MARYLAND STATE BAR ASSOCIATION
SECTION OF TAXATION

November 7, 2007

VIA E-MAIL (Sheila.Hixson@house.state.md.us) and
FACSIMILE (410) 841-3777
Delegate Sheila E. Hixson, Chair
House Ways and Means Committee
Room 131
House Office Building
Annapolis, MD 21401-1912

Re: SB2

Dear Delegate Hixson:

This letter is being submitted to you on behalf of the Section of Taxation of the Maryland State Bar Association regarding certain provisions we understand are included in Senate Bill 2.[1] The Tax Section has adopted the following principles as its framework for evaluating and commenting on pending State tax legislation:

(1) Simplicity - is the proposed law able to be easily understood by the taxpayers who will be subject to it and by the administrators who must administer it?

(2) Fairness - will the proposed law result in similar tax consequences for similarly situated taxpayers?

(3) Transparency - will taxpayers know that the tax as enacted exists and how it impacts them and other persons?

(4) Enforceability/Compliance - is the tax law able to be easily administered and can non-compliance opportunities be minimized without disproportionate cost?

(5) Legal Considerations - is the tax law consistent with existing laws and taxes, not itself in violation of any existing law or legal principles, and in accord with the federal and Maryland Constitutions?

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[1] It should be noted that, to a great extent, we are "flying blind" with respect to the actual content and language of SB2, since we have not seen the bill as presented for approval by the Senate. We believe our comments are, in concept, on point with respect to the actual content of the bill assumed to be pending before your Committee. However, we appreciate your understanding if any of our comments appear to be off the mark as, by necessity, this letter is based, in part, on news reports.

We believe that the above principles allow for an objective evaluation of proposed tax legislation. As such, we are specifically not providing any commentary on policy matters which, although certainly worthy of consideration by your Committee, introduce subjective criteria as to which the Section of Taxation is not in a position to comment.

With the above principles in mind, we are limiting our comments to only two of the many issues that are currently before the General Assembly; i.e., certain of the services that are proposed to be subject to the expanded sales tax and combined reporting for corporate income tax purposes. Because of the speed at which SB2 proceeded through the Senate, we regret that we were unable to submit comments on these provisions when they were pending before the Senate.[2] The following comments are the views of the Section of Taxation and do not represent the position of the Maryland State Bar Association.

COMBINED REPORTING

As originally introduced in the Senate, SB2 would have subjected groups of "unitary" corporations to combined reporting for Maryland income tax purposes. This was purportedly done in an effort to address alleged tax avoidance achieved through the operation of a "unitary" business through affiliated multi-state corporations. We believe that adopting such a fundamental change in Maryland income tax law without a full evaluation of the consequences of such a measure would be ill-advised for several reasons. Maryland has been a "separate return" state for decades. As recently as 2004, measures were adopted by the General Assembly to provide broad power to the Maryland Comptroller to address situations where affiliated corporations are not dealing at arm's length with each other. Specifically, Chapter 556 of the Laws of 2004 enacted Section 10-109 of the Tax-General Article giving "Section 482" powers to the Comptroller to reallocate income and expense among affiliated corporations. (Section 10-306.1 of the Tax-General Article was also enacted providing for the disallowance of deductions of certain inter-company payments). The broad powers conferred upon the

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[2] While this letter is limited to the issues noted above, the Section of Taxation did submit comments to the House Ways and Means Committee, the House Appropriation Committee, and to the Senate Budget and Tax Committee on the "controlling interest" provisions of SB2 which would impose transfer and recordation taxes on the transfer of a controlling interest in certain "real estate entities". Although we are not addressing these provisions in this letter, we understand that certain amendments were approved by the Senate Budget and Tax Committee that would increase the controlling interest threshold that would have to be met before imposition of the taxes, increase the percentage of real estate assets that an entity would have to own before being considered a "real estate entity", provide for certain additional exemptions from tax, and defer the effective date of the provision. The Section of Taxation supports these amendments.

Comptroller under Chapter 556 have not been in effect long enough to determine whether these measures adequately address the purported abuses that combined reporting is supposed to address. Therefore, we urge the Committee to refrain from fundamentally changing Maryland's income tax system before the provisions enacted in 2004 have been allowed to be fully implemented.

