Department of Legislative Services

Maryland General Assembly
2005 Session

FISCAL AND POLICY NOTE

Senate Bill 403 (Senator Pinsky, *et al.*)
Budget and Taxation

Corporate Income Tax Reform - Combined Reporting

This bill requires affiliated corporations to compute Maryland taxable income using "combined reporting," and requires that income attributable to Maryland be derived using a "water's edge" method.

The bill takes effect July 1, 2005 and applies to tax year 2006 and beyond.

Fiscal Summary

State Effect: Any increase in general fund and Transportation Trust Fund revenues cannot be reliably estimated at this time. No effect on expenditures.

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

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: Beginning in tax year 2006, 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 taxable income as the starting point. 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: Sixteen states currently require combined reporting for affiliated companies. Proponents of combined reporting state that it is effective in limiting certain tax-avoidance strategies. These strategies include passive investment companies (also known as Delaware holding companies), transfer pricing schemes, intangible asset spin-offs, and isolating profitable activities from nexus in the State. Delaware holding companies (DHCs) are out-of-state subsidiaries established in Delaware (or other states providing similar tax advantages) by companies operating in Maryland to hold and manage assets.

In response to these strategies, 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 technique. 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.

State Revenues: The amount of revenue increase caused by the bill, which is unknown, depends on the additional tax revenues collected from affiliated corporations who would be required to compute Maryland taxable income using combined reporting. The bill applies beginning with tax year 2006. Any increase in revenues would begin in fiscal 2007.

The bill would require companies to calculate Maryland taxable income by disregarding transactions between members of a unitary group. While this provision would go beyond the provisions enacted by Chapter 557 of 2004, the extent of revenue gain cannot be reliably estimated. In addition, the Comptroller's Office 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 losses could be imported, they are more likely outweighed by the impact of bringing in additional income to the State.

Additional Information

Prior Introductions: None.

Cross File: HB 676 is listed as a cross file but the bills are not identical.

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

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