MARYLAND BUSINESS TAX REFORM COMMISSION

Raymond S. Wacks, Chairman

Maryland Business Tax Reform Commission
Minutes of Meeting
May 13, 2009

A meeting of the Maryland Business Tax Reform Commission was held in the House of Delegates Office Building, Room 130 on Wednesday, May 13, 2009 at 1:30 p.m.

Those present were:

Raymond Wacks, Chairman
Delegate Sheila Hixson
Delegate D. Page Elmore
Senator Richard Madaleno
Senator Nancy J. King
Secretary T. Eloise Foster, Dept. of Budget & Management
Linda Tanton, Deputy Comptroller
Secretary Christian Johansson, Dept. of Business & Economic Development
James Kercheval, MACO Representative
Michael Leszca, MML Representative
Paul Nolan, Manufacturers Alliance of Maryland
Steven Banks, Greater Baltimore Committee
Karen Syrylo, Maryland Chamber of Commerce
Jennifer Yang Japp, Public Member
Michael Ettlinger, Public Member
Martin Lobel, Public Member

David F. Roose, Bureau of Revenue Estimates
Andrew Schaufele, Bureau of Revenue Estimates
George Manev, Department of Budget & Management
Marc Nicole, Department of Budget & Management
Robert Young, Department of Assessments and Taxation

The meeting was open to the public and members of local government, state government and other interested parties were in attendance.

Chairman Raymond Wacks opened the meeting at 1:40 p.m. and asked committee members to introduce themselves. The chairman briefly explained what would be discussed at the meeting and indicated that everyone is eligible for reimbursement of expenses. Mr. Wacks also indicated that a letter of exemption for disclosure was enclosed in their packet of information. He then turned the meeting over to Mr. David Roose for the presentation.

Mr. Roose introduced himself as well as the other panel members for the meeting's presentation: Andy Schaufele, Bureau of Revenue Estimates, George Manev, Department of Budget & Management and Robert Young, State Department of Assessment & Taxation. Mr. Roose went on to say that they would provide a high-level overview of Maryland's tax structure from a business perspective covering the four main taxes – individual income tax, corporate income tax, sales tax and property tax.

Mr. Roose went on to say that a sound tax system should be economically neutral; not distorting the spending, saving and investment decisions of consumers and businesses; virtually all taxes do have impacts on economic decisions, but that effect should be minimized to the extent possible. A sound tax system should be simple, easy for taxpayers to comply with and understand. It should not be difficult to administer, minimize the costs of administration and the burden on taxpayers, and enhance the fairness of the system.

Over half of general fund revenues come from the individual income tax. Although generally not thought of as a tax on business, it probably generates roughly the same amount of revenue from business as the corporate income tax. Entities such as partnerships, limited liability corporations, and subchapter S corporations pass their income through to the owners or shareholders of the entities, known as "pass-through entities" (PTEs). The income of these businesses is reported on the individual income tax returns of the owners.

Mr. Roose referred everyone to the graph on page 2 of the handout which shows Maryland's income tax collections over the past 20 years, which indicates strong growth in the late 1990s followed by two years of decline in 2002 and 2003, with a significant surge in recent years. The graph also shows the volatility of the revenue source due to an increasing importance of capital gains, which are very volatile and will become increasingly volatile with the new income tax brackets. Business also plays a role; more than 10% of revenues come from business.

The starting point for Maryland's tax, as with most states, is federal adjusted gross income, or FAGI. This includes wages, capital gains, interests, dividends, retirement distributions, most other income, and business income or business loss, less "above the line" deductions which include half of the self-employment tax and other self-employment related items, and the domestic production activities deduction. Maryland makes some specific adjustments for FAGI, both positive and negative, known as addition and subtraction modifications. Important modifications include those from PTE activity, expenses related to Maryland business tax credits and those related to provisions in federal tax law from which Maryland has "decoupled": Section 179 expensing, bonus depreciation, deduction for domestic production activities. After additions and subtractions are made, the result is Maryland modified income.

There are new personal exemptions and several additional rate brackets effective for tax year 2008. To the extent business returns are higher income than others, the new rates will obviously have an impact. There are a number of business-related tax credits available for the individual income tax; credits reduce the tax liability dollar for dollar.

