F I S C A L   I M P A C T   R E P O R T

ORIGINAL DATE 1/18/06
SPONSOR Wirth **LAST UPDATED** 1/25/06 **HB** 123

SHORT TITLE Corporate Income Tax Rates and Reporting **SB**

ANALYST Francis

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY06	**FY07**	**FY08**		
	20,000.0	40,000.0	Recurring	General Fund
	See narrative for detail			

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION
LFC Files
Taxation and Revenue Department (TRD)

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

House Bill 123 amends the corporate income and franchise tax act (7-2A-5 NMSA 1978) by requiring all unitary corporations to file a combined return with other unitary corporations as though they were a single corporation. HB 123 also reduces the top corporate income tax rate from 7.6 percent to 7.2 percent. The top rate applies to corporations with income greater than $1 million.

The provisions of the bill are applicable beginning January 1, 2007.

FISCAL IMPLICATIONS

The Taxation and Revenue Department (TRD) has estimated that requiring combined reporting would increase general fund revenues by 20 percent. In FY06, that increase is $30 million and in FY07 and beyond that increase is $60 million.

Decreasing the top CIT rate from 7.6 percent to 7.2 percent will reduce CIT collections by $10 million in FY06 and $20 million in FY07 and beyond.

Table 1: Net Impact of HB 123 (Thousands of Dollars)

	FY06	FY07	FY08
Mandatory Combined Reporting	30,000	60,000	60,000
Top CIT Rate Cut	(10,000)	(20,000)	(20,000)
Total Impact	20,000	40,000	40,000

Corporate income tax collections are extremely volatile. Collections are currently estimated to be $340 million in FY06 according to the Consensus Revenue Group, which is a high for CIT collections. In FY05, CIT revenue was $250 million and before that as low as $120 million. Most of the volatility comes from the oil and gas industry which has had a spectacular year. Prices for oil and gas are at record highs and though they are expected to come down, they will come down to a level that is still fairly high by historical standards.

Numbers of Filers by Filing Method

In tax year 2003, approximately 16,000 firms filed New Mexico corporate income tax returns as separate corporate entities (SCE). Approximately 370 returns were filed as combined unitary, while 866 firms filed federal consolidated returns. SCE filers paid approximately 46 percent of the tax; combined filers paid approximately 10 percent of the tax obligations, while federal consolidated return filers paid roughly 44 percent of New Mexico's corporate income taxes. SCE filers tend to be relatively small firms, although they can be quite large. Of the firms with New Mexico base income greater than zero, the average tax liability among SCE filers was approximately $4,000, while combined filers averaged approximately $36,000 per return and consolidated filers averaged roughly $62,000 per return. Major SCE filers consisted primarily of firms in the mineral extraction, manufacturing and retail industry. Firms in mineral extraction industries are also heavily represented among combined and consolidated filers.

SIGNIFICANT ISSUES

Combined Reporting: Most corporations only do business in one state and so their CIT filing is relatively straight-forward and combined reporting is not an issue for them. Where combined reporting is an issue is where companies have significant operations in a state but very little income when they file as separate entities, an option for NM CIT reporting. The use of subsidiaries called “passive investment companies,” or PICs, has proliferated in the last decade which is the primary reason states are moving towards requiring combined reporting. A PIC generally has no economic activity other than the ownership of intangibles like trademarks, logos, copyrights and patents. The PIC is a subsidiary of the parent corporation so only the parent corporation benefits from the proceeds of the PIC.

For example, if two companies have competing retail operations in the state. Company A is local and so all of their income is accounted for on their CIT return. Company B has a PIC in Delaware (the host of many PICs since there is no corporate income tax) which owns the logo and trademark that Company B uses to market its products. Company B leases the intangible property from the PIC for an amount that roughly equals its net income. Company B now has a competitive advantage over Company A because they have not paid any income tax in NM since they shifted it to their PIC in a state where there is no income tax.

Table 2: PIC Example		
	Company A	Company B
Revenue	1,000,000	1,000,000
Operating Costs	500,000	500,000
Lease Costs for Intangibles (logos, trademarks)	0	350,000
Net Income in NM (@ 5.8%)	500,000	150,000
NM Income Tax	**29,000**	**8,700**

As Table 2 shows, Company A has a competitive disadvantage since it is paying three times the corporate income tax as company B. This is a very simplistic example to demonstrate the problem. Actual corporate income tax filings are infinitely more complicated but the advent of mandatory combined reporting occurred because of the aggressive tax planning multi-state corporations have engaged in. By combining the mandatory combined reporting with a decrease in the corporate income tax rate, companies that will be impacted by the combined reporting requirement who have economically valid multi-state transactions will benefit from the lower corporate income tax rate.

