

Department of Legislative Services
Maryland General Assembly
2019 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 377

(Senator Pinsky, *et al.*)

Budget and Taxation

Corporate Income Tax - Combined Reporting

This bill requires affiliated corporations to compute Maryland taxable income using combined reporting. **The bill takes effect July 1, 2019, and applies to tax year 2020 and beyond.**

Fiscal Summary

State Effect: General fund revenues increase by \$20.5 million in FY 2020 from additional corporate income tax revenues. Transportation Trust Fund (TTF) revenues increase by \$3.8 million and Higher Education Investment Fund (HEIF) revenues increase by \$1.6 million in FY 2020. Potential significant increase in general fund expenditures in FY 2020 through 2022 due to administrative costs at the Comptroller's Office. TTF expenditures increase by \$0.5 million in FY 2020 and by \$1.7 million in FY 2024.

(\$ in millions)	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024
GF Revenue	\$20.5	\$71.4	\$77.3	\$78.6	\$70.1
SF Revenue	\$5.3	\$18.5	\$20.1	\$20.4	\$18.2
GF Expenditure	\$2.1	\$0.1	\$0.1	\$0	\$0
SF Expenditure	\$0.5	\$1.8	\$1.9	\$1.9	\$1.7
Net Effect	\$23.3	\$88.1	\$95.4	\$97.0	\$86.5

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

Local Effect: Local highway user revenues distributed from the corporate income tax increase by \$0.5 million in FY 2020 and by \$1.7 million in FY 2024. 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 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.

The Comptroller must report to the General Assembly by March 31 of each year on an estimate of the total additional tax revenue from corporations, if any, which will be collected in the next fiscal year as a result of using the combined reporting method.

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. Prior to tax year 2018, corporations were 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. Chapter 342 of 2018 altered the apportionment formula so that by tax year 2022, all corporations subject to the corporate income tax, with an exception for specified worldwide headquartered companies, that carry on a trade or business in and out of State must allocate to the State the part of the corporation's Maryland modified income derived from or attributed to being carried on in the State using an apportionment formula in which Maryland modified income is multiplied by 100% of the sales factor. The Maryland tax liability of a corporation equals the Maryland taxable income multiplied by the tax rate, less any tax credits.

Combined Reporting

As **Exhibit 1** shows, more than half of the 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.

Exhibit 1
States with Combined Reporting

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

Source: CCH Intelliconnect

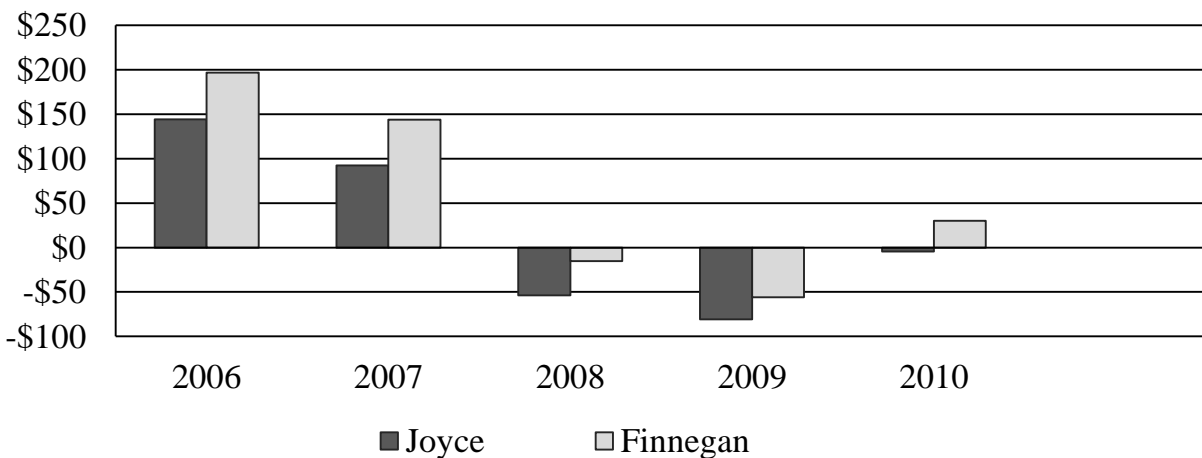
Comptroller's Analysis of Combined Reporting

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. About 65% of the revenues that would have been generated under Finnegan in tax year 2010 were attributable to corporations in the retail trade and accommodation and food services industries.

Tax year 2010 data shows 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: The bill requires combined reporting using the Finnegan method beginning in tax year 2020. As a result, general fund revenues increase by \$20.5 million, TTF revenues increase by \$3.8 million, and HEIF revenues increase by \$1.6 million in fiscal 2020. **Exhibit 3** shows the impact of combined reporting in fiscal 2020 through 2024.

Exhibit 3
Effect of Combined Reporting
Fiscal 2020-2024
(\$ in Millions)

<u>Revenues</u>	<u>FY 2020</u>	<u>FY 2021</u>	<u>FY 2022</u>	<u>FY 2023</u>	<u>FY 2024</u>
General Fund	\$20.5	\$71.4	\$77.3	\$78.6	\$70.1
HEIF Revenues	1.6	5.4	5.8	5.9	5.3
TTF Revenues	3.8	13.1	14.2	14.4	12.9
Total Revenues	\$25.9	\$90.0	\$97.4	\$99.0	\$88.2
TTF Expenditures	\$0.5	\$1.8	\$1.9	\$1.9	\$1.7

HEIF: Higher Education Investment Fund

TTF: Transportation Trust Fund

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 2020 may be significantly less than estimated and may result in a revenue decrease, although combined reporting is not expected to decrease future tax revenues.

State Expenditures: A portion of TTF revenues are used to provide capital transportation grants to local governments. Thus, any increase in TTF revenues from corporate tax revenues results in a 13.5% increase in TTF expenditures to local governments. Accordingly, TTF expenditures increase by \$0.5 million in fiscal 2020 and by \$1.7 million in fiscal 2024 as shown in Exhibit 3.

The Comptroller’s Office reports that it will incur additional expenditures beginning in fiscal 2020 in order to implement combined reporting. The Comptroller’s Office reports that it is transitioning to a new integrated tax system, Compass, which will make implementing combined reporting in fiscal 2020 more complicated, especially in regard to doing a Joint Systems Test. Thus, the Comptroller’s Office anticipates needing consultants to aid in drafting regulations and with the administrative implementation, especially with integrating combined reporting into Compass. Additional expenses include:

- hiring three contractual auditors to handle an expected increase in taxpayer queries beginning in part of fiscal 2020 through one-half of fiscal 2022;
- computer programming expenditures, including 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 2020 through 2022. 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 over \$1.0 million annually. The Comptroller’s Office can report to the General Assembly on the estimate of additional tax revenue from combined reporting with existing resources, since there is no provision requiring a separate informational filing form for affected corporations.

Exhibit 4
Comptroller’s Office Administrative Expenses
Fiscal 2020-2022

	<u>FY 2020</u>	<u>FY 2021</u>	<u>FY 2022</u>
Computer Programming	\$1,000,000	\$0	\$0
Consultants	925,000	0	0
Auditors	93,800	128,300	66,300
Training Expenses	41,550	0	0
Taxpayer Notification	38,750	0	0
Total Expenses	\$2,099,100	\$128,300	\$66,300

Local Revenues: Local governments receive a portion of corporate income tax revenues as local highway user revenues through capital transportation grants. Under this bill, local highway user revenues increase by \$0.5 million in fiscal 2020 and by \$1.7 million in fiscal 2024.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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