SB 851

Department of Legislative Services

Maryland General Assembly
2004 Session

FISCAL AND POLICY NOTE

Senate Bill 851 (Senator Brinkley)
Budget and Taxation

Income Tax - Corporations - Addition Modification for Royalty Payments

This bill requires a corporation, for purposes of determining Maryland taxable income, to add back to its taxable income royalty payments paid to specified related members of the same corporate family under specified circumstances. The bill also creates a statutory settlement period for the Comptroller to settle specified litigation, with provisions regarding penalties and interest, and forgiveness of certain tax liabilities.

The bill takes effect July 1, 2004 and is applicable to all taxable years beginning after December 31, 2004.

Fiscal Summary

State Effect: Corporate tax revenues could be affected based on changes to retrospective tax liabilities and prospective tax rules. The amount and direction of such change cannot be reliably estimated at this time; however, it is likely the magnitude is significant and it is more likely to be a revenue decrease than a revenue increase. Seventy-six percent of any change in revenue would be reflected in the general fund, and 24% in the Transportation Trust Fund (TTF).

Local Effect: Any impact on corporate taxes dedicated to the TTF would affect local governments' 30% highway user grant share.

Small Business Effect: Minimal overall, but potentially meaningful in limited circumstances. It is assumed that most of the affected taxpayers will not be small businesses; however, any small businesses subject to the corporate income tax provisions could be meaningfully affected.

Analysis

Bill Summary: The bill requires a corporate taxpayer to include as an addition modification to federal taxable income any otherwise deductible royalty payments if the royalty payments are directly or indirectly paid, accrued, or incurred to a related member during the taxable year to the extent the royalty payments are deductible in calculating federal taxable income.

However, the addition may not be required if and to the extent that the royalty payments meet any of the following conditions:

- the related member during the same taxable year directly or indirectly paid, received, accrued, or incurred the amount to or from a person that is not a related member; the transaction was entered into for a valid business purpose; and the royalty payments are made at arm's length rates and terms;
- the related member receiving the royalty payments acquired the intangible assets, for which royalty payments are being made, from a person or entity that was not a related member; the transaction was entered into for a valid business purpose; and the royalty payments are made at arm's length rates and terms;
- the royalty payments are paid or incurred to a related member organized under the laws of a country other than the U.S., and the country has entered into a comprehensive income tax treaty with the U.S.;
- the related member receiving the royalty payments is subject to a tax measured by its net income or receipts in a state or possession of the U.S. imposing a statutory tax rate of at least 4.5%; or
- the transaction giving rise to the royalty payments between the taxpayer and the related member has a valid business purpose, other than the avoidance of the payment of income taxes as determined under regulations promulgated by the Comptroller, and the payments are made at arm's length rates and terms.

For the purpose of computing Maryland modified income, a taxpayer would be allowed to subtract royalty payments directly or indirectly received from a related member during the taxable year to the extent the payments are included in the taxpayer's federal taxable income, unless the royalty payments would not be required to be added back by the taxpayer under the bill or other State tax provisions.

"Majority interest," "royalty payments," "related member," and "valid business purpose" are terms defined in the bill.

The bill also requires the Comptroller to administer a settlement period from July 1, 2004 through December 31, 2004 applicable to State corporate income tax that has been or may be assessed by the Comptroller as a result of the Court of Appeals decisions in

Comptroller of the Treasury v. SYL, Inc., and Comptroller of the Treasury v. Crown Cork & Seal Company (Delaware), Inc., 375 Md. 78 (2003). The bill allows a taxpayer to elect whether to have additional income tax calculated as though otherwise deductible payments were added back to the paying taxpayer's federal taxable income, or as though the receiving taxpayer were subject to the State corporate income tax. The Maryland income tax may not be calculated more than once for the same transaction. The Comptroller is required to waive all penalties attributable to the taxes paid during the settlement period. The Comptroller is prohibited from assessing interest on taxes paid during the settlement period at a rate exceeding 6.5%.

If all taxes and related interest described above are paid during the settlement period for the taxpayer's taxable years beginning on or after January 1, 1996, and ending on or before December 31, 2003, then no payment is required with respect to taxable years beginning before January 1, 1996, during the settlement period or in any other action by the Comptroller.

Treatment of interest expenses, as opposed to royalty payments, paid to related members is affected by the bill only to the extent that interest amounts relate to the use, maintenance, or management of intangible assets.

