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Maryland Legislation Requires Corporate Taxpayers To Bare It All

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With today's energy costs, most corporations no doubt would have preferred a lump of coal to the latest Maryland tax legislation. Unlike the Grinch and Scrooge, the Maryland General Assembly apparently was not overcome by the holiday spirit in the end. Who knows, if we wish hard enough, maybe by next year this can be the ghost of Christmas past. For now, corporations that do business in Maryland and each of their affiliated entities should budget for increased compliance and administrative costs for corporate income tax reporting.

The Special Session of Maryland General Assembly ended November 19, 2007 without the passage of the combined reporting regime proposed by Governor Martin O'Malley and anticipated by many taxpayers. The Maryland General Assembly was expected to overhaul Maryland's tax regime to include combined reporting, following the trend in other states. It didn't. Instead, new corporate tax legislation[1] signed into law adopts other relevant tax changes, including increasing the corporate income tax rate from 7% to 8.25%, increasing the sales and use tax rate from 5% to 6%, expanding the sales and use tax base to include taxation of certain computer services, expanding the real estate recordation tax to include transfers of a controlling interest in an entity holding real estate, and importantly, adopting the most formidable corporate reporting requirements ever adopted by a state taxing authority.

Arduous Reporting Requirements

Arguably, the most notable development coming out of the Special Session was the passage of S.B. 2, the Tax Reform Act of 2007 ("the Act"), which requires detailed and extensive corporate income tax reporting for Maryland taxpayers and their affiliates for tax years beginning after December 31, 2005, regardless of whether the affiliates have nexus with Maryland.

It is important to note that at this time, the Act merely requires the reporting of information relating to non-nexus affiliates and does not yet impose a tax on the

[1] The bills signed by the Governor on November 19, 2007 include H.B. 1, the Budget Reconciliation Act; S.B. 2, the Tax Reform Act of 2007; S.B. 3, the Maryland Education Trust Fund; H.B. 4, Video Lottery Terminals – Authorization and Limitations; H.B. 5, the Transportation and State Investment Act; and S.B. 6, Working Families and Small Business Health Coverage Act.

activities of these companies. The new reporting requirements are likely a precursor of additional changes or challenges to come.

Comprehensive Affiliated Group Reporting

The Act requires a Maryland taxpayer to file a disclosure statement with respect to the activities of the members in its corporate group. A "corporate group" is (i) an affiliated group or controlled group under Sections 1504 or 1563 of the Internal Revenue Code; or (ii) an affiliated group of corporations engaged in a unitary business where more than 50% of the voting stock of each member is directly or indirectly owned by a common owner or owners or a member of the group.[2]

Every Maryland taxpayer is required to file a statement each year identifying each member of its corporate group and disclosing for each member: (i) whether the member filed a Maryland income tax return; (ii) the total worldwide sales for that member for the taxable year; and (iii) the total Maryland sales for that member for the taxable year. In addition, a Maryland taxpayer must file a statement identifying each state in which a member of the group filed a corporate income tax return. For those states requiring combined or consolidated reporting, the taxpayer must disclose which members of the affiliated group are included in such reports.

It Gets Worse – Additional Filings For Publicly Traded Companies

The Act requires additional detailed reporting for any publicly traded company, regardless of whether such company has nexus for Maryland corporate income tax purposes. A "publicly traded corporation" is a corporation that is regularly traded on an established securities market in the United States or a foreign country, or a corporation more than 50% of the voting stock of which is owned, directly or indirectly, by a corporation or other business entity regularly traded on such a market.[3]

For purposes of the publicly traded company reporting requirements, Maryland has adopted a new, broader definition of "doing business" in Maryland that includes activities that might not otherwise create nexus for corporate income tax purposes such as making sales of tangible personal property to Maryland purchasers, performing services for Maryland customers, earning income from intangible property sitused in Maryland, and regularly soliciting sales in Maryland. If a publicly traded company meets this broader definition of "doing business," it will be subject to the publicly traded company reporting requirements.

Publicly traded companies doing business in Maryland must disclose certain basic company information, including the corporation's name, address, North American Industry Classification System (NAICS) Code, and any corporation that directly or indirectly owns 50% or more of the corporation's voting stock. More importantly, a publicly traded company must disclose the information required to be reported or used

[2] Md. Code Ann. § 10-804.1(A)(2).

[3] Md. Code Ann. § 10-804.1(A)(4).

in preparing a Maryland income tax return, regardless of whether such return is in fact due for the publicly traded company.

If the publicly traded company is not required to file a Maryland corporate income tax return, the company may alternatively provide a statement explaining why a return is not required and disclose an estimate of the corporation's total gross receipts from sales to Maryland customers.

Pity The Publicly Traded Company With Worldwide Gross Receipts In Excess Of $100 Million

A publicly traded corporation whose corporate group's worldwide gross receipts are in excess of $100 million will be subject to even more onerous reporting requirements for its corporate group. Companies with worldwide gross receipts in excess of $100 million must disclose the information required in the publicly traded company information report discussed above for *all* members of the corporate group regardless of whether they meet the definition of doing business in Maryland. Thus, a publicly traded company with more than $100 million of worldwide receipts will be required to either provide the information required to be reported on a Maryland income tax return or the alternative statement as to why such a return is not required with receipts disclosure *for each member of its corporate group*.

