which we all understood to be false, was to 'trickle down' the giant tax cuts for corporations to low-and middle-class earners. That never happened. Corporations turned those tax breaks into stock buy-backs and bonuses for executives.

And, on top of all of that, they STILL got breaks from Maryland. Giant multi-state corporations that made huge profits from the federal tax giveaway still managed to get around paying taxes for their subsidiaries in Maryland. This needs to end.

This bill takes aim at one of the major 'loopholes' for large corporations – Combined Reporting.

Combined reporting would treat a parent company and its subsidiaries as one corporation for state income tax purposes. Doing so would prevent companies from reducing their taxable profits by artificially shifting revenue on paper to out-of-state subsidiaries. Closing the combined reporting loophole would raise at least $120 million per year.

Maryland's corporate income tax is calculated using a formula that considers how much of a company's sales are located in Maryland. This system helps to prevent multiple states from taxing a business's profits. However, when a company located in Maryland makes sales into another state, this income is sometimes not taxed by any state; instead, it becomes "nowhere income."

Maryland needs revenues to support its residents and small businesses who have suffered during the pandemic. We believe it's time for the big corporations to step up and pay their fair share. We support this bill and recommend a **FAVORABLE** report in committee.

SB576-FAV-AFSCME.pdf
Uploaded by: Cindy Smalls
Position: FAV

Testimony SB 576- Corporate Income Tax – Combine Reporting
Budget & Taxation Committee
March 7th, 2023
Support

AFSCME Maryland representing state and Higher Education employees stand in supports of SB 576 which closes two major corporate tax loopholes by enacting combined reporting. SB 576 changes address aspects of our tax system that allow large, multi-state corporations to use accounting gimmicks to avoid paying Maryland taxes. While these practices are currently legal in Maryland, most other states have already closed these loopholes.

Enacting combined reporting would provide a more complete and accurate accounting of the profit's corporations earn from their activities in Maryland than the current method of calculating the corporate income tax. This legislation would treat a parent company and its subsidiaries as one corporation for state income tax purposes, preventing companies from artificially shifting profits on paper to an out-of-state subsidiary.

This legislation could generate more than $120 million in annual revenue for the state once fully implemented. This long-term revenue source can help ensure the state keeps its commitment to tackling the issue of understaffing within our state agencies and or funding the Blueprint for Maryland's Future while also maintaining and strengthening other essential public services. We must choose whether to commit.

This legislation would close another loophole that shields some corporate profits from taxation. Maryland's corporate income tax is calculated using a formula that considers how much of a company's sales are in Maryland. This system helps to prevent multiple states from taxing a business's profits. However, due to a federal law passed in the 1950s, when a company located in Maryland makes sales into another state, this income is sometimes not taxed by any state and it becomes "nowhere income."

We must begin to seek other ways of increasing revenues in Maryland to meet the needs of its citizens. Today, we see state employees working more with less and enduring short-staffing and excessive overtime due to lack of revenues. Legislation like HB 46 attempts to further that quest to look closely at Maryland's tax structure and give away.

For these reasons, we urge the committee for a favorable report on SB 576.

SB 576 - Corporate Income Tax - Combined Reporting

Uploaded by: Donna Edwards

Position: FAV

MARYLAND STATE & D.C. AFL-CIO

AFFILIATED WITH NATIONAL AFL-CIO

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President
Donna S. Edwards

Secretary-Treasurer
Gerald W. Jackson

SB 576 - Corporate Income Tax - Combined Reporting
Senate Budget and Taxation Committee
March 7, 2023

SUPPORT

Donna S. Edwards
President
Maryland State and DC AFL-CIO

Madam Chair and members of the Committee, thank you for the opportunity to provide testimony in support of SB 576 - Corporate Income Tax - Combined Reporting. My name is Donna S. Edwards, and I am the President of the Maryland State and DC AFL-CIO. On behalf of the 300,000 union members in the state of Maryland, I offer the following comments.

Maryland's workers already pay their fair share of taxes. Big corporations doing business and making profits in Maryland do not. Combined reporting ensures that multi-state corporations pay taxes on the incomes they generated in our state. SB 576 requires businesses to file tax returns as a single unitary business, preventing many businesses from eliminating their tax obligations through playing a shell game of hiding profits in corporate holding entities in states with lower taxes. This bill removes the unfair advantage that currently exists for big corporations to engage in tax-evasion, at the expense of workers and small businesses. Businesses that operate solely within our state cannot duplicate the tax avoidance strategies of large, multi-state corporations, and, therefore, are at a competitive disadvantage against companies with near limitless resources. Taxes are an obligation we share to fund the society we want and when businesses choose to not pay it forces others to pay more or cut vital services.

Twenty-eight states and the District of Columbia already use combined reporting. A report by the Center on Budget and Policy Priorities found that 108 of Maryland's 120 largest multistate corporations already operate in states with combined reporting. Of those 120 largest multistate corporations, over half of them operated in ten or more combined reporting states. Marriott testified in opposition to combined reporting in 2022 while simultaneously bragging about the number of hotels it operates throughout the country. Marriott has more hotels in California, a state with combined reporting, than any other state. The state with the second highest number of Marriott locations in Texas, another state with combined reporting. States as varied as West Virginia, Arizona, and Massachusetts all follow this same procedure for taxing interstate business transactions.

Businesses seek to operate in Maryland because they can generate a profit from our highly skilled workforce and robust consumer base. None of that would change if combined reporting were implemented. SB 576 would change the ability of companies to hide profits out of state so that they

avoid their obligation to help fund the state services and programs that create the workforce and consumer base that they rely on.

According to analysis by the Maryland Center on Economic Policy implementing combined reporting would bring in $120 million annually to state revenues. Additional revenue will be needed over the next few years to ensure that we can meet our obligations under the Blueprint for Maryland's Future, along with any additional programs we hope to create.

SB 576 puts Maryland small businesses on an equal footing with their large competitors, ensuring every entity is paying taxes on income earned. Failing to close this loophole results in Maryland being shorted millions of dollars in revenue on an annual basis. That shortfall in tax revenue must be picked up by the workers of Maryland, and it is time to provide them with relief by holding multi-state corporations accountable. SB 576 brings fairness to our tax code. It takes the pressure off Maryland's workers and asks multinational corporations to start pulling their weight.

We urge a favorable report for SB 576.

SB 576 - Supp - to B&T - Combined Reporting.pdf
Uploaded by: Henry Bogdan
Position: FAV

MARYLAND NONPROFITS
marylandnonprofits.org

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410.727.6367 | 800.273.6367 | Fax 410.235.2190

March 7, 2023

Testimony on Senate Bill 576
Corporate Income Tax - Combined Reporting
Senate Budget and Taxation Committee

Position: Favorable

Maryland Nonprofits is a statewide association of more than 1500 nonprofit organizations and institutions. As a member of the Fair Funding Coalition we strongly urge you to support Senate Bill 576 to make our system of business taxation more equitable by adopting the "combined reporting" method for corporations to determine their income tax lability to the State of Maryland.

Combined reporting would require corporations to include all parent and subsidiary companies operating in the United States when calculating their corporate income tax responsibility, a reform known as combined reporting. This method closes the door to a range of currently legal accounting tactics businesses use to avoid paying taxes to Maryland. For example, a company may establish a subsidiary in a state with a lower tax rate and shift its earnings there on paper by purchasing goods from the subsidiary at artificially high prices. Combined reporting essentially treats a parent company and its subsidiaries as one corporation for state income tax purposes. Doing so prevents companies from reducing their taxable revenue by artificially shifting it out of state.

Combined reporting helps put smaller corporations with no presence outside of Maryland on a more equal tax footing with larger companies that operate in many states. Main Street businesses – which are responsible for most of the job creation in Maryland – cannot afford to spend millions developing these complicated tax avoidance structures, but their large competitors can, and in doing so gain an unfair advantage. This bill would level the playing field for local business, protecting local jobs.

Combined reporting is already well established across the country. There are 28 states plus the District of Columbia using combined reporting today – a diverse group that include Alaska, California, Kentucky, Massachusetts, and West Virginia. Because it is so common, most large corporations that would be subject to these provisions already have significant experience complying with it elsewhere. **Nine-tenths of the largest employers in Maryland already operate – or are part of a corporate family that operates – in combined reporting states.** Most of these companies operate in California, the strictest combined reporting state of all. Three fourths of them operate in multiple combined reporting states.

Legislative analysts in 2022 estimated that adopting combined reporting would increase state revenues by upward of $160 million per year once fully implemented, enabling the state to invest more in public health, education, and other essential services that we will need to rebuild hollowed-out public services and strengthen the foundations of our economy in the long run. Cleaning up our tax code by removing special interest tax breaks is the best way to raise the resources Maryland needs to build world-class public schools, a healthy population, and modern transportation infrastructure.

Maryland has a lot to offer as a place to do business, and will retain these advantages with corporate tax reforms that support increased investments in the foundation of our economy:

- we have the highest median household income nationwide;
- our workforce is highly educated, with the second-highest share of advanced degree holders among the 50 states;
- we have the second-highest share of millionaire households nationwide – after New Jersey, a combined reporting state;
- and our mix of taxes and the services they support is the second-most favorable to business nationwide, according to the accounting and consulting firm Ernst and Young. Maryland businesses get $1.43 in benefits for every dollar they pay in state and local taxes.

Senate Bill 576 represents an important step forward for Maryland's revenue system. If enacted, it would help us make the investments needed to recover from the pandemic and build Maryland's future prosperity. **We urge you to give this bill a favorable report**

SB0576-Support-RacheffJ-20230307.pdf
Uploaded by: James Racheff
Position: FAV

March 7, 2023

Maryland General Assembly
Maryland State Senate
Budget and Taxation Subcommittee

3 West
Miller Senate Office Building
Annapolis, Maryland 21401

Senate Bill SB0576, FAVORABLE

Dear Chairman Guzzone and members of the committee,

Thank you for allowing me to submit testimony in support SB0576, Combined Reporting, for the 2023 legislative session.

My name is Jim Racheff. I am a Maryland resident and have started three small businesses based in Maryland. The largest concern is a leading biotechnology company with more than 100 employees that was named one of the Maryland Technology Council's "Firm of the Year." I have been honored to be named Frederick County Entrepreneur of the Year and was a member of County Executive Gardner's Business and Industry Cabinet. I've come to speak to you today about a couple of terms we hear bantered about an awful lot these days.

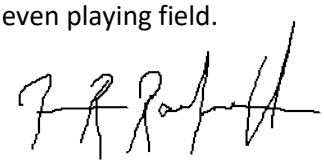
The first is "business friendly." In some respects, the State of Maryland is very business friendly. Businesses in Maryland draw consumers from households with the highest median household income in the United States and draw employees from a highly educated workforce: ranked 2nd in the Nation for per capita college and graduate degrees and boasts the highest-rated public school system in the country. These factors and many others – rather than marginal tax differential – are what make Maryland an attractive economy for businesses of all sizes.

The other term we hear a lot these days is "job creation." We know that most net job growth comes from high-impact small businesses. And we know that small businesses drive the innovation economy, patenting at an annual rate up to 13 times that of large corporations. We also know that small businesses pay 3 times in taxes and 4 ½ times the cost to comply with regulations than their large business counterparts. And now we hear that over a third of the largest corporations doing business in the State typically pay no corporate income tax?

We don't begrudge paying our fair share of taxes; as I mentioned earlier, Maryland is a great State with many economic advantages. Nor do we dismiss the important role that larger, multi-state businesses play in our state's economy. But small businesses often find themselves at a competitive disadvantage - and we don't have armies of tax attorneys, CPAs, public relations experts, and lobbyists to find every accounting trick and defend every loophole.

To ask the companies we rely on for job creation, innovation, and economic stability to pay not only their share but also subsidize their multi-state counterparts seems counter-intuitive and - dare I say it - "Business Unfriendly." We are not asking for an unfair advantage - only that we get an even playing field.

Respectfully submitted, Jim Racheff
314 Upper College TER, Frederick Maryland 21701



SB 576 Fair Funding Coalition_FAV.pdf
Uploaded by: Jessi Ahart
Position: FAV

Communities United
2221 Maryland Ave, 2nd Floor
Baltimore, MD 21218

Testimony in Support of SB 576
Sen. Guy Guzzone, Chair
Senate Budget & Taxation Committee

I am writing on behalf of Communities United, one of over 30 organizations across the state that have come together as The Maryland Fair Funding Coalition, committed to creating a fair and equitable tax system that supports the public services families and communities need to thrive.

The coalition supports proposals focused on eliminating loopholes and tax breaks that benefit special interests and fixing our upside-down tax code, which allows the wealthiest individuals to pay the smallest share of their income in state and local taxes. We believe large, profitable corporations should pay what they truly owe in taxes and not expect working families to continue to subsidize more than their share of taxes that support our roads, schools, and infrastructure.

Our coalition supports SB 576, which closes a major corporate tax loophole by enacting combined reporting.

Enacting combined reporting would change how corporate income tax is calculated and provide a more complete and accurate accounting of the profits corporations earn from their activities in Maryland than the current method. This legislation prevents companies from reducing their taxable profits by artificially shifting revenue out of state because it treats a parent company and its subsidiaries as one corporation for state income tax purposes.

This legislation could generate more than $200 million in annual revenue for the state once fully implemented. This long-term revenue source can help ensure the state keeps its commitment to students by fully funding the Blueprint for Maryland's Future while also maintaining and strengthening other essential public services.

We must choose whether to commit to the investments necessary for thriving communities, or to instead continue to prioritize tax breaks that benefit powerful special interests but do nothing to help our economy. Our coalition urges our legislators to commit to Maryland's working families and the future of our economy.

Therefore, we urge a favorable report on Senate Bill 576

Sincerely,

Jess Ahart
Executive Director
Communities United

SB 576_MD Center on Economic Policy_FAV.pdf
Uploaded by: Kali Schumitz
Position: FAV

MDCEP
MARYLAND CENTER ON ECONOMIC POLICY

MARCH 7, 2023

Closing Corporate Tax Loopholes Would Enable Maryland to Invest in our Future

Position Statement in Support of Senate Bill 576

Given before the Senate Budget and Taxation Committee

Senate Bill 576 would close a loophole that allows large, multistate corporations to artificially lower their tax responsibilities in Maryland. Allowing these special tax breaks makes it harder to invest in the pillars of Maryland's economy, such as health care and education, and primarily benefits the small minority of wealthy, overwhelmingly white households that hold the bulk of corporate stock. It also puts small, Maryland-based businesses at a disadvantage. **The Maryland Center on Economic Policy supports Senate Bill 576** because it would improve a provision of our tax system that shields corporate profits from taxation.

Senate Bill 576 would require corporations to include all parent and subsidiary companies operating in the United States when calculating their corporate income tax responsibility, a reform known as combined reporting. Combined reporting closes the door to a range of currently legal accounting tactics businesses use to avoid paying taxes to Maryland.[i] For example, a company may establish a subsidiary in a state with a lower tax rate and shift its earnings there on paper by purchasing goods from the subsidiary at artificially high prices. Combined reporting essentially treats a parent company and its subsidiaries as one corporation for state income tax purposes. Doing so prevents companies from reducing their taxable revenue by artificially shifting it out of state.

Combined reporting helps put smaller corporations with no presence outside of Maryland on a more equal tax footing with larger companies that operate in many states. Main Street businesses – which are responsible for most of the job creation in Maryland – cannot afford to spend millions developing these complicated tax avoidance structures, but their large competitors can, and in doing so gain an unfair advantage. This bill would level the playing field for local business, protecting local jobs.

Combined reporting is already well established across the country. There are 28 states plus the District of Columbia using combined reporting today – a diverse group that include Alaska, California, Kentucky, Massachusetts, and West Virginia. Because it is so common, most large corporations that would be subject to these provisions already have significant experience complying with it elsewhere.[ii] Nine-tenths of the largest employers in Maryland already operate – or are part of a corporate family that operates – in combined reporting states. Most of these companies operate in California, the strictest combined reporting state of all. Three fourths of them operate in multiple combined reporting states.

Analysis by the Institute on Taxation and Economic Policy finds that closing corporate tax loopholes would primarily increase the tax responsibilities of the wealthiest individuals, who today pay a smaller share of their

income in state and local taxes than the rest of us do.[iii] It would also improve racial equity by raising more revenue from the small minority of wealthy, overwhelmingly white households that hold the bulk of corporate stock.[iv]

Legislative analysts in 2022 estimated that adopting combined reporting would increase state revenues by upward of $200 million per year once fully implemented, enabling the state to invest more in public health, education, and other essential services that we will need to rebuild hollowed-out public services and strengthen the foundations of our economy in the long run.[v] Cleaning up our tax code by removing special interest tax breaks is the best way to raise the resources Maryland needs to build world-class public schools, a healthy population, and modern transportation infrastructure.

Maryland has a lot to offer as a place to do business, and will retain these advantages with corporate tax reforms that support increased investments in the foundation of our economy. We have the highest median household income nationwide.[vi] Our workforce is highly educated, with the second-highest share of advanced degree holders among the 50 states. We have the second-highest share of millionaire households nationwide – after New Jersey, a combined reporting state.[vii] And our mix of taxes and services is the second-most favorable to business nationwide, according to the accounting and consulting firm Ernst and Young.[viii] Maryland businesses get $1.43 in benefits for every dollar they pay in state and local taxes.

Senate Bill 576 represents an important step forward for Maryland's revenue system. If enacted, it would help us make the investments needed to recover from the pandemic and build Maryland's future prosperity.

For these reasons, the Maryland Center on Economic Policy respectfully requests that the Budget and Taxation Committee make a favorable report on Senate Bill 576.

Equity Impact Analysis: Senate Bill 576

Bill summary

Senate Bill 576 closes a loophole that currently allows large, multistate corporations to reduce their tax responsibilities in Maryland. Enacting combined reporting would require corporations to include all parent and subsidiary companies operating in the United States when calculating their corporate income tax responsibility, preventing the use of complex accounting tactics to artificially shift profits into lower-tax jurisdictions.

Background

Combined reporting is well established across the country.

- Twenty-eight states plus the District of Columbia use combined reporting today – a diverse group that include Alaska, California, Kentucky, Massachusetts, and West Virginia. Because it is so common, most large corporations that would be subject to these provisions already have significant experience complying with it elsewhere.[ix] Nine-tenths of the largest employers in Maryland already operate – or are part of a corporate family that operates – in combined reporting states. Most of these companies operate in California, the strictest combined reporting state of all. Three fourths of them operate in multiple combined reporting states.

Equity Implications

- Corporate tax loopholes primarily benefit the small number of wealthy households that hold the bulk of

corporate stock and other financial assets. Multiple intersecting areas of historical and continuing racist policy have made household wealth in the United States heavily lopsided. The wealthiest 10% of white households nationwide (about 6% of all households) control nearly two-thirds of all built-up wealth.[x] Closing corporate tax loopholes would ensure that our tax code does not place greater responsibilities on people who derive their income from work than on those whose income comes from wealth, and thereby lower one barrier that holds back many Marylanders of color.

- Closing corporate tax loopholes would generate revenues that could be invested in essentials like world-class schools, sufficient child care assistance, and reliable transit. Investing in these basics strengthens our economy during an especially difficult time and can dismantle the economic barriers that too often hold back Marylanders of color.

Impact

Senate Bill 576 would likely **improve racial and economic equity** in Maryland.

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[i] Michael Mazerov, "State Corporate Tax Shelters and the Need for 'Combined Reporting,'" Center on Budget and Policy Priorities, 2007, https://www.cbpp.org/research/state-corporate-tax-shelters-and-the-need-for-combined-reporting?fa=view&id=777

[ii] Mazerov, Michael and Mark Enriquez, "Vast Majority of Large Maryland Corporations are Already Subject to 'Combined Reporting' in Other States," Center on Budget and Policy Priorities, November 9, 2010, http://www.cbpp.org/cms/?fa=view&id=3317.

[iii] Meg Wiehe, Aidan Davis, Carl Davis, Matt Gardner, Lisa Christensen Gee, and Dylan Grundman, "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," Institute on Taxation and Economic Policy, 2018, https://itep.org/wp-content/uploads/whopays-ITEP-2018.pdf

[iv] Michael Leachman, Michael Mitchell, Nicholas Johnson, and Erica Williams, "Advancing Racial Equity with State Tax Policy," Center on Budget and Policy Priorities, 2018, https://www.cbpp.org/research/state-budget-and-tax/advancing-racial-equity-with-state-tax-policy

[v] Elizabeth Allison, "Fiscal and Policy Note: Senate Bill 576," Department of Legislative Services, 2023, https://mgaleg.maryland.gov/2023RS/fnotes/bil_0006/sb0576.pdf

[vi] 2021 American Community Survey one-year estimates.

[vii] "American States with the Highest Ratio of Millionaire Households Per Capita in 2020," Statista, 2022, https://www.statista.com/statistics/294941/largest-ratio-millionaire-households-per-capita-us/

[viii] Andrew Phillips, "Total State and Local Business Taxes for FY21," Ernst & Young LLP, 2022, https://www.ey.com/en_us/tax/total-state-and-local-business-taxes-for-fy21

[ix] Mazerov and Enriquez, 2010.

[x] Leachman et al., 2018

Combined Reporting States.pdf
Uploaded by: Karen Lewis Young
Position: FAV

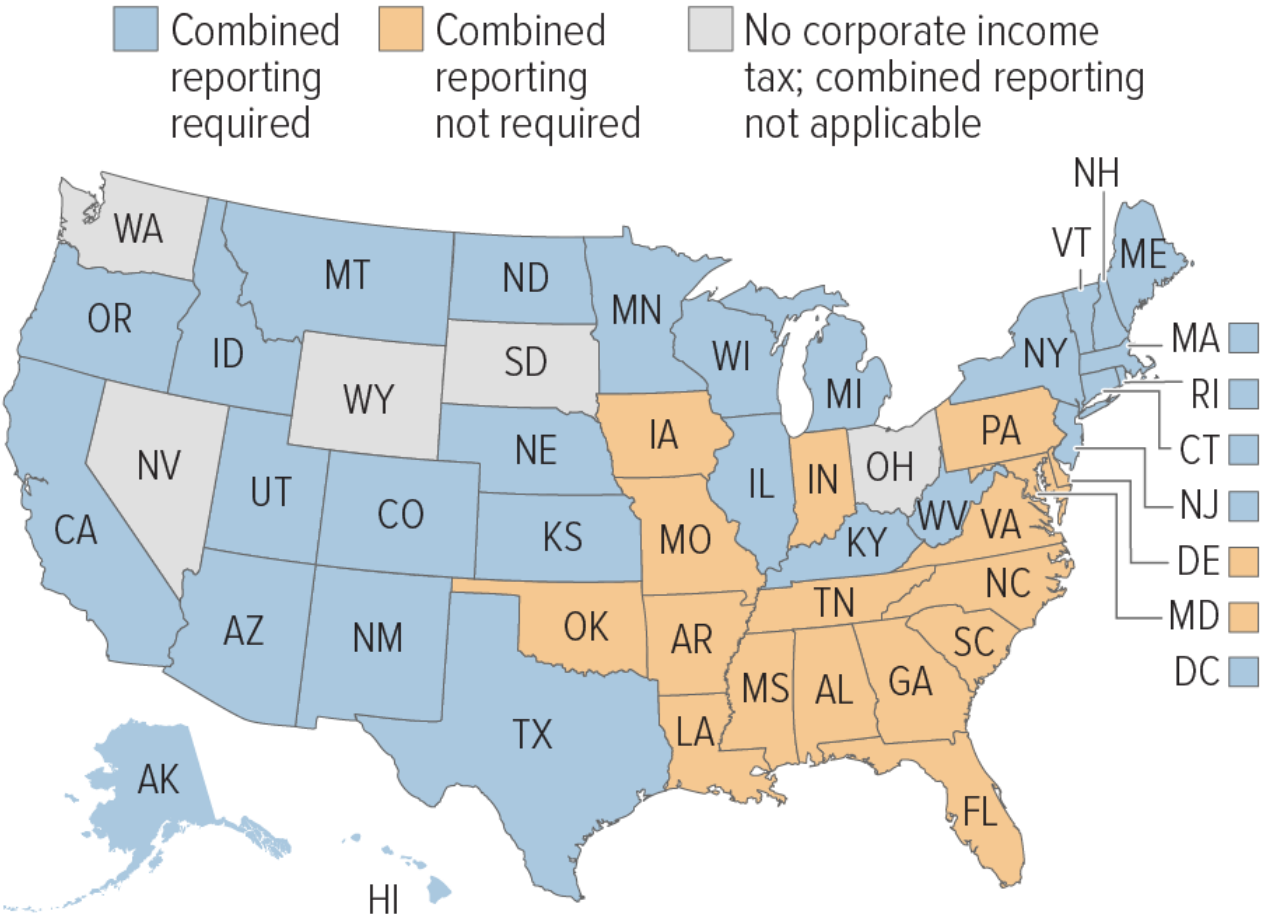
Combined Reporting States

State	Legislature Party	Governor's Party	Year Adopted
California	Democratic	Democratic	Before 2004
Colorado	Democratic	Democratic	Before 2004
Connecticut	Democratic	Democratic	2015
District of Columbia	Democratic	Democratic	2011
Hawaii	Democratic	Democratic	Before 2004
Illinois	Democratic	Democratic	Before 2004
Maine	Democratic	Democratic	Before 2004
Massachusetts	Democratic	Republican	2009
New Jersey	Democratic	Democratic	2018
New Mexico	Democratic	Democratic	2020
New York	Democratic	Democratic	2007
Oregon	Democratic	Democratic	2013
Rhode Island	Democratic	Democratic	2014
Vermont	Democratic	Republican	2004
Alaska	Republican	Republican	Before 2004
Arizona	Republican	Republican	Before 2004
Idaho	Republican	Republican	Before 2004
Kansas	Republican	Democratic	Before 2004
Kentucky	Republican	Democratic	2018
Michigan	Republican	Democratic	2009
Montana	Republican	Republican	Before 2004
New Hampshire	Democratic	Republican	Before 2004
North Dakota	Republican	Republican	Before 2004
Ohio#	Republican	Republican	2005
Texas*	Republican	Republican	2008
Utah	Republican	Republican	Before 2004
Virginia	Split	Republican	2021
West Virginia	Republican	Republican	2007
Wisconsin	Republican	Democratic	2009
Nebraska	Non-partisan	Republican	Before 2004
Minnesota	Split	Democratic	Before 2004

Map of States with Combined Reporting for SB576.pd
Uploaded by: Karen Lewis Young
Position: FAV

Center on Budget and Policy Priorities

28 States Plus D.C. Require Combined Reporting for the State Corporate Income Tax



Note: Combined reporting treats a parent company and its subsidiaries as one entity for state income tax purposes, thereby helping prevent income shifting.

Source: John C. Healy and Michael S. Schadewald, "2019 Multistate Corporate Tax Guide, Vol. 1," Kentucky HB 487 (2018), effective January 1, 2019; New Jersey AB 4262 (2018), effective July 1, 2019, New Mexico, HB 6 (2019), effective January 1, 2020

MORE ON THIS TOPIC

REPORT

Advancing Racial Equity With State Tax Policy

NOVEMBER 15, 2018

SB576 Corporate Income Tax - Combined Reporting.pd
Uploaded by: Karen Lewis Young
Position: FAV

KAREN LEWIS YOUNG
Legislative District 3
Frederick County

Committee on Education, Energy, and the Environment

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Karen.Young@senate.state.md.us

THE SENATE OF MARYLAND
ANNAPOLIS, MARYLAND 21401

March 6th, 2023
Support of SB 576 – Corporate Income Tax - Combined Reporting
The Honorable Senator Guy Guzzone
Budget and Tax Committee
Maryland Senate
11 Bladen Street, Room 302
Annapolis, MD 21401

Chair Guzzone, Vice-Chair Rosapepe, and Esteemed Members of the Senate Budget and Tax Committee:

Enacting SB 576 changes how corporate income tax is calculated and provides a more accurate reflection of the profits that large multi-state corporations earn from their activities in Maryland.

Corporations that produce and sell goods in multiple states are required to pay state corporate income taxes based on the portion of their profits that can be attributed to the states in which they operate. Simply selling goods in a state does not alone subject a corporation to that state's corporate income tax. Under federal law, states can only tax corporations with a sufficient "nexus" to the state, which generally means a physical presence. As a result, many multi-state corporations have "nowhere" income that cannot be taxed in any state.

"Nowhere income" creates an opportunity for multistate corporations to avoid paying a state's income taxes. For example, if a Maryland-based company only makes 10% of its sales in Maryland, then the remaining 90% will be "nowhere income" that is not taxed anywhere. Yet, that company takes full advantage of Maryland's infrastructure and talented workforce. This loophole hurts Maryland's small businesses because they usually pay state income tax on 100% of their profits yet must compete with larger rivals that pay much less.

Under a combined reporting law, a multi-state parent company and its subsidiaries are treated as one corporation for state income tax purposes. It establishes that multi-state corporation's report to the state income based on the amount of Maryland business they conduct. This strategy prevents the multi-state company from reducing its taxable profits through a range of legal accounting tactics.

Fairness and the Financial impact

First and foremost, this is a fairness issue. Combined reporting helps to put larger multi-state companies on more equal tax footing with those businesses whose enterprises are in Maryland only. Main street businesses cannot afford these complicated tax avoidance structures. In that way, large multi-state competitors gain an unfair advantage.

Multi-state corporations and their employees consume Maryland resources and services. They use roadways and bridges and ride our mass transit. Their kids attend our public schools, yet their employers are not paying their fair share of taxes.

Many local businesses in each of our own districts have yet to recover from COVID-19. At the same time, many large corporations have done very well and profits have grown.

Combined reporting is well-established around the country in both red and blue states (see attachment). Requirements are currently in effect in 29 states as well as the District of Columbia. Hawaii and New Hampshire have both considered moving to international combined reporting.

SB 576 could provide more than $200 million per year in additional revenues once fully phased in. The bill would have no effect on local or small business as it only applies to large corporations.

I urge a favorable report.

Sincerely,

Senator Karen Lewis Young

SB 576_Fair Funding Coalition_FAV.pdf
Uploaded by: Kevin Slayton
Position: FAV

MARYLAND
FAIR FUNDING
COALITION

Testimony in Support of SB 576
Sen. Guy Guzzone, Chair
Senate Budget & Taxation Committee

The Maryland Fair Funding Coalition is a coalition of more than 30 organizations across the state that are committed to creating a fair and equitable tax system that supports the public services families and communities need to thrive.

The coalition supports proposals focused on eliminating loopholes and tax breaks that benefit special interests and fixing our upside-down tax code, which allows the wealthiest individuals to pay the smallest share of their income in state and local taxes. We believe large, profitable corporations should pay what they truly owe in taxes and not expect working families to continue to subsidize more than their share of taxes that support our roads, schools, and infrastructure.

Our coalition supports SB 576, which closes a major corporate tax loophole by enacting combined reporting.

Enacting combined reporting would change how corporate income tax is calculated and provide a more complete and accurate accounting of the profits corporations earn from their activities in Maryland than the current method. This legislation prevents companies from reducing their taxable profits by artificially shifting revenue out of state because it treats a parent company and its subsidiaries as one corporation for state income tax purposes.

This legislation could generate more than $200 million in annual revenue for the state once fully implemented. This long-term revenue source can help ensure the state keeps its commitment to students by fully funding the Blueprint for Maryland's Future while also maintaining and strengthening other essential public services.

We must choose whether to commit to the investments necessary for thriving communities, or to instead continue to prioritize tax breaks that benefit powerful special interests but do nothing to help our economy. Our coalition urges our legislators to commit to Maryland's working families and the future of our economy.

Therefore, we urge a favorable report on Senate Bill 576

SB0576_FAV_LWVMD Corporate Income Tax - Combined R
Uploaded by: Lois Hybl
Position: FAV

LEAGUE OF WOMEN VOTERS® OF MARYLAND

TESTIMONY TO THE SENATE BUDGET AND TAXATION COMMITTEE

SB 576 Corporate Income Tax - Combined Reporting

POSITION: Support

BY: Nancy Soreng, President

Date: March 7, 2023

Promoting a sound economy and maintaining an equitable and flexible system of taxation are among the League's basic principles. LWVMD's positions include support for: 1) a progressive tax system, and 2) an equitable and efficient fiscal structure.

Maryland League members understand the importance of the relationship between various revenue sources available to the state government and the services provided by those revenues. A sound revenue system must allow the State to invest in essential public goods such as education, transportation, and health care.

Currently, corporations can shift funds to other states where they will be taxed at a lower rate. Combined reporting requires corporations which do business in several states to have a single set of books so that all its profits are reported.

Combined reporting helps put smaller corporations with no presence outside of Maryland on a more equal tax footing with larger companies that operate in many states. The current system places a heavier state tax burden on businesses, both large and small, which do business only in Maryland.

Combined Reporting is already well established around the country. Maryland should join in.

We urge a favorable report on SB 576.

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410-269-0232 * info@lwvmd.org * www.lwvmd.org

SB 576 Support.pdf
Uploaded by: Maddie Long
Position: FAV

Testimony in Support of
Senate Bill 576: Corporate Income Tax - Combined Reporting

Budget and Taxation Committee
Position: Favorable

March 7, 2023

Strong Schools Maryland is a network of education advocates dedicated to ensuring the full funding and faithful implementation of the Blueprint for Maryland's Future. We are also a member of the Maryland Fair Funding Coalition, a group of more than a dozen organizations formed to ensure that the state has the resources it needs to make significant investments in education funding. **We stand in support of Senate Bill 576**, which if enacted, would eliminate a corporate tax loophole by requiring taxable income to be computed using a combined reporting method.

Large, multi-state and multinational corporations can take advantage of accounting gimmicks to avoid their tax responsibility in Maryland. A parent company and its subsidiaries can count as one corporation for state income tax purposes, effectively allowing companies to shift funds to other states to lower taxable income. This bill would bring our tax code up to speed with 29 other states (including DC). Further, both the Fair Funding Coalition and the Fiscal and Policy Note estimate that closing the loophole would raise at least $200 million per year.

Maryland has now begun including Medicaid data in its direct certification process, which increases eligibility for students and their schools to access certain resources, like free and reduced priced meals. This new method has identified a massive blindspot in our counting of students in poverty. **The**

State has been missing nearly 1 in 9 students all across Maryland, with especially large concentrations in Montgomery, Anne Arundel, and Prince George's counties.[1] The official count is 110,501 students, and as a result, translates to more than $1.6 billion in additional compensatory education costs. Updated projections now cast the Blueprint fund in deficit beginning in Fiscal Year 2027. The revenue source generated by combined reporting can help ensure the state keeps its commitment to students by fully funding the Blueprint for Maryland's Future.

