COMPTROLLER of MARYLAND
Serving the People

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Honorable Martin O'Malley
Governor of Maryland
State House
Annapolis, Maryland 21404

Honorable Thomas V. "Mike" Miller, Jr.
President of the Senate
State House
Annapolis, Maryland 21404

Honorable Michael E. Busch
Speaker of the House
State House
Annapolis, Maryland 21404

Dear Governor, President and Speaker:

As required by Tax-General 10-804.1(e), I am pleased to provide this report on Maryland's corporate income tax and the revenue effect of possible corporate income tax changes. This report is not intended to be a thorough analysis of the advantages and disadvantages of combined reporting or other changes to the corporate income tax. Rather, it is intended to provide a factual foundation, of both the current tax structure and alternative tax structures, upon which such analyses can be based. A great deal of progress in illuminating issues surrounding Maryland's corporate income tax and tax base has been made, including the creation of a database required under 10-804.1(e). Much work, however, remains to be accomplished, as detailed below.

Corporate Statistics of Income Reports

Attached to this letter are statistics of income reports for Maryland's corporate income tax for tax years 2003 through 2006. These reports contain detailed information about the corporate income tax, with data broken out by Maryland modified income, industry, and multistate and 100% Maryland corporations. These reports should provide for a better understanding of Maryland's existing corporate income tax base. Published annually, the statistics of income reports will be available online.

Corporate Reporting

As a result of Chapters 177 and 178 of the 2008 Session of the General Assembly, Maryland undertook an unprecedented effort to collect information from corporate taxpayers to enable the estimation of the revenue effects of instituting combined reporting and other possible income tax changes. Information reports were initially due October 15, but shortly before the due date the Joint Committee for Administrative, Executive, and Legislative Review extended the deadline 45 days, until December 1. At that time, we initiated a delinquency control effort to obtain reports we believed were due and unfiled. In mid-December, 14,722 letters were mailed to entities we had identified as corporate groups indicating that we believed they were possibly subject to the reporting requirements. Over 1,200 reports were submitted after December 1.

Due to a variety of reporting issues, discussed below, an estimate of what the revenue impact of combined reporting would have been in tax year 2006 is not currently possible, although the Comptroller's Office continues to work towards that goal. Despite that problem, estimates can be made of the revenue effects of two other possible corporate income tax changes, instituting the throwback rule (for tangible personal property sold from Maryland under separate entity reporting) and requiring 100% allocation of nonoperational income to Maryland. Extensive analysis of the information reports has resulted in the following tentative conclusions.

Combined Reporting

Analysis of these corporate reports over the past two months has uncovered a number of substantial problems which prohibit, at this time, a determination of what the revenue effect would have been if Maryland had required combined reporting for tax year 2006. However, these reports have already shed light on the nature of Maryland's corporate income tax base. Information reports for tax year 2006 were received from just under 6,100 corporate groups,

Unitary Groups in Maryland

Entities in Unitary Group	Number of Groups	Entities in Unitary Group	Number of Groups
2 - 5	3,191	41 - 50	117
6 - 10	1,085	51 - 75	137
11 - 15	519	76 - 100	71
15 - 20	317	101 - 200	102
21 - 30	337	Over 200	46
31 - 40	161		

representing over 96,400 separate entities. Over 14,700 of these reporting entities had nexus in Maryland; in other words, approximately 23% of Maryland's corporate taxpayers are members of a unitary group. These entities had Maryland modified income (on a separate entity basis) of $198.6 billion, over 95% of total Maryland modified income, as would generally be expected. As would also be expected, most of these unitary groups include only a small number of entities. The following table shows the distribution of unitary group size.

While it is clear that many if not most corporate groups reported the required information correctly, it is also clear that a variety of issues must be resolved before the 2006 data is able to be used to analyze the impact of combined reporting on Maryland's current tax base. The issues include possibly incomplete reports, illogical data, and typical data entry errors.

One of the most significant problems is that a large number of groups effectively reported that they have no eliminations, or intercompany transactions, which are fundamentally the issue combined reporting is intended to address. Of the 6,083 reports received, fully 2,190 (36%) reported no eliminations. Excluding the groups with only two or three members, who are thought to be very likely to have no intercompany transactions (counting as one entity the aggregated entities with no sales or other activity in Maryland), 675 of the remaining 1,915 groups reported no eliminations, and of the 400 largest groups, 105 did not report any eliminations. In a similar vein, over 160 group reports contained an entity that made an addition or subtraction modification for tax year 2006 under Tax-General 10-306.1 for interest or intangible expenses paid to related parties and yet indicated no eliminations.

