Business Implications of the Tax Provisions of HB 753 – Taxes and Revenues

prepared by:

Chuck Montague
Mark Vulcan
Roger Fujihara
Elissa Prichep
Pradeep Ganguly

Maryland Department of Business & Economic Development
Aris Melissaratos, Secretary
410-767-6301
217 E. Redwood Street, Baltimore, MD 21202

April 23, 2003
(revised May 15, 2003)

Summary of Business Implications

This bill is a sweeping revision of the Maryland corporate tax structure. The fiscal note with the bill indicates that, in the first year alone, it extracts over $130 million dollars from Maryland businesses, with no return to businesses for this loss. A stable business environment is a strong attraction for companies to locate in a jurisdiction. In a period when Maryland is trying to improve its business-friendly image, this bill does not contribute to that effort.

Key Implications

Provision 1: 10% Corporate Income Tax Surcharge for three years

- This directly affects the bottom line of Maryland businesses.
- It places further burden on companies already contributing to the state's income.

Provision 2: Corporate Tax Changes – includes provisions on IRC Section 482 (Delaware Holding Companies), Throwback Rule, and Non-operational Income

IRC § 482 (Delaware Holding Companies)

- This provision could add to the difficulty attracting higher-end retail to some jurisdictions in the state.
- There are valid uses of payments to holding or parent companies located in other states that justify setting up a holding company in another state.

Throwback Rule

- Among Maryland's competitor states (VA, PA, DE, NJ, NC, WV), only DC has a throwback rule.
- A Throwback Rule would change a long history of relatively stable Maryland corporate income tax law.
- This provision will adversely and disproportionately impact Maryland's small businesses.

Non-operational Income

- This provision is anti-business in that it creates a disincentive to establish a headquarters in Maryland.
- All of our competitor states (VA, PA, DE, NJ, NC, WV, DC) tax "non-operational income" (or non-business income using some other term) for corporations headquartered in their state.

Provision 3: 2% Premium tax on HMOs and MCOs

- Health care costs for businesses would increase, as the HMO's expect to pass the premium tax through to policyholders.
- The pool of uninsured Marylanders will increase.
- This works against the "Small Business Health Insurance Affordability Act" (SB 477, 2003 session), which tries to "maintain affordability" of health care for small businesses.

Provision 1: 10% Corporate Income Tax Surcharge

Summary: A 10% surcharge on Maryland's corporate tax will raise the effective corporate tax rate, for a period of three years, to 7.7% from the current level of 7.0%.

- The 10% surcharge will directly affect the bottom line, reducing the profitability of any company paying taxes in MD. This may also adversely impact employment in Maryland.

- The burden of this provision will be placed on those companies already contributing to the state's income.

- Maryland's corporate tax rate is lower than most of our competitor states (PA, DE, NJ, WV, DC), except for VA (6.0 %) and NC (6.9%)

Provision 2: Corporate Tax Changes

Summary: This section includes provisions on IRC Section 482 (Delaware Holding Companies), Throwback Rule, and Non-operational Income

IRC Section 482 authority

Summary: This provision gives the Comptroller the authority to make accounting changes to income, deductions, credits, and allowances between and among businesses, whether or not related, when, in the Comptroller's judgment, they do not reflect "arms-length" transactions and are intended to shelter profit or inflate expenses.

- VA, NJ, and NC have some form of § 482 provisions. WV uses a consolidated return.

- The IRS has this authority under IRC § 482. The Maryland Comptroller was denied this authority in a legal challenge, as it was not explicitly granted by statute.

Delaware Holding Companies

Summary: The provision requires that interest and intangible expenses (e.g., royalties) be disallowed among entities under certain circumstances,

- This provision has negative implications for business location and retention. This provision sends a business-unfriendly message to large businesses, such as major retail, warehousing and distribution facilities, that Maryland might try to attract.

- This financial strategy is used almost exclusively by large businesses, mostly retailers.

- Although it is unlikely that this provision would influence a siting decision in a rapidly growing or large market, it could go against Maryland at marginal locations. Some jurisdictions in the state have had difficulty attracting higher-end retail and this provision could exacerbate such problems.

- In particular, this provision may have serious implications for large warehousing and distribution facilities that might otherwise locate in Maryland. Warehousing and distribution are targeted growth-industry sectors in Maryland.
- Of our competitor states, NJ recently enacted a similar bill. It is too early to estimate the long-term economic effects of this decision.
- The Manufacturers' Alliance of Maryland has identified many valid uses for payments to holding or parent companies in other states. These include the requirement of such payments to allow a subsidiary to sue third parties for infringement of intellectual property and to insulate the property from the parent's liability.