During testimony at the Revenue Stabilization and Tax Policy Interim Committee (RSTP), TRD indicated that approximately 2 percent of corporations would be affected by requiring combined reporting. Most corporations in New Mexico are single location companies who will not be affected at all by combined reporting. These companies will to the extent that they have more than $1 million in income will benefit from the decrease in the top CIT rate.

At the same RSTP meeting, representatives of the Association on Commerce and Industry (ACI) indicated that the proposal unnecessarily complicates the tax system and would make New Mexico uncompetitive in attracting economic development.

Sixteen states currently require combined reporting: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, and Utah. Many of them are in the West and are New Mexico’s neighbors. The only neighbors that do not require combined reporting are Oklahoma and Texas and Texas does not have an income tax. Table 3 has the detail provided by TRD.

TRD provided the following table – nearby states are in bold:

Table 3: Illustration: Corporate Income Tax Rates and Combined Filing Status Requirement

State	Tax Rates	Tax Brackets		# of Brackets	Mandatory Combined?
Alabama	6.5	----Flat Rate----		1	No
Alaska	1.0 - 9.4	10,000	90,000	10	Yes
Arizona	**6.968 (b)**	**----Flat Rate----**		**1**	**Yes**
Arkansas	1.0 - 6.5	3,000	100,000	6	No
California	**8.84 (c)**	**----Flat Rate----**		**1**	**Yes**
Colorado	**4.63**	**----Flat Rate----**		**1**	**Yes**
Connecticut	7.5 (d)	----Flat Rate----		1	No
Delaware	8.7	----Flat Rate----		1	No
Florida	5.5 (f)	----Flat Rate----		1	No
Georgia	6.0	----Flat Rate----		1	No
Hawaii	4.4 - 6.4 (g)	25,000	100,000	3	Yes
Idaho	7.6 (h)	----Flat Rate----		1	Yes
Illinois	7.3 (i)	----Flat Rate----		1	Yes
Indiana	8.5	----Flat Rate----		1	No
Iowa	6.0 - 12.0	25,000	250,000	4	No
Kansas	**4.0 (l)**	**----Flat Rate----**		**1**	**Yes**
Kentudky	4.0 - 8.25	25,000	250,000	5	No
Louisiana	4.0 - 8.0	25,000	200,000	5	No
Maine	3.5 - 8.93 (m)	25,000	250,000	4	Yes
Maryland	7.0	----Flat Rate----		1	No
Massachusetts	9.5 (n)	----Flat Rate----		1	No
Minnesota	9.8 (o)	----Flat Rate----		1	Yes
Misissippi	3.0 - 5.0	5,000	10,000	3	No
Missouri	6.25	----Flat Rate----		1	No
Montana	6.75 (p)	----Flat Rate----		1	Yes
Nebraska	5.58 - 7.81	50,000		2	Yes
New Hampshire	8.5 (q)	----Flat Rate----		1	Yes
New Jersey	9.0 (r)	----Flat Rate----		1	No
New Mexico	**4.8 - 7.6**	**500,000**	**1 million**	**3**	**No**
New York	7.5 (s)	----Flat Rate----		1	No
North Carolina	6.9 (t)	----Flat Rate----		1	No
North Dakota	2.6 - 7.0	3,000	30,000	5	Yes
Ohio	5.1 - 8.5 (u)	50,000		2	No
Oklahoma	**6.0**	**----Flat Rate----**		**1**	**No**
Oregon	6.6 (b)	----Flat Rate----		1	Yes
Pennsylvania	9.99	----Flat Rate----		1	No
Rhode Island	9.0 (b)	----Flat Rate----		1	No
South Carolina	5.0	----Flat Rate----		1	No
Tennessee	6.5	----Flat Rate----		1	No
Utah	**5.0 (b)**	**----Flat Rate----**			**Yes**
Vermont	7.0 - 9.75 (b)	10,000	250,000	4	No
Virginia	6.0	----Flat Rate----		1	Not a unitary state
Wst Virginia	9.0	----Flat Rate----		1	No
Wisconsin	7.9	----Flat Rate----		1	No

Information Sources: Federation of Tax Administrators web site; "2001 Multistate Corporate Tax Guide", Panel Publishers and "Setting the Record Straight on Combined Reporting" published by the Massachusetts Budget and Policy Center Notes: Wyoming, South Dakota, Nevada, Washington ,Texas and Michigan do not impose corporate income taxes.

