HB 731

Department of Legislative Services

Maryland General Assembly
2011 Session

FISCAL AND POLICY NOTE

House Bill 731 (Delegate Ross, *et al.*)
Ways and Means

Corporate Income Tax - Combined Reporting

This bill requires affiliated corporations to compute Maryland taxable income using "combined reporting."

The bill takes effect July 1, 2011, and applies to tax year 2012 and beyond.

Fiscal Summary

State Effect: General fund revenues increase by $32.2 million in FY 2012 due to additional corporate income tax revenues. Transportation Trust Fund (TTF) revenues increase by $6.7 million in FY 2012 and Higher Education Investment Fund (HEIF) revenues increase by $2.5 million. Potential significant increase in general fund expenditures in FY 2012 through 2014 due to administrative costs at the Comptroller's Office.

($ in millions)	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
GF Revenue	$32.2	$119.1	$125.1	$130.7	$134.6
SF Revenue	$9.2	$34.4	$36.2	$37.8	$38.9
GF Expenditure	-	-	-	$0	$0
Net Effect	$41.4	$153.6	$161.3	$168.5	$173.5

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 $0.7 million in FY 2012 and by $3.3 million in FY 2016. 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 Comptroller is required 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 multistate 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 apportioned income 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 corporations incorporated in the United States and specified others (those 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 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 federal law) are not subject to the corporate 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:

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 three-factor apportioned formula of payroll, property, and sales, with sales double weighted or, in the case of a manufacturing corporation, a single sales factor formula. The apportionment factor is then 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 efforts have 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 in recent years that would require combined reporting, impose an alternative minimum assessment on corporations, attempt to increase tax compliance related to offshore "tax havens," and employ 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, burden of implementation, and impacts on specific corporate sectors.

Chapter 3 of the 2007 special session made significant changes to the State's tax structure as part of a plan to address the State's structural deficit. As introduced, the Governor included in the legislation a proposal to require multistate corporate groups to use the combined reporting method. In lieu of requiring combined reporting, Chapter 3 as enacted provided for enhanced reporting of corporate data to the Comptroller and also established the Maryland Business Tax Reform 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 March 2010, the Comptroller's Office issued its second analysis of the revenue impact of combined reporting, including an initial analysis of the impact combined reporting would have had on corporate income tax returns filed in tax year 2007 and a revised analysis of tax year 2006 returns. The Comptroller's Office estimated these impacts under two different methods of apportioning the income of a combined group to Maryland (known as "Joyce" and "Finnegan") and concluded that the method employed could alter the estimated revenue impacts. Under both methods, the denominator of the apportionment factor is based on the total payroll, property, and sales of all members of the unitary 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 in tax year 2006 by about $144 million (a net change in corporate income tax revenues of 17%), and revenues would have increased by $197 million or 23.5% under Finnegan. In tax year 2007, revenue increases would have totaled $92 million under Joyce (a net increase of 13%) and $144 million, or 20%, under Finnegan.

Tax year 2006 and 2007 data show that the total tax liabilities for manufacturing, retail, and finance corporations would have been significantly higher under combined reporting while total tax liabilities for utility corporations would have been significantly lower. It should be noted that even within industries with a significant change in total tax liabilities, the change was not uniform for all corporations. For example, in tax year 2007 under Finnegan 31% of corporations would have had a tax decrease, 40% a tax increase, and 29% would have had no change.

The Maryland Business Tax Reform Commission issued its final report on December 2010. As part of this report, the Comptroller's Office provided a preliminary analysis of the impact of combined reporting in tax year 2008. The preliminary estimate indicated that had combined reporting been in effect for tax year 2008, the State would have collected less revenue that it actually did under existing law. The State would have lost approximately $51 million under the Joyce method and $13 million under the Finnegan method of apportionment. The Comptroller's Office will be issuing its final estimate of the tax year 2008 revenue impacts in March 2011. The Maryland Business Tax Reform Commission issued three recommendations in its final report, including a recommendation that the General Assembly not implement combined reporting in the 2011 session.

State Revenues: The bill requires combined reporting using the Finnegan method beginning in tax year 2012. As a result, general fund revenues increase by $32.2 million in fiscal 2012, TTF revenues increase by $6.7 million, and HEIF revenues increase by $2.5 million. **Exhibit 1** shows the impact of the bill in fiscal 2012 through 2016.

This estimate is based on the Comptroller's estimate of the tax year 2007 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 based on these variables and the 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 2012 may be significantly less than estimated and may result in a revenue decrease.

Exhibit 1
Effect of Combined Reporting
($ in Millions)

	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
GF Revenues	$32.2	$119.1	$125.1	$130.7	$134.6
HEIF Revenues	2.5	9.2	9.7	10.1	10.4
TTF Revenues	6.7	25.2	26.5	27.7	28.5
State	6.0	22.4	23.5	24.5	25.3
Local	0.7	2.9	3.0	3.2	3.3
Total Revenues	**$41.3**	**$153.6**	**$161.3**	**$168.5**	**$173.5**

The Comptroller's Office advises that the preliminary estimated decrease in tax year 2008 revenues due to combined reporting likely reflects that 2008 experienced the largest, most sustained drop in corporate profits since World War II. It also estimates that, although possible, combined reporting is not expected to decrease future tax revenues and that tax year 2007 is the most appropriate tax year to use in determining the impact of combined reporting on future revenues.

State Expenditures: The Comptroller's Office reports that it will incur additional expenditures beginning in fiscal 2012 in order to implement combined reporting. These expenses include:

- hiring three contractual auditors to handle an expected increase in taxpayer queries beginning in part of fiscal 2012 through one-half of fiscal 2014;
- computer programming expenditures including processing changes to the SMART income tax return processing and imaging systems and systems testing;
- taxpayer notification expenses; and
- providing training to corporate audit and taxpayer service staff.

Exhibit 2 shows the estimated administrative costs at the Comptroller's Office in fiscal 2012 through 2016.

Exhibit 2
Comptroller's Office Administrative Expenses

	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Computer Programming	$800,000	$0	$0	$0	$0
Auditors	88,100	143,000	74,600	0	0
Taxpayer Notification	42,500	0	0	0	0
Training Expenses	34,000	0	0	0	0
Total Expenses	**$964,600**	**$143,000**	**$74,600**	**$0**	**$0**

Additional Information

Prior Introductions: Similar bills have been introduced in the 2010 session. HB 584 received a hearing in the House Ways and Means Committee, but no further action was taken. SB 354 and HB 10 proposed to distribute the estimated increase in revenue resulting from combined reporting to offset State retirement and pensions systems costs. HB 10 received an unfavorable report from the House Appropriations Committee. SB 354 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken.

Cross File: SB 305 (Senator Pinsky, *et al.*) - Budget and Taxation.

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

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mc/jrb

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