Department of Legislative Services

Maryland General Assembly
2003 Session

FISCAL AND POLICY NOTE

House Bill 776 (Delegate Hixson, *et al.*)
Ways and Means

Corporations and Other Business Entities - Fees and Taxes

This bill: (1) includes several measures designed to prevent corporations from avoiding the Maryland corporate income tax by shifting income away from the State through the use of Delaware Holding Companies (DHCs) and other State tax avoidance techniques; (2) alters the allocation of nonapportionable nonoperational income of multistate corporations subject to the State's corporate income tax; (3) applies a "throwout" rule in determining whether sales are "in the State" for purposes of the State's corporate income tax apportionment; and (4) increases the annual filing fee for corporations and real estate investment trusts and imposes this annual fee on nonincorporated entities currently required to file annually but with no fee.

The bill takes effect June 1, 2003 and is applicable to all taxable years beginning after December 31, 2002. The Comptroller's authority under the bill to distribute, apportion, or allocate gross income, deductions, credits, or allowances between and among two or more organizations, trades, or businesses to clearly reflect income is applicable to any taxable year for which an assessment is not barred by the statute of limitations. Combined reporting for unitary groups is required for tax years beginning on or after January 1, 2005.

Fiscal Summary

State Effect: The increase in State corporate income tax revenues cannot be precisely estimated at this time, but could range from $45 million to $175 million annually, with a midrange estimate of $110 million annually, based on a full fiscal year of tax collections. Of this amount, 76% would be credited to the general fund and 24% to the Transportation Trust Fund (TTF). State general fund revenues from increased and expanded filing fees are expected to increase by approximately $10.8 million in FY 2003 (reflecting the bill's June 1 effective date) and by approximately $43.3 million in FY 2004 and thereafter.

Local Effect: Local government transportation revenues would increase based on their share of TTF revenue-sharing.

Small Business Effect: Minimal. It is assumed that virtually all corporations employing the affected tax strategies are not small businesses and would not be affected by the corporate tax changes. Small businesses subject to the expanded or increased filing fees would be minimally affected.

Analysis

Bill Summary, Current Law, Background, and State Revenues: The bill makes four changes to State corporate income tax law to address DHCs and other techniques to shift income away from the State for tax purposes, makes two other corporate tax law changes, and changes corporate filing fees.

Combined Reporting and Delaware Holding Companies

Bill Summary

The bill provides authority to the Comptroller to allocate income tax attributes (income, deductions, credits, etc.) among two or more businesses that are owned or controlled directly or indirectly by the same interests, if the Comptroller determines the allocation is necessary to prevent the evasion of taxes or to clearly reflect the income of any of the businesses (known as Section 482 authority in reference to the applicable Internal Revenue Code provision).

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: (1) the corporation and the related member are members of the same unitary group and compute Maryland taxable income using the combined reporting method; or (2) the corporation establishes that: (i) the transaction did not have as a principal purpose the avoidance of tax; (ii) the interest expense was paid pursuant to an arm's length rate or price; and (iii) either: (a) the related member paid or incurred the interest or intangible expense to an unrelated person; or (b) the related member paid state (or foreign) taxes in the aggregate on the amount received at an effective rate of at least 4%.

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

For tax years beginning after 2004, the bill requires unitary groups to file "combined income tax returns," except as provided by regulations. The bill requires a corporation that is a member of a unitary group to compute its Maryland taxable income using the combined reporting method: (1) taking into account the combined income of all members of the unitary group; (2) apportioning the combined income to Maryland using the combined factors of all members of the unitary group; and (3) allocating the amount determined under (2) among the members of the group that are subject to the Maryland income tax. The bill provides for use of the "water's edge method," essentially including only "U.S. corporations" (corporations incorporated in the U.S. and specified others, generally having significant U.S. presence) in the unitary group for combined filing purposes.

