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

ORIGINAL DATE 01/23/17

SPONSOR SCORC **LAST UPDATED** 03/08/17 **HB**

SHORT TITLE Unitary Group Combined Tax Reporting **SB** 1/SCORCS

ANALYST Clark

REVENUE (dollars in thousands)

Estimated Revenue*					Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**	**FY20**	**FY21**		
$0	Unknown Loss or Gain	Unknown Loss or Gain	Unknown Loss or Gain	Unknown Loss or Gain	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

*The long-term revenue impact is likely to be positive, but based on the effects of the bill that can cause both revenue losses and revenue gains and a lack of sufficient information about the companies that would be affected, the short-term impact is unknown.

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

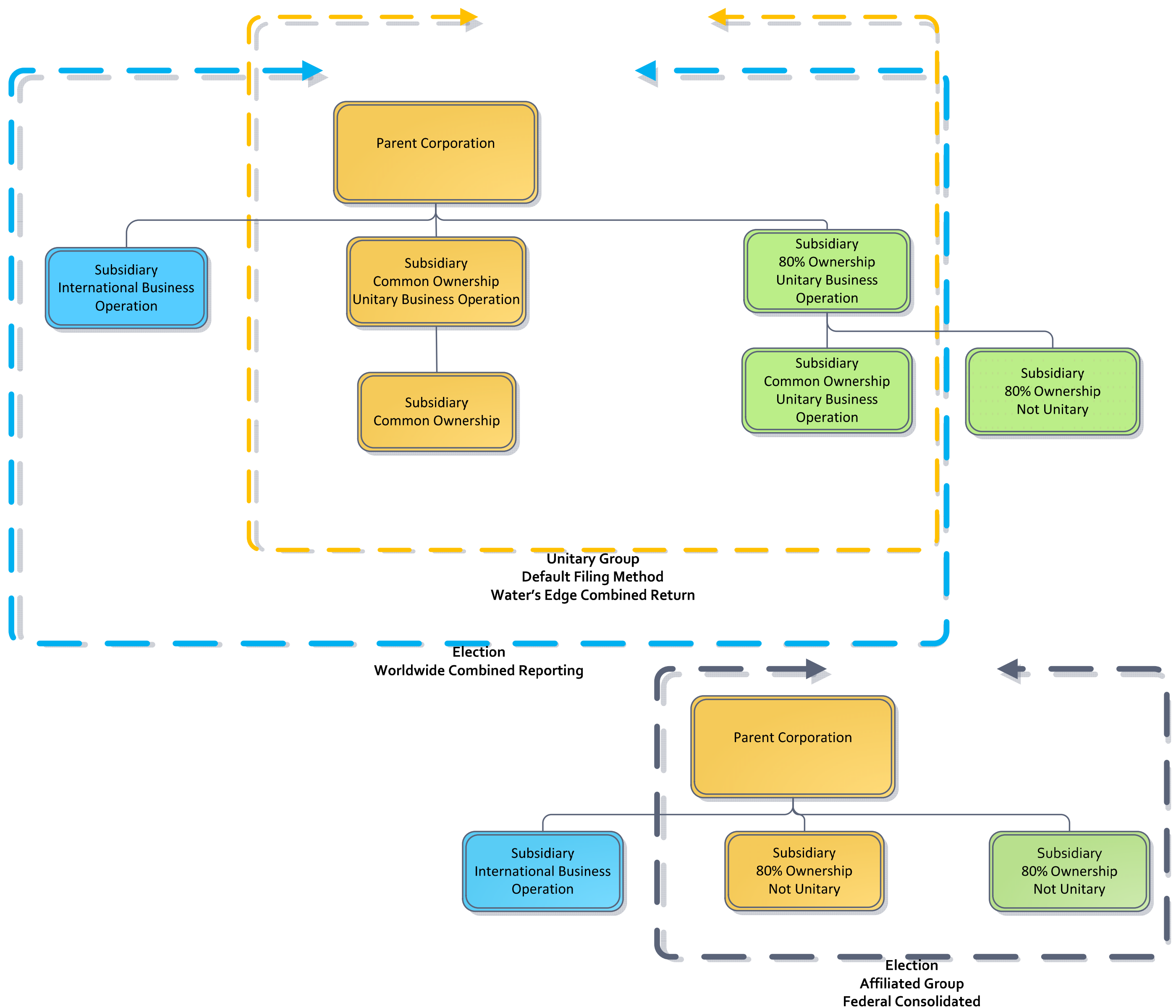
Synopsis of Bill

Senate Corporations and Transportation Committee Substitute for Senate Bill 1 amends Sections 7-2A-2 NMSA 1978 and 7-2A-8.3 NMSA 1978 and repeals Section 7-2A-8.4 NMSA 1978. The purpose of the bill is to specify the default filing methods for corporations. By default, a unitary group of corporations shall file a water's edge combined report, but may elect to file a worldwide combined return. An alternate filing method for qualifying corporations is a consolidated return for a group of firms in an affiliated group included in the report to the Internal Revenue Service (IRS) on a consolidated basis provided that all the corporations on the return consent to report to New Mexico on the same basis. Once a filing method has been used to file a return in New Mexico, a return shall not be filed under any other method without the permission of the

secretary or the change in reporting is required or allowed by the IRS. Additionally, the bill excludes from base income 100 percent of a dividend from a foreign subsidiary that is a member of a unitary group.

