Department of Legislative Services
Maryland General Assembly
2007 Special Session

FISCAL AND POLICY NOTE

House Bill 16 (Delegate Ross)
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 January 1, 2008 and applies to tax year 2008 and beyond.

Fiscal Summary

State Effect: General fund revenues would increase by $27.7 million in FY 2009 and by $33.5 million in FY 2012. Transportation Trust Fund revenues could increase by $8.7 million in FY 2009 and by $10.6 million in FY 2012. General fund expenditures could increase by $114,400 in FY 2008 due to implementation costs at the Comptroller's Office.

($ in millions)	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
GF Revenue	$0	$27.7	$28.0	$31.5	$33.5
SF Revenue	0	8.7	8.8	9.9	10.6
GF Expenditure	.1	0	0	0	0
Net Effect	($.1)	$36.4	$36.8	$41.4	$44.1

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Local highway user revenues could increase by approximately $2.6 million in FY 2009 and by $3.2 million in FY 2012. 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. A corporation that is a member of a unitary group must 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 apportionment determined under item 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 OECD, regardless of whether the jurisdiction is listed as a tax haven by 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 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 combined reporting in other states, Maryland corporate income tax revenues, recent corporate tax compliance legislation, the potential fiscal effects of combined reporting, and "tax havens."

Corporate Income Tax Rates in Surrounding States

Exhibit 1 lists the corporate income tax rates in Maryland and surrounding states.

Exhibit 1
Corporate Income Tax Rates
Maryland and Surrounding States
Tax Year 2007

State	Tax Rate
Pennsylvania	9.990%
District of Columbia	9.975%
New Jersey	9.000%
West Virginia	8.750%
Delaware	8.700%
Maryland	**7.000%**
North Carolina	6.900%
Virginia	6.000%

Maryland's Corporate Income Tax

Every Maryland corporation and every corporation that conducts business within Maryland, including public service companies and financial institutions, are required to pay the corporate income tax. 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 2007, corporate income tax revenues totaled $776 million. Consistent with a national increase in corporate profitability and statutory changes, State corporate income tax revenues have more than doubled in the last five years. However, Legislative Services estimates that corporate income tax revenues will remain relatively flat through fiscal 2013.

Recent Tax Compliance Legislation

Corporate income tax compliance legislation enacted in 2004 and 2007 addressed two well-publicized techniques for avoiding State income tax in a "separate reporting" jurisdiction such as Maryland – Delaware Holding Companies (DHCs) and captive Real Estate Investment Trusts (REITs).

Chapter 556 of 2004 restricted the ability of corporations to use DHCs to shift income away from the State for tax purposes. Additional legislation, Chapter 557 of 2004, created a statutory settlement period for the Comptroller to settle DHC-related litigation. The Comptroller's Office estimates that Chapter 556 has increased corporate income tax revenues by $40 million annually. The settlement period netted approximately $199 million in one-time revenues, $151 million for the general fund, and $48 million for the Transportation Trust Fund.

In response to reports that some retailers and banks were employing captive REITs to avoid income taxes in several states, the General Assembly adopted legislation (Chapter 583 of 2007) that limits a company's ability to avoid the Maryland corporate income tax by shifting income away from the State through the use of a captive REIT. Typically, a corporation would form a captive REIT and pay rent to themselves in order to avoid State

taxes. The Department of Legislative Services estimates that Chapter 583 will increase corporate income tax revenues by approximately $10 million annually.

The 2007 tax compliance legislation, however, does not deal with other tax avoidance strategies, including other uses of DHCs not addressed by the 2004 legislation, "transfer pricing" manipulation, and the use of subsidiaries to isolate profitable activities of an enterprise from nexus with the State.

Combined Reporting in Other States

Twenty-one states currently provide for a mandatory combined reporting method related to the taxation of corporations: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Texas, Utah, Vermont, and West Virginia. 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, including Connecticut, Iowa, Massachusetts, Missouri, Pennsylvania, and Wisconsin.

Combined Reporting Revenue Effects

Over the years, there has been considerable uncertainty as to the fiscal effect of combined reporting. In the case of corporate income taxes, due to the volatility of profits over time and sensitivity to corporate structures and inter-company transactions, the accepted form of revenue estimation is to directly simulate 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 and is thus unable to perform this type of analysis. 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 Minnesota, 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 2** lists the expected distributional effect by the federal income of a corporation filing in Pennsylvania.

Exhibit 2
Combined Reporting Tax Effect in Pennsylvania by Federal Income Size
Percentage of Additional Tax Revenues

Federal Income	Percentage of Additional Tax Revenues
Negative	-0.5%
$0	0.0%
$1-$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 avoidance 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." 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, not just those that would be addressed by combined reporting.)