Given the above, it is not clear if many corporate groups, including many of the largest in the nation, have reflected any required adjustments in data reported for the separate entities of the group, or if they have filed an incomplete or inaccurate information report. The Comptroller's Office will be communicating with these corporations in order to determine how, or if, their corporate report reflected eliminations. This uncertainty over what reported data represents is the primary factor an estimate of the revenue effect of combined reporting for tax year 2006 be provided at this time.

In addition, many groups reported data that appear very unlikely to be correct. For example, a number of the reports indicated a larger receipts factor under Joyce rules of apportionment than under Finnigan rules. Other reports showed a substantial increase in the property or payroll factor under Finnigan relative to Joyce; as Finnigan is distinguished from Joyce by the inclusion of those entities which make sales into the State but do not have nexus, it is improbable that either factor, but especially the property factor, could increase by more than a *de minimus* amount. Some reports showed much larger property or payroll factors under Joyce than Finnigan; these two factors should be nearly equivalent in almost all cases. Yet others reported adjusted receipts factors in excess of the receipts of the individual entities of the group. These types of issues may arise largely from the fact that, until recent years, no nearby states, and very few east of the Mississippi, have used combined reporting. Many regional corporate groups have had no exposure to what is a substantially different method of calculating income tax, and may have submitted an inaccurate report despite a good faith effort to comply with the requirements.

The last major category of data problems are typographical and other data entry errors. In this first year of information reporting, all data had to be entered into the reporting system manually. Manual data entry results in significantly more errors than electronically submitted data. The Comptroller's staff are analyzing the data reported for the 96,400 individual entities for likely typographical errors, and will be working with respondents to resolve these issues.

The Comptroller's Office is taking the following steps to improve the quality of the tax year 2006 (and 2007) data, and the reporting system for tax year 2008 and later:

- All large groups that reported no eliminations will be asked to confirm that they had no intercompany transactions, to explain how they were accounted for in the report, or to submit a revised report.

- Comptroller staff will continue to analyze the reports, attempting to resolve other irregularities through analysis of all reported data and by working with respondents.

- The Comptroller's Office will work to upgrade the reporting system to allow for electronic uploads of data, which should reduce the burden on respondents and substantially increase the accuracy of the data.

- Having now analyzed actual corporate reports, we have developed a better understanding of what data is relevant for study, and what further data elements may be required. These conclusions will be shared with the Business Tax Reform Commission and the business community, and the reporting system for tax year 2008 will be revised accordingly.

Throwback Rule

Corporate income is typically apportioned to the states in which a corporation does business, as measured by some combination of receipts, property and payroll. However, income can be earned in states in which a corporation does not have nexus (generally a state in which sales are made but in which the corporation has no payroll or property), and which is therefore not taxed by that state. The throwback rule brings this "nowhere income" back to the state in which the goods were produced or from which they were shipped.

According to the tax year 2006 corporate reporting data, 330 entities would have had $9.3 billion of income from sales made into states in which they do not have nexus thrown back to Maryland. After apportioning that income and accounting for the fact that many of these entities had losses in 2006, corporate income tax revenues would have been $20.7 million higher, or roughly 2.8%, with 201 entities paying higher tax. If sales to the federal government were also thrown back to Maryland, an additional $2.5 billion would have been thrown back, and corporate income tax revenues would have increased a further $9.3 million. The actual revenue increase had the throwback rule been in effect would have been greater, barring behavioral changes, as single-entity corporations and noncorporate entities were exempt from these reporting requirements.

100% Allocation of Nonoperational Income

Generally, income from the regular course of business is apportionable. Certain items of non-business income, however, must be assigned to the state in which the income-producing assets are managed, usually the state of domicile, and cannot be taxed by other states. Maryland law, however, apportions away much of this type of non-business income which no other state has the authority to tax. If 100% of nonoperational income were allocated to Maryland, corporate income tax revenues would have increased at least $21.5 million. Again, this increase is probably understated due to the fact that single-entity corporations and noncorporate entities did not fall under these reporting requirements. Importantly, though, nonoperational income results from extraordinary transactions, by definition. It can therefore be expected to be volatile. In fact, many of the 33 entities which would have paid higher taxes in 2006 would have paid only several thousand more dollars in tax; most of the additional revenue would have come from a small number of businesses.

As noted above, the Comptroller's Office will continue to analyze the corporate reports, both as to the tax year 2006 data itself and to improving the corporate reporting system for future years. If you have any questions about this information, please do not hesitate to contact me at (410) 260-7450.

Sincerely,

David Roose
Director, Bureau of Revenue Estimates