Now is the time to ensure corporations pay their fair share, and now is the time to secure revenue sources that can fulfill the promises of the Blueprint.

For these reasons, we urge a favorable report on Senate Bill 576.

For more information, contact Maddie Long:
maddie@strongschoolsmaryland.org

[1] DLS 2023 Fiscal Briefing

SB0576 - Corporate Income Tax - Combined Reporting

Uploaded by: Rick Tyler, Jr.-Chair

Position: FAV

Maryland Education Coalition

Ellie Mitchell & Rick Tyler, Jr. – Co-Chairs

Web site - www.marylandeducationcoalition.org *** **Email** – md.education.coaliton@gmail.com

March 7, 2023

Senate Budget and Taxation Committee
Senator Guy Guzzone, Chair
SB0576 - Corporate Income Tax - Combined Reporting
Position - **FAVORABLE**

The Maryland Education Coalition (MEC) was originally founded over 40 years ago (1980) and is the oldest, most experienced, and diverse public education advocacy coalition in Maryland. MEC is currently made up of over twenty statewide organizations and individuals advocates(see below). We advocate for adequate funding, equitable policies, and transparent accountability statewide for the estimated 900,000 students in Maryland's public schools, regardless of their academic, cultural, economic, geographic, racial, or other demographic status.

Consistent with our mission, MEC joins other members of the Fair Funding Coalition in support of House Bill 46 - Corporate Income Tax - Combined Reporting. MEC urges the committee members to review the testimony of the Fair Funding Committee to have a clear understanding of our rational, which we believe is fair and more equitable for all Maryland taxpayers. We also believe that the passage of HB 46 along with HB 39 would give Maryland the authority and payer to ensure that corporations pay their fair share with reporting transparency.

MEC also believes Maryland has an obligation to ensure all revenue due is reported and collected now and in future years to meet Maryland's Constitutional Mandate in Article VII, Education, Section 1 is met currently and in future years, which states – "The General Assembly, …, shall by Law establish throughout the State a thorough and efficient System of Free Public Schools; and shall provide by taxation, or otherwise, for their maintenance".

Why is this important? According to recent estimates, revenue dedicated for public education is projected to have a deficit structural balance of about (-$707.6 million) by FY 2025 and a deficit cash balance of about (-$1.5 billion) by FY 2027. Both deficits are projected to significantly increase during the latter years. (see attached)

MEC believes Maryland must begin now to identify all possible revenue sources and close all possible loopholes to ensure public education is fully funded as promised in future years, so students have a greater opportunity to graduate college and career ready with access to needed student services required to promote success.

Therefore, **MEC urges the Budget and Taxation Committee to issue a favorable report for SB0576 - Corporate Income Tax - Combined Reporting this year, because our students cannot wait.**

Ps – MEC also joins the Fair Funding Coalition in support of House Bills 142 & 148

Appendix Q

Blueprint for Maryland's Future Fund Projected Revenues and Expenditures

Category	FY 2022 Actual	FY 2023 Working	FY 2024 Allowance	FY 2025 Projection	FY 2026 Projection	FY 2027 Projection	FY 2028 Projection
Blueprint Fund Carryover Balance	**672,476,114**	**964,282,230**	**2,057,532,033**	**2,242,431,714**	**1,534,795,057**	**253,112,028**	**-1,492,920,900**
Education Trust Fund (ETF)	375,000,000	618,929,502	616,440,160	624,489,459	632,657,044	642,644,654	651,074,969
Less: Built to Learn Debt Service	0	-60,000,000	-125,000,000	-125,000,000	-125,000,000	-125,000,000	-125,000,000
Sales and Use Tax	542,650,442	623,144,736	765,653,742	806,969,421	860,374,201	912,518,089	936,966,480
Sports Wagering	14,165,443	47,368,674	48,913,395	51,049,343	53,287,443	59,972,263	84,520,252
Income Tax Diversion	0	800,000,000	0	0	0	0	0
State Reserve Fund Diversion	0	0	500,000,000	0	0	0	0
Interest Earnings	0	28,928,467	61,725,961	67,272,951	46,043,852	7,593,361	0
Total Blueprint Revenues	**931,815,885**	**2,058,371,379**	**1,867,733,259**	**1,424,781,174**	**1,467,362,540**	**1,497,728,367**	**1,547,561,702**
Foundation Program	0	59,512,788	42,030,825	105,373,580	349,434,437	599,536,377	809,549,418
Regional Cost Difference	0	157,909,651	155,975,828	158,972,712	163,014,604	170,085,902	175,175,176
Compensatory Education	0	0	390,841,994	417,006,814	498,519,338	491,811,874	526,127,554
Special Education	65,468,589	90,217,113	153,054,291	202,267,935	255,309,844	341,456,337	432,907,659
Limited English Proficiency	0	88,178,255	136,372,984	185,795,449	222,740,410	258,355,939	299,814,240
Prekindergarten	53,674,670	144,063,352	99,575,076	120,200,000	205,100,000	263,100,000	337,500,000
Concentration of Poverty School Grant	117,109,071	190,286,426	274,290,497	420,149,204	505,927,300	582,451,600	718,782,431
Teacher Salaries	75,000,001	9,033,505	9,534,911	20,000,000	28,000,000	37,000,000	49,000,000
College and Career Readiness	0	18,669,966	19,888,102	21,243,547	22,299,383	28,421,189	43,248,248
Education Effort	0	0	91,070,820	168,300,000	207,600,000	207,200,000	210,700,000
Transitional Supplemental Instruction	23,000,000	3,951,813	51,323,687	39,398,480	26,869,465	0	0
Blueprint Transition Grants	0	57,688,465	57,688,465	49,035,197	37,497,504	28,844,235	20,190,963
Categorical Early Childhood Programs	81,282,457	61,111,256	67,241,419	67,218,682	49,265,155	58,017,459	66,837,777
Categorical Teacher Support Programs	4,555,768	16,099,699	21,891,000	25,391,000	25,391,000	25,391,000	25,391,000
Innovative Programs	8,288,594	2,000,000	2,000,000	0	0	0	0
Hold Harmless Provisions	209,384,067	0	0	0	0	0	0
MDH Consortium on Coord. Comm. Supp.	0	50,000,000	85,000,000	110,000,000	130,000,000	130,000,000	130,000,000
Accountability & Implementation Board	119,675	4,800,000	4,800,000	1,800,000	1,800,000	1,800,000	1,800,000
Other	2,126,877	11,599,287	20,253,679	20,265,231	20,277,129	20,289,384	20,302,007
Total Expenditures	**640,009,769**	**965,121,576**	**1,682,833,578**	**2,132,417,831**	**2,749,045,568**	**3,243,761,296**	**3,867,326,473**
Closing Fund Balance	**964,282,230**	**2,057,532,033**	**2,242,431,714**	**1,534,795,057**	**253,112,028**	**-1,492,920,900**	**-3,812,685,672**
Structural Balance	**291,806,116**	**1,093,249,803**	**184,899,681**	**-707,636,657**	**-1,281,683,029**	**-1,746,032,929**	**-2,319,764,771**

SOURCE: Maryland Budget Highlights, Fiscal Year 2024 - page 232

SB576_MSEA_Zwerling_FAV.pdf
Uploaded by: Samantha Zwerling
Position: FAV

MARYLAND STATE EDUCATION ASSOCIATION

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Testimony in SUPPORT of Senate Bill 576
Corporate Income Tax –Combined Reporting

Senate Budget & Taxation Committee
March 7, 2023

Samantha Zwerling
Government Relations

The Maryland State Education Association supports Senate Bill 576, which enacts combined reporting and brings fairness to Maryland's corporate taxation.

MSEA represents 75,000 educators and school employees who work in Maryland's public schools, teaching and preparing our almost 900,000 students so they can pursue their dreams. MSEA also represents 39 local affiliates in every county across the state of Maryland, and our parent affiliate is the 3 million-member National Education Association (NEA).

MSEA supports passage of an adequate, sustainable, predictable revenue stream that will adequately fund both the operating and construction costs of our public schools. A great public school for every child means our students have updated technology, small manageable classes, safe and modern schools, proper healthcare and nutrition, and have highly qualified and highly effective educators. The Blueprint for Maryland's Future outlines improvements to access to Pre-K and Career Technology Education, as well as expansion of the educator workforce and increased salaries to help deliver individualized instruction and recruit and retain the best workforce in the country.

Implementing the Blueprint for Maryland's Future with fidelity, dealing with the impacts of the COVID-19 pandemic, and properly serving the 110,000 recently identified students eligible for free and reduced price meals will take considerable investments of state funds. Thanks to the tough decisions this committee has made in the past, the Blueprint's state contributions are funded into FY26. The estimated $200 million per year generated from the implementation of this bill would go a long way in helping fund the Blueprint in the out-years and ensuring Maryland's public schools meet our expectations. SB 576 is part of that funding solution.

MSEA urges a Favorable Report on Senate Bill 576.

SEIU Testimony IN FAVOR of SB 576 Combined Reporti

Uploaded by: Terry Cavanagh

Position: FAV

SEIU MARYLAND & DC STATE COUNCIL

1410 Bush Street, Suite F
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Testimony in SUPPORT of SB 576
Corporate Income Tax – Combined Reporting
Senate Budget & Taxation Committee
March 7, 2023
1:00 PM

Submitted to Guy Guzzone, Chairman
By Terry Cavanagh, Executive Director

SEIU Maryland & DC State Council requests a **Favorable Report on SB 576**.

With over two million members, SEIU is the largest labor union in North America. We are uniting workers in health care, public services, including in public education, and property services to improve lives and the services we provide. In the Maryland, Washington, DC, and Virginia area, we represent over 50,000 workers.

We are thousands of essential workers in nursing homes, hospitals, schools and public buildings. We are the broad working class. We pay our taxes, be they income taxes, sales taxes, or property taxes.

We have supported "Combined Reporting" for many, many years. We continue to do this for a simple reason:

Many profitable corporations in Maryland do not pay their fair share in taxes. This is wrong and must be corrected.

We have all heard the arguments against Combined Reporting before.

- If this bill passes, businesses will leave the state.

- If this bill passes, businesses won't bring jobs to Maryland.

- If this bill passes, it won't raise anywhere near what is claimed.
- If this bill passes, it may mean an actual loss of revenue.

- It's complicated and it's too hard.
- "I know a guy" who talked to someone in some other state and they're so happy Maryland hasn't passed this bill.

If any of this were true, it would also apply to other states. Surely at least one of all the other states that have adopted Combined Reporting, after seeing the results of what they had wrought, would repeal such a terrible and flawed law. We know that not one of the states has done so. Why?

What do we say to Maryland's small businesses who compete against those corporations which can apply these tax avoidance schemes, that they may not?

What do we say to those hard-working, middle- and lower-income Marylanders who pay their fair share of taxes after they learn that the Maryland General Assembly allows corporations year after year after year to use machinations to avoid paying their fair share?

Is the General Assembly's response, "The time for fairness must wait, while the time for unfairness remains with us forever."?

We ask you to put an end to this tax avoidance scheme and pass Combined Reporting. Now.

We ask a Favorable Report on Senate Bill 576. Thank you.

HB0576_FAV_MarylandRise.pdf
Uploaded by: Trap Jervey
Position: FAV

Contact:Trap Jervey, trap@marylandrise.org

TESTIMONY ON SB 576
Corporate Income Tax - Combined Reporting

Senate Budget and Tax Committee
March 7, 2023

SUPPORT

Maryland Rise is a non-partisan, not-for-profit organization working to promote economic opportunity for all Marylanders, not just the wealthy and well-connected.

Maryland Rise supports proposals focused on eliminating loopholes and tax breaks that benefit special interests and fixing our upside-down tax code, which allows the wealthiest individuals to pay the smallest share of their income in state and local taxes. We believe large, profitable corporations should pay what they truly owe in taxes and not expect working families to continue to subsidize more than their share of taxes that support our roads, schools, and infrastructure.

Maryland Rise supports SB 576, which closes a major corporate tax loophole by enacting combined reporting.

Enacting combined reporting would change how corporate income tax is calculated and provide a more complete and accurate accounting of the profits corporations earn from their activities in Maryland than the current method. This legislation prevents companies from reducing their taxable profits by artificially shifting revenue out of state because it treats a parent company and its subsidiaries as one corporation for state income tax purposes.

This legislation could generate more than $200 million in annual revenue for the state once fully implemented. This long-term revenue source can help ensure the state keeps its commitment to students by fully funding the Blueprint for Maryland's Future while also maintaining and strengthening other essential public services.

We must choose whether to commit to the investments necessary for thriving communities, or to

instead continue to prioritize tax breaks that benefit powerful special interests but do nothing to help our economy. Our coalition urges our legislators to commit to Maryland's working families and the future of our economy.

Therefore, we urge a favorable report on Senate Bill 576

Innovation Principles (1) for Multistate CIT Plann

Uploaded by: Don Griswold

Position: FWA

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state

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Innovation Principles for Multistate CIT Planning — Part 1

by Don Griswold

Reprinted from *Tax Notes State*, May 16, 2022, p. 729

Innovation Principles for Multistate CIT Planning — Part 1

by Don Griswold

Don Griswold

Don Griswold works to encourage informed public discourse about the social justice implications of state and local tax policy. Previously, he worked as a *Fortune* 10 conglomerate's executive tax counsel, a Big Four accounting firm's national partner in charge of state tax technical services, a nationwide SALT litigation partner with two AmLaw 100 firms, and an adjunct professor of tax at Georgetown University Law Center.

In this installment of Just SALT, Griswold begins a six-part series illustrating many of the principles underlying proactive structural planning seeking to reduce the multistate income tax obligations of large corporations. He explains foundational analytical building blocks to illustrate recurrent strategy types and the inadequacy of current state countermeasures in subsequent parts. Throughout the series, he proposes that the best counter to planners' ongoing innovations would be state adoption of true unitary combined reporting.

Proactive state corporate income tax (CIT) planning — restructuring a corporate group's legal entities and the financial transactions among them in a way that reduces the group's multistate income tax obligations in a lawful manner — remains alive and well today. This is true despite two decades of creative government countermeasures since the heyday of state CIT minimization in the Roaring '90s, a period that Nobel Prize-winning economist Joseph Stiglitz has described as a time of "innovativeness" that sometimes led companies to "increase their profits more by figuring out how to avoid taxes than by producing better products."[1]

Lawful state CIT avoidance cost the public $17 billion of state tax revenue ($2.85 billion from multistate planning, the rest from "offshoring") in 2018.[2] How is it that states have remained so "vulnerable to a wide variety of corporate tax shelters and tax-avoidance strategies"[3] despite tightened accounting and disclosure rules for aggressive tax positions, targeted antiabuse laws, and the adoption by over half the states of water's-edge unitary combined reporting?

Writing in *Tax Note*s, one well-known innovator of such strategies has explained that today's planning is "more complex than strategies of earlier generations"; that if a strategy can garner an opinion that it is "more likely than not" to beat a state challenge in court, "the bite of FIN 48" is merely a flesh wound; that financial statement reserves for uncertain tax positions mean little to companies that care most about "cash flow"; and that UTPs become bookable tax reductions for old years when the assessment limitations period expires or states simply give away earlier years in amnesties and voluntary disclosure programs.[4] "It makes sense to do state planning," this adviser explains, "even if the planning takes a few years to 'mature' into financial statement earnings."

Most importantly, the state CIT adviser industry provides large corporations with a well-

[1] Joseph Stiglitz, "The Roaring Nineties," *The Atlantic*, Oct. 2002.

[2] Richard Phillips and Nathan Proctor, "A Simple Fix for a $17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens," Institute on Taxation and Economic Policy (ITEP), at 10, 14, 15 (Jan. 2019).

[3] Michael Mazerov, "State Corporate Tax Shelters and the Need for 'Combined Reporting,'" Center on Budget and Policy Priorities, at 1 (Oct. 26, 2007).

[4] Charles E. Barnwell Jr., "State Tax Planning — What's Left?" *State Tax Notes*, Dec. 21, 2009, p. 857. Barnwell was one of my two mentors in the 1990s as I began my long career in state and local tax avoidance innovation. No nonpublic information is traceable to any specific person or entity in this series of articles.

funded intellectual infrastructure that is constantly innovating. By the time underresourced state revenue departments figure out one generation of planning strategies, industry is already on to the next. No increase in the sophistication of audit techniques, and no set of reactive antiabuse laws, can keep up with this industrial-scale innovation. If states keep on playing the CIT game as they have played it for decades, industry will continue to win, and the public will continue to lose.

This little series of articles seeks to raise awareness of industry's enduring innovation advantage by illustrating how state CIT planners think. I hope that the perspectives shared here will help state auditors identify and neutralize the next generations of planning. My goal here, though, is to persuade the state tax policymaking community to push for widespread state legislative adoption of a CIT filing method that will neutralize industry's advantage in one fell swoop. I call this approach "true" unitary combined reporting (TUCR).

TUCR is a worldwide unitary combination filing method that includes four primary elements:

- worldwide unitary combination with no water's-edge election (no exclusion of foreign affiliates) to neutralize state tax piggybacking on federal tax strategies that shift profits out of the United States;
- "multi-industry" unitary combination that includes payers of specialized taxes (like banks and insurers) to eliminate opportunities arising from discontinuities among varying business activity tax bases; and
- "throwback" sales factor apportionment sourcing to limit corporations' ability to generate "nowhere income" (a slice of the profit pie that escapes tax everywhere) by increasing the likelihood that the worldwide apportioned share of their taxable income will be 100 percent.[5]

[5] In this proposal, I have chosen not to wade into the controversial *Joyce/Finnigan* debate even though it ultimately must be addressed and resolved in order to make TUCR consistent across the states in matters — including a multi-entity unitary group's apportionment, throwback calculations, and the siloing or sharing of tax attributes like carryovers of state tax credits and net operating losses — that are central to TUCR's ability to neutralize multistate CIT avoidance planning completely. *See generally* "Finnigan Briefing Book Provided to Phil Skinner," Multistate Tax Commission; *In re the Appeal of Joyce Inc.*, Calif. Board of Equalization 1966); and *In re the Appeal of Finnigan Corp.*, No. 85-623-LB (Calif. BOE 1990).

So, let's get to work. Here in part 1 of the series, we will enter into the mindset of a state CIT planner by exploring some of the most common elements that constitute the building blocks of state CIT planning.

A Primer: CIT From a Planner's Perspective

If a state has the power to tax a company, the company's CIT liability is its tax base multiplied by its effective tax rate (ETR; statutory tax rate multiplied by the company's apportionment percentage). If the company has multiple legal entities, the state's filing method (separate or combined) determines how the calculation works for the group:

If jurisdiction, then

Tax = [Tax Base] x ([Statutory Tax Rate] x Apportionment %])

subject to separate or coming filing rules.

Complexity and inconsistency beset the corporate income tax laws of the 50 states just as they do the Internal Revenue Code, so even this rudimentary equation provides a rich source of material for developing a host of CIT minimization strategies.

Jurisdiction

If a state is powerless to impose tax on a legal entity, that entity becomes highly prized by tax planners as a place to concentrate taxable income. For that reason, isolation of a legal entity from a state's power to tax has been central to much state CIT planning.

Planners often start with P.L. 86-272, which provides a federal safe harbor from CIT for businesses that limit their in-state activity to soliciting sales of tangible goods, then proceed to the constitutionally established outer limits of state CIT imposition power ("nexus"), which for a quarter century planners argued was limited by an ambiguous U.S. Supreme Court ruling[6] to legal entities having a "physical presence" (ownership of property, employment of personnel, or contractors) in the state. The "nexus isolation" building block (discussed below) is still present in many CIT strategies despite a 2017 Supreme

[6] *Quill v. North Dakota*, 504 U.S. 298 (1992).

Court ruling that retroactively subjects to tax jurisdiction any legal entity having "an extensive virtual presence" in the state.[7]

Tax Base

Reduce a corporation's tax base, and you reduce its tax. State CIT tax bases are "net" income, obtained by deducting from gross income a variety of expenses. Deductions are highly manipulable elements, and thus are highly prized by tax planners, who have a field day with tax base "erosion" and other techniques discussed below.

Most states' CITs are imposed on a tax base that begins with a company's federal income tax base, which then makes a variety of addition and subtraction modifications, along with other adjustments. States do not always conform to all IRC income tax provisions (depreciation and the dividends received deduction are frequent areas of nonconformity), and the significant differences between the federal consolidated group and the various types of state filing methods (discussed below) make, for example, the federal consolidated return regulations (addressing intercompany transactions) irrelevant or problematic.

Apportionment

Analogizing a corporation's tax base to a pie, apportionment addresses how big a slice is portioned out to each state that has jurisdiction to tax it. States properly want fair and full apportionment, while planners want lots of pie left remaining on their client's plate. States divide up ("apportion") the profit pie by using a formula that examines measurable proxies for business activity. Many states now apportion based solely on a sales fraction, though for decades most included property and payroll fractions as well.

Let's illustrate by imagining ABC-Co — a seller of goods that has nexus with Pennsylvania, conducts activities that forfeit the safe harbor of P.L. 86-272, and thus is liable for CIT in Pennsylvania (which has adopted single-sales-factor apportionment).[8] Imagine that ABC-Co has $100 million of total gross sales receipts across the country in a given tax year, $12 million of that attributable to customers located in Pennsylvania. ABC-Co, then, has a 12 percent Pennsylvania apportionment fraction:

$$\frac{\$12\text{M PA Sales}}{\$100\text{M Sales Everywhere}} = 12\% \text{ Pennsylvania apportionment}$$

ETR

Planners find it useful to think in terms of a legal entity's ETR, calculated by multiplying the state's statutory CIT rate by the company's apportionment fraction for that state. Consider the company in the paragraph above: 12 percent of its taxable income is apportioned to Pennsylvania. If we round up Pennsylvania's 9.9 percent statutory CIT rate to 10 percent to simplify the math, the company has a 1.2 percent ETR in Pennsylvania. For reasons explained below, planners often add up a company's ETRs in every state that follows the separate-filing (S/F) method. The resulting "S/F ETR" is often set as a bogey for the "state tax minimization" planning team to eliminate completely.

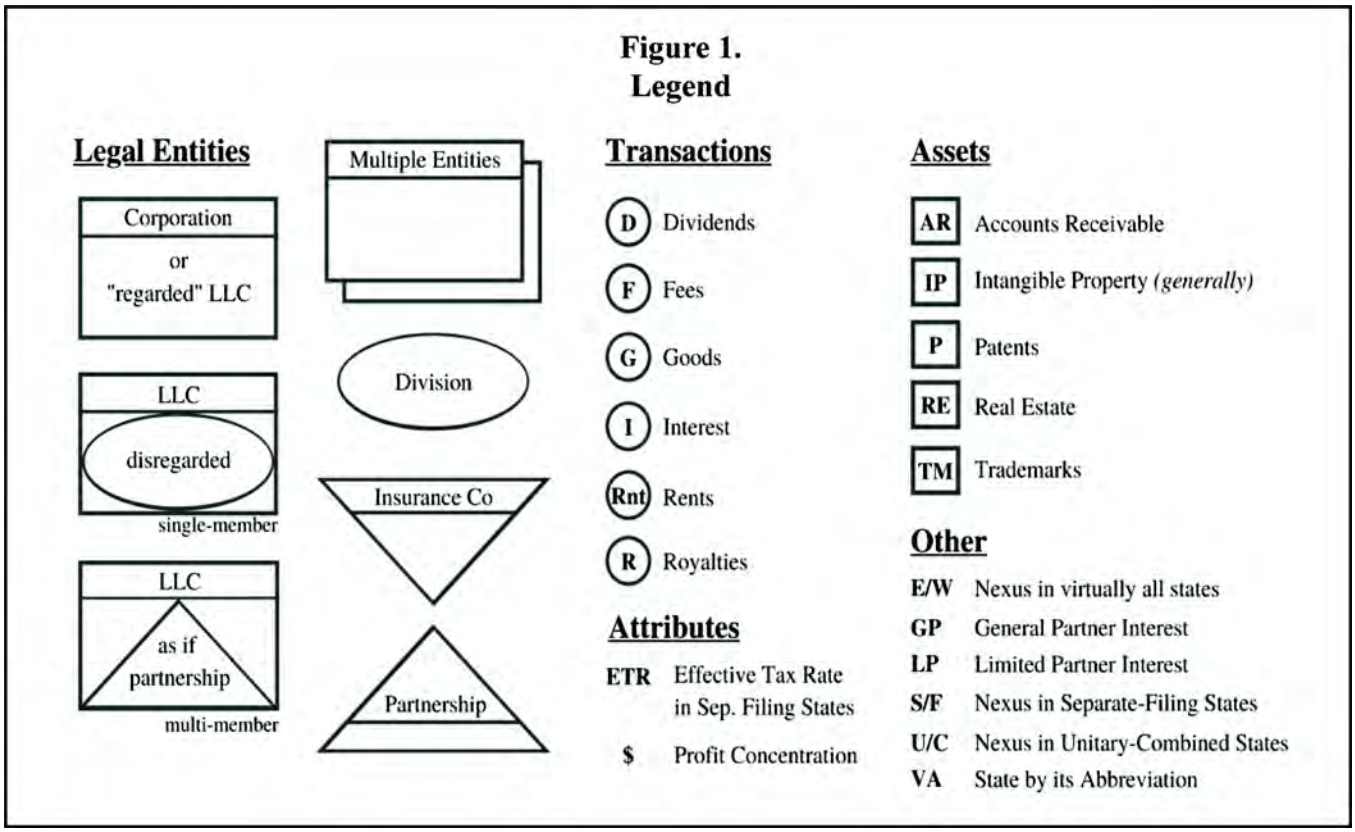
Filing Method

Most large business enterprises today operate with multiple legal entities, as a result of acquisitions or other legitimate business reasons, but also to avoid tax and other regulatory obligations. While the IRC takes a "federal consolidated group" approach to such multi-entity businesses, states generally use one of three basic methods, sometimes allowing taxpayers to choose among them: separate filing, water's-edge unitary combination, and worldwide unitary combination.[9]

[7] *South Dakota v. Wayfair Inc.*, 585 U.S. ___ (2018).

[8] 72 Pa. Stat. section 7401(3)2(a)(9)(A)(v).

[9] A fourth method, in which some separate-filing states require multiple nexus entities to file a combined return after apportioning their gains and losses, is a wrinkle not addressed here.

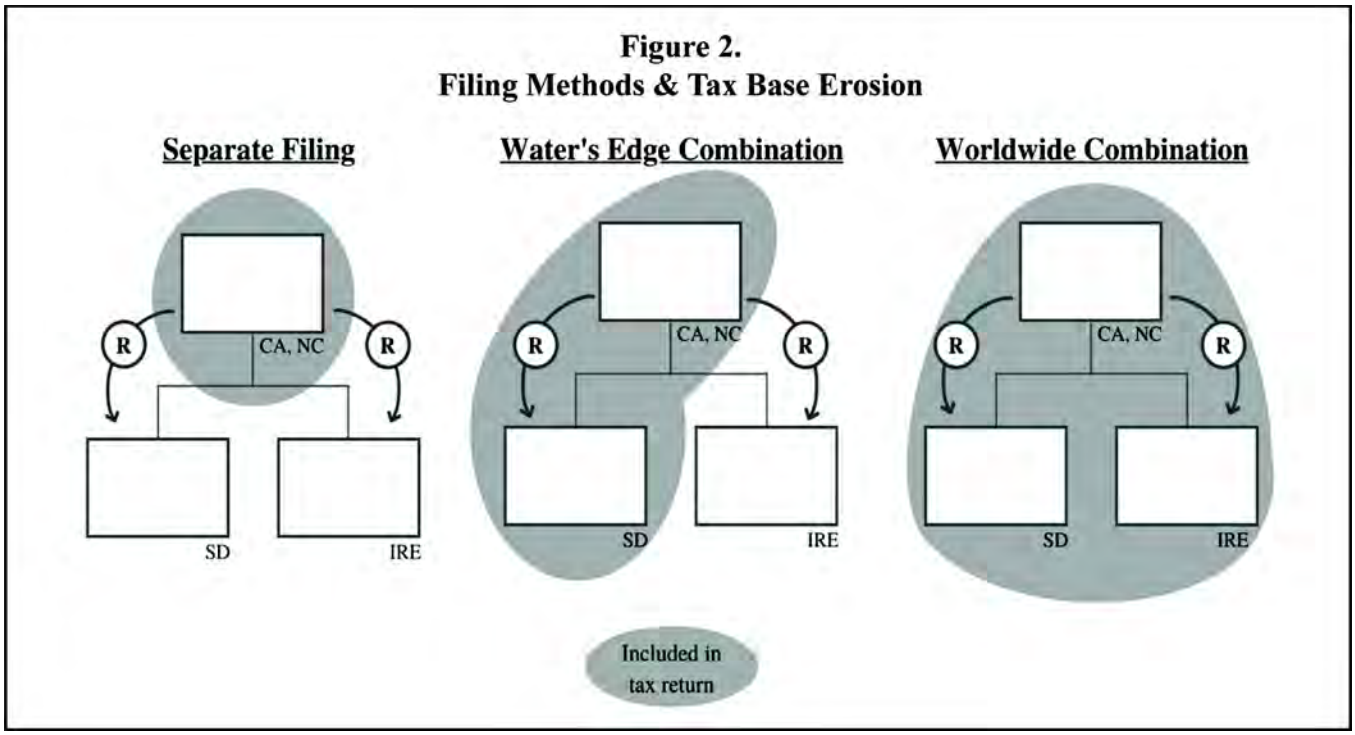


Separate-filing methods ignore the business reality that an integrated "unitary" business group operates for all intents and purposes as if it were a single legal entity; separate-filing states require each entity that "has nexus" with the state to file its own separate CIT return, ignoring the interrelated mutual dependency of the group as a whole. This system makes the separate-filing state highly vulnerable to efforts by planners to escape some of that tax.

"Unitary combined reporting" methods come today in two major forms. Comporting well with the business reality of integrated mutual interdependence among members of a unitary group, but virtually nonexistent at present,[10] the "*worldwide* unitary combination method" determines the tax base and apportionment factors of in-state legal entities (those that "have nexus") by combining tax base and apportionment data from all unitary legal entities (whether they have nexus or not) around the world. Most common is the "*water's-edge* unitary combination method," which — departing from business reality for multinational corporations — excludes foreign affiliates from the calculations. This approach leaves massive holes in water's-edge unitary combined states' protection. Worldwide unitary combination — particularly when strengthened to become TUCR — would be the single most effective antidote to CIT avoidance.

The varying levels of protection offered by these three filing methods are illustrated in Figure 2. First, though, it may be useful to familiarize yourself with the legend in Figure 1, which will be useful throughout this multipart series of articles.

[10] New Hampshire's recent decision to evaluate moving from water's-edge to worldwide combined reporting is welcome news. *See* Benjamin Valdez, "New Hampshire Creates Worldwide Reporting Study Commission," *Tax Notes Today State*, Apr. 13, 2022.



In Figure 2, Parent has nexus in North Carolina (a separate-filing state) and California (a water's-edge combination state). Parent has created two NewCos — one in South Dakota (which does not impose a CIT),[11] and another in Ireland (until recently, a notorious tax haven)[12] — transferring its domestic trademarks to one and its foreign trademarks to the other, and now paying royalties (shown with arrows) for that use. The shaded ovals represent the reach of the state's filing method. The separate-filing state (North Carolina) loses tax base that has been siphoned off by both of Parent's contrived royalty deductions, foreign and domestic. The water's-edge combined state (California) does not lose tax base for the domestic royalty because both sides of that transaction (royalty deduction and royalty income) are within the combined group, canceling each other out; but California does lose tax base for the foreign royalty because its combination stops at the water's edge.

Only worldwide combination (with or without the TUCR enhancement) prevents this base erosion completely, including (and canceling out) the deduction and income sides of both the foreign and domestic royalties that were artificially created by the tax planner.

Building Blocks for CIT Planning

To begin our discussion of building block elements, recall that the tax formula discussed above in the planner's CIT primer includes three core attributes — jurisdiction (nexus), tax base, and apportionment — that can be manipulated by the planner at will. Mixing and matching these planning elements in the contexts of a corporate group's particular (and manipulable) fact pattern, the planner develops one or more structural CIT avoidance strategies for consideration by its corporate client. Later in this series we will discuss a variety of these strategies, grouping them into "families" that share similar features.

Some of the naming conventions and organizing taxonomy here will have been used by planners that the reader has come across; others may not. The goal here is to suggest a common vocabulary and a common way for auditors, policy analysts, and policymakers to think about the CIT avoidance problem.

[11] South Dakota Department of Revenue, Corporate Income Tax.

[12] Liz Alderman, "Ireland's Days as a Tax Haven May Be Ending, but Not Without a Fight," *The New York Times*, July 8, 2021.

Apportionment Engineering

Much structural CIT planning in separate-filing states boils down to (1) creating tax-favored legal entities and then (2) concentrating most of the group's profits there instead of in tax-disfavored affiliates. Qualify a company as a nexus-isolated intangibles holding company (IHC) tax shelter in a tax haven state like Delaware (infamous for its Delaware intangible holding companies, or DHCs),[13] for example, and you've got an entity with a zero apportionment fraction, and thus an ETR of zero in separate-filing states. Alternatively, put that IHC in a state like Wyoming that imposes no CIT,[14] and you've got another zero-ETR entity where you can park your income-producing assets.

Zero is tempting for a planner. Advisers still propose variations on the DHC/IHC structure (illustrated later in this series) today, decades after they became notorious, and many sophisticated companies still have these structures in the organization chart's diverse grab bag of simple and sophisticated avoidance strategies.

But zero is not the only game in town. CIT planning is often an exercise in ETR arbitrage, relocating taxable income from an entity with a high ETR to an entity with a lower ETR. For such "apportionment engineering" work, apportionment factors sourced to unitary states become valuable attributes for the planner. Move them around as much as you like and they will have no impact in unitary states, but they can drive separate-filing state apportionment (and thus S/F ETR) down when cleverly rearranged.

