HB 887

Department of Legislative Services

Maryland General Assembly
2014 Session

FISCAL AND POLICY NOTE

House Bill 887 (Delegate Mizeur, *et al.*)
Ways and Means

Corporate Income Tax - Main Street Employer Tax Rebate

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 combined reporting to the Small Business Personal Property Tax Rebate Fund, a special fund established by the bill to provide grants to small businesses to assist in the expense of paying personal property taxes.

The bill takes effect July 1, 2014, and applies to tax year 2014 and beyond.

Fiscal Summary

State Effect: General fund revenues increase by $14.6 million in FY 2015 from additional corporate income tax revenues. Transportation Trust Fund (TTF) revenues increase by $3.1 million, of which $2.8 million goes to the State, and Higher Education Investment Fund (HEIF) revenues increase by $1.1 million in FY 2015. Special fund revenues distributed to the Small Business Personal Property Tax Rebate Fund increase by $66.8 million in FY 2016 and by $72.1 million in FY 2019. Potential significant increase in general fund expenditures due to administrative costs at the Comptroller's Office and the State Department of Assessments and Taxation (SDAT). Small Business Personal Property Tax Rebate Fund expenditures increase beginning in FY 2016.

($ in millions)	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
GF Revenue	$14.6	$0	$0	$0	$0
SF Revenue	$4.2	$66.8	$73.2	$69.7	$72.1
GF Expenditure	$0.2	$0.3	$0.3	$0.3	$0.3
SF Expenditure	$0	$66.8	$73.2	$69.7	$72.1
Net Effect	$18.6	($0.3)	($0.3)	($0.3)	($0.3)

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 $0.3 million in FY 2015. Local expenditures are not affected.

Small Business Effect: Small businesses that pay personal property taxes would benefit from the rebate provided by the bill.

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.

The bill establishes the Small Business Personal Property Tax Rebate Fund to use the additional revenue from adopting combined reporting to reimburse small businesses for personal property taxes that have been paid. SDAT must administer the fund, which is a special, nonlapsing fund. Any unspent balance does not revert to the general fund, but investment earnings of the fund are paid into the general fund. The State Treasurer must hold the fund separately and invest the money in the fund in the same manner as other State money may be invested. The Comptroller must account for the fund, which consists of:

- revenue distributed to the fund from additional revenue attributable to combined reporting;
- money appropriated in the State budget to the fund; and
- any other money from any other source accepted for the benefit of the fund.

A small business is a for-profit enterprise with 25 or fewer employees. A small business may submit an application to SDAT for a personal property tax rebate equal to the personal property taxes paid during the fiscal year. At the end of the fiscal year, SDAT may approve personal property tax rebate applications up to the amount of revenue in the Small Business Personal Property Tax Rebate Fund. If the total amount of rebates applied for in the application period exceeds the total amount available, SDAT is required to reduce the amount of the rebate by the proportionate amount of the excess. SDAT is required to adopt regulations for the personal property tax rebate, provide forms and information on the rebate application, and report to the Governor and General Assembly annually on the number of rebates issued in the previous fiscal year.

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 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.

Personal Property Taxes

The State has not imposed personal property taxes since fiscal 1984 and all personal property is exempt from the State property tax. However, counties, municipalities, and special taxing districts are authorized to tax personal property.

Business entities in Maryland may be required to pay local personal property taxes. The State mandates certain exemptions from personal property assessment including aircraft, manufacturing tools, equipment or machinery, research and development property, farm implements, agricultural products, livestock, and residential property (nonbusiness property). Local governments are authorized to exempt from taxation tools, equipment, or machinery used in manufacturing.

Except for personal property used in connection with a business, personal property owned by an individual is not subject to valuation or taxation. Personal property used in connection with a business is also exempt if it is owned by an individual and is located at the individual's residence and either (1) is used in connection with a licensed family day care home or (2) had a total original cost (excluding vehicles) of less than $10,000.

Local governments may provide various additional exemptions.

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 apportionment 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 the 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 and captive Real Estate Investment Trusts. 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.

As **Exhibit 1** shows, approximately 23 states and the District of Columbia currently require some form of combined reporting. The other 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 revenue impacts, burden of implementation, and impacts on specific corporate sectors of combined reporting.

Exhibit 1
States with Combined Reporting

Alaska	Kansas	New Mexico
Arizona	Maine	New York
California	Massachusetts	North Dakota
Colorado	Michigan	Ohio
District of Columbia	Minnesota	Utah
Hawaii	Montana	Vermont
Idaho	Nebraska	West Virginia
Illinois	New Hampshire	Wisconsin

Source: CCH Intelliconnect

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 to 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.

