# SILVER BULLET

*The Corporate Tax Cut & Loophole Elimination Plan*

Progressive Maryland Education Fund

- How Maryland State Government Can Balance its Budget Overnight In a Fair and Popular Manner


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## EXECUTIVE SUMMARY

Maryland's fiscal structure is in crisis. Even after two years of painful spending cuts under Governor Bob Ehrlich – cuts totaling approximately $1 billion or fully 10% of discretionary spending -- the state faces a projected budget deficit of $400 million for fiscal year 2006. And that deficit is projected to balloon to an average of $1 billion in future years. This report shows that these growing deficits are partially attributable to the rapid decline of the Maryland corporate income tax—and shows that the growth of profitable yet "zero-tax" corporations is driving this decline. The report also describes a tax reform plan that could recoup up to $650 million annually for the Maryland Treasury by clamping down on endemic corporate tax dodging. These recouped funds would easily wipe out the state government's projected deficit of $400 million in fiscal year 2006 and pay for all projected K-12 and community college construction in that year. Thereafter, this revenue could be used to pay down the bulk of future budget deficits.

Our reform plan:

- is based on previously unreleased data from the Comptroller's office about "no-tax" corporations in Maryland

- offers a comprehensive solution to corporate tax shirking to replace the piecemeal, unsuccessful approach pursued so far by the General Assembly

- would help safeguard Maryland's corporate income tax against anticipated further deterioration of the federal corporate income tax system

- is based on Maryland precedent and proven, successful reforms already law in other states

- would raise enough revenue to close next year's state budget deficit, pay for next year's school and community college construction, and help retire all future deficits as well

- would accomplish all these goals without creating any new tax burdens on regular folks or on small, locally-owned companies, which are an important pillar of Maryland's economy and an indispensable ladder of upward social mobility. Indeed, our plan raises enough revenue to finance a corporate income tax rate *cut*

- conforms to the wishes of the overwhelming majority of Marylanders as revealed by new polling data published for the first time in this report

In short, our plan offers a very rare "silver bullet" solution to a complex public policy dilemma. But it does contain a single catch: enacting the plan would require lawmakers in Annapolis to summon the political courage to side with regular folks and against the big corporate special interests that fund their campaigns. Do our lawmakers have the courage for that kind of fight?

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# MAIN REPORT

Over the past two years, Gov. Bob Ehrlich has led the way in cutting about $1 billion from the Maryland state budget – nearly 10% of discretionary spending – as his preferred method of closing back-to-back deficits.

Ehrlich has also raised what he calls "user fees" – mostly de facto unfair taxes on working families, such as the "car tax" and "flush tax".

Through these cuts and regressive taxes, the Governor has balanced the budget almost entirely on the backs of hardworking families. To close future deficits projected at roughly $1 billion per year over the next five years, Ehrlich is again reaching for his budget chainsaw, ordering his cabinet secretaries this summer to prepare *another* 12% in cuts to the budget.[1]

The Governor's war on working families is wreaking havoc on a state government that was already one of the leanest in the country before he took office in 2002. Maryland ranks 38th out of 50 states in terms of the amount of total income claimed by state and local governments. Government revenues actually declined by 7 percent between 1979 and 1999, when adjusted for inflation – one of the only states that experienced a decline in revenue.[2]

Because our government is revenue-deprived, we are underinvesting in our future. Maryland ranks 47th among states in total direct general expenditures as a percentage of personal income.[3] Maryland ranks 44th in spending on schools and libraries and 47th in spending on health and social services, measured as a percent of total income.[4] And this anemic level of public investment has dropped even further over the past two years thanks to approximately $1 billion in cuts.

## CORPORATE TAX LOOPHOLES: A MAJOR CAUSE OF THE DEFICIT

The state government does not take in enough revenue (a problem that first developed during decades of Democratic control of state government and now is growing worse under Ehrlich). To restore adequacy to the Maryland tax system, all progressive sources of revenue ought to be on the table for consideration. But one revenue source in particular looms large as a major reason for Maryland's shortage of revenue: the state's disappearing corporate income tax.