To illustrate the engineering of a desirable low-S/F ETR entity, recall the ABC-Co example in the primer above. ABC-Co starts out with a high Pennsylvania apportionment fraction, calculated like this:

$$\frac{\$12\text{M PA Sales}}{\$100\text{M Sales Everywhere}} = 12\% \text{ Pennsylvania apportionment}$$

But imagine that the planner discovers in the client's org chart a large affiliate, XYZ-Co, which is also subject to Pennsylvania CIT (perhaps because it owns a distribution center in the state) and sells $300 million of goods each year — but only to customers in unitary combined filing states (like California). Imagine also that, as a stand-alone entity, XYZ-Co's apportionment in Pennsylvania, where it makes no sales at all, is zero:

$$\frac{\$0\text{ PA Sales}}{\$300\text{M Sales Everywhere}} = 0\% \text{ Pennsylvania apportionment}$$

Simply merge XYZ-Co into ABC-Co and (voila!) the resulting entity (call it New ABC-Co) has $12 million of sales to Pennsylvania customers and $400 million of sales everywhere. New ABC-Co's apportionment calculation looks like this:

$$\frac{\$12\text{M} + \$0\text{ PA Sales}}{\$100\text{M} + \$300\text{M Sales Everywhere}} = \frac{\$12\text{M}}{\$400\text{M}}$$

$$= 3\% \text{ Pennsylvania apportionment}$$

The planner's exercise in apportionment engineering cut New ABC-Co's Pennsylvania apportionment from 12 percent to 3 percent. Again, rounding Pennsylvania's statutory tax rate up to 10 percent to keep the math simple, New ABC-Co's ETR dropped from 1.2 percent to 0.3 percent. The savvy planner will look for an XYZ-Co that has a much lower profit margin than ABC-Co, bringing in lots of "unitary factors" to dilute apportionment without bringing in additional tax base (offsets to tax reductions).

Additive apportionment dilution can be supplemented with subtractive dilution if a "factor trap" entity is created — perhaps a captive insurance company or (in days gone by) the infamous Texas limited partnership (both discussed later in this series). To completely neuter apportionment engineering, a state must adopt TUCR with a worldwide and multi-industry method.

Asset Placement

Another common element in CIT planning focuses on the strategic placement of assets within the corporate group. Asset placement can affect any or all of the three manipulable core attributes

[13] *See, e.g.*, "Delaware: An Onshore Tax Haven," ITEP (Dec. 2015).

[14] Janelle Cammenga, "State Corporate Income Tax Rates & Brackets 2021," Tax Foundation (Feb. 3, 2021).

in the CIT formula — nexus, tax base, and apportionment. Real and tangible assets like office buildings and equipment, when moved, may strip a legal entity of nexus (remove it from a state's power to impose CIT) or create nexus for it. If the state's apportionment formula includes a property factor, asset placement affects the portion of an entity's tax base that may be taxed in a separate-filing state. If the asset attracts an income stream (rent, royalties, or interest, for example), that asset's placement also manipulates the sales factor in every separate-filing state.

Three types of assets are of particular interest to planners when they work on manipulation of the tax base: assets that attract income streams from third parties; assets that the company anticipates selling at a large gain or a large loss; and assets that, if separated from the affiliated user, can move tax base from one entity to another. For the latter type, intragroup assets like patents, trademarks, real estate, promissory notes, and accounts receivable can produce the kinds of intercompany transactions that are essential to creating deductible expenses for entities with a high ETR in separate-filing states.

The asset placement building block is central to the stashing, straddling, and siphoning families of strategies described and illustrated later in this series. Adoption of TUCR would neutralize the effectiveness of asset placement as a building block in most structural CIT planning strategies.

Complexity

Try a little exercise when you have too much time on your hands (and access to a good online state tax research tool): Find a company that has had published court decisions in multiple states, each state prosecuting its attempt to shut down a CIT avoidance strategy or two that its revenue department identified on audit. From time to time, you will find that two states will have identified entirely different planning strategies, each missing a significant strategy that the other state's auditors caught.

This may not be accidental. When aggressive companies engage creative advisers — particularly when such an engagement reoccurs multiple times over a period of years, perhaps with a different adviser each time — the planning company will have deployed a diverse portfolio of strategies throughout its legal structure. Planners hope that auditors will stop once they find the "low hanging fruit." The more sophisticated (and recent) the strategy, the more likely it is to be hidden in a series of complex and obscure intercompany relationships among multiple obscure entities that are designed, quite simply, to tire out the state's audit team or run out the clock on the audit.

Income Concentration

Strategy identifiers like "income shifting," "profit siphoning," "base shifting," and "base erosion" all refer to building blocks that move taxable income from a tax-disfavored entity to a tax-favored entity. For the most part, these strategies concentrate the tax base in a tax-favored entity by moving it there, with attendant apportionment changes that the planner will include in a spreadsheet in which it models projected "savings" (avoidance).

The income concentration element, though, can also be achieved by letting the tax base just sit in the entity in which it historically resided. Income concentration may be paired with apportionment engineering — converting the original entity itself from tax-disfavored (high ETR in separate-filing states) to tax-favored (low or no S/F ETR).

This "sit still" income concentration may be paired with the nexus isolation building block (discussed below) by stripping out of the entity all operations that carry separate-filing state nexus with them, leaving only unitary state nexus (and thus a zero S/F ETR) behind. It can also be combined with two frequently paired building blocks — supply chain segregation and transfer pricing — to strip down a multifunction operating entity into a sleek entrepreneur-type holding company that claims entitlement to most of the group's profits while containing few of the group's nexus- or apportionment-producing activities in separate-filing states. (This will be illustrated later in the series.)

Whether income concentration is achieved by moving the income or skinnying down the ETR, this central element of many CIT avoidance strategies can be eliminated with legislative adoption of TUCR.

Nexus Isolation

While apportionment engineering concedes an entity's nexus but seeks to dilute the portion of its income that the state may tax, the "nexus insulation/isolation" building block goes for broke, seeking to reduce the entity's S/F ETR down to zero.

For decades, U.S. Supreme Court precedent on the topic was squishy enough to allow every planner to claim that its DHCs and IHCs had no CIT nexus anywhere except for the tax-haven-hosting state in which they had pretended to set up shop.[15] They filed no tax returns for such entities, taking a "catch me if you can" approach to their tax compliance obligations.

Companies whose business is limited to the solicitation and sale of tangible goods (plus a handful of ancillary activities) might also rely on the added protection of a federal law that provided a broad safe harbor from state CIT jurisdiction.[16] With a nexus-insulated entity in the group, other building blocks could be used to siphon, stash, and stuff the planner's way to "optimal" (very low) tax levels.

In 2017, however, the Supreme Court retroactively pulled the rug out from under planners who sought to use the nexus isolation building block. The Court's *Wayfair*[17] decision arguably stands for the proposition that virtually any entity with a website has commerce clause "substantial nexus" everywhere . . . so the planner's hope for nexus isolation may turn on litigation over a due process "minimum contacts" nexus; on the state's "doing business" tax jurisdiction statute, which is often very broad; and on the post-*Wayfair* status of P.L. 86-272 (has this federal safe harbor been mooted because some of every company's online presence is inescapably unrelated to solicitation of sales?).

The uncertain viability of planners' "no nexus" assertions is not, however, any reason for vulnerable states (separate-filing states and, to a lesser but still financially massive extent, water's-edge unitary states) to think they can escape the continued embarrassment and revenue devastation of giving away the fisc to CIT planners. Post-*Wayfair*, some of the nexus battles will continue to be litigated. In any event, nexus insulation is not a necessary element to many CIT planning strategies. TUCR remains the only complete answer.

Nonconformity

State CIT systems generally take a corporation's federal corporate income tax base as the starting point for the tax calculation. From the CIT planner's perspective, this is great news because most federal tax strategies that shrink (temporarily or permanently[18]) the tax base — like siphoning profits to overseas tax havens — also shrink the CIT base. This is sometimes referred to as "piggyback planning."

Separate-filing states are not the only victims of their general conformity to a federal tax base that is routinely and massively reduced by federal tax planning. Go back and take another look at Figure 2. Unitary combined states, with limited exceptions, end combination at the water's edge, leaving themselves exposed to all the federal tax siphoning strategies to which separate-filing states are exposed. Separate-filing and water's-edge unitary states all lose over $14 billion in tax revenue annually to general conformity to the avoidance-riddled federal corporate income tax base.[19] State adoption of TUCR (grounded on a worldwide filing group) would eliminate the state revenue hits that attend initial conformity to the federal income tax base.

Disappointing state legislative debates regarding global intangible low-taxed income[20] — will a state choose not to conform to these federal antiabuse rules or decouple its way into continuing vulnerability — stand in contrast to reasonable conformity/nonconformity policy debates in connection with the many inherent

[15] *Quill*, 504 U.S. 298.

[16] P.L. 86-272.

[17] *Wayfair*, 585 U.S. ___.

[18] If a taxpayer is patient enough to wait for the next corporate welfare giveaway, in the form of the tax-free or tax-favored "repatriation" provisions that Congress adopts from time to time, deferral of tax liability becomes permanent.

[19] *See* ITEP, *supra* note 2.

[20] The Tax Cuts and Jobs Act of 2017 adopted some provisions that put a bit of a dent in federal tax avoidance with its GILTI rules — effectively imposing a minimum tax on some types of planning structures — and all the states should conform. A state's failure to conform to the GILTI regime is simply voluntary vulnerability. *See* Daniel Bunn, "Gift or Lump of Coal: U.S. Cross-Border Tax Changes Won't Be Home for Christmas," Tax Foundation (Dec. 20, 2021).

incongruities between federal and state group filing methods.

One such incongruity — inconsistent conformity to some rules governing deductions for dividends received from an affiliate — was used by me and my team in the 1990s to create an infamous CIT avoidance scheme in the "straddling" family of strategies illustrated later in this series: the captive real estate investment trust. Some inconsistencies are industry specific. Insurers, for example, are taxed federally on their net income while most states impose a gross receipts tax on premiums, leading planners to innovate the "captive insurer" and "adaptive insurer" CIT strategies (also illustrated in forthcoming articles).

Recharacterization

Federal and state governments on audit sometimes attempt to combat tax minimization planning by recharacterizing the nature of some transactions or entities on the grounds that they are shams (lacking sufficient economic substance or a dominant nontax business purpose) or organized into a series of steps designed to produce a tax-reducing result that would not exist under a simpler set of steps.

Planners do the same thing, but in reverse; this building block is omnipresent in CIT planning. Recharacterization — in the sense of changing the appearance of facts so that a tax auditor may not notice that tax avoidance is occurring — may include creating entities that exist only (or almost only) on paper;[21] claiming deductions for transactions under written "agreements" in which there actually exists only one party, not two;[22] or maintaining two sets of books (the true financial accounting records presented to SEC-attestation auditors and a second set maintained only for preparation of tax returns and for presentation to revenue department CIT auditors).[23] Dividends paid by a specialized entity can be laundered by passing them through an intermediate buffer entity on the way to the ultimate recipient, altering the treatment of those dividends.[24] (This building block appears in the REIT strategy illustrated later in the series.) The list goes on.

Shelter Entities

For state CIT avoidance to succeed, jurisdiction must be eliminated, apportionment must be diluted, or tax base must be reduced. Regarding the latter, quite frequently "reduce" means "move." Taxable income is often removed from one legal entity's tax base by moving it to the tax base of an affiliated legal entity. Broadly speaking, the recipient entity — the next building block up for discussion — is a "tax shelter" entity.

Best known to the public are tax shelter entities explicitly established and hosted in tax haven jurisdictions. Internationally, the most infamous tax havens include jurisdictions spread all over the world — Bermuda, the British Virgin Islands, and the Cayman Islands in the Caribbean; Ireland, Luxembourg, the Netherlands, and Switzerland in Europe; Hong Kong and Singapore in Asia; and more. Much closer to home, the United States — particularly including the states of Alaska, Delaware, Nevada, South Dakota, and Wyoming — has been added to lists of jurisdictions that actively host secrecy and tax haven activities.[25]

The most widely known state corporate income tax haven in the United States, of course, is Delaware, host of the infamous DHC tax shelter entity discussed earlier and illustrated later in this series. The now-defunct "Michigan single business tax holding company" may or may not have been designed intentionally to cannibalize revenue from its sister states, as was the DHC, but it functioned similarly as a state-designed tax shelter vehicle.[26]

Tax shelter entities are designed by planners as well as by tax-haven-hosting states, as we have seen in our exploration of the apportionment engineering building block above. Bespoke IHCs

[21] *PepsiCo v. Illinois*, 16 TT 82; 17 TT 16 (Ill. Tax Trib. 2021).

[22] *See, e.g.*, Jesse Drucker, "Friendly Landlord: Wal-Mart Cuts Taxes by Paying Rent to Itself," *The Wall Street Journal*, Feb. 1, 2007, p. A-1.

[23] *Hormel Foods v. Wisconsin*, WI TAX No 07-I-17 (2010).

[24] *AutoZone Investment Corp v. South Carolina*, Dkt. No. I9.ALJ-1 7.0068.CC (S.C. ALC 2020).

[25] Will Fitzgibbon and Asraa Mustufa, "Another President Under Investigation, U.S. Condemned as Tax Haven by European Parliament as Pandora Papers Fallout Continues," International Consortium of Investigative Journalists (Oct. 22, 2021); and "Corporate Tax Haven Index," Tax Justice Network (2021).

[26] *See Martha Stewart Omnimedia v. Michigan*, No. 409820 (Mich. Tax Trib. 2011); and *Kmart v. New Mexico*, 131 P.3d 22 (N.M. 2005).

(also known as intellectual property holding companies, royalty companies, trademark holding companies, finance companies, passive investment companies, and the like) — much like off-the-shelf state-hosted entities like DHCs[27] — generally receive profit shifting out of affiliates that are heavily taxed in separate-filing states. These IHCs generally locate (or pretend to locate) their headquarters and substantial apportionment factors in unitary combined states (in which domestic structural CIT planning is ineffective) or in states that do not impose a CIT at all.

CIT-minimizing corporations also use natural tax shelter entities, requiring no host state to offer them, no planner to engineer them — the preexisting LossCo. Find a legal entity in the affiliated group that is expected to produce significant net operating losses (or carry these NOLs over to future years) for the foreseeable future, and the corporation has a natural entity into which it may shift CIT base siphoned out of an entity with a high ETR in separate-filing states.[28] Or vary the approach by converting the profitable affiliate into a disregarded single-member limited liability company and have the LossCo buy it and let the LLC's tax base flow up and become absorbed by the NOLs.

A LossCo with expiring NOLs (those that the entity will be unable to use before the carryforward period expires) is a particularly attractive building block for CIT planners because it extracts value out of a wasting asset. Perhaps even more attractive to the planner, though, is the LossCo that runs losses year in and year out, because the planner will not need to build in an "exit strategy" to minimize the tax cost of getting out of the structure when it stops producing tax reductions. An example might be a publicly traded holding company that does little more than borrow from outside banks, carrying interest expense deductions that it cannot offset by itself.

A natural LossCo will not be found in every org chart, of course. In that case, an unnaturally perpetual LossCo can be engineered by planners. A common version of this strategy is usually produced inadvertently by less sophisticated planners who set such artificially high transfer prices that the DHC/IHCs suck their royalty-paying operating company affiliates into a perpetual loss position. The resulting NOL carryforwards can become so large that years later, a more sophisticated follow-on adviser may suggest folding the DHC back into the operating company. This makes for a much less obvious target for state auditors, who may not think to look back to long-closed years to discover that the innocuous-looking NOLs were actually generated years ago by aggressive tax planning.[29]

Consequently, companies with NOLs should be viewed by state tax auditors as potentially no more "natural" than the run-of-the-mill IHC with adviser-gerrymandered nexus and apportionment factors.

Supply Chain Segregation

There are and always have been, of course, supply chains for every type of good or service in every economy. Supply chains are often highly complex. Raw materials are acquired, extracted, stored, transported, divided, combined, manufactured, assembled, packaged, and otherwise transformed multiple times along the upstream supply chain; and then on the downstream, the goods are marketed, sold, stored, and transported multiple times along the way to multiple business-to-business and eventually end-user customers; and finally, the used goods are sent along through the waste management, processing, and disposal part of the supply chain. Service industries have their analog.

Many business enterprises specialize in a narrow sliver or two of the enormously complex supply chains of which they are a part. Others may be more vertically integrated, performing a larger swath of the supply chain. Some businesses historically performed multiple steps in their

[27] *See TD Banknorth. v. Vermont Department of Taxes*, 967 A.2d 1148 (Vt. 2008).

[28] Such strategies may be employed in some unitary-combination states as well because some such states — like California — silo NOLs as they do credits, departing from the "as if a single taxpayer" treatment that is the consistent tax policy objective of unitary combination, and preventing the sharing of such tax attributes among different legal entities within the unitary group. (But we promised not to get into the *Joyce/Finnigan* debate.)

[29] In such cases, state auditors may be able to pick up large taxable gains under IRC section 311(b) if the intangible property has appreciated significantly in value over time.

pieces of the supply chain within a single legal entity, while others separated the work into a variety of business entities.

The building block here involves segregating different pieces of a business enterprise's slice of the supply chain into separate legal entities. This planning element may be combined with other elements (apportionment engineering, nexus isolation, asset placement, transfer pricing) — for which the ultimate goal is concentrating taxable income in low S/F ETR entities — within a structure aimed at appearing to a revenue department auditor like "business as usual" instead of like what it is: clever manipulation of entities and their financial relationships in order to escape tax.

Here again, as with many other elements of structural CIT planning, TUCR neutralizes this building block by treating the business enterprise for tax purposes the way the business enterprise treats itself for operational purposes — like a single entity.

Transfer Pricing

Distilled to its essence, most structural CIT planning today achieves its tax-minimizing goals primarily by manipulating a corporate group's legal entities, the transactions among them, and (the final building block we shall discuss) the prices of those transactions.

Just how much tax can a planner escape with the creative setting of the price on an intercompany royalty, interest rate, factoring discount, sales price, or management fee? Genuine prices are set in the marketplace — where independent parties negotiate with one another — but a group of commonly controlled companies do not comprise a marketplace of independent parties. Intercompany transactions are always intragroup, and thus completely manipulable by the planner.

Faced with this manipulability problem, federal and international tax systems — in which the far more effective antiavoidance tool of unitary combined reporting has historically been unavailable — rely heavily on transfer pricing rules that are founded on the arm's-length fiction. Imagine a buyer and a seller standing in a marketplace — perhaps a farmer and a traveling merchant in colonial times meeting on the bucolic town green — each distrustful of the other as they haggle over price. They stand a good distance apart, keeping each other "at arm's length." They are strangers; hugging is not happening. Then fast-forward to the extensive development of this concept in IRC section 482 and its surrounding constellation of regulations, rulings, court decisions, and economists' analyses . . . all based on the shaky foundation of an inadequate legal fiction.

Planners rely on the transfer pricing fiction as one of their building blocks, but, fortunately, the states need not play this game. As will be explained more completely in part 2 of this series, states' efforts to counter the transfer pricing building block are a carnival sideshow into which planners are happy to distract them. Worldwide unitary combination (with the TUCR enhancements) makes this building block irrelevant. Treat intercompany transactions within a true unitary group like what they are — the mere movement of money from the right to the left pocket — and most CIT avoidance evaporates.

Conclusion

These 10 CIT planning elements are not the only building blocks available to the corporate state tax planning community, but they are among the most commonly used elements for the manufacture of scores of CIT avoidance strategies. Next, rather than jumping directly into a discussion of those strategies, part 2 of this series will address countermeasures — antidotes, if you will — that states have taken, or could take, in an attempt to close the multibillion-dollar CIT planning loophole identified by the Institute on Taxation and Economic Policy.[30] Spoiler alert: I will argue that not one of the antidotes currently in use comes close in effectiveness to the measure that every state legislature should adopt without further delay: TUCR — true unitary combined reporting. ■

[30] *See* ITEP, *supra* note 2.

Innovation Principles (2) for Multistate CIT Plann

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Innovation Principles for Multistate CIT Planning — Part 2

by Don Griswold

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Innovation Principles for Multistate CIT Planning — Part 2

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Don Griswold

Don Griswold works to encourage informed public discourse about the social justice implications of state and local tax policy. Previously, he worked as a *Fortune* 10 conglomerate's executive tax counsel, a Big Four accounting firm's national partner in charge of state tax technical services, a nationwide SALT litigation partner with two AmLaw 100 firms, and an adjunct professor of tax at Georgetown University Law Center.

In this installment of Just SALT, Griswold continues a six-part series on corporate income tax reduction planning. In part 2, he illustrates state countermeasures and proposes that the best is true unitary combined reporting.

The aim of this six-part series is to strengthen corporate income tax (CIT) auditors' and policymakers' ability to counter lawful state CIT reduction planning. An appreciation for the broad principles underlying this planning and its constantly evolving innovations, I hope, will put into stark relief two realities: First, the tax avoidance community's innovations will always be steps ahead of auditors and legislators; and second, current countermeasures are inadequate. Only by taking unitary combined reporting to the next level can government solve the CIT avoidance problem. I recommend that states adopt true unitary combined reporting (TUCR), described below.

Part 1[1] of the series offered a CIT primer from a planner's perspective and illustrated "building blocks" that are foundational to much CIT planning. Parts 3 through 6 will group related state CIT planning strategies into "families," and illustrate them in analysis and in figures. The reader may find it useful to refer to the legend provided in Figure 1 in the first article. Figures will be numbered consecutively across the series, for ease of cross-referencing.

Introduction to State Countermeasures

The least effective way to stop corporations from avoiding $17 billion in CIT every year[2] is to enact an endless series of one-off loophole closures targeted at each planning strategy as it hits the newspapers — as happened in a number of states after Walmart's real estate investment trust-based CIT reduction strategy was outed publicly by *The Wall Street Journal*.[3] This approach captures only the tiniest tip of the avoidance iceberg and allows clever planners to tweak the strategy in response to each law change so that even the visible tip does not remain neutralized for long.

Substantive countermeasure development properly starts for government at the same place that substantive planning innovation starts for corporations — that broad formula discussed in the primer in part 1 of this series:

*If **jurisdiction**, then*

$$Tax = [\textbf{Tax Base}] \times ([Statutory\ Tax\ Rate] \times [\textbf{Apportionment}\ \%])$$

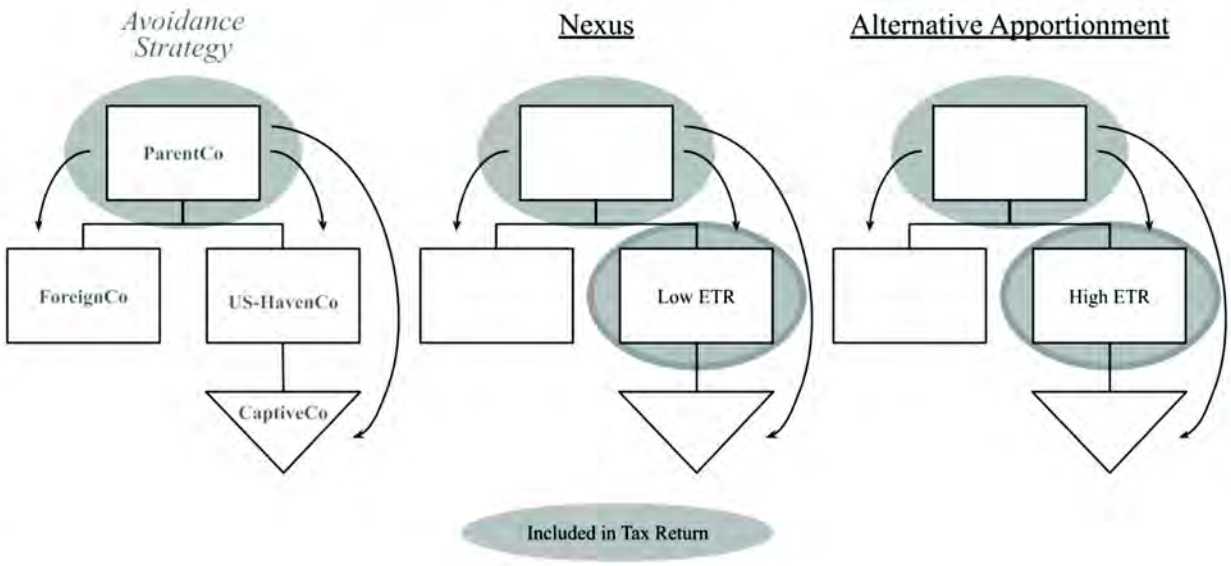
*subject to separate or combined **filing method** rules.*

[1] Don Griswold, "Innovation Principles for Multistate CIT Planning — Part 1," *Tax Notes State*, May 16, 2022, p. 729.

[2] *See* Richard Phillips and Nathan Proctor, "A Simple Fix for a $17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens," Institute on Taxation and Economic Policy, at 10, 14, 15 (Jan. 2019); Griswold, *supra* note 1, discussion at fn. 2.

[3] Jesse Drucker, "Wal-Mart Cuts Taxes by Paying Rent to Itself," *The Wall Street Journal*, Feb. 1, 2007.

Figure 3A .
Antidotes Based on Separate Filing



Readers will recall that three core attributes in this formula — jurisdiction (nexus), tax base, and apportionment — can be manipulated by the planner and used as building blocks to create a wide variety of CIT reduction strategies. They will also note that a fourth core attribute — filing method — can be altered by a state legislature.

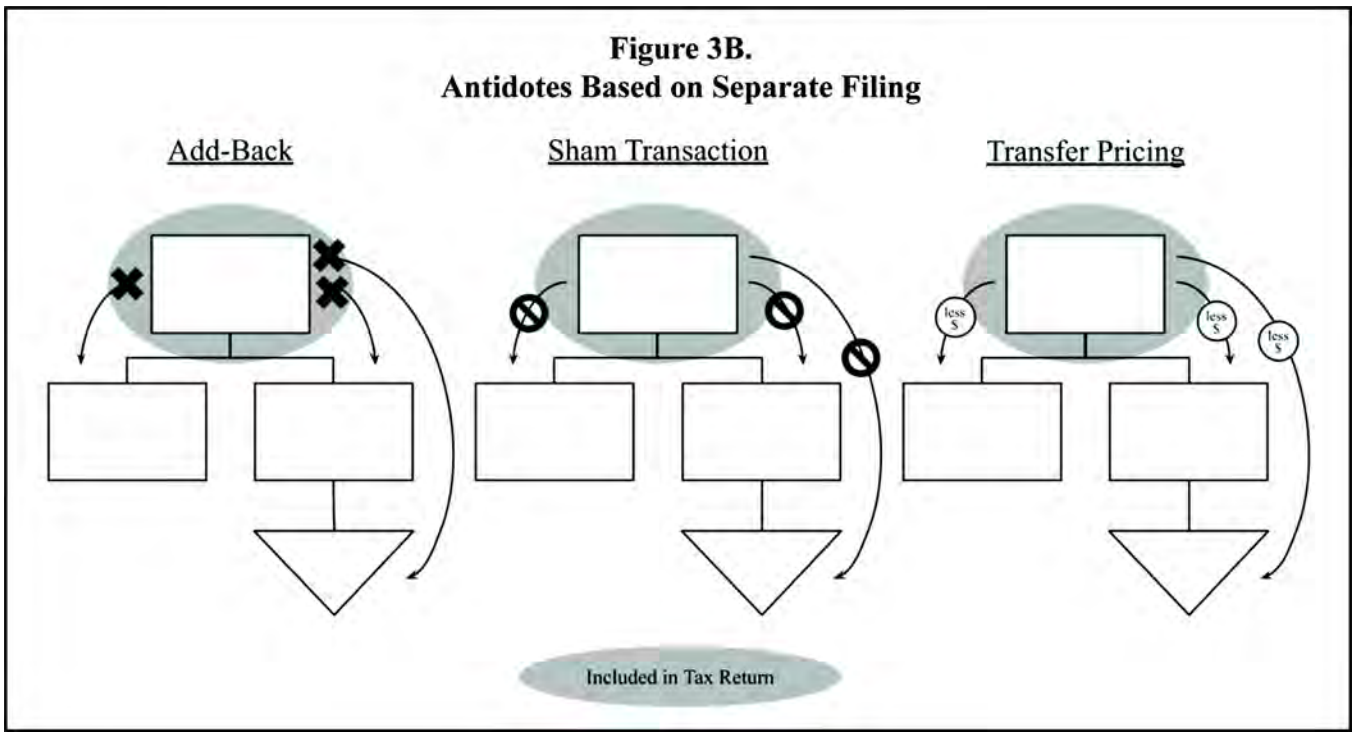
Antidotes Grounded in Separate Filing

Nearly half the states that impose a corporate income tax still require or allow corporations to file using the separate-filing method.[4] Under this method, a legal entity must file its own separate CIT return if it has in-state nexus; tax base and apportionment factors of affiliated entities within the corporate group are excluded from the calculations in these returns. In contrast, other states adopt some form of the unitary combined reporting method, which reflects the economic reality that corporate groups act for all intents and purposes like a single enterprise, and so includes tax base and apportionment factors of more members of that group, whether those entities have nexus or not.

Separate-filing states pursue one or more of seven primary antidotes — by statute or on audit — that can produce some incomplete reduction of CIT avoidance. Each such countermeasure has been, and continues to be, subject to significant audit litigation, making each of these antiabuse methods costly, time consuming, and uncertain in its results.

Figures 3A and 3B illustrate five of these antidotes, applied to a generic CIT avoidance strategy: ParentCo (highly taxed by a state where it has nexus) shifts profits (via royalties, interest, and so forth) to two domestic affiliates (US-HavenCo with no nexus outside a tax haven state and Captive InsuranceCo not subject to CIT) and one ForeignCo.

[4]Twenty-one states either offer only separate filing (Alabama, Arkansas, Delaware, Florida, Georgia, Indiana, Iowa, Louisiana, Maryland, Missouri, North Carolina, Oregon, Pennsylvania, South Carolina, and Tennessee) or offer it as an election (Alaska, Mississippi, Montana, Oklahoma, Virginia, and Vermont). Six states either impose a business activity tax that is an alternative to the CIT (gross receipts taxes and the like) or — inexcusably — impose no business activity tax of any serious moment on corporations (Nevada, South Dakota, and Wyoming).



Nexus

Historically, the initial reaction of various separate-filing states to base-shifting tax avoidance was to follow the money. Discovering that some of ParentCo's tax base had been moved (or pretended to have been moved) to US-HavenCo, these states figured they could simply tax US-HavenCo.[5]

CIT avoidance defenders argued that separate-filing states did not possess the jurisdictional authority to impose CIT on US-HavenCo, turning their argument into a constitutional question by analogizing to a couple of Supreme Court cases[6] that barred a state's assertion of sales/use tax (SUT) jurisdiction when a company had no "physical presence" in that state: In the absence of an in-state physical presence (people or property), the connection/nexus between state and company would be insufficient. At great cost and delay, separate-filing state revenue departments battled corporate avoiders in the courts over this issue — did the SUT nexus rule apply as well to CIT? They litigated for 25 years before the Supreme Court changed its mind and ruled that the actual nexus rule for SUT was not physical but "virtual" presence.[7]

Despite the states' significant victory in *Wayfair*, the precise contours of this new standard and its application to CIT reduction strategies could consume more years in the judicial system. More dramatically, as illustrated in Figure 3A, any state effort to assert jurisdiction to tax ForeignCo would be fraught with obstacles, and nexus is simply irrelevant when the company moves its corporate-income-taxable profits to gross premiums taxpayer CaptiveCo.

Alternative Apportionment

Much like rocket missions into outer space, CIT planning strategies often have built-in redundancies.[8] For example, planners often make sure that should a state prevail on nexus, it will find insufficient apportionment (and thus

[5] *See Geoffrey Inc. v. South Carolina Tax Commission*, 437 S.E.2d 12 (S.C. 1993).

[6] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); *National Bellas Hess v. Illinois*, 386 U.S. 753 (1977).

[7] *South Dakota v. Wayfair Inc.*, 585 U.S. __ (2018).

[8] "Redundancy in Critical Mechanical Systems," NASA, Lesson No. 659 (Feb. 1, 1999).

insufficient tax base) in the recipient affiliate to get much of any tax revenue out of it. Faced with a strategy pairing nexus insulation with apportionment engineering, many separate-filing states on audit have asserted the "discretionary authority" to change the statutory apportionment rules on a taxpayer-specific basis.[9] Protracted litigation often results, with state victory by no means guaranteed.[10] Figure 3A illustrates this by showing US-HavenCo's "low ETR" in the nexus chart changed to "high ETR" in the alternative apportionment chart.

Addbacks

Eventually, separate-filing states figured they could make an end run around the nexus and apportionment battles by giving up their "follow the money" approach. They shifted their focus away from recipient US-HavenCo and back to the CIT-avoiding entity itself, then simply denied ParentCo's deductions for royalty or interest payments made to affiliates by "adding them back" to income. Addbacks respect the transactions but deny the tax benefits. As illustrated in Figure 3B, addbacks can address a wider set of tax haven entities. Vulnerable to distracting and expensive litigation[11] and narrowly targeting an incomplete suite of CIT reduction strategies (typically addressing only intercompany royalties and sometimes interest), however, statutory addbacks are an inadequate countermeasure.

Sham Transaction Doctrine

Sources of tax law go beyond statutes from the legislature and regulations, rulings, and so forth from the executive. The judicial branch interprets the law; judges are not infrequently criticized for "making new law" as well. That is the American system, carried over from Britain, and it has a name: the common law.

One important common law doctrine that is available for state revenue department use in its antiabuse efforts is the step transaction doctrine, which empowers the state to ignore the various steps in a planner's restructuring scheme and treat all the steps as a single integrated event, disallowing the intended tax reduction. Another is the "sham" doctrine, empowering the state to ignore an entity or a transaction because it is a fake — designed by a planner and implemented by a company but lacking economic substance (business reality) or a primary nontax business purpose.[12]

The sham doctrine may be used by separate-filing states and in combined-reporting states whose filing methods do not embrace all the provisions I recommend below as part of TUCR. Figure 3B shows that, like addbacks, the sham approach neutralizes the planning with CaptiveCo and ForeignCo as well as US-HavenCo. This approach is more flexible than addbacks because it is limited neither to specified transaction types nor by a set of statutory exceptions. It does suffer, however, from the same primary failing as addback challenges: It is highly vulnerable to the resource drain and uncertainty of audit litigation.[13]

Transfer Pricing

"We have basically won," think many companies and their advisers when a revenue department auditor decides to challenge CIT planning by nibbling around the edges of its lost tax base (Figure 3B), quibbling over the correct price for a planner-fabricated transaction.

Much ado has been made over the years regarding a need for states to learn IRC section 482 transfer pricing principles from federal auditors and economists, regarding a role the Multistate Tax Commission might play in improving the quality of state transfer pricing

[9] Such assertions could be based upon the state's adoption of the Uniform Division of Income for Tax Purposes Act section 18, upon analogy to the state's general conformity to the federal IRC and its transfer pricing rules under IRC section 482, upon general common law principles, or upon a variety of other antiabuse statutes. *See, e.g.*, N.C. Gen. Stat. section 105-130.16(6); N.J. Rev. Stat. section 54:10A-10(a).