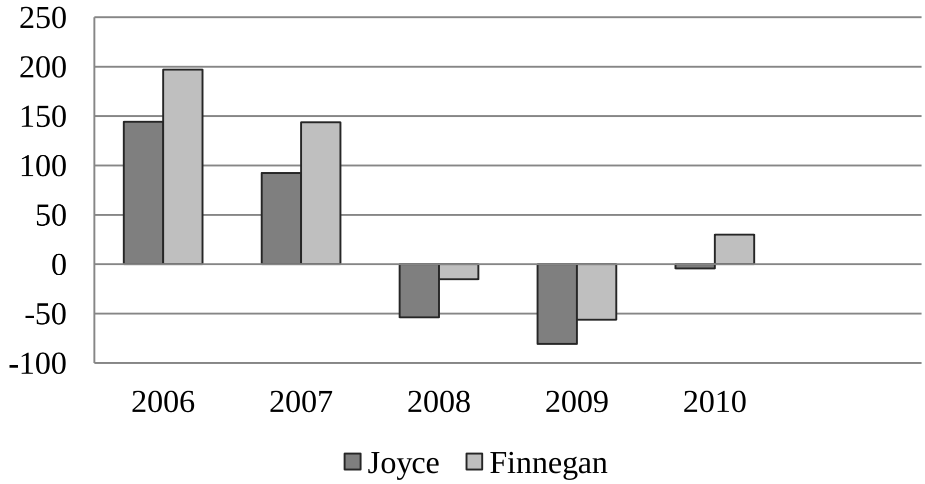
Comptroller's Analysis of Combined Reporting

The Comptroller's Office issued its most recent analysis of the revenue impact of combined reporting in March 2013, including an initial analysis of the impact combined reporting would have had on corporate income tax returns filed in tax year 2010. The Comptroller's Office estimated the impact under two different methods of apportioning the income of a combined group to Maryland (known as "Joyce" and "Finnegan") and concluded that the specific 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. The Finnegan method apportions the payroll, property, and sales of all entities with nexus with Maryland 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 decreased corporate income tax revenues in tax year 2010 by about $4.5 million, and revenues would have increased by $30.1 million under Finnegan.

Tax year 2010 data show that the total tax liabilities for health care and social assistance, transportation and warehousing, and utility industries would have been almost $40.9 million lower under Joyce, while the retail, professional, scientific, and technical services and administrative support, waste management, and remediation services industries would have paid about $37.7 million more in tax. 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 2010 under Finnegan 32% of corporations would have had a tax decrease, 40% a tax increase, and 28% would have had no change. **Exhibit 2** shows the corporate income tax revenues under the Finnegan and Joyce methods from tax year 2006 through 2010.

Exhibit 2
Effect of Combined Reporting
Tax Years 2006-2010
($ in Millions)



Source: Comptroller's Office

Personal Property Tax

The assessment of personal property is the responsibility of SDAT, while the collection of the tax on personal property is the responsibility of local governments. The department separately values inventory and all other tangible business personal property based on information filed annually by property owners by April 15 (the data is as of the preceding January 1). Property owners may request a filing extension of two months.

Inventory is valued at its "fair average value," which means the lower of cost or market value. All other personal property, including office furniture, fixtures, equipment, and plant machinery, is valued at "full cash value." Uniform rates of depreciation are applied to the cost of the property to determine full cash value.

Exhibit 3 shows the estimated personal property taxes paid to each county in fiscal 2013 based on the number of personal property certifications, the assessable base, the average assessment per certification, and current personal property tax rates. Personal property certifications are similar to the number of personal property accounts except that in some instances businesses can have multiple certifications due to having personal property located in more than one jurisdiction. As such, certifications are a more accurate representation of the personal property located in each county.

