HB 753

Department of Legislative Services

Maryland General Assembly
2003 Session

FISCAL AND POLICY NOTE
Revised

House Bill 753 (Delegate Hixson, *et al.*)

Ways and Means Budget and Taxation

Taxes and Revenues

This bill: (1) makes several changes to State corporate income taxation; (2) imposes a 10% corporate income tax surcharge for tax years 2003, 2004, and 2005; and (3) imposes the 2% insurance premium tax on health maintenance organizations (HMOs) and Medicaid managed care organizations (MCOs).

The bill generally takes effect July 1, 2003, although the various provisions have different effective dates.

Fiscal Summary

State Effect: General fund revenues could increase by approximately $135.6 million in FY 2004 and approximately $157.5 million in FY 2005. In addition, special fund revenues (to the Transportation Trust Fund (TTF)) could increase by approximately $11.1 million annually; $7.7 million is transferred from the TTF to the general fund in FY 2004 only. Future year growth reflects annualization and forecasted growth.

($ in millions)	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
GF Revenue	$135.6	$157.5	$168.7	$133.0	$143.9
SF Revenue	3.4	11.1	11.1	11.1	11.1
SF Expenditure	.2	0	0	0	0
Net Effect	$138.8	$168.6	$179.7	$144.1	$154.9

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

Local Effect: See discussion below. Local highway user revenue sharing would increase by an estimated $3.3 million annually.

Small Business Effect: Small businesses subject to the corporate income tax provisions could be meaningfully affected. Minimal overall, but potentially meaningful in limited circumstances.

Analysis

Bill Summary: See discussion under State Revenues.

Current Law: See discussion under State Revenues.

Background: The Commission on Maryland's Fiscal Structure (Puddester Commission) offered several options for increasing tax revenues, including measures related to the taxation of multistate corporations under the corporate income tax and expanding the insurance premium tax to health maintenance organizations.

State Revenues: For each of the bill's provisions, the impact on State revenues, as well as a brief discussion of current law and the proposed changes, are discussed below and shown in **Exhibit 1**.

Corporate Tax Changes

The bill makes three changes to State corporate income tax law:

<u>Disallowance of Certain Delaware Holding Company (DHC) Transactions</u>

This bill permits the Comptroller to distribute, apportion, or allocate gross income, deductions, credits, or allowances between and among two or more organizations, trades, or businesses, whether or not incorporated, whether or not organized in the United States, and whether or not affiliated, if: (1) the organizations, trades, or businesses are owned or controlled directly or indirectly by the same interests; and (2) the Comptroller determines that the distribution, apportionment, or allocation is necessary in order to reflect an arm's length standard, within the meaning of § 1.482-1 of the regulations of the Internal Revenue Service (IRS) and to clearly reflect the income of those organizations, trades, or businesses (known as "Section 482 authority"). The Comptroller is required to apply the administrative and judicial interpretations of § 482 of the Internal Revenue Code in administering the bill.

The bill requires a corporation, for purposes of determining Maryland taxable income, to add back to federal taxable income any otherwise deductible interest expense or intangible expense paid directly or indirectly to one or more related members, as defined, unless the corporation establishes that: (1) the transaction did not have as a principal purpose the avoidance of tax; (2) the interest expense was paid pursuant to an arm's length rate or price; and (3) either: (a) the related member paid or incurred the interest or intangible expense to an unrelated person; (b) the related member paid state (or foreign) taxes in the aggregate on the amount received at an effective rate of at least 4%; or (c) in the case of an interest expense, the related members are banks. The addition modification also does not apply to any intangible expense paid, accrued, or incurred to purchase, license, develop, or protect patents, trade secrets, copyrights, or trademarks used in the biotechnology industry.

The bill requires affiliated groups of corporations to provide a report of intermember sales and other transactions, if requested by the Comptroller.

Allocation of Nonapportionable Income

The bill provides that if the trade or business is a unitary business, the part of a corporation's Maryland modified income derived from or reasonably attributable to trade or business carried on in the State is determined by adding: (1) the corporation's *nonoperational* income that is allocated to the State under the bill; and (2) the part of the corporation's operational income derived from or reasonably attributable to trade or business carried on in the State as determined under existing apportionment rules. Under the bill, to the extent allowed under the U.S. Constitution, if the principal place from which the trade or business of a corporation is directed or managed is in the State, *all* the corporation's nonoperational income would be allocated to Maryland.

Unlike most other states, Maryland currently does not distinguish between business and nonbusiness (or nonoperational) income. Rather, all income of a multistate corporation doing business in the State is apportioned under State corporate income tax rules, either under the "three-factor" apportionment formula or the "single sales factor" formula for manufacturing firms. Federal constitutional interpretation provides, however, that only the corporation's "home" state is constitutionally entitled to tax nonbusiness income. Thus, under current law, some nonoperational income of Maryland-based firms with multistate operations is apportioned away from Maryland, even though that nonoperational income cannot be taxed in those other states.

Throw-back Rule

The bill provides that sales of tangible personal property are included in the numerator of the sales factor for determining the Maryland tax liability of a multistate corporation if: (1) the property is delivered or shipped to a purchaser within the State, regardless of the f.o.b. point or other conditions of the sale; or (2) the property is shipped from an office, store, warehouse, factory, or other place of storage in this State and the corporation is not taxable in the state of the purchaser. The bill provides that a corporation is taxable in a state if: (1) in that state the corporation is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or (2) that state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether, in fact, the state imposes a tax.