A publicly traded company with more than $100 million of worldwide receipts will also be required to disclose:

(i) the members of the corporate group that would be included in a water's-edge, combined group if such a return were required and the difference in Maryland tax that would be due if the company were to report its tax using a water's-edge, combined reporting methodology;

(ii) the difference in Maryland tax that would be required if Maryland adopted a throwback rule for sales factor purposes;

(iii) the amount of any nonapportionable income and where such income is allocated;

(iv) for Maryland headquartered companies, the difference in Maryland tax that would be due if the company were required to allocate 100% of its nonapportionable income to Maryland;

(v) full-time employment in Maryland for the past three years; and

(vi) for all U.S. corporations or affiliates of U.S. corporations, profits before tax reported on the 10-K filed with the Securities and Exchange Commission.

Expect An Audit (And Penalties)

All statements required by Maryland must be filed annually, for all taxable years beginning after December 31, 2005. Any statement filed must be signed under oath and is subject to audit by the Comptroller. In addition, the Act imposes significant penalties for failure to comply. A person required to file the statement who willfully fails to do so or files a false statement is guilty of a misdemeanor and, on conviction, is subject to a fine not to exceed $10,000 or imprisonment not to exceed five years, or both.

What Does This Mean For Maryland Taxpayers?

The obvious initial impact that these reporting requirements will have on companies is the significant increased administrative cost and burden associated with the preparation of Maryland corporate income tax data, effectively in the form of a Maryland corporate income tax return, for affiliates that may or may not have any contact with Maryland, or even a unitary relationship with a Maryland taxpayer. However, this is only the tip of the iceberg. The Maryland reporting requirements may result in additional tax for even the most conservative taxpayers, through Maryland's processing and interpretation of the data presented and Maryland tax laws.

Additional Assessments Of Tax

Current Maryland taxpayers that comply with the reporting requirements may face additional audits in Maryland. This is particularly likely for taxpayers with intercompany transactions. It is widely known that the Maryland Comptroller's position is that pursuant to the Maryland Court of Appeals' 2003 decision in *Syl, Inc. and Crown Cork & Seal Co.*,[4] virtually any company that receives intangible income from a Maryland affiliate is taxable on that income, regardless of the nature of the specific activities of that company or the relationship between that company and the Maryland affiliate. This position has been extended to a host of intercompany intangible transactions that may not be covered by Maryland's intangible expense disallowance statute.

Taxpayers should not be surprised if the required statements result in the generation of additional audits by the Maryland Comptroller in light of the Comptroller's interpretation of *Syl, Inc.* or other related positions. In the Comptroller's 2009 budget plan, the Comptroller set forth his plan to generate an additional $200 million of revenue through an increase in audit and compliance staff and an upgrade of technology. Specifically, the Comptroller's plan stated that Maryland currently has an inventory of more than 300 holding company audits and are beginning to audit taxpayers that utilize captive REITs, as well as other non-filers.[5] The Comptroller requested additional staff to audit these taxpayers. It is likely that the corporate reporting will provide a road map pursuant to which the Comptroller will seek out additional companies to audit.

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[4] *Syl, Inc. v. Comptroller*; *Crown Cork & Seal Co. v. Comptroller*, 825 A.2d 399 (Md. 2003).

[5] Letter from Comptroller Franchot to the Honorable Eloise Foster, Secretary Department of Budget and Management, regarding FY 2009 Over-the-Target Request Tax Gap Initiative (September 27, 2007).

Future Legislative Changes

The Comptroller plans to use information from the corporate reports to support further changes to Maryland's taxing scheme. The Act specifically provides that the information disclosed on the corporate reports will be used for proposals for changes to the corporate income tax. On numerous occasions in the past, including the Special Session that ended November 19, 2007, the Maryland General Assembly has considered moving to combined reporting. Although this was not passed as part of the Act, the Act establishes a Business Tax Reform Commission to review and evaluate Maryland's current business tax structure and make specific recommendations for changes, including possible changes to the tax rate, tax base broadening measures, measures to address tax avoidance strategies, and elimination of ineffective or inefficient tax policies intended as economic development incentives.

The Business Tax Reform Commission was specifically charged with the task of evaluating the possibility of adopting a combined reporting regime using the "water's-edge method" for unitary groups of affiliated corporations or the imposition of an alternative business tax, such as a gross receipts, value added or alternative minimum tax. Taxpayers can expect the mandatory corporate information reporting to be used in the Business Tax Reform Commission's evaluation and recommendation of additional changes.

What Next?

It seems likely that someone will challenge the requirements at some point in the future. The arduous reporting requirements and penalties may very well be held to violate the Commerce Clause and Due Process Clause of the U.S. Constitution. The Act clearly imposes reporting requirements on corporations that do not have nexus with Maryland, and even goes so far as to adopt a different, broader definition of "doing business" for purposes of the corporate reporting requirements. Similarly, the Act requires reporting and penalties for all affiliated companies regardless of whether such companies are unitary with a Maryland taxpayer.

These sweeping changes appear to be an indication of changes to come. As the Business Tax Reform Commission begins its review, the debate over combined reporting and alternative income taxes will be at the forefront of the discussion when the Maryland legislature begins its regular session in January of 2008. Hopefully, dropping the potentially unconstitutional reporting requirements will be on the list.■

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