HB 584

Department of Legislative Services

Maryland General Assembly
2010 Session

FISCAL AND POLICY NOTE

House Bill 584 (Delegate Ross, *et al.*)
Ways and Means

Corporate Income Tax - Combined Reporting

This bill requires affiliated corporations to compute Maryland taxable income using "combined reporting."

The bill takes effect July 1, 2010, and applies to tax year 2010 and beyond.

Fiscal Summary

State Effect: General fund revenues increase by $104.6 million in FY 2011 due to additional corporate income tax revenues. Transportation Trust Fund (TTF) revenues increase by $26.7 million in FY 2011. Future years reflect annualization and current economic forecast. General fund expenditures increase by $20,000 in FY 2011 due to administrative costs at the Comptroller's Office.

($ in millions)	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015
GF Revenue	$104.6	$88.4	$95.3	$98.7	$104.7
SF Revenue	$26.7	$22.6	$24.4	$25.2	$26.8
GF Expenditure	$.0	$0	$0	$0	$0
Net Effect	$131.3	$111.0	$119.6	$123.9	$131.5

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Local highway user revenues distributed from the corporate income tax increase by $8.0 million in FY 2011. Local expenditures are not affected.

Small Business Effect: Minimal.

Analysis

Bill Summary: The bill requires affiliated corporations to compute Maryland taxable income using "combined reporting." The Comptroller is required to adopt regulations to carry out the combined reporting provisions of the bill and the regulations must be consistent with the principles for determining the existence of a unitary business adopted by the Multi-State Tax Commission.

Combined groups are required to file "combined income tax returns," except as provided by regulations. A corporation that is a member of a combined group must compute its Maryland taxable income using the combined reporting method: (1) taking into account the combined income of all members of the combined group; (2) apportioning the combined income to Maryland using the combined factors of all members of the combined group; and (3) allocating the apportionment determined under item two among the members of the group that are subject to the Maryland income tax. The bill provides that, subject to regulations issued by the Comptroller, corporations may elect to use the "water's edge method," essentially including only "U.S. corporations" (corporations incorporated in the United States and specified others, generally having significant U.S. presence) in the combined group for combined filing purposes.

Current Law:

Corporate Income Tax

A corporate income tax rate of 8.25% is applied to a corporation's Maryland taxable income. In addition to increasing the tax rate, Chapter 3 of the 2007 special session temporarily distributed the estimated revenue increase to the newly established Higher Education Investment Fund (HEIF). The Budget Reconciliation and Financing Act of 2009 (Chapter 487) extended this provision through fiscal 2010 and stated that it is the intent of the General Assembly that, when it is fiscally prudent to do so, HEIF be made permanent. As a result, corporate income tax revenues in fiscal 2010 are distributed to the general fund (73.6%), TTF (20.4%), and HEIF (6.0%). Beginning in fiscal 2011, corporate income tax revenues will be distributed to the general fund (79.6%) and to the TTF (20.4%).

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 of 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 Maryland law, however, the application of the unitary business principle is limited in the case of affiliated groups of related corporations because of the requirement that each separate corporation must file a separate income tax return and determine its own taxable income on a separate basis. For a multi-corporate group, the unitary business principle is restricted to consider only the isolated income and business activities of each separate legal entity. Even though the activities of related corporations may constitute a single unitary business, the affiliated corporations that lack nexus with the State (or are protected from taxation by P.L. 86-272) are not subject to the State's income tax and neither the net income nor the apportionment factors of those affiliated corporations are taken into account on the corporate income tax return of any related corporation that is subject to the tax.

Background:

Maryland's Corporate Income Tax

Every Maryland corporation and every corporation that conducts business within Maryland, including public service companies and financial institutions, are required to pay the corporate income tax. The tax base is the portion of federal taxable income, as determined for federal income tax purposes and adjusted for certain Maryland addition and subtraction modifications, that is allocable to Maryland. Federal taxable income for this purpose is the difference between total federal income and total federal deductions (including any special deductions). The next step is to calculate a corporation's Maryland taxable income. The Maryland taxable income of a corporation that operates wholly within the State is equal to its Maryland modified income. Corporations engaged in multistate operations are required to determine the portion of their modified income attributable to Maryland, based on the amount of their trade or business carried out in Maryland. Corporations are generally required to use either a double weighted sales factor (payroll and property being the other factors) or, in the case of a manufacturing corporation, a single sales factor. The apportionment factor is multiplied by a corporation's modified income to determine Maryland taxable income. The Maryland tax liability of a corporation equals the Maryland taxable income multiplied by the tax rate less any tax credits.

