FISCAL IMPACT REPORT

		ORIGINAL DATE	03/03/09		
SPONSOR	Wirth	**LAST UPDATED**		**HB**	
SHORT TITLE	Corporate Tax To Public School Fund			**SB**	389
				ANALYST	Francis

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY09	**FY10**	**FY11**		
	$94,700.0	$69,800.0	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

Relates to SB648, HB331

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Public Education Department (PED)

SUMMARY

Synopsis of Bill

Senate Bill 389 mandates that “unitary” corporations file a combined report, repeals the section that refers to “consolidated” returns, and distributes 16.66 percent of the corporate income tax revenue to the public school fund.

Key terms:

1. “unitary” corporation means two or more integrated corporations that are owned in the amount of more than fifty percent and controlled by the same person and that satisfies one of the following conditions:
    a. Evidence of central purchasing, advertising, accounting and other centralized services
    b. Centralized management or executive force and centralized system of operation
    c. The operations of the corporations are dependent upon or contribute property or services to one another individually or as a group.
2. “consolidated” corporation means a corporation that reports to the IRS its net income consolidated with other corporations.

3. "public school fund" is a fund in the general fund that is used to fund the state equalization guarantee, school transportation costs and supplemental distributions.

This change would be effective for tax years 2009 and beyond.

FISCAL IMPLICATIONS

TRD reports, based on modeling actual corporate tax returns, that mandating combined reporting would increase corporate income tax (CIT) revenue by 20 percent. To determine the fiscal impact, the increased amount was based on CIT *before* credits. The distribution to the public school fund of 16.66 percent is *after* credits so there is some residual that goes to unrestricted general fund.

	FY10	FY11	FY12	FY13
General fund	13.60	9.86	13.03	14.53
Public School Fund	81.12	59.94	64.57	70.87
TOTAL	94.72	69.80	77.60	85.40

TRD:

Recent simulations performed on New Mexico corporate income tax return data indicate that mandating combined filing would increase New Mexico corporate income tax revenues by approximately 20 percent.[1] The current forecasts for corporate income tax revenues (net of credits) by the State's consensus revenue estimating group are: $349 million in FY 2009; $334 million in FY 2010; $349 million in FY 2011; $388 million in FY 2012; and $427 million in FY 2013.

FY10 is higher than other years since it includes half of 2009 that has been estimated under current law and half that will be estimated under SB389.

SIGNIFICANT ISSUES

TRD:

The allowance of "separate corporate entity" (SCE) reporting under current law creates opportunities for controlled groups of corporations to shift profits to their out-of-state affiliates by inflating or creating artificial inter-company charges to the in-state entity. Because affiliated corporations almost always file a consolidated return for federal income tax purposes, the inter-company charges are not subject to federal audit scrutiny. Determining the legitimacy of these inter-company charges (for instance, the proper amount of rent for an in-state store charged by a Delaware subsidiary) is very difficult and time-consuming for TRD auditors.

The availability of the election to use the SCE reporting method under current law is

[1] This percentage is consistent with estimates of revenue increases due to use of combined reporting in other states. For details, see "Setting the Record Straight on Combined Reporting" published by the Massachusetts Budget and Policy Center:
http://www.massbudget.org/recordoncr.pdf.

considered a tax incentive to attract firms to New Mexico. Eliminating the election might discourage some firms from locating or expanding in New Mexico.

The consolidated filing method reduces tax compliance costs for electing corporations, reduces administrative cost for TRD, and allows corporations and TRD to rely on the results of IRS audits to determine the effect of audit adjustments on NM corporate income tax liabilities. These benefits would be lost under the bill, which repeals the option of filing a consolidated return.

According to PED, this is one of the funding sources recommended for financing the proposed funding formula in HB331.

New Mexico Tax Research Institute and Association of Commerce and Industry have reported to interim legislative committees that mandating combined reporting may have negative effects in terms of attracting and retaining companies in NM. One of the concerns is that multistate companies that establish a presence in New Mexico may operate at a loss for the first few years as the new site is established. By mandating combined reporting, positive earnings from other states may be drawn into New Mexico and taxed rather than reporting the loss from the entity in New Mexico. Because of this the current law allowing for different methods makes New Mexico more competitive with neighboring states that do require combined reporting and therefore becomes an economic development tool.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Relates to HB331 which establishes a new funding formula for public school funding.

