HB 553

Department of Legislative Services
Maryland General Assembly
2007 Session

FISCAL AND POLICY NOTE

House Bill 553 (Delegate Ross, *et al.*)
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, 2007 and applies to tax year 2007 and beyond.

Fiscal Summary

State Effect: The extent of any State revenue gain depends on the net change in corporate tax liabilities and cannot be reliably estimated. Based on national estimates and estimates for other states, corporate income tax revenues could increase by approximately $25 million annually beginning in FY 2008, which reflects a $19 million increase in general funds and a $6 million increase in Transportation Trust Fund (TTF) revenues.

Local Effect: Based on the assumptions above, local highway user revenues could increase by approximately $1.8 million annually beginning in FY 2008. Expenditures would not be affected.

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 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 "United States corporations" (corporations incorporated in the United States 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 being identified by the Organization for the Economic Co-operation and Development (OECD) as a tax haven or having a harmful preferential tax treatment or is identified by the Comptroller as exhibiting the characteristics of a tax haven established by the OECD, regardless of whether the jurisdiction is listed as a tax haven by the OECD.

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 in the case of affiliated groups of related corporations because of the requirement that each separate corporation must file a separate income tax return and determine its own taxable income on a separate basis. For a multi-corporate group, the unitary business principle is restricted to consider only the isolated income and business activities of each separate legal entity. Even though the activities of related corporations may constitute a single unitary business, the affiliated corporations that lack nexus with the State (or are protected from taxation by P.L. 86-272) are not subject to the State's income

tax and neither the net income nor the apportionment factors of those affiliated corporations are taken into account on the corporate income tax return of any related corporation that is subject to the tax.

Background: The following is a brief discussion of national corporate income tax trends, combined reporting in other states, Maryland corporate income tax revenues, Delaware holding company legislation, and the potential fiscal effects of combined reporting.

National Corporate Income Tax Trends

Recently, state corporate income taxes have become the subject of renewed interest to both state and federal policymakers. The cause of this elevated interest may be the gradual decline in revenue generated by the tax as compared to other revenue sources, as well as the expansion of electronic commerce and federal tax policy changes that affect state corporate income taxes. While state corporate income taxes represent a relatively small portion of total state tax revenue in most states (less than 5.2% of total state tax revenue in 2003), corporate income taxes still generated $28.5 billion in 2003. On average, from fiscal 1994 to 1998, states collected approximately $29.2 billion in corporate income tax revenues – 5.3% of all own-source revenues and 22% of personal income taxes collected. From fiscal 1999 to 2003, states collected, on average, $29.7 billion in corporate income tax revenues, representing 4.2% of all own-source revenues and 16% of total personal income taxes collected.

Researchers have employed a variety of measures to assess corporate income tax revenues relative to other factors, including gross domestic product (GDP), corporate profits before taxes, and total taxes collected by states. These measures show that total corporate income tax revenues have declined relative to other state revenue collections and economic activity. For example, from fiscal 1972 to 1981, total state corporate income tax revenues comprised an annual average of 0.43% of GDP, compared with 0.33% of GDP from fiscal 1994 to 2003.

Combined Reporting in Other States

Seventeen states currently provide for mandatory combined reporting: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, Utah, and Vermont. In addition, in several other states, under certain circumstances, combined or "consolidated" reporting either is required, allowed at the election of the taxpayer, or may be required at the discretion of the tax administrator. Several states have considered adopting mandatory

combined reporting in the past few years; these include Connecticut, Iowa, Massachusetts, Missouri, Pennsylvania, and Wisconsin.

Maryland's Corporate Income Tax

Every Maryland corporation and every other corporation that conducts business within Maryland must pay the corporate income tax, assessed at a rate of 7%. The tax base is the portion of federal taxable income, as determined for federal income tax purposes and adjusted for certain Maryland addition and subtraction modifications, that is allocable to Maryland. Federal taxable income for this purpose is the difference between total federal income and total federal deductions (including any special deductions). The next step is to calculate a corporation's Maryland taxable income. The Maryland taxable income of a corporation that operates wholly within the State is equal to its Maryland modified income. Corporations engaged in multistate operations are required to determine the portion of their modified income attributable to Maryland, based on the amount of their trade or business carried out in Maryland. Corporations are generally required to use either a double weighted sales factor (payroll and property being the other factors) or, in the case of a manufacturing corporation, a single sales factor. The apportionment factor is multiplied by a corporation's modified income to determine Maryland taxable income. The Maryland tax liability of a corporation equals the Maryland taxable income multiplied by the tax rate less any tax credits.