Combined Reporting

Corporate income tax reform activity has significantly increased in Maryland and several other states in the wake of highly publicized cases involving corporate income tax avoidance at both the federal and state levels. Corporate income tax compliance legislation enacted in 2004 and 2007 addressed two well-publicized techniques for

avoiding State income tax in a "separate reporting" jurisdiction such as Maryland – Delaware Holding Companies (DHCs) and captive Real Estate Investment Trusts (REITs). In addition to this legislation, the General Assembly has considered proposals that would require combined reporting, impose an alternative minimum assessment on corporations, attempt to increase tax compliance related to offshore "tax havens," and employ throwback rules that would tax income that is not apportioned to any state.

A number of states, including Maryland, allow or require that taxes on income be computed on the basis of the books and records of separate corporate entities without regard to the fact that the entity may be a member of a commonly owned and controlled group of entities functioning as a single business. Under combined reporting, the combined income of all members of the unitary group is taken into account as the starting point for determining Maryland taxable income. The combined taxable income is then apportioned to Maryland using the combined apportionment factors of all the members of the group. Considerable debate exists over the combined reporting revenue impacts, implementation burden, and impacts on specific corporate sectors.

Chapter 3 of the 2007 special session overhauled the State's tax structure as part of a plan to address the State's structural deficit. As introduced, the Governor included a proposal to require multistate corporate groups to use the combined reporting method. In lieu of requiring combined reporting, Chapter 3 as enacted provides for enhanced reporting of corporate data to the Comptroller and also establishes a business tax study commission to review and evaluate the State's business tax structure. The information required to be submitted under Chapter 3 is designed to enable the Comptroller to analyze the impacts of combined reporting as well as assess and enhance overall corporate tax compliance. Chapter 3 is also designed to provide data necessary to (1) enable a better assessment of the current statutory incidence of the corporate income tax; (2) analyze the impacts of other corporate income tax proposals; and (3) analyze the impact of changes in the corporate income tax and job growth in the State.

Comptroller's Analysis of Combined Reporting

In October 2009, the Comptroller's Office issued an initial analysis of the impact combined reporting would have had on corporate income tax returns filed in tax year 2006. The analysis included the estimated impact on total revenues and impact on taxpayers by income and industry classification. The Comptroller's Office estimated these impacts under two different methods of apportioning the income of a combined group to Maryland ("Joyce" and "Finnegan") and concluded that the method employed could alter the estimated impacts. Under both methods, the denominator of the apportionment factor is based on the total payroll, property, and sales of all members of the group, regardless of whether they are subject to Maryland's corporate income tax (have nexus with Maryland). Under the Joyce method of apportionment, the numerator

consists of the payroll, property, and sales of all of the entities in the group with nexus. Finnegan also apportions the payroll, property and sales of all entities with nexus as well as the payroll, property, and sales of companies that make sales into the State.

The Comptroller's Office estimates that the Joyce method of apportionment would have increased corporate income tax revenues by about $109 million, a net increase of 12.5% ($170 million and 19.5% under Finnegan). The Comptroller's Office stressed that the estimates were preliminary, likely to change as corporations file amended returns, and was not an estimate of the fiscal impact of adopting combined reporting during the 2010 session.

Several factors will likely alter the current fiscal impact compared with the impact in tax year 2006, notably the steep decrease in corporate profits. The Comptroller's Office noted that two of the industries that produced the vast majority of additional revenue in tax year 2006, retail trade and finance and insurance services, are among those that have been hardest hit by the recession. The Comptroller's Office will issue revised tax year 2006 estimates in March 2010 as well as providing an initial analysis of tax year 2007.

Exhibit 1 lists the percentage of returns with an increase, decrease, and no change in tax liability in tax year 2006 by the income of the corporate group under the Joyce apportionment method as well as the net change in tax liability for each income group. Overall, the number of returns experiencing a decrease, increase, and no change in tax liability was roughly equal except that the average tax liability increase was significantly more than the average decrease in tax liability. Net tax liabilities were lower for corporate groups that were nontaxable and with less than $1 million in Maryland modified income, roughly the same for incomes between $1 million and $100 million, and were significantly higher for groups with incomes in excess of $100 million. Although numerous taxpayers across income groups would have an increase in tax liability, the vast majority of the estimated increase was generated by the 3% of returns with incomes in excess of $1 billion.