Current Law

In general, the Maryland corporate income tax is computed using federal provisions to determine income and deductions. For a business that is wholly within the State, a corporation is required to allocate all its income to Maryland. For a multistate corporation, only that part of its income that is "derived from or reasonably attributable to its trade or business in the State" is subject to the Maryland income tax. 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. The three-factor formula, for example, compares the property, payroll, and sales (double-weighted) of the corporation in the State to the total property, payroll, and sales (double-weighted) of the corporation everywhere. This apportionment reflects federal constitutional requirements prohibiting a state from taxing value earned outside its borders and requiring that there be a minimum connection (or "nexus") between interstate activities and a state for the state to impose its income tax.

If a multistate firm is a "unitary business," a corporation is required to allocate its income to Maryland using an apportionment fraction (formulary apportionment). 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 current Maryland law, the application of the unitary business principle is limited, because each separate corporation, including each member of an affiliated group of corporations, is required to file a separate income tax return and determine its own taxable income on a separate basis. As a result, only the net income and apportionment

factors of the unitary operations of each separate corporation are used to determine each corporation's Maryland taxable income. The net income and apportionment factors of affiliated corporations are not taken into account, even where the activities of the related corporations constitute a single unitary business. If the affiliated corporations lack nexus with the State, those affiliated corporations are not taxed by the State.

Background

There are several problems for tax administration under separate reporting. First, the Comptroller's Office must attempt to police transfer pricing between related corporations to prevent the use of intercorporate transactions to effectively shift profits to a low-tax or no-tax state. Second, corporations may use DHCs (also known as passive investment companies, or PICs) to shelter passive income, for example by shifting investments or loans to the DHC, which is not subject to Maryland tax. (Under Delaware law, "passive investment companies" are not subject to corporate income tax if their activities are limited to management of intangible assets.) In return, investment income can be returned to the Maryland operating company through dividends, which are not taxable under certain circumstances. Under Maryland law, corporations generally are entitled to a 100% deduction for dividends received from affiliated corporations (80% common ownership).

Third, a DHC can be used to reduce the operating income of a Maryland operating company by placing trademarks, tradenames, or other intangible assets in the DHC, and requiring the operating company to pay a royalty for the use of the intangible asset. The most frequently cited example of this technique involves Toys R Us. Toys R Us incorporated a subsidiary in Delaware (called Geoffrey) to which it transferred valuable trademarks and tradenames, including the "Toys R Us" trademark. The subsidiary executed a license agreement allowing its parent to use the Toys R Us trademark, other trademarks, and know-how. In return, the parent paid its subsidiary a royalty, which it deducted in calculating the taxable income it apportioned to the states where it had stores. Thus, the business deducted the royalty in calculating apportionable income, while the DHC was not subject to any state tax on the receipt of the royalty.

To address these various tax avoidance mechanisms, several states that follow the separate entity reporting rule have adopted specific provisions that essentially treat the separate entity and related corporations as a single person for various purposes, by disregarding certain inter-member transactions. In particular, these provisions disallow deductions for payments of interest or intangible expenses to a related corporation, except in specified circumstances. This bill provides for the denial of these deductions for inter-member transactions, though such inter-member transactions should become less significant when the combined reporting requirements go into effect. While these provisions are effective at addressing some of the tax avoidance techniques mechanisms,

such as the transfer of trademarks, tradenames, and know-how to a DHC, they are ineffective against various others, such as shifting passive investments to a DHC.

One approach to addressing these strategies, the combined reporting method, looks beyond the legal structure of separate incorporation to determine whether two or more members of an affiliated group of corporations are engaged in a single unitary business. Combined reporting is intended to ensure that the income of a multi-corporate business is computed and apportioned in the same manner as in the case of a single corporate business to promote equality and uniformity in the application of the state's tax laws. For this purpose, the unitary concept, rather than a corporate entity concept, is used in determining the tax base and apportioning income to the taxing state. Thus, combined reporting performs the same function for unitary corporate entities, to prevent the erosion of taxes, as does formula apportionment for corporate divisions.

Through combined reporting, the income of an out-of-state affiliate would be reflected in the combined income of a Maryland operating company. The apportionment factors of the affiliate would also be included in the formula used to apportion the combined income to Maryland. Because the affiliate is presumed to be entirely out-of-state, its apportionment factors would be included in the denominators but not in the numerators of the apportionment formula. To the extent the out-of-state affiliate had significant property, payroll, or sales out of state, the combined income of the unitary group would be apportioned away from Maryland by operation of the apportionment formula, resulting in potentially reduced taxes under combined reporting. However, in the case where the out-of-state affiliate is a DHC, very little will be added to the denominators of the apportionment formula, because DHCs typically have virtually no tangible property, payroll, or sales anywhere.

