HB 1206

Department of Legislative Services

Maryland General Assembly
2004 Session

FISCAL AND POLICY NOTE

House Bill 1206 (Delegate Ross)
Ways and Means

Corporate Income Tax Reform

This bill requires affiliated corporations to compute Maryland taxable income using "combined reporting," and requires that income attributable to Maryland be derived using a modified "water's edge" method and specifically includes corporations incorporated in a "tax haven" country.

The bill takes effect June 1, 2004 and is applicable to all taxable years beginning after December 31, 2003.

Fiscal Summary

State Effect: Based on estimates from national data and existing Maryland litigation, and reflecting the implementation in tax year 2004, corporate tax revenues could increase by $55 million in FY 2005 and thereafter. Seventy-six percent of this revenue would be dedicated to the general fund, and 24% to the Transportation Trust Fund (TTF). Expenditures would not be affected.

($ in millions)	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
GF Revenue	$41.8	$41.8	$41.8	$41.8	$41.8
SF Revenue	13.2	13.2	13.2	13.2	13.2
Expenditure	$0	$0	$0	$0	$0
Net Effect	$55.0	$55.0	$55.0	$55.0	$55.0

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

Local Effect: See discussion below. Local highway user revenue sharing could increase by an estimated $4.0 million annually.

Small Business Effect: Minimal overall, but potentially meaningful in limited circumstances. It is assumed that most of the affected taxpayers will not be small businesses; however, any small businesses subject to the corporate income tax provisions could be meaningfully affected.

Analysis

Bill Summary: For tax years beginning after 2003, 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.

The bill provides that a unitary group for purposes of the combined reporting method must include "a corporation that is in a unitary relationship with the taxpayer and is incorporated in a tax haven country." "Tax haven country" is defined as any of a specific list of countries. The Comptroller is required to report each year on which countries should be considered tax haven countries and provide draft legislation to update the list.

The bill requires corporations that are members of an affiliated or controlled group, if requested to do so by the Comptroller, to provide a statement of all intermember costs, expenses, sales, exchanges, or other transactions involving tangible or intangible property for a given tax year and the amount reported by each member of the affiliated or controlled group to each state and tax haven jurisdiction including the tax liability and allocation or apportionment method employed.

Current Law: In general, the Maryland corporate income tax is computed using federal provisions to determine income and deductions. Maryland is a "unitary business" state, in that a corporation is required to allocate all its Maryland income (that portion that is "derived from or reasonably attributable to its trade or business in the State") attributable to the corporation's "unitary business." 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, however, 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 separately incorporated affiliate* are used to determine each affiliate's Maryland taxable income. The net income and apportionment factors of other 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: Separate reporting poses problems for tax administration because 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. In particular, corporations may use Delaware Holding Companies (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 most circumstances.) Similarly, the Maryland company may be required to pay license or royalty fees to the DHC, which may serve as the holder of trademarks or other intangible assets. The fees paid by the Maryland firm are deductible, while the income from intangible assets is generally not taxable in Delaware and certain other jurisdictions.

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-entity business is computed and apportioned in the same manner as in the case of a single-entity 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. For these reasons, combined reporting is viewed as a more comprehensive approach to addressing State corporate tax avoidance techniques than proposals that address specific expense deductions associated with different types of transactions between related members of the same corporate family.

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. If an affiliate were 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.

In a decision filed June 9, 2003 (*Comptroller of the Treasury v. SYL, Inc., Comptroller of the Treasury v. Crown Cork & Seal Company (Delaware) Inc.*), the Maryland Court of Appeals ruled that two corporations doing business in Maryland could not use Delaware holding companies to shelter income earned in Maryland from the Maryland income tax. The court found that even though the two subsidiary corporations did no business in Maryland, other than licensing intellectual property for use in Maryland, and owned no tangible property in Maryland, there was a sufficient nexus between the State and the two out-of-state subsidiary corporations so that the imposition of the Maryland income tax does not violate either the Commerce Clause of the U.S. Constitution or principles of due process.