Exhibit 3
Average Personal Property Taxes Paid
Fiscal 2013

County	Personal Property Tax Rate	Certifications	County Personal Property Base	Average Certification	Average Tax Per Certification
Allegany	$2.4525	2,187	$185,823,080	$84,967	$2,084
Anne Arundel	2.3525	14,964	1,679,479,660	112,235	2,640
Baltimore City	5.6700	11,993	1,001,346,920	83,494	4,734
Baltimore	2.7500	20,579	1,749,664,190	85,022	2,338
Calvert	2.2300	2,316	110,382,040	47,661	1,063
Caroline	2.2250	930	49,501,820	53,228	1,184
Carroll	2.5450	5,082	262,560,570	51,665	1,315
Cecil	2.4768	2,325	178,140,550	76,620	1,898
Charles	2.8025	3,214	194,639,000	60,560	1,697
Dorchester	2.4400	1,029	27,592,670	26,815	654
Frederick	0.0000	0	0	0	0
Garrett	0.0000	1	91,575,580	91,575,580	0
Harford	2.6050	6,685	558,654,000	83,568	2,177
Howard	2.9750	9,796	960,787,430	98,080	2,918
Kent	0.0000	0	0	0	0
Montgomery	2.5075	30,090	2,192,697,120	72,871	1,827
Prince George’s	3.2975	16,697	1,322,169,630	79,186	2,611
Queen Anne’s	0.0000	0	0	0	0
St. Mary’s	2.1425	2,891	153,400,110	53,061	1,137
Somerset	2.2093	540	32,648,650	60,460	1,336
Talbot	0.0000	0	0	0	0
Washington	2.3700	3,679	385,285,610	104,726	2,482
Wicomico	2.1010	3,045	352,041,010	115,613	2,429
Worcester	1.9250	5,819	200,356,400	34,431	663
Total		**143,862**	**$11,688,746,040**	**$81,250**	**$37,187**

Source: State Department of Assessments and Taxation

State Revenues: The bill requires combined reporting using the Finnegan method beginning in tax year 2014 and requires the Comptroller's Office to distribute the estimated increase, if any, to the Small Business Personal Property Tax Rebate Fund established by the bill beginning in fiscal 2016. It is assumed that any revenue generated by the bill in fiscal 2015 is distributed according to current law. As a result, general fund revenues increase by $14.6 million in fiscal 2015, TTF revenues increase by $3.1 million, of which $2.8 million goes to the State, and HEIF revenues increase by $1.1 million. **Exhibit 4** shows the impact of enacting combined reporting in fiscal 2015 through 2019.

This estimate is based on the Comptroller's estimate of the average impact of combined reporting in prior tax years, 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 any given year, corporate revenue could decrease significantly, like in tax year 2009, due to the high level of volatility in combined reporting. In addition, the bill does not alter safe harbor requirements. As a result, the fiscal impact of the bill in fiscal 2015 may be significantly less than estimated and may result in a revenue decrease, although combined reporting is not expected to decrease future tax revenues.

Exhibit 4
Effect of Combined Reporting
Fiscal 2015-2019
($ in Millions)

	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
General Fund	$14.6	$0	$0	$0	$0
HEIF	1.1	0	0	0	0
TTF	3.1	0	0	0	0
State	*2.8*	*0*	*0*	*0*	*0*
Local	*0.3*	*0*	*0*	*0*	*0*
Special Fund	0	66.8	73.2	69.7	72.1
Total	**$18.8**	**$66.8**	**$73.2**	**$69.7**	**$72.1**

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 provide rebates to small businesses for the expense of paying personal property taxes. Therefore, special fund expenditures increase by $66.8 million in fiscal 2016.

The Comptroller's Office reports that it will incur additional expenditures beginning in fiscal 2015 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 2015 through one-half of fiscal 2017;
- 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 5 shows the estimated administrative costs at the Comptroller's Office in fiscal 2015 through 2017. Additionally, if the Comptroller participates in the Multistate Tax Commission's income tax audit program, which would require the Comptroller's Office to provide assessments on audits of multistate businesses, expenditures would increase by $200,000 annually, but it has the potential to increase revenue by approximately $1.0 million annually.

Exhibit 5
Comptroller's Office Administrative Expenses
Fiscal 2015-2017

	FY 2015	FY 2016	FY 2017
Computer Programming	$1,000,000	$0	$0
Consultants	400,000	0	0
Auditors	87,400	123,600	64,000
Taxpayer Notification	36,900	0	0
Training Expenses	41,300	0	0
Total Expenses	**$1,565,600**	**$123,600**	**$64,000**

Additionally, general fund expenditures for SDAT increase by $234,216 in fiscal 2015, which accounts for the bill's July 1, 2014 effective date and a 90-day start-up delay. This estimate reflects the cost of hiring one administrator, one office secretary, one administrative officer, and two office service clerks to administer the Small Business Personal Property Tax Rebate Program and prepare an annual report. It includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Positions	5
Salaries and Fringe Benefits	$213,631
Operating Expenses	20,585
Total FY 2015 State Expenditures	**$234,216**

Future year expenditures reflect full salaries with annual increases and employee turnover as well as annual increases in ongoing operating expenses.

Additional Information

Prior Introductions: HB 1158 of 2013 received a hearing in the House Ways and Means Committee, but no further action was taken.

Cross File: None.

Information Source(s): State Department of Assessments and Taxation, Comptroller's Office, Department of Legislative Services

Fiscal Note History: First Reader - February 23, 2014
ncs/jrb

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