Sixteen states provide for mandatory combined reporting: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, and Utah. Several other states require or allow combined or consolidated reporting under a variety of circumstances.

The Comptroller's Office made a presentation to the Commission on Maryland's Fiscal Structure (Puddester Commission) outlining the problem for the corporate income tax posed by the proliferation of DHC and other tax avoidance techniques. The office distributed the list of current litigated tax cases involving DHC and other deductions. In its final report, the Puddester Commission included combined reporting for affiliated corporations and other measures related to the taxation of multistate corporations under the corporate income tax as an option that "could provide more fairness in taxation and generate additional revenues."

State Revenues

The increase in State corporate income tax revenues from the various provisions of this bill cannot be reliably estimated at this time. It is not known how many corporations are utilizing the various inter-company transfers and other tax avoidance techniques that are prohibited 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 the anti-DHC provisions other than combined reporting could increase State corporate taxes from $20 million to $150 million, with a midrange estimate of approximately $85 million.

This estimate is based on audit and litigation data indicating that an average annual audit found reduced tax liabilities of $100,000 for the licenses, royalties, and other deductions noted above (reflecting deductions of approximately $1.4 million). If only about 1% of the approximately 75,000 annual corporate tax filers are currently utilizing these deductions but would be prevented from doing so under the bill, then State corporate tax revenues could increase by $85 million. Legislative Services notes that the Comptroller's Office could not produce a precise estimate, but used the same audit database to suggest an illustrative revenue range of between $14 and $25 million, or more, from the anti-DHC actions.

The fiscal impact from the combined reporting requirement also cannot be reliably estimated at this time but could result in additional revenues similar to those from the other anti-DHC provisions. This estimate reflects the fact that for some corporate taxpayers, Maryland tax liability could actually decrease under combined reporting because combined reporting could also bring in losses of entities that are unrelated to the Maryland business and therefore would have been excludable from Maryland income under current law. On the other hand, combined reporting may limit the impact of other tax avoidance techniques that are not addressed by the other anti-DHC provisions. The estimated revenue increase from combined reporting is imbedded in, not in addition to, the estimate for the other anti-DHC provision.

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.

Allocation of Nonapportionable Income

Bill Summary

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 Maryland modified income that is nonoperational income would be allocated to the State. "Nonoperational income" is defined as all income other than operational income. "Operational income" is defined as all income that is apportionable under the U.S. Constitution.

Current Law

Maryland does not currently 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. The three-factor formula, for example, compares the property, payroll, and sales (double-weighted) of the corporation in the State to the total property, payroll, and sales (double-weighted) of the corporation everywhere.

Under the line of U.S. Supreme Court decisions upholding the constitutionality of "formulary apportionment" for multistate corporations, certain income of multistate corporations is not subject to apportionment under certain circumstances, and only the corporation's "home" state is constitutionally entitled to tax this income. An example of this type of income is interest earnings on cash that is held for a future corporate acquisition (i.e., not used as working capital in ongoing business operations). Thus, though Maryland law appears to provide for full apportionment, in fact the State cannot tax any portion of the constitutionally protected income of a corporation that is domiciled in another state.

Background

When determining the part of a multistate corporation's income that is subject to a state corporate income tax, most states distinguish between business income and nonbusiness

income. For example, the Uniform Division of Income for Tax Purposes Act (UDITPA) defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business." Such income "includes income from tangible and personal property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

After making this distinction, most states provide for assignment or allocation to a particular state (typically, the state of the commercial domicile of the business) of those items of nonbusiness income, and then apportion the business income according to formulary apportionment, such as the three-factor formula.

