Department of Legislative Services

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FISCAL AND POLICY NOTE
First Reader

Senate Bill 205 (Senator Serafini)
Budget and Taxation

Corporate Income Tax - Federal Repatriation Holiday

This bill provides a subtraction modification under the State corporate income tax for dividends received by a corporation from a controlled foreign corporation (CFC) if the dividends are included in federal taxable income as part of a repatriation holiday under Section 965 of the Internal Revenue Code (IRC) or another similar provision of IRC. The Comptroller must provide for the administration of the subtraction modification if federal legislation is enacted establishing a repatriation holiday for the qualifying dividends. The intent of the bill is that if the federal government provides favorable income tax treatment for corporate profits from outside the country that are brought back into the United States, then the State would not tax those profits.

The bill takes effect July 1, 2017, and applies to tax year 2017 and beyond.

Fiscal Summary

State Effect: General fund, Transportation Trust Fund, and Higher Education Investment Fund revenues could decrease significantly as a result of allowing the subtraction modification provided by the bill. General fund expenditures increase by $60,000 in FY 2018 for one-time tax form changes and computer programming modifications at the Comptroller's Office.

Local Effect: Local highway user revenues could decrease significantly. Expenditures are not affected.

Small Business Effect: Minimal. Most small businesses are not corporations that receive dividends from CFCs.

Analysis

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.

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.

Corporations may subtract the following from federal taxable income when calculating Maryland taxable income: dividends for domestic corporations claiming foreign tax credits, dividends from affiliated domestic international sales corporations, dividends from related foreign corporations, interest from U.S. obligations, and other specified miscellaneous subtractions. The subtraction modification for dividends from related foreign corporations is for dividends received from a corporation if the receiving corporation owns, directly or indirectly, 50% or more of the paying corporation's outstanding shares of capital stock and the paying corporation is organized under the laws of a foreign government.

Federal law generally requires U.S. citizens, resident individuals, and domestic corporations to be taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries is generally subject to U.S. tax only when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income is generally deferred.

Background: No current federal legislation regarding a repatriation holiday exists, although legislation has been introduced in Congress in recent years.

Internal Revenue Code Section 965

IRC Section 965, created under the American Jobs Creation Act of 2004, provides that a corporation that is a U.S. shareholder of a CFC could elect, for one taxable year, a dividends received deduction (85%) for qualifying cash dividends received from its CFCs. Any dividend otherwise qualifying for the deduction must be reduced if the dividend is funded, directly or indirectly, by the U.S. shareholder.

For the dividends to qualify, they must be invested in the United States under a properly approved domestic reinvestment plan. Permitted investments include the following:

- hiring and training of workers;
- infrastructure and capital improvements;
- research and development;
- financial stabilization for the purpose of U.S. job retention or creation;
- certain acquisitions of business entities with U.S. assets;
- advertising and marketing; and
- acquisition of rights to intangible property, such as patent rights.

Nationally, the 2004 federal repatriation holiday resulted in 843 corporations out of the approximately 9,700 corporations with CFCs in 2004 taking advantage of the deduction. They repatriated almost $362 billion, of which $312 billion qualified for the deduction.

The Joint Committee on Taxation recently estimated that there is approximately $2.6 trillion in earnings of foreign subsidiaries of U.S. corporations held offshore – up from $2.3 trillion in 2012.

State Revenues: A repatriation holiday creates an incentive for U.S. shareholders to receive dividends from a CFC that, in theory, they would have kept overseas if not for the tax holiday, so federal tax revenues increase in the short term. However, to the extent this creates an incentive for companies to shift their profits and investments overseas in anticipation of more tax holidays, the Joint Committee on Taxation estimates that the federal government would lose billions of income tax revenue over the long term. While a federal repatriation holiday is likely to sway business decisions, it is unlikely that the subtraction modification in this bill would influence business decisions since the State income tax is only a small portion of a CFC's overall tax liability.

While the bill would reduce State corporate income tax revenues, the total fiscal impact cannot be reliably estimated at this time. The overall impact would depend on the number of taxpayers who file in Maryland and take advantage of any federal tax holiday, but revenues could decrease significantly.

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of $60,000 in fiscal 2018 to add the subtraction modification to the corporate income tax return. This includes data processing changes to the SMART income tax return processing and imaging systems and systems testing.

Local Revenues: Local governments receive a portion of corporate income tax revenues to support the construction and maintenance of local roads and other transportation facilities. Under this bill, local highway user revenues could decrease significantly.

Additional Information

Prior Introductions: SB 400 of 2016 and SB 845 of 2016 each received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. SB 385 of 2014 received an unfavorable report by the Senate Budget and Taxation Committee. The cross file of SB 845 of 2016, HB 1254, passed the House and received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. The cross file of SB 385 of 2014, HB 171, received a hearing in the House Ways and Means Committee, but no further action was taken.

Cross File: None.

Information Source(s): Comptroller's Office; Joint Committee on Taxation; Department of Legislative Services

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