SB 701

Department of Legislative Services
Maryland General Assembly
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FISCAL NOTE
Revised

Senate Bill 701 (Senator Neall, *et al.*)
Budget and Taxation Ways and Means

Income Tax - Single Sales Factor Apportionment for Manufacturing Corporations

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This bill alters Maryland's corporate tax law so that a manufacturer's income tax is based solely on its percentage of in-State sales. The bill changes the formula used to apportion income to the State, for purposes of the corporate income tax, for "manufacturing corporations" that carry on a trade or business in and out of the State from a three-factor apportionment formula to a single sales factor apportionment.

The bill takes effect July 1, 2001, and applies to all taxable years beginning after December 31, 2000.

Fiscal Summary

State Effect: Potential change in general fund and Transportation Trust Fund (TTF) revenues as a result of changing the corporate income tax apportionment formula for manufacturers. However, the magnitude and direction of the change cannot be reliably estimated at this time. Studies conducted in other states with larger manufacturing bases than Maryland, have projected state revenue losses as a result of switching to a single sales factor.

Local Effect: Potential change in local government revenues depending on the overall State impact.

Small Business Effect: Potential meaningful. Small manufacturing companies that are located predominantly in Maryland would realize decreased tax liabilities. However, small manufacturing companies that are not located predominantly in Maryland would realize increased tax liabilities.

Analysis

Bill Summary: A manufacturing corporation is defined as a domestic or foreign corporation which is primarily engaged in activities that, in accordance with North American Industrial Classification System (NAICS), United States Manual, United States Office of Management and Budget, 1997 Edition, would be included in sector 11, 31, 32, or 33. These include:

Sector 11 -- crop production, animal production, forestry and logging, fishing, hunting and trapping, and support activities for agriculture and forestry.

Sector 31-33 -- food manufacturing, beverage and tobacco product manufacturing, textile mills, textile product mills, apparel manufacturing, leather and allied product manufacturing, wood product manufacturing, paper manufacturing, printing and related manufacturing, petroleum and coal products manufacturing, chemical manufacturing, plastics and rubber manufacturing, nonmetallic mineral product manufacturing, primary metal manufacturing, fabricated metal manufacturing, machinery manufacturing, computer and electronic manufacturing, electrical equipment, appliance and component manufacturing, transportation equipment manufacturing, furniture and related product manufacturing, and miscellaneous manufacturing.

A refiner -- a person who makes motor fuel from crude oil by changing the physical or chemical characteristics of the crude oil -- is not a manufacturing corporation.

In filing its tax return each year, a manufacturing corporation must certify that the NAICS code reported on its Maryland return is consistent with the code reported to other government agencies. If the Comptroller determines that a corporation has submitted information that incorrectly classifies the corporation as a manufacturing corporation, the Comptroller shall reclassify the corporation in an appropriate manner.

The bill also requires that as a part of its 2001 and 2002 income tax return, a manufacturing corporation must submit a report that describes the difference in taxes owed as a result of the single sales factor apportionment method as well as other information about corporate sales, taxable income, and property owned in the State and worldwide. Finally, the bill requires the Comptroller to report to the General Assembly

and the Governor by October 1, of 2003 and 2004 on: (1) the number of corporations filing in the prior year that used the single sales factor apportionment; (2) the number of corporations paying less in Maryland income tax as a result of using single sales factor apportionment and the aggregate amount of Maryland tax savings for these corporations; and (3) the number of corporations paying more in Maryland income tax as a result of using single sales factor apportionment and the aggregate amount of additional Maryland income taxes paid by these corporations.

Current Law: Multi-state manufacturing companies must allocate a portion of their taxable income to Maryland to reflect the proportional amount of their total business activity which is carried out in the State. A three-factor apportionment formula is used. The ratios of Maryland property to total property and Maryland payroll to total payroll are added to twice the ratio of Maryland sales to total sales. This sum is divided by four, resulting in a percentage which is applied to taxable income to determine Maryland taxable income.

