SB 341

Department of Legislative Services
Maryland General Assembly
2005 Session

FISCAL AND POLICY NOTE

Senate Bill 341 (Senator Miller, *et al.*)
Budget and Taxation Ways and Means

Income Tax - Corporations - Payments to Related Entities - Foreign Taxes

This bill expands, by including taxes paid to foreign governments, existing exemptions to the requirement that specified corporations add back intangible transfers to holding companies.

The bill takes effect July 1, 2005 and applies to tax year 2005 and beyond.

Fiscal Summary

State Effect: Indeterminate decrease in State general fund and special fund revenues beginning in FY 2006. No effect on expenditures.

Local Effect: Local revenues would decline as a result of decreased local highway revenues distributed from the corporate income tax.

Small Business Effect: None.

Analysis

Current Law: The Comptroller can 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 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.

A corporation, for purposes of determining Maryland taxable income, is required 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 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 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. The bill defines the manner by which the 4% effective rate is calculated, provides for an alternate calculation of the 4% effective tax rate under certain circumstances, and grants the Comptroller the authority to determine by regulation additional alternative calculations if necessary.

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.

Background: So-called "Delaware holding companies" (DHCs) 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, DHCs 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 response to these DHCs, Chapter 556 of 2004 included several measures designed to prevent corporations from avoiding the Maryland corporate income tax by shifting

income away from the State through the use of DHCs and other State tax avoidance techniques.

Chapter 557 of 2004 created a statutory settlement period for the Comptroller to settle DHC-related litigation. The Comptroller was required to waive all penalties attributable to the taxes paid during the settlement period and prohibited from assessing interest on taxes paid during the settlement period at a rate exceeding 6.5%. If all required taxes and interest were paid for taxable years beginning with 1995 during the settlement period, then no assessment could be made for tax years prior to 1995. The settlement period was from July 1, 2004 through November 1, 2004.

By the end of the settlement period, the Comptroller's Office received applications on behalf of 443 corporate entities. The Comptroller approved approximately $207.8 million in settlement payments from the 443 applicants and approximately $9 million in refunds for a net amount of approximately $198.7 million. Of this amount, approximately $151 million was deposited into the State's general fund and $48 million to the Transportation Trust Fund.

State Revenues: The amount of the revenue loss caused by the bill, which is unknown, depends on the number of companies affected and the amount of intangible transfers that would not be subject to State taxation.

The Board of Revenue Estimates estimates that the requirements of Chapter 556 of 2004 that specified parent companies add back intangible transfers to holding companies increases corporate income tax revenues by $30 million annually. The Comptroller's Office advises that it is not known how many companies would be affected by the provisions of this bill but, of the DHC-related audits conducted, the intangible transfers were to companies located in the United States and the companies who accepted the settlement offer were typically transferring money to companies in Nevada and Delaware.

In addition, the Comptroller retains the ability to require intangible related add-backs if the Comptroller decides that the transfer is an attempt to avoid State taxes.

Additional Information

Prior Introductions: None.

Cross File: HB 638 (Delegate Barve) – Ways and Means.

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

Fiscal Note History: First Reader - February 23, 2005
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