The Legislative Finance Committee has adopted the following principles to guide responsible and effective tax policy decisions:

1. ***Adequacy:*** *revenue should be adequate to fund government services.*
2. ***Efficiency:*** *tax base should be as broad as possible to minimize rates and the structure should minimize economic distortion and avoid excessive reliance on any single tax.*
3. ***Equity****: taxes should be fairly applied across similarly situated taxpayers and across taxpayers with different income levels.*
4. ***Simplicity****: taxes should be as simple as possible to encourage compliance and minimize administrative and audit costs.*
5. ***Accountability/Transparency:*** *Deductions, credits and exemptions should be easy to monitor and evaluate and be subject to periodic review.*

More information about the LFC tax policy principles will soon be available on the LFC website at www.nmlegis.gov/lcs/lfc

TECHNICAL ISSUES

TRD:

There is no effective date prescribed for distributions to the Public School Fund to begin. Making the changes applicable to tax years beginning on or after January 1, 2009, would change the tax reporting method required from many corporations for their current tax year, which is already underway. These corporations would be required to change their tax computations almost immediately in order to make estimated payments by June 15,

2009. TRD would not be able to provide much guidance to affected companies; significant lead time would be required to develop regulations and other guidance. A delayed applicability date would allow corporations time to implement the change and TRD time to provide crucial guidance.

ALTERNATIVES

To address concerns of NMTRI and ACI, a temporary provision allowing for separate reporting could be established so the beginning period of a company's expansion into New Mexico could file as a separate entity but after the period (e.g. three years) the company must file as a combined entity.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

SB389 is related to SB648 which changes the way the franchise tax is levied.

OTHER SUBSTANTIVE ISSUES

All other Western states with a corporate income tax currently mandate combined reporting, under which controlled groups of "unitary" (interdependent) U.S.-based corporations must file a single return that eliminates all inter-company transactions. Texas recently adopted mandatory combined reporting for their tax. The Blue Ribbon Tax Commission endorsed the concept of mandatory combined reporting in 2003.

Eastern states have not generally adopted combined reporting, although in response to some well-publicized "tax planning" techniques, a number of these states have recently adopted "add-back" or "anti-passive investment company" legislation. These laws require taxpayers to disallow the amounts of royalty and interest amounts paid to "intangible holding companies" based in low-tax states like Delaware. The discretionary powers necessary to properly implement both the "add-back" provisions and the "forced combination" techniques have generated significant litigation. New York and West Virginia recently enacted mandatory combined filing, and other Eastern states are considering it in response to budget shortfalls.

Background Information:
Current Law
Corporations with a taxable presence ("nexus") in the State must file a New Mexico corporate income tax return. A corporation may elect to file as a "separate corporate entity" (SCE), or file a return that includes affiliate corporations under one of two methods: "unitary combined" or "federal consolidated". These filing-method options are sometimes referred to as "the ladder" because when moving from SCE to combined to consolidated reporting, corporations generally include larger amounts of corporate income in their New Mexico corporate income tax return (before allocation and apportionment; see below). After the first filing year, corporations are allowed to elect a different filing method without permission from TRD if the new filing method is higher on the filing method "ladder". That is, a corporation is allowed to change from SCE filing to combined or consolidated filing, or from combined to consolidated, without permission. A corporation cannot, however, change from combined or consolidated to SCE, or from consolidated to combined, without permission, and TRD generally does not approve such an election unless the corporation has reorganized in a way that justifies the change or the proposed new reporting method would better reflect industry practices than the corporation's current

method.