In fiscal 2006, corporate income tax revenues totaled $820 million. Consistent with the increase in corporate profitability nationwide, corporate income tax revenues have more than doubled since fiscal 2003. The Board of Revenue Estimates projects, however, that corporate income tax revenues will remain at or below fiscal 2006 collections through fiscal 2011.

Delaware Holding Company (DHC) Legislation

Chapter 556 of 2004 restricts the ability of corporations to use DHCs to shift income away from the State for tax purposes. Chapter 556 requires an addition modification under the Maryland corporate income tax for the amount of specified payments made to a related party that are deducted for federal income tax purposes. Additional legislation, Chapter 557 of 2004, created a statutory settlement period for the Comptroller to settle DHC-related litigation.

Based on limited data so far, the Comptroller's Office estimated that Chapter 556 increased corporate income tax revenues by approximately $40 million in tax year 2004. The amount of annual revenue gain, however, is expected to decline over time as fewer corporations are expected to utilize these types of transactions and perhaps employ other

tax planning strategies. The settlement period netted approximately $199 million in one-time revenues, $151 million for the general fund, and $48 million for the TTF.

DHC legislation addressed one well-publicized technique for avoiding state income tax in a "separate reporting" jurisdiction such as Maryland. However, the legislation does not address other strategies including other uses of DHCs not addressed by the 2004 Maryland legislation, "transfer pricing" manipulation, and the use of subsidiaries to isolate profitable activities of an enterprise from nexus with the State.

Combined Reporting Revenue Effects

Over the years, there has been considerable uncertainty as to the fiscal impact of combined reporting. In the case of corporate income taxes, due to the volatility of profits over time and sensitivity to corporate structure and inter-company transactions, the accepted form of revenue estimation is to directly simulate the tax accounting changes to a representative panel of sample tax returns. Due to the confidentiality of tax return data, however, the Department of Legislative Services lacks access to this data.

The Pennsylvania Department of Revenue recently produced an in-depth fiscal estimate of implementing combined reporting in that state using actual tax data. The Department of Revenue estimated the impact of combined reporting by matching the tax returns of corporations that filed in Pennsylvania to federal return data and data from the Minnesota Department of Revenue, which requires combined reporting.

The Department of Revenue estimated a variety of policies combined with implementing combined reporting; Pennsylvania limits to $2 million the amount of net operating losses a corporation can carry forward. The department estimated that combined reporting would generate an additional $480 million in annual corporate income tax revenues with the net operating loss limitation in place. If the net operating loss provision was repealed, however, combined reporting generated an additional $190 million annually in corporate income taxes.

The Pennsylvania analysis estimated that larger corporations would bear a larger share of the increased tax burden under combined reporting. **Exhibit 1** lists the expected distributional effect by the federal income of a corporation filing in Pennsylvania.

Exhibit 1
Combined Reporting Tax Impact in Pennsylvania, by Federal Income Size

Federal Income	Percentage of Additional Tax Revenues
Negative	-0.5%
$0	0.0%
$1 to $1 million	0.7%
$1 million – $10 million	3.2%
$10 million – $100 million	16.4%
$100 million – $1 billion	63.7%
Greater than $1 billion	16.5%

Source: Pennsylvania Department of Revenue

Unlike Maryland, Pennsylvania does not currently have statutory provisions designed to prevent tax planning strategies employed by utilizing DHCs. The Pennsylvania Department of Revenue, in a separate analysis, estimated that Pennsylvania loses $100 million annually from the use of DHCs.

The Multistate Tax Commission (MTC) concluded in a recent study that "various corporations are increasingly taking advantages of structural weaknesses and loopholes in the state corporate tax system." The MTC estimated that in 2001, states lost $12.4 billion, or 35% of total collections, to tax avoidance techniques. Commonly employed tax avoidance strategies include the use of related entities to shield income and taking advantage of differences in state corporate tax policies to create "nowhere" income that is never taxed by any state. 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.)

"Tax Haven Countries"

In 1998, the OECD issued "*Harmful Tax Competition – An Emerging Global Issue.*" This report established an international framework to counter the spread of "harmful tax competition." The OECD has issued periodic progress updates, and in 2000, the OECD Committee on Fiscal Affairs identified numerous countries that had "harmful preferential tax regimes." Subsequently, the OECD determined that 33 jurisdictions have made

commitments to transparency and effective exchanges of information and are considered co-operative jurisdictions. The OECD still determines that Andorra, Liberia, Liechtenstein, the Marshall Islands, and Monaco are uncooperative tax havens.

