



Analysis of state policy choices with particular attention to their impacts on low- and moderate-income Marylanders

SPECIAL REPORT

Maryland Budget Update

CORPORATE INCOME TAX COMBINED REPORTING

Special Report
October 2, 2009

**Maryland Budget & Tax
Policy Institute**
190 W. Ostend Street
Suite 201
Baltimore, MD 21230

410-727-6367
fax 410-727-1914
www.marylandpolicy.org

*a project of the
Maryland Association of
Nonprofit Organizations*

all rights reserved ©

Maryland's Bureau of Revenue Estimates has released its long-anticipated analysis of the revenue effects of "combined reporting" for corporation income taxes.

The report estimates that if corporate income tax combined reporting had been in effect in Maryland in 2006, the state would have raised an additional \$109 million to \$170 million, depending on the details of the combined reporting requirement.

move profits out of the states in which they are earned and into states in which they will be taxed at lower rates — or not at all. Households and businesses located entirely in Maryland, which do not have the opportunities or resources to engage in interstate income-shifting, end up paying higher taxes than necessary to make up for the taxes that multi-state corporations are able to avoid.

Governor O'Malley proposed combined reporting as part of his budget-balancing plan in 2007. The legislature dropped the combined reporting provision from its final version of the package, but created a commission to study business taxes and report its recommendation in December 2010. This group is the recipient of the Bureau of Revenue Estimates' report.

Revenue Effects

If combined reporting had been in effect in Maryland in 2006, corporations would have paid an additional \$109 million to \$170 million in income taxes. This would be because Maryland affiliates of national corporations would have reported all the profits of their parents, subsidiaries and other affiliated companies. They would then have scaled this total down by a factor to represent Maryland's share of the corporate group's total income. This equates to 12.5% or 19.5% of total corporate income tax revenues.

The difference between the two estimates is the precise rules for calculating Maryland's share of the corporate group's income. The smaller figure does not count an affiliated company's sales in Maryland towards Maryland's share of overall profits if the affiliated company has no assets or employees in Maryland.

Cautionary Notes

The Bureau of Revenue Estimates' study is the most thorough and comprehensive study of combined reporting effects undertaken by any state. However, it is only a simulation of the "pro forma" effects, based on companies' self-reported data and a past year.

The report's authors emphasize that the estimated revenues are only the "what if?" number for combined reporting in 2006. They point out that the estimated revenue from enacting combined reporting now would be different for several reasons.

Different economic conditions. The estimate is based on companies' reports of their 2006 incomes and profits. Tax year 2006 occurred at the height of the last economic expansion. The state's corporate income tax revenue total of \$868 million that year was the largest on record.

Since then, the national economic recession has reduced corporate profits nationally and in Maryland. In the current economic environment, the gains from combined reporting would be significantly less. The effect should be expected to grow again as the economy-and profits-recover.

Tax years and fiscal years. Corporations pay tax on a "tax year" usually corresponding to the calendar year. The state's fiscal year runs from July to June. Corporations pay estimated payments throughout the year, and then pay their final liability (or receive a refund) upon filing a final return. Often, there are extensions or amended returns. As a result, only about 33% of corporation income tax is received by the state in the same-numbered fiscal year. About 70% to 80% comes in the final year. That adds to more than 100%, and there are net refunds from amended returns in the third and fourth year.

For this reason, the initial effects of a new combined reporting system will take three to four years before the revenue stream reaches its full amount and evens out.

General fund. The state's budget shortfall is normally reported as the estimated shortfall in the state general fund. However, only about 80% of corporation tax revenues are paid to the general fund. The rest goes to the Transportation Trust Fund.

Behavioral and reporting changes. The Bureau's estimates assume no changes in companies' behavior as a result of a change to combined reporting. The change in tax law will almost certainly spur some changes in business and accounting practices, and this could affect the estimates. In addition, the data reported by companies reflected varying definitions and understandings of the combined reporting unit. If a combined reporting law were in effect, the taxpayers' combined units would all be governed by the same legal definitions.

