**SB 354**

# Department of Legislative Services

Maryland General Assembly
2010 Session

## FISCAL AND POLICY NOTE

Senate Bill 354 (Senator Pinsky, *et al.*)
Budget and Taxation

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**Corporate Income - Combined Reporting - Pension Sustainability Trust Fund**

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This bill requires affiliated corporations to compute Maryland taxable income using "combined reporting." The Comptroller is required to distribute the estimated revenues generated as a result of the bill to the Pension Sustainability Trust Fund, a special fund established by the bill to offset the State retirement and pensions systems costs.

The bill takes effect July 1, 2010, and applies to tax year 2011 and beyond.

## Fiscal Summary

**State Effect:** General fund revenues increase by $23.7 million in FY 2011 due to additional corporate income tax revenues. Transportation Trust Fund (TTF) revenues increase by $6.1 million in FY 2011. Special fund revenues distributed to the new pension fund increase by $107.5 million in FY 2012 and by $131.5 million in FY 2015. General fund expenditures increase by $20,000 in FY 2011 due to administrative costs at the Comptroller's Office. Pension Sustainability Trust Fund expenditures increase beginning in FY 2012, with a corresponding decrease in general, special, and federal fund expenditures.

| ($ in millions) | FY 2011 | FY 2012 | FY 2013 | FY 2014 | FY 2015 |
|---|---|---|---|---|---|
| GF Revenue | $23.7 | $0 | $0 | $0 | $0 |
| SF Revenue | $6.1 | $107.5 | $119.5 | $127.7 | $131.5 |
| GF Expenditure | $.0 | ($87.8) | ($97.7) | ($104.4) | ($107.4) |
| SF Expenditure | $0 | $97.7 | $108.6 | $116.1 | $119.4 |
| FF Expenditure | $0 | ($9.8) | ($10.9) | ($11.7) | ($12.0) |
| Net Effect | $29.8 | $107.5 | $119.5 | $127.7 | $131.5 |

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

**Local Effect:** Local highway user revenues distributed from the corporate income tax increase by $1.8 million in FY 2011. Local expenditures are not affected.

**Small Business Effect:** Minimal.

## Analysis

**Bill Summary:** The bill requires affiliated corporations to compute Maryland taxable income using "combined reporting." The additional income tax revenues that the Comptroller estimates is attributable to combined reporting must be transferred to the Pension Sustainability Trust Fund. By March 1 of each calendar year, the Comptroller must estimate the additional corporate income tax revenue, if any, generated from combined reporting for the fiscal year that begins on July 1 of that year. The Comptroller is also required to distribute the amount of estimated additional revenue attributable to combined reporting to the Pension Sustainability Trust Fund. The bill requires the Comptroller to adopt regulations to carry out the combined reporting provisions of the bill and the regulations must be consistent with the principles for determining the existence of a unitary business adopted by the Multi-State Tax Commission.

Combined groups are required 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 "U.S. corporations" (corporations incorporated in the United States and specified others, generally having significant U.S. presence) in the combined group for combined filing purposes.

**Current Law:**

*Corporate Income Tax*

A corporate income tax rate of 8.25% is applied to a corporation's Maryland taxable income. In addition to increasing the tax rate, Chapter 3 of the 2007 special session temporarily distributed the estimated revenue increase to the newly established Higher Education Investment Fund (HEIF). The Budget Reconciliation and Financing Act of 2009 (Chapter 487) extended this provision through fiscal 2010 and stated that it is the intent of the General Assembly that, when it is fiscally prudent to do so, HEIF be made permanent. As a result, corporate income tax revenues in fiscal 2010 are distributed to the general fund (73.6%), TTF (20.4%), and HEIF (6.0%). Beginning in fiscal 2011, corporate income tax revenues will be distributed to the general fund (79.6%) and to the TTF (20.4%).

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.

*Teacher and State Employee Pension Systems*

Teachers and State employees are members of one of four pension systems:

- Teacher' Retirement System (TRS)
- Employees' Retirement System (ERS)
- Teachers' Pension System (TPS)
- Employees' Pension System (EPS)

Chapters 23 and 24 of 1979 created TPS and EPS, and closed TRS and ERS to new membership. For the purpose of calculating State pension contributions, however, the two employee plans are combined and the two teacher plans are combined. However, because TRS/ERS have been closed for 30 years, the vast majority of teachers and State employees are in TPS/EPS, which have an employee contribution of 5% of earnable compensation and provide a retirement benefit allowance according to the following formula:

| Years of Creditable Service Before 1998 | x | Average Final Compensation (AFC) | x | 1.2% |
|---|---|---|---|---|

Plus

| Years of Creditable Service After 1998 | x | AFC | x | 1.8% |
|---|---|---|---|---|

**Background:**

*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.