Under existing Maryland apportionment of income rules, the sales factor of the apportionment fraction is generally determined by including in the denominator all sales of the corporation and by including in the numerator only those sales of property delivered or shipped to a purchaser within the State, regardless of point of shipment or other conditions of sale, making Maryland a "destination" state. However, federal law (Public Law 86-272) essentially prevents other states from imposing corporate taxes on sales by Maryland corporations, even though they make sales in those states, if there is a lack of nexus. The interaction of Maryland's corporate taxation rules and the federal restriction therefore results in "nowhere income" – income that is apportioned nowhere for state income tax purposes. Under the bill, in calculating the sales factor of the apportionment fraction, sales of goods to a purchaser located in another state where the seller is not taxable are included (or "thrown back") into the numerator of any state where the seller is taxable.

Subtotal Revenues – Corporate Tax Changes

It is not known how many corporations are utilizing the various intercompany transfers and other tax avoidance techniques, the deductions for which would be disallowed under the bill. Based on the Comptroller's Office's data of firms that are currently subject to audit or tax litigation (until the Comptroller's Office essentially ceased pursuing these avoidance techniques pending clarity on their legality under State tax law), as well as fiscal estimates by other states that have eliminated these techniques, the additional revenues from these provisions could increase State corporate taxes by up to $180 million annually. The House Ways and Means Committee, in its fiscal estimate of this bill as part of the House of Delegates budget-balancing package, conservatively estimated at a minimum of $35 million in additional general fund revenues in fiscal 2004 and beyond from the corporate tax changes.

Based on the existing statutory formula providing that 76% of revenues go to the general fund and 24% to the TTF, TTF revenues would increase by $11.1 million annually. For fiscal 2004 only, however, $7.7 million of TTF revenues, reflecting the Maryland Department of Transportation's 70% share of highway user revenues, are transferred to the general fund.

It should also be noted that in the absence of this legislation, if the Comptroller's Office loses its pending litigation regarding the DHC strategies, there would be a strong incentive for virtually all corporations paying a substantial corporate income tax to employ these techniques. Under that scenario, the fiscal impact of this bill in preventing such a revenue loss, i.e., by preserving currently anticipated revenues, would be substantially higher. The bill requires the Comptroller, in conjunction with the business community, to study the issues of combined reporting under the income tax by business entities.

Ten Percent Corporate Income Tax Surcharge

For a taxable year beginning after December 31, 2002 but before January 1, 2006, in addition to the existing corporate income tax, a 10% surcharge is imposed on the Maryland tax liability of each corporation. The revenues associated with the surcharge are distributed 100% to the general fund and are not subject to the standard corporate income tax distribution that provides a share to the TTF. For taxable years beginning during 2003, the "safe harbor" provision for estimated tax payments is altered to require estimated payments based on the surcharge. This provision is estimated to increase State tax revenues by $44.0 million in fiscal 2004. Fiscal 2005 and 2006 estimates grow based on forecasted underlying corporate tax estimates.

HMO and MCO Premium Tax

The bill imposes the 2% insurance premium tax on HMOs and Medicaid MCOs that is currently imposed on all gross direct insurance premiums derived from business in Maryland. All health insurers, other than nonprofit health service plans, fraternal benefit societies, and HMOs are currently subject to the premium tax. An MCO is not considered an insurer. There are currently 14 HMOs and six MCOs operating in Maryland. Applying the 2% premium tax to these organizations could increase revenues by at least $48.9 million in fiscal 2004. Future year revenue estimates reflect annualization and assume 12.7% health care inflation for HMOs and 6.7% medical inflation in the Medicaid program for MCOs.

State Expenditures: The Comptroller's Office could implement the additional provisions with existing budgeted resources. The Maryland Insurance Administration advises that it will incur $185,000 in one-time special fund programming expenditures. The State may experience an increase in its health care costs if its selected HMO providers increase their premiums as a result of the tax.

Local Revenues: To the extent that corporate tax revenues increase under the corporate tax law changes, then 30% of any additional TTF revenues would be distributed to local governments based on the State's highway user revenue sharing. Based on the estimated increase in State corporate tax revenues, local revenue sharing could increase by $3.3 million annually.

Small Business Effect: Most taxpayers subject to the corporate income tax changes or the insurance premium tax are not small businesses; however, if a small business were subject, they could be meaningfully affected. Also, small businesses that purchase health insurance via HMOs could experience an increase in their premiums.

Additional Information

Prior Introductions: None.

Cross File: None.

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

Fiscal Note History:	First Reader - March 3, 2003
mld/jr	Revised - House Third Reader - March 21, 2003
	Revised - Enrolled Bill - April 7, 2003
	Revised - Clarification - April 9, 2003

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Exhibit 1
HB 753 - Additional Revenues
($ in Millions)

	Fund Source	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
Corporate tax changes*	GF @ 76%	$35.0	$35.0	$35.0	$35.0	$35.0
	TTF @ 24%	11.1	11.1	11.1	11.1	11.1
Less transfer from TTF for FY 2004 only	from TTF	-7.7				
	to GF	7.7				
10% Corporate income tax surcharge for 3 years**	GF	44.0	45.3	46.7	0.0	0.0
Insurance premium tax on HMOs and MCOs	GF	48.9	77.2	87.0	98.0	108.9
Subtotal – additional GF revenues		**$135.6**	**$157.5**	**$168.7**	**$133.0**	**$143.9**
Subtotal – additional TTF revenues		**$3.4**	**$11.1**	**$11.1**	**$11.1**	**$11.1**
Total additional revenues		**$139.0**	**$168.6**	**$179.7**	**$144.1**	**$154.9**

*Assumes minimum of $46 million total funds. Bill provides for $7.7 million transfer from the Maryland Department of Transportation in fiscal 2004 to reflect foregone TTF-MDOT share for one year only.

**Surcharge revenues dedicated 100% to GF only.

Source: Department of Legislative Services