HB 457

Department of Legislative Services
Maryland General Assembly
2022 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 457 (Delegate Lehman, *et al.*)
Ways and Means

Corporate Income Tax - Throwback Rule and Combined Reporting

This bill (1) applies a "throwback" rule in determining whether sales are considered in the State for purposes of the State's corporate income tax apportionment formula; (2) requires affiliated corporations to compute Maryland taxable income using combined reporting; and (3) creates a subtraction modification against the State income tax for certain deferred tax liabilities and assets. **The bill takes effect July 1, 2022, with the throwback rule applying to tax year 2022 and beyond, and other specified provisions of the bill take effect July 1, 2023 and apply to tax year 2024 and beyond.**

Fiscal Summary

State Effect: General fund revenues increase by $13.2 million in FY 2023 from additional corporate income tax revenues. Transportation Trust Fund (TTF) revenues increase by $2.4 million and Higher Education Investment Fund (HEIF) revenues increase by $1.0 million in FY 2023. Potential significant increase in general fund expenditures due to administrative costs at the Comptroller's Office. TTF expenditures increase by $0.3 million in FY 2023 and by $3.2 million in FY 2027.

($ in millions)	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027
GF Revenue	$13.2	$80.3	$168.6	$174.6	$181.4
SF Revenue	$3.4	$20.8	$43.7	$45.3	$47.0
SF Expenditure	$0.3	$2.0	$3.0	$3.1	$3.2
Net Effect	$16.3	$99.2	$209.4	$216.8	$225.2

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

Local Effect: Local highway user revenues increase by $0.3 million in FY 2023 and by $3.2 million in FY 2027. 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.

The Comptroller must assess interest and penalties if a corporation pays estimated tax of less than 90% of the required tax for tax year 2022.

Combined Reporting

Beginning in tax year 2024, the bill requires corporations engaged in a unitary business 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 or pass-through entity 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. If a unitary business includes income from a partnership, the income to be included in the total income of the combined group equals the direct and indirect distributive share of the partnership's unitary business income allocated to any member of the combined group. 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.

Deferred Tax Liabilities and Assets Subtraction Modification

The bill creates a subtraction modification against the State corporate income tax for a corporation that was publicly traded or affiliated with a publicly traded corporation on or before the enactment of combined reporting, as enacted by the bill, if the enactment resulted in an aggregate (1) increase to the combined group's net deferred tax liability; (2) decrease to the combined group's net deferred tax asset; or (3) change from a net deferred tax asset to a net deferred tax liability. The subtraction modification, subject to certain calculations, is equal to one-tenth of the amount necessary to offset the increase, decrease, or change. It may be used to reduce the combined group's Maryland modified income for 10 consecutive years beginning with the first taxable year that begins after December 31, 2028.

The subtraction calculated under the bill may not be reduced as a result of any event that occurs after the calculation, including the disposition or abandonment of any asset. The subtraction must be calculated without regard to the federal tax effect and may not alter the tax basis of any asset.

If the subtraction exceeds Maryland modified income computed without regard to the subtraction, the excess amount may be carried forward to succeeding tax years until the excess is fully used.

By July 1, 2025, a combined group that intends to claim a subtraction under the bill must file with the Comptroller a statement that specifies the total amount of the subtraction that the combined group intends to claim. The Comptroller may review and alter the amount of the subtraction specified in the statement or the subtraction claimed on a tax return for any taxable 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 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.

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.

State Revenues: The bill requires the adoption of a throwback rule under the corporate income tax beginning in tax year 2022 and requires combined reporting under the corporate income tax beginning in tax year 2024. As a result, general fund revenues increase by $13.2 million, TTF revenues increase by $2.4 million, and HEIF revenues increase by $1.0 million in fiscal 2023. **Exhibit 1** shows the impact of the bill in fiscal 2023 through 2027.

Exhibit 1
Projected State Fiscal Impact
($ in Millions)

	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027
General Fund	$13.2	$80.3	$168.6	$174.6	$181.4
HEIF	1.0	6.1	12.7	13.2	13.7
TTF	2.4	14.8	31.0	32.1	33.3
Total	**$16.6**	**$101.2**	**$212.4**	**$219.9**	**$228.4**
TTF Expenditures	**$0.3**	**$2.0**	**$3.0**	**$3.1**	**$3.2**

HEIF: Higher Education Investment Fund
TTF: Transportation Trust Fund

This estimate is based on the Comptroller's estimate of the average impact of combined reporting in prior tax years and the adoption of a throwback rule, adjusted for subsequent changes in the economy and corporate income tax revenues. 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 the factors that influence the corporate income tax.

The subtraction modification provision of the bill has no immediate fiscal impact, as subtraction modifications may be claimed beginning in tax year 2029. As a result, the increase in fiscal 2029 revenues resulting from the bill will be lower by approximately 30% of the tax year 2029 decrease stemming from the subtraction modification due to corporations adjusting estimated tax payments. General fund, TTF, and HEIF revenue increases will be further impacted beginning in fiscal 2030.

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 $0.3 million in fiscal 2023 and by $3.2 million in fiscal 2027 as shown in Exhibit 1.

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

- hiring contractual auditors to handle an expected increase in taxpayer queries;
- 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.

Accordingly, general fund expenditures may increase by $3.6 million in the first fiscal year in which the Comptroller's Office incurs these expenses and about $300,000 annually thereafter.

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 $0.3 million in fiscal 2023 and by $3.2 million in fiscal 2027. The net increase in local highway user revenues from the bill will be lower beginning in fiscal 2029 to the extent that corporations claim the subtraction modification established under the bill.

Additional Information

Prior Introductions: None.

Designated Cross File: None.

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

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