Maryland also has a mandatory statewide local income tax, Mr. Roose explained. The rates shown on page 5 are flat rates applied to net taxable income. Combined, therefore, the top marginal income tax rate in Montgomery County is 9.45%, while in Worcester County it is 7.5%; top federal rate is currently 35%. Special nonresident tax in the amount of the lowest county income tax rate is applied to nonresidents at 1.25%. Karen Syrylo noted that the credit for taxes paid to other states only applies to the State portion of the income tax; there is no credit available against the local income tax.

For purposes of this discussion, business income is defined as that reported on schedules C, E and F of the federal income tax return. C is business income or loss, E is partnerships, S-corporations, royalties, rental real estate, as well as estates and trusts. The vast majority comes from partnerships and S-corporations. F is farm income.

Net business income of $16.1 billion was reported on 625,000 Maryland returns for tax year 2006, roughly 25% of all returns. The net income was just under 10% of total FAGI reported on Maryland returns. Much of that income is taxable in other states, the states in which the PTE is operating. In order to avoid double taxation, a credit is allowed for the taxes paid to other states in the amount of the tax actually paid, or the tax that would have been paid on that income if earned in Maryland. Nonresidents reported almost $23 billion of business income; however, only $1.5 billion was taxable.

Mr. Wacks asked the members if they had any questions. Senator Madaleno asked about the availability of capital gains data for returns with business income. Mr. Roose responded that the Comptroller's Office now has a very robust statistics of income database and that questions such as this can now be answered in detail with relative ease; this information will be provided at a future meeting.

Ms. Syrylo said that Maryland is a small business state, with tens of thousands of business entities paying individual income tax rather than corporate income tax. There was some discussion, with questions as to how Maryland compares to other states in this regard. Secretary Johansson noted that businesses look at the aggregate tax burden and see little distinction between state and local taxes. On a related note, Senator Madaleno asked about rates in other local jurisdictions with an income or income-related tax.

David Roose then introduced Andrew Schaufele who then gave a general overview of the corporate income tax structure in Maryland.

Corporate income tax collections have experienced strong growth as well as volatility with downward swings in times of recession; collections trend with the general economy stated, Mr. Schaufele. There is a strong growth through 1990s before the recession in 2001 and tremendous growth from 2002 to 2006. That growth was likely the result of strong corporate profits and the closing of a tax loophole. According to the Bureau of Economic Analysis, from the second quarter of 2002 to the third quarter of 2006, corporate profits nationally grew a historical 161%, from $554 billion to $1.4 trillion, growing by double digits every quarter. In addition, tax year 2004 was the first year corporations were required to add back income that may have previously been attributed to "Delaware Holding Companies."

The corporate income tax was the 3rd largest source of general fund revenue for the State in FY 2008. While it is the third largest, it was only 4.1% of general fund revenues in 2008. The personal income and sales tax generally make up 80-85% of revenues.

Mr. Schaufele went on to discuss the tax base and tax calculation stating the calculation begins with Federal Taxable Income which is essentially the companies' profits according to the federal government, and comes from the federal return. Maryland additions and subtractions are made to federal taxable income. One of the most important is Section 10-306.1 related party transaction is meant to address the "Delaware Holding Company" issue. Many companies had affiliates in Delaware that owned intangible assets such as trademarks or copyrights. The holding company would then collect royalties or other fees for the use of intangible property. Therefore, the Maryland company would deduct the royalties or fees as expenses and avoid taxation of that income in Maryland. In Delaware intangible income is not taxed. Companies were allowed to settle with the state in 2004, which resulted in $198.7 million, of which $151 million went to the general fund.

The domestic production activities addition decouples Maryland from a federal law that allows a company to deduct 9% of income attributable to production activities within the United States. The addition for dividends paid to a captive REIT (Real Estate Investment Trust) is the other attempt at closing a loophole. Companies were able to shift income from taxation by owning a captive REIT.

The REIT would own the property the company used and rent or lease it to the company. Under federal law, REITs that meet certain conditions, can deduct dividends paid to shareholders. This modification adds the deducted dividend back into taxable income. There are also subtraction modifications which are listed constitutionally required and some are in conjunction with certain decoupling measures.

