

Department of Legislative Services
 Maryland General Assembly
 2020 Session

FISCAL AND POLICY NOTE
 First Reader

Senate Bill 311 (Senator Pinsky, *et al.*)
 Budget and Taxation

Corporate Tax Fairness Act of 2020

This bill applies a “throwback” rule in determining whether sales are considered in the State for purposes of the State’s corporate income tax apportionment formula, beginning in tax year 2020. The Comptroller must assess interest and penalties if a corporation pays estimated tax of less than 90% of the required tax for tax year 2020. The bill also requires affiliated corporations to compute Maryland taxable income using combined reporting beginning in tax year 2021. **The bill takes effect July 1, 2020.**

Fiscal Summary

State Effect: General fund revenues increase by \$83.3 million in FY 2021 from additional corporate income tax revenues. Transportation Trust Fund (TTF) revenues increase by \$8.5 million and Higher Education Investment Fund (HEIF) revenues increase by \$3.5 million in FY 2021. Potential significant increase in general fund expenditures in FY 2021 through 2023 due to administrative costs at the Comptroller’s Office. TTF expenditures increase by \$1.2 million in FY 2021 and by \$2.2 million in FY 2025.

(\$ in millions)	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025
GF Revenue	\$83.3	\$143.1	\$151.6	\$149.1	\$153.7
SF Revenue	\$12.0	\$29.2	\$32.1	\$31.3	\$32.5
GF Expenditure	\$3.2	\$0.1	\$0.1	\$0	\$0
SF Expenditure	\$1.2	\$2.8	\$3.1	\$3.0	\$2.2
Net Effect	\$91.0	\$169.4	\$180.6	\$177.4	\$183.9

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

Local Effect: Local highway user revenues increase by \$1.2 million in FY 2021 and by \$2.2 million in FY 2025. Local expenditures are not affected.

Small Business Effect: Minimal.

Analysis

Bill Summary:

Throwback Rule

Sales of tangible personal property must be included in the numerator of the sales factor used for determining the Maryland taxable income of a multistate corporation if (1) the property is delivered or shipped to a purchaser within the State, regardless of the point from where it is shipped or other conditions of the sale or (2) the property is shipped from an office, store, warehouse, factory, or other place of storage in the State and the corporation is not taxable in the state of the purchaser. The bill provides that a corporation is considered taxable in a state if (1) in that state the corporation is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax or (2) that state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether, in fact, the state imposes a tax.

Combined Reporting

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 those generally having significant United States presence in the combined group for combined filing purposes.

The Comptroller must report to the General Assembly by March 31 of each year on an estimate of the total additional tax revenue from corporations, if any, which will be collected in the next fiscal year as a result of using the combined reporting method.

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 multicorporate 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.

Under existing Maryland apportionment of income rules, the sales factor of the apportionment fraction is generally determined by including in the denominator all sales of the corporation and by including in the numerator only those sales of property delivered or shipped to a purchaser within the State, regardless of point of shipment or other conditions of sale, making Maryland a "destination" state. However, federal law essentially prevents other states from imposing corporate taxes on sales by Maryland corporations, even though they make sales in those states, if the corporation limits its activities in the other states to specified permissible activities. The interaction of Maryland's corporate taxation rules and the federal restriction therefore results in "nowhere income" – income that is apportioned nowhere for state income tax purposes. Under the bill, in calculating the sales factor of the apportionment fraction, sales of goods to a purchaser located in another state where the seller is not taxable are included (or "thrown back") in the numerator if the property is shipped from Maryland.

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.

Prior to tax year 2018, corporations were 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 one-factor formula based on sales, referred to as a single sales factor formula. The apportionment factor is then multiplied by the corporation's modified income to determine Maryland taxable income.

Chapters 341 and 342 of 2018 phase in a requirement that all corporations subject to the corporate income tax, with an exception for specified worldwide headquartered companies, use a single sales factor formula to apportion income to the State.

The Maryland tax liability of a corporation equals the Maryland taxable income multiplied by the tax rate, less any tax credits.

Throwback Rule

The Comptroller's Office issued in March 2013 its most recent [analysis](#) of the revenue impact of adopting the throwback rule on corporate income tax returns filed in tax year 2010. The Comptroller's Office estimated that under a throwback rule, 144 entities would have had \$4.6 billion of income from sales made into states in which they did not have nexus thrown back to Maryland. After apportioning this income and accounting for losses, corporate income tax revenues would have increased by \$15.7 million, with 94 of the entities paying additional taxes. If sales to the federal government were also thrown back to Maryland, which is not required by the bill, corporate income taxes would have increased by an additional \$28.1 million. In tax years 2006, 2007, 2008, and 2009, adoption

of a throwback rule that did not include government sales was estimated to have increased corporate income tax revenues by \$44.3 million, \$31.3 million, \$32.8 million, and \$96.5 million, respectively.

