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

SPONSOR Wirth

ORIGINAL DATE 01/30/12
LAST UPDATED 02/13/12

HB

SHORT TITLE Corporate Tax Rates & Combined Reporting

SB 9/SFCS

ANALYST Smith

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Nonrecurring	Fund Affected
FY14	FY15	FY16		
Roughly Zero			Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY13	FY14	FY15	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	80.0	80.0		160.0	Recurring	Taxation Revenue Department

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From

No Taxation and Revenue Department (TRD) on Substitute

SUMMARY

Synopsis of Bill

The Senate Finance Committee Substitute to SB9 institutes mandatory combined corporate income tax reporting for “big box” retailers. The target archetype is “a unitary corporation that provides retail sales in a facility of more than thirty thousand square feet under one roof”.

The bill also reduces the top rate from 7.6% to 7.5%.

Effective Date: January 1, 2013

FISCAL IMPLICATIONS

It should always be noted that corporate income tax estimates are especially imprecise. Analysts have attempted to balance the increase from combined reporting against the reduction in the top rate. It has been assumed that “big box” retailers would generate 25% of all revenue increases from combined reporting and that the “long run” increase would be around $5 million. The estimate also assumes that the bill would pass legal muster.

TRD research combined reporting during the interim. They reported that range of estimates on the in effect is very wide, from 0% (no increase in revenue) to 20%. Revenues are expected to increase initially and the rate of increase is expected to slow down during the later years as taxpayers adjust their corporate structures and transactions to minimize liability. Part of the initial gain is due to one-time factors like the disallowance of losses earned by separate entities. Once taxpayers realize they are subject to combined reporting, they are more likely to restructure their business operations to reduce their liability **as long as it makes economic sense for them to do so**. New Mexico is typically a small proportion of a national retail company’s sales base. It may be more trouble than it is worth to restructure in a tax efficient manner.

Lastly, analysts assumed that a $5 million dollar increase (from combined reporting) was enough to buy down the top rate versus all rates by 1%. A “microsimulation” of TRD data bases could have a materially different result (in either direction).

Effective Date: January 1, 2013

SIGNIFICANT ISSUES

New Mexico’s relatively high CIT rate has been identified as an economic development hindrance. However, simple mandated combined reporting creates trade-offs among several desirable goals of tax policy. On one hand, combined reporting can prevent some tax avoidance strategies that could enable multi-state corporations to shift income from New Mexico to states with lower income tax rates. On the other hand, the determination of what is a “unitary” corporation has been interpreted in varying ways by the courts, which can create uncertainty and compliance costs for taxpayers and administrative burdens for TRD.

In addition, mandatory combined reporting may discourage corporations with profitable operations in other states from locating in New Mexico, since profits from existing operations would be partially taxable in New Mexico even though their New Mexico start-up operation was not profitable.

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. Texas recently adopted mandatory combined reporting for their Margin Tax. The Blue Ribbon Tax Commission endorsed the concept of mandatory combined reporting in 2003, although the commission recommended that the added revenue from combined reporting be used to reduce the corporate income tax rate. New Mexico’s corporate income tax rate is currently one of the highest among western states. Several western states allow “single-weighted sales factor” apportionment of income for their corporate income tax. For companies with a large portion of sales outside the state, this method has the effect of reducing their corporate income tax liability. New Mexico requires most companies to use “three-factor apportionment,” including payroll, property and sales. Thus, the burden of New Mexico's corporate income tax is more likely to fall on payroll and property in the state than the corporate income tax in single-weighted sales factor states.

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 certain amounts paid to related companies located in other states. The add-back approach can be considered a more targeted approach to the potential for income shifting to avoid state tax. The discretionary powers necessary to properly implement both the "add-back" provisions and the "forced combination" techniques have generated significant litigation. Massachusetts, New York and West Virginia recently enacted mandatory combined filing. SB-7 is an example of an add-back statute.

ADMINISTRATIVE IMPLICATIONS

TRD has reported that Regulation 3.4.10.8(B) NMAC will need to be changed (or a new regulation added) to reflect that after January 1, 2013, a taxpayer that previously filed as a separate corporate entity, but is part of a unitary corporation, as that term is defined in Section 7-2A-2Q NMSA 1978, must file its New Mexico CIT returns using the combined unitary group method or the federal consolidated method.

The proposal will require TRD and taxpayers to address many issues of law that have not been addressed in the past because combined filing was available as an election but has not been mandated. The Department will have to develop regulations clarifying how the requirements will be implemented. Taxpayers will have to determine which of their operations are affected. The administrative cost estimate is based on an additional auditor to specialize in corporate income tax.

TECHNICAL ISSUES

TRD notes that, although current law Section 7-2A-2(Q) contains a definition of "unitary" corporation, the definition contains a number of terms that are subject to varying interpretation. In addition, lack of clarity in other areas of New Mexico's corporate income tax creates uncertainty for taxpayers trying to determine the income and expenses of the unitary group. An example is the treatment of net operating losses incurred by companies that are currently not reported on New Mexico tax returns but would be included in a combined return under the proposal. New Mexico law is silent on this issue, although a regulation implies that these losses would not be allowed on the combined return. Although such treatment increases the potential revenue impacts of the proposal, it could also be punitive for some taxpayers, because their losses were incurred through business operations and not through tax avoidance behavior. Disallowing these losses effectively wipes out a valuable asset. If treatment of these issues is not clarified in the statute, it increases the likelihood there will be litigation of the issues in the future.

OTHER SUBSTANTIVE ISSUES

Does the bill meet the Legislative Finance Committee tax policy principles?

- **Adequacy**: Revenue should be adequate to fund needed government services.

- **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
- **Equity**: Different taxpayers should be treated fairly.
- **Simplicity**: Collection should be simple and easily understood.
- **Accountability**: Preferences should be easy to monitor and evaluate

SS/amm:lj