HB 1298

Department of Legislative Services

Maryland General Assembly
2014 Session

FISCAL AND POLICY NOTE

House Bill 1298 (Delegate Healey, *et al.*)
Ways and Means

Business Relief and Tax Fairness Act of 2014

This bill requires affiliated corporations to compute Maryland taxable income using combined reporting. The bill also reduces the annual filing fee for specified annual reports from $300 to $150.

The bill takes effect July 1, 2014, with the combined reporting provisions applicable to tax year 2015 and beyond.

Fiscal Summary

State Effect: General fund revenues increase by $14.6 million in FY 2015 from additional corporate income tax revenues, offset by general fund revenue losses of $39.6 million from the reduction of filing fees. Transportation Trust Fund (TTF) revenues increase by $3.1 million, of which $2.8 million goes to the State, and Higher Education Investment Fund (HEIF) revenues increase by $1.1 million in FY 2015. Potential significant increase in general fund expenditures in FY 2015 through 2017 due to administrative costs at the Comptroller's Office.

($ in millions)	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
GF Revenue	($25.0)	$11.7	$17.7	$14.5	$16.0
SF Revenue	$4.2	$15.1	$15.1	$14.3	$14.8
GF Expenditure	-	-	-	-	-
Net Effect	($20.8)	$26.8	$32.8	$28.9	$30.9

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 $0.3 million in FY 2015 and by $1 million in FY 2019. Local expenditures are not affected.

Small Business Effect: Minimal. Small businesses that file certain annual reports benefit from a reduction of the filing fee from $300 to $150. Most small businesses are not affiliated corporations so combined reporting has a minimal effect on those businesses.

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 Multistate 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 apportioned income 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 corporations incorporated in the United States and specified others (those generally having significant U.S. presence) in the combined group for combined filing purposes.

Additionally, the bill reduces the filing fee from $300 to $150 collected by the State Department of Assessments and Taxation (SDAT) for the following reports:

- annual report of a Maryland corporation, except a charitable or benevolent institution, nonstock corporation, savings and loan corporation, credit union, family farm, and bank institution;
- annual report of a foreign corporation subject to the jurisdiction of the State, except a national banking association, savings and loan association, credit union, nonstock corporation, and charitable and benevolent institution;
- annual report of a Maryland savings and loan association, banking institution, or credit union, or of a foreign savings and loan association, national banking association, or credit union that is subject to the State's jurisdiction;
- annual report of a Maryland limited liability company, limited liability partnership, limited partnership, or of a foreign limited liability company, foreign limited liability partnership, or foreign limited partnership, except a family farm;

- annual report of a business trust; and
- annual report of a real estate investment trust or foreign statutory trust doing business in the State.

Current Law: A corporate income tax rate of 8.25% is applied to a corporation's Maryland taxable income. 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 federal law) are not subject to the corporate 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 three-factor apportionment formula of payroll, property, and sales, with sales double weighted or, in the case of a manufacturing corporation, a single sales factor formula. The apportionment factor is then multiplied by the 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 efforts have 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 and captive Real Estate Investment Trusts. In addition to this legislation, the General Assembly has considered proposals in recent years that would require combined reporting, impose an alternative minimum assessment on corporations, attempt to increase tax compliance related to offshore "tax havens," and employ rules that would tax income that is not apportioned to any state.

As **Exhibit 1** shows, approximately 23 states and the District of Columbia currently require some form of combined reporting. The other 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 revenue impacts, burden of implementation, and impacts on specific corporate sectors of combined reporting.

Exhibit 1
States with Combined Reporting

Alaska	Kansas	New Mexico
Arizona	Maine	New York
California	Massachusetts	North Dakota
Colorado	Michigan	Ohio
District of Columbia	Minnesota	Utah
Hawaii	Montana	Vermont
Idaho	Nebraska	West Virginia
Illinois	New Hampshire	Wisconsin

Source: CCH Intelliconnect

Chapter 3 of the 2007 special session made significant changes to the State's tax structure as part of a plan to address the State's structural deficit. As introduced, the Governor included in the legislation a proposal to require multistate corporate groups to use the combined reporting method. In lieu of requiring combined reporting, Chapter 3 as enacted provided for enhanced reporting of corporate data to the Comptroller and also established the Maryland Business Tax Reform 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 to 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.

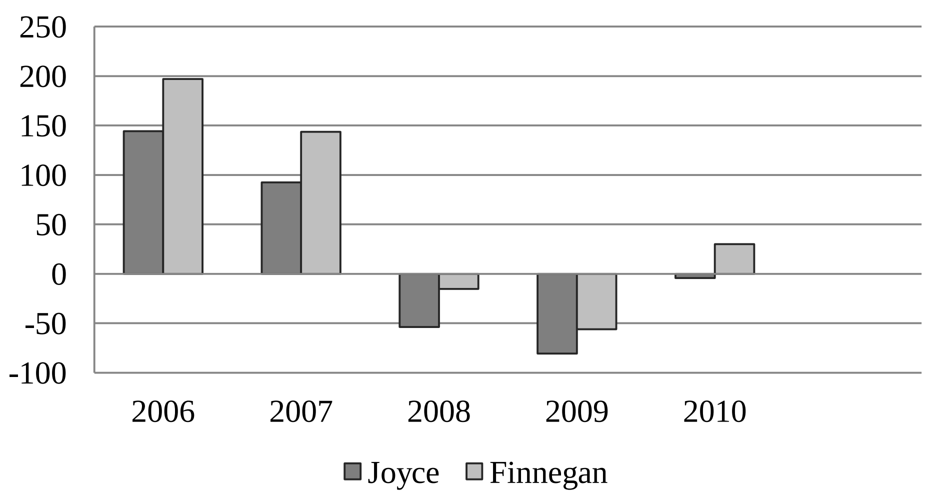
Comptroller's Analysis of Combined Reporting

The Comptroller's Office issued its most recent analysis of the revenue impact of combined reporting in March 2013, including an initial analysis of the impact combined reporting would have had on corporate income tax returns filed in tax year 2010. The Comptroller's Office estimated the impact under two different methods of apportioning the income of a combined group to Maryland (known as "Joyce" and "Finnegan") and concluded that the specific method employed could alter the estimated revenue impacts. Under both methods, the denominator of the apportionment factor is based on the total payroll, property, and sales of all members of the unitary 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. The Finnegan method apportions the payroll, property, and sales of all entities with nexus with Maryland 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 decreased corporate income tax revenues in tax year 2010 by about $4.5 million, and revenues would have increased by $30.1 million under Finnegan.