Evidence is mounting that revenues from Maryland's corporate income tax – which is supposed to equal 7 percent of corporate profits – are rapidly vanishing despite robust corporate profits.

- The Multistate Tax Commission -- the national, bipartisan association of state comptrollers – estimates that corporate tax shirking robs Maryland of up to 34 percent of the corporate income taxes we should collect each year.[5]
- According to Maryland Deputy Comptroller Stephen M. Cordi, the corporate share of Maryland income taxes has fallen by nearly half over

the past two decades, down from 13 percent in 1980 to just 7.6 percent of income tax revenue in 2002.[6]

- As a result, Maryland now has the lowest business taxes of any state in the country when business taxes are measured as a share of all taxes, according to the conservative Council on State Taxation.[7]

Why is Maryland dead last among the 50 states in business tax collection as a percentage of all taxes? Because 2/3 of the biggest corporations in our state – a list that includes Comcast, Wal-Mart, and Citicorp – have simply ceased paying income taxes in Maryland, despite huge profits. We know this shocking fact thanks to an analysis prepared in March of this year by Maryland Comptroller William Donald Schaefer and released to the public by the Progressive Maryland Education Fund.[8] The Comptroller's March analysis is included as an appendix to this report.

This year, Maryland tried to take a small step in the right direction by closing at least one corporate tax loophole, the infamous Delaware Holding Company scam. But Delaware this spring passed its own law to partially nullify the Maryland law.[9] And Gov. Ehrlich is already trying to gut the Delaware loophole-closer.[10] Clearly, piecemeal approaches to corporate tax avoidance do not work. Other states, foreign countries, and corporate accountants will always invent new ways to circumvent piecemeal reforms enacted in Annapolis. Maryland needs a comprehensive, airtight solution to corporate tax avoidance.

Exactly how much does corporate tax avoidance rob the Maryland Treasury each year? Only the Comptroller has all corporate tax returns, so only he could make a global estimate. In lieu of that estimate (the calculation of which would be very difficult methodologically), the Comptroller has provided other information -- published for the first time in this report and reviewed below -- that shines a strong light on corporate income tax avoidance and points the way toward a specific type of reform. Suffice it here to say that any guesstimate of the total annual revenue lost to Maryland as a result of corporate tax avoidance must surely run into the many hundreds of millions of dollars, if not more than $1 billion. The attached appendix presents anecdotal evidence supporting a guesstimate in that range.

## THE COMPTROLLER'S NEW ANALYSIS: WHAT IT MEANS FOR REFORM

A hitherto unpublished analysis by the Comptroller prepared recently at the request of the Progressive Maryland Education Fund and attached to this report points the way toward comprehensive reform. Specifically, the Comptroller's analysis shows that the main reason why so many companies pay no or little state income tax is because the Maryland corporate income tax form takes "federal taxable income" as its starting point. As you can see in the Comptroller's attached spreadsheet, more than half of the 180 companies he examined reported no federal taxable income in 2001. Thus, these companies begin their Maryland tax form with a big fat "0". The Maryland corporate income tax rate is 7 percent. 7% x 0 = 0.

The Comptroller's findings are buttressed by a just-published report by Citizens for Tax Justice and the Institute on Taxation and Economic entitled *Corporate*

*Income Taxes in the Bush Years*. This report found that between 2001 and 2003, 82 of America's most profitable companies paid no federal corporate income tax.