[10] Andrea Muse, "No Authority for Investee Approach, Attorney Tells Massachusetts High Court," *Tax Notes Today State*, Apr. 8, 2022.

[11] *See, e.g., Surtees v. VFJ Ventures Inc.*, 8 So. 3d 950 (Ala. Civ. App. 2008).

[12] This common law doctrine has been codified in IRC section 7701(o).

[13] *See, e.g., Sherwin-Williams Co. v. Commissioner*, 438 Mass. 71 (2002).

audits, and regarding allegations that states rely too much on one or another particular transfer price testing method.[14]

But these debates miss the point. The federal government is forced by global circumstances to live in a fantasy world in which the IRS is reduced to accepting as factual the entirely fanciful notion that a multi-entity unitary business does not act like it is under common control. For some unitary multinational or multistate business enterprises, fine distinctions like legal entities and geographic boundaries may be little more than nuisances, to which the C-Suite pays attention only to avoid regulatory (including tax) limitations or to comply with them. From the market perspective, a unitary business generally operates as if it were a single legal entity.

But for opportunities to avoid the unpleasantness of taxation and regulation, such a C-suite would rarely slow down to clutter the company's org chart with scores of specialized legal entities. But for the tax avoidance benefits, that CEO would not allow the "crown jewels" of the company's intellectual property collection to be moved into an Intangibles HoldCo because federal law may limit recovery in an infringement suit to the holding company's sliver of lost royalties rather than the whole group's lost profits. But for the tax benefits, that general counsel may not look away as the chief tax officer "negotiates" written license agreements on behalf of both sides of a fictitious "deal."

My left hand does not negotiate with my right because they're both controlled by the same brain, but federal transfer pricing principles demand that we suspend our rational disbelief. In contrast, multistate CIT principles are more reality based — at least among those tax-mature states that have adopted some form of statutory unitary combined reporting. In the unitary combination environment, the right hand is understood to share the same brain with the left, so hands are disregarded as separate conscious entities, and "transactions" between them are ignored.

U.S. states are privileged to operate within a legal system that recognizes the unitary business principle — the foundation of formulary apportionment and combined reporting — and thus enables the states to conform their corporate income tax systems to modern business realities.[15] Unlike our federal government operating on the global stage, states do not have to rely upon transfer pricing concepts as an antidote to CIT avoidance. They can conform their tax systems to modern business realities; they can adopt TUCR.

Selective Combination

Figures 3A and 3B illustrated five of seven incomplete challenge mechanisms commonly employed by separate-filing states — nexus, alternative apportionment, addbacks, sham transaction, and transfer pricing — and demonstrated their inadequacies. We turn now to Figure 4A, which uses the same generic tax avoidance scheme to illustrate separate-filing states' two primary dalliances with the combination concept in their search for CIT avoidance countermeasures that still fall short of unitary group combination — sham entity and ad hoc combination.

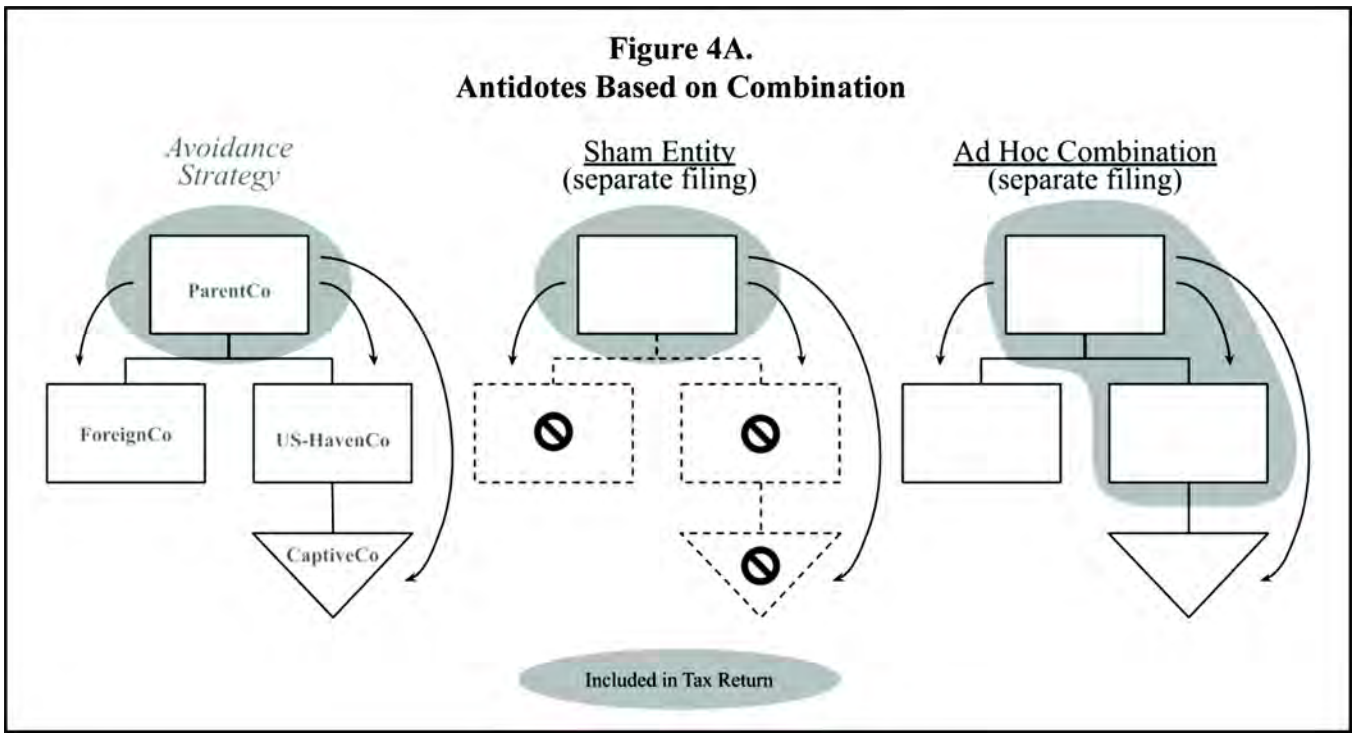
These two selective combination countermeasures can be applied only on audit because they are so taxpayer specific. This stands in marked contrast to TUCR, which is not dependent upon catching a company's planning on audit, but instead neutralizes CIT planning automatically (assuming legal compliance and no tax evasion).

Sham Entity

The common law sham doctrine — discussed above in the context of disregarding a planner's creation of several tax-avoidance-motivated intercompany *transactions* — can be applied as well to NewCo *entities* created by the CIT planner.

[14] *See, e.g.*, Doug Schwerdt, Guy Sanschagrin, and Bill Lunka, "SALT Transfer Pricing — What You Need to Know: Part 1," *Tax Notes State*, Jan. 24, 2022, p. 359.

[15] "The linchpin of apportionability in the field of state income taxation is the unitary business principle" because that principle reflects "the underlying economic realities." *Mobil Oil v. Vermont*, 445 U.S. 425, 439, 441 (1980).



Strictly speaking, this separate-filing state antidote is not a combination method but, as shown in Figure 4A, it achieves the same results. Instead of requiring US-HavenCo, ForeignCo, and CaptiveCo to file a combined report with ParentCo, the state argues that the planner's new entities have no real existence apart from ParentCo. Here, the state analogizes to the avoidance planner's strategy of using a disregarded single-member limited liability company to allow tax base and apportionment factors to flow up (pass through) to the parent as if they were mere divisions of a single legal entity.[16] The state here uses the "disregarded entity" concept in reverse, neutralizing the avoidance.

Or so goes the hope. The common law sham doctrine is vulnerable, as noted above, to the vagaries, expense, and delays of audit litigation. A separate-filing state is barely dipping its toes into combined reporting when it pursues this difficult and litigious path, perhaps inviting more trouble than it is worth. Adoption of TUCR is the better answer.

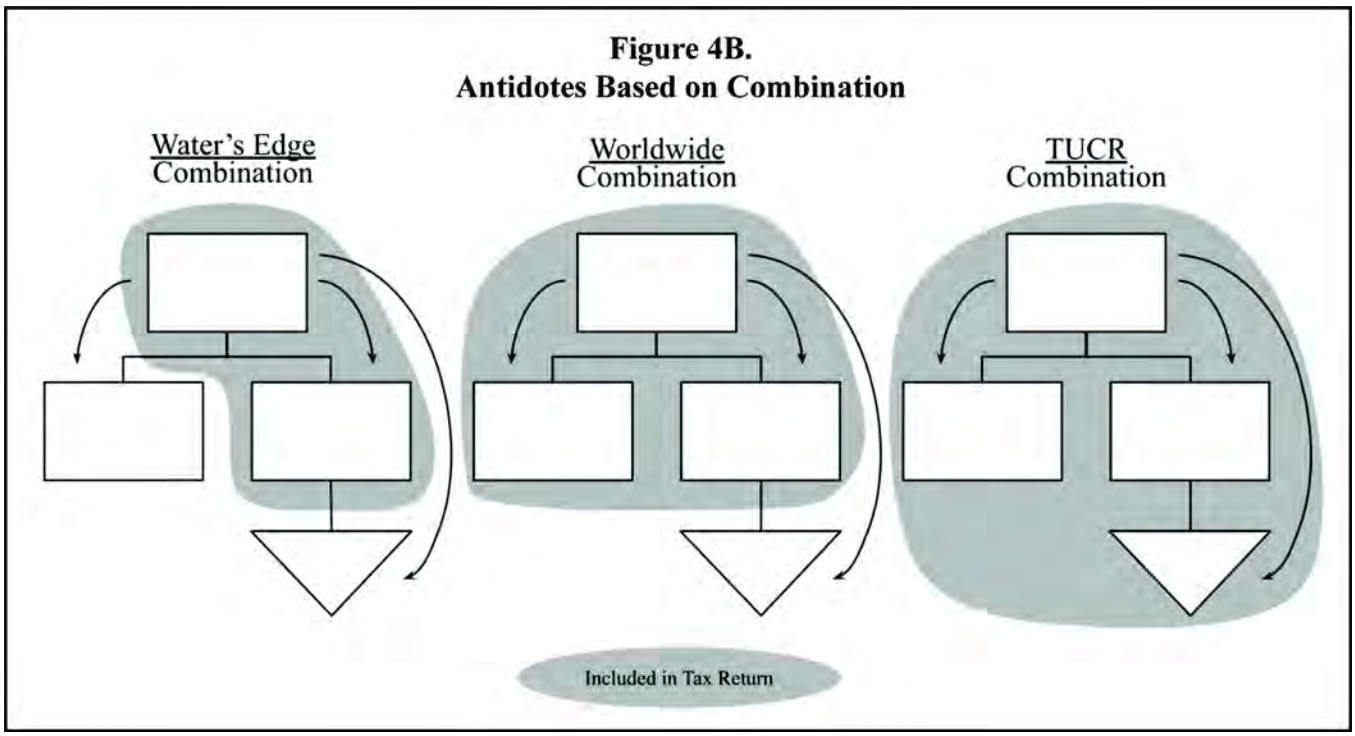
Ad Hoc 'Cherry-Picked' Combination

This last of the separate-filing state countermeasures, also presented in Figure 4A, may appear to be quite like the first of the unitary combined state antidotes illustrated in Figure 4B, but it differs in two important ways. These differences bear both on the perceived legitimacy of the antidote and on the problems of cost, uncertainty, and delay that plague all the countermeasures attempted by separate-filing states.

First, while water's-edge combination is outlined clearly in statutes that all taxpayers can understand and must follow, the source of authority for ad hoc combination is the same unstable "discretionary authority" upon which states rely for their alternative apportionment antidote, discussed above.[17]

[16] *See* discussion of the apportionment engineering and shelter entity "building blocks" earlier in this series at Griswold, *supra* note 1.

[17] The same imprecise contours of "discretionary authority" that create fertile ground for CIT planners to stymie successful application of the alternative apportionment antidote also afflicts the ad hoc combination counter because it too is rooted in UDITPA section 18, analogy by conformity to IRC section 482, common law principles, and so forth.



Second, like the sham entity antidote, ad hoc combination does not require the state to combine all unitary affiliates as unitary combined states must. (Figures 4A and 4B do not pick up this critical nuance.) In fact, if US-HavenCo has nexus with the separate-filing state, under this countermeasure the state may attempt the unconstitutional task of combining it with ParentCo even if they are not unitary with each other. States employing the ad hoc combination antidote have been accused of cherry-picking only those entities for which combination would increase the state's tax take, while ignoring those that do the opposite.

This concludes the overview of separate-filing states' primary approaches to neutralizing common CIT reduction strategies. The features common to all?

- They are often costly, slow, and ineffective.
- Adoption of any type of unitary combined reporting would solve some of these problems.
- Adoption of TUCR would solve virtually all these problems.

Incomplete Combination

Turning now from separate-filing states (which are highly vulnerable to CIT avoidance) to unitary combined reporting states (where legislators may not appreciate that they too are vulnerable), take a look at Figure 4B. Also based on the same generic CIT avoidance strategy shown in the other figures, Figure 4B illustrates three broad categories of the unitary combined reporting method — water's-edge, worldwide, and TUCR.

Please recall three points from part 1 of this series.[18] First, the "unitary business principle" — constitutionally permitting states to tax a multi-entity unitary enterprise essentially as if it were a single entity — has the advantage (from the economic validity and fairness standpoints) of being consistent with the business reality of how multistate and multinational executives actually operate their businesses. The separate-filing method decidedly does not share that consistency. Second: While the unitary group of a multinational business comprises all its unitary affiliates worldwide, and it is constitutionally

[18] Griswold, *supra* note 1.

permissible for a state to include them all in a single report,[19] most states today choose by law to combine a smaller group composed only of U.S. domestic entities. For these states, combination stops at "the water's edge."[20] Third: The water's-edge and worldwide methods fail to include some essential enhancements that create TUCR. (These enhancements are elaborated below.)

Figure 4B shows it all: Water's-edge combination neutralizes many domestic CIT reduction strategies, worldwide combination neutralizes a larger but still incomplete set of strategies, and TUCR neutralizes them all.

Water's-Edge Unitary Combination

Unitary combined reporting — even when inclusion in that group stops at the water's edge — is superior to every countermeasure that a separate-filing state can throw at a CIT planning problem. Water's-edge combination escapes much of the litigation that plagues all the separate-filing states' antidotes.[21] It is the dominant method of combined reporting in the country today, perhaps because of significant lobbying by corporate interests against worldwide combination, which neutralizes CIT avoidance that piggybacks on federal avoidance, while water's edge does not.

Despite its superiority to separate-filing countermeasures, water's-edge combination has serious flaws. Figure 4B demonstrates the problem graphically: The water's-edge rule — excluding both foreign affiliates and entities whose business activities are taxed with reference to a tax that is based on something other than net income — leaves a great many tax avoidance strategies unimpeded.

Rifle-shot attempts to move a water's-edge method incrementally toward worldwide — like "tax haven blacklist" laws that include in the combined report net income from enumerated countries widely understood to be hosts of significant tax shelter activity (like the Bahamas, Belize, Bermuda, the British Virgin Islands, Ireland, Netherlands, Switzerland, and more) — are inadequate stopgap methods that will always leave states steps behind the "catch me if you can" CIT avoiders.

Water's-edge unitary combination states are still vulnerable to the planners' innovations. Their legislatures would protect the public fisc much more effectively if they would just adopt TUCR.

Worldwide Unitary Combination

Figure 4B makes worldwide unitary combination look a lot more effective than water's-edge combination because it is. Worldwide combination (elimination of the water's-edge election) brings into the tax return the tax bases and apportionment factors of all unitary group members in most types of industries, regardless of their location. As noted in part 1 of this series, state CIT calculations of the tax base for a company typically begin with its federal tax base. That means the company's federal tax avoidance strategies — which typically include moving tax base out of the United States and into tax haven jurisdictions around the globe, often through highly complex maneuvers involving many fabricated legal entities and transactions overseas — are baked into its CIT starting point calculations.

State CIT planners piggyback in a significant way on the work of their federal tax planning colleagues. Based on data analysis by the Institute on Taxation and Economic Policy and the U.S. PIRG Education Fund, a whopping $14 billion of the $17 billion in tax revenue lost annually by the states to CIT avoidance is due to this federal tax avoidance piggyback.[22] Water's-edge states that congratulate themselves for having smarter tax policy than separate-filing states ought not to rest on their laurels, because water's-edge combination closes less than 20 percent of the avoidance loophole, compared with worldwide combination states. But worldwide unitary

[19] *Barclays Bank v. California*, 512 U.S. 298 (1994); *see also Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983).

[20] It stops at the land borders with Canada and Mexico as well, but we get the point.

[21] This is not to say that big dollar unitary state CIT issues have not been slogged out in court; they have. Aggressive tax return "filing" positions or refund claims are produced by the same CIT planning innovators who develop proactive structural planning. *See, e.g.*, *Microsoft v. California*, 39 Cal. 4th 750, 139 P.3d 1169, 47 Cal. Rptr.3d 216 (2006); *General Mills v. California*, 146 Cal. Rptr.3d 475 (Ct. App. 2012). However, these issues appear to be far more "out in the open" than those produced by the proactive structural planning that is the focus of this series of articles.

[22] *See* the Institute on Taxation and Economic Policy, *supra* note 2, at 2.

combined reporting is rare. Furthermore, even this improved method still leaves open some gaping avoidance holes. These are addressed in the third unitary combined filing method discussed in this article, TUCR.

Best Antidote: True Unitary Combined Reporting

Take a look back at figures 4A and 4B and you will observe a conceptual progression — from a fully vulnerable separate-filing state dipping its toe into combination by "shamming" some entities, to the potentially unconstitutional ad hoc combination approach, to water's-edge (domestic) unitary combination, to worldwide unitary combination, and finally to an enhanced worldwide unitary combination method that is truly complete — TUCR.

To maximize states' defenses against the CIT planning industry, I propose that every state adopt TUCR. It is not enough for the states to adopt traditional worldwide unitary combination because that approach — depending upon the details of the state's statutes or upon the vagaries of common law court decisions — would leave open five significant CIT avoidance-enabling gaps:

- the water's-edge election;
- the nonconforming industry exclusion;
- the "80/20" back door;
- the "nowhere income" phenomenon; and
- the combined-but-still-separate method.

TUCR resolves four of these five problems with:

- real worldwide combination;
- multi-industry combination;
- 80/20 elimination; and
- throwback sales-factor apportionment.

I have not recommended that TUCR include a fifth strengthening provision — "single taxpayer" unitary combination — out of a concern that the long-simmering "*Finnigan* rule or *Joyce* rule" controversy may need even more time to develop before such a proposal could gain traction.[23]

Figure 4B illustrates the first two enhancements made by TUCR: its inclusion of all unitary affiliates — regardless of geographic location or industry specialization — in the combined return.

Real Worldwide Combination

Not a single state today actually provides a combination method that always includes, for all types of CIT payers, unitary affiliates across the globe. Most states provide only for water's-edge combination, Alaska requires worldwide combination only for a specific industry and some noncompliant taxpayers,[24] and a handful of states (incredibly) provide taxpayers with a get-out-of-CIT-free card — the opportunity to choose whichever method produces the smallest amount of tax.[25]

Such elections — between separate filing and combined reporting or (in unitary states) between water's-edge and worldwide reporting — are ignominious examples of poor state tax policy. These elections allow a planner to develop CIT reduction strategies for each method, model the results, and then elect whichever filing method escapes the most tax. These elections, which have been passed by state legislatures and signed into law by governors, take voluntary vulnerability to new lows.

Water's-edge combination is an invitation for CIT planners to piggyback on their federal tax planning colleagues' schemes and add more of their own. TUCR puts an end to this vulnerability, providing for just one filing method — worldwide unitary combination.

Multi-Industry Combination

When it comes to inclusion of appropriate entities, however, geography is not the only potential get-out-of-CIT-free card that TUCR takes away from CIT avoiders. Industrial specialization is also at play.

The vulnerability here is state CIT statutes that — for good or bad policy reasons (we need not address that question here) — create industry-specific departures from the usual CIT rules for business activity taxes. A business enterprise may include some entities (fabricated by avoidance

[23] *See* Griswold, *supra* note 1, fn. 6.

[24] Alaska Admin. Code 15 section 20.100(a).

[25] *See, e.g.*, Cal. Rev. & Tax Cd. Section 25101; D.C. Code Ann. section 47-1810.07(b); Mass. Gen. L. section 32B(c)(3).

planners or essential to real operations) that are not subject to the CIT, or that are subject to CIT under specialized rules, according to industry-based distinctions. Some types of business entities may be subject in some states to different tax bases (bank excise taxes[26] or insurance premium taxes,[27] for example). Or perhaps they are CIT payers but are provided with apportionment rules that differ from those for most industries (railroads or telecommunications companies, for example).[28]

When otherwise combinable unitary entities in a particular industry are subject to a non-CIT base or to nonstandard apportionment rules, the difficulty of figuring out how to combine them may cause some states to take the easy (but ultimately costly) way out, throw up their metaphorical hands, give up on the unitary combination principle along with its antiabuse benefits, and exclude entities in these industries from the combined group. The difficulty of making adjustments to tax base or apportionment rules, however, is no justification for not doing it. Much thornier tax issues have been addressed and resolved by smart people in state legislatures and revenue departments. A failure to figure this out would be a failure of governmental obligation to citizens.

TUCR includes all unitary affiliates, regardless of specialized industry, in the combined group. This is illustrated in Figure 4B by inclusion of CaptiveCo in the TUCR combined group. The following two features of TUCR are not reflected in Figure 4B.

80/20 Elimination

Three decades ago, a few water's-edge unitary combination states were persuaded to carve a back door into the combined group edifice, allowing any domestic legal entity with 80 percent or more of its property and payroll outside the United States (and thus 20 percent or less within the United States) to be excluded from the water's-edge combined group.[29] There was no genuine policy reason for the rule; it was sought and obtained by lobbyists seeking a back door through which CIT planners could transport tax base out of the state's reach. Sixteen states today offer CIT planners the 80/20 back door, making these states knowing hosts of a tax haven that impoverishes their own citizens. TUCR closes this back door.

Throwback

In part 1 of this series, I explained that "analogizing a corporation's tax base to a pie, apportionment addresses how big a slice is portioned out to each state that has jurisdiction to tax it."[30] Returning to this metaphor, one of the goals of CIT planners is to leave some of the pie on the plate untaxed anywhere. Recall from the avoidance-planner's CIT primer[31] that the size of the slice to which any one state is entitled will be determined by formulary apportionment, which may or may not include property and payroll factors but always includes a sales factor. The sales factor for a state is calculated as a fraction whose numerator is sales sourced to the state (because the company's customers are located there) and denominator is all sales everywhere.

The planner's goal in this case (leaving some pie untaxed on the plate) has been well described as the creation of "nowhere income." The planner achieves this goal by structuring the selling affiliate in a way that it is not subject to tax in some of the states where its customers are located. To do this, the planner uses the "nexus insulation" building block described in part 1, perhaps aided by the federally created jurisdictional safe harbor of Public Law 86-272.

If the whole pie is the taxpayer's total sales everywhere, then the slice left untaxed on the pie plate is nowhere income; the CIT-planning company takes it home, sharing some of it with the planner as a fee. The nationwide public is entitled to tax the entire pie; the only issue should be which states get how big a slice. This is where the "throwback" rule comes in. The state from which the goods are sent out to the customer (the "origin" state) is entitled to "throw back" to its

[26] *See, e.g.*, 32 V.S.A. section 5836 et seq. (Vermont).

[27] *See, e.g.*, Conn. Gen. Stat. section 12-201 et seq.

[28] *See, e.g.*, Va. Code Ann. section 58.1-420(A); Va. Admin. Code 23 section 10-120-270.

[29] *See, e.g.*, Bruce J. Fort, "Anatomy of a Domestic Tax Shelter," *Tax Notes State*, May 17, 2021, p. 689.

[30] Griswold, *supra* note 1.

[31] *Id.*

numerator the sales made into states ("destination" states) that do not possess the jurisdiction to impose CIT on the company but would if they could.[32]

Throwback sales-factor-apportionment sourcing prevents corporations from generating nowhere income by ensuring that the worldwide apportioned share of its taxable income is 100 percent, or close to it.[33] TUCR includes this rule.

Conclusion

State legislatures that leave unreformed their separate-filing or incomplete unitary combination regimes victimize their own citizens. Despite the variety of piecemeal countermeasures discussed above, these inadequate CIT filing methods are littered with gaping holes. Each year, large multinationals exploit those holes to shift $17 billion in tax obligations[34] from wealthy shareholders onto small businesses that pay their fair share, and ultimately onto the working class and the poor when other taxes — particularly consumption taxes that fall most heavily on these groups — are increased to cover CIT shortfalls.[35] Also, the avoiders force reductions in public services that the people have demanded at the ballot box.

TUCR would put an end to avoiders' industrial-scale reductions of CIT revenue if all states would adopt it. Avoidance normalizers can be expected to resist TUCR, just as they have resisted calls for less complete unitary combined filing laws that would make state filing methods more inclusive, complete, fair, and reflective of business reality.[36] TUCR would deny these interests the power to continue draining the public fisc to the detriment of the public. State adoption of TUCR would neuter most CIT avoidance, improve tax fairness, bring in balanced tax revenue, and increase voluntary compliance as taxpayer perceptions of improved fairness increase.

In the event that policymakers need more evidence of the enduring advantage possessed by avoiders — an advantage that only TUCR can reverse — the remaining articles in this series will explain and illustrate a wide range of CIT avoidance strategies and their ability to mutate in response to state antidotes. Using only public information about specific planners and avoiders, I will name names. Next up: the aging but still widespread "siphoning" family of CIT avoidance strategies, including naked, natural, and turbo-charged holding companies of various stripes, and more. ■

[32] *See, e.g.*, Ark. Code Ann. section 26-51-716.

[33] Sales would not be thrown back if they were made to a destination state that does not impose a CIT.

[34] The Institute on Taxation and Economic Policy, *supra* note 2.

[35] *See* Griswold, "Efficiency vs. Equity in COST's Consumption Tax Study," *Tax Notes State*, Apr. 25, 2020, p. 425.

[36] *See, e.g.*, Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Council On State Taxation (May 2008).

Innovation Principles (3) for Multistate CIT Plann

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by Don Griswold

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Don Griswold

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In this installment of Just SALT — part 3 of his six-part series on corporate income tax avoidance in the states — Griswold illustrates "siphoning" strategies and reminds readers that the most effective state countermeasure is true unitary combined reporting.

State corporate income tax (CIT) avoidance, estimated to cost the public $17 billion a year,[1] is the dominant segment of a larger corporate state and local tax planning industry that reduces other tax revenue as well. Sales and use tax (SUT) strategies include "drop kicks" (seller contributes assets to a NewCo and sells the stock — not subject to SUT — to buyer, who then liquidates NewCo and keeps the assets)[2] and "kickbacks" (company shares its big city tax "savings" with a low-rate tax haven town in exchange for setting up a sham purchasing office in that town).[3] The latter, a type of "procurement company" structure, may be used to escape CIT as well, and will be illustrated in part 4 of this series at Figure 12.

A state personal income tax avoidance strategy made infamous in the wake of the Pandora Papers exposé last fall[4] — incomplete non-grantor trusts built on the nexus isolation and asset placement building blocks discussed in part 1 of this series — also helps the rich and superrich duck their creditors and their federal gift tax obligations. Real estate transfer taxes have been dodged with drop kicks,[5] state unemployment taxes with "SUTA dumping,"[6] real property taxes with asset stashing,[7] and tobacco taxes with old-fashioned cross-border smuggling.[8] Unclaimed property liabilities — which are not strictly taxes but are typically handled in corporate tax departments because planners there find willing buyers — have been

[1] Richard Phillips and Nathan Proctor, "A Simple Fix for a $17 Billion Loophole: How States Can Reclaim Revenue Lost to Tax Havens," Institute on Taxation and Economic Policy (ITEP) (Jan. 2019). The lost revenues are itemized by state in Table 5 at p. 15.

[2] Bruce P. Ely, William T. Thistle, and Michael W. McLoughlin, "Recent Developments in State Taxation of Pass-Through Entities and Their Owners," WG&L, at 15 (2010).

[3] Gregory Karp, "RTA Sues American Airlines Over Fuel Sales Tax Practices," *Chicago Tribune*, Mar. 12, 2014.

[4] *See* Will Fitzgibbon and Asraa Mustufa, "Another President Under Investigation, U.S. Condemned as Tax Haven by European Parliament as Pandora Papers Fallout Continues," International Consortium of Investigative Journalists, Oct. 22, 2021; and Elaine Segarra Warneke, Tiffany Christiansen, and Annette Kunze, "Legislative Proposal C — Taxation of Income From an Incomplete Gift Non-Grantor (ING) Trust" (2021).

[5] E.J. Dionne Jr., "New York Closes Loophole in City Realty Transfer Tax," *The New York Times*, Aug. 8, 1981 (after the skyscraper atop New York's Grand Central Terminal was sold transfer tax free).

[6] Albert Crenshaw, "Firms Boost Use of Ploy to Reduce State Taxes," *The Washington Post*, Dec. 26, 2003 (the tax avoider company — with a poor "experience rating" and thus a high state unemployment tax act tax rate for firing too many employees — creates a NewCo, qualifying it for the lower "new employer rate," and transfers old employees to the NewCo).

[7] Joseph K. Eckert, Robert J. Gloudemans, and Richard R. Almy, *Property Appraisal and Assessment Administration* 83 (1990). The "income approach" to appraising value, described here, may be manipulated by separating the real property from intangibles (like a hotel's trade name) that are central to the property's projected income stream.

[8] Jerry Markon, "Feds Begin Crackdown on Cigarette Smuggling," *The Washington Post*, May 18, 2003.

escaped by numerous retailers using "gift card companies."[9]

The Six S's of CIT Planning

Planners at various firms have varying names for similar strategies. Some names used in this series — like Naked Delaware holding company, East-West Split, Procurement Co, Captive REIT, and Factor Co — are in nearly universal circulation among SALT professionals, whether they work in the corporate, government, or advisory communities. For other strategies, the diagrams will be immediately recognizable for most players in the CIT avoidance industry, even if the names selected — like The Entrepreneur, Stuffed Substance IHC, Natural "In Lieu" Operations Shelter, and Financial Warehouse — are perhaps more adviser-specific.

To help state tax auditors and policymakers get inside the heads of CIT-avoidance planners, I have organized a selection of common CIT-circumvention strategies into six family groups: siphoning, stripping, straddling, stuffing, stashing, and secreting (the Six S's). Here in part 3, siphoning strategies will be described and illustrated. It may be useful at this point for readers to look back at the Legend (Figure 1) in part 1 of this series[10] to recall the meaning of the shapes and abbreviations used in the forthcoming illustrations.[11]

Siphoning

Strategies that act like a siphon — sucking tax base out of a corporate entity that is subject to a state's tax jurisdiction and spitting it into an entity located somewhere safe (a jurisdiction where the recipient entity is subject to little or no tax) — are common in CIT planning. Innovative planners build these strategies with multiple building blocks,[12] including nexus isolation, asset placement, transfer pricing, and apportionment engineering. For a time, they were also built on the foundation of a notorious U.S.-based tax haven.

Delaware has long been on the shortlist of shameless tax haven states that "cannibalize"[13] their sister states' tax bases in exchange for large quantities of small fees charged by in-state service providers. The Delaware holding company (DHC) — exempting royalties, interest, and other intangibles-based income from tax[14] — was the first structural CIT-avoidance strategy to be commodified by the Big 4 accounting firms. By the time the South Carolina Supreme Court released its decision[15] outing Toys R Us for setting up a DHC, the strategy was relatively common, but in the decade following that 1993 decision, its use exploded. The DHC (explained and illustrated immediately below at Figure 5) became "the little black dress" that Big 4 advisers wore to every CIT-avoidance party.

Naked DHC and Turbocharged IHC

Figure 5 illustrates side by side the classic RoyaltyCo based on a DHC and a "turbocharged" variant loaning the royalty receipts right back up to the parent. These are but two of the almost endless variations on this theme.

RoyaltyCo: The first siphoning strategy that jumped to nationwide attention in state tax circles has stayed in the state tax limelight for decades. The best-known CIT avoider of all time was once the dominant chain retailer of children's toys: Toys R Us, whose "Geoffrey the Giraffe" mascot adorned the backlit glass sign above store entryways, beckoning to children who gleefully dragged their tired parents behind them.

[9] *French v. Card Compliant*, Del. S. Ct. Case No. 327, 2019; and Joe Carr, Nick Boegel, and Michael Kenehan, "Unclaimed Property: Who Ate My Gift Card Balance?" BDO US LLP, at 23 (2016).

[10] Don Griswold, "Innovation Principles for Multistate CIT Planning — Part 1," *Tax Notes State*, May 16, 2022, p. 729.

[11] Please recall as well that no nonpublic information is identified to any specific person or entity in this series of articles.

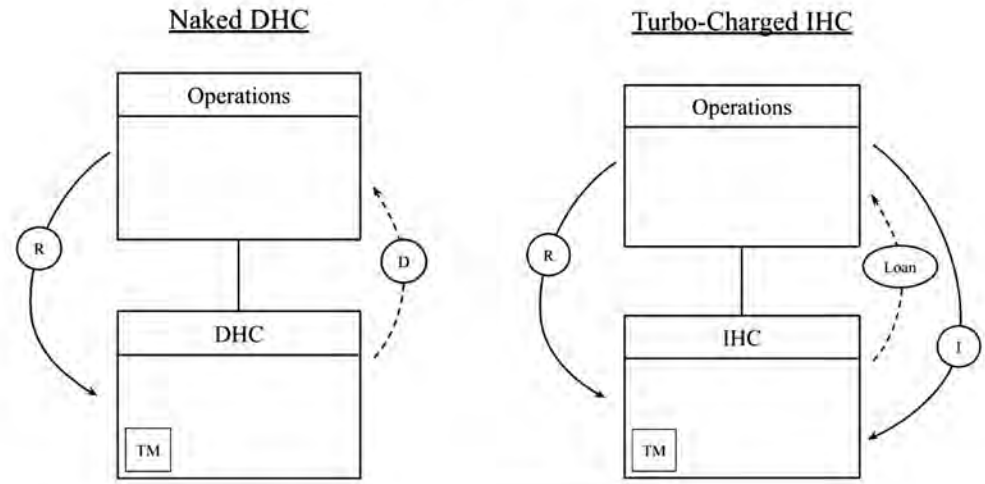
[12] Griswold, *supra* note 10, at 732.