The Comptroller's Office states that the actual revenue gain from the throwback rule in each tax year would have been greater as single-entity corporations and noncorporate entities were exempt from the reporting requirements.

As **Exhibit 1** shows, 28 states and the District of Columbia currently have some type of throwback rule.

Exhibit 1
States with Throwback Rules

Alabama	Kansas	North Dakota
Alaska	Kentucky	Oklahoma
Arkansas	Louisiana	Oregon
California	Maine	Rhode Island
Colorado	Massachusetts	Tennessee
Connecticut	Mississippi	Utah
District of Columbia	Missouri	Vermont
Hawaii	Montana	West Virginia
Idaho	New Hampshire	Wisconsin
Illinois	New Mexico	

Source: CCH Intelliconnect

Combined Reporting

As **Exhibit 2** shows, more than half of the 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.

Exhibit 2
States with Combined Reporting

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

Source: CCH Intelliconnect

Of the states with combined reporting, 11 are members of the Multistate Tax Commission (MTC). Member states pool their resources to select candidates for tax audits. The commission's audit staff performs these audits as though they were part of a state's own audit staff, forwarding their findings and recommendations to the member states for assessment and collection at the completion of the audit.

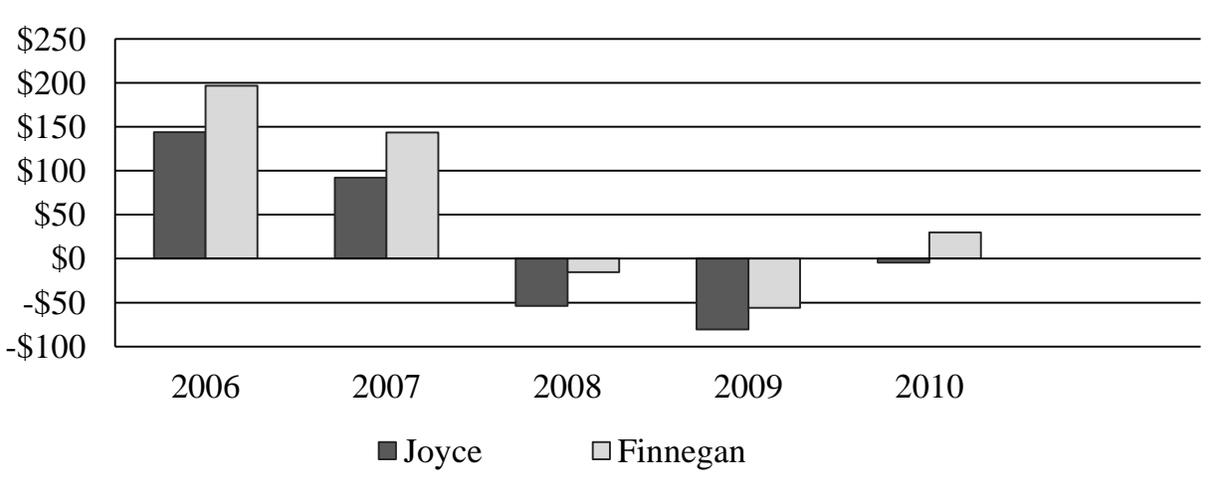
Comptroller's Analysis of Combined Reporting

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. About 65% of the revenues that would have been generated under Finnegan in tax year 2010 were attributable to corporations in the retail trade and accommodation and food services industries.

Tax year 2010 data shows 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 3** shows the corporate income tax revenues under the Finnegan and Joyce methods from tax year 2006 through 2010.

Exhibit 3
Effect of Combined Reporting
Tax Years 2006-2010
(\$ in Millions)



Source: Comptroller’s Office

State Revenues: The bill requires combined reporting for corporations beginning in tax year 2021 and applies a throwback rule beginning in tax year 2020. As a result, general fund revenues increase by \$83.3 million, TTF revenues increase by \$8.5 million, and HEIF revenues increase by \$3.5 million in fiscal 2021. **Exhibit 4** shows the impact of combined reporting and the throwback rule in fiscal 2021 through 2025.