*Combined Reporting*

Corporate income tax reform activity has significantly increased in Maryland and several other states in the wake of highly publicized cases involving corporate income tax avoidance at both the federal and state levels. 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). In addition to this legislation, the General Assembly has considered proposals that would require combined reporting, impose an alternative minimum assessment on corporations, attempt to increase tax compliance related to offshore "tax havens," and employ throwback rules that would tax income that is not apportioned to any state.

A number of states, including Maryland, allow or require that taxes on income be computed on the basis of the books and records of separate corporate entities without regard to the fact that the entity may be a member of a commonly owned and controlled group of entities functioning as a single business. Under combined reporting, the combined income of all members of the unitary group is taken into account as the starting point for determining Maryland taxable income. The combined taxable income is then apportioned to Maryland using the combined apportionment factors of all the members of the group. Considerable debate exists over the combined reporting revenue impacts, implementation burden, and impacts on specific corporate sectors.

Chapter 3 of the 2007 special session overhauled the State's tax structure as part of a plan to address the State's structural deficit. As introduced, the Governor included a proposal to require multistate corporate groups to use the combined reporting method. In lieu of requiring combined reporting, Chapter 3 as enacted provides for enhanced reporting of corporate data to the Comptroller and also establishes a business tax study commission to review and evaluate the State's business tax structure. The information required to be submitted under Chapter 3 is designed to enable the Comptroller to analyze the impacts of combined reporting as well as assess and enhance overall corporate tax compliance. Chapter 3 is also designed to provide data necessary to (1) enable a better assessment of the current statutory incidence of the corporate income tax; (2) analyze the impacts of other corporate income tax proposals; and (3) analyze the impact of changes in the corporate income tax and job growth in the State.

*Comptroller's Analysis of Combined Reporting*

In October 2009, the Comptroller's Office issued an initial analysis of the impact combined reporting would have had on corporate income tax returns filed in tax year 2006. The analysis included the estimated impact on total revenues and impact on taxpayers by income and industry classification. The Comptroller's Office estimated these impacts under two different methods of apportioning the income of a combined group to Maryland ("Joyce" and "Finnegan") and concluded that the method employed could alter the estimated impacts. Under both methods, the denominator of the apportionment factor is based on the total payroll, property, and sales of all members of the group, regardless of whether they are subject to Maryland's corporate income tax (have nexus with Maryland). Under the Joyce method of apportionment, the numerator consists of the payroll, property, and sales of all of the entities in the group with nexus. Finnegan also apportions the payroll, property and sales of all entities with nexus as well as the payroll, property, and sales of companies that make sales into the State.

The Comptroller's Office estimates that the Joyce method of apportionment would have increased corporate income tax revenues by about $109 million, a net increase of 12.5% ($170 million and 19.5% under Finnegan). The Comptroller's Office stressed that the estimates were preliminary, likely to change as corporations file amended returns, and

was not an estimate of the fiscal impact of adopting combined reporting during the 2010 session.

Several factors will likely alter the current fiscal impact compared with the impact in tax year 2006, notably the steep decrease in corporate profits. The Comptroller's Office noted that two of the industries that produced the vast majority of additional revenue in tax year 2006, retail trade and finance and insurance services, are among those that have been hardest hit by the recession. The Comptroller's Office will issue revised tax year 2006 estimates in March 2010 as well as providing an initial analysis of tax year 2007.

**Exhibit 1** lists the percentage of returns with an increase, decrease, and no change in tax liability in tax year 2006 by the income of the corporate group under the Joyce apportionment method as well as the net change in tax liability for each income group. Overall, the number of returns experiencing a decrease, increase, and no change in tax liability was roughly equal except that the average tax liability increase was significantly more than the average decrease in tax liability. Net tax liabilities were lower for corporate groups that were nontaxable and with less than $1 million in Maryland modified income, roughly the same for incomes between $1 million and $100 million, and were significantly higher for groups with incomes in excess of $100 million. Although numerous taxpayers across income groups would have an increase in tax liability, the vast majority of the estimated increase was generated by the 3% of returns with incomes in excess of $1 billion.

