
Maryland's Corporate Income Tax Overview and Issues

**Presentation to the
Senate Budget and Taxation Committee**

**Department of Legislative Services
Office of Policy Analysis
Annapolis, Maryland**

August 30, 2011

Corporate Income Tax – Discussion Topics

- Overview and Background
- Issues and Recent Proposals
- Gross Receipts Tax/Alternative Minimum Assessment

Overview and Background

Corporate Income Tax – Overview

- The corporate income tax applies to each Maryland corporation and every other corporation that has nexus with Maryland
- First enacted in 1937 at a rate of 0.5%, the corporate income tax is currently imposed at a rate of 8.25%, with various tax exemptions and/or credits available to qualifying businesses
- Forty-three states and the District of Columbia currently impose a corporate income tax
 - Four states impose a type of business activity or gross receipts tax in lieu of a corporate income tax (Michigan, Ohio, Texas, and Washington state), and three states do not impose a corporate income tax (Nevada, South Dakota, and Wyoming)
- Local jurisdictions in Maryland are not authorized to impose corporate income taxes
- While Maryland imposes a single corporate income tax rate, a number of states have graduated corporate income tax rates

Calculation and Applicability

- For a corporation located solely in Maryland with no operations in other states, that corporation's calculation of Maryland taxable income is relatively straightforward
- For a Maryland corporation with multistate operations, however, the calculation of corporate income tax is more complicated and can also provide opportunities for using tax planning and avoidance mechanisms
- While corporations pay the corporate income tax, business entities such as partnerships, limited liability companies, and sole proprietorships are considered pass-through entities for tax purposes – these entities are generally taxed through the individual income tax

Calculation

- Federal taxable income – starting point
- Maryland modified income – federal taxable income plus or minus Maryland addition and subtraction modifications
- Maryland taxable income:
 - Wholly local corporation – Maryland modified income is Maryland taxable income
 - Multistate corporation – determines portion of Maryland modified income attributable to Maryland based on amount of business carried out in Maryland
- Maryland tax liability is Maryland taxable income times tax rate (8.25%) minus any tax credits

Recent Significant Changes

- Rate increased from 7.0 to 8.25% beginning in tax year 2008
 - Additional revenues were dedicated to the general fund and the newly created Higher Education Investment Fund
- Apportionment formula for multistate corporations
- Expanded applicability of the tax to long distance telephone companies, financial institutions, local telephone companies, and electric and gas utilities
- Prevention of tax avoidance mechanisms
 - Statutes enacted in 2004 and 2007 restricted the use of Delaware Holding Companies and Captive Real Estate Investment Trusts to avoid State corporate income taxes
- Tax credits

Significant Tax Credits

Primarily Business Credits

- Enterprise Zone
- Maryland-mined Coal
- Job Creation
- Sustainable Communities
(previously Heritage Structure
Rehabilitation)
- Businesses that Create New Jobs
- Maryland Disability Employment
- Employer-provided Long-term Care
Insurance
- Employer-provided Commuter
Benefits
- One Maryland
- Clean Energy Incentive
- Research and Development
- Green Buildings
- Long-term Employment of Qualified
Ex-felons
- Biotechnology Investment
- Film Production
- InvestMaryland

Rates in Maryland and Surrounding States

Tax Year 2011

<u>State</u>	<u>Tax Rate</u>
Pennsylvania	9.99%
Washington, DC	9.975%
Delaware	8.7%
West Virginia	8.5% *
Maryland	8.25%
Virginia	6.0%