Background: The majority of the states that use an apportionment formula with regard to the corporate income tax use a double-weighted sales (receipts) factor. A growing trend over the past several years, however, has been for states to enact apportionment formulas that give greater, or even exclusive weighting, to sales.

The double weighting of the sales factor is seen as generally favoring manufacturers with in-State investments in payroll (people) and property in that, when compared to an equally-weighted three-factor formula, it serves to apportion more of the corporation's income to the jurisdictions in which the sales of products occur, reducing the percentage of income apportioned to the state in which the payroll and property producing the product is located.

The benefit to an in-State manufacturer of switching to an apportionment formula based solely on sales (called single sales factor apportionment) is that it would reduce the amount of income apportioned to the state in which the manufacturer invests in property and payroll, and increase the amount of income apportioned to the jurisdiction in which the manufacturer makes sales. The intent of this change is to encourage companies to locate more of their plants and jobs in the enacting state by reducing the tax they must pay based on those factors. However, if there are any differences in tax rates and taxable income among states, or other factors determining plant location, this effect could be reduced.

In 2001, six states -- Massachusetts, Illinois, Iowa, Nebraska, Texas, and Connecticut -- will use only the sales factor in apportioning tax liability for some or all businesses. Massachusetts and Connecticut use the single sales factor for manufacturing companies

only. Over half of the 50 states have increased the weighting on the sales factor in recent decades, giving it twice the weighting of the other two factors. Four others allow super-weighting of the sales factor (Minnesota 70%, Ohio 60%, Pennsylvania 60%, and Michigan 90%).

Studies conducted in several states, including Wisconsin, Massachusetts, and Connecticut, projected state revenue losses as a result of switching to the single sales factor. However, these losses do not take into account potential increased revenue from other taxes such as the personal income tax, the sales tax, and property tax generated through the possible retention and/or expansion of manufacturers in those states. Other studies have projected a corporate expansion in a state as a result of shifting to single-factor apportionment, which could produce additional revenues to offset at least to some extent the direct corporate income tax losses.

Exhibit 1 illustrates how the single sales factor apportionment formula works compared to the current apportionment formula for two multi-state manufacturing corporations, one predominantly in Maryland and the other predominantly outside of Maryland. It is assumed that both companies have $10 million in net taxable income nationwide.

Exhibit 1
Predominantly In-State Corporation

Current Apportionment Formula

Sales	4% (x2) = 8%
Property	15%
Payroll	20%
Total	43%
Percentage Apportioned to MD	10.75% (43%/4)
Amount Apportioned to MD	$1,075,000 ($10,000,000 x10.75%)
Amount of MD Corp. Income Tax	**$75,250** ($1,075,000 x 7%)

Proposed Apportionment Formula

Sales	4%
Property	N/A
Payroll	N/A
Total	4%
Percentage Apportioned to MD	4% (4%/1)
Amount Apportioned to MD	$400,000 ($10,000,000 x 4%)
Amount of MD Corp. Income Tax	**$28,000** ($400,000 x 7%)

Predominantly Out-of-State Corporation

Current Apportionment Formula

Sales	8% (x2) = 16%
Property	6%
Payroll	3%
Total	25%
Percentage Apportioned to MD	6.25% (25%/4
Amount Apportioned to MD	$625,000 ($10,000,000 x 6.25%)
Amount of MD Corp. Income Tax	**$43,750** ($625,000 x 7%)

Proposed Apportionment Formula

Sales	8%
Property	N/A
Payroll	N/A
Total	8%
Percentage Apportioned to MD	8% (8%/1)
Amount Apportioned to MD	$800,000 ($10,000,000 x 8%)
Amount of MD Corp. Income Tax	**$56,000** ($800,000 x 7%)

The portion of income actually taxed by other states depends on the taxability in other states and the apportionment rule that is followed by the other states.