There is no effective date of this bill. It is assumed that the effective date is 90 days after this session ends. However, the provisions of the bill apply to taxable years beginning January 1, 2018.

The Taxation and Revenue Department (TRD) provided the following graph to illustrate how these filing selection methods would work.



FISCAL IMPLICATIONS

The bill would simultaneously increase general fund revenues from certain changes and for certain taxpayers and decrease revenues from other changes and for other taxpayers. TRD was unable to estimate the impact or determine whether the total effect would be positive or negative. However, the primary purpose of a state moving to combined filing or combined reporting is to prevent income-shifting, which can cause state revenue losses, and the long-term impact is likely to be positive. TRD provided the following information related to the fiscal impact.

GenTax software system data for tax years 2010 through 2015 was analyzed to attempt to ascertain the fiscal impact. Based on averages across this time period, there are: approximately 550 corporate income tax (CIT) (≈ 2.7 percent) taxpayers filing using a combined unitary (COMB) election; approximately 1,150 (≈ 5.6 percent) filing using a federal consolidated (CONS) election; and approximately 18.8 thousand CIT taxpayers (≈ 91.7 percent) filing as separate corporate entities (SCE). The proposed bill affects all existing types of filers, as SCEs would be required to file combined returns as the new default method, and existing combined or consolidated filers may have to make adjustments from current law for foreign source dividends.

The fiscal impact of this bill is unknown, as the resulting changes in filing group composition, apportionment factors, base income, and net income cannot be quantified with existing TRD data. The bill could have revenue generating impacts with respect to some taxpayers and revenue reducing impacts for others, depending on the calculus of those factors. The exclusion of foreign source dividends for taxpayers that currently file combined or consolidated returns may constitute a negative revenue impact.

A review of several experiences and studies on combined reporting provided a range of estimates including zero change or no increase in revenue after requiring combined returns to as much as a 20 percent gain. An estimate for this would require information TRD does not have, such as the full income, loss, and apportionment factor data for an entire combined group that files only for its separate entities in New Mexico. Therefore, TRD cannot reliably estimate any revenue gains from the proposed change.

SIGNIFICANT ISSUES

This bill provides a common method of combined reporting for corporate entities, an option sometimes referred to as combined filing. See the attachment to this analysis for details on how combined filing/reporting works. TRD provided the following analysis.

Currently, of the 44 states that impose corporate income taxes, 24 states and D.C. require combined reporting. One of the principal purposes for enacting combined reporting is to protect state revenues against income-shifting. There are generally two ways to prevent income-shifting: (1) required combined reporting, which eliminates the intercompany transactions that permit the shift; or (2) "addback" statutes, which require separate entity filers to "add back" to their income certain intercompany payments.

Some tax experts estimate that corporate income-shifting structures, which largely result from a separate entity filing regime, can cost states billions of dollars in lost revenues. Historical examples have included the establishment of a trademark holding company in a tax haven state

to increase the business expense deduction of the in-state separate entity filer, and thereby reduce taxable income. The establishment and use of a real-estate investment trust (REIT) can achieve the same result. Income-shifting structures can be complex, but most derive from the inability of separate entity filing regimes to treat the unitary group of related companies as a single taxpayer.

As more than half the states that impose corporate income tax already require combined reporting, most multistate taxpayers are familiar with unitary rules, principles, and reporting mechanics. However, combined reporting can result in increased tax burdens to certain taxpayers depending on facts and circumstances.

The exclusion of foreign dividends from combined or consolidated group's income also raises policy issues that require consideration. Most states that have combined reporting provide some sort of foreign dividend deduction. New Mexico, under current law, and several other states do not allow deductions for dividends received from foreign affiliates when taxpayers file on a combined or consolidated basis. From the perspective of aligning with other states, a foreign dividend exclusion would achieve parity with other states. However, most of these states adopted foreign dividends deductions before large companies began shifting income outside the United States. Known now as base erosion and profit shifting (BEPS), many large companies are diverting US income to foreign "tax havens" to reduce overall US taxation. Obviously, not all companies have the ability or the proclivity to shift income. However, BEPS is a worldwide issue for many economic leading countries. Since unitary companies can operate cross border, and as BEPS becomes a growing issue, there are countervailing policy reasons for not allowing foreign dividend deductions.