**Exhibit 1**
**Combined Reporting Impact by Corporate Group Income**
**Under Joyce Method of Apportionment**
**Tax Year 2006**

| | Percentage of Returns with: | | | All Returns | |
|---|---|---|---|---|---|
| **Group Maryland Modified Income** | **Tax Decrease** | **Tax Increase** | **No Change** | **Number** | **Net Change in Tax Liability ($ in Millions)** |
| Nontaxable | 29% | 0% | 71% | 2,249 | ($61.3) |
| Under $500,000 | 32% | 48% | 20% | 791 | (0.7) |
| $500,000-$999,999 | 37% | 48% | 16% | 197 | (54.4) |
| $1-$5 Million | 39% | 50% | 11% | 677 | (2.5) |
| $5-10 Million | 37% | 54% | 9% | 343 | (0.7) |
| $10-$25 Million | 35% | 57% | 8% | 499 | (2.9) |
| $25-100 Million | 37% | 56% | 6% | 694 | (2.0) |
| $100-$250 Million | 30% | 65% | 6% | 352 | 18.0 |
| $250-$500 Million | 27% | 71% | 2% | 173 | 19.0 |
| $500 million-$1 Billion | 28% | 68% | 4% | 124 | 39.1 |
| $1 Billion and Over | 26% | 74% | 0% | 158 | 157.4 |
| All Returns | 32% | 35% | 32% | 6,257 | 109.0 |

Source: Comptroller's Office

Under Finnegan, the results were mostly similar, although it was estimated that net tax liabilities would increase for corporate groups with incomes in excess of $25 million (instead of $100 million as under Joyce), with net tax increases about one-fifth higher for corporate groups with the highest income.

**Exhibit 2** lists the estimated impact by the predominant industry classification of the corporate group. Although the impact within each industry displayed significant variation, it was estimated that there were large net decreases in total tax liabilities in utilities, manufacturing, management of companies, and health care and large increases in the trade and finance and insurance industries. Under Finnegan, however, it was estimated that the manufacturing industry would have a large net increase in total tax liabilities while larger increases were estimated in professional, scientific, and technical services; finance and industry, trade, and information industries.

**Exhibit 2**
**Combined Reporting Impact by Industry**
**Joyce Method of Apportionment**
**Tax Year 2006**

| | Percent of Returns with: | | | All Returns | |
|---|---|---|---|---|---|
| **Industry** | **Tax Decrease** | **Tax Increase** | **No Change** | **Returns** | **Net Change in Tax Liability ($ in Millions)** |
| Agriculture | 28% | 38% | 34% | 29 | $0.1 |
| Mining | 26% | 42% | 32% | 31 | 0.2 |
| Utilities | 32% | 33% | 35% | 94 | (15.9) |
| Construction | 35% | 34% | 30% | 297 | 4.8 |
| Manufacturing | 35% | 37% | 28% | 1,470 | (6.2) |
| Wholesale Trade | 33% | 46% | 21% | 426 | 13.2 |
| Retail Trade | 25% | 51% | 24% | 404 | 77.4 |
| Transportation and Warehousing | 34% | 42% | 24% | 229 | 3.0 |
| Information | 32% | 29% | 39% | 333 | 1.8 |
| Finance and Insurance | 31% | 34% | 35% | 608 | 44.3 |
| Real Estate and Rental and Leasing | 31% | 29% | 40% | 429 | 0.9 |
| Professional, Scientific, and Technical Services | 30% | 30% | 40% | 905 | 1.7 |
| Management of Companies | 38% | 29% | 33% | 269 | (10.1) |
| Admin. Support, Waste Mgmt. Remediation Services | 35% | 33% | 32% | 215 | 0.1 |
| Educational Services | 43% | 34% | 23% | 47 | (0.6) |
| Health Care and Social Assistance | 31% | 30% | 39% | 166 | (9.0) |
| Arts, Entertainment, and Recreation | 37% | 21% | 42% | 43 | (0.6) |
| Other | 32% | 29% | 39% | 131 | 0.0 |
| **Total** | **32%** | **35%** | **32%** | **6,257** | **109.0** |

*Teacher and Employee Pensions*

Chapter 440 of 2002 (the Budget Reconciliation and Financing Act) established the "corridor" funding method to mitigate the effects of fluctuations in market returns on the State's pension contribution rates by spreading out those effects over five years. In fiscal 2001, investment returns for the State Retirement and Pension System fell 9.4%, prompting projected employer contribution rates for fiscal 2003 to increase for the first time in five years. Instead, the corridor method froze employer contribution rates for the State pension plans covering teachers and regular State employees, the two largest State pension plans, at their fiscal 2002 levels as long as the two systems remained actuarially funded between 90% and 110%. Under the corridor method, when the plans' funded levels drop below 90%, the employer contributions increase by an amount equal to one-fifth of the difference between the prior year's contribution and the "true" actuarial rate required to fully fund the systems. The employees' system fell out of the corridor in fiscal 2005, and the teachers' plans fell out of the corridor in fiscal 2006. As of June 30, 2009, the employees' system is 61.2% funded and the teachers' system is 66.1% funded; neither is projected to reach 90% funding for at least 10 years.