Decades ago, it made sense to piggyback Maryland's tax system on the federal system because Maryland got the free benefit of IRS enforcement. But over the past 25 years, Congress and administrations of both parties have enacted tax giveaway after giveaway while also hobbling the enforcement and audit capabilities of the IRS.[11] As a result, fewer and fewer companies – even profitable ones – bother to pay federal corporate income taxes. The gutting of the federal tax system has reached new and dangerous dimensions in the era of George W. Bush and Tom DeLay, thanks to their endless tax cuts, tax credits, and tax depreciations for their corporate cronies and campaign donors. But these policies have done more than create the biggest federal budget deficit in U.S. history. They have also hamstrung Maryland's corporate income tax system, because the starting point of the Maryland corporate income tax return is "federal taxable income". Should Maryland's ability to collect the revenue we need for vital public investment be thwarted by policies made in Washington, DC?

Of course not.

## THE CORPORATE TAX CUT AND LOOPHOLE ELIMINATION PLAN

There **is** a way for Maryland to protect itself from the federal government's rapidly deteriorating tax system. Other states – notably New Hampshire and New Jersey -- have already done so. Our plan, relying on best practices from these and other states, features five basic components, which together would recoup enough revenue to close Maryland's budget deficit next year – and perhaps in future years as well.

1. New Jersey-style, gross-receipts-based alternative minimum assessment (AMA). This reform, implemented in 2003 by New Jersey, allows corporations to pay whichever is the higher of either the traditional profits-based corporate income tax or an alternative tax based on gross receipts and commit to paying the tax based on profits or gross receipts for five years. In computing the tax, a company can exclude up to $2 million in gross receipts or $1 million in gross profits. The most a company is required to pay under the alternative minimum assessment is $5 million.

   A gross-receipts AMA kills several birds with one stone in that it:

   - protects a state's corporate income tax system from the rapidly decaying federal tax system. In New Jersey, gone are the days when big corporations blithely declare "zero federal taxable income" and thereby pay no state income taxes. Federal taxes are based on profits. But gross receipts are an entirely different type of tax liability, which accountants cannot conjure away with creative bookkeeping. Receipts are what go into the cash register and cannot be defined out of existence (unless a corporation resorts to outright fraud, which very few attempt). As a result, every big corporation will have to pay at least some taxes.

- Follows precedent in that Maryland and many other states have already partially decoupled their estate tax as well as its business depreciation allowance from a federal system that recklessly lavishes giveaways on millionaires and multinational corporations.

- Creates a more stable revenue stream for the state. Receipts are more stable over time and through recessions than are profits and therefore allow the state to better predict revenue and plan for the future.

- Exempts small businesses, the overwhelming majority of which are Maryland-owned and Maryland-based, by excluding a firm's first $2 million in gross receipts or $1 million in gross profits.

- Brings in an estimated $368 million in revenue (see attached worksheet).

- Enjoys broad public support. A June 2004 Gonzales poll commissioned by PMEF (published for the first time in this report) shows that 82% of Marylanders favor a NJ-style AMA (poll attached)

2. <u>Combined Reporting of Corporate Income</u>. AMA eliminates most but not all corporate tax dodging. Big corporations also cheat on their taxes by creating fake subsidiaries and resorting to dishonest accounting. Requiring "combined reporting" of corporate income best stops these practices. Combined reporting embodies a simple, mainstream value: a corporation should not be allowed stash profits in multiple (often phony) subsidiaries in an effort to beat taxes while simultaneously declaring <u>all</u> these same profits to Wall Street in an effort to boost its stock. Combined reporting requires a corporation to have a single set of books and therefore report to the Comptroller <u>all</u> its profits, regardless of where they are stashed. And it prevents a corporation from getting tax breaks for loaning itself money, among other bogus practices. Thus, combined reporting treats corporations like real persons, who may not create fake versions of themselves in order to hide income from the Comptroller or engage in sham transactions.

   Combined reporting has other virtues in that it:

   - would recoup approximately $175 million annually in lost corporate tax revenue for Maryland. According to a 2003 study by the Multistate Tax Commission, combined reporting would recoup fully $209 million for Maryland. But Maryland this year closed one of the worst corporate loopholes, the Delaware Holding Company scam. Considering this new law, but also considering that the state of Delaware this year diminished the value of Maryland's loophole-closer with a law that partially negates the Maryland law, we calculate that combined reporting would in fact bring in approximately $175 million.