Under Finnegan, the results were mostly similar, although it was estimated that net tax liabilities would increase for corporate groups with incomes in excess of $25 million (instead of $100 million as under Joyce), with net tax increases about one-fifth higher for corporate groups with the highest income.

Exhibit 1
Combined Reporting Impact by Corporate Group Income
Under Joyce Method of Apportionment
Tax Year 2006

	Percentage of Returns with:			All Returns	
Group Maryland Modified Income	Tax Decrease	Tax Increase	No Change	Number	Net Change in Tax Liability ($ in Millions)
Nontaxable	29%	0%	71%	2,249	($61.3)
Under $500,000	32%	48%	20%	791	(0.7)
$500,000-999,999	37%	48%	16%	197	(54.4)
$1-5 Million	39%	50%	11%	677	(2.5)
$5-10 Million	37%	54%	9%	343	(0.7)
$10-25 Million	35%	57%	8%	499	(2.9)
$25-100 Million	37%	56%	6%	694	(2.0)
$100-250 Million	30%	65%	6%	352	18.0
$250-500 Million	27%	71%	2%	173	19.0
$500 million-1 Billion	28%	68%	4%	124	39.1
$1 Billion and Over	26%	74%	0%	158	157.4
All Returns	32%	35%	32%	6,257	109.0

Source: Comptroller's Office

Exhibit 2 lists the estimated impact by the predominant industry classification of the corporate group. Although the impact within each industry displayed significant variation, it was estimated that there were large net decreases in total tax liabilities in utilities, manufacturing, management of companies, and health care and large increases in the trade and finance and insurance industries. Under Finnegan, however, it was estimated that the manufacturing industry would have a large net increase in total tax liabilities while larger increases were estimated in professional, scientific, and technical services; finance and industry, trade, and information industries.

Exhibit 2
Combined Reporting Impact by Industry
Joyce Method of Apportionment
Tax Year 2006

	Percent of Returns with:			All Returns	
Industry	**Tax Decrease**	**Tax Increase**	**No Change**	**Returns**	**Net Change in Tax Liability ($ in Millions)**
Agriculture	28%	38%	34%	29	$0.1
Mining	26%	42%	32%	31	0.2
Utilities	32%	33%	35%	94	(15.9)
Construction	35%	34%	30%	297	4.8
Manufacturing	35%	37%	28%	1,470	(6.2)
Wholesale Trade	33%	46%	21%	426	13.2
Retail Trade	25%	51%	24%	404	77.4
Transportation and Warehousing	34%	42%	24%	229	3.0
Information	32%	29%	39%	333	1.8
Finance and Insurance	31%	34%	35%	608	44.3
Real Estate and Rental and Leasing	31%	29%	40%	429	0.9
Professional, Scientific, and Technical Services	30%	30%	40%	905	1.7
Management of Companies	38%	29%	33%	269	(10.1)
Admin. Support, Waste Mgmt. Remediation Services	35%	33%	32%	215	0.1
Educational Services	43%	34%	23%	47	(0.6)
Health Care and Social Assistance	31%	30%	39%	166	(9.0)
Arts, Entertainment, and Recreation	37%	21%	42%	43	(0.6)
Other	32%	29%	39%	131	0.0
Total	**32%**	**35%**	**32%**	**6,257**	**109.0**

State Revenues: The bill requires combined reporting beginning in tax year 2010. As a result, general fund revenues increase by $104.6 million in fiscal 2011 and TTF revenues increase by $26.7 million. **Exhibit 3** shows the impact of the bill in fiscal 2011 through 2015.

Exhibit 3
Effect of Combined Reporting
($ in Millions)

	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015
GF Revenues	$104.6	$88.4	$95.3	$98.7	$104.7
TTF Revenues	26.7	22.6	24.4	25.2	26.8
State	18.7	15.8	17.1	17.7	18.7
Local	8.0	6.8	7.3	7.6	8.0
Total Revenues	**$131.3**	**$111.0**	**$119.6**	**$123.9**	**$131.5**

This estimate is based on the Comptroller's estimate on the tax year 2006 impact of combined reporting, adjusted for subsequent changes in the economy and corporate income tax revenues. The actual impact of combined reporting could vary significantly than estimated above based on these variable factors and implementation of combined reporting as adopted by regulations.

State Expenditures: The Comptroller's Office reports that it will incur additional expenditures of $20,000 in fiscal 2011 in order to provide combined reporting training to auditors.

Local Revenues: Local highway user revenues distributed from the corporate income tax will increase beginning in fiscal 2011 as shown in Exhibit 3.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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