	State Corporate Tax Rates			Combined and Consolidated Reporting			
		If Multiple Rates:					
State	**Top Rate**	**Lowest Rate**	**Number of Brackets**	**Mandatory**	**State May Require**	**State May Permit**	**Taxpayer May Elect**
Alabama	6.5						Consolidated
Alaska	9.4	1.0	10	Both			
Arizona	6.968			Combined	Consolidated	Consolidated	Consolidated
Arkansas	6.5	1.0	6			Consolidated	
California	8.84			Combined	Combined	Combined	Combined
Colorado	4.63			Combined			Consolidated
Connecticut	7.5					Consolidated	Combined
Delaware	8.7						
District of Columbia	9.975				Consolidated		
Florida	5.5						Consolidated
Georgia	6.0				Consolidated	Consolidated	
Hawaii	6.4	4.4	3		Both	Consolidated	
Idaho	7.6			Combined			
Illinois	7.3			Combined			
Indiana	8.5				Both	Combined	
Iowa	12.0	6.0	4		Consolidated		Consolidated
Kansas	7.1	4.0	2		Combined	Consolidated	Combined
Kentucky	6.0	4.0	3	Consolidated			
Louisiana	8.0	4.0	5		Both		
Maine	8.93	3.5	4	Combined			
Maryland	8.25						
Massachusetts <1>	9.5			Combined	Consolidated		Combined
Michigan	4.95				Consolidated	Consolidated	
Minnesota	9.8			Combined			
Mississippi	5.0	3.0	3			Combined	
Missouri	6.25					Consolidated	
Montana	6.75			Combined		Consolidated	Consolidated
Nebraska	7.81	5.58	2	Both			
Nevada	----- *No Corporate Income Tax* -----						
New Hampshire	8.5			Combined			
New Jersey	9.0	6.5	3		Consolidated		
New Mexico	7.6	4.8	3				Both
New York <2>	7.1			Combined			
North Carolina	6.9				Both		
North Dakota	6.5	2.6	5	Combined			
Ohio	8.5	5.1	2		Combined	Combined	
Oklahoma	6.0					Consolidated	Consolidated
Oregon	6.6			Consolidated			
Pennsylvania	9.99						
Rhode Island	9.0						
South Carolina	5.0					Consolidated	Combined
South Dakota	----- *No Corporate Income Tax* -----						
Tennessee	6.5				Both	Both	
Texas	----- *No Corporate Income Tax* -----						
Utah	5.0			Combined			
Vermont	8.5	6.0	3	Combined			Consolidated
Virginia	6.0					Consolidated	
Washington	----- *No Corporate Income Tax* -----						
West Virginia <3>	8.75			Combined			Consolidated
Wisconsin	7.9						
Wyoming	----- *No Corporate Income Tax* -----						

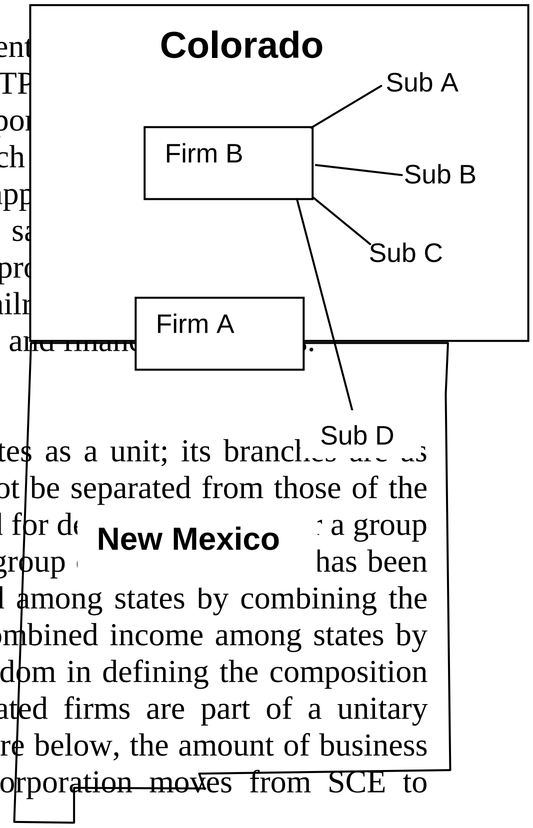
Sources: Federation of Tax Administrators; *2007 Multistate Tax Guide* , CCH Inc.; Web sites of State Tax Departments; Tax Foundation.

Notes:

<1> Massachusets Combined Reporting requirement is effective for tax years beginning January 1, 2009.

<2> New York Combined Reporting requirement is effective for tax years beginning January 1, 2007.

<3> West Virginia's Combined Reporting requirement is effective for tax years beginning January 1, 2009.