Throwback Rule

Summary: This provision adopts the sales throwback rule in Maryland, by which sales of tangible personal property will be taxed in Maryland (included in the sales factor) if the property is delivered or shipped to a purchaser outside Maryland and the sale is not taxable in the state where the product was delivered.

- Although approximately one-half of the states use a throwback rule, these are predominantly western states. Among Maryland's competitor states (VA, PA, DE, NJ, NC, WV), only DC has a throwback rule. Therefore, adopting this tax provision will make it more difficult for Maryland to compete.
- A Throwback Rule would change a long history of relatively stable Maryland corporate income tax law. The General Assembly has repeatedly expressed its intent that Maryland manufacturers should be taxed only on their Maryland sales. By changing the corporate law so drastically, Maryland generates a shifting environment for corporations, which is seen as strongly business-unfriendly.
- This provision will adversely and disproportionately impact Maryland's small businesses. Nearly 95% of Maryland business establishments are small firms employing fewer than 100 employees.
- This bill would tax the sales of Maryland-domiciled companies if they had only traveling sales force making calls in another state that did not have a corporate income tax. This is the case for most small Maryland companies. Large companies already pay tax in most states because they have a nexus. Simply having a traveling sales force call upon customers in another state does not create nexus.

Non-operational income tax

Summary: If the principal place from which the trade or business of a corporation is directed or managed is in Maryland, all of the corporation's non-operational income, to the extent allowed under the U.S. Constitution, would be allocated to Maryland. Non-operational income (income that is not apportionable) is a new term in Maryland tax law.

- This provision is anti-business in that it creates a disincentive to establish a headquarters in Maryland.

- All of our competitor states (VA, PA, DE, NJ, NC, WV, DC) tax "non-operational income" (or non-business income using some other term) for corporations headquartered in their state. Therefore Maryland will lose the benefit of claiming this business-friendly advantage.

- One major type of income that would be taxed under the proposed bill is the gain on the sale of an entire division or business segment. The U.S. Supreme Court has explicitly allowed such income to be included in non-operational income.

Provision 3: 2% Premium tax on HMOs and MCOs

Summary: This imposes a 2% tax on health care premiums for HMOs and MCOs.

- The 2% premium tax will have three adverse effects:
  (1) <u>Costs</u> for small businesses would increase.
  (2) The pool of <u>uninsured Marylanders</u> would increase.
  (3) There would be some loss of <u>jobs</u> due to drop in healthcare demand that is likely to result from the increased number of uninsured.

- Several of the largest Maryland HMOs indicated that they would pass on the tax through to their policyholders.

- HMO coverage tends to be lower cost than other policy plans, and thus more frequently chosen by cost-sensitive employees and small businesses.

- The impact of the increase will fall disproportionately on small businesses and cost-sensitive individuals, both employees and self-employed, as they are most vulnerable to rate increases and can easily go from being insured to uninsured.

- Although some employers may absorb some or even all of the increase, others are likely to pass a large fraction to the employee. With a typical 4:1 employer-employee split of premium costs, some employees could see a 10% increase in their premiums.

- An increase in healthcare costs will increase the number of uninsured, reducing the demand for healthcare. This will result in some job losses directly attributable to the premium tax. Although this is difficult to estimate, a 2% premium tax could reduce statewide employment by 250 jobs based on estimates from LECG and American Association of Health Plans (AAHP).

- CareFirst is the largest provider of health care insurance plans to Maryland's small businesses. MAMSI and Kaiser also cover a large part of the healthcare insurance market. Together, HMOs cover approximately 38% of the healthcare insurance market in Maryland.

- HMOs underwrite a sizeable number of policies to individuals who are not covered by employer-provided health care insurance, or otherwise wish to purchase individual or family medical insurance. These individuals are often on the "margin" in terms of being able to afford health insurance.

- Over the past several years, health care costs have been rising faster than inflation. HMOs have asked for, and were approved, rate increases in past years – as much as 13%. These rate increases, although necessary, resulted in some policyholders – small firms and individuals – dropping out of the plans.

- The compound effect of the premium tax and health care cost inflation will be devastating for marginal policyholders. Many small firms and individuals who can barely afford their current health care premiums would likely drop out of the plans.

- Economists for the AAHP estimate that for a 2% increase in premiums, about 0.5% of those insured would drop their coverage. With about 1.5 million workers covered and 38% coverage by HMOs, this would mean about 3,000 individuals would be added to the ranks of the uninsured.

- As the uninsured population increases, so will the incidence of emergency room visits by the uninsured population. This will raise hospital costs, which will ultimately raise the costs of state-funded medical programs and Medicaid.

