SB 727

Department of Legislative Services

Maryland General Assembly
2003 Session

FISCAL AND POLICY NOTE

Senate Bill 727 (Senator Stoltzfus)
Budget and Taxation

Corporate Income Tax - Intercompany Pricing

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) of the U.S. Treasury and to clearly reflect the income of those organizations, trades, or businesses. The Comptroller is required to apply the administrative and judicial interpretations of § 482 of the Internal Revenue Code in administering the bill.

The bill takes effect June 1, 2003 and applies to all taxable years beginning after December 31, 2002.

Fiscal Summary

State Effect: The impact on corporate income tax revenues cannot be reliably estimated at this time and would depend on the number of successful audits. The number of successful audits is assumed to be minimal. Of any additional revenues, 26% would be dedicated to the Transportation Trust Fund (TTF), and the remainder to the general fund.

Local Effect: Local highway user revenues would increase based on the 30% of TTF revenues from any additional corporate income taxes.

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.

Analysis

Current Law: Current law does not expressly authorize the Comptroller to reallocate income, deductions, and other tax attributes between and among related entities. There is no express authority under current law for the Comptroller to challenge a transaction between related entities that does not reflect an arm's length standard. However, where a transaction between related entities is not based on an arm's length standard, the transaction may be subject to challenge by the Comptroller on other grounds under current law, including possibly that the transaction lacks economic substance or that an expense incurred in connection with the transaction is not a necessary and reasonable business expense.

Background: Section 482 of the Internal Revenue Code gives the IRS the authority to do such reallocation among related firms to prevent evasion of taxes or to clearly reflect the income of each of the related firms. Specifically, Section 482-1 (allocation of income and deductions among taxpayers) defines an arm's length standard by stating that "in determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances."

The IRS does this reallocation with the goal of identifying federal corporate income tax liabilities that may be artificially reduced by transactions between related businesses where transfer prices may be established unreasonably high or low. To the extent, however, that transactions between interrelated firms operate to avoid State corporate income taxes, the IRS would have little or no incentive to reallocate those transactions if they would not result in higher federal corporate income tax liabilities.

The Court of Appeals, in the case of *Comptroller v. Gannett Co.*, Inc., 356 Md. 699, 741 A. 2d 1130 (1999), held that the Comptroller could not invoke § 482 of the Internal Revenue Code to impute to a corporation doing business in Maryland interest income from intercompany accounts held between the corporation and its subsidiaries. The Comptroller had attempted in that case to use § 482 to require the taxpayer to restate its taxable income from the number that appeared on its federal consolidated income tax return.

This bill would expressly provide § 482 authority to the Comptroller, but limits the authority to circumstances where the Comptroller determines that the reallocation is necessary to reflect an arm's length standard. As a result, the authority under the bill would not prevent corporations from avoiding the Maryland income tax by shifting income away from the State through the use of Delaware Holding Companies and other common tax avoidance mechanisms, as long as the transactions between the related companies reflected an arm's length standard.

State Revenues: The increase in State corporate income tax revenues from the granting of § 482 authority cannot be reliably estimated at this time. It is not known how many corporations are utilizing the various intercompany transfers and other tax avoidance techniques, and of these transactions, how many reflect something other than an arm's length standard. It is assumed, however, that the vast majority of interagency transactions arguably reflect an arm's length standard, so these transactions would not be covered by this bill. Thus, any corresponding increase in tax revenues from the additional authority under this bill is likely to be minimal. For illustrative purposes, however, the Department of Legislative Services (DLS) notes that the size of these transactions can be quite large. 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), DLS found that an average annual audit identified reduced tax liabilities of $100,000 for the licenses, royalties, and other transactions among related firms (reflecting deductions of approximately $1.4 million).

The Comptroller's Office assumes that the bill could result in an "unknown, possibly significant increase" in revenues.

Additional Information

Prior Introductions: None.

Cross File: None designated.

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

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