Unlike most states, for corporations domiciled in the State, Maryland allows income to be apportioned, including nonbusiness income that – to the extent it is nonapportionable under the U.S. Constitution – may not be taxable in any other state. This bill makes a distinction under the State's corporate income tax between apportionable income and nonapportionable income, and provides for the existing formulary apportionment for only operational income. Nonoperational income of a Maryland-domiciled corporation, however, would be subject to a 100% allocation to Maryland. The effect of the bill is that to the extent that the income of a Maryland-domiciled multistate corporation is not subject to apportionment by other states, Maryland would tax 100% of that income.

State Revenues

The fiscal impact from the apportionment of nonbusiness income cannot be reliably estimated at this; however, it is not unreasonable to anticipate that it could generate additional corporate income tax revenues of $5 million annually, based on a full year of tax collections. The Comptroller's Office could not provide an estimate of the fiscal impact of this provision.

"Throwout" Rule

Bill Summary

Sales of tangible personal property are excluded from the denominator of the sales factor for determining the Maryland tax liability of a multistate corporation if: (1) the purchaser is the U.S. government; or (2) the corporation is not taxable in the state of the purchaser.

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.

Current Law

If the multistate operations of a multistate corporation constitute a unitary business, an apportionment fraction is applied to the corporation's Maryland modified income to determine the part of the corporation's income that is attributable to Maryland. In general, a three-factor apportionment fraction is used, based on a comparison of sales, property, and payroll of the corporation in the State to sales, property, and payroll of the corporation everywhere. For manufacturing corporations, under legislation enacted in 2001 a special "single sales factor" apportionment fraction is used for tax years beginning after December 31, 2000 to determine the part of the corporation's income that is attributable to Maryland.

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 the sales of property if the property is delivered or shipped to a purchaser within the State, regardless of the point of shipment or other conditions of sale.

Background

Federal law (Public Law 86-272) essentially prevents a state from taxing income derived within the state of any person if the person limits its business activities in the state to "solicitation of orders" and "delivery of orders" from a point outside the state. It applies broadly to prohibit "a net income tax on the income derived within such state by any person from interstate commerce" if the person limits its activities in the state to "solicitation of orders .. for sales of tangible personal property" and filling such orders by "shipment or delivery from a point outside the state." As a result of P.L. 86-272, corporations are often not subject to income tax by a state even though they make sales into that state, because of the lack of nexus.

The interaction of Maryland's corporate taxation rules and the federal restriction results in "nowhere income" – income that is apportioned nowhere for state income tax purposes. Many states with corporate income taxes attempt to address "nowhere income" by imposing either a "throwback" or "throwout" rule. This bill creates a Maryland "throwout" rule.

A throwout rule works as follows. 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 excluded from the denominator of any state where the seller is taxable. This is known as a throwout rule because for apportionment purposes the sales to a purchaser in a state where the corporation is nontaxable are thrown out from the state from which

the goods were shipped. West Virginia and New Jersey have expressly adopted the throwout rule.

State Revenues

The fiscal impact from the throwout rule cannot be reliably estimated at this time; however, it is not unreasonable to anticipate that it could generate additional corporate income tax revenues of $20 million annually, based on a full year of tax collections. The Comptroller's Office could not provide an estimate of the fiscal impact of this provision.

Filing Fees

Bill Summary

For business entities required to file with the State Department of Assessments and Taxation (SDAT), the bill raises the annual filing fee, from $100 to $250, for Maryland and foreign corporations and specified financial institutions. The bill charges a $250 fee for the annual filing of a Maryland or foreign limited liability company (LLC), limited liability partnership (LLP), or limited partnership (LP). The bill also raises the annual filing fee for a real estate investment trust (REIT) from $25 to $250.

Current Law

A $100 filing fee is applicable to the annual report filed with SDAT of a Maryland corporation, most annual reports of foreign corporations subject to Maryland's jurisdiction, a Maryland savings and loan association, banking institution, or credit union or of a foreign savings and loan association, or credit union that is subject to the jurisdiction of this State. The annual filing fee for a REIT doing business in Maryland is $25. No fee is charged for the annual filing of a Maryland or foreign LLC, LLP, or LP.

Background

Exhibit 1 shows corporate and other annual filing fees for Maryland and selected surrounding jurisdictions.