ADMINISTRATIVE IMPLICATIONS

TRD has reported that the administrative costs are expected to be relatively modest.

TECHNICAL ISSUES

TRD: As a result of Conoco and Intel v. TRD (1997), the Department may not include foreign dividends and subpart F income in the tax base for separate filers, but the Department can and does include foreign dividends and subpart F income in the tax base for combined and consolidated filers. (Subpart F income is income earned by controlled foreign corps in tax haven countries. It is treated as a "deemed dividend" by the U.S. Internal Revenue Code since it may never be formally repatriated.)

OTHER SUBSTANTIVE ISSUES

Detailed TRD analysis of substantive issues:

Current Practice and Probable Basis for the Proposed Legislation.

Under current law, each member of an affiliated group of corporations may file as a separate entity in New Mexico. Only the entity with a taxable presence ("nexus") must file a return in the state. This filing method creates opportunities for controlled groups of corporations to shift profits to their out-of-state affiliates by inflating inter-company charges to the in-state entity. Because affiliated corporations almost always file a single "consolidated" return for federal purposes, the inter-company charges are not subject to federal audit scrutiny. Policing 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 state tax auditors. 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 composite return, eliminating all inter-company charges. The states impose their apportioned tax on a larger tax base, likened by some to taxing a smaller share of a bigger pie. The Blue Ribbon Tax Commission endorsed the concept of mandating combined filing in 2003.

Eastern states have not generally adopted combined filing, although in response to some well-publicized "tax planning" techniques, 13 Eastern 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. New York allows its tax commissioner to "force" mandatory combining to avoid income distortion. The discretionary powers necessary to properly implement both the "add-back" provisions and the "forced combination" techniques have generated significant litigation. Vermont has recently enacted mandatory combined filing, and other Eastern states are considering it in response to budget shortfalls. Although there is some anecdotal evidence that the "federal consolidated" method has led to some revenue losses from particular taxpayers with highly profitable in-state operations, use of the option gives both the states and the taxpayers absolute certainty as to which entities must be included on a return, eliminating disputes as to whether two business segments or separate entities are interdependent. As shown in the illustration below, about 16 states require combined reporting..

Eliminate Separate Corporate Entity Reporting: Arguments For and Against

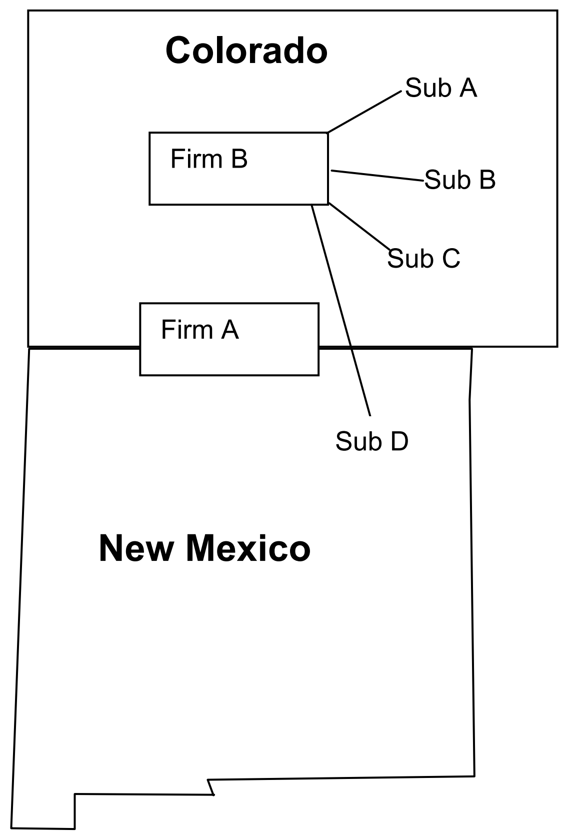
Arguments in favor of eliminating separate corporate entity (SCE) reporting include:

1) Its elimination will reduce corporate tax planning that cost states corporate income tax revenues

2) Eliminating SCE will make state corporate income tax practices more uniform than they currently are.
Arguments against the approach:
1) Eliminating SCE filing would discourage economic development by discouraging firms from locating in a particular state.

