Department of Legislative Services Maryland General Assembly

2003 Session

FISCAL AND POLICY NOTE

Senate Bill 397 Budget and Taxation (Senator Pinsky, et al.)

Income Tax - Multistate Corporations - Allocation of Nonapportionable Income

This bill alters the allocation of nonapportionable nonoperational income of multistate corporations subject to the State's corporate income tax.

The bill takes effect July 1, 2003 and is applicable to all taxable years beginning after December 31, 2002.

Fiscal Summary

State Effect: The effect on State corporate income tax revenues cannot be precisely estimated at this time; however, it is not unreasonable to anticipate that the bill's provisions could generate additional corporate income tax revenues of \$5 million annually, based on a full year of tax collections. Of this amount, 76% would be credited to the general fund and 24% to the Transportation Trust Fund (TTF).

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.

Analysis

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."

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 only for 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 effect on State corporate income tax revenues cannot be precisely estimated at this time; however, it is not unreasonable to anticipate that the bill's provisions could generate additional corporate income tax revenues of \$5 million annually, based on a full year of tax collections. Of this amount, 76% would be credited to the general fund, and 24% to the TTF. The Comptroller's Office was not able to provide an estimate of the revenue impact.

State Expenditures: The impact on workload and corresponding administrative expenditures 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.

Additional Comments: The fiscal estimates reflect full-year collections. It cannot be reliably estimated at this time when the State would begin to recoup a full year of collections, but 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): Comptroller's Office, Department of Legislative Services

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