[13] Daniel Hemel, "South Dakota's Tax Avoidance Schemes Represent Federalism at Its Worst," *The Washington Post*, Oct. 7, 2021.

[14] Del. Code Ann. tit. 30, section 1902(b)(8).

[15] *Geoffrey v. South Carolina*, 437 S.E.2d 13, 313 S.C. 15 (1993).

Figure 5.
Naked Delaware Holding Company



Toys R Us restructured its operations in 1984 to sidestep its state corporate income tax responsibilities around the country. Boiled down to its essence, the strategy was simple: Start with a historically typical structure (a single entity owns both the trademarks and the stores that use them), create a NewCo subsidiary to acquire and hold that intellectual property (the trade names "Toys R Us" and of course "Geoffrey"), organize that NewCo in a tax haven state that promises by statute not to tax it (Delaware, the king of domestic tax havens, obliged with its DHC law), try to make sure the DHC would not be subject to state CIT jurisdiction anywhere else (the power to tax elicits the power to avoid), and then contribute the trade names to the NewCo in a routinely available tax-free manner.[16]

Suddenly, Operations Co. (OpCo, the company running the stores) no longer owned critical assets that encouraged kids to drag their parents into its stores (not any old toy store, but specifically the local Toys R Us). Those assets were the multicolored company logo and that adorable cartoon giraffe. OpCo would have to pay for its use of assets that it no longer owned; it would have to pay the DHC (cheekily named Geoffrey) a royalty in exchange for a license to use the IP that it once owned. The royalty would be based on a percentage of net sales.

Using the CIT avoidance building blocks of asset placement, nexus isolation, shelter entities, and transfer pricing, Toys R Us had created a siphon, sucking tax base out of all separate-filing states because royalty payments are deductible business expenses. The siphon spit out that tax base into an entity (the DHC) that was subject to tax only in a tax haven state that declined to tax it. That entity existed only on paper, "naked" of any economic substance of any kind and existing for no business purpose other than to escape its state CIT obligations.[17]

The nakedness of DHCs became nearly as well known as the strategy became widespread. A case involving Berkshire Hathaway's Justin Boots and Acme Brick business units describes the lack of substantive company involvement in the affairs of its paper-only CIT-avoidance vehicles, and the brazen flaunting of their purposes in the very names of these entities. The case describes one entity, to which the OpCos' trademarks had been transferred, as "a Delaware corporation that, during part of the tax period in question, shared approximately 1,100 square feet of office space

[16] *See* IRC section 351, which most states follow under tax laws that generally conform to the Internal Revenue Code . . . except when they don't.

[17] *Geoffrey*, and similar cases that arose later in other states.

with 40 other companies and employed one individual who spent two hours monthly on Acme Royalty business. This individual served as officer and director for Acme Royalty, as well as 20 to 30 other companies."[18]

As scores of household names followed in Toys R Us's footsteps, some — like Kmart,[19] another now-defunct former giant of the chain retailing industry — would branch out of DHCs and into other locations for their intangible holding companies (IHCs, also known as passive investment companies). Some IHCs, like the one used by Kmart for its CIT dodging, were based in Michigan, where the now-defunct single business tax made the state a tax haven because it excluded royalties from the tax base. Others were based in jurisdictions that were more "natural" — the subject of the next illustrated strategy, in Figure 6.

In most of these cases, the DHC/IHC had no need for the cash, but the parent OpCo still needed it. Many CIT dodgers simply "swept" the cash back up from the DHC to the parent, sometimes recording such sweeps on a separate set of books (just for tax purposes, in case a revenue department auditor started nosing about), and other times not even bothering to make the accounting entries for an entity that had no substantive existence anyway— in the eyes of the outside world or (usually) of any corporate insiders except a few members of the tax department.

The more careful avoiders would go to the trouble of actually declaring a dividend and returning the cash (received as royalties) to the parent formally. This was done in a tax-favored manner because the parent would wipe out that income with a dividends received deduction.[20] The tax base cash ended up "round-tripped" in a circular flow of cash that put it right back in the same place it started. From an economic standpoint, all that had actually taken place was the creation of that siphoning deduction and the resulting reduction or elimination of CIT. The naked DHC side of Figure 5 illustrates this.

FinanceCo: In addition to siphoning by moving intellectual (intangible) property like patents and trademarks to a RoyaltyCo, planners also siphoned tax base using a different financial transaction — lending cash in exchange for interest. The DHC/IHC here (often called FinanceCo) would be set up to conduct faux intercompany lending operations. FinanceCos would hold intercompany promissory notes payable. How those notes got there, or what business purpose there might be for having them there, was hardly the point. — OpCo would pay interest to the FinanceCo-DHC, taking a deduction and escaping CIT, and then receive it back as a tax-free dividend.

A particularly aggressive form of paper siphoning took place when the parent would not even bother borrowing money from FinanceCo. Instead, the parent OpCo would simply make a contribution to the capital of the IHC subsidiary — contributing not cash but a piece of paper, a promissory note receivable, entitling the IHC to receive interest payments from the parent — without having given in exchange anything of value (other than an increase in the value of its stock).

Loan Participation Company: Another variant of the FinanceCo strategy, designed specifically for financial institutions, followed similar principles: The parent Bank or bank holding company would own a new DHC that would own a new Loan Participation Co (LPC). A capital contribution of "loan participations" (entitling the owner to interest income on some portion of a loan portfolio) would be contributed from Bank down to DHC, which would lend those participations on down to LPC. When borrowers paid interest to LPC, it was required to pay interest to DHC (retaining only a modest taxable profit). DHC sits in a tax haven, so it is not taxable on the interest; it flows that cash on up to Bank as a tax-favored dividend.[21]

These variants on the intercompany debt strategy are commonly known in the CIT planning community as internal leveraging.

[18] *Acme Royalty Co. v. Missouri*, 96 S.W.3d 72 (2002).

[19] *Kmart v. New Mexico*, 131 P.3d 22, 139 N.M. 172 (2005).

[20] Most states conform more or less to IRC section 243.

[21] "[Redacted] Business Restructuring for State Tax Minimization (STM) Feasibility Report," KPMG (Nov. 19, 1998) in Michael J. Houser, "S.B. 1172 'Fair Tax Penalties' — What You May Not Know," North Carolina Department of Revenue, tab 4 (2010).

These strategies round-trip cash around the company's planner-modified org chart (the pictorial representation of all its various legal entities in a format that shows who owns who) to transform the nature of that cash, to recharacterize it, and to launder it from taxable income into tax-free income. DHCs operated as financial laundromats.

Turbocharged IHC: An early innovation built on the integration of the naked RoyaltyCo and the naked FinanceCo was called "turbocharging" by some planners. Illustrated on the right side of Figure 5, you will see two siphons. First is the royalty from OpCo to the IHC, just like that on the left side of Figure 5. Instead of dividending the cash back up, however, the turbocharged IHC lends the money back up. Receiving a loan from its subsidiary, OpCo becomes liable for interest. Payment of interest back to the IHC creates another siphoning deduction for the parent. The money could be round-tripped nearly endlessly in this way. Double laundromat, anyone? Triple? Dare we try for quadruple?

ManagementCo: Royalties, interest, and management fee markups together made up the top three "base shifting" vehicles in the early days of structural CIT reduction planning.

In addition to intercompany licensing and intercompany debt, many planners created shared services or ManagementCo entities, particularly if the company was headquartered in a unitary combined state to which tax base could be shifted out of affiliates without increasing the group's tax in the headquarters state.

ManagementCo might employ all the back-office workers, or even staff some market-facing functions. It would take a deduction for salaries, benefits, offices, and equipment, of course, but OpCo affiliates (with high separate-filing effective tax rates) paid ManagementCo a management fee that included a markup "profit" element. The markup portion (rarely defended with a transfer pricing study but typically air-thumbed with a "cost plus 5 percent" guesstimate) was deductible for the OpCos in addition to those (real) legacy expenses, and thus created another siphon.

The *Fortune* 500 have largely moved well beyond RoyaltyCo, FinanceCo, and ManagementCo strategies (and well beyond even many of the more sophisticated strategies described below). Nevertheless, the studied eye can still find vestiges of these early strategies lurking in the dark shadows of many a CIT dodger's org chart.

Many of these old DHCs may no longer perform their original CIT elimination function for *Fortune* 500 companies, though some still churn out "savings" in the sleepiest states. Or the strategies may still be "turned on" everywhere with a relatively modest production of avoidance, left laying around in the hope that a revenue department auditor might find one, write up an audit assessment with a sense of satisfaction, and then close out the audit without finding the hidden and more sophisticated strategies that produce much larger reductions of tax.

Section 197 Amortization Alternative: Another innovation was to have the IHC sell the IP back to the parent that had originally owned it. Under IRC section 197, the purchaser of intangibles may take amortization deductions for the purchase of goodwill and some other intangibles. A federal section 197 amortization deduction could siphon tax base just as effectively as a royalty deduction, but it would escape audit notice or (should a diligent auditor find it) escape application both of the addback antidote and the transfer pricing antidote.[22]

Natural IHC

Engineered tax haven states like Delaware (states where the legislature passed specific CIT-avoidance-friendly laws to become a major destination of choice for the CIT-dodging community) remained in common use by planners for many years. Indeed, as noted above, many DHCs can still be found in corporate org charts around the country.

However, it did not take innovative planners long to recognize that an abundance of "natural" havens existed among the United States for those who wished to escape responsibility for CIT in separate-filing states.

No-CIT-State IHCs: Nevada, South Dakota, and Wyoming have been obvious choices for

[22]These and other antidotes (inadequate countermeasures employed by states in an attempt to neutralize the tax avoidance) are described in part 2 of this series: Griswold, "Innovation Principles for Multistate CIT Planning — Part 2," *Tax Notes State*, May 30, 2022, p. 921.

planners because they impose no CIT and no significant alternative business activity taxes. Several states impose significant non-CIT taxes on the activity of operating a business; gross-receipts-type taxes are imposed today by Oregon, Texas, and Washington, making them (not impossible but) tricky locations for IHCs. Wyoming and South Dakota are not particularly close to market centers, making them adequate choices for planners not looking to build up any apparent "economic substance" in their IHCs.

But Nevada's proximity to California (analogous to Delaware's proximity to New York City) makes it a highly attractive location for tax dodgers. It may not be that hard for a *Fortune* 500 company to build up an appearance of economic substance in its Nevada IHCs by persuading some residents of Sacramento or the San Francisco Bay Area to relocate just two or three hours away to Reno or Carson City.

Unitary-State IHCs: A great many locations are natural for the establishment of an IHC or other siphon-receiving entity: unitary combined reporting states. As illustrated in Figure 2 in part 1 of this series,[23] the planner's creation of domestic unitary NewCo entities and the fabrication of transactions among domestic unitary group members are essentially nonevents for purposes of determining the group's tax liability in such states.

While unitary combination makes it difficult to escape tax in those unitary combined states, there is a dark side to this light. The presence of some unitary states makes separate-filing states even more vulnerable to CIT-avoidance strategies. The planner can go to town with all kinds of clever planning to duck CIT in separate-filing states without worrying that this might increase tax in unitary states. The avoider might, for example, move its controlled foreign corporation affiliates under a unitary state IHC, so that when it receives foreign dividends that carry some tax liability with them, these are insulated from taxation by separate-filing states.

Unitary combined states are natural locations for IHCs.

Fig Leaf IHCs: Over time, CIT planners dressed up their naked IHCs with a fig leaf or two (perhaps allocating a few hours of a company employee's weekly time to the IHC, which perhaps was charged rent for a small office and a phone line).

Figure 6 illustrates a simplified version of food maker Hormel's application of this sort of approach, building off a couple of IHCs based in its headquarters state — Minnesota, a unitary-combined-filing state. Founded on two natural shelters, Hormel[24] purchased from its advisers two siphoning strategies (intercompany interest and intercompany royalties), plus a stashing strategy (intercompany factoring of accounts receivable) that will be discussed and illustrated more fully at Figure 13 in part 4 of this series.

The maker of Spam appeared to be comfortable making sham too. Indeed, the Wisconsin Tax Appeals Commission found that "the evidence shows that Hormel's other alleged purposes for engaging in the challenged transactions were a mere 'fig leaf' covering its real purpose, which was tax avoidance."

Following a pitch from EY, Hormel paid the Big 4 accounting firm a typical fee ($400,000) to create a CIT-reduction structure, which followed the three phases commonly used by all the Big 4 when they sell these CIT structural planning projects: (1) a feasibility review that modeled the CIT "savings,"[25] (2) a preliminary design phase, and (3) a design document.

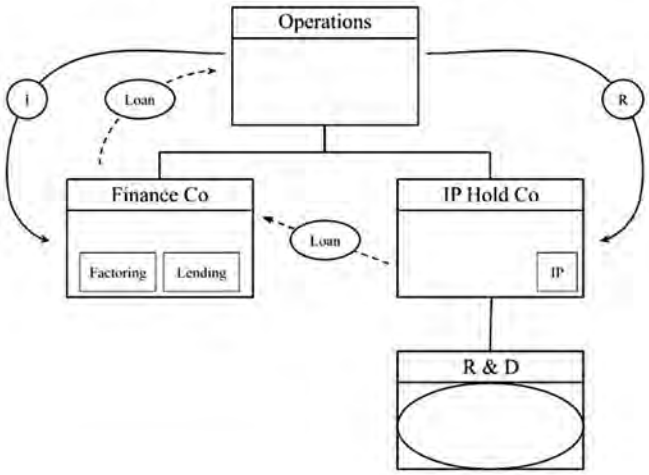
As shown in Figure 6, the parent OpCo created three NewCos: It contributed its trademarks and patents for its Spam recipe to its IP-HoldCo (an IHC). On paper, it moved its research and development function (R&D employees and equipment located in the Minnesota headquarters and facilities in four other unitary states) out of the parent and into a new single-member limited liability company that defaulted by law into treatment as a disregarded entity; that is, it was treated as if it were a division of its owner.

[23] Griswold, *supra* note 10, at 733.

[24] *Hormel Foods v. Wisconsin*, Wis. Tax No. 07-I-17 (2010).

[25] Tax "savings" is the industry's euphemism for "avoidance," universally used to normalize this antisocial activity.

Figure 6.
"Natural" Intangible Holding Company



R&D LLC was then contributed to IP-HoldCo along with "other operations that may be transferred to give it substance" without giving it nexus or apportionment factors in any separate-filing states, which otherwise could tax the shelter vehicles IP HoldCo and FinanceCo. (This use of the apportionment engineering and nexus isolation building blocks constitutes a stuffing strategy that will be discussed in part 6 of this series, at Figure 18.) The new FinanceCo was tasked with intercompany lending and factoring.

The result: With interest and royalty deductions, Hormel "base shifted" out of the parent OpCo (with its high separate-filing state effective tax rate) and into two tax-favored entities with no nexus or apportionment in separate-filing states.

The Wisconsin Tax Appeals Commission found in the Hormel Spam case some facts that are so typical in CIT planning that they will be familiar to the lawyers and accountants who work in corporate tax departments or for the firms that support their efforts. These include[26]:

- High-pressure sales tactics were used; the Hormel tax department "had been contacted quite often by all the major accounting firms proposing the use of an intellectual property company to save taxes."
- EY promised minimal disruption to real business operations as a result of implementing the CIT minimization plan, which "provides state tax savings and reduces downside risks without impacting management reports."
- "The accounting for [IP HoldCo] was set up in a manner so as 'not to disturb the current operating P & L's,' [profit and loss financial statements] and would have 'no impact on current management reports.'"
- "Other than the anticipated tax savings, Hormel did not analyze the costs or benefits of these planned transactions."
- Purported nontax business purposes for the restructuring did not come from anyone at Hormel. The business purposes (drafted by EY and then presented without modification to Hormel's board) were right off the Big 4 firms' business purpose à la carte menu that they routinely offered in their slide presentations to clients:
  - tool to determine IP value;
  - measure affiliates' performance against each other;
  - better IP management;
  - exploitation of IP value;
  - better product development;

[26] *Hormel Foods*, Wis. Tax No. 07-I-17.

- reduction of the cost of doing business, including taxes

- Planners at the outside advisory firm called the shots: "E&Y's plan of restructuring was the basis for the bullet points in the draft Board resolution approving the plan."
- EY set the royalty rates. However, the commission found that the rates "were not separate royalty rates for patents, trademarks and copyrights, just a single royalty rate schedule for all of the intellectual property."
- Hormel demonstrated that the purported transfer of IP from the parent to IP HoldCo was not real when, after the new structure was put in place, its filings with the U.S. Patent and Trademark Office showed the parent OpCo continuing as the owner.

In more than a few cases of CIT circumvention — whether the planner uses a naked DHC or a natural IHC with a little unitary fig leaf stuffing — the purported business purposes and economic substance are not accurate representations of the facts.

80/20 Backdoor Siphon

More than half the unitary combined reporting states extend to all multinational corporations a statutory invitation to siphon away their tax base. Having taken the prudent step of adopting some version of the unitary combined reporting method, states that stop there are vaccinated against domestic CIT siphoning strategies. Other states, inexplicably volunteering for vulnerability, have gone on to open up an 80/20 back door for tax base siphoning.

In Illinois, as in many unitary states, this is a long-standing invitation, a built-in back door out of any company's water's-edge group, should a company wish to use it. Simply engineer the affairs of a domestic affiliate so that 80 percent or more of its property and payroll is located outside the United States and — like magic — that entity would be excluded from the water's-edge combined group, primed and ready to receive tax base that has been siphoned out of Illinois.[27]

A mobile computing company named Zebra Technologies is one of many companies that accepted the 80/20 invitation simply by pretending to restructure its operations. It created a couple of new IHCs in Delaware and transferred some patents to those IHCs, which then charged the U.S. OpCo an exorbitant royalty (9.5 percent of gross sales, not even net — a telltale sign that the adviser, the company's decision-maker, or both were more greedy than cautious); "moved" the pretend IHCs to Bermuda; and paid an accommodating service provider to help Zebra pretend the IHCs were real.[28]

Figure 7.
80/20 Backdoor Siphon

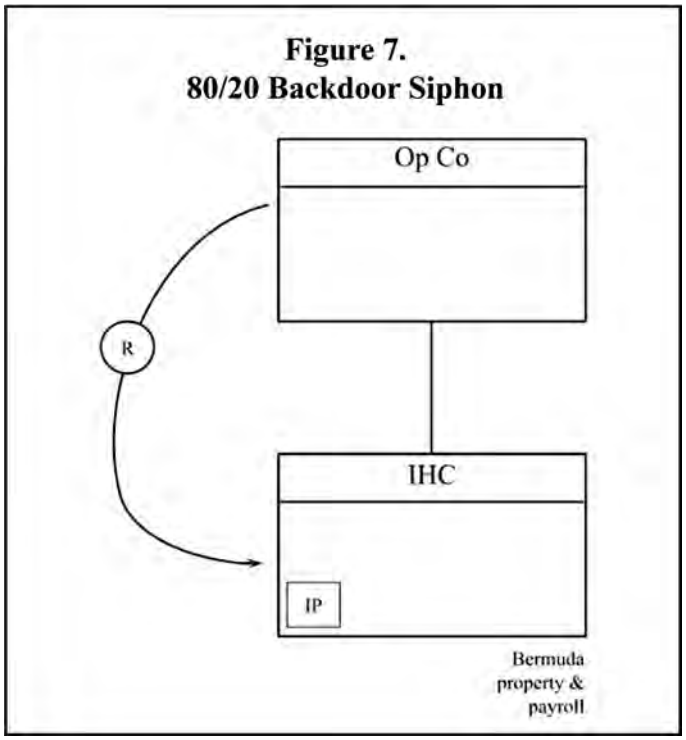


Figure 7 presents a simplified version of the new structure. Having no operations anywhere but the pretend operations in Bermuda (where the enabling service firm collected from Zebra a small fee to rent a bit of property — perhaps a brass nameplate along with the scores of others on the front door of a tiny office — and a sliver of the service provider's economic-substance-generating time), the naked IHCs still had the audacity to claim they had more than 80 percent

[27] Ill. Admin. Code tit. 86, section 100.9700(c)(2)(A).

[28] *Zebra Technologies v. Illinois*, 799 N.E.2d 725, 344 Ill. App.3d 474 (2003).

of their property and payroll outside the United States.

The consequence that Zebra (and other 80/20 users, like omnipresent chain retailer Target[29]) hoped for: The royalty siphoning strategy would avoid CIT not only in separate-filing states (the usual victims of siphoning strategies) but in many unitary combined states as well.

Who Buys This Stuff?

"It takes two to tango," several of my high-level CIT planning colleagues often said. The DHC, IHC, and 80/20 backdoor strategies, like all avoidance techniques in the siphoning and stripping[30] families, rely for their tax avoidance impact on having at least two parties — one dancing on the inside of the state's jurisdictional grasp, and the other dancing on the outside, as their hands move back and forth between inside and outside.[31] Often, though, avoiders have to fake the second dancer.

The state countermeasure recommended in this series — true unitary combined reporting (TUCR) — shines a light on this subterfuge. TUCR reveals that in economic reality, there is just one dancer pretending to tango in the dark. Any states adopting TUCR would have seen no revenue loss from these strategies. Not a penny.

Without TUCR in place across all the states, however, there is ample opportunity for aggressive companies and their planners to avoid CIT by using siphoning strategies. Let's close by naming a few more names.

Additional Buyers of Siphoning Strategies

Companies using these sorts of domestic siphoning strategies — strategies based on various combinations of the apportionment engineering, asset placement, nexus isolation, recharacterization, shelter entity, and transfer pricing building blocks — appear most likely to get caught by state revenue department auditors, for they make up the largest group of companies publicly revealed to be engaged in structural tax avoidance for CIT.

In addition to the CIT avoiders already mentioned in this series, some other companies whose strategies include those in the siphoning family are:

- Berkshire Hathaway. (In addition to the naked IHC siphoning strategy it employed for its business units discussed above, Warren Buffett's See's Candies and Columbia Insurance Co. affiliates siphoned royalties to a traditional insurance company at the receiving end of the siphon. This "adaptive insurer" strategy will be illustrated at Figure 19 in part 5 of this series as one of the straddling strategies.)[32]
- ConAgra (siphoning internal-use trademarks and stashing marks licensed to third parties).[33]
- Crown Cork & Seal Co. (DHC for trademarks and patents).[34]
- Food Lion grocery stores. (IHC for store and private-label trademarks, management fees — deployed even in the wake of its "flipping green chicken" scandal — to be discussed further in the stuffing strategies section at Figure 18 in part 5 of this series.)[35]
- The Gap Inc. (DHC later swapped out for a unitary IHC).[36]
- Kimberly-Clark Corp. (Finance and royalty IHCs, later partially converted into "embedded royalties" — thinly disguised as intercompany "rebates" rather than dressed up with more obfuscation in the Entrepreneur strategy, to be discussed in the stripping family section in part 4 of this series.)[37]

[29] *Target Brands v. Colorado*, 2015CV33831 (2017).

[30] Stripping is up next, in part 4 of this series.

[31] Figure 2 in part 1 of this series illustrates this inside/outside tango. *See* Griswold, *supra* note 10, at 733.

[32] *Utah State Tax Commission v. See's Candies Inc.*, 2018 Utah 57 (2018).

[33] *Griffith v. Conagra Brands*, 728 S.E.2d 74 (W. Va. 2012); and *Conagra v. Maryland*, 211 A.3d 611 (2019).

[34] *Maryland v. Crown Cork and Seal*, 375 Md. 78, 825 A.2d 399 (2003).

[35] *Delhaize America v. Lay*, 731 S.E.2d 486 (N.C. 2012); Gregory G. Dess and Joseph C. Picken, "Creating Competitive (Dis)advantage: Learning From Food Lion's Freefall," 13(3) *Acad. Mgmt. Persp.* 97 (1999); and Houser, *supra* note 21.

[36] *Louisiana v. Gap (Apparel) Inc.*, 886 So. 2d 459 (2004).

[37] *Kimberly Clark v. Massachusetts*, 83 Mass. App. Ct. 65, 981 N.E.2d 208 (2013).

- The Limited (Abercrombie & Fitch and Lane Bryant's royalty IHCs with turbocharging loans back).[38]
- Lorillard Tobacco Co. (whose plan was done so sloppily that its IHC — Lorillard Subsidiary Co. — appears to have been left with the planner's placeholder name from early draft design reports, and whose royalty rate was set at a very high 13 percent of net sales).[39]
- Martha Stewart Living Omnimedia Inc. (paired in CIT avoidance with Kmart, which sublicensed to its Michigan IHC the Martha Stewart trademarks that she first licensed to Kmart — through her own IHC).[40]
- MCI Worldcom (infamous for the accounting scandals that led to its demise).[41]
- Media General (intercompany royalties for Federal Communications Commission licenses and the "combination" case that the South Carolina Department of Revenue was pleased to lose).[42]
- R.R. Donnelley (in addition to its trademark IHC, it brazenly gave its FactorCo stashing entity a name that telegraphed its method of sidestepping CIT: RR Receivables).[43]
- Spring Industries (naked DHC).[44]
- TJ Maxx/Marshalls (turbocharged Nevada IHC).[45]
- Walmart Inc. (infamous for its captive REIT — to be discussed in part 5 of this series in the straddling family of strategies at Figure 16 — this *Fortune* 5 behemoth also siphoned royalties using a stripping East Co/West Co strategy for itself and its Sam's Club stores, illustrated in part 4 at Figure 8).[46]
- Wendy's Co. (siphoned trademark royalties to a captive insurer, illustrated in part 5 in the straddling family at Figure 14).[47]
- W.L. Gore & Associates Inc. (the inventor and manufacturer of Gore-Tex avoided CIT with patent and trademark siphoning as well as stashing investment securities).[48]
- Zebra Technologies Corp. (siphoning royalties to its Bermuda-based 80/20 back door).[49]

There are more, of course. Additional court case examples of CIT avoiders that use siphoning strategies include CarMax,[50] Family Dollar,[51] Home Depot,[52] IDC Research,[53] Kohl's department stores,[54] Manpower,[55] Nordstrom,[56] Praxair,[57] Sherwin-Williams paints,[58] Sony Entertainment,[59] Talbots,[60] and Vanity Fair.[61]

'Kitchen Sink' Buyers

Lists of siphoning strategy users inevitably include some avoiders that — when presented with CIT circumvention options by their planner — appear to have packed up "everything but the kitchen sink." It is difficult to determine from the

[38] *A&F Trademark v. Tolson*, 167 N.C. App. 150, 605 S.E.2d 187 (2004); and *Lanco v. New Jersey*, 908 A.2d 176, 188 N.J. 380 (2006).

[39] *Kohl's Department Stores v. Virginia*, Va. Cir. Ct., No. CL 12-1774 (2021).

[40] *Martha Stewart Omnimedia v. Michigan*, Mich. Tax Trib., No. 409820 (2011).

[41] *See, e.g.*, Barney Tumey et al., "States Will Receive $315 Million From MCI in Tax Settlement," *BNA Daily Tax Report*, Oct. 5, 2005; U.S. Bankr. S.D. N.Y., *In re: Worldcom Inc. Debtors*, "Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner," Jan. 26, 2004; Michael Mazerov, "State Corporate Tax Shelters and the Need for 'Combined Reporting,'" Center on Budget and Policy Priorities, at 1 (Oct. 26, 2007).

[42] *Media General v. South Carolina*, 694 S.E.2d 525 (2010).

[43] *R.R. Receivables v. Arizona*, 224 Ariz. 254, 229 P.3d 266 (2010).

[44] *Spring Licensing v. New Jersey*, 29 N.J. Tax 1 (2015).

[45] *TJX v. Massachusetts*, Mass. App. Ct. Dkt. No. 09-P-1841 (2010).

[46] *Wal-Mart Stores East Inc. v. Hinton*, 197 N.C. App. 30, 676 S.E.2d 634 (2009).

[47] *Wendy's v. Illinois*, 996 N.E.2d 1250 (2103); and *Wendy's v. Virginia*, CL09-3757, Va. Cir. (2012).

[48] *Gore Enterprise Holdings v. Maryland*,437 Md. 492, 87 A.3d 1263 (2014).

[49] *Zebra Technologies v. Illinois*, 799 N.E.2d 725, 344 Ill. App. 3d 474 (2003).

[50] *Carmax Auto Superstores West Coast Inc. v. South Carolina*, App. Case No. 2012-212203; Op. No. 27474.

[51] *Family Dollar Stores v. Wilkins*, 2005-V-469 (Ohio Bd. of Tax App. 2008).

[52] *Home Depot USA v. Arizona*, Ariz. Super. Ct. No. 2006-000240 (2009).

[53] *IDC Research v. Massachusetts*, 78 Mass. App. Ct. 352, 937 N.E.2d 1266 (2010).

[54] *Kohl's Department Stores v. Virginia*, Va. Cir. Ct. No. CL 12-1774 (2021).

[55] *Manpower v. Maryland*, Md. Tax Ct. No. 13-IN-00-0121 (2018).

[56] *Nordstrom v. Maryland*, Md. Tax Ct. No. 07-IN-00-0317 (2010).

[57] *Praxair Technology v. New Jersey*, 988 A.2d 92, 201 N.J. 126 (2009).

[58] *Sherwin-Williams v. Massachusetts*, 778 N.E.2d 504 (Mass. 2002).

[59] *Robinson v. Jeopardy Productions*, 315 So. 3d 273 (La. App. 2020).

[60] *Talbots v. Maryland*, 06-IN-00-0226; 06-IN-00-0227, Md. Tax Ct. (2008).

[61] *Surtees v. VFJ Ventures*, 8 So. 3d 950 (2008).

cases and news reports whether these kitchen sink buyers of a multiplicity of avoidance services were being greedy (seeking to escape every last tax penny possible) or strategic (creating a diverse portfolio of strategies — overlapping and redundant, or conceptually distinct) in order to reduce the risk that state auditors would find everything and shut it all down.

The greedy ones (and there are many) sometimes amp up their tax reduction so much that they do more than reduce their taxes — they run their avoidance entities into a loss position. Year after year, the OpCo on the sending end of a royalty siphon (for example) might generate far greater deductions than income because an aggressive or sloppy planner (more than a few are both) had teamed up with a greedy and careless avoider company (more than a few of them, too, are both) to set the intercompany royalty rates unreasonably high, with little or no mooring to market realities.

Unused losses could be carried over from year to year until used or expired; these long-term tax attributes — net operating loss carryovers — might often be accepted unchallenged by a state revenue department auditor many years later, perhaps long after the royalty arrangement had been "turned off" by the avoider, making the abusive nature of the NOLs difficult to notice. The more aggressive the strategy, sometimes, the longer its tail.

Among the kitchen sink buyers whose CIT planning portfolio includes siphoning strategies are:

- AutoZone Inc. (IHCs for trademarks and management fee markups, along with a variety of other CIT planning strategies).[62]
- Belk Department Stores (purchaser of a full package of the planner's CIT circumvention offerings).[63]
- Michael's Stores (particularly ProcurementCo stripping strategy in addition to Finance and IP siphoning strategies).[64]
- Staples Inc. (Its plethora of CIT-ducking strategies included royalties siphoned to a unitary-stuffed recipient in a stripping East-West arrangement, online nexus isolation, ProcurementCo, and more.)[65]
- Target Corp. (It purchased multiple strategies including unitary-based IHC Royalty and Finance Companies, ProcurementCo, and an 80/20 Hong Kong-diluted back door — to be illustrated at Figure 11 in part 4 of this series — all supported poorly with off-the-shelf business purposes and perfunctory "corporate formalities.")[66]
- Tractor Supply Co. (This niche retailer — comfortable with stocking pet food, horse riding clothing, and tractor repair parts together —was apparently also comfortable stocking up on a diverse set of planning strategies, including trademark royalties and interest siphoned to unitary-stuffed IHCs, Shared Services Co, ProcurementCo, and an Employee Lease Co for payroll factor apportionment engineering.)[67]

Piggybackers

Also, recall (from part 2 of this series)[68] that siphoning strategies used at the federal level (shifting tax base to overseas tax havens) have a direct piggyback effect in U.S. states, avoiding CIT not only in separate-filing states, but also in water's-edge unitary combined states and worldwide unitary combined states that offer a water's-edge election. The Institute on Taxation and Economic Policy and the U.S. Public Interest Research Group estimate that the annual

[62] *Autozone Investment Corp. v. South Carolina*, Docket No. I9.ALJ-17.0068.CC (S.C. ALC 2020).

[63] *Belk Inc. v. South Carolina*, Docket No. 2O-ALJ-f7-02f 1-CC (S.C. ALC 2020).

[64] *Michael's Stores v. South Carolina*, Docket No. 19-ALJ-17-0044-CC (S.C. ALC 2020).

[65] *Staples v. Maryland*, 2597 (Ct. Spec. App. Md. 2018).

[66] *Target Brands v. Colorado*, 2015CV33831 (2017).

[67] *Tractor Supply v. South Carolina*, Docket No. 19-ALJ-17-0416-CC (S.C. ALC 2020).

[68] Griswold, *supra* note 22.

piggybacking loss to water's-edge unitary combined states exceeds $14 billion;[69] the California Budget and Policy Center estimates its share of that annual revenue loss is $4 billion.[70]

Apple, one of the world's largest corporations, is a good example of the piggybacking problem. It "sidesteps billions in taxes" with various siphoning and stashing planning strategies, including use of an investment affiliate located in the natural tax haven of Reno, Nevada.[71]

> The major strategy Apple uses to reduce its U.S. tax bill is to artificially shift large amounts of its domestic profits into tax havens. This allows Apple to avoid paying U.S. taxes on these profits while also paying very little in foreign taxes. . . .
>
> Like many other multinationals, Apple exploits this loophole by using accounting maneuvers to shift its U.S. profits overseas (often only on paper) and then indefinitely deferring U.S. taxes on them.[72]

The only antidote to the states' automatic piggybacking on this type of massive federal tax avoidance siphoning is adoption of TUCR.

Next up: Part 4 of this series will explain and illustrate another of the Six S's of CIT avoidance planning — stripping. ■

[69] ITEP, *supra* note 1.

[70] Kayla Kitson, "California Loses Nearly $70 Billion Annually Through Tax Breaks: Much of the Loss Is to High-Income Households & Corporations," California Budget and Policy Center (Apr. 2022).

[71] Charles Duhigg and David Kocieniewski, "How Apple Sidesteps Billions in Taxes," *The New York Times*, Apr. 28, 2012.

[72] ITEP, "Fact Sheet: Apple and Tax Avoidance" (Nov. 2017).