State Revenues

There are approximately 127,800 Maryland corporations, 28,100 foreign corporations, 200 Maryland financial institutions, and 200 foreign financial institutions that would have their filing fees increased by $150 (from $100 to $250). In addition, there are approximately 250 REITs whose annual filing fee would increase by $225 (from $25 to $250) and approximately 79,000 noncorporate business entities (LLCs, LLPs, and LPs)

that currently do not pay a fee with their annual filing. Based on these numbers, general fund revenues would increase by approximately $43.3 million in fiscal 2004 from fees for annual filings with SDAT. Because it is assumed that industry growth and contraction are roughly equal, out-year revenue projections are also approximately $43.3 million.

Of the business entities that must file annually during fiscal 2003, approximately 25% in each category files their annual reports by June 15 rather than April 15 based on historical filing patterns. Because of the bill's June 1, 2003 effective date, business entities that file after June 1 would be subject to the bill's filing fees. Assuming this, approximately 32,000 Maryland corporations, 7,000 foreign corporations, 50 Maryland and 50 foreign financial institutions, 60 REITs, and 19,800 noncorporate business entities would pay the bill's filing fees in fiscal 2003. This represents approximately $10.8 million in general funds during fiscal 2003.

State Expenditures: The impact on workload and corresponding administrative expenditures by the Comptroller's Office from the corporate tax changes is assumed to be minimal and absorbable within existing resources. The Comptroller's Office advises that it would incur approximately $48,000 in additional programming costs to update the corporate tax form. The Department of Legislative Services advises that since forms and instructions are updated annually, the cost of these changes could be absorbed within existing resources.

SDAT estimates that approximately 45,000 business entities would send their annual filing documents with either the incorrect fee or no fee during June 2003, which is in fiscal 2003. For each of these filings, SDAT would need to send a notice informing the business of the proper fee. Of the notices, approximately 5,000 would be sent during fiscal 2003, and the remainder would be sent in fiscal 2004, accounting for processing time. Assuming this, general fund expenditures for postage would increase by approximately $1,850 in fiscal 2003 and $14,800 in fiscal 2004 because of the bill.

Additional Comments: The fiscal estimates noted above for the corporate income tax provisions reflect full-year collections. It cannot be reliably estimated at this time when the State would begin to recoup a full year of collections, because current "safe harbor" rules could allow affected corporations to defer payment of any additional tax liabilities until such taxes are finally due. To the extent that the State wishes to capture such additional tax revenues in fiscal 2004, an amendment requiring estimated payments based on the new tax liability may be appropriate.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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Analysis by: Matthew D. Riven

Direct Inquiries to:
(410) 946-5510
(301) 970-5510

Exhibit 1
Annual Filing Fees for Corporations and Other Business Entities
Maryland and Nearby Jurisdictions

Entity Type	MD	DE	DC	NC	PA	VA	WVA
Corporations (Stock)	$100	$20+$30-$150,000 based on # of shares	$200 every 2 years	$20	$0	$100-$1,700 based on shares	$25-$100 based on shares
Domestic Limited Liability Companies (LLCs)	$0	$100	$100 every 2 years	$200	$360 per member, professional only	$50	$25
Foreign Limited Liability Companies (LLCs)	$0	$100	$200 every 2 years	$200	$360 per member, professional only	$50	$25
Domestic Limited Partnerships (LPs)	$0	$100	$200 every 2 years	$200	$240 per partner, professional only	$50	$25
Foreign Limited Partnerships (LPs)	$0	$100	$200 every 2 years	$200	$240 per partner, professional only	$50	$25
Domestic Limited Liability Partnerships (LLPs)	$0	$100	$200 every 2 years	$200	$240 per partner, professional only	$50	$25
Foreign Limited Liability Partnerships (LLPs)	$0	$100	$200 every 2 years	$200	$240 per partner, professional only	$50	$25

Note: Pennsylvania applies its fees only to "professional associations."

Sources: Maryland State Department of Assessments and Taxation
Delaware Division of Corporations
District of Columbia Department of Consumer and Regulatory Affairs
North Carolina Department of State (Corporations Division)
Pennsylvania Department of State (Corporations Bureau)
Virginia State Corporation Commission
West Virginia Secretary of State