SB 398

Department of Legislative Services

Maryland General Assembly
2003 Session

FISCAL AND POLICY NOTE

Senate Bill 398 (Senator Pinsky, *et al.*)
Budget and Taxation

Corporate Income Tax Reform

This bill 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 common State tax avoidance techniques.

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 $20 million to $150 million, with a midrange estimate of approximately $85 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).

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: 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. This apportionment reflects federal constitutional requirements prohibiting a state from taxing value earned outside its borders and requires 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. 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. The 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 precisely 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 approximately $100,000 for the licenses, royalties, and other deductions noted above (reflects 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 of 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 provisions.

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.

State Expenditures: The impact on workload and corresponding administrative expenditures by the Comptroller's Office 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 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): Comptroller's Office, Department of Legislative Services

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