After applying the additions and subtractions to federal taxable income you arrive at Maryland modified income and at this point the apportionment factor is applied to determine the amount of income that is taxable in Maryland. The current rate of 8.25% applied to Maryland taxable income results in gross Maryland tax. Some credits are refundable, meaning they can actually take taxable income negative and create a refund. Others can be carried over to a future year if the tax liability hits -0-. The allowable credits are the actual liability to the state and are larger than current year credits because of carryovers. Some information has been left out for disclosure purposes and it is worth noting that several of the Heritage Structure Rehabilitation credits were taken by non profit entities. Mr. Schaufele explained that, of nearby states, Maryland had the most credits available as well as the broadest range of credits.

Mr. Schaufele went on to discuss the major changes in corporate income tax since 2001. In 2004 companies were offered settlements for past Delaware Holding Company transactions, $198.7 million and the corporate rate increase from 7% to 8.25% in the 2007 Special Session.

Following legal changes is a more in depth discussion of income apportionment. The two most important apportionment methods are double-weighted sales, three-factor apportionment and single-factor apportionment for manufacturers. The default formula is the double weighted sales three-factor formula which the majority of companies use. Included in the numerator is the ratio of gross receipts delivered, shipped, or attributable to Maryland relative to the companies total receipts and this factor is then multiplied by two. The double weighted sales factor is then added to the ratio of payroll attributable to Maryland and the ratio of property attributable to Maryland. The sum of the above factors is then divided by 4 giving the apportionment factor. The single sales factor formula applies to manufacturing companies with more than 25 employees. The formula includes only the ratio of gross receipts attributable to Maryland to the companies' total receipts. This formula became applicable for tax years beginning in 2001.

The 2006 Single Factor Apportionment Study table summarizes the results of the study on the effect of the single sales formula on tax year 2006. Taxable income fell for the 1022 companies using the formula. Of that amount, 325 companies saw their liability increase while it declined for another 309. The net effect was an almost $19 million revenue loss for the state. Karen Syrylo, Maryland Chamber of Commerce representative questioned the analysis of the study; what did we do with PTE losses? Did we use their tax change or did we calculate using corporate rates?

The Maryland's Corporate Income Tax Base by Industry table shows some statistics of corporate tax payers broken out by their federal business activity code and then by taxable corporations for tax year 2006. The grouping to the left includes all corporations. There were 64,270 corporations that filed returns. The Maryland Modified Income column includes negative income, and 14.4% of all filers were in the realm of Professional, Scientific and Technical Services followed closely by Real Estate, Rental and Leasing. Though manufacturing only made up 8.2% of returns, they account for 29.6% of all taxable income. The grouping to the right only includes taxable companies. Only 43% of companies filing had taxable income. The most drastic changes in the share of Maryland Modified Income are apparent in the retail trade which fell 9.3% and the information industry which grew 5.5% stated Mr. Schaufele.

Maryland's Corporate Income Tax Base by Income tables break the tax year 2006 corporations out by multistate and unistate and then by Maryland Modified Income class. Of the 38,973 unistate corporations, 13,803 had taxable income totaling $2.0 billion (2,047,685). Of the 25,297 multistate corporations, 14,014 had taxable income totaling $458 billion (457,906,361). Multistate corporations accounted for 99.6% of Maryland modified income and 81% of the net tax liability.

Mr. Schaufele concluded his discussion with the State Corporate Income Tax Rates table for tax year 2008 and stated that it is difficult to compare apples to apples using only a table. Many states have multiple tax brackets, alternative minimum taxes, gross receipt taxes or different rates for banks, while Maryland has only a flat rate. Maryland has the 16th highest rate when compared with the highest rate of other states. Our rate is lower than Delaware, Pennsylvania, New Jersey, West Virginia and Washington, D.C. However, we are higher than both North Carolina and Virginia.

Mr. Roose thanked Andrew Schaufele for his presentation and introduced Mr. Manev, who went on to discuss the Sales and Use Tax being the second largest source of general fund revenue, representing 27.1% of general fund revenue in fiscal year 2008. Generally thought of as a tax paid by consumers, the tax does have a substantial business component as it applies to the sale of most tangible personal property in the State.

Mr. Wacks asked the members for speaker recommendations for later meetings, stressing that the commission should hear from a balanced variety of perspectives. A number of suggestions were offered, including

Mr. Robert Young, Maryland Department of Assessments and Taxation then spoke in detail regarding the Real and Personal Property Assessment Data.

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