*Rate is currently scheduled to drop to 6.5% by tax year 2014

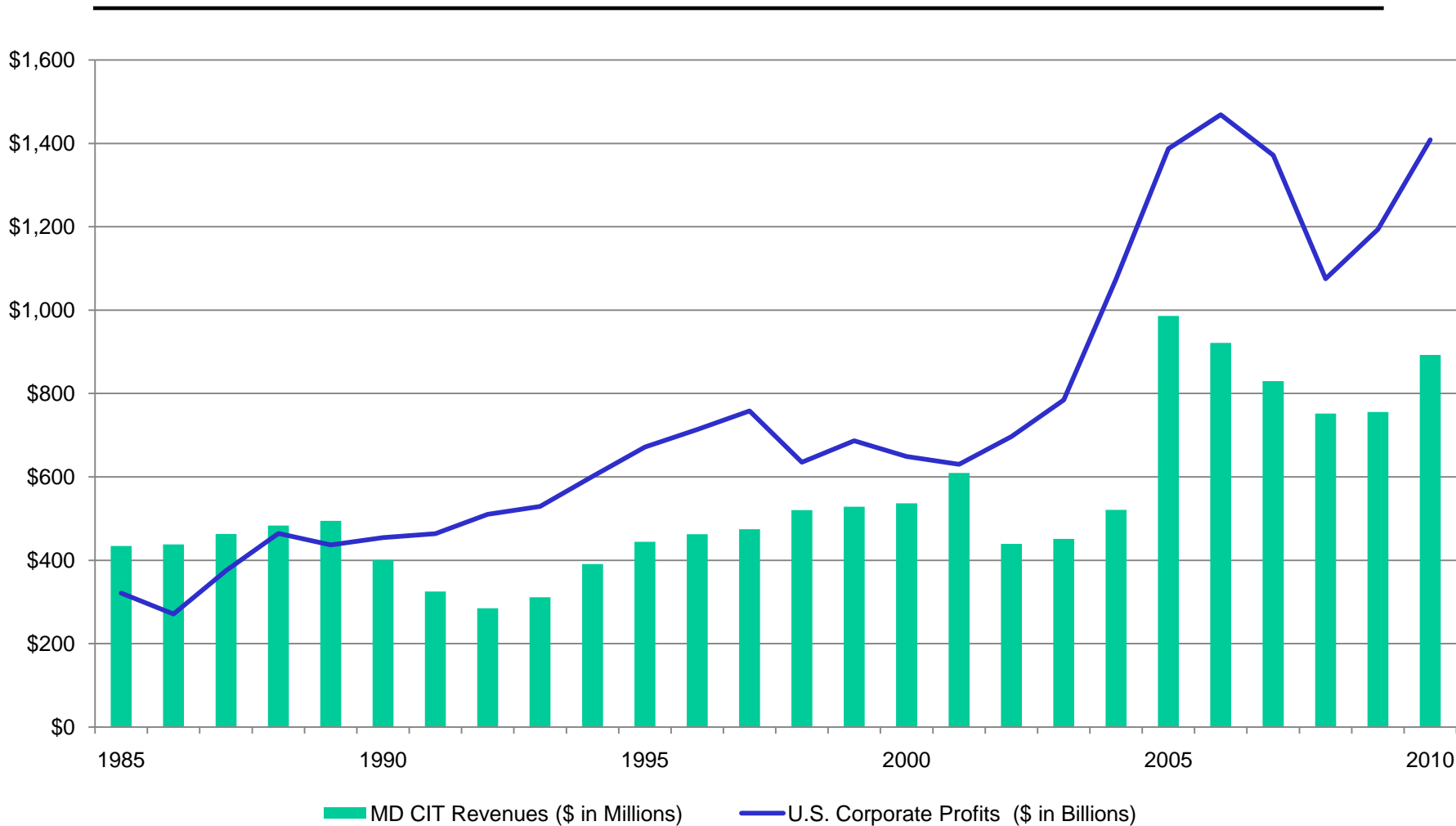
States with Recent Rate Changes

- Since 2006, Maryland, Illinois, and Oregon have increased their corporate income tax rates
- In that same time period, Kansas, Kentucky, Massachusetts, New York, North Dakota, and West Virginia provided some form of corporate income tax rate reduction
- Of the states with a rate reduction, Massachusetts (2009), New York (2007), and West Virginia (2009) also implemented combined reporting