"Tax Haven Countries"

In 1998, OECD issued *Harmful Tax Competition – An Emerging Global Issue*. This report established an international framework to counter the spread of "harmful tax competition." 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, OECD determined that 33 jurisdictions have made commitments to transparency and effective exchanges of information and are considered cooperative jurisdictions. 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 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 • sending money to a tax haven and keeping it there; • establishing a new company in a tax haven; • creating a company in a tax haven in a tax-neutral manner from the sale of assets located in another country; and • 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 (U.S. $26.3 billion) was repatriated from the Republic of Ireland.

State Revenues: The provisions of the bill apply beginning with tax year 2008. The bill does not alter safe harbor provisions related to combined reporting. In addition, the Comptroller's Office may face implementation challenges, in addition to any legal challenges from corporations. Due to these factors, it is estimated that the bill would not impact revenues in fiscal 2008. **Exhibit 3** shows the fiscal impact of the bill over a five-year period, and **Exhibit 4** shows the projected distribution of local highway user revenues in fiscal 2009.

Exhibit 3
HB 16 Fiscal Impact
($ in Millions)

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Total TTF	**0**	**$8.7**	**$8.8**	**$9.9**	**$10.6**
MDOT Share	0	6.1	6.2	7.0	7.4
Local Share	0	2.6	2.7	3.0	3.2
General Funds	**0**	**27.7**	**28.0**	**31.5**	**33.5**
Total	**$0**	**$36.4**	**$36.9**	**$41.4**	**$44.0**

This estimate is based on existing research on the revenue impacts of combined reporting and increased revenue per tax year over time as implementation and legal issues are resolved. Fiscal 2009 reflects the impact of most of tax year 2008 and about one-third of tax year 2009. Future years reflect the estimated correlation between tax year and fiscal year revenue. To the extent that corporations employ alternative tax planning strategies

in the future not covered by current law, revenue increases from implementing combined reporting would be greater than estimated.

The bill requires companies to calculate Maryland taxable income by disregarding transactions among members of a unitary group. While this provision would go beyond the provisions enacted by Chapter 557 of 2004, the Comptroller's Office notes that combined reporting could also bring in losses by entities that are unrelated to 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.

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.

State Expenditures: The Comptroller's Office could increase by $114,400 in fiscal 2008 due to implementation costs, which include costs for:

- 25 employees attending a Multistate Tax Commission training program at a cost of $1,200 per person;
- 12 auditors attending a two-week training program at a cost of $4,200 per person; and
- $34,000 in computer programming modifications.

Additional Information

Prior Introductions: HB 553 of 2007, an identical bill, was not reported from the House Ways and Means Committee. 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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Analysis by: Robert J. Rehrmann

Direct Inquiries to:
(410) 946-5510
(301) 970-5510

Exhibit 4
Fiscal Effect on Local Highway User Revenues
Fiscal 2009

County	Funding Under HB 16	Funding Current Law	Difference	Percent Difference
Allegany	$7,771,900	$7,739,700	$32,200	0.4%
Anne Arundel	33,437,900	33,299,200	138,700	0.4%
Baltimore City	242,464,100	241,272,500	1,191,600	0.5%
Baltimore	45,461,800	45,273,300	188,500	0.4%
Calvert	6,857,500	6,829,100	28,400	0.4%
Caroline	5,372,600	5,350,300	22,300	0.4%
Carroll	15,202,200	15,139,200	63,000	0.4%
Cecil	8,402,900	8,368,000	34,900	0.4%
Charles	10,785,000	10,740,300	44,700	0.4%
Dorchester	5,956,000	5,931,300	24,700	0.4%
Frederick	19,959,100	19,876,300	82,800	0.4%
Garrett	6,728,600	6,700,700	27,900	0.4%
Harford	17,604,100	17,531,100	73,000	0.4%
Howard	16,810,800	16,741,100	69,700	0.4%
Kent	3,019,200	3,006,700	12,500	0.4%
Montgomery	47,431,200	47,234,500	196,700	0.4%
Prince George’s	41,362,700	41,191,200	171,500	0.4%
Queen Anne’s	6,202,500	6,176,700	25,800	0.4%
St. Mary’s	8,275,100	8,240,800	34,300	0.4%
Somerset	3,578,600	3,563,800	14,800	0.4%
Talbot	4,909,400	4,889,000	20,400	0.4%
Washington	12,848,800	12,795,500	53,300	0.4%
Wicomico	9,812,400	9,771,700	40,700	0.4%
Worcester	7,368,700	7,338,100	30,600	0.4%
Total	**$587,623,100**	**$585,000,100**	**$2,623,000**	**0.4%**