Current Law: Under current Maryland law, if a multistate firm is a "unitary business," the corporation is required to allocate its income to Maryland using an apportionment fraction (discussed below). (Essentially, a unitary business exists when the operations of the business in various locations or divisions or through related members of a corporate group are interrelated to and interdependent on each other to such an extent that it is reasonable to treat the business as a single business for tax purposes and it is not practicable to accurately reflect the income of the various locations, divisions, or related members of a corporate group by separate accounting.) However, the application of the unitary business principle is limited in Maryland, because the multistate firm may have various, separately-incorporated affiliates, each of which is required to file a separate income tax return and determine its own taxable income on a separate basis. As a result, only the net income and apportionment factors of the unitary operations *of each separate affiliated corporation* are used to determine each corporation's Maryland taxable income. The net income and apportionment factors of affiliated corporations are not taken into account, even where the activities of the related corporations constitute a single unitary business. If the affiliated corporations are not doing business in the State and lack nexus with the State, those affiliated corporations are not taxed by the State.

Background: So-called "Delaware holding companies" are out-of-state subsidiaries established in Delaware (or in other states providing similar tax advantages) by companies operating in Maryland to hold and manage intangible assets. Because Delaware does not tax such companies on the income generated by trademarks, intellectual property, and other intangible assets, Delaware holding companies have been used by Maryland operating companies to attempt to shelter income from the Maryland

corporate income tax. Companies seek to reduce state income tax liability in Maryland and other states by putting intangible assets such as trademarks and other intellectual property in a corporate subsidiary in Delaware. The Maryland operating company then pays the subsidiary for the right to use the trademarks or other intangible assets, resulting in an expense deduction for the Maryland operating company that reduces its Maryland taxable income.

In a decision filed June 9, 2003 (*Comptroller of the Treasury v. SYL, Inc., Comptroller of the Treasury v. Crown Cork & Seal Company (Delaware) Inc.*), the Maryland Court of Appeals ruled that two corporations doing business in Maryland could not use Delaware holding companies to shelter income earned in Maryland from the Maryland income tax. The court found that even though the two subsidiary corporations did no business in Maryland, other than licensing intellectual property for use in Maryland, and owned no tangible property in Maryland, there was a sufficient nexus between the State and the two out-of-state subsidiary corporations so that the imposition of the Maryland income tax does not violate either the Commerce Clause of the U.S. Constitution or principles of due process.

The Court of Appeals held that an appropriate portion of the income of each of the Delaware holding companies was subject to Maryland income tax. The court found that the Delaware holding companies had "no real economic substance as separate business entities" and that "sheltering income from state taxation was the predominant reason for the creation" of the out-of-state subsidiaries. The U.S. Supreme Court subsequently denied the petitions of SYL, Inc., and Crown Cork and Seal to review their cases.

The amount involved in these two cases was a little over $2 million, representing tax assessments against these two Delaware holding companies for tax years between 1986 and 1993. The decision, however, has implications for approximately 70 cases pending or scheduled for hearings before the Tax Court, involving approximately $79 million in tax assessments, interest, and penalties for tax years through 1995-1996. The Comptroller offered favorable settlement terms (including a reduced interest rate on penalties) for firms settling prior to December 31, 2003 and remitting payment by January 30, 2004. So far, approximately $9 million has been paid, with taxpayers accounting for at least $47 million worth of liability rejecting the settlement offer. The decision also affects several dozen other related cases that are currently under administrative review by the Comptroller, and the Comptroller is negotiating with these firms as well. These firms have until March to settle with the Comptroller.

State Revenues: The fiscal impact of this bill will derive from two components: (1) the increase or decrease in revenues associated with the more favorable terms upon which firms that are currently in litigation with the Comptroller may settle that litigation; and (2) any increase or decrease associated with the change in deductibility rules for royalty payments to related firms.

Current Litigation

The impact from the proposed settlement period on current litigation will depend on the relative impact on various liability periods, and cannot be reliably estimated at this time. As noted above, the Comptroller is currently in litigation, and settlement negotiations, regarding approximately $79 million in tax liability prior to 1997. These firms are estimated to have approximately $90 million of liability for the period from 1997 to the present, which reflects the full, rather than settlement, penalty rate.

Under the bill, any firms that, during the settlement period, settle disputed tax liability from 1997 to the present would be absolved of any prior liability. Thus, theoretically, the full $79 million of pre-1997 liability could be lost, including the $9 million already paid that would have to be refunded. In practice, as noted above, a significant number of taxpayers have rejected the Comptroller's settlement offer. The Comptroller will be required to pursue these taxpayers in court, and litigation could drag on for several years, with the outcome not assured. The Comptroller may never recoup the full $79 million but only some portion thereof. Consequently, lost revenues from absolving firms of those liabilities would be less than $79 million.