Fiscal 2012 Revenues

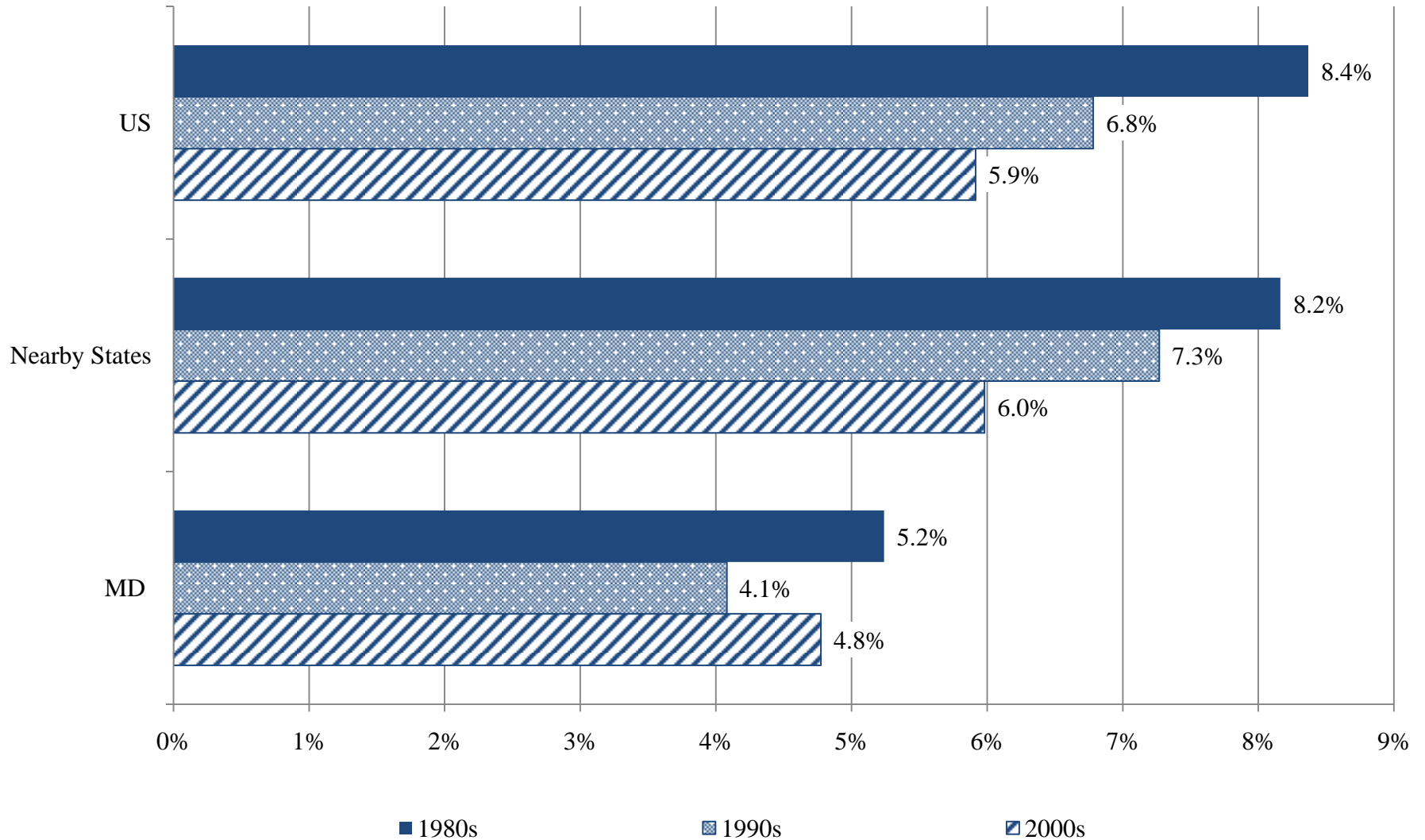
- Projected fiscal 2012 corporate income tax revenues – \$845 million, split between the general fund (73.6%), Transportation Trust Fund (20.4%), and the Higher Education Investment Fund (6.0%)
 - General Fund: \$622 million, or approximately 4.5% of total general fund revenues
 - Transportation Trust Fund: \$172 million
 - Higher Education Investment Fund: \$51 million

Maryland Corporate Income Tax Revenues and U.S. Corporate Profits



CIT: corporate income tax

Corporate Income Tax Reliance



Revenue Trends Over Time

- Reasons cited for relative decline of corporate income tax revenues:
 - Federal corporate income tax actions
 - State income tax reductions (rates, income determination, tax credits)
 - Increase in corporate entities organizing as pass-through entities that file under the personal income tax
 - Tax planning

Issues and Recent Proposals

Issues and Recent Proposals

- Federal limitations on state taxing authority
- Unitary business principle/apportionment of income
- Combined reporting
- Throwback rule
- Allocation of nonoperational income
- Alternative minimum assessment on gross receipts/profits

Taxing Multistate Corporations – Overview

- Federal constitutional and statutory limitations on state taxing authority:
 - Nexus
 - “Fair apportionment”
- Unitary business principle/apportionment
- Corporate income tax filing – separate or combined

Federal Limitations on Taxing Multistate Corporations

- Nexus/jurisdiction to tax
 - Constitutional requirements — sufficient contacts with state required
 - Federal statute — P.L. 86-272 prohibits a state from asserting nexus over a corporation that only solicits sales of tangible personal property
- The tax base of a multistate corporation must be “fairly apportioned” among jurisdictions