**State Revenues:** The bill requires combined reporting beginning in tax year 2011 and requires the Comptroller's Office to distribute the estimated increase, if any, to the Pension Sustainability Trust Fund established by the bill beginning in fiscal 2012. It is assumed that any revenue generated from the bill in fiscal 2011 is distributed according to current law. As a result, general fund revenues increase by $23.7 million in fiscal 2011 and TTF revenues increase by $6.1 million. Special fund revenues increase by $107.5 million in fiscal 2012 and by $131.5 million in fiscal 2015. **Exhibit 3** shows the impact of combined reporting in fiscal 2011 through 2015.

**Exhibit 3**
**Effect of Combined Reporting**
**($ in Millions)**

| | FY 2011 | FY 2012 | FY 2013 | FY 2014 | FY 2015 |
|---|---|---|---|---|---|
| GF Revenues | $23.7 | $0.0 | $0.0 | $0.0 | $0.0 |
| TTF Revenues | 6.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| SF Revenues | 0.0 | 107.5 | 119.5 | 127.7 | 131.5 |
| **Total Revenues** | **29.8** | **107.5** | **119.5** | **127.7** | **131.5** |

This estimate is based on the Comptroller's estimate on the tax year 2006 impact of combined reporting, adjusted for subsequent changes in the economy and corporate income tax revenues. The actual impact of combined reporting could vary significantly than estimated above based on these variable factors and implementation of combined reporting as adopted by regulations. In addition, the bill does not alter safe harbor

requirements. As a result, the fiscal impact of the bill in fiscal 2011 may be significantly less than estimated and may result in a revenue decrease. The Comptroller's Office advises that the amount distributed to the fund in each fiscal year may vary substantially from the actual impact of combined reporting given the volatility of the corporate income tax, difficulty in estimating the fiscal impact of combined reporting, and timing of the bill.

**State Expenditures:** The bill requires the Comptroller's Office to distribute the estimated revenue increase resulting from the bill to a special fund established to offset the State's cost of contributions to State retirement and pension systems. Teacher pension contributions are paid entirely by general funds, while State employee contributions are assumed to be allocated 60% general funds, 20% special funds, and 20% federal funds. It is assumed that all of the revenue generated by the bill offsets these required contributions. Therefore, general fund expenditures decrease by $87.8 million in fiscal 2012. Special fund and federal fund expenditures both decrease by $9.8 million in fiscal 2012. **Exhibit 4** shows the net impact of the bill in fiscal 2011 through 2015.

**Exhibit 4**
**SB 354 Net Impact**
**($ in Millions)**

| | FY 2011 | FY 2012 | FY 2013 | FY 2014 | FY 2015 |
|---|---|---|---|---|---|
| **Revenues** | | | | | |
| GF Revenues | 23.7 | 0 | 0 | 0 | 0 |
| TTF Revenues | 6.1 | 0 | 0 | 0 | 0 |
| SF Revenues | 0 | 107.5 | 119.5 | 127.7 | 131.5 |
| **Total Revenues** | **$29.8** | **$107.5** | **$119.5** | **$127.7** | **$131.5** |
| **Expenditures** | | | | | |
| ***Pension Fund*** | | | | | |
| Special Fund | 0 | 107.5 | 119.5 | 127.7 | 131.5 |
| ***Pension Contributions*** | | | | | |
| General Fund | 0 | (87.8) | (97.7) | (104.4) | (107.4) |
| Special Fund | 0 | (9.8) | (10.9) | (11.7) | (12.0) |
| Federal Fund | 0 | (9.8) | (10.9) | (11.7) | (12.0) |
| **Total Expenditures** | **$0** | **$0** | **$0** | **$0** | **$0** |
| **Net Impact** | **$29.8** | **$107.5** | **$119.5** | **$127.7** | **$131.5** |

*Comptroller's Office*

The Comptroller's Office reports that it will incur additional expenditures of $20,000 in fiscal 2011 in order to provide combined reporting training to auditors.

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## Additional Information

**Prior Introductions:** None.

**Cross File:** None.

**Information Source(s):** Comptroller's Office, Maryland State Retirement Agency, Department of Legislative Services

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