Combined reporting would also fail several of the principles outlined above. In particular, combined reporting is anything but simple. Defining what constitutes a "unitary" business has engendered years and years of litigation in those states that have adopted the combined reporting approach. The prolonged litigation and the associated uncertainty that this would create raises enforceability issues as well as issues under the fairness and transparency principles outlined above.

We understand that SB2, as amended, has dropped the adoption of combined reporting. For the above reasons, we are fully supportive of this as well as the creation of a Maryland Business Tax Reform Commission as set forth in SB27 which, among other things, would be charged with evaluating the advisability of combined reporting. However, the portion of SB27 (assuming it has been incorporated into SB2), that would require the compilation and submission of numerous items of information in connection with returns filed after June 1, 2008 is unnecessarily burdensome and pre-emptive of information that the Commission should otherwise be empowered to require from taxpayers. Under SB27, "publicly traded corporations" "doing business in the State" would be required to submit extensive information to the Comptroller. "Doing business in the State" is broadly defined and would include a publicly traded corporation that has employees or representatives in Maryland as well as those making sales of tangible personal property to purchasers in Maryland, even though the corporation is not required to file an income tax return with the Comptroller. The "doing business" definition could include corporations which, pursuant to Federal law (P.L. 86-272) cannot be the subject of Maryland income taxation. Further, the broad definition of "doing business" may seek information from out-of-state corporations beyond what is constitutionally permitted.

While the Comptroller clearly needs to gather information relevant to the consideration of combined reporting and other potential corporate tax changes, the type of information that should be compiled should be left for the Commission to determine rather than unnecessarily prescribing detailed, burdensome requirements in the law. The Commission could be given a deadline to prescribe the type of information that will need to be reported on returns filed after June 1, 2008.

SALES TAX ON SERVICES

Professional Services. In applying the principles outlined above to an expansion of the Maryland sales tax to services, we feel it is vital not to expand the tax to services where there is some question as to the geographic location of where such services are provided and delivered. There can be little question that when certain types of services, such as auto repair, hair cuts, or other services that are clearly applicable to a thing or person are performed as to where such services take place. Therefore, it is fairly clear and easy to enforce when the Maryland sales and use tax would apply to such services and Maryland's right to tax such services raises no constitutional question. However, many services, particularly professional services or any other services involving advice or other intangible benefits can be very nebulous as to what state, if any, would be appropriate to tax those services. Therefore, any type of service where a hypothetical situation can be easily imagined where constitutional and enforceability issues arise should be a guideline as to services to which the Maryland sales and use tax should not be expanded. A readily apparent hypothetical would be as follows:

A Maryland headquartered company hires a Florida architect to design a plant for the company to be located in Virginia. The Florida architect has no contacts in Maryland, and has only communicated with the Maryland client through email and telephone conversations. The Florida architect does the plans for the building, including visiting Virginia to inspect the site. He emails the plan to the Maryland company, which receives them in its Maryland headquarters. The plans have been given to the construction contractor who builds the Virginia plant.

The above scenario raises numerous questions as to whether a Maryland sales tax on services would apply, which Maryland could constitutionally impose. The non-resident architect, who has no nexus in Maryland, would not be required to collect a sales or use tax because of his lack of physical presence in Maryland. Is the Maryland company liable for the use tax, even though the services were performed outside Maryland, because the plans were delivered in Maryland? Or, because the actual benefit of the plans would be located in Virginia, would the tax not apply?

Similar hypotheticals could be concocted for business consulting, accounting services (including tax preparation services), and just about every other kind of service that involves supplying a product that is in the nature of advice, or can be communicated orally, via hard copy documentation, or over the internet.

As previously stated, to be effective, a tax bill must be understandable by both the taxpayer and the tax collector. This is especially true when non-tax professionals

are drafted into the service of tax collection. When the State of Maryland enlists its businessmen and women to collect taxes on its behalf ("Agent"), it has an obligation to provide clear instruction as to the type of transaction or service that is subject to the tax. Otherwise, if the Agent misunderstands the instructions, he or she bears the terrible burden of being personally responsible for the uncollected taxes.

Placing a tax on services has always been difficult because of the confusion that arises from attempting to define a specific service. Should a service be unclearly defined, a taxpayer could find himself responsible for taxes that he had no knowledge was his responsibility to collect.