State Fiscal Effect: The Comptroller's Office indicates that the bill would result in an overall revenue increase. However, the magnitude of the increase cannot be quantified at this time. The Comptroller's Office indicates this conclusion is based on several factors:

- Maryland has a small manufacturing base and a high average income, compared to other states. As a result, it is assumed that: (1) the State is a net importer of manufactured goods; (2) most goods sold in the State are from manufacturers whose sales factor is higher than their property or payroll factors.

- It is assumed that companies with a sales factor higher than their property or payroll factors will apportion more of their income to Maryland and thus incur a higher income tax liability; and companies with a sales factor lower than their property or payroll factors will apportion less of their income to Maryland and therefore incur a lower income tax liability.

- A study was conducted by the Comptroller's Office in 1990, when the State was considering moving from a single-weighted sales factor to the current double-weighted sales factor, that indicated that manufacturing companies would pay more as a group under a double-weighted sales formula as opposed to a single-weighted sales formula.

- The Comptroller's Office advises that the current apportionment formula also provides an incentive for corporations to alter their tax planning to avoid Maryland

income tax. The Comptroller advises that a preliminary examination of a limited number of in-State and out-of-State manufacturing companies indicates that these companies could realize tax savings if they were to alter their tax planning under the current apportionment formula. However, none have appeared to do so.

However, the Department of Legislative Service (DLS) advises that it is possible that this proposal could result in a revenue loss rather than a revenue increase. Any changes in corporate tax planning that result from the bill, such as corporations restructuring their operations to shift sales and/or jobs out of Maryland or to shift Maryland sales to a related corporation that is not a manufacturing corporation, could result in potentially significant revenue losses. Also, the Comptroller's assumptions do not appear to take into account that many out-of-State manufacturing corporations that sell or that have products that are sold in Maryland are not taxable in Maryland because they lack nexus in the State. Federal law prohibits states from taxing corporations that make sales in a state but lack nexus in the state.

It should also be noted that the Comptroller's study on the double-weighted sales factor option was conducted in 1990 and used tax year 1988 data. Maryland's economy as well as the national economy has changed over the past ten years. Also, due to the reporting requirements on corporate income tax returns at the time of the study which limited the sampling criteria, the industry level information, on which the conclusion that manufacturing companies as a group would pay more under a double-weighted sales formula was based, is not statistically valid.

Massachusetts has a single sales factor for manufacturers, including defense contractors, that was fully phased in on January 1, 2000. Tax officials in Massachusetts estimated that an apportionment formula other than one with equal weighting to property, payroll, and sales would result in a revenue loss of approximately $184 million in fiscal 2000. This estimate, in addition to manufacturers, included the impact of applying a single sales factor only for mutual fund corporations, with sales based on the domicile of the shareholders in the mutual fund. A recent study conducted by the Connecticut Department of Revenue Services indicated that changing to a single sales factor from a three-factor formula would cost an estimated $15 - $25 million annually.

According to Bureau of Labor Statistics for 2000, Maryland has a smaller manufacturing base than either of these states. Manufacturing jobs represented 15.7% of the nonagricultural labor force in Connecticut, and 13.1% in Massachusetts. It represents 7.3% in Maryland. Manufacturing represents approximately 14% of the civilian workforce, nationwide.

Local Fiscal Effect: Local government revenues would be impacted by any changes (positive or negative) in both personal and corporate income tax revenues. Seventy-five percent (75%) of corporate tax revenues are distributed to the general fund, and 25% are distributed to the Transportation Trust Fund (TTF). Of the 25% distributed to the TTF, approximately 30% is distributed to local jurisdictions.

Additional Information

Prior Introductions: None.

Cross File: None. HB 11 (Delegate Taylor, *et al.* – Ways and Means) is a similar bill.

Information Source(s): Comptroller of the Treasury (Bureau of Revenue Estimates); Center on Budget and Policy Priorities; The Business Council of New York State, Inc.; Department of Legislative Services

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