The Court of Appeals held that an appropriate portion of the income of each of the Delaware holding companies was subject to Maryland income tax. The court found that the Delaware holding companies had "no real economic substance as separate business entities" and that "sheltering income from state taxation was the predominant reason for the creation" of the out-of-state subsidiaries. The U.S. Supreme Court subsequently denied the petitions of SYL, Inc. and Crown Cork and Seal to review their cases.

The amount involved in these two cases was a little over $2 million, representing tax assessments against these two Delaware holding companies for tax years between 1986 and 1993. The decision, however, has implications for approximately 70 cases pending or scheduled for hearings before the Tax Court, involving approximately $79 million in tax assessments, interest, and penalties for prior tax years. The Comptroller offered favorable settlement terms (including a reduced interest rate on penalties) for firms settling prior to December 31, 2003 and remitting payment by January 30, 2004. So far, approximately $9 million has been paid, with taxpayers accounting for at least $47 million worth of liability rejecting the settlement offer. The decision also affects several dozen other related cases that are currently under administrative review by the

Comptroller, and the Comptroller is negotiating with these firms as well. These firms have until March to settle with the Comptroller.

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.

A similar "tax haven" provision has been enacted in Montana.

State Revenues: It is not known how many corporations are utilizing tax avoidance long-term techniques that would become moot under the bill. The Multistate Tax Commission (MTC) produced a study this summer examining the nationwide impact of state corporate income tax avoidance strategies. For Maryland, it estimated a revenue loss of $75 million to $161 million. (This estimate included all tax avoidance strategies and circumstances, including issues of "nowhere" income that are not covered by this bill.) The MTC estimate is consistent with estimates developed by other states that have eliminated (or proposed eliminating) these techniques, and with the Comptroller's existing litigation discussed above. Assuming the low end of the MTC estimate and taking into account that not all tax avoidance is covered under the bill, Maryland's corporate income taxes could increase by $55 million on an annualized basis.

Based on these assumptions, and the implementation for tax year 2004, it is reasonable to assume additional total corporate tax revenues of $55 million annually beginning in fiscal 2005. Based on the existing statutory formula providing that 76% of revenues go to the general fund and 24% to the TTF, $41.8 million in additional revenues would be realized to the general fund, and $13.2 million to the TTF. It should be noted that by taking a more comprehensive approach to State tax avoidance than the more limited anti-DHC provisions, there is the potential for even greater revenue increases than estimated here. There is also the likelihood of increased future robustness of corporate tax revenues, because future tax avoidance strategies would be more effectively forestalled.

The Comptroller's Office did not provide a fiscal estimate, although acknowledges that combined reporting would "help to eliminate illegitimate transactions between related entities and holding companies." The Comptroller also notes that combined reporting could also bring in losses of entities that are unrelated to the Maryland business and would have been excludable from Maryland income under current law. Legislative Services notes that while the possibility of imported losses is possible, they are likely far more than outweighed by the impact of current tax avoidance planning. Legislative Services also notes that enactment of prospective combined reporting legislation could encourage additional settlement of the existing DHC litigation discussed above.

MTC estimated an additional State tax loss of $90 million attributable to international tax sheltering beyond the estimates discussed above. Any additional Maryland revenues from this provision cannot be reliably estimated at this time, but could be significant if enforcement issues can be overcome.

The Governor's fiscal 2005 revenue estimate, as reflected in his budget, assumes additional general fund revenue (above the Bureau of Revenue Estimates' base estimate) of $83.6 million from "corporate income tax." The Administration advises that of this $84 million, $64 million is one-time revenue related to collection of delinquent payments based on the court cases discussed above. The remaining $20 million is estimated to be ongoing general funds resulting from enactment of corporate income reform provisions such as this one. This $20 million in general funds implies total additional corporate tax revenues of $26 million based on the split between general funds and TTF revenues.

State Expenditures: The Comptroller's Office advises that it could implement the bill's provisions with existing budgeted resources.

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 $4.0 million in fiscal 2005 and thereafter.

Small Business Effect: Most taxpayers subject to the corporate income tax changes are not small businesses; however, if a small business were subject, they could be meaningfully affected.

Additional Information

Prior Introductions: None.

Cross File: SB 727 (Senator Ruben, *et al.*) – Budget and Taxation.

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

Fiscal Note History: First Reader - February 24, 2004
ncs/jr

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