Innovation Principles (4) for Multistate CIT Plann

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by Don Griswold

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Don Griswold

Don Griswold works to encourage informed public discourse about the social justice implications of state and local tax policy. Previously, he worked as a *Fortune* 10 conglomerate's executive tax counsel, a Big Four accounting firm's national partner in charge of state tax technical services, a nationwide SALT litigation partner with two AmLaw 100 firms, and an adjunct professor of tax at Georgetown University Law Center.

In this installment of Just SALT, Griswold illustrates stripping strategies for multistate tax planning and continues to build the case for state legislatures to shut them down by adopting true unitary combined reporting.

Corporations and their advisers enjoy an embedded innovation advantage over the people and their governments when it comes to state tax avoidance and collection. Illustrating this advantage by grouping state corporate income tax (CIT) planning strategies into the siphoning, stripping, straddling, stuffing, stashing, and secreting families, this series seeks to demonstrate the failure of existing state countermeasures and the superiority of true unitary combined reporting (TUCR).[1]

Stripping is the topic for today, following the discussion of siphoning in part 3.[2] First, however, a note on the interchangeable use of "avoidance" and "planning" in this series.

Tax Planning vs. Tax Avoidance

A subcommittee of the U.S. Senate's Homeland Security Committee published a report in 2005 criticizing some of the country's top law and accounting firms for their roles in the innovation, marketing, implementation, and defense of federal income tax avoidance activities in the "tax shelter industry."[3] The committee's focus was on federal tax, but the firms all plied this trade for state CIT avoidance purposes as well.

No judgment is intended concerning the propriety of the devices illustrated here, whether described as "planning/reduction" or "avoidance/shelter" strategies. But the Senate's guidelines may be instructive for any reader who wishes to judge:

> In its broadest sense, the term "tax shelter" is a device used to reduce or eliminate the tax liability of the tax shelter user. This may encompass legitimate or illegitimate endeavors. While there is no one standard to determine the line between legitimate "tax planning" and "abusive tax shelters," the latter can be characterized as transactions in which a significant purpose is the avoidance or evasion of Federal, state or local tax in a manner not intended by the law.[4]

Stripping

Following the first generation of broadly marketed CIT avoidance strategies (siphoning strategies like naked Delaware holding companies (DHCs), intangible holding companies (IHCs)

[1] Don Griswold, "Innovation Principles for Multistate CIT Planning — Part 2," *Tax Notes State*, May 30, 2022, p. 921 (Innovation: Part 2).

[2] Griswold, "Innovation Principles for Multistate CIT Planning — Part 3," *Tax Notes State*, June 20, 2022, p. 1263 (Innovation: Part 3).

[3] Michael Bopp, Joyce Rechtschaffen, and Amy Newhouse, "The Role of Professional Firms in The U.S. Tax Shelter Industry," U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs (Apr. 13, 2005).

[4] *Id.* at 3-4.

with a veneer of substance, and the like),[5] avoidance innovators started looking for enhancements and alternatives that could keep them several "catch me if you can" steps ahead of revenue department auditors.

Could the shelter entities (recipients of siphoned streams of royalties, interest, and management fees) be disguised so auditors would have a more difficult time discovering them? Could the siphon streams themselves be disguised, recharacterized, transformed, or substituted — particularly to preserve tax avoidance in states that were beginning to adopt systemic antiabuse rules like the addback of deductions for intercompany intangibles transactions?[6]

This line of brainstorming led to the development of stripping strategies. In this family, the planner often starts with a company that has historically conducted all or many of its activities within a single legal entity — an all-purpose operating company, or OpCo. The planner strips out from the OpCo a variety of activities and assets; mixes and matches the stripped-out items, separately incorporating various combinations; and in this process uses some planning building blocks described in part 1 of this series[7] — particularly apportionment engineering, supply chain segregation, income concentration, nexus isolation, and transfer pricing.

The stripping strategies selected for discussion here are East-West Co, SalesCo, The Entrepreneur (sometimes referred to as embedded royalties), an 80/20 enhancement to that strategy, Procurement Co (two variants), and FactorCo.

East-West Split

In the mid '90s and early aughts, it was not too much of an exaggeration to generalize that most states east of the mighty Mississippi River were separate-filing states while most of the states to its west had adopted the unitary combination method.[8]

A number of large chain retailers historically operated (from a managerial and economic perspective) pretty much as a single-entity operating company, with headquarters functions, procurement, distribution, nationwide marketing, trademark management, and store ownership (or leasing) all in that single entity. Such an organization had nexus everywhere it did business, and 100 percent of its income was apportioned among the states. In the first generation of cookie-cutter CIT avoidance, as we have seen, the way to sidestep one's tax obligations was to drop the intellectual property into a naked DHC. Think *Toys R Us* or *Kmart*.[9]

What might happen, planners began to think, if they could persuade senior management to strip before they siphoned?

What if they were to abandon the DHC/IHC model and simply strip out from the operating parent all the stores in separate-filing states, leaving the rest (headquarters functions and IP ownership, in addition to the unitary-state stores) behind, up at the parent? Most separate-filing states were in the eastern United States, so they might call that new entity Retail-East, even if it included a few west-of-the-Mississippi states (like Arkansas, Louisiana, and Missouri) that required separate filing. What if, further, they were to strip unitary-state stores and the IP out of the parent as well, and into its own entity, to be called NewCo Retail-West? (Maine and New Hampshire were already unitary then, but what state revenue auditor in those days would look that hard at the composition of companies called East and West anyway?)

CIT planners around the country sketched out the scenarios and started modeling them, knowing that intercompany movement of apportionment factors, income, and other elements sometimes produced unexpected results. In the chain retail world, however, where income pretty much tracks with

[5] Griswold, "Innovation: Part 3," *supra* note 2.

[6] *Id.* at 923-924 and Figure 3B.

[7] Griswold, "Innovation Principles for Multistate CIT Planning — Part 1," *Tax Notes State*, May 16, 2022, p. 729 (Innovation: Part 1).

[8] For a discussion of these methods, see *id.* at 731-733 and Figure 2.

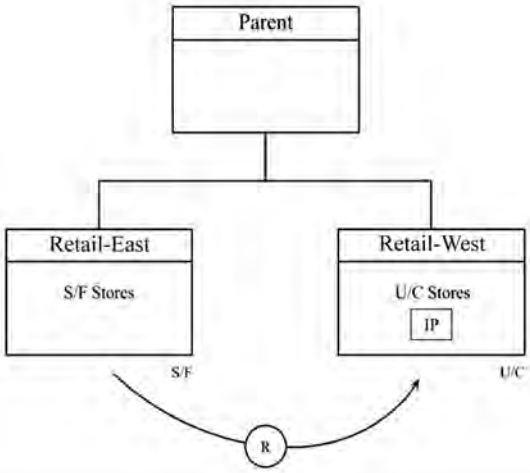
[9] *Geoffrey Inc. v. South Carolina*, 437 S.E.2d 13 (S.C. 1993); and *Kmart v. New Mexico*, 131 P.3d 22 (N.M. 2005). *See* discussion in Griswold, "Innovation: Part 3," *supra* note 2, at 1264-1266 and Figure 5.

apportionment factors, the results were relatively straightforward and avoider-friendly:

- Retail-East (owner of separate-filing-state stores but not of the store name and other trademarks they used every day) would be required to pay Retail-West (owner of those marks and of the unitary-state stores) a royalty for the right to use the marks.
- Retail-West would have nexus only (or so planners thought for many years) in combined-reporting states, where the intercompany flow of royalties would, by statute, be ignored.
- Recall the analogy from earlier parts of this series: Moving a cash-packed wallet from my right pocket to my left does not alter my financial position, just as moving an income-attracting trademark from one member of a unitary group to another does not change the group's financial position. The stripping strategy would have no impact on Retail-West's CIT liability, but it makes Retail-West an excellent tax shelter entity.
- Retail-East would avoid CIT in separate-filing states as it took deductions for those royalty payments to Retail-West, just as it would avoid CIT if it paid royalties to a naked DHC.

Figure 8 illustrates a simple version of the East-West strategy that has been adopted by many companies, including ubiquitous chain retailers AutoZone,[10] CarMax,[11] Rent-A-Center,[12] Staples,[13] and Walmart.[14] (The reader may find it helpful to refer to the legend in part 1 of this series.)[15]

Figure 8.
East-West Co



In this strategy, the stripping and rearranging of store ownership and operations produces the same kind of CIT-ducking as a naked DHC. Avoiders found that the East-West strategy might be easier to defend against (and escape detection by) state auditors who were still looking for DHCs and IHCs. The trademark-owning company in an East-West strategy no longer exists only on a document inside a filing cabinet in the dingy office of an adviser in Wilmington, Delaware, or Hamilton, Bermuda; Retail-West owns scores of stores, employs hundreds of people, and earns a great deal of income from selling goods, not merely from licensing IP. With this strategy, avoiders could stay ahead of auditors — at least for a time, and time was all the avoiders required, because by the time state revenue departments became aware of East-West as a replacement for DHC, armies of planners would already be hard at work developing a third generation of strategies, always staying an innovation generation ahead of the separate-filing states.

What, you may ask, would have happened if these separate-filing states had instead adopted TUCR? TUCR would have automatically neutralized the East-West strategy (no audit required), just as it neutralizes DHCs and their ilk.

In a TUCR environment, planners' "catch me if you can" innovation advantage is meaningless when all they are doing is developing more clever

[10] *AutoZone Investment Corp. v. South Carolina*, Dkt. No. I9.ALJ-1 7.0068.CC (S.C. ALC 2020).

[11] *CarMax Auto Superstores West Coast Inc. v. South Carolina*, 767 S.E.2d 195 (S.C. 2014).

[12] *Rent-A-Center East v. Indiana*, No. 49T10-0612-TA-00106 (2015).

[13] *Staples Inc. v. Maryland*, No. 2597 (Md. Ct. Spec. App. Aug. 9, 2018).

[14] *Wal-Mart Stores East Inc. v. Hinton*, 676 S.E.2d 634 (N.C. App. 2009).

[15] Griswold, "Innovation: Part 1," *supra* note 7, at 732, Figure 1.

ways to move money from the avoider's right pocket to its left. For TUCR states, the money is still in the avoider's pants.

SalesCo

East-West stripping is attractive to a big-box chain retailer because similar operations are spread relatively evenly around the country. In contrast, a consumer products company may have sales offices and employees in all 50 states, warehouses and distribution centers located in a dozen or so of those, and manufacturing plants scattered around. If its sales function creates nexus (and tax liability) almost everywhere,[16] it can strip that function out of the profitable entity and dump it into a newly created entity, SalesCo.

Figure 9.
Sales Co to SalesCo

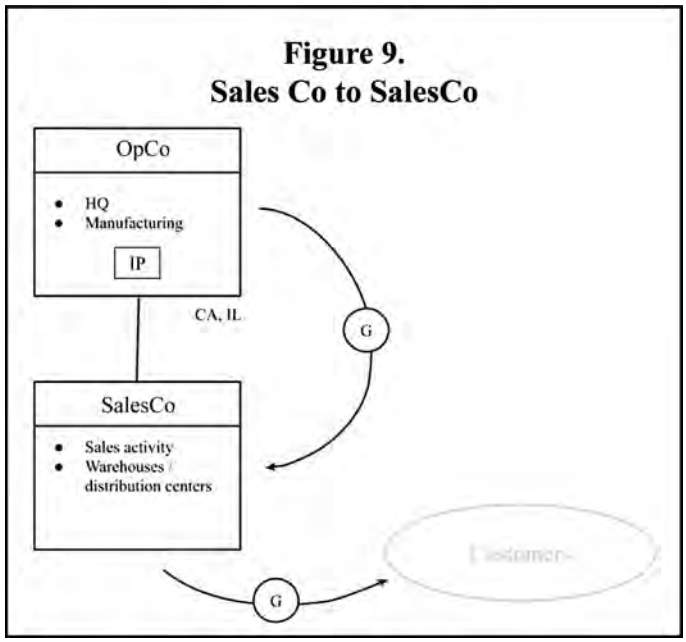


Figure 9 illustrates how a "buy/sell" SalesCo strategy works for many avoiders, particularly those with headquarters and manufacturing facilities only in combined-reporting states.[17] Assume parent OpCo is headquartered in California (a combined-reporting state), that its plants are in California and Illinois (another combined-reporting state), but that its sales operations are everywhere — that is, in all 50 states plus the District of Columbia.

The nexus-isolation, apportionment engineering, and transfer pricing building blocks of CIT planning[18] are involved here. Stripping the sales, warehousing, and distribution functions out of OpCo and into SalesCo isolates OpCo from nexus in separate-filing states. It also reduces OpCo's separate-filing-state apportionment — and thus its effective tax rate (ETR) — to zero, so a successful state nexus challenge won't net it any tax revenue. OpCo has essentially become a tax shelter entity, so setting the price of goods between OpCo and SalesCo exceptionally high will concentrate most of the group's profits in the tax shelter, leaving the high-tax entity (SalesCo) with very little tax base.

SalesCo has been a commonly employed structure, but there have been few published court or administrative decisions on the subject to publicize this ubiquity. One CIT avoider that did litigate the issue is Columbia Sportswear.[19] It resisted auditors' efforts to neutralize the strategy in a separate-filing state, Indiana. Why did it wage the fight in a separate-filing state? Because a state with TUCR (or even with water's-edge unitary combination) would have brought the avoidance structure to naught. A company like Columbia would not have even tried to use siphoning or stripping strategies to elude CIT in a TUCR state.

More stripping innovation would be necessary, though, if our consumer products company had significant headquarters or manufacturing operations in separate-filing states. Creative planners took another look at the "supply chain segregation" building block, and developed our next stripping strategy, which they fondly dubbed The Entrepreneur.

The Entrepreneur

Perhaps the Big 4 SALT partners who developed and named this strategy conceived of an "entrepreneur" as a person (corporate or

[16] OpCo may or may not have been able to insulate itself from nexus by qualifying for the P.L. 86-272 federal safe harbor. *See* Griswold, "Innovation: Part 1," *supra* note 7, at 730-731.

[17] In contrast to buy/sell SalesCos, commission SalesCo strategies are generally disfavored by planners because of old Supreme Court precedent that may allow a state — after lengthy and costly litigation — to attribute such a SalesCo's nexus to OpCo. *See Tyler Pipe Industries Inc. v. Washington*, 483 U.S. 232 (1987).

[18] *See* Griswold, "Innovation: Part 1," *supra* note 7.

[19] *Columbia Sportswear USA Corp. v. Indiana*, 45 N.E.3d 888 (Ind. T.C. 2015).

human) who dreams up the visionary ideas, controls the intellectual capital, has at its disposal various fungible functionaries to carry out directions from the top, and receives the lion's share of the endeavor's financial rewards. If that image sounds rather like the Big 4 compensation pyramid, it also describes the transfer pricing theory that underlies this next CIT planning strategy.

Those innovative planners, the reader will recall, were working to stay steps ahead of separate-filing-state revenue department auditors. Catch me if you can. The old *Geoffrey*-style[20] naked DHC and its immediate progeny relied heavily on intercompany royalties to shift one entity's tax base to a tax-favored affiliate. But intercompany royalties stuck out like a sore thumb to auditors (who tried their best to undermine the RoyaltyCo's avoidance results with nexus, alternative apportionment, and sham challenges), and increasingly to legislators (who put their fingers in the holes of the avoidance dike with addback statutes).[21]

What could the planners do to achieve the same base-siphoning avoidance impact they got with royalties, without the structure looking like it was royalty based?

Brainstorming again — and focusing on the consumer products companies for which they had created stripped SalesCos — they recalled that when a consumer buys, say, a tube of toothpaste, much of that toothpaste's price reflects the marketing value of the trademarks that distinguish it from competitors on the grocery shelf. From that perspective, could royalty fees be considered essentially "embedded" in the sales price for goods?

Well, perhaps yes, perhaps no, but the strained analogy still might help the planners sell an "intercompany sales of goods" stripping strategy to companies that were accustomed to paying for strategies based on royalty siphons. And so The Entrepreneur strategy (sometimes called the Principal strategy) was born, continuing right where the SalesCo strategy leaves off.

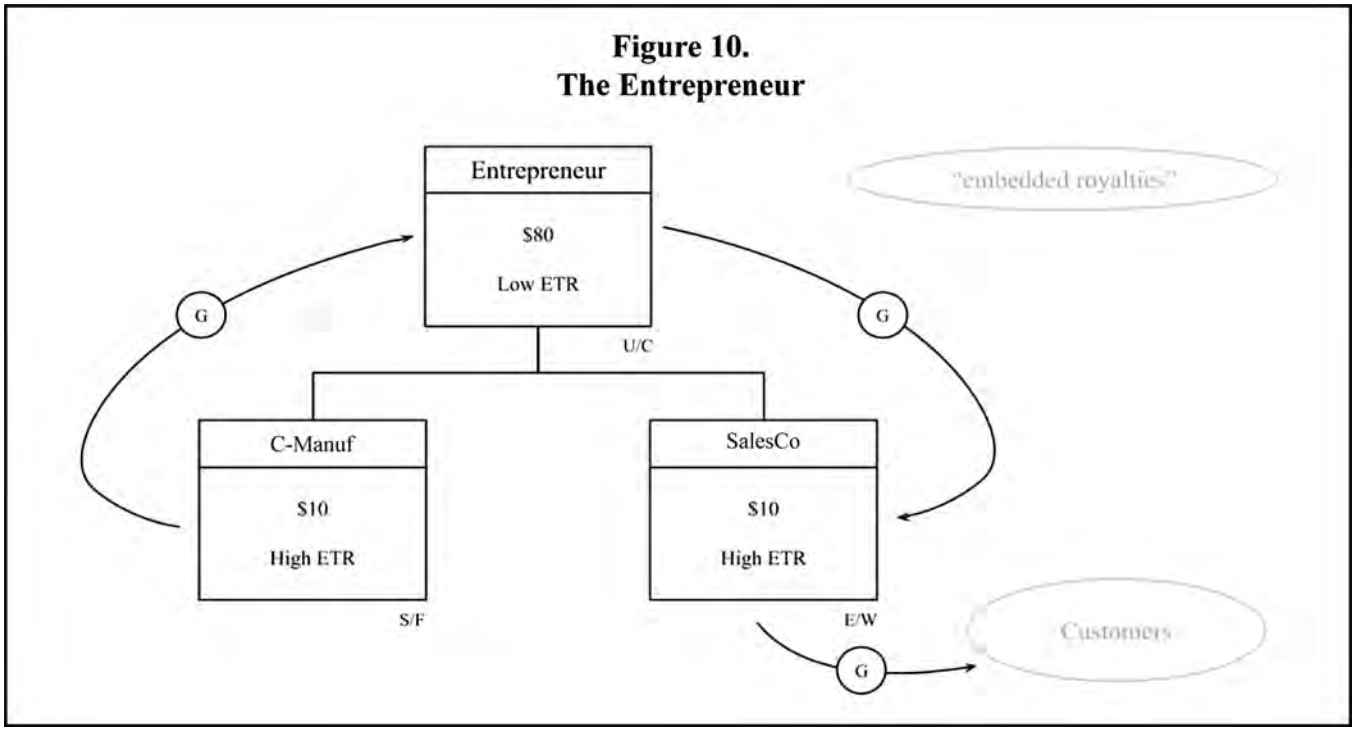
Take a look back at Figure 9. The sales and distribution functions have been stripped out of the OpCo parent, which still retains, in addition to the headquarters function, a major part of the supply chain: the manufacturing stage. Let's strip that out into a NewCo and call it Contract Manufacturer (C-Manuf for short). The stripped down OpCo can now be renamed "Entrepreneur." That name might be more fitting if we were to strip out another low-value ministerial function — the back-office headquarters work like legal, tax, accounting, and IT — into a SharedServicesCo. Perhaps strip out a separate MarketingCo as well. Many avoiders' structures do have such entities, which receive management fees (with a markup on the costs of these functions), but we have omitted these for the sake of simplicity in Figure 10.

Figure 10 provides a simplified illustration of the varying ETRs (high or low ETRs in separate-filing states) created in this structure, and of the concentration of most group profit in The Entrepreneur, which serves as the tax shelter in this scheme:

- C-Manuf manufactures goods in plants located in separate-filing states. If any of those states apportion based on the traditional three-factor formula (property, payroll, and sales), or if their single-sales-factor formula sources receipts to origin (instead of the economically correct rule of sourcing to the market), then C-Manuf will have a high separate-filing-state ETR. The avoider will not want much of the group's profits there.
- SalesCo, as we saw above, will have a high separate-filing-state ETR as well, so, as in the SalesCo-alone strategy, it too will be designed to earn as little profit as possible.
- The Entrepreneur, in contrast, will be engineered to have a low ETR in separate-filing states. Perhaps it has its headquarters (and only nexus) in a combined-reporting state as in our Figure 9; in that case, its separate-filing ETR will be zero.

[20] *Geoffrey*, 437 S.E.2d 13.

[21] *See* Griswold, "Innovation: Part 2," *supra* note 1.



But if The Entrepreneur is headquartered in a separate-filing state, the planner will have to engage in some structural apportionment engineering to drive that ETR down, stuffing The Entrepreneur with activities that bring in unitary factors. A combined-reporting state sales office properly belongs in the SalesCo, and a combined-reporting state manufacturing plant properly belongs in C-Manuf, but the planner (modeling out alternative scenarios until the structure hits the CIT "savings" numbers promised to the client) might just swallow hard and stuff them up into The Entrepreneur anyway. Its separate-filing-state apportionment must be diluted, one way or another.

As with most of the CIT planning strategies described in this series of articles, The Entrepreneur in Figure 10 — some variant of which was apparently used by companies such as AutoZone[22] and Belk Department Stores[23] — seeks to circumvent CIT only in the most vulnerable states, those that have not adopted combined reporting. Water's-edge combined reporting (even though it provides less robust defenses than the recommended TUCR method) would shut down the avoidance described in this strategy.

Innovative planners and avoiders also thought about how water's-edge combined-reporting states automatically shut down this avoidance strategy. Crack open a soda pop, and let's talk about what they did next.

80/20 Entrepreneur Enhancement

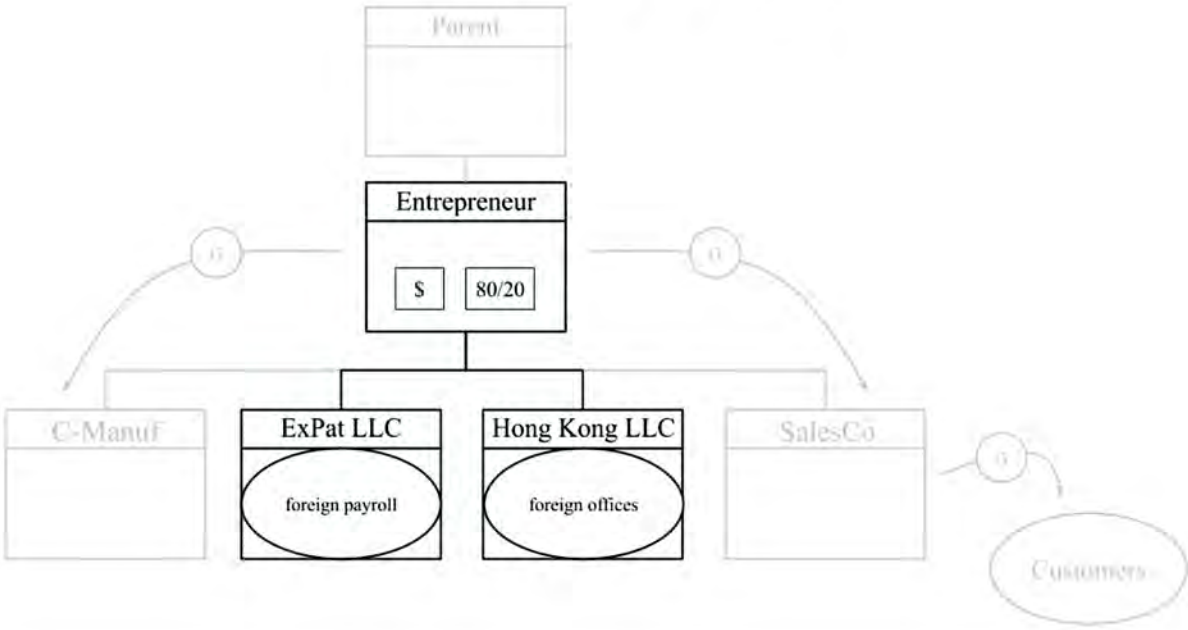
Fortune 50 member PepsiCo (maker of Quaker Oats, Tropicana, Frito-Lay products, as well as its eponymous soft drink) adopted a version of The Entrepreneur entity stripping strategy described above, seeking to sidestep CIT in separate-filing states with a structure that looks much like that illustrated in Figure 10. Not content with escaping CIT only in separate-filing states, however, Pepsi and its advisers cast about for a way to enhance The Entrepreneur strategy so that it could duck CIT in water's-edge combined-reporting states as well.[24]

[22] *AutoZone*, Dkt. No. I9.ALJ-1 7.0068.CC.

[23] *Belk Inc. v. South Carolina,* Dkt. No. 2O-ALJ-f7-02f 1-CC (S.C. ALC 2020).

[24] *PepsiCo v. Illinois*, 16 TT 82; 17 TT 16 (Ill. Tax Trib. 2021).

Figure 11.
80/20 Entrepreneur Enhancement



Remember the 80/20 backdoor that Zebra Technologies used to siphon tax base out of Illinois (a combined-reporting state)?[25] Pepsi and its advisers figured they could use the 80/20 exception to unitary combination in a stripping strategy, too.

Figure 11 shows how Pepsi and its advisers did it. The greyed-out boxes and arrows show Pepsi's basic Entrepreneur structure: The operating company was stripped of its manufacturing operations, which were separately incorporated in C-Manuf; its sales operations were similarly stripped out and placed into a new SalesCo. (These temporary naming conventions, or something very like them, are used by most planners as they develop their avoidance plans in the feasibility and design stages. Nearing the implementation phase, planners invite their clients to provide final names intended to obscure the structure's intent from state tax auditors.)

With little of the group's profit allocated by transfer pricing to either of these NewCos (as in Figure 10), most of the profit in Figure 11 was concentrated in what remained of Pepsi's old Frito-Lay operating company — renamed Entrepreneur Co here because it has basically nothing left in it but the brains and IP of the operation. Stripped of any separate-filing operations, The Entrepreneur Co could claim nexus insulation and zero (or tiny) engineered apportionment in separate-filing states.

This phase of its Entrepreneur strategy (shown in Figure 10), Pepsi hoped, would allow it to successfully escape CIT in all the separate-filing states.

Turning to Figure 11 now, the reader will recognize The Entrepreneur structure in grey, with The Entrepreneur itself, along with two new entities, in black.

The bold black boxes in Figure 11 illustrate the combined-reporting state enhancement. To qualify The Entrepreneur for the 80/20 back door, Pepsi needed to get 80 percent or more of Entrepreneur's payroll and property to be located outside the United States. After the initial stripping, Entrepreneur didn't have much property or payroll left to strip, so its U.S. apportionment factors could be diluted without

[25] *See* Griswold, "Innovation: Part 3," *supra* note 2, at 1270 and Figure 7.

it having to move in much foreign property and payroll at all.

To engineer the necessary apportionment dilution, Pepsi first set up two NewCos — we'll call them ExPat LLC and Hong Kong LLC — organized as limited liability companies with Entrepreneur Co as the single member of each. Defaulting to "disregarded" status (treating the LLCs as if they were divisions of Entrepreneur Co for state and federal income tax purposes), whatever apportionment factors were possessed by these disregarded single-member LLCs would simply flow up into Entrepreneur Co and be counted there in the 80/20 qualification calculation.

For the property factors, PepsiCo transferred to Hong Kong LLC the ownership of some of its international offices. For the payroll factors, it moved (at least on paper) its preexisting network of "expatriate" employees who had been seconded from the United States to temporary assignments overseas, where they were already living and working.

Et voilà! More than 80 percent of Entrepreneur Co's property and payroll were (at least on paper) overseas. Entrepreneur Co, along with its enormous tax base, was now excluded from the unitary combined return in more than half the unitary-combined states.

After stripping out the original OpCo's separate-filing-state nexus and apportionment-producing operations and using transfer pricing to concentrate most of the group's profits there, Pepsi had created an Entrepreneur Co with most of the group's tax base but virtually none of its separate-return-state ETR. On top of that, Pepsi had turned its Entrepreneur Co into an 80/20 company as well by stuffing it with foreign property and payroll factors. Putting together a variety of building blocks and hybrid strategies, what had Pepsi achieved?

The bulk of the group's income would, Pepsi hoped, sidestep CIT almost everywhere. Illinois, California, and other water's-edge combined-reporting states will win some and lose some when they attempt to neutralize this type of avoidance structure for all those companies that try it.

Alternatively, every one of these water's-edge combined-reporting states could eliminate this tax avoidance scheme; no further litigation needed. How? By adopting TUCR.

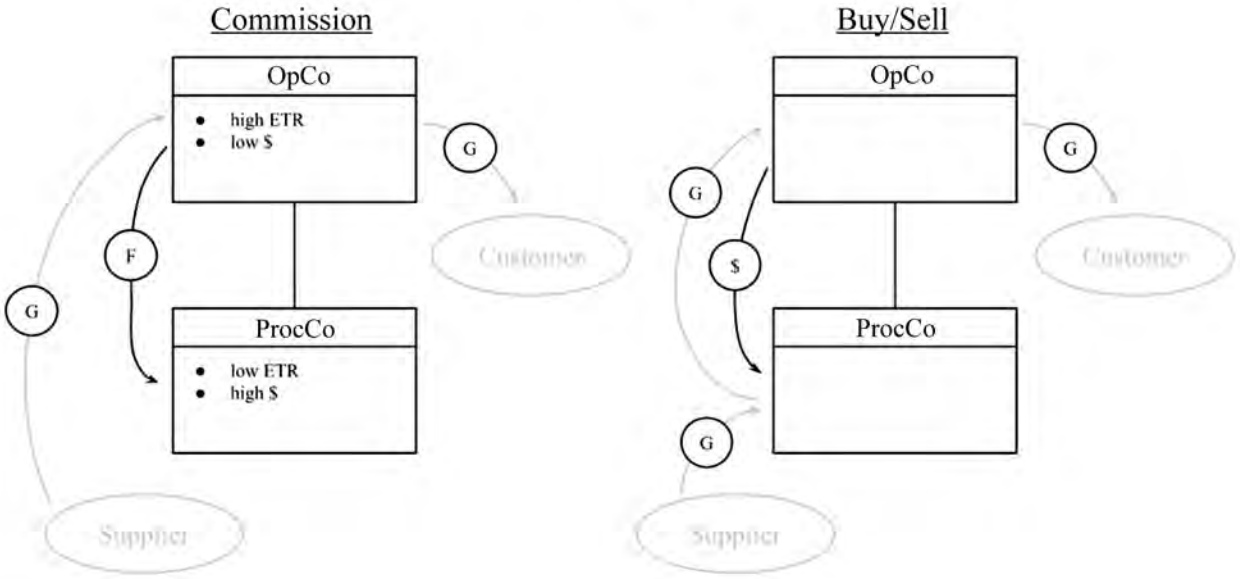
Procurement Co

In the SalesCo and The Entrepreneur strategies outlined earlier, planners designed stripping strategies by starting with the "supply chain segregation" building block. If the sales and distribution segment of the supply chain attracts too much nexus and too much separate-filing-state ETR, the avoider cleverly strips out that segment and skinnies down the new SalesCo's tax base with transfer pricing. Similarly, if the manufacturing segment of the supply chain sits in a handful of states that greatly increase OpCo's apportionment factors there, strip out that segment and reduce new C-Manuf's tax base by asserting that it's entitled to only tiny profits.

Various strippable functions: Is there any part of the supply chain that we have not yet stripped out? The answer will, of course, vary by company. The Research and Development Co. (R&D-Co) is common in CIT avoidance structures, as are Employee LeaseCos, TransportationCos, MarketingCos, OnlineSalesCos . . . the list is long and diverse. So the avoidance innovator starts ruminating again.

Stripping out the purchasing function: In our example here, the innovator has identified yet another segment to strip. This next set of stripping strategies looks further upstream in the supply chain. Depending upon the industry, this may be the extraction of minerals from mines or food from farms, or perhaps the acquisition of unfinished goods that the company will process before selling along in the supply chain to its customer — which may be the ultimate consumer or a business-to-business customer that occupies a downstream segment of the supply chain. In all these cases, the segment about which we speak is essentially procurement.

Figure 12.
Procurement Co



Planning innovators found that if they stripped out the organization's procurement function into its own legal entity, they could use a procurement company (typically known as ProcCo or ProCo) as a CIT side-stepping strategy as well. ProcCo may be appended to The Entrepreneur structure in Figure 10, hanging off the manufactured ManufacturingCo at the bottom left of the chart, or stripped out in any number of other structures.

A popular strategy, ProcCo has been deployed across multiple industries, but particularly in the chain retail industry, which has always been a hotbed of CIT avoidance. Michaels Stores,[26] Staples,[27] Target,[28] and Tractor Supply,[29] for example, are apparently among this strategy's users.

Figure 12 presents two common variants of a simple ProcCo structure that strips the purchasing function from an otherwise multipurpose OpCo.[30]

OpCo has a high ETR in separate-filing states, so the planner shifts OpCo's tax base to a newly stripped out ProcCo. Moving the procurement function to a combined-reporting state will give ProcCo the necessary low ETR in separate-filing states so that it can function as a tax shelter. If moving that function is not realistic, alternative means of apportionment engineering might include a strategy in the "stuffing" family, to be illustrated in part 6 of this series, in Figure 18: the Stuffed Substance IHC.

For both ProcCo variants in Figure 12, the goal is to concentrate income in the low-ETR entity, ProcCo, rather than in the high-ETR entity, OpCo. When, as here, the income concentration building block is preferred over income siphoning, the pricing building block is

[26] *Michaels Stores Inc. v. South Carolina*, Dkt. No. 19-ALJ-17-0044-CC (S.C. ALC 2020).

[27] *Staples*, No. 2597.

[28] *Target Brands Inc. v. Department of Revenue*, No. 2015CV33831 (Colo. Dist. Ct., City and Cty. of Denver, 2017).

[29] *Tractor Supply Co. v. South Carolina*, Dkt. No. 19-ALJ-17-0416-CC (S.C. ALC 2020).

[30] The reader may recall that a ProcCo can be designed by the planner to escape or defer its client's sales/use tax obligations as well as its corporate income tax obligations. *See* Griswold, "Innovation: Part 3," *supra* note 2, at 1264.

central. The commission model reduces OpCo's tax base because OpCo takes a deduction for the commission or service fee it pays to ProcCo. The buy/sell variant is more common, perhaps because it allows the company to claim supplier-provided volume purchase discounts for ProcCo, justifying its price markup when it on-sells to OpCo.