Offsetting the bill's forgiveness of pre-1997 liabilities is the possibility that firms may use the settlement period to pay liabilities for the period from 1997 to present. As noted above, the Comptroller has identified approximately $90 million for that period, with the potential of much more liabilities for firms that have not yet been audited for these tax avoidance techniques. The Comptroller estimates that, of the $79 million pre-1997 liabilities, approximately 40% is associated with interest (and $1 million for penalties, due to the favorable penalty offer). Assuming the 40% interest factor applies to the $90 million in post-1997 liabilities, firms could save $18 million in interest and an undetermined amount of penalties, which are waived. These savings would also apply to firms that have yet been audited.

Legislative Services notes, however, that any decision by firms to concede tax liability may be affected by factors other than the favorable terms of the settlement offer. To the extent that firms believe that they comply with acceptable practice under the *SYL/Crown Cork* interpretation, or to the extent they are concerned with outstanding liability in other states, they may be unwilling to settle, regardless of the attractiveness of the terms. On the other hand, the settlement period may be most attractive to firms with the weakest legal positions, who would have settled (or lost in court) in any event, generating no additional revenue to the State.

Standard for Deductibility for Royalty Payments to Related Firms

It is not known how many corporations are utilizing the royalty-payment deductions that are affected by the bill. The Multistate Tax Commission (MTC) produced a study this summer examining the nationwide impact of all tax avoidance strategies. For Maryland,

it estimated a revenue loss of $75 million to $161 million. (This estimate included all tax avoidance strategies and circumstances, including issues of "nowhere" income that are not covered by this bill.) The commission estimated an additional State tax loss of $90 million attributable to international tax sheltering. The MTC estimate is consistent with estimates developed by other states that have eliminated (or proposed eliminating) these techniques, and with the Comptroller's existing litigation discussed above.

The effect on the use of transfers of intangible assets as a result of this legislation: (1) cannot be reliably estimated at this time; (2) would depend on the difference in stringency between the existing *SYL/Crown Cork* ruling versus this bill, particularly as it relates to royalty versus interest payments; but (3) any potential revenue loss, if it occurred, could be significant.

The Court of Appeals found that the Delaware holding companies of the related Maryland firms were liable for State tax. The court found that the holding companies had "no real economic substance as separate business entities" and that "sheltering income from state taxation was the predominant reason for the creation" of the out-of-state subsidiaries.

Under this bill, the Maryland firm, not the Delaware firm, would be liable for any additional taxes as a result of the addition modification associated with the disallowed deduction; however, the bill does not require an addition modification if, among other exemptions, the transaction giving rise to the royalty payments between the taxpayer and the related member has a valid business purpose, other than the avoidance of the payment of income taxes as determined under regulations promulgated by the Comptroller, and the payments are made at arm's length rates and terms. Absent further legal tests of the *SYL/Crown Cork*, and in light of potential actions that firms could take to establish the necessary "valid business purpose," it is not clear whether the bill would generate more tax revenues than current law. In fact the ease of establishing at least a *pro forma* valid business purpose under the bill could lead to lower corporate tax revenues than under current law.

State Expenditures: The Comptroller's Office advises that it would incur approximately $100,000 in one-time computer reprogramming expenditures to add two additional lines to the corporate tax form, and add capability to gather the resulting information. The Comptroller has previously indicated that it could implement similar corporate tax changes with existing budgeted resources.

Local Revenues: To the extent that corporate tax revenues increase or decrease under the proposed changes, then State's highway user revenue sharing grants to local governments, which constitute 30% of any additional TTF revenues, would increase or decrease accordingly.

Small Business Effect: Most taxpayers subject to the corporate income tax changes are not small businesses; however, if a small business were subject, they could be meaningfully affected.

Additional Comments: The Governor's fiscal 2005 revenue estimate, as reflected in his budget, assumes additional general fund revenue (above the Bureau of Revenue Estimates' base estimate) of $83.6 million from "corporate income tax." The Administration advises that of this $84 million, $64 million is one-time revenue related to collection of delinquent payments based on the court cases discussed above. The remaining $20 million is estimated to be ongoing general funds resulting from enactment of corporate income reform provisions such as this one. This $20 million in general funds implies total additional corporate tax revenues of $26 million based on the split between general funds and TTF revenues.

Also, the Comptroller's Office notes that the office has the legal authority to negotiate settlement terms, including penalty and interest terms that are more favorable than the statutory default. The Comptroller advises that a statutory amnesty "would undermine voluntary compliance with tax law on matters that are [in] the slightest dispute, making it much more difficult for the Comptroller to collect taxes when they are due and also as specific disputes are carried through the range of compliance activities."

Additional Information

Prior Introductions: None.

Cross File: HB 1122 (Delegate Cryor) – Ways and Means.

Information Source(s): Comptroller's Office, Department of Legislative Services

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