All three filing methods require the allocation and apportionment Division of Income for Tax Purposes Act (UDITPA). UDITP provide rules whereby a corporation (or affiliated group of corpo one state divide income and expenses among the states in which business income is allocated whereas business income is app formula based on the separate ratios of property, payroll and s amount of the respective factor in all states. UDITPA pr apportionment rules for certain industries, including airlines, rail trucking companies, broadcasters, and to firms in the publishing a .

Unitary Business

A unitary business is generally regarded to be one that operates as a unit; its branch dependent on the business as a whole that their activities cannot be separated from those of the main organization. A number of legal tests have been developed for d a group of businesses constitutes a unitary business. The income of a group has been determined to be a unitary group can only feasibly be sourced among states by combining the incomes of all members of the group and apportioning that combined income among states by formula. New Mexico statutes currently allow firms some freedom in defining the composition of their unitary businesses -- i.e., in defining whether affiliated firms are part of a unitary business and filing taxes accordingly. As illustrated in the figure below, the amount of business income subject to apportionment generally increases as a corporation moves from SCE to combine to consolidate reporting.

The figure shows two affiliated corporations, Firm A and Firm B. Firm A operates partially within both New Mexico and Colorado, but Firm B itself operates only in Colorado. However, Firm B has four subsidiaries, three of which (Sub A, Sub B and Sub C) operate only in Colorado, with the fourth (Sub D) operating in New Mexico. Firms A and B (but not necessarily B's subsidiaries) are assumed to be a unitary group (because of, for example, shared trademarks, ownership, purchasing or other activities), and also to be a consolidated group for federal income tax purposes.

Under "separate corporate entity" (SCE) reporting, Firm A is allowed to file its New Mexico corporate income tax return as if it were a separate entity totally unrelated to Firm B or its subsidiaries. All of Firm A's income would be included in its return, but its business income would be apportioned between Colorado and New Mexico using the three-factor apportionment formula. The income and apportionment factors of Firm B and its subsidiaries would be excluded from Firm A's return. (Sub D would be required to file a New Mexico corporate income tax return, which it is assumed would be filed using SCE reporting.)

Under "unitary combined" reporting, Firms A and B would combine their income and report as if they were a single firm. If any of the subsidiaries of Firm B are not considered part of the unitary business, their incomes would not be included, nor would their property, payroll and sale be included in the denominator of the apportionment factors. Under "federal consolidated" reporting, Firms A and B and all of B's subsidiaries would be included in the return (assuming they all formed a federal consolidated group). Under both "unitary combined" and "federal consolidated" reporting, the income of all included corporations would be included in the return, with transactions among the included corporations eliminated. The return would also include the apportionment factors of all the included corporations.

Effect of Reporting Method on Corporate Income Tax Liability
The movement from separate corporate entity to unitary combined to federal consolidated reporting generally increases the taxable income reported on a return, which in itself would increase income tax liability. However, as each affiliate's income is added to the return, the affiliate's apportionment factors are also added to the return, which would decrease income tax liability if the affiliate has no in-state activities. Whether a corporation's income tax liability increases or decreases under alternative reporting methods depends on whether the effect on taxable income outweighs the effect on apportionment factors. It also depends on whether an included affiliate has losses, which might reduce the taxable income that would be reported under a lower reporting method on the "ladder".

Eliminating one or more of the elective filing method options available under current law would be expected to increase revenues, on the assumption that firms have elected the filing method that minimizes their corporate income tax liabilities over time. However, if the elimination of a filing option resulted in some firms deciding to reduce their operations in the State, or new firms deciding not to locate in the State, there could be some partially offsetting negative revenue impact from eliminating options.

Numbers of Returns Filed by Reporting Method
As shown in the following table, in tax year 2005 approximately 18,000 firms filed New Mexico corporate income tax returns as separate corporate entities (SCE). Approximately 500 returns were filed as combined unitary, while 1,057 firms filed federal consolidated returns. SCE filers paid approximately 54 percent of the tax; combined filers paid approximately 14 percent of the tax obligations, and federal consolidated return filers paid approximately 32 percent of New Mexico's corporate income tax. SCE filers *tend* to be relatively small firms, although they can be quite large. The average tax liability among SCE filers was approximately $9,750, while combined filers averaged approximately $95,000 per return and consolidated filers averaged approximately $100,000 per return. Major SCE filers consisted primarily of firms in the mining extraction and manufacturing industries. Firms in mining industries are also heavily represented among combined and consolidated filers.

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