- only affects the big multistate corporations – such as Comcast and Victoria's Secret – that resort to multiple subsidiaries and dishonest accounting. By contrast, Maryland-based, unistate corporations are, by definition, unaffected by combined reporting.

- is already law in 16 states and works well, so this is no risky, unproven scheme.

- enjoys the overwhelming support of Marylanders, who immediately understand its basic fairness. The attached June 2004 poll shows that fully 79% of Marylanders support combined reporting.

3. Elimination of indefensible tax giveaways intentionally inserted into the tax code by lawmakers. PMEF, using the official *2003 Tax Expenditure Report* authored by the Ehrlich Administration, has identified dozens of absurd tax giveaways to mostly corporate special interests that should be immediately abolished. We compile and discuss them in PMEF's report, issued last month, *Giving Away the Store: Giveaways to Those Who Need Them Least in the Maryland State Tax Code* (attached). Abolishing these giveaways to polluters, monopolists, millionaires and country clubs would recoup at least $162 million per year for the Treasury.

4. 10 percent *cut* in corporate income tax rate. AMA and combined reporting affect mostly larger, multistate firms. By contrast, smaller, unistate (i.e., Maryland-only) firms would be unaffected by combined reporting and relatively few by AMA. But as pillars of the economy and ladders of upward social mobility, these local firms should be positively *rewarded* with a 10% **cut** in the corporate income tax rate (i.e., from 7% down to 6.3%). This tax cut would cost the Treasury approximately $55 million.[12]

5. Earmark the revenue recouped by this plan in FY 2006 for public school and community college construction. Based on his record as Governor, we fear that Gov. Ehrlich would waste the revenue raised by this plan on new giveaways to his big corporate campaign donors. For that reason, we urge the General Assembly to earmark the revenue in FY 2006 for K-12 and community college construction. Construction of new K-12 facilities is especially pressing in a state where more and more students are jammed into trailers and crumbling facilities.[13] In FY 2006, the state will spend approximately $160 million on such construction.[14] The revenue raised by this plan could cover this cost and eliminate the entire projected FY06 budget deficit of $400 million.[15] In years thereafter, the revenue raised by this plan would probably have to be earmarked entirely for deficit reduction.

**Grand Total of Revenue Recouped for the Treasury:**

| | |
|---|---|
| AMA | +$368 million |
| Combined Reporting | +$175 million |
| Elimination of Tax Giveaways in the Code | +$162 million |
| 10% Corporate Income Tax Cut | -$55 million |
| **Grand Total in Recouped Revenue** | **+650 million** |

## POPULARITY OF CLOSING CORPORATE TAX LOOPHOLES

This plan makes sense substantively. And it makes sense politically because Marylanders overwhelmingly believe that corporate tax shirking ought to stop. In the same June 2004 poll discussed above, Marylanders chose closing corporate tax loopholes as their favorite means of balancing the budget, rating it much higher than slots, more budget cuts, or new taxes. Moreover, the poll shows that 86% of Marylanders agree with the statement: "In order to close Maryland's long-term budget deficit, lawmakers have already cut $1 billion from the state budget over the past 18 months. We can't balance the budget only with cuts or only with new taxes. Instead, we should enforce better corporate tax compliance by closing corporate tax loopholes." (see attached poll)

## CONCLUSION

In total, our plan could recoup up to $650 million per annum for the Treasury. In FY 2006, this money could finance desperately needed school and community college construction <u>plus</u> retire the entire projected deficit. Thereafter, this sum would wipe out the bulk of future deficits, which are forecasted at approximately $1 billion per annum over the next few years.