Under either variant, the result is the same: The vulnerable separate-filing state loses revenues unnecessarily. Adopt TUCR, and the vulnerability ends.

FactorCo

Looking back down the supply chain even beyond the sales and distribution stages, the planner finds another strippable function that can be used to CIT avoidance advantage: the collections function.

When a company's customer buys on credit, the asset the business receives is not cash but an account receivable. The company's collections department generally will not be able to collect 100 percent of those receivables, and it may take time and resources to do the collecting. Irrespective of tax avoidance, a cash-strapped business may "factor" those receivables to convert them into cash . . . for a price. That price here is called "discount."

"Factor" is both a verb — the act of obtaining short-term nonrecourse financing by selling one's accounts receivable to a third party — and a noun: The cash-hungry company factors (sells) its accounts receivable to a factor (a third-party financial institution like altLine or RTS Financial) at a discount. The Factor determines that discount through an underwriting process that evaluates the quality of the receivables, the company's collections history, and so on, then adds a profit element for itself. Factoring may be done with or without notification to the company's debtor-customers. In the no-notification model (perfect for tax avoiders seeking to keep structural and transactional changes a secret from everyone except the state auditor the avoider hopes to deceive), payments still come from customers to the company, which remits them to the Factor.

Planning innovators wondered about a captive FactorCo. The company with the accounts receivable incurs a loss when it factors them at a discount to the Factor. Tax base erosion here would be caused by that artificially engineered discount.

The client need not be cash-starved; indeed, the ideal target would not be so, for in that case it may well have been doing genuine factoring in the marketplace. No. Here, the ideal target would have large accounts receivable of sufficiently poor quality (or at least with enough facts that a creative transfer pricing economist could weave a story of poor quality) just sitting on its books in the collections department.

Figure 13 provides yet another reminder that if a financial transaction is conducted in the real world, it can be created inside a corporate group to dodge CIT. Here we illustrate a typical FactorCo strategy, much like that used by "kitchen sink"[31] alleged avoidance purchasers like AutoZone[32] and Belk Department Stores,[33] as well as by avoiders like R.R. Donnelley,[34] which opted for a less diversified but perhaps more nuanced CIT avoidance portfolio.

The FactorCo must have low or no separate-filing-state ETR, so many avoiders use DHCs or IHCs (familiar from the siphoning family above). Others use affiliates into which they have stuffed dilutive unitary-state apportionment factors (from companies that operated within, or sold to customers located in, unitary combined-reporting states).[35] TUCR, of course, would have neutralized this.

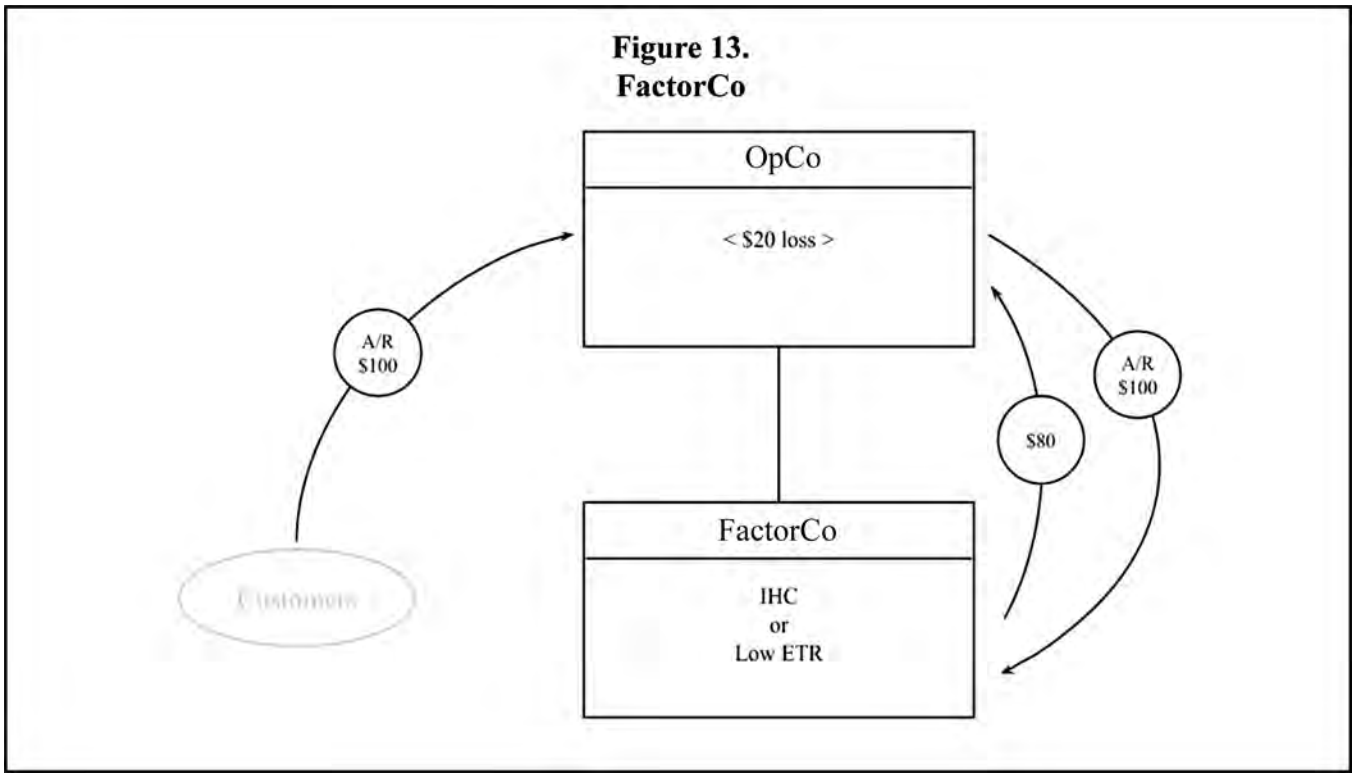
[31] *See* Griswold, "Innovation: Part 3," *supra* note 2, at 1272.

[32] *AutoZone*, Dkt. No. I9.ALJ-1 7.0068.CC.

[33] *Belk*, Dkt. No. 2O-ALJ-f7-02f 1-CC.

[34] *R.R. Donnelley & Sons Co. v. Arizona*, 224 Ariz. 254, 229 P.3d 266 (2010).

[35] *See also* Virginia Public Document Ruling No. 11-162 (2011).



The Tax Avoidance Tango

The stripping family, like the siphoning family of CIT avoidance strategies illustrated in part 3, victimizes vulnerable states that still rely on only a grab bag of costly, slow, and uncertain countermeasures.

For innovative tax avoidance planners and their corporate clients, the secret to successful state CIT avoidance is getting states to believe that they are stuck with the splintering of a single unitary business group into two or more independent actors, and that these actors are engaged in meaningful intercompany financial transactions with each other . . . when they are not.[36]

It takes two to dance the tax avoidance tango, but the TUCR filing method recognizes that there is in reality just one dancer here, whose embracing arms deceptively move money from his right pocket to his left.

Straddling strategies will be addressed next, in part 5. And guess what: TUCR would neutralize them, too. ■

[36] *See* Griswold, "Innovation: Part 1," *supra* note 7, at 739.

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SB 0576—SUPPORT

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Testimony of Don Griswold
before the
Maryland Senate Budget and Taxation Committee
March 7, 2023
In Support of Senate Bill 576—Combined Reporting

Dear Chairman Guzzone, Vice Chair Rosapepe, Members of the Budget & Taxation Committee:

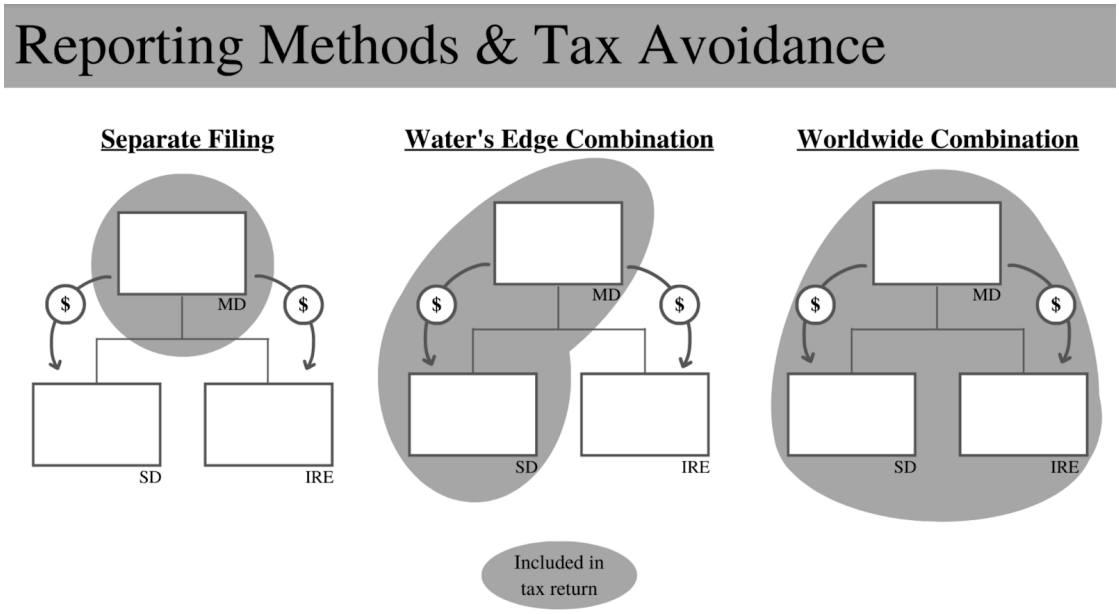
State corporate tax avoidance was my career and obsession for more than three decades. I co-built and led a 600-person "state tax minimization" function at a Big 4 accounting firm in the 1990s, creating structures that lawfully avoided many millions of dollars in corporate income tax (CIT) for my large corporate clients, mainly in states that had not enacted combined reporting —including Maryland—where corporate tax avoidance is easier than shooting fish in a barrel.

I served Berkshire Hathaway as its Executive Tax Counsel in Omaha, following years of defending my clients' tax avoidance schemes as an appellate litigator at AmLaw100 law firms, and teaching the next generation of tax lawyers as an adjunct professor at Georgetown Law.

But tax fairness and anti-corruption became my new passions when I switched sides recently. *Bloomberg* publishes my *Rethinking Tax* column; I advise civil society entities on tax justice; I launched a global tax transparency initiative at the International Anti-Corruption Conference.

And I advise state legislators just how easy it is to shut down corporate income tax dodging: Simply enact worldwide combined reporting—with no election out.

Take a look at this visual from my *Tax Notes* series revealing the secrets of state CIT avoidance:



The visual shows simple tax avoidance by a tiny corporate group—& 3 state antidotes.

Corporate Structure: Each box represents a corporate entity. The parent operates in Maryland. It owns two subsidiaries—one operates in South Dakota (which has no corporate income tax); the other operates in Ireland (a tax haven). Parent with subs constitute an integrated business. The structure (with avoidance scheme) is shown 3 times to illustrate 3 state antidote options.

Avoidance Scheme: Avoiders dodge Maryland tax with a wide diversity of complex schemes, but all involve shifting taxable profits among members of the integrated unitary business group. Avoiders simply move profits out of Maryland's tax net and into a jurisdiction where those profits are subjected to a lower (or zero) effective tax rate. That's the game. And Maryland is the loser.

State Antidotes: "Separate filing" is Maryland's existing reporting method under §10-811. "Water's edge combination" is SB 576's de facto proposal because it allows taxpayers to elect out of "worldwide combination" under proposed §10-402.1(C)(1) and §10-402.1(E).

Here's what you need to know about Maryland corporate income tax avoidance:

Think of it this way: An avoider essentially moves their wallet from their left pocket to the right. Tax only the left pocket and Maryland loses. But tax the whole unitary pair of pants, and the avoider's sleight of hand is fruitless; Maryland still taxes the wallet.

The visual above presents an over-simplified example of avoidance, but your largest corporate taxpayers pay millions in fees to sophisticated advisors who dream up endless variations. That was my job, for decades. You may find it useful to read my (attached) four-part series in *Tax Notes*—"Innovation Principles for Multistate CIT Planning"—which details the process by which a select group of innovators in the tax avoidance industry develop ever new schemes that keep their clients always several steps ahead of those voluntary-victim states who decline to enact worldwide combined reporting (with no election out), instead enacting partial antidotes.

The series explains the fundamental building blocks of CIT avoidance strategy development: apportionment engineering, asset placement, complexity/obfuscation, income concentration, nexus isolation, nonconformity, recharacterization, shelter entities, supply chain segregation, transfer pricing, and more. The series organizes CIT planning strategy types into six "families" — siphoning, stripping, straddling, stuffing, stashing, and secreting—and then illustrates a wide range of specific strategies (footnoting to court cases naming companies that have used them).

Here's what the visual teaches:

"Separate filing" is the method used now by Maryland, where virtually all CIT avoidance works. Your statutory rifle-shot antidotes (add-backs, transfer pricing) only nibble at the edges.

SB 576's adoption of "worldwide combination" is the right approach, for this would neutralize virtually all CIT avoidance—if the bill stopped there. Instead, SB 576 goes on to give half the tax dodge back to avoiders. How? By allowing avoiders a "water's edge" election. Don't do that. It neutralizes only the tax dodge schemes that use domestic affiliates while leaving foreign-affiliate schemes—which piggyback on the company's coexisting federal tax avoidance—untouched.

Two other matters:

Get rid of the "deferred tax liability" provision in SB 576's proposed §10-311. It perversely reimburses tax dodgers for the economic impact of losing the tax avoidance that you're ending. Tax laws change all the time, and taxpayers must deal with all impacts—both direct (changes to their tax liabilities) and indirect (real or imagined stock market impacts, etc).

Also, as you're considering testimony offered by industry associations whose membership includes tax avoiders made notorious in court decisions and in the press, understand that the mission of such organizations is to preserve and protect laws that enable their avoidance. No evidence supports their strained arguments about economic growth, complexity, uncertainty.

Conclusion

After hemming and hawing for years, Maryland should seize this opportunity now to neutralize the corporate income tax abuse that has been allowed to misdirect public resources into private pockets.

I support Senate Bill 576 as an excellent beginning.

Even if SB 576's current water's edge approach is all that Maryland is able to enact at present, that would represent an important step in the right direction.

But I hope that—whether here in the Budget and Taxation Committee or later in the process—you will go all the way to enacting the correct tax policy choice of worldwide combined reporting with no water's edge election out.

Respectfully,

Don Griswold
Just SALT Policy LLC

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

Before the
Maryland Senate Budget and Taxation Committee

Hearing on S.B. 576, Combined Reporting
March 7, 2023

Chair Guzzone, Vice Chair Rosapepe, 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 in fiscally responsible, 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. 576, Senator Young's and Senator Rosapepe's bill to mandate the use of combined reporting 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 doing so 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 tax minimization 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. 576 nullifies entity isolation, while the Joyce approach does so only partially.

Another example of a tax minimization strategy to which Maryland remains vulnerable because it does not require combined reporting is just plain-vanilla intercompany transfer pricing. That involves one member of a corporate group located in a lower-tax state charging a corporate subsidiary doing business in Maryland an artificially high price for inventory for resale or for production inputs for a product or service for sale to Maryland customers. In the past couple of years, I was hired to be an expert witness in two cases involving another non-combined-reporting state's efforts to nullify this tax avoidance strategy, which is being exploited by two household name big box retailers that have stores in Maryland as well. In the one case that went to trial, the transfer prices for inventory, marketing, management, and other services are being set so high that the in-state stores were reporting losses even though the retail chain is highly profitable on a national basis. The state faces an uphill battle in challenging those prices, a battle it wouldn't have to be fighting had state lawmakers there mandated combined reporting.

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

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 and 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.

Opponents of combined reporting here often point to the fact that its enactment will create "winners and losers," that is, that some corporations will actually pay less tax under combined reporting than they do under the current, "separate filing" system. That is indeed true. The most common reason for that result is that corporations that have some subsidiaries with true, economic losses can use those losses to offset the profits of other subsidiaries immediately, rather than having

to carry them forward and deduct them in future years. Many significant changes in tax policy and tax law create winners and losers, and I have never understood why combined reporting opponents think that the fact that some corporations will pay less is a compelling argument against the change. To the contrary, it shows that this is a neutral tax policy change and not the "money grab" that opponents make it out to be.

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

Tax avoidance 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 the 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 has 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 the intangible addback law that Maryland has adopted.

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. And, of course, our neighbor West Virginia is a combined reporting state as well.

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 those 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 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." It should be noted, however, that the latter 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.

Combined Reporting and Corporate Income Tax Revenue Volatility

Combined reporting opponents also claim its adoption would increase the year-to-year variability of corporate tax receipts so much as to make its adoption inadvisable. This claim rests on the fact that in some of the five years from 2006 to 2010 during which Maryland had in effect a requirement that corporations file hypothetical, or "pro-forma" tax returns using combined reporting, corporate income tax receipts under combined reporting would have been lower than they were under the existing "separate filing system. Viewed in the larger context, however, this fact does not diminish the case for combined reporting to any meaningful extent:

- The reduction in revenues was quite modest and occurred in only two of the five years under the "Finnigan" method of combined reporting, which is the method embodied in S.B. 576.

In tax year 2008, having the Finnigan method in effect would have reduced corporate tax revenues by only $15.4 million, or 1.9 percent. In 2009, it would have reduced corporate tax revenues by $56.1 million, or 6.5 percent. Moreover, even with that larger impact in 2009, corporate tax revenues would still have risen between tax year 2008 and 2009 by $26.4 million, or 3.4 percent.

- These reductions are of the same order of magnitude as normal year-to-year fluctuations in corporate tax receipts. For example, corporate tax receipts fell 2.4 percent between tax year 2005 and 2006 and 9.0 percent between tax year 2009 and 2010. No one could reasonably argue that fluctuations of such magnitude would justify repealing the corporate income tax, so it is disingenuous of combined reporting proponents to argue that fluctuations of similar magnitude attributable to combined reporting justify forgoing this valuable reform — all the more so when one notes that it would have boosted corporate tax receipts by fully 27 percent in tax year 2006 and 20 percent in tax year 2007.

- The years during which pro-forma combined filing was in effect were not normal years. The Great Recession that began in December 2007 and ended in June 2009 was the deepest U.S. economic downturn since the Great Depression. Drawing any conclusions regarding the inevitable impact of combined reporting on Maryland corporate tax receipts during recessions based on these particular years is problematic.

- During the Great Recession, national personal income fell 5.2 percent from the second quarter of 2008 to the first quarter of 2009, while Maryland personal income fell only 3.0 percent during that period. Based on that experience, combined reporting opponents imply that corporations taxable in Maryland are inevitably going to be substantially more profitable than their out-of-state affiliates during recessions because the Maryland economy is substantially shielded from downturns by the presence of federal government activities. They argue that with combined reporting Maryland's corporate income tax will be "importing the losses" of those out-of-state affiliates, leading to reduced revenue. But, again, the Great Recession was atypical. During the 2001 recession, there was very little difference in the growth rates of the U.S. and the Maryland economies. National personal income declined by only 0.1 percent from its highest to lowest point, while it increased by just 0.3 percent in Maryland during the same period.

Many revenue sources, such as capital gains realized by high-income people, are also quite volatile and frequently drop significantly during recessions. No one suggests that the appropriate response to this volatility is to forgo the revenue and sacrifice the improvement in tax fairness that including the revenue source in the tax system creates. The appropriate solution is for the state to have an adequate rainy-day fund with which to weather recessions and to build into state budgets only the average annual yield of the revenue source rather than the amount it generates in peak years. That is the appropriate strategy with which to address the underlying inherent volatility of state corporate taxes and any modest increase in that volatility that the adoption of combined reporting might lead to. Given the state's needs for critical investments in education, health care, and other services, it makes no sense to forgo an annual revenue yield in excess of $200 million because of the possibility of a slight increase in corporate income tax volatility.

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 based 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 <u>state</u> 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.

The Bill Should Be Amended to Drop the New Deduction for "Deferred Tax Liability"

There is one provision of this bill which I respectfully urge the Committee to remove by amendment before approving it. It would enact a new corporate income tax deduction that would eventually cause the state to forgo a significant portion of the additional revenue that would be raised by this bill. The deduction is intended to offset a purely <u>paper</u> "expense" incurred by some large corporations when the state adopts combined reporting. The corporate proponents of this new deduction claim that without it, their stockholders will unfairly suffer a "double impact" from

the change. The first impact is the actual increase in Maryland income tax liability an affected corporation will experience when their tax-avoidance strategies are nullified. The second impact is an alleged drop in the corporation's stock value caused by an increase in the "deferred tax liability" reported on the corporation's financial statements. Proponents seek the new deduction to offset the alleged stock market effect — yet they have provided no evidence that the effect will actually occur. Such evidence should be readily available if the claim were true, given that a dozen states have adopted combined reporting in the past 20 years.

I have written an entire report on this proposed deduction, titled "States Should Reject Corporate Demands for "Deferred Tax" Deductions" (May 2019). It is available on the Center's website. The following are the main reasons why its enactment is completely unjustified:

- The proposed deduction is a narrow, special-interest tax break that only a handful of states have approved.

- The rationale for the deduction — that increased tax expenses reported on a corporation's financial statements would adversely affect a corporation's stock values — is implausible.

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

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

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

Again, I respectfully urge the Committee to amend this provision out of the bill.

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.

In conclusion, I respectfully urge the Committee to favorably report S.B. 576 with an amendment to remove the deduction for deferred taxes. 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.

SB 576_MDCC_Corporate Income Tax-Combined Reportin
Uploaded by: Andrew Griffin
Position: UNF

MARYLAND
Chamber of Commerce

LEGISLATIVE POSITION:
UNFAVORABLE
Senate Bill 576
Corporate Income Tax – Combined Reporting
Senate Budget & Taxation Committee

Tuesday, March 7, 2023

Dear Chairman Guzzone 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 6,400 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.

Senate Bill 576 would mandate that certain corporations compute their Maryland income tax using the combined reporting method -- a highly complex system of determining taxable income among all states in which a company does business.

Requiring combined reporting would be a bad tax policy choice for Maryland.

- Data collected by the Maryland Comptroller's Office showed that the revenue impact of mandatory combined reporting would be volatile, including revenue losses in some years.
- The data collected by the Comptroller's Office showed that some corporations would see a *reduction* of their Maryland corporate income tax liability, while other corporations would experience an increase in their tax; i.e., there are both winners and losers. **See an example below showing how the arithmetic of combined reporting can reduce a company's tax.**
- Experiences in other states have shown that after adoption of combined reporting the revenue increase expected did not materialize.
- In 2004, the Maryland General Assembly enacted provisions into the state's tax law that addressed the perceived abuses of "shipping profits outside the state" via intercompany transactions. Additionally, the Comptroller's aggressive audits have resulted in huge additional tax assessments from companies that had utilized intercompany transactions in reducing their Maryland income tax for both pre and post 2004 years.
- Combined reporting is a complex methodology that involves US Constitutional constraints that have been addressed by the US Supreme Court and in dozens of state court cases; it is much more than just adding all related corporations' data together, but rather requires detailed factual analysis to determine which corporations form the "unitary business group."
- The complexity of the combined reporting system would require significant training of the Comptroller's personnel and would likely require add additional staff. There would also be a need for educational outreach to Maryland taxpayers and tax practitioners.

- The complexity of the combined reporting system will further add to the cost of compliance by Maryland's businesses and add to the costs of the State's administration of the income tax.
- Our close competitor states of Virginia, Pennsylvania and Delaware do not require combined reporting.

Example of combined reporting, this one results in less Maryland tax to be paid:

Corporation	Net Income	Apportionment factors: in MD / Everywhere
Parent	$20,000,000	30,000,000/100,000,000
Subsidiary A	30,000,000	10,000,000/500,000,000
Subsidiary B	10,000,000	Zero / 400,000,000
Total group	$60,000,000	40,000,000/ 1,000,000,000

Maryland Tax Calculation – Separate returns:

Parent	$20,000,000 x 30M/100M x 8.25% =	$495,000
Subsidiary A	$30,000,000 x 10M/500M x 8.25% =	$ 49,500
Subsidiary B	Zero apportionment	0
Total		$544,500

Maryland Tax Calculation – Combined reporting:

Total group	$60,000,000 x 40M/1,000M x 8.25% =	$198,000

Group pays **less** Maryland income tax, i.e.,
Maryland's revenue **loss** from combined reporting = $346,500

Over the last decade, combined reporting has been exhaustively researched and debated among policymakers in Annapolis and across the state. The prevailing sentiment remains that combined reporting is not an appropriate or accurate method of computing state taxable income or attributing multistate business income to economic activity in Maryland. In fact, a combined reporting system would result in significant and unintended negative consequences for business taxpayers, including competitive disadvantage, undue complexity and administrative burden, all while resulting in no guaranteed increase to state revenue.

Combined reporting is not a guarantee for increased state tax revenue. Proponents of combined reporting contend that it will raise millions in additional tax revenue without data to support that argument. In fact, Maryland's own Business Tax Reform Commission found that instituting combined reporting "would result in a shift of the tax burden, substantial in some cases, among industries and among taxpayers, resulting in winners and losers." The Commission explained further that the reasons cited in support of combined reporting have each been addressed through other legislative vehicles adopted by the General Assembly and tougher audit methods now utilized by the Comptroller's Office.

Since 2004, the Comptroller's Office has utilized two provisions of the State's tax statute to correct perceived abuses of intercompany/interstate transactions: the "add-back" provision that disallows deductions for certain expenses paid to related corporations in other states; and provisions granting the Comptroller discretionary powers to adjust amounts of income and expenses between related corporations.

Combined reporting presents a real competitive disadvantage for Marylanders. Within the region, many of our neighboring states—including Virginia, Pennsylvania, and Delaware—do not utilize the combined reporting method. **In fact, during their 2021 legislative interim, the Virginia General Assembly's Combined Reporting Workgroup determined that combined reporting was not a more efficient system of deterring abusive tax planning beyond their existing tax policy requiring add-backs of certain intercompany transactions – the exact same policy and authority already granted to Maryland's Comptroller.** They further found that combined reporting would not cause a sea change in tax revenue collected, with their results showing 13% of taxpayers would pay more in tax under combined reporting, 14% would pay less, and 73% would pay roughly the same in tax, thus further reinforcing the understanding that combined reporting simply shifts the tax burden among certain industries, creating winners and losers. It would be detrimental for Maryland to employ a new taxation system that will harm the attraction and retention of businesses, and cost Marylander's access to new jobs and economic opportunities, all while increasing the complexity and costs of administering Maryland tax law.

Furthermore, the State's switch to single sales-factor only became fully phased in last year and this committee has heard legislation in the past to provide deferred tax relief to those businesses that experienced detrimental impacts as a result of the shifting tax burden created by that policy. We are only now in a position to fully understand what the impacts of that policy are on revenue collections, now is not the time to implement yet another change in State tax policy.

Maryland businesses are continuing to struggle with extreme workforce shortages and persistently high inflation. According to the New York Federal Reserve there is a 53.8% probability the United States will enter a meaningful economic recession by January 2024.[1] Implementing new income tax schemes that have proven unreliable for revenue collection would clearly have a negative impact on Maryland's job creators and the state budget.

For these reasons, the Maryland Chamber of Commerce respectfully requests an **unfavorable report** on **HB 46**.

[1] https://www.reuters.com/markets/us/two-fed-measures-see-notable-recession-risk-despite-strong-data-2023-02-24/

2023 GBCC SB 576 Combined Reporting.pdf
Uploaded by: Ashlie Bagwell
Position: UNF

THE GREATER BETHESDA CHAMBER of COMMERCE
Smart Business, Bright Future
95th ANNIVERSARY

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STATEMENT BY
THE GREATER BETHESDA CHAMBER OF COMMERCE
REGARDING
SENATE BILL 576-- CORPORATE INCOME TAX-COMBINED REPORTING
SENATE BUDGET AND TAXATION COMMITTEE
MARCH 7, 2023
POSITION: UNFAVORABLE REPORT

On behalf of our 500-member businesses and more than 45,000 employees in Montgomery County, this statement is in **Opposition to SB 576 – Corporate Income Tax—Combined Reporting.** This bill would require certain groups of corporations to file a combined income tax return reflecting the aggregate income tax liability of all the members of the group.

A number of years ago, the Augustine Commission issued a report recommending that combined reporting not be adopted in Maryland and stated, "This debate causes uncertainty and sends a negative message to businesses considering expansion in or relocation to the State. In its effort to reform the corporate income tax and generate additional revenues, **combined reporting can create revenue volatility and winners and losers among corporate taxpayers.** Combined reporting can also lead to additional litigation from taxpayers and create additional administrative costs for both taxpayers and the State.

At a time when businesses throughout the State and nation continue to be concerned about the economic ramifications from the COVID-19 crisis and the current economic uncertainty, now is not the time to cause more confusion and difficulty for corporations of all sizes to do business here.

We agree 100% with the Augustine Commission report, and as we do every year this issue comes up, ask that the committee render an **unfavorable report.** Thank you for your consideration of our remarks.

SB0576 -- Corporate Income Tax - Combined Reportin

Uploaded by: Brian Levine

Position: UNF

Senate Bill 576 -- *Corporate Income Tax - Combined Reporting*
Senate Budget and Taxation Committee
March 7, 2023
Oppose

The Montgomery County Chamber of Commerce (MCCC), the voice of business in Metro Maryland, opposes Senate Bill 576 -- *Corporate Income Tax - Combined Reporting.* This bill requires affiliated corporations to compute Maryland taxable income using combined reporting.

MCCC opposes restructuring the corporate income tax to impose combined reporting in Maryland because of its adverse impact on Maryland's business competitiveness. MCCC cites the recommendations of the Maryland Business Tax Reform Commission (MBTRC), which was created in 2007 to review and evaluate the State's business tax structure. The Maryland General Assembly explicitly directed the MBTRC to review whether to implement combined reporting. In its 2010 final recommendations, the MBTRC recommended against combined reporting in Maryland. The Commission's final report explained its reasoning in rejecting combined reporting due to the following:

- **Complexity** – combined reporting is a complex change for taxpayers, tax preparers, and the Comptroller's Office.
- **Shift of Tax Burden** – combined reporting shifts the tax burden, substantially in some cases, among industries and among taxpayers, resulting in winners and losers.
- **Unnecessary** – many of the tax avoidance measures which combined reporting is intended to prevent have already been addressed by the State through the Delaware holding company add back, the captive real estate investment trust (REIT) legislation, and other measures.
- **Increased Volatility** – a Comptroller's study of corporate returns indicated that combined reporting would lead to increased volatility in corporate income tax revenues, already one of the State's most volatile revenue sources.

Later, in 2015, the Maryland Economic Development and Business Climate Commission, also known as the Augustine Commission, issued a report recommending against the adoption of combined reporting in Maryland. The report stated that combined reporting "…can create revenue volatility and winners and losers among corporate taxpayers." The report added that, "Combined reporting can also lead to additional litigation from taxpayers and create additional administrative costs for both taxpayers and the state."

MCCC continues to support the creation of a commission to examine and make recommendations as to how to make Maryland's tax structure more fair, equitable, and economically competitive. This more comprehensive and strategic approach should be adopted, rather than a piecemeal approach to tax policy.

For these reasons, the Montgomery County Chamber opposes Senate Bill 576 and requests an unfavorable report.

The Montgomery County Chamber of Commerce, on behalf of our nearly 500 members, advocates for growth in business opportunities, strategic investment in infrastructure, and balanced tax reform to advance Metro Maryland as a regional, national, and global location for business success. Established in 1959, MCCC is an independent non-profit membership organization and a proud Montgomery County Green Certified Business.

Brian Levine | Vice President of Government Affairs
Montgomery County Chamber of Commerce
51 Monroe Street | Suite 1800
Rockville, Maryland 20850
301-738-0015 | www.mcccmd.com

SB0576_UNF_MTC_Corporate Income Tax - Combined Rep
Uploaded by: Drew Vetter
Position: UNF

MARYLAND TECH COUNCIL

TO: The Honorable , Chair
Members, House Ways and Means Committee
The Honorable Mary A. Lehman

FROM: Andrew G. Vetter
Pamela Metz Kasemeyer
J. Steven Wise
Danna L. Kauffman
Christine K. Krone
410-244-7000

DATE: March 7, 2023

RE: **OPPOSE** – Senate Bill 576 – *Corporate Income Tax – Combined Reporting*

The Maryland Tech Council (MTC) is a collaborative community, actively engaged in building stronger life science and technology companies by supporting the efforts of our individual members who are saving and improving lives through innovation. We support our member companies who are driving innovation through advocacy, education, workforce development, cost savings programs, and connecting entrepreneurial minds. The valuable resources we provide to our members help them reach their full potential making Maryland a global leader in the life sciences and technology industries. On behalf of MTC, we submit this letter of **opposition** for Senate Bill 576.

The application of combined reporting reflected in Senate Bill 576, which includes but is not limited to requirements for affiliated corporations to compute Maryland taxable income using combined reporting and creates a subtraction modification against the State income tax for certain deferred tax liabilities and assets. The passage of Senate Bill 576 would create uncertainty for Maryland businesses while adding significant complication to the corporate tax structure. Senate Bill 576 makes Maryland a less attractive location for businesses and at a competitive disadvantage to competitor states without combined reporting including Virginia, Pennsylvania, and North Carolina. For these reasons, MTC requests an unfavorable report.

SB 576 Combined Reporting Oppose Final.pdf
Uploaded by: Katherine Bennett
Position: UNF

SB 576
Oppose

Corporate and Business Entities – Combined Reporting
Comments on SB 576

Company Overview

NextEra Energy Resources, LLC, together with its affiliated entities, is a clean energy leader and is one of the largest wholesale generators of electric power in the U.S., with more than 27,000 megawatts of total net generating capacity, primarily in 38 states and Canada as of year-end 2022. NextEra Energy Resources is the world's largest generator of renewable energy from the wind and sun, and a world leader in battery energy storage. The business operates clean, emissions-free nuclear power generation facilities in New Hampshire and Wisconsin as part of the NextEra Energy nuclear fleet. NextEra Energy Resources is a subsidiary of Juno Beach, Florida-based NextEra Energy, Inc. (NYSE: NEE). For more information, please visit www.NextEraEnergyResources.com.