Our concern is that some of the other services that the General Assembly is considering subjecting to sales tax are difficult to clearly define. As of the date of this letter, our understanding is that SB 2 provides that landscaping services, video arcades and computer services will be subject to Maryland sales tax. Questions immediately arise as to the definition of these services and how the sales tax will be applied to them.

Landscaping. If the sales and use tax is expanded to cover "landscaping services," it will be extremely difficult for taxpayers (and the Comptroller) to determine if they are subject to the tax. Since "landscaping services" are not defined by statute, taxpayers will have to rely on the ordinary understanding of term. However, there is not even a common consensus of what "landscaping" means. Webster's Ninth New Collegiate Dictionary defines landscaping as "to modify or ornament (a natural landscape) by altering the plant cover. " However, Random House defines landscaping as "to improve the appearance of (an area of land, a highway, etc.), as by planting trees, shrubs, or grass, or altering the contours of the ground." Thus, without a clear statutory definition of "landscaping services", it is likely that the bill will unintentionally subject certain taxpayers to sales and use tax and that those taxpayers will not even know it. For example, excavating contractors that "alter the contours of the ground" could be subject to tax. On the other hand, it is conceivable that certain grounds maintenance that is not specifically "planting trees, shrubs or grass" or "altering the contours of the ground" will not be subject to the tax. Thus, it is possible that certain services that the General Assembly intends to subject to the tax will not be covered by the bill. Finally, for a tax to be effective, the Agent responsible for its collection must have sufficient knowledge and skill to collect the tax from its customers and remit the tax to the Comptroller's Office. Ensuring that landscapers have this knowledge will be a challenge. This is not a profession that can be easily reached through one or two channels.

Video Arcades. Additionally, a video arcade must be clearly defined. Are the number of video games provided in the establishment the dispositive factor? At what point will a pool hall or a restaurant or bar that provide video games for their customers be effected by this requirement?[3]

Computer Services. The taxation of these services raises many of the same issues discussed above with respect to Professional Services. It is well settled that the sales and use tax applies to the sale of tangible personal property (and certain services) that are delivered in Maryland. Generally, it is not difficult for taxpayers or the Comptroller to determine if tangible personal property is delivered in Maryland, and thus subject to the sales and use tax. In some cases, it is not difficult to determine if certain services are delivered in Maryland (cleaning of a commercial building in Maryland). However, in many cases, it is difficult to determine if services are delivered in Maryland. There are likely many businesses in Maryland that rendered "computer services" from their office in Maryland to customers outside of Maryland. On the other hand, there are likely many out of state businesses who render "computer services" from their out-of-state offices to customers in Maryland. In either case, it is unclear if the "computer services" are delivered in the state where the services are rendered or in the state where the customer is located.

In any case, if "computer services" are determined to be delivered where the services are rendered, the Maryland sales tax will not apply to "computer services" rendered out-of-state even if the customers are in Maryland. Instead, Maryland taxpayers will only have to pay sales tax on "computer services" if the services are performed by a computer service provider located in Maryland. If "computer services" are determined to be delivered where the customer is located, then many out-of-state computer service providers will not have to collect and remit the sales tax if they do not have sufficient nexus with Maryland.

These issues are further complicated by the complexity of computer networks and systems that may be in multiple states (or countries). For example, a computer services provider could render "computer services" to a Maryland taxpayer with regard to a computer system that is located outside of Maryland. Again, it is unclear where those "computer services" are delivered.

[3] Receipts of video arcades are already subject to the admissions tax, generally at a 10% rate. The effect of the 10% limitation on the combination of the sales and admissions taxes (to be increased under SB2 to 11%) should be considered in terms of the effect this would have on the distribution of these taxes between the state and local governments.

Placing a tax on services has always been difficult because of the confusion that arises from attempting to define a specific service. The above comments are presented in an effort to draw attention to this problem. Should a service be unclearly defined, or the situs of the taxable service left uncertain, a taxpayer could find himself responsible for taxes that he had no knowledge was his responsibility to collect.

We greatly appreciate your consideration of these comments. Please let us know if there is any additional assistance that the Tax Section may provide to the Committee. We would welcome the opportunity to address questions or provide technical assistance by appearing before the Committee, through the submission of supplementary correspondence, or otherwise to facilitate the Committee's review.

Respectfully submitted,

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