Some might argue that switching to a receipts-based AMA and instituting combined reporting is a radical and risky scheme. We could not disagree more. This plan is based on Maryland precedent and successful models already law in other states. And who could seriously argue that a status quo is acceptable in which 2/3 of the biggest and most profitable corporations in our state no longer bother to pay a single red cent in income tax? Anybody who argues for the status quo is the true radical – of the Tom DeLay variety.

Moreover, our reform plan would help safeguard Maryland's revenue structure against anticipated further deterioration of the federal tax system. It would create no new burdens on hardworking families or on small, locally-owned companies, which are the backbone of Maryland's economy and an important ladder of upward social mobility. And it conforms to the wishes of the overwhelming majority of Marylanders. If ever there were a policy and political silver bullet, our plan is it.

Will our elected officials in Annapolis accede to the will of the people and implement this commonsense plan? Or will they cave to political pressure from Comcast, Wal-Mart, and their other deep-pocket campaign contributors?

**ATTACHMENTS**

- Report by the conservative Council on State Taxation showing that Maryland ranks dead last among the 50 states in tax burden on business (available digitally at: http://www.statetax.org/Content/ContentGroups/Home_Page_Content/Right_Column_Area/50-StateStudy.pdf )
- Appendix 1: Anecdotal Evidence on How Much Revenue Maryland Loses Each Year to Corporate Tax Avoidance (available digitally at: http://progressivemaryland.org/files/public/documents/reports/2004/Silver%20Bullet:%20The%20Corporate%20Tax%20Cut%20and%20Loophole%20Elimination%20Plan/Appendix%201%20-%20Anecdotal%20Evidence%20on%20Lost%20Corporate%20Income%20Tax%20Revenue%20in%20Maryland.doc )
- June 2004 Gonzales poll showing that closing corporate tax loopholes is Marylanders' preferred means of closing the state government's budget deficit (available at: http://progressivemaryland.org/files/public/documents/reports/2004/Silver%20Bullet:%20The%20Corporate%20Tax%20Cut%20and%20Loophole%20Elimination%20Plan/Gonzales%20Poll%20of%20Marylanders%20on%20Budget%20Deficit%200406.doc )
- Comptroller's analysis of March 2004 showing that 90 of the largest 130 for-profit corporations in Maryland paid no income tax at all in 2002
- Spreadsheet compiled by the Progressive Maryland Education Fund proving that 105 of these same 130 companies were profitable in 2002 and so therefore should have paid income tax (available digitally at: http://progressivemaryland.org/files/public/documents/reports/2004/Silver%20Bullet:%20The%20Corporate%20Tax%20Cut%20and%20Loophole%20Elimination%20Plan/Profitability%20of%20the%20Biggest%20Probable%20Corporate%20Tax%20Cheaters%20in%20Maryland.doc )
- Comptroller's analysis of August 2004 pinpointing the chief cause of corporate failure to pay Maryland state income tax: declaration by corporations of zero *federal* taxable income (two parts: letter available digitally at: http://progressivemaryland.org/files/public/documents/reports/2004/Silver%20Bullet:%20The%20Corporate%20Tax%20Cut%20and%20Loophole%20Elimination%20Plan/Comptroller%20Analysis%20of%20Corporate%20Tax%20Avoidance%20-%20Aug.%202004%20-%20Letter.doc ; spreadsheet attachment available digitally at: http://progressivemaryland.org/files/public/documents/reports/2004/Silver%20Bullet:%20The%20Corporate%20Tax%20Cut%20and%20Loophole%20Elimination%20Plan/Comptroller%20Analysis%20of%20Corporate%20Tax%20Avoidance%20-%20Aug.%202004%20-%20Spreadsheet%20Attachment.xls )