OPPOSITION to SENATE BILL 576

Purpose: Senate Bill ("SB") 576 proposes a significant change to Maryland's system of taxing businesses. Specifically, SB 576 would implement the unitary combined reporting method ("combined reporting method") by replacing the current separate entity filing method. The bill would require the combined reporting method mandatory for taxable years beginning after Dec. 31, 2024.

NextEra Energy Resources opposes SB 576 for the following reasons:

- The unitary combined reporting taxation method arbitrarily attributes more income to Maryland than is justified by a company's economic activity within the state. While the legislation touts itself as being a fairer approach to the current separate reporting methodology, such arbitrary assignment of income leads to inequitable results.

- The combined reporting method has historically been found to reduce economic growth in states that have a corporate income tax rate in excess of 8%. Maryland's corporate income tax is 8.25%.

- Proponents of the combined reporting method suggest it is a simpler approach to determining corporate tax liability. However, determining the composition of the unitary group is extremely complicated, subjective, and potentially costly for both the state and the business, often resulting in expensive, time-consuming litigation.

- Moreover, determining a revenue estimate for combined reporting is fraught with uncertainty. Pursuant to an analysis of Tax Years 2006-2010 conducted by the State Comptroller's Office, the unitary combined reporting method would have resulted in an estimated increase in revenue in 2006 and 2007, an estimated decrease in revenue in 2008 and 2009, and relatively flat revenue in 2010. As such, the combined reporting method arbitrarily creates winners and losers among businesses – and could result in greater tax liability for a business one year in Maryland, but lower tax liability for the same business in Maryland in another year – which clearly leads to revenue volatility for the state at a time when both businesses and the state need revenue stability.

- Proponents of the combined reporting method in Maryland erroneously claim implementation of the combined reporting method will close corporate loopholes, thereby preventing multi-state companies from using tax planning or shifting revenues from Maryland to other states to avoid tax exposure. However, the Maryland General Assembly has already implemented reforms to address intercompany shifting of interest and intangibles (§10-306.1), and further provided the State Comptroller the authority to adjust income involving other intercompany transactions (§10-109).

- The bi-partisan Maryland Economic Development and Business Climate Commission ("Augustine Commission") has previously opposed the adoption of combined reporting in the state. In its January 2016 report, the Augustine Commission strongly opposed combined reporting (e.g., "Recommendation 5: Do not adopt combined reporting and indicate clearly the intent not to do so" (Augustine Commission Report at xii)). As the Augustine Commission Report states, "[f]or many years, the General Assembly has considered whether to impose combined reporting in Maryland. This debate causes uncertainty and sends a negative message to business considering expansion in or relocation to the State. In its effort to reform the corporate income tax and generate additional revenues, combined reporting can create revenue volatility and winners and losers among corporate taxpayers. Combined reporting can also lead to additional litigation from taxpayers and create additional administrative costs for both taxpayers and the State (Augustine Commission Report at 38-39). Similar conclusions were reached by the Maryland Business Tax Reform Commission in its exhaustive 2010 study.

- Despite the recommendations of the bipartisan Augustine Commission, combined reporting continues to be introduced and debated on an annual basis. The same arguments are raised in support of enacting combined reporting in Maryland: (i) a majority of states have implemented combined reporting; and, (ii) combined reporting could secure additional revenue for the state.

- In the immediate region, only New Jersey and the District of Columbia have adopted combined reporting. Thus, the adoption of combined reporting could

further jeopardize the business attractiveness and competitive standing of Maryland vis-à-vis its neighbors.

- Maryland also adopted single sales factor apportionment for determining its corporate income tax in 2018. The impact of this equally significant change in corporate taxation remains, at best, unclear. Thus, it would be prudent to consider combined reporting as part of a comprehensive study of state tax policy – particularly the impact on business investment in jobs and economic development -- before rushing to implement it now.

- Companies such as NextEra Energy Resources, which do business in multiple states, closely monitor the quality of business climate before making investment decisions. Regulatory certainty – stability of laws and regulations – is a critical factor in investment decisions. The perennial General Assembly debate over combined reporting, "causes uncertainty and sends a negative message to businesses considering expansion in or relocation to the State" (Augustine Commission Report at 39). Given that combined reporting has an unclear financial impact to the State, NextEra Energy Resources recommends that the Committee fully analyze the potential impacts to the business community of combined reporting before proceeding with any implementation.

In conclusion, NextEra Energy Resources respectfully encourages an unfavorable report on SB 576.

FINAL Opposition Letter SB 576.pdf
Uploaded by: Kim Mayhew
Position: UNF

PotomacEdison
A FirstEnergy Company

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10802 Bower Avenue
Williamsport, MD 21795

OPPOSE – Senate Bill 0576
SB0576 – Corporate Income Tax – Combined Reporting
Budget and Taxation Committee
Tuesday, March 7, 2023

Potomac Edison, a subsidiary of FirstEnergy Corp., serves approximately 280,000 customers in all or parts of seven Maryland counties (Allegany, Carroll, Frederick, Garrett, Howard, Montgomery, and Washington Counties). FirstEnergy is dedicated to safety, reliability, and operational excellence. Its ten electric distribution companies form one of the nation's largest investor-owned electric systems, serving customers in Ohio, Pennsylvania, New Jersey, New York, West Virginia, and Maryland.

Unfavorable

Potomac Edison / FirstEnergy **opposes Senate Bill 0576 – Corporate Income Tax – Combined Reporting.** SB 0576 requires affiliated corporations to compute Maryland taxable income using a certain combined reporting method.

Potomac Edison / FirstEnergy requests an Unfavorable report on SB 0576 for the following reasons.

Senate Bill 0576, although vague and lacking necessary detail for implementation, proposes a dramatic change to Maryland's system of taxing businesses. Specifically, SB 0576 would replace the current individual or separate entity filing method with a unitary combined reporting method ("combined reporting"). Combined reporting has been exhaustively researched and debated among policymakers in Maryland. They have always concluded that combined reporting is not an appropriate or accurate method of computing state taxable income or attributing multistate business income to economic activity in Maryland.

Combined reporting would competitively disadvantage Maryland. Within the region, neighboring states - including Virginia, Pennsylvania, and Delaware - do not utilize the mandatory combined reporting method. Maryland's economic development efforts would be thwarted by the adoption of a new taxation system that would harm the attraction and retention of businesses and the jobs and economic opportunities these businesses provide.

Potomac Edison / FirstEnergy is highly regulated in each of the states in which we serve customers. The regulation over companies that distribute electricity imposes very strict accounting and is one key reason states like New Jersey have exempted regulated utilities from their unitary taxation statutes. The type of taxation contemplated in SB 0576 would overburden our electric customers, along with the Public Service Commissions in each state.

For the above reasons, and to avoid the negative consequences of utilizing the mandatory combined reporting method, Potomac Edison / FirstEnergy respectfully request an **Unfavorable** report on Senate Bill 0576.

MBIA Letter of Opposition SB 576.pdf
Uploaded by: Lori Graf
Position: UNF

MARYLAND BUILDING INDUSTRY ASSOCIATION
11825 West Market Place | Fulton, MD 20759 | 301-776-6242

March 6, 2023

The Honorable Guy Guzzone
Senate Budget and Taxation Committee
Miller Senate Office Building,
3 West Wing 11 Bladen St.,
Annapolis, MD, 21401

RE: Letter of Opposition SB0576 Corporate Income Tax – Combined Reporting

Dear Chairman Guzzone:

The Maryland Building Industry Association, representing 100,000 employees statewide, appreciates the opportunity to participate in the discussion surrounding **SB0576 Corporate Income Tax – Combined Reporting**. MBIA **opposes** the Act in its current version.

This measure would require corporations to calculate their Maryland taxable income using combined reporting. Combined reporting filings are administratively difficult for small businesses, which makes it difficult for an owner to understand them and provide information. Preparation takes more time, and thus incurs higher fees, to file these returns as well. Requiring a switch to combined reporting should not be taken lightly by the State, and much more due-diligence and guidelines would need to be provided to ensure that small business owners understand what the rules are if this method of filing could be successful.

For these reasons, MBIA respectfully requests the Committee give this measure an **unfavorable** report. Thank you for your consideration.

For more information about this position, please contact Lori Graf at 410-800-7327 or lgraf@marylandbuilders.org.

cc: Members of the Senate Budget and Taxation Committee

DOCS-#230032-v1-SB_576_2023.pdf
Uploaded by: Matthew Celentano
Position: UNF

March 7, 2023

The Honorable Chair Guy Guzzone
House Ways and Means Committee
3 West
Miller Senate Office Building
Annapolis, Maryland 21401

RE: Senate Bill 576 – Corporate Income Tax – Combined Reporting

Unfavorable

Dear Chair Guzzone:

We are writing on behalf of the American Council of Life Insurers ("ACLI") and the League of Life and Health Insurers of Maryland ("League"). ACLI and the League's member companies together provide over 95% of the life, disability, long term care insurance and annuities in Maryland and nationally. We ask for your opposition to unitary/combined reporting, or in the alternative, we ask for an exemption for insurance companies from unitary/combined reporting.

The enactment of unitary/combined reporting will subject insurers to income tax **in addition to** premium taxes, which they currently pay.

Insurers should be excluded because they are currently taxed under a completely different system than non-insurers. Insurers are taxed on gross premiums received rather than net income. **Premium taxes are paid whether the business is profitable or not.** Premium taxes are also paid by both Maryland domestic and foreign (domiciled in a state other than Maryland) insurers. Because of the heavy burden posed by the upfront premium tax, insurers are exempt from corporate income tax.

The benefits to the state of Maryland of the current state insurance company premium tax system are:

1. Stable source of revenue
2. Predictable source of revenue
3. Administrative ease and legal certainty
4. Credit certainty

Life insurers paid approximately $111,000,000 in premium taxes in 2015. Obviously, health insurers and property casualty insurers paid millions of additional dollars in 2015. If life insurers had paid taxes based upon the regular business tax, they would have paid $75 million in 2015 or $36 million less than what was paid through premium taxes.

Any attempt to combine income tax with a premium tax system presents numerous problems. Probably the most critical of these problems is the impact on the national retaliatory tax system which is unique to

the insurance industry. That system exists because the federal McCarran-Ferguson Act, 15 U.S.C. Sec. 1011 et seq. excludes the business of insurance from Commerce Clause applicability. Moreover, insurers have a different accounting system (statutory vs. GAAP) than non-insurers.

The forced combination of insurance companies with affiliated non-insurance companies would, for both the insurance industry and the state raise critical tax policy concerns, add tax burdens and uncertainties, create myriad administrative and substantive issues, and almost certainly lead to litigation.

For these reasons ACLI and the League respectfully request an unfavorable report on the provisions concerning unitary combined reporting or that insurers be expressly excluded from the application of combined/unitary reporting.

Respectfully submitted,

Matthew Celentano
American Council of Life Insurers
The League of Life and Health Insurers of Maryland

cc: Members, Senate Budget and Taxation Committee

MD SB 576_GBA Opposition to Unitary Combined Repor
Uploaded by: Meredith Beeson
Position: UNF

March 7, 2023

The Honorable Guy Guzzone
3 West Miller Senate Office Building
11 Bladen Street
Annapolis, MD 21401

Re: GBA Opposes U.S. Source Income Provision in SB 576

Dear Chair Guzzone, Vice Chair Rosapepe and Members of the Senate Budget and Taxation Committee:

On behalf of the Global Business Alliance (GBA), I am writing in opposition to certain provisions within SB 576 that would create an unfavorable tax environment that will deter investment and growth in the state and make Maryland an outlier from other states that have adopted combined reporting.

GBA represents nearly 200 U.S. companies with a global heritage. Nearly 800 international companies employ over 111,000 workers in Maryland. [1] Nationally, on average, these firms pay American workers more than $84,000 annually in wages and benefits, which is 10 percent higher than the economy-wide average.

Despite the fact that over twenty states have implemented combined reporting, **none** have required the inclusion of foreign entities solely based on receipt of U.S. source income. SB 576, in its current form, would create an extraterritorial water's edge tax system that imposes unfair and inappropriate double taxation for international businesses located in Maryland.

The most concerning provision in SB 576 is section 10-402.1(E)(2)(VI)(1), which asserts foreign unitary corporations that derive income from sources within the United States ("U.S. source income") would be required to be included in the Maryland water's edge combined group. Water's edge combined reporting in other states generally limits the unitary group to only U.S. affiliates, with very specific limited exceptions, none of which involve a U.S. source income standard. This approach would have the following negative consequences:

Create Disputes with Treaty Partners: Bilateral tax treaties ensure Maryland employers do not face double taxation on U.S. source income. In the past, some foreign governments have even enacted retaliatory action in response to states seeking to adopt a tax structure without a true water's edge system. If adopted, Maryland would be an outlier with other states and at odds with federal tax norms, which damages the state's economic competitiveness. Taxing U.S. source income would lead to extraterritorial double taxation, as this income is

[1] Bureau of Economic Analysis (BEA), Survey of Current Business, Activities of U.S. Affiliates of Foreign Multinational Enterprises in 2020, released August 2022.

already taxed by the country in which it is received. This hurts efforts to attract and retain international companies in the state.

Increase Revenue Volatility: Combined reporting is not a remedy for increasing revenue and could result in a loss of annual taxes collected. Proponents of SB 576/HB 46 cite needed funding for important state programs, but relying on an unstable revenue stream could be short-sighted and unsustainable. In Virginia, an interim legislative study commission and a burdensome informational-only filing were required for taxpayers to calculate taxes based on a combined reporting election. The Commonwealth concluded in 2021 to not move forward with combined reporting and one reason cited was the lack of a predictable revenue stream or possibility of a loss of revenue. [2]

Generate More Complexity for Maryland Tax Administrators: As written, this bill would distort traditional norms of the water's edge methodology by including foreign affiliates with U.S. source income in a combined group. Every state with combined reporting has opted for a true water's edge methodology, which does not include all unitary foreign companies simply because they have U.S. source income. This approach creates significant complexity and compliance burdens not only for the state but for Maryland employers as well.

Maryland already addresses abusive related party transactions with expense deduction addback rules.[3] These rules provide for specific exceptions for legitimate business transactions, including companies' operations in treaty countries. The U.S. source income provision in SB 576 effectively overrides the exceptions to the expense deduction addback rules, which were carefully crafted to protect legitimate business transactions.

To ensure Maryland remains an attractive destination for investment, we encourage the committee to consider the negative impacts of SB 576. If you have questions, please contact me at mbeeson@globalbusiness.org or at (202) 770-5141.
Sincerely,

Meredith Beeson
Senior Director, State Affairs
Global Business Alliance

[2] "Work Group to Assess the Feasibility of Transitions to a Unitary Interim Study Reporting System for Corporate Income Tax Purposes" Division of Legislative Services 2021 Interim Legislative Study; Commonwealth of Virginia.
[3] Maryland Tax- General Article Section 10-306.1.

GLOBAL BUSINESS ALLIANCE
Investing in America

Foreign Direct Investment Strengthens MARYLAND'S ECONOMY

HIGH QUALITY JOBS

111,400 workers in Maryland are employed as a result of international investment.

MANUFACTURING

28,400 workers in Maryland - **26 percent** of all FDI jobs in the state - are in the **manufacturing sector**.

GLOBALLY CONNECTED

Among all international employers, those from the **United Kingdom**, the **Netherlands** and **Canada** support the largest number of jobs in Maryland.

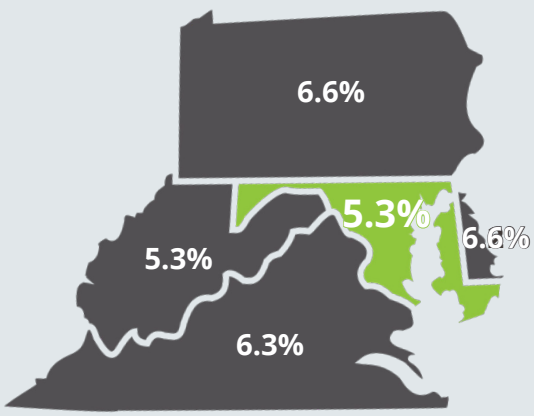
MANY EMPLOYERS

Nearly **800 international employers** have operations in Maryland.

INTERNATIONAL INVESTMENT CONTRIBUTES TO MARYLAND'S ECONOMY

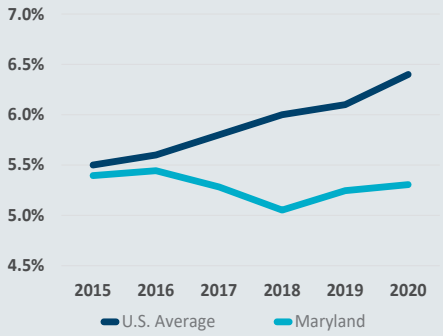
Maryland vs. Its Neighbors

FDI Jobs as a % of Total Employment



Maryland vs. USA

FDI Jobs as a % of Total Employment



Maryland trails the national average in its portion of jobs supported by FDI.

From 2010 to 2020, Maryland's FDI employment...

10%

while the state's overall private-sector employment

4%

DISCOVER THE FULL LIST OF GBA MEMBERS

Nearly 200 international companies comprise GBA's membership, representing a slice of the U.S. economy that provides eight million high-quality jobs that pay an average of 10 percent higher compensation than the economy-wide average. Our members are some of the largest international employers in the country. Browse through our membership list using the QR code.

Figures based on the Bureau of Economic Analysis (BEA), Survey of Current Business, *Activities of U.S. Affiliates of Foreign Multinational Enterprises in 2020*, released August 2022, and the Global Business Alliance's *Economic Bedrock Report*, released Fall 2018.

GLOBAL BUSINESS ALLIANCE

Investing in America

Foreign Direct Investment Strengthens AMERICA'S ECONOMY

MANUFACTURING

In the last five years, international companies created **nearly 400,000** new manufacturing jobs while the U.S. overall sadly **lost 223,000**.

INNOVATION

International companies spend more than **$71 billion** on U.S. R&D activities, or **13%** of all R&D performed by U.S. companies.

EXPORTS

U.S. workers of international companies produce **24%** of U.S. exports, shipping **$347 billion** in goods to customers around the world.

SUPPLY CHAINS

For every U.S. job at an international company, **three more** are supported in the U.S. economy.

TAX

International companies pay **18%** of all federal corporate income taxes.

Record Number of FDI Jobs

7.9 MILLION Nationally, 7.9 million U.S. workers are employed by international companies.

Good Paying Jobs

$84,836 Across the nation, U.S. workers at international companies earn 10 percent higher compensation than the economy-wide average - making $84,836 annually.

Current Employers Drive Growth

50% Last year, FDI in the U.S. was driven largely - 50 percent - by reinvesting earnings from current employers, above the historic trend.

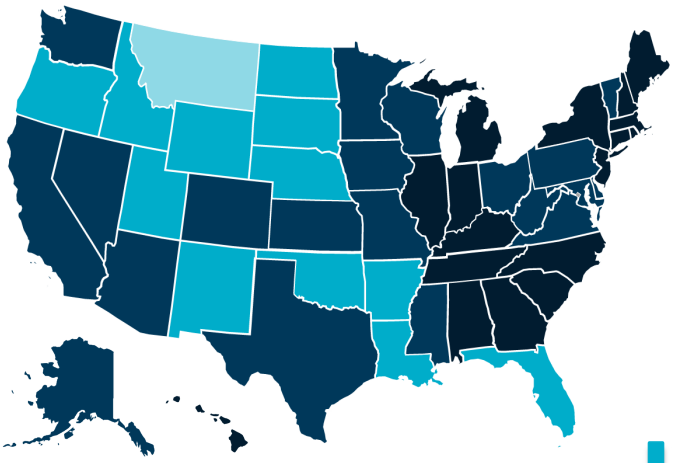
From 2015 to 2020, America's FDI employment...

15%

while the country's overall private-sector employment remained

FLAT

Share of Foreign Direct Investment Jobs by State



Foreign Direct Investment in America by Country

Figures based on the Bureau of Economic Analysis (BEA), Survey of Current Business, *U.S. International Transactions*, released September 2022; *Activities of U.S. Affiliates of Foreign Multinational Enterprises in 2020*, released August 2022.

03072023 COST Testimony in Opposition to SB 576 (M

Uploaded by: Patrick Reynolds

Position: UNF

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March 7, 2023

Senator Guy Guzzone, Chair
Senator Jim Rosapepe
Maryland General Assembly
Senate Budget and Taxation Committee

Re: Opposition to Senate Bill 576, Mandatory Unitary Combined Reporting

Dear Chair Guzzone, Vice Chair Rosapepe, and Members of the Committee:

Thank you for the opportunity to provide testimony today on behalf of the Council On State Taxation (COST) in opposition to Senate Bill 576 (S.B. 576), Corporate Income Tax – Combined Reporting, which would impose mandatory unitary combined reporting (MUCR).

MUCR arbitrarily assigns income to a state, negatively impacts the real economy, has an unpredictable effect on state revenue, and imposes significant administrative burdens on both the taxpayer and the State. This conclusion has been supported by Maryland's Commission in 2016 and Virginia's Work Group in 2021[1]—both validated by estimated revenue reports from actual informational unitary combined reporting filings for the respective states. The Maryland Economic Development and Business Climate Commission, established at the request of the General Assembly's leadership, has expressed that Maryland should not adopt MUCR because it would: (1) create revenue volatility, (2) pick winners and losers among taxpayers, and (3) lead to additional litigation and administrative costs. Virginia's Work Group, similarly established by the Virginia General Assembly, concluded that "[a]t this point in time, Virginia should not proceed with further study into the implementation of unitary combined reporting in the Commonwealth[.]"[2]

[1] In 2021, Virginia required corporations that are members of a "unitary business" to file informational unitary combined reporting filings, and the Division of Legislative Services and the Department of Taxation established a work group to study the administrative feasibility and the projected impact on Virginia's tax revenue of adopting mandatory unitary combined reporting. H.B. 1800 (Va. 2021); H.J.R. 563 (Va. 2021 Special Session 1). The 25-member work group was composed of state officials, tax administrators, business representatives and tax practitioners.

[2] Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes, published November 1, 2021, p. 40. This recommendation was centered on "the additional complexity of combined filing compared with Virginia's current system, the uneven impact the transition may have on certain taxpayers, and the potential damage to Virginia's business climate. Additionally, Work Group members argued that current provisions in Virginia law such as its add-back statute already address the common tax shifting strategies that combined reporting is intended to remedy." *Id.* at 4.

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 that would be negatively impacted by this legislation.

COST's Position on Mandatory Unitary Combined Reporting

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

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

Problems with Mandatory Unitary Combined Reporting

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and business taxpayers is the breadth of a state's corporate income tax base. The first approach, "separate entity reporting," treats each corporation as a separate taxpayer. This is the method Maryland currently uses; it is also used by Maryland's regional competitor-states, including Delaware, Pennsylvania, and Virginia. The second approach, MUCR, treats affiliated corporations (parents and subsidiaries) engaged in a "unitary business" as a single group for purposes of determining taxable income.[3] MUCR has several serious flaws.

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

[3] The concept of a "unitary business" is a constitutional requirement that limits the states' authority to determine the income of a multistate enterprise taxable in a state. Due to varying state definitions and case law decisions, the entities included in a unitary group are likely to vary significantly from state to state.

States that use MUCR have experienced lower job growth than have states that use separate entity reporting. From 1982-2006, job growth was 6% lower in states with MUCR than states without it (after adjusting for population changes).[4] Furthermore, MUCR has been found to reduce economic growth, especially when the tax rate exceeds 8%[5] (Maryland's rate is 8.25%).

- **Uncertain Revenue –** Implementing MUCR would have an unpredictable and uncertain effect on Maryland's revenue. The corporate income tax is the most volatile tax in every state in which it is levied, regardless of whether MUCR is employed. A study conducted by the University of Tennessee found no evidence that states with MUCR collect more revenue, and a later study found that MUCR may or may not increase revenue.[6]

    - ***Maryland*:** Maryland's own commission found similar uncertainty and volatility, with MUCR increasing revenue in some years and reducing it in others. Maryland presently has five years of data on combined reporting, and, depending on which type of apportionment is used, MUCR may have resulted in less revenue than the State's current corporate income tax structure in two or three of those years.[7]

    - ***Virginia*:** Based on informational unitary combined reporting filings for the 2019 tax year, Virginia's 2021 Work Group found that "73% of corporations showed essentially no change in tax liability, 13% showed an increase in tax liability, and 14% showed a decrease in tax liability before tax credits were applied."[8]

    - ***Indiana*:** The Indiana Legislative Services Agency conducted a study in 2016 finding that any potential positive revenue impact from adopting MUCR would be only short-term and would likely decline to zero in the long-term.[9]

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

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[4] Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Ernst & Young, May 30, 2008, p. 16.
[5] William F. Fox, LeAnn Luna, Rebekah McCarty, Ann Boyd Davis and Zhou Yang, "An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes," University of Tennessee, Center for Business and Economic Research, October 30, 2009, p. 39. Another study by the two lead authors commissioned by the National Conference of State Legislatures reached similar conclusions.
[6] *Ibid*. 3, p. 34.
[7] Andrew Schaufele, Director, MD Bureau of Revenue and Estimates, Report on Combined Reporting to Governor, President and Speaker, March 1, 2013.
[8] Work Group to Assess the Feasibility of Transitioning to a Unitary Combined Reporting System for Corporate Income Tax Purposes, published November 1, 2021, p. 17.
[9] A Study of Practices Relating to and the Potential Impact of Combined Reporting, Office of Fiscal and Management Analysis, Indiana Legislative Services Agency, October 1, 2016.

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

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

    - *Calculating Combined Income***:** Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most MUCR states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In addition to variations in apportionment formulas among the states that apply to all corporate taxpayers, further compliance costs related to MUCR result from variations across states in the methods used to calculate the apportionment factors. From a financial reporting perspective, adopting MUCR is a significant change that requires states to consider ways to mitigate the immediate and negative impact those tax changes have on a company's financial reporting.[10]

- **Arbitrary –** Although proponents of MUCR argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under MUCR create new distortions in assigning income to different states. The MUCR assumption that all corporations in an affiliated unitary group have the same level of profitability is not consistent with either economic theory or business experience. Consequently, MUCR may reduce the link between income tax liabilities and

[10] ASC 740 (formally FAS 109) requires a recordation of tax expense under certain circumstances that can negatively impact a company's stock price and value. *See* Dr. Lauren Cooper and Joel Walters, "Mitigating the Impact of State Tax Law Changes on Company Financial Statements," State Tax Research Institute, June 2020.

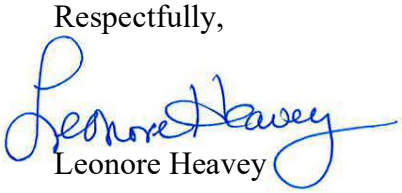
where income is actually earned. Many corporate taxpayers may conclude that there is a significant risk that MUCR will arbitrarily attribute more income to a State than is justified by the level of a corporation's real economic activity in the State.

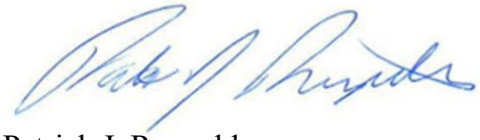
Conclusion

Studies show that MUCR is the most costly and uncertain way for the State to raise revenue because of its negative impact on job creation and revenue volatility. In addition, the General Assembly's own commission, which was tasked with studying how to improve the State's economy, stated that MUCR should be expressly rejected because the legislature's continued consideration of MUCR discourages business investment in the State.[11] MUCR will not help Maryland attract jobs or investment and should not be adopted.

For all of these reasons, COST urges members of the committee to please vote "no" on S.B. 576.

Respectfully,





Leonore Heavey Patrick J. Reynolds

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

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

SB576_UNF_MRA.pdf
Uploaded by: Sarah Price
Position: UNF

SB576 Corporate Income Tax - Combined Reporting
Senate Budget and Taxation Committee
March 7, 2023

Position: Unfavorable

Background: SB576 would require businesses to use a combined reporting method when computing their taxable income for Maryland state income taxes.

Comments: The Maryland Retailers Association (MRA) is strongly opposed to the use of combined reporting methods for calculating a business's taxable income as the Maryland Economic Development and Business Climate Commission explicitly recommended against the implementation of combined reporting. This method of assessing a business's income has been found to negatively impact job growth and is not an accurate method of calculating a business's in-state income.

This proposal would create administrative burdens for businesses operating in Maryland and would discourage businesses from expanding into the state by establishing an unfair tax structure that captures business operations from elsewhere in the country. Our only neighboring state that uses combined reporting is West Virginia, where it may be counterbalanced by a lower corporate income tax rate at 7.75%. The Tax Foundation, an independent tax policy nonprofit, ranked Maryland at number 46 in the nation in its annual State Business Tax Climate Index for 2023. Maryland must remain competitive in order to attract corporate headquarter expansions, online order fulfillment facilities, and other new business entities, and this will not be accomplished by implementing combined reporting.

For these reasons, MRA would urge an unfavorable report on SB576. Thank you for your consideration.

Marriott Testimony in Opposition to SB576 FINAL 03
Uploaded by: Travis Cutler
Position: UNF

Marriott International, Inc.
Corporate Headquarters
7750 Woodmont Avenue
Bethesda, MD 20814

SENATE BILL 576:
CORPORATE INCOME TAX- COMBINED REPORTING
BUDGET AND TAXATION COMMITTEE

STATEMENT OF OPPOSITION

March 7, 2023

Marriott International, Inc. is a global lodging leader headquartered in Bethesda, Maryland. Since its founding in the 1920s as a small restaurant chain in Washington, DC, the company has grown to comprise more than 8,000 lodging properties in 129 countries and territories, including over 100 hotels and 10,000 associates here in the State of Maryland.

Marriott opposes Senate Bill 576, as it would create a tax regime that is unpredictable, complex to administer, and a potential deterrent to growth.

Tax liability resulting from combined reporting can be unpredictable from one year to the next, making financial forecasting more difficult for a multistate company like Marriott. While Marriott's income from operations in Maryland could be relatively steady from year to year, our Maryland income tax liability could vary dramatically under combined reporting depending on the performance of units in other states with variable travel markets and levels of profitability. This unpredictability can be uniquely problematic for a public company attempting to deliver consistent shareholder value. Further, as noted by numerous analysts, this unpredictability can translate more broadly to variable state corporate income tax revenues year over year.

A combined reporting regime adds administrative complexity when making the fact-specific determination of what constitutes a unitary group each year, and when calculating combined income separately instead of relying on federal combined income. This means additional time spent by companies preparing returns, and new responsibilities for auditors now tasked with examining the operations of a multistate taxpayer and its affiliates – instead of just accounting information and tax returns.

Last, as a matter of tax and economic policy, while it is often said that combined reporting "closes loopholes," that is not the case -- it is simply a different tax calculation system. In the process of transitioning to such a system Maryland would invariably pick winners and losers. There are companies like Marriott with headquarters, deep roots and significant operations in Maryland that will be hurt by combined reporting. We ask that the General Assembly balance these impacts against perceived gains and consider other revenue proposals that might offer more stability and predictability. As written, this transition to combined reporting will hurt select Maryland-based companies just as much as companies based elsewhere.

Over the years, the state has convened a multitude of workgroups and commissions tasked with analyzing the merits of a combined reporting tax scheme. Each time the findings have fallen short of justifying such a transition here in Maryland, and that remains the case in 2023. For these reasons we urge an unfavorable report on SB 576.

Thank you for your consideration.

Contact:
Travis Cutler
Director, State Government Affairs

MACPA Written SB 576 _ Corporate Income Tax - Comb

Uploaded by: MB Halpern

Position: INFO

Mar. 7, 2023

The Honorable Guy Guzzone, Chair
Budget & Taxation Committee
Miller Senate Office Building
Annapolis, Md. 21401

Re: SB 576, "*Corporate Income Tax - Combined Reporting*" - **INFORMATIONAL**

Dear Chair Guzzone and members of the Committee:

The Maryland Association of CPAs represents nearly 8,000 Certified Public Accountants throughout the state. These CPAs work in public practice, private industry, government, non-profit, and education.

A change to a combined reporting system would positively impact some businesses while negatively impacting others, as was demonstrated in data collected by the Office of the Comptroller. As CPAs, we represent businesses in both categories and, as such, do not take a position to support or oppose the adoption of combined reporting into Maryland law. Our focus is to ensure that any legislation enacted on this topic allows a sufficient amount of time to prepare and implement the change. The language should be both enforceable and unambiguous in order for our members to effectively compute this tax for clients.

Combined reporting creates additional complexities in corporate income tax systems and taxpayer compliance, not to mention the challenging financial statement accounting required by CPAs to assist their clients (balance sheet deferred tax accounts must be reevaluated for the change). This is the case even for companies that have no immediate cash effect from the change — e.g., if they have losses and will pay no tax under combined reporting. Other states have included provisions in their legislation that help to reduce this complexity.

Beyond interpreting the legislation, significant advanced preparation is required of the Comptroller's office, and by taxpayers and tax preparers. The Comptroller's office must prepare draft regulations, allow for the required public comment period, and finalize the regulations. In anticipation of a more complex audits and appeals process, significant training is required of the state auditors and taxpayer-assistance staff. Administrative protocols including forms, instructions, and computer programming changes are necessary to accommodate the new filing method. Other states can be used as models, but these processes must still be adapted specifically to Maryland.

Taxpayers and tax practitioners will need to be educated about the new statute, regulations, and updated forms. Many will have to modify or acquire new tax preparation software. They will have to study the detailed operations of each and every corporation in order to make the fact-driven and interpretive determinations of which corporations are properly includable in a "unitary" combined reporting group, and they will have to collect data they never had to prepare before, for correct preparation of the income tax return. Organizations such as the MACPA will need to actively publicize the new requirements and provide educational programs to CPAs and their clients to help prepare for these new processes.

Maryland and many nearby states have always been separate entity states, so combined reporting is a new concept to many Maryland taxpayers and tax practitioners. Combined reporting will have implications for all corporate groups no matter the size of their businesses, and small and medium-sized corporations — of whom there are many with operations in Maryland — will find the new administrative requirements most burdensome. Allowing sufficient time to educate them would make for a better transition to the new law.

Combined reporting is a complex change for taxpayers, tax preparers, and the Comptroller's office. Without opposing or supporting the adoption of combined reporting, we respectfully ask for your consideration of these complex compliance requirements and incorporate the necessary preparation time, we suggest at least two years, required at all levels for satisfactory implementation.

Thank you very much for the opportunity to offer these comments for your consideration. If you have any questions or if we can provide additional information, please contact Mary Beth Halpern of the MACPA at marybeth@macpa.org or 443-632-2330.

Sincerely,

MACPA State Tax Committee

cc: Nick Manis, Manis Canning & Associates