Unitary Business Principle

- “Unitary business” — where in-state and out-of-state operations of a multistate enterprise are interdependent on and contribute to one another
- Where a unitary business exists, the income of the enterprise attributable to a particular state is commonly measured by “apportionment” of income based on the operations of the entire unitary business within and outside the state
- Maryland has long recognized the unitary business principle by requiring apportionment of income for multistate corporations
- The factors generally used to apportion income are property, payroll, and sales in a state

Apportionment in Maryland

- Apportionment methods:
 - In general, three-factor, double-weighted sales factor apportionment is required
 - Manufacturers use a single sales-factor apportionment method
- The double-weighting of the sales factor and single sales factor apportionment reduces the tax for “in-state” taxpayers, apportioning more (or all) income based on location of sales rather than property or payroll
- According to taxpayer data analyzed by the Comptroller, single sales factor apportionment for manufacturers reduced State revenues by \$19.0 million in tax year 2006, \$14.2 million in tax year 2007, and \$12.6 million in tax year 2008

Limitations of the Unitary Business Principle in Maryland

- The application of the unitary business principle is limited in Maryland for multi-corporate enterprises because of the requirement for “separate reporting” by each separate corporation
- 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 State income tax
- As such, neither the net income nor the apportionment factors of those affiliated corporations are considered for purposes of the tax

Combined Reporting – Overview

- Under combined reporting, formal corporate structure is disregarded to determine the share of income of a multistate enterprise that is attributable to a state
- The combined income of all members of a unitary group is taken into account, and the combined taxable income is then apportioned to the state using the combined apportionment factors of all the members of the group
- Legislation to implement combined reporting in Maryland has been introduced numerous times in recent years, most recently in Senate Bill 305/House Bill 731 of 2011
- Just over half of the states with a corporate income tax currently require some form of combined reporting – since 2006, five states and the District of Columbia have introduced combined reporting

Combined Reporting – Advantages

- Provides uniform treatment of multistate enterprises without regard to corporate structure
- Reduces administrative burdens by eliminating the need to examine the validity and reasonableness of intercompany transactions
- Reduces motivation for tax avoidance behavior and removes a competitive disadvantage for local corporations, which are unable to use cross-border tax planning techniques to avoid the tax
- Likely State revenue gain over time – the Department of Legislative Services (DLS) estimates that combined reporting could generate up to \$150 million annually

Combined Reporting – Disadvantages

- The determination of what constitutes a unitary business can be complex and lead to costly and time-consuming litigation
- Combined reporting is perceived as business unfriendly and would be a dramatic change for many business entities, tax professionals, and the Comptroller
- Difficult to estimate State revenue impacts from year-to-year
- Creates revenue “winners and losers” among categories of industries

Throwback Rule

- Federal constitutional and statutory nexus requirements may prevent other states from imposing corporate income taxes on Maryland corporations even though they make sales in those states
- The interaction of Maryland's existing apportionment of income rules and the federal nexus restrictions may result in income that is apportioned nowhere for state corporate income tax purposes and is not taxed
- Many states address "nowhere income" by imposing a "throwback rule" under the sales factor of the apportionment formula
- Under the throwback rule, sales to a purchaser located in another state where the seller is not taxable are "thrown back" to the state from which the seller made the sale – this can also include sales to the federal government
- Imposing a throwback rule could generate up to \$40 million annually

Allocation of Nonoperational Income

- Unlike most other states, Maryland does not distinguish between “business” and “nonbusiness” (or nonoperational) income
- As such, Maryland law provides that all income of a multistate corporation doing business in the State is apportioned
- The interaction of Maryland law and federal restrictions may result in nonoperational income that is not taxed by Maryland or any other state (nowhere income)
- Estimating the additional revenues that could be generated from the allocation of nonoperational income to Maryland is difficult, as those revenues would likely be very volatile from year-to-year

Gross Receipts Tax/Alternative Minimum Assessment

Gross Receipts Tax – Overview

- In looking at ways to tax business income, another approach is a business tax based on gross receipts
- A gross receipts tax (GRT) is typically a low rate tax assessed on the receipts of most or all types of businesses, generally with some level of exemption provided
- The GRT applies whenever a product or service – from raw materials through the finished product purchased by a consumer – is sold by one business to another in the process of making a product or providing a service

States with a Gross Receipts Tax

- A few states impose some form of a GRT, usually in conjunction with, or in lieu of, a corporate income tax
- Examples include:
 - As an alternative minimum to the corporate income tax (Kentucky)
 - As a replacement for the corporate income tax (Ohio)
- Many local jurisdictions in Virginia impose an occupational license fee or tax based on gross receipts
- Delaware imposes a GRT and other corporate taxes, but does not impose a sales tax