For all these reasons, the simulated effects for 2006 will differ from the effect on the state budget of actually implementing combined reporting.

“Winners and Losers”

For each multi-state company, combined reporting will change the overall profits that are subject to Maryland taxes, and the factors to calculate Maryland's share of the total. As a result, some will pay more tax, but others will save money.

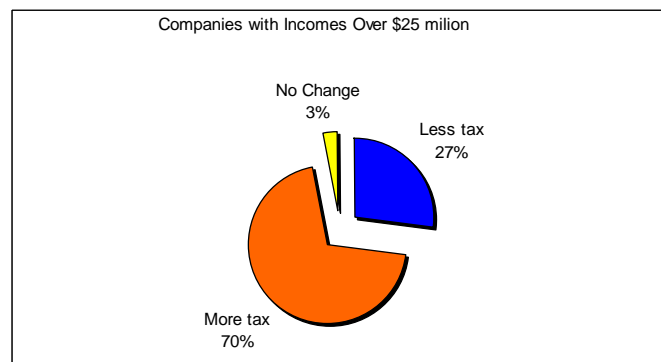
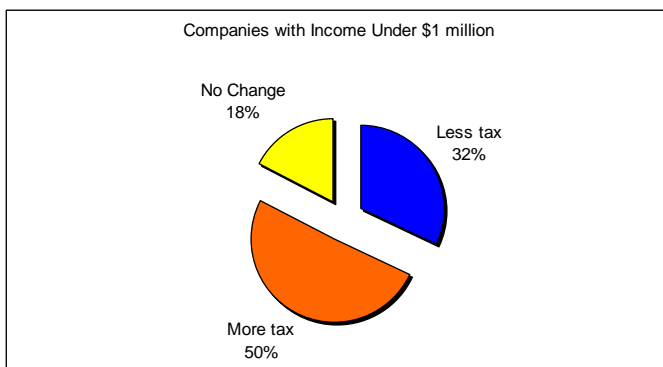
In the scenario where the state gains \$170 million, about 2400 companies owe more tax, 1900 save money, and 1900 do not change.

The Bureau tabulated the estimated effects according to business size and the predominant industry of the business.

Small companies are more likely to benefit from combined reporting. Larger businesses tend to owe higher taxes. The chart below shows this effect using data from the Bureau of Revenue Estimates' \$170 million simulation.

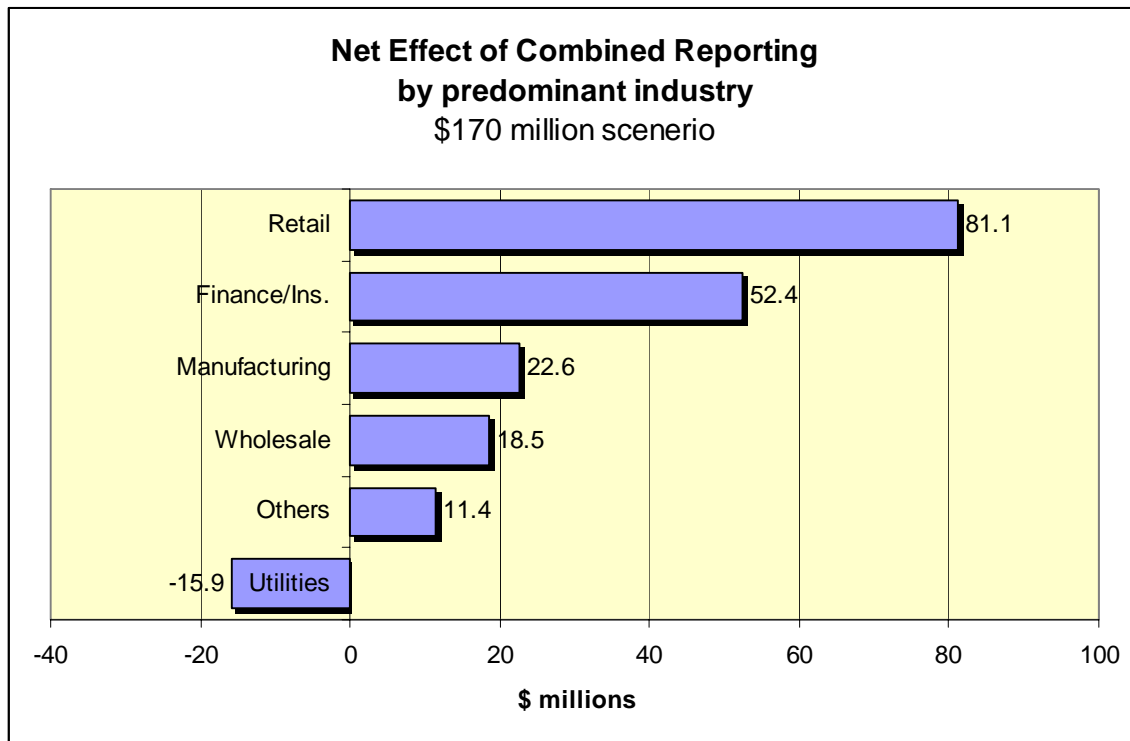
Estimated Effects of Combined Reporting in 2006

