SB 603

Department of Legislative Services

Maryland General Assembly
2009 Session

FISCAL AND POLICY NOTE

Senate Bill 603 (Senator Pinsky, *et al.*)
Budget and Taxation

Corporate Income Tax - Rate Reduction and Reform

This bill requires affiliated corporations to compute Maryland taxable income using "combined reporting." The bill also creates a $2,000 tax credit against the corporate income tax for certain companies in tax year 2009 and 2010. The corporate income tax rate in tax year 2011 will be equal to an amount estimated by the Comptroller to return 60% of any revenue gains from combined reporting to corporate income taxpayers. The bill also states that it is the intent of the General Assembly to pass legislation in 2011 that will permanently reduce the corporate income tax rate by 60% of the estimated increase in revenues due to combined reporting.

The bill takes effect July 1, 2009 and applies to tax year 2009 and beyond.

Fiscal Summary

State Effect: General fund revenues may increase significantly beginning in FY 2010 due to increased net corporate income tax revenues. Transportation Trust Fund (TTF) revenues may increase significantly beginning in FY 2010 due to additional corporate income tax payments. Corporate income tax revenues may increase by $15 million to $30 million annually beginning in FY 2010.

Local Effect: Local highway user revenues distributed from TTF will increase significantly beginning in FY 2010. Based on the assumptions above, local highway user revenues may increase by $1.0 million to $1.8 million annually beginning in FY 2010.

Small Business Effect: Minimal.

Analysis

Bill Summary: The bill: (1) requires affiliated corporations to compute Maryland taxable income using "combined reporting"; (2) allows certain corporations to claim a $2,000 nonrefundable credit against the corporate income tax in tax years 2009 and 2010; (3) requires the Comptroller to report by March 1, 2010 on the estimated additional tax revenues that will be collected in tax year 2011 as a result of combined reporting and the estimated corporate income tax rate that is required to return 60% of the estimated revenue gain to corporate income taxpayers; (4) requires the Comptroller to adopt regulations necessary to adopt the bill; and (5) terminates corporate reporting requirements, as enacted by Chapter 3 of the 2007 special session and amended by Chapter 177 of 2008, effective January 1, 2009.

The bill contains intent language that legislation be adopted by the General Assembly in 2011 that will permanently reduce the State corporate income tax rate, for tax years beginning after December 31, 2011, to the rate the Comptroller's Office estimates will return 60% of the additional income tax revenue from corporations that would otherwise be collected as a result of combined reporting.

The bill requires affiliated corporations to compute Maryland taxable income using "combined reporting." The bill requires combined groups to file "combined income tax returns," except as provided by regulations. A corporation that is a member of a combined group must compute its Maryland taxable income using the combined reporting method: (1) taking into account the combined income of all members of the combined group; (2) apportioning the combined income to Maryland using the combined factors of all members of the combined group; and (3) allocating the apportionment determined under item two among the members of the group that are subject to the Maryland income tax. The bill provides that, subject to regulations issued by the Comptroller, corporations may elect to use 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 combined group for combined filing purposes.

The tax credit available in tax year 2009 and 2010 is equal to the lesser of $2,000 or the State income tax for that tax year. Any unused amount of the credit may not be carried over to any other tax year. The credit may not be claimed by a corporation that is a member of a unitary group, the members of which in the aggregate have more than 250 employees in the State.

Current Law: A corporate income tax rate of 8.25% is applied to a corporation's Maryland taxable income.

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 of 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.

Corporate reporting requirements as enacted by Chapter 3 of the 2007 special session and amended by Chapter 177 of 2008 terminate January 1, 2011.

Background: The following is a brief discussion of Maryland corporate income tax revenues and recent corporate tax compliance legislation.

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.

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 2007 tax compliance legislation, however, does not deal with other tax avoidance strategies, including other uses of Delaware Holding Companies 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.

State Revenues: The bill will require combined reporting, create a $2,000 nonrefundable corporate tax credit in tax years 2009 and 2010, and requires an adjustment to the corporate income tax rate in tax year 2011. As a result, State revenues may increase significantly beginning in fiscal 2010. Although the amount of total revenues cannot be precisely estimated, **Exhibit 1** illustrates the estimated impact if a total of $15 to $30 million is collected.

Exhibit 1
Allocation of Potential Revenue Impacts
($ in Millions)

Total Collections	**$15.0**	**$30.0**
General Fund	11.9	23.9
Transportation Trust Fund	3.1	6.1
State	2.1	4.3
Local	1.0	1.8

This estimate is based on previous estimates of combined reporting, adjusted for recent tax law changes and changes in the economy and forecasted corporate income tax revenues. As required by Chapter 3 of the 2007 special session and Chapter 177 of 2008, the Comptroller's Office issued a report March 3, 2009 providing corporate income tax information including the revenue effect of possible corporate income tax changes. The Comptroller's Office indicated that due to a variety of reporting issues, an estimate of what the revenue impact of combined reporting would have been in tax year 2006 is not currently possibly, although the Comptroller's Office continues to work towards that goal.

Additional Information

Prior Introductions: None.

Cross File: HB 1244 (Delegate Ross) - Ways and Means.

Information Source(s): Department of Legislative Services

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