Tax year 2010 data show that the total tax liabilities for health care and social assistance, transportation and warehousing, and utility industries would have been almost $40.9 million lower under Joyce, while the retail, professional, scientific, and technical services and administrative support, waste management, and remediation services industries would have paid about $37.7 million more in tax. It should be noted that even within industries with a significant change in total tax liabilities, the change was not uniform for all corporations. For example, in tax year 2010 under Finnegan 32% of corporations would have had a tax decrease, 40% a tax increase, and 28% would have had no change. **Exhibit 2** shows the corporate income tax revenues under the Finnegan and Joyce methods from tax year 2006 through 2010.

Exhibit 2
Effect of Combined Reporting
Tax Years 2006-2010
($ in Millions)



Source: Comptroller's Office

State Revenues: In 2013, SDAT collected $77.9 million from the $300 annual report filing fee. By reducing the filing fee by half, general fund revenues decrease by $39.6 million in fiscal 2015. Future year revenue losses reflect 1% growth.

The bill requires combined reporting using the Finnegan method beginning in tax year 2015. As a result, general fund revenues increase by $14.6 million in fiscal 2015, TTF revenues increase by $3.1 million, of which $2.8 million goes to the State, and HEIF revenues increase by $1.1 million. **Exhibit 3** shows the impact of enacting combined reporting in fiscal 2015 through 2019.

This estimate is based on the Comptroller's estimate of the average impact of combined reporting in prior tax years, adjusted for subsequent changes in the economy and corporate income tax revenues. The actual impact of combined reporting could vary significantly than estimated based on these variables and the implementation of combined reporting as adopted by regulations. In any given year, corporate revenue could decrease significantly, like in tax year 2009, due to the high level of volatility in combined reporting. In addition, the bill does not alter safe harbor requirements. As a result, the fiscal impact of the bill in fiscal 2015 may be significantly less than estimated and may result in a revenue decrease, although combined reporting is not expected to decrease future tax revenues.

Exhibit 3
Effect of Combined Reporting
Fiscal 2015-2019

	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
General Fund	$14,551,407	$51,734,765	$58,145,862	$55,317,697	$57,226,992
HEIF	1,127,226	4,007,638	4,393,573	4,179,873	4,324,142
TTF	3,108,466	11,051,562	10,686,780	10,166,984	10,517,899
State	*2,810,053*	*9,990,612*	*9,660,849*	*9,190,954*	*9,508,181*
Local	*298,413*	*1,060,950*	*1,025,931*	*976,030*	*1,009,718*
Total	**$18,787,099**	**$66,793,965**	**$73,226,215**	**$69,664,554**	**$72,069,033**

State Expenditures: The Comptroller's Office reports that it will incur additional expenditures beginning in fiscal 2015 in order to implement combined reporting. These expenses include:

- hiring three contractual auditors to handle an expected increase in taxpayer queries beginning in part of fiscal 2015 through one-half of fiscal 2017;

- computer programming expenditures, including processing changes to the SMART income tax return processing and imaging systems and systems testing;
- taxpayer notification expenses; and
- providing training to corporate audit and taxpayer service staff.

Exhibit 4 shows the estimated administrative costs at the Comptroller's Office in fiscal 2015 through 2017. Additionally, if the Comptroller participates in the Multistate Tax Commission's income tax audit program, which would require the Comptroller's Office to provide assessments on audits of multistate businesses, expenditures would increase by $200,000 annually, but it has the potential to increase revenue by approximately $1.0 million annually.

Exhibit 4
Comptroller's Office Administrative Expenses
Fiscal 2015-2017

	FY 2015	FY 2016	FY 2017
Computer Programming	$1,000,000	$0	$0
Consultants	400,000	0	0
Auditors	87,400	123,600	64,000
Taxpayer Notification	36,900	0	0
Training Expenses	41,300	0	0
Total Expenses	**$1,565,600**	**$123,600**	**$64,000**

Additional Information

Prior Introductions: Similar bills were introduced in the 2013, 2012, 2011, and 2010 sessions. SB 469 of 2013 received an unfavorable report from the Senate Budget and Taxation Committee. Its cross file, HB 1246 of 2013, received a hearing in the House Ways and Means Committee, but no further action was taken. SB 269 of 2012 received an unfavorable report in the Senate Budget and Taxation Committee. SB 305 of 2011 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. Its cross file, HB 731 of 2011, received a hearing in the House Ways and Means Committee, but no further action was taken. HB 584 of 2010 received a hearing in the House Ways and Means Committee, but no further action was taken. SB 354 and HB 10 of 2010 proposed to distribute the estimated increase in revenue resulting from combined reporting to offset State retirement and pension system costs. HB 10 received an unfavorable report from the House Appropriations Committee. SB 354 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken.

Cross File: SB 395 (Senator Pinsky, *et al.*) - Budget and Taxation.

Information Source(s): State Department of Assessments and Taxation, Comptroller's Office, CCH Intelliconnect, Department of Legislative Services

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