Increasing globalization has spurred the growth of offshore financial centers (OFCs). OFCs are typically smaller jurisdictions where most of the companies are controlled by nonresidents that are primarily finance-related and attract investment by offering low-taxes with business-friendly regulation. Examples include Bermuda, Jersey, and the British Virgin Islands. While disagreement exists, when a jurisdiction combines the characteristics of an OFC with strict banking secrecy laws and little regulation or oversight it is typically labeled a “tax haven” country.

Critics contend that OFCs and tax haven countries allow corporations and wealthy individuals to avoid taxes and shift resources away from “real economies” and that the limited regulation enables increased criminal activity and corporate malfeasance. On the other hand, others argue that OFCs facilitate legitimate business transactions, such as captive finance in the Bermudas, provide competition that limits taxation in other countries, and that other countries have lax regulation and treatment of foreign income. For example, in the United States few states examine the true owner of corporations registered in the state, with Delaware and Nevada offering particularly low levels of scrutiny. In addition, the United States imposes low taxes on the money held in banks by nonresidents. These deposits total $2.5 trillion, over twice the amount of foreign deposits in Switzerland.

Unlike most of the OECD, the United States imposes a worldwide tax system where the profits of a company are taxed regardless of origin. Corporations are provided a credit for foreign taxes paid in order to prevent double taxation. The other tax system used is territorial – where only in-country profits are taxed. While both systems are subject to international tax avoidance, four common methods that utilize tax havens under a worldwide tax system include: (1) sending money to a tax haven and keeping it there; (2) establishing a new company in a tax haven; (3) creating a company in a tax haven in a tax neutral manner from the sale of assets located in another country; and (4) shifting profits from higher-tax countries to a tax haven. Of these methods, the last method is the most common and includes either transferring a company’s financial risk (and potential future profits) to a tax haven or exploiting ambiguities in the transfer-pricing rules which govern how multinationals divide up profits among the countries they operate in.

Determining where a company creates value, and thus where profits should be taxed, is difficult at best due to the complexity of valuing mobile intangible assets such as patents. Companies have a lot of latitude in setting the price that subsidiaries charge each other for goods and services, creating large opportunities to shift profits away from higher-tax

countries given that close to 60% of all international trade is conducted within multinational corporations.

Recent federal legislation provided a tax amnesty that allowed U.S. companies with overseas operations to repatriate profits and pay 5.35% in corporation tax rather than the full rate of 35%. In response, American companies repatriated close to $350 billion in previously untaxed foreign profits. These earnings came from a variety of countries, including countries that although provide a low tax structure, are not considered tax havens. For example, an estimated 18.2 billion euros (US $22.7 billion) was repatriated from the Republic of Ireland.

State Revenues: The amount of revenue increase caused by the bill, which cannot be reliably estimated at the time, depends on the additional tax revenues collected from affiliated corporations who would be required to compute Maryland taxable income using combined reporting. The provisions of the bill apply beginning with tax year 2007. Any increase in revenues would begin in fiscal 2008.

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.

Based on revenue estimates for combined reporting in other states, the MTC estimate of Maryland corporate income tax revenue lost to tax sheltering, and the effect of the estimated increase in revenue due to the DHC law, Legislative Services estimates that this increase could range from $25 to $50 million annually, with the lower range of the estimate more likely in the near term. To the extent that corporations employ alternative tax planning strategies in the future not covered by the DHC law, revenue increases from implementing combined reporting will be greater.

The Multistate Tax Commission estimated a State tax loss of $90 million attributable to all international tax sheltering. The bill's provisions, however, apply to a limited number of tax havens. Given the likely limited number of corporations involved and enforcement difficulties, any revenue gain from this provision of the bill is likely to be minimal.

Additional Information

Prior Introductions: Similar bills were introduced in the 2006, 2005, and 2004 sessions. HB 76 of 2006 was not reported from the House Ways and Means Committee. HB 62 of 2005 received an unfavorable report from the House Ways and Means Committee. SB 727/HB 1206 of 2004 were not reported from the Senate Budget and Taxation and House Ways and Means committees, respectively.

Cross File: None.

Information Source(s): Comptroller's Office, U.S. General Accounting Office, U.S. Internal Revenue Service, Multistate Tax Commission, Organization for Economic Co-operation and Economic Development, Pennsylvania Department of Revenue, *The Economist*, United Nations Conference on Trade and Development, Department of Legislative Services

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