- Appendix 2: How Much Revenue a NJ-style AMA Could Generate for Maryland (available digitally at: http://progressivemaryland.org/files/public/documents/reports/2004/Silver%20Bullet:%20The%20Corporate%20Tax%20Cut%20and%20Loophole%20Elimination%20Plan/Appendix%202%20-%20Worksheet%20on%20How%20Much%20Revenue%20AMA%20Could%20Recoup%20for%20Maryland.doc )
- Report of Multistate Tax Commission on how much combined reporting could recoup for Maryland state government (available at: http://www.mtc.gov/TaxShelterRpt.pdf )
- *Giving Away the Store: Giveaways To Those Who Need Them Least in the Maryland State Tax Code,* Progressive Maryland Education Fund, September 2004, which lists $162 million in tax giveaways intentionally inserted into the tax code by lawmakers over the years, mostly benefiting big corporations (available digitally at: http://progressivemaryland.org/files/public/documents/reports/2004/Giving%20Away%20The%20Store%20--%20Giveaways%20to%20Those%20Who%20Need%20Them%20Least%20in%20the%20Maryland%20State%20Tax%20Code.pdf )

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[1] David Nitkin, "State Spending Plans Stay Wrapped in Secrecy", *Baltimore Sun*, September 18th, 2004.
[2] "Report Shows That Maryland Revenue and Taxes are Among Lowest in the Nation", Maryland Budget and Tax Policy Institute, 2002, http://www.marylandpolicy.org/chartbookv2002webintro.htm
[3] "Is Maryland Government Too Big?", Maryland Budget and Tax Policy Institute, 2003, http://www.marylandpolicy.org/mpr3-6.pdf
[4] Peter Berns, "Don't Blame Spending for Maryland Shortfall", 11/08/02 op ed in *Baltimore Sun.*
[5] *Corporate Tax Sheltering and the Impact of State Corporate Income Tax Revenue Collections*, Multistate Tax Commission, July 2003, Table 1.
[6] Stephen M. Cordi, *Corporate Tax Sheltering in Maryland*, PowerPoint Presentation, July 2003, p. 3. Available at: www.mtc.gov/07-31Cordi.pdf
[7] Robert Cline, William Fox, Tom Neubig, Andrew Phillips, *Total State and Local Business Taxes: A 50-State Study of Taxes Paid by Businesses in FY 2003*, Council on State Taxation, January 2004, Table 3.
[8] See table attached to this report, prepared by the Progressive Maryland Education Fund, listing out the companies named by the comptroller as probable tax-shirkers in 2002, along with the profits they reported in that same year on their respective 10-K forms and Annual Reports.
[9] http://www.grantthornton.com/downloads/DE_SALT_6-25-04_99864.pdf
[10] http://www.washingtonpost.com/wp-dyn/articles/A6994-2004Oct4.html ; http://www.baltimoresun.com/news/local/bal-te.md.taxes05oct05,1,5185510.story?coll=bal-home-headlines
[11] Just this month, Congress enacted yet more giveaways – a $143 billion in tax breaks for big corporate special interests. Jonathan Weisman, "Senate Passes Corporate Tax Bill. Bush Plans to Sign $143 Billion in Cuts", *The Washington Post*, October 12, 2004, p. A1. On the gutting of the IRS, see Albert B. Crenshaw, "A Shackled IRS", *The Washington Post*, Oct. 3, 2004, p. F1.
[12] The corporate income tax is currently bringing in approximately $553 million in FY 2005. *Maryland Fiscal Year 2005 Budget: Budget Highlights*, Department of Budget and Management (2004), p. 10. So a 10% cut in the corporate income tax rate would translate into approximately $55 million.
[13] Ylan Q. Mui, "Fed-Up Md. Students Create a Video SOS. School Decay Recorded, Aired at Budget Hearing", *The Washington Post*, October 12, 2004, p. B04.
[14] Assuming the Governor submits a request for these items in his FY2007 budget similar to those in his FY2006 initial budget. See *Maryland Fiscal Year 2005 Budget: Budget Highlights*, Dept. of Budget and Management, Jan. 2004, p. 22.
[15] Latest deficit estimate reported in "Metro in Brief", *The Washington Post*, Oct. 20, 2004, p.B3