- The "Small Business Health Insurance Affordability Act" (SB 477, 2003 session) reduces the premium rate affordability cap for the standard plan from 12% to 10% of the average annual wage (AAW) in Maryland. This is intended "to maintain affordability" of health care for small businesses in Maryland. The 2% HMO/MCO Tax works directly in opposition to this.

- The fiscal note for SB 477 from MD Dept. of Legislative Services shows that the cost of a standard plan premium per employee is 9.3% of the Maryland AAW (as of 12/31/01; plan cost per employee = $3,565; AAW = $38,329).

- If health care costs rise an average of 8% next fiscal year (and an 8% rate increase were approved) and an additional 2% premium tax is levied, the average plan cost would rise to $3,927, which is 10.25% of Maryland AAW. This is a very conservative estimate – the fiscal note for HB 753 predicts a 12.7% rise!

- Clearly, the compound effect of a rate increase AND a 2% premium tax will exceed the affordability limits set by SB 477.

- The Fiscal Note to SB 477 notes: "If MHCC finds the average rate for the standard plan . . . exceeds 10% of Maryland's average annual wage, MHCC must modify [the Comprehensive Standard Health Benefit Plan] by increasing the cost sharing arrangements or decreasing required benefits." These are exactly the actions that will be taken by some employers in response to increased premiums.

- Maryland manufacturers vehemently voiced their concern about rising health care costs in the series of forums held by DBED around the state.

The Impact of HB 935 on Businesses

(HB 935: Budget Reconciliation and Financing Act of 2003)

HB 935 contains some provisions that also adversely affect businesses. If HB 935 is passed into law, the negative effects of HB 753, noted above, would be in addition to these. The major business implications of HB 935 are summarized below.

1. Increase Filing Fees
Summary: The filing fee for all businesses would be increased. Many business entities, such as LLCs, that have previously not incurred fees would now have filing fees.

- Some real estate companies have diversified their property holdings under separate LLCs to prevent legal claims based on one property from adversely interfering with the activity of their other properties. Companies that own many properties will not see their fees go only to $300/year, but will have this fee multiplied by the number of LLCs that they own. This will require some companies pay fees of $3,000 or higher.

- This increase in fees may lower the returns on property to a level that some businesses that are essential to meeting the housing demand in neighborhoods would close because of the added tax burden.

2. Accelerate Withholding
Summary: This provision requires companies that withhold more than $700 per quarter to file on a monthly rather than a quarterly basis.

- This provision would triple paperwork while reducing firms' cash flows. Businesses need ways to reduce paperwork, while complying with all Federal, state and local laws.

- Transferring funds for withholding taxes to the Comptroller's office monthly rather than quarterly reduces cash flows for businesses – most critical for day-to-day operation of all businesses, but especially small firms. Accelerated transfer of money to the State directly reduces the cash for day-to-day operations of the business.

- Besides requiring the accelerated transfer of withholding tax, the requirement indirectly imposes further record keeping, paperwork and administrative duties on the companies. Filing must now be done twelve times per year instead of only four. Companies must also track their employees withholding amounts to determine those that surpass the level required for monthly filing.

3. Cap Heritage Tax Credit for Commercial Properties

Summary: The Heritage Tax Credit had a $3 million cap per commercial projects and the 2002 legislature had made it clear that their intent was to limit the credit to $50 million per year. This bill, however, places a formal cap on this credit at $23 million for 2003 and $15 million for 2004, significantly reducing the allowable credit.

- The Maryland Bankers Association believes that many urban development projects in Frederick and Baltimore City would not have been undertaken without this tax credit.

- As this tax credit is not discretionary, it would be allocated on a first-come, first-served basis. Thus, the decision to fund certain real estates projects that would be beneficial to the economy would be postponed or forgone due to the lack of support from this tax credit.

4. Eliminate Graduated Withholding

Summary: This raises the amount of withholdings on all earnings to 4.75%, eliminating the marginal tax rates previously imposed on the first $3,000 (2%, 3%, and 4% on each $1,000 of this $3,000).

- This affects all employees and employers in Maryland. Like the accelerated withholding, it is a transfer of cash from the employers to the state.

Telephone Interviews

Maryland Retailers Association: Tom Saquella, Executive Director
Karen T. Syrylo, CPA
Manufacturers' Alliance of Maryland: Gene Burner

Maryland Bankers Association: Kathleen Murphy, President and CEO
Greater Baltimore Property Owners' Association: Bob Enten
Maryland Association of Certified Public Accountants: J. Thomas Hood, Executive Director

CareFirst BlueCross BlueShield: Fran Doherty, Government Relations
MAMSI: Beth Sammis, Government Relations
KAISER PERMANENTE: Gail Thompson
American Assoc. of Health Plans: Teresa Chovan, Director, Policy Research

---