SB 187

Department of Legislative Services

Maryland General Assembly
2004 Session

FISCAL AND POLICY NOTE
Revised

Senate Bill 187 (The President) (By Request – Administration)
Budget and Taxation Ways and Means

Office of the Comptroller - Tax Compliance - Settlement Period

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This bill creates a statutory settlement period for the Comptroller to settle specified litigation, with provisions regarding penalties and interest, and forgiveness of specified tax assessments. The bill takes effect July 1, 2004 and is contingent on enactment of HB 297.

Fiscal Summary

State Effect: The bill's settlement provisions cannot be reliably estimated at this time and will depend on individual taxpayers' evaluation of the attractiveness of the Comptroller's current negotiations versus the provisions of this bill. In some instances, revenues may be collected sooner under the statutory settlement than they would be under the ongoing litigation and negotiations.

Local Effect: To the extent that corporate tax revenues increase under the corporate tax law changes, then 30% of any additional Transportation Trust Fund (TTF) revenues would be distributed to local governments based on the State's highway user revenue sharing.

Small Business Effect: The Administration has determined that this bill has minimal or no impact on small business (attached). Legislative Services concurs with this assessment. (The attached assessment does not reflect amendments to the bill.)

Analysis

Bill Summary: The bill requires the Comptroller to administer a settlement period from July 1, 2004 through November 1, 2004 applicable to State corporate income tax that has been or may be assessed by the Comptroller on the basis of issues that were ruled on by the Maryland Court of Appeals in the decisions in *Comptroller of the Treasury v. SYL, Inc.*, and *Comptroller of the Treasury v. Crown Cork & Seal Company (Delaware), Inc.*, 375 Md. 78 (2003).

The bill allows a taxpayer to elect whether to have additional income tax calculated as though otherwise deductible payments were added back to the paying taxpayer's federal taxable income, or as though the receiving taxpayer were subject to the State corporate income tax. The Maryland income tax may not be imposed more than once for the same transaction. The Comptroller is required to waive all penalties attributable to the taxes paid during the settlement period. The Comptroller is prohibited from assessing interest on taxes paid during the settlement period at a rate exceeding 6.5%.

If all taxes and related interest described above are paid during the settlement period for the taxpayer's taxable years beginning on or after January 1, 1995, and ending on or before December 31, 2003, then no assessment for any taxable year beginning before January 1, 1995 may be enforced.

Current Law: In the above two decisions, 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.

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.

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 tax years from 1982 through 1996. (These firms are also estimated to have an additional $90 million of liability for the period from 1997 to the present.)

The Comptroller offered favorable settlement terms (including a reduced interest rate on penalties) for firms settling pre- and post-1997 tax liabilities prior to December 31, 2003 and remitting payment by January 30, 2004. So far, approximately $9 million of pre-1997 tax liabilities 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.

House Bill 297 includes several measures designed to prospectively prevent corporations from avoiding corporate income tax by shifting income away from the State through the use of Delaware holding companies and other State tax avoidance techniques.

State Revenues: The fiscal impact of the bill's settlement provisions cannot be reliably estimated at this time and will depend on individual taxpayers' evaluation of the attractiveness of the Comptroller's current negotiations versus the provisions of this bill. In some instances, revenues may be collected sooner under the statutory settlement than they would be under the ongoing litigation and negotiations.

The Governor's fiscal 2005 revenue estimate, as reflected in the budget, assumes additional general fund revenue (above the Bureau of Revenue Estimates' base estimate) of $83.6 million from "corporate income tax," of which $64 million is one-time revenue related to collection of delinquent payments based on the court cases discussed above.

Under the bill, any firms that, during the settlement period, settle disputed tax liability from 1997 to the present would be absolved of any prior liability. Thus, theoretically, the full $79 million of pre-1997 liability could be lost as a result of the bill, including the $9 million already paid, which would have to be refunded. In practice, as noted above, a significant number of taxpayers have rejected the Comptroller's settlement offer. The

Comptroller will be required to pursue these taxpayers in court, and litigation could drag on for several years, with the outcome not assured. The Comptroller thus may never recoup the full $79 million but only some portion thereof.

Offsetting the losses from the bill's forgiveness of pre-1997 liabilities is the possibility that additional firms may use the settlement period to settle liabilities for the period from 1997 to the present. The reduced interest, and waived penalty, may cause revenues to be realized more quickly from a settlement, even if the Comptroller were to ultimately prevail in litigation with individual taxpayers.

Based on the current distribution of corporate income taxes, 76% of any additional revenue would be dedicated to the general fund and 24% to the TTF.

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: HB 297 (The Speaker and the Minority Leader) (By Request – Administration) – Ways and Means.

Information Source(s): Department of Legislative Services

Fiscal Note History:	First Reader - February 23, 2004
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