Exhibit 4
Fiscal Impact of Legislation
Fiscal 2021-2025
(\$ in Millions)

	<u>FY 2021</u>	<u>FY 2022</u>	<u>FY 2023</u>	<u>FY 2024</u>	<u>FY 2025</u>
Combined Reporting	\$33.9	\$121.8	\$137.2	\$133.4	\$138.7
Throwback Rule	61.4	50.6	46.5	47.0	47.5
Total Revenues	\$95.3	\$172.3	\$183.7	\$180.4	\$186.1
General Fund	\$83.3	\$143.1	\$151.6	\$149.1	\$153.7
HEIF	3.5	8.5	9.3	9.1	9.5
TTF	8.5	20.7	22.7	22.2	23.0
Total Revenues	\$95.3	\$172.3	\$183.7	\$180.4	\$186.1
TTF Expenditures	\$1.2	\$2.8	\$3.1	\$3.0	\$2.2

HEIF: Higher Education Investment Fund

TTF: Transportation Trust Fund

This estimate is based on the Comptroller's estimate of the adoption of a throwback rule and assumes that pass-through entities will be required to comply with the throwback rule. Accordingly, the estimate assumes 40% of the revenue is from corporations and 60% is from pass-through entities. The estimated impact for combined reporting also reflects the average impact of combined reporting in prior tax years, adjusted for subsequent changes in the economy and corporate income tax revenues. It also reflects combined reporting using the Finnegan method. The actual impact of combined reporting could vary significantly from the estimates based on these variables and the implementation of combined reporting as adopted by regulations. In any given year, revenues could decrease significantly due to the high level of volatility in factors that influence the corporate income tax.

Additionally, if the Comptroller participates in the MTC income tax audit program, it has the potential to increase revenues by an additional \$1.0 million annually, which is not reflected in Exhibit 4.

State Expenditures: A portion of TTF revenues are used to provide capital transportation grants to local governments. Thus, any increase in TTF revenues from corporate tax revenues results in a 13.5% increase in TTF expenditures to local governments

(9.6% beginning in fiscal 2025). Accordingly, TTF expenditures increase by \$1.2 million in fiscal 2021 and by \$2.2 million in fiscal 2025, as shown in Exhibit 4.

The Comptroller's Office reports that it will incur additional expenditures beginning in fiscal 2021 in order to implement combined reporting for specified corporations. These expenses include:

- hiring two contractual tax consultants to respond to legal questions, process amended returns, and create tax forms and webpages beginning in part of fiscal 2021 through one-half of fiscal 2023;
- hiring one contractual revenue examiner to handle an expected increase in taxpayer queries beginning in part of fiscal 2021 through one-half of fiscal 2023;
- consultant fees for aiding in drafting regulations and administrative implementation;
- computer programming expenditures, including processing changes to the 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 2021 through 2023. The Comptroller's Office is transitioning from its SMART system to a new integrated tax system, the Compass project. It is expected that the corporate income tax will transition to the new system during the first quarter of 2021. The cost of modifying the Compass system for combined reporting will depend on contract renegotiations, thus, it is unknown at this time. However, since the corporate income tax is the third largest tax type in the State and the entire Compass project is projected to cost over \$150.0 million, the Comptroller estimates that it may cost approximately \$2.5 million in fiscal 2021 to add combined reporting to the system. The Department of Legislative Services notes that since these costs are unknown, the actual costs could vary.

Additionally, if the Comptroller participates in the MTC's income tax audit program, which would require the Comptroller's Office to provide assessments on audits of multistate businesses, expenditures will increase by \$200,000 annually. The Comptroller's Office can report to the General Assembly on the estimate of additional tax revenue from combined reporting with existing resources, since there is no provision requiring a separate informational filing form for affected corporations.

Exhibit 5
Comptroller's Office Administrative Expenses
Fiscal 2021-2023

	<u>FY 2021</u>	<u>FY 2022</u>	<u>FY 2023</u>
Computer Programming	\$2,500,000	\$0	\$0
Consultants	550,000	0	0
Contractual Employees	94,700	126,700	65,100
Training Expenses	41,550	0	0
Taxpayer Notification	38,750	0	0
Total Expenses	\$3,225,000	\$126,700	\$65,100

Local Revenues: Local governments receive a portion of corporate income tax revenues as local highway user revenues through capital transportation grants. Under this bill, local highway user revenues increase by \$1.2 million in fiscal 2021 and by \$2.2 million in fiscal 2025.

Additional Information

Prior Introductions: None.

Designated Cross File: None.

Information Source(s): Comptroller's Office; CCH Intelliconnect; Multistate Tax Collection; Department of Legislative Services

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