HB 62

# Department of Legislative Services

Maryland General Assembly
2005 Session

## FISCAL AND POLICY NOTE

House Bill 62 (Delegate Ross)
Ways and Means

## Corporate Income Tax Reform

This bill requires affiliated corporations to compute Maryland taxable income using "combined reporting," and requires that income attributable to Maryland be derived using a modified "water's edge" method and specifically includes corporations incorporated in a "tax haven" country.

The bill takes effect June 1, 2005 and applies to tax year 2005 and beyond.

## Fiscal Summary

**State Effect:** Any increase in general fund and Transportation Trust Fund (TTF) revenues cannot be reliably estimated at this time.

**Local Effect:** Local revenues would increase as a result of increased local highway revenues distributed from the corporate income tax.

**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 unitary groups to file "combined income tax returns," except as provided by regulations. The bill requires a corporation that is a member of a unitary group to compute its Maryland taxable income using the combined reporting

method: (1) taking into account the combined income of all members of the unitary group; (2) apportioning the combined income to Maryland using the combined factors of all members of the unitary group; and (3) allocating the amount determined under (2) among the members of the group that are subject to the Maryland income tax. The bill provides for use of the "water's edge method," essentially including only "U.S. corporations" (corporations incorporated in the U.S. and specified others, generally having significant U.S. presence) in the unitary group for combined filing purposes.

The bill provides that a unitary group for purposes of the combined reporting method must include "a corporation that is in a unitary relationship with the taxpayer and is incorporated in a tax haven country." "Tax haven country" is defined as any of a specific list of countries. The Comptroller is required to report each year on which countries should be considered tax haven countries and provide draft legislation to update the list.

**Current Law:** In general, the Maryland corporate income tax is computed using federal provisions to determine income and deductions. Maryland is a "unitary business" state, in that a corporation is required to allocate all its Maryland income (that portion that is "derived from or reasonably attributable to its trade or business in the State") attributable to the corporation's "unitary business." 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.

Under current Maryland law, however, the application of the unitary business principle is limited, because each separate corporation, including each member of an affiliated group of corporations, 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 separately incorporated affiliate* are used to determine each affiliate's Maryland taxable income. The net income and apportionment factors of other affiliated corporations are not taken into account, even where the activities of the related corporations constitute a single unitary business. If the affiliated corporations lack nexus with the State, those affiliated corporations are not taxed by the State.

**Background:**

*Combined Reporting*

Sixteen states currently require combined reporting for affiliated companies. Proponents of combined reporting state that it is effective in limiting certain tax-avoidance strategies. These strategies include passive investment companies (also known as Delaware holding companies), transfer pricing schemes, intangible asset spin-offs, and isolating profitable activities from nexus in the State. Delaware holding companies (DHCs) are out-of-state subsidiaries established in Delaware (or other states providing similar tax advantages) by companies operating in Maryland to hold and manage assets.

In response to these strategies, Chapter 556 of 2004 included several measures designed to prevent corporations from avoiding the Maryland corporate income tax by shifting income away from the State through the use of DHCs and other State tax avoidance techniques. The Board of Revenue Estimates estimates that the requirements of Chapter 556 of 2004 that specified parent companies add back intangible transfers to holding companies increases corporate income tax revenues by $30 million annually.

*International Transfers*

Most corporations of significant size are faced with applying international tax rules to some aspect of their business. Under the federal tax system, domestic corporations are typically taxed on income regardless of where it is earned. Thus, U.S. corporations are subject to U.S. tax on income from foreign operations in addition to the foreign tax they pay on such income in the country it is earned. Corporations can, however, generally reduce federal taxes on income earned from foreign operations by the amount of income and withholding taxes they pay on this income in the country where it is earned. However, income a corporation's foreign subsidy earns, except certain types of income such as passive, investment-type income, is usually not subject to federal tax until the subsidiary repatriates the income to its U.S. parent. The deferral of federal tax liability from a foreign subsidiary's income can provide that subsidiary's U.S. parent corporation with financial benefits if this income is invested abroad on a long-term basis.

Every year, U.S.-based multinational corporations transfer hundreds of billions of dollars and goods and services between their affiliates in the United States and their foreign subsidies. Although such transactions may be part of normal business operations for multinational corporations, variations in corporate tax rates across countries create the potential for multinational corporations to engage in transactions with their foreign subsidies with the purpose of reducing their overall tax burden. For example, multinational corporations may try to maximize income they report in countries with low

tax rates through the pricing of intercompany transactions of goods or services. This pricing can affect the distribution of profits and taxable income among related companies. Transactions intended to reduce a corporation's overall tax burden may be particularly relevant to corporations with subsidiaries in tax haven countries that impose no or nominal tax on income.

**State Revenues:** The amount of revenue increase caused by the bill, which is unknown, depends on the additional tax revenues collected from affiliated corporations who would be required to compute Maryland taxable income using combined reporting. The provisions of the bill apply beginning with tax year 2005. Any increase in revenues would begin in fiscal 2006.

The bill would require companies to calculate Maryland taxable income by disregarding transactions between members of a unitary group. While this provision would go beyond the provisions enacted by Chapter 557 of 2004, the extent of revenue gain cannot be reliably estimated. In addition, the Comptroller's Office notes that combined reporting could also bring in losses of entities that are unrelated to the Maryland business and would have been excludable from Maryland income under current law. Legislative Services notes that while losses could be imported, they are more likely outweighed by the impact of bringing in additional income to the State.

The Multistate Tax Commission estimated a State tax loss of $90 million attributable to international tax sheltering. Any additional Maryland revenues from this provision cannot be reliably estimated at this time, but could be substantial if significant enforcement issues can be overcome. In addition, the Office of Associate Chief Counsel (International Division) of the Internal Revenue Service advises that several of the countries listed as tax haven countries by the bill have made financial transparency and regulatory commitments to the Organization for Economic Co-operation and Development and are not currently considered tax haven countries.

---

## Additional Information

**Prior Introductions:** HB 1206 of 2004, a similar bill, was not reported from the Ways and Means Committee.

**Cross File:** None.

**Information Source(s):** Comptroller's Office, General Accounting Office, Internal Revenue Service, Multistate Tax Commission, Department of Legislative Services

**Fiscal Note History:** First Reader - March 8, 2005
ncs/hlb

---

Analysis by: Robert J. Rehrmann

Direct Inquiries to:
(410) 946-5510
(301) 970-5510