\$170 million scenario, selected income levels



In addition, industries are affected differently from combined reporting. Under the \$170 million scenario, net additional taxes from “retail trade” and “finance and insurance” companies together would have made up 78% of all the additional tax dollars. In retail trade, companies paying additional tax outnumber those with reduced tax bills more than two-to-one.

In the health care and social assistance industry, in contrast, the industry as a whole would pay less taxes under combined reporting and the number of companies with gains and losses are about equal.



Conclusion: This Is Not the Time to Wait and See

In the ideal world, it might be a good thing to collect more data and better understand the differential effects of combined reporting on different businesses before making a decision about the best tax policy. Or it might represent a delaying tactic by the advocates for large, multistate corporations. The Maryland Budget and Tax Policy Institute believes that under the state’s current circumstances of great financial pressure, we know enough now to enact combined reporting while it’s most needed. Refinements can easily be made down the road if credible evidence of inequities or other problems emerge.

The state’s financial situation is dire, and the data from the report is good enough. After all, combined reporting is not an experimental policy. It is up and running in 23 states.

Solving the state’s projected budget shortfall of \$2 billion only with cuts will require severe losses to health, education, public safety and safety net programs. These public services are important to Maryland’s business community as well as to households. The Bureau of Revenue Estimates’ study shows that

combined reporting revenue would not solve the state's entire problem, but it would add significant resources for needed public services.

More importantly, combined reporting would provide a basis for taxing corporations that is more reflective of economic realities than the current system, and which would be less prone to a wide range of manipulative practices used by some businesses to shelter income from Maryland taxes.

The Governor and legislature should support a combined reporting law in the 2010 legislative session to take effect in tax year 2010.

Sources:

Bureau of Revenue Estimates, Analysis of Tax year 2006 Maryland Corporation Information Reports, Comptroller of Maryland, 2009.

Mazero, Michael. A Majority of States Have Now Adopted a Key Corporate Tax Reform — "Combined Reporting," Center on Budget and Policy Priorities, 2009.

<http://www.cbpp.org/cms/index.cfm?fa=view&id=246>

About the Maryland Budget & Tax Policy Institute

The Maryland Budget and Tax Policy Institute is a nonpartisan research organization that provides timely, accurate and accessible analysis of state budget and tax issues. In addition to general budget and tax research and analysis, the Institute examines issues affecting low-income Marylanders and other vulnerable populations and the important community programs that serve them. For additional information, to be added to our e-mail list, or to make a tax-deductible contribution, please visit our website at www.marylandpolicy.org.

The Maryland Budget and Tax Policy Institute gratefully acknowledges the Ford Foundation, which provides financial support for the Institute under its State Fiscal Analysis Initiative. Additional general support for the Maryland Budget and Tax Policy Institute is provided by the Moriah Fund, the Eugene and Agnes E. Meyer Foundation, the Fund for Change, the Open Society Institute-Baltimore, and generous individual donors.

The Institute is a project of Maryland Nonprofits, www.mdnonprofits.org.