Eliminate Federal Consolidated Reporting: Arguments For and Against
The primary argument for eliminating consolidated reporting is based on a view that states lose substantial corporate income tax revenue by allowing consolidated filing. The primary argument against eliminating consolidated filing is that it is extremely easy to enforce by simply requiring firms to submit copies of their federal tax returns when filing state corporate income tax returns.

Description of Reporting Methods
Current New Mexico statutes allow groups of affiliated firms to file as "separate corporate entity" (SCE), "unitary combined" and "federal consolidated group". This option is sometimes referred to as "the ladder" because when moving from separate corporate entity to combined, then federal consolidated reporting, firms include greater amounts of corporate income in amounts of income reported. All three filing options require allocation and apportionment under the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA and associated regulations provide rules whereby corporations or groups of corporations operating in more than one state divide income and expenses among the states in which they operate. It provides special rules, for example, for airlines, railroads, construction contractors, trucking companies, broadcasters, and to firms in the publishing and financial industries. In tax years following the first one in which corporations report, they are allowed to employ a different filing method without permission from the Department so long as they select a higher position on the "ladder". In other words, they are allowed to change from separate corporate entity to combined or consolidated without permission from the Department. But they may not change from combined to separate corporate entity without permission from the Department; and the Department does not generally allow the election unless the proposed new reporting method is a better reflection of industry practices than the one the firm currently employs.



Unitary Businesses and Filing Methods
A unitary business is generally regarded to be one that operates as a unit; its branches are so 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 determining whether a group of businesses constitutes a unitary business, yet the practical effect of the concept is that, once a group of businesses has been

defined as a unitary group, the only feasible approach to sourcing their incomes is via combining incomes from all group members and subjecting them to formula apportionment. 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. This discretion is contained in the three options allowed for filing returns. As illustrated in the figure below, the proportion of business activity subject to apportionment increases as a firm moves from separate corporate entity to combined and then federal consolidated group reporting. New Mexico statutes allow firms to move up the ladder, but not down without permission of the Taxation and Revenue Department Secretary.

Differences in the three filing methods can be understood with the aid of the figure. Assume, as illustrated in the figure, that two affiliated firms -- firm A and firm B -- operate in Colorado and New Mexico. Firm A operates partially within both states, but Firm B's physical presence is limited to Colorado. Firm B controls a number of subsidiaries -- three of which are in Colorado, while one is located in New Mexico. The firms are, in fact, related in some way -- via, for example, shared trademarks, ownership, purchasing or other activities.

Under separate corporate entity reporting, Firm A is allowed to report as if it were a separate entity totally unrelated to Firm B or the subsidiaries. That is, Firms A and B are not considered unitary. Total income produced by firm A would be taxable, but Firm A's business income would be apportioned between Colorado and New Mexico using the three-factor apportionment formula. Income and apportionment factors of Firm B and the various subsidiaries would be ignored. If Firm B is a subsidiary of A, Firms A and B would each file separate returns based on the proportion of business conducted in New Mexico by each firm. Under a combination of domestic unitary corporations reporting system, firms A and B would combine their income and report as if they were a single firm. If subsidiaries of firm B are not considered part of the unitary business, their incomes would not be counted, nor would their activities be accounted for in the apportionment factor. If federal consolidated group reporting is employed, all firms and subsidiaries' incomes shown in the figure would be combined, including apportionment factors and incomes that are not considered part of the unitary businesses. Many intergroup transactions would be eliminated, however, because they would not reflect total business activity. Payroll, property and wages of all units would be accounted for in the apportionment factor.

Effects on Tax Obligations

The movement from separate corporate entity to combined, then consolidated reporting involves increasing taxable income from a group of business organizations attributable to a single taxpayer -- a factor that tends to increase tax obligation. As each subsidiary's income is added to the group, however, data from its activities also flows into the apportionment formula. To the extent that the subsidiary has no instate activities, it lowers the apportionment percentage, thus decreasing tax obligations. Whether the firm's total tax obligation increases or decreases depends on whether the former effect exceeds the latter one. Eliminating filing options is almost always expected to increase revenues, on the assumption that firms choose the filing method that generates the lowest tax obligations. To the extent that it causes firms to cease doing business in a particular state, it may have the opposite effect, however.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

Companies will still be able to shift incomes from NM to other states where there is no income tax.

POSSIBLE QUESTIONS

What kind of transactions are valid between unitary corporations? In other words, what legitimate business practices will be affected by making combined reporting mandatory?

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