Gross Receipts Tax in Delaware

- Delaware imposes a tax on the gross receipts of most businesses, in addition to a corporate income tax and a corporate franchise tax
- The GRT is levied on the seller of goods or services, rather than on the consumer
- Delaware increased most of its GRT rates in 2009 and again in 2010, with rates currently ranging from 0.1037 to 2.0736%, depending on the type of business activity
- While no deductions are allowed for the cost of goods sold, labor costs, interest expense, and state or federal taxes, most businesses are entitled to an exclusion, which generally starts at \$80,000 per month, depending on the type of business activity conducted

Gross Receipts Tax Rates in Delaware

<u>Business Activity</u>	<u>Percentage of Aggregate Gross Receipts</u>
Lessees	2.0736% of rent paid under a lease of tangible personal property
Retailers	0.7776%
Contractors	0.6739%
Licensed Occupations	0.4147%
Wholesalers	0.4147%
Grocery Store Retailers	0.3402% of the first \$2 million per month; 0.6372% of monthly receipts above that amount
Manufacturers	0.1944%
Farm Machinery Retailers	0.1037%

Revenues from the Gross Receipts Tax and Other Business Taxes in Delaware

- Net Delaware general fund GRT revenues, plus annual business licensing fees, totaled \$195 million in fiscal 2010, or about 6.0% of all state general fund revenues
- Delaware's corporate franchise tax, also imposed on limited partnerships and limited liability companies, and its corporate income tax generated a combined total of \$853 million in general fund revenues in fiscal 2010, or about 26.3% of total general fund revenues in the state

Alternative Minimum Assessment Maryland Legislation

- Legislation has been introduced in recent years, most recently Senate Bill 979 of 2011, to impose an alternative minimum assessment (AMA) on a corporation based on either gross receipts or gross profits
- If the AMA calculated under the method elected by the taxpayer exceeded corporate income tax liability, the corporation would be required to pay the amount of the excess as additional tax
- Corporations could claim a credit for the amount of the AMA paid against future corporate income tax revenues to the extent the corporate income tax exceeds the AMA in those tax years

AMA – Maryland Legislation (Cont.)

- Gross receipts method
 - Graduated rates ranging from 0.125% for gross receipts between \$10.0 million and \$20.0 million to 0.4% for gross receipts in excess of \$75.0 million
 - Exemption for gross receipts up to \$10.0 million
- Gross profits method
 - Graduated rates ranging from 0.25% for gross profits between \$2.0 million and \$10.0 million to 0.8% for gross profits in excess of \$37.5 million
 - Exemption for gross profits up to \$2.0 million
- While potentially significant, the amount of revenues that could be generated from the AMA cannot be reliably estimated at this time

Gross Receipts Tax – Advantages

- Provides for collection of taxes from profitable companies that minimize or avoid income taxes through tax planning techniques and unprofitable companies that may benefit from public services
- May allow states to collect tax from companies protected from income taxes because of federal constitutional and statutory limitations
- Provides a more stable revenue source
- Lower compliance and administrative costs as compared to the income tax
- Broader tax base can allow for a lower rate or rates

Gross Receipts Tax – Disadvantages

- Can create tax pyramiding and potential multiple layers of taxation
- Tends to favor large, vertically integrated businesses that are able to avoid multiple layers of taxation
- Heavier burden on high volume, low-profit margin businesses
- Can be unfair to smaller and start-up enterprises, as it is not based on ability to pay
- Administrative simplicity may be reduced by the need to allocate receipts of multistate enterprises or by providing separate tax rates for different industries

Gross Receipts Tax – Revenues

- To determine the potential revenues that could be derived from imposing a GRT in Maryland, DLS has reviewed economic census data from the U.S. Census Bureau
- In developing its estimates, DLS has taken into account several factors that would reduce the taxable base for a GRT, including exemptions for categories of businesses similar to those provided in Delaware, the difficulty of tax collection, and limitations on the data collected by the economic census
- The revenue estimates assume the same GRT rate is applied across all industries

Estimated Revenues from Imposing a Gross Receipts Tax in Maryland

<u>GRT Rate</u>	<u>Estimated Revenues</u>
0.25%	\$700 million
0.50%	\$1.4 billion
1.0%	\$2.8 billion
1.5%	\$4.1 billion

GRT: gross receipts tax