HB 1037

Department of Legislative Services

Maryland General Assembly
2004 Session

FISCAL AND POLICY NOTE

House Bill 1037 (Delegate Hixson, *et al.*)
Ways and Means

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 State tax avoidance techniques.

The bill takes effect July 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, corporate tax revenues could increase by $37 million in FY 2005, $46 million in FY 2006, and $55 million in FY 2007 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	$27.9	$34.8	$41.8	$41.8	$41.8
SF Revenue	8.8	11.0	13.2	13.2	13.2
Expenditure	$0	$0	$0	$0	$0
Net Effect	$36.7	$45.8	$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 each year upon full annualization.

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: The bill authorizes 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 U.S., 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 and to clearly reflect the income of those organizations, trades, or businesses (known as "Section 482 authority"). The Comptroller is required to apply the administrative and judicial interpretations of § 482 of the Internal Revenue Code in administering the provision.

The bill requires a corporation, for purposes of determining Maryland taxable income, to add back to its taxable income any otherwise deductible interest expense or intangible expense paid directly or indirectly to one or more related members, as defined, unless the corporation establishes by clear and convincing evidence that: (1) the transaction did not have as a principal purpose the avoidance of tax; (2) the interest expense was paid pursuant to an arm's length rate or price; and (3) either: (a) the related member paid or incurred the interest or intangible expense to an unrelated person; (b) the related member paid state (or foreign) taxes in the aggregate on the amount received at an effective rate of at least 4%; or (c) in the case of an interest expense, the related members are banks.

An "intangible expense" is defined as: (a) an expense, loss, or cost for, related to, or in connection directly or indirectly with, the direct or indirect acquisition, use, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property, to the extent the expense, loss, or cost is allowed as a deduction or cost in determining taxable income for the taxable year under the Internal Revenue Code; (b) a loss related to or incurred in connection directly or indirectly with factoring transactions or discounting transactions; (c) a royalty, patent, technical, or copyright fee; (d) a licensing fee; and (e) any other similar expense or cost. "Intangible property" is defined as patents, patent applications, trade names, trademarks, service marks, copyrights, and similar types of intangible assets.

The disallowance of the deduction for these intangible expenses does not apply to any intangible expense to purchase, license, develop, or protect patents, trade secrets, copyrights, or trademarks used in the biotechnology industry.

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

Current Law: Under current Maryland law, if a multistate firm is a "unitary business," the corporation is required to allocate its income to Maryland using an apportionment fraction (discussed below). (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.) However, the application of the unitary business principle is limited in Maryland, because the multistate firm may have various, separately-incorporated affiliates, each of which 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 affiliated 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 are not doing business in the State and lack nexus with the State, those affiliated corporations are not taxed by the State.

Background: So-called "Delaware holding companies" are out-of-state subsidiaries established in Delaware (or in other states providing similar tax advantages) by companies operating in Maryland to hold and manage intangible assets. Because Delaware does not tax such companies on the income generated by trademarks, intellectual property, and other intangible assets, Delaware holding companies have been used by Maryland operating companies to attempt to shelter income from the Maryland corporate income tax. Companies seek to reduce state income tax liability in Maryland and other states by putting intangible assets such as trademarks and other intellectual property in a corporate subsidiary in Delaware. The Maryland operating company then pays the subsidiary for the right to use the trademarks or other intangible assets, resulting in an expense deduction for the Maryland operating company that reduces its Maryland taxable income.

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.

State Revenues: It is not known how many corporations are utilizing the tax avoidance techniques the deductions for which would be disallowed under the bill. The Multistate Tax Commission (MTC) produced a study this summer examining the nationwide impact of these 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 commission estimated an additional State tax loss of $90 million attributable to international tax sheltering.

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. Given the required changes to corporate tax practices and the timing of corporate tax filings, it could take several fiscal years for the full impact of the provisions to be realized.

The bill also requires that, for a taxable year beginning after December 31, 2003 but before January 1, 2005, the Comptroller assess interest and penalties if a corporation pays estimated income tax for the taxable year in an amount less than 90% of the tax required to be shown on the corporation's income tax return for the taxable year. The provision will accelerate receipt of any additional prospective tax liabilities where they might otherwise be deferred to subsequent fiscal years due to existing safe harbor provisions.

Based on these assumptions, and the change to the safe harbor provisions, total corporate tax revenues could increase by $38 million in fiscal 2005, $46 million in fiscal 2006, and $55 million in fiscal 2007 and thereafter. Based on the existing statutory formula providing that 76% of revenues go to the general fund and 24% to the TTF, additional revenues would be realized as follows:

Estimated Additional Revenues by Fund Source Based on Assumed Increase in Corporate Income Tax Collections
($ in millions)

	Fiscal 2005	Fiscal 2006	Fiscal 2007 and Thereafter
General Fund	$27.9	$34.8	$41.8
TTF	8.8	11.0	13.2
Total	**$36.7**	**$45.8**	**$55.0**

The Comptroller's Office estimates that the anti-DHC provision could increase revenues by $25 million, or more, annually. Enactment of prospective legislation could encourage additional settlement of existing litigation, as discussed above. The Comptroller also notes, however, that the exemption of banks and biotechnology companies from the required addition modification could significantly reduce revenues through the legitimization of holding companies for these entities. The Comptroller notes that banks paid at least $16.7 million in corporate taxes for tax year 2001; the amount of taxes paid by biotechnology firms could not be readily determined, but could also significantly reduce future revenues.

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 would incur approximately $50,000 in one-time computer reprogramming expenditures to add one additional line to the corporate tax form and add capability to gather the resulting information. The Comptroller has previously indicated that it could implement similar corporate tax changes 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 $2.6 million in fiscal 2005, $3.3 million in fiscal 2006, and $4.0 million in fiscal 2007 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: None.

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

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