ADMINISTRATIVE IMPLICATIONS

There would be a minimal administrative impact to TRD. The agency reports modification of forms, instructions, and publications related to the Corporate Income and Franchise Tax Act would be necessary. Modifications to the GenTax business rules will be required. All modifications can be done with minimal cost to the department as part of the annual renewal of the tax program. Minor changes to audit procedures will be required.

TECHNICAL ISSUES

TRD reports the bill has two technical issues. The bill creates a 100 percent foreign dividend deduction. The first issue: 100 percent deduction deviates from current practice in most states. The proposed bill offers a more generous deduction. For constitutional reasons, New Mexico currently follows federal practice and allows a foreign dividend deduction for separate entity filers. However, the amount of the deduction is scaled based on the US company's degree of ownership in the foreign affiliate or subsidiary. For example, under IRC § 245, a 70 percent deduction is allowed dividends received from 10 percent-or-more-owned foreign corporations. The deduction is 80 percent in the case of dividends received from 20 percent-or-more-owned foreign corporations. A 100 percent deduction is allowed for dividends received from wholly owned foreign subsidiaries, as long as the dividends are out of earnings and profits for the tax year and the subsidiary's income is effectively connected with a U.S. business.

In New Mexico, separate entity filers receive the following:

- 100 percent of dividends received from 80 percent-or-more-owned foreign corporations;
- 80 percent of dividends received from less-than-80 percent but more-than-20 percent-owned foreign corporations; and
- 70 percent of dividends received from less-than-20 percent-owned foreign corporations.

Second, and more problematically, the amendment fully eliminated foreign dividends from inclusion in "base income," but continues to provide "factor relief" (page 2, lines 20-25) as though 50 percent of foreign dividends are still included in base income. This will have the unintended affect or reducing the New Mexico apportionment formula without a corresponding increase in the tax base. When foreign dividends are included in base income, the denominators of the apportionment formula factors are adjusted upward based on the factors of the foreign subsidiaries that paid the dividends. This adjustment is intended to reflect how the income was earned. When no foreign dividends are included in base income, factor relief is both unnecessary and distortive, as it credits taxpayers with generating income outside the US, but does not include any income from those sources in the tax base. The result is a lower tax liability in New Mexico, and an inexact, distortive representation of the firm's total unitary group.

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

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

JC/jle/al/jle

Attachment 1

ITEP
INSTITUTE ON TAXATION AND ECONOMIC POLICY

Policy Brief

Informing the debate over tax policy nationwide

August 2011

Combined Reporting of State Corporate Income Taxes: A Primer

Over the past several decades, state corporate income taxes have declined markedly. One of the factors contributing to this decline has been aggressive tax avoidance on the part of large, multi-state corporations costing states billions of dollars. The most effective approach to combating corporate tax avoidance is the use of combined reporting, a method of taxation currently employed in more than half of the states with a corporate income tax. Eight states have enacted legislation to institute combined reporting within the past five years. Commissions and lawmakers in several other states, such as North Carolina, Maryland, Rhode Island and Kentucky, have recently recommended its adoption. This policy brief explains how combined reporting works.

How Combined Reporting Works

For corporations that only do business in one state, paying corporate income taxes can be pretty simple – all of their profits are taxable in the state in which they are located. For corporations with subsidiaries in multiple states, the task of determining the amount of profits subject to taxation is more complicated. There are broadly two ways of doing this: **combined reporting**, which requires a multi-state corporation to add together the profits of all of its subsidiaries, regardless of their location, into one report, and **separate accounting**, which allows companies to report the profit of each of its subsidiaries independently.

For example, if the Acme Corporation has three subsidiaries in three different states, a combined reporting state would require Acme to report the profits of the four parts of the corporation as one total, on the grounds that each of the parts of the corporation contribute to its profitability. In contrast, a separate accounting state would require only those parts of the Acme Corporation that have "nexus" in that state – that is, enough in-state economic activity to be subject to the state's corporate income tax – to report their profits, even if the out-of-state parts of the corporation are responsible for the bulk of Acme's overall profits.

States with Combined Reporting, 2011

Alaska, Arizona, California, Colorado, District of Columbia, Hawaii, Idaho, Illinois, Kansas, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Texas, Utah, Vermont, West Virginia, Wisconsin

As of 2011, twenty four states have adopted combined reporting. The District of Columbia, Massachusetts, Michigan, Texas, New York, Vermont, West Virginia, and Wisconsin all enacted legislation to institute combined reporting within the past five years.

How Businesses Abuse Separate Accounting

In addition to allowing companies to structure their operations so that some subsidiaries avoid taxation, separate accounting enables corporations to use certain gimmicks to shift their profits from high-tax states to low-tax states. The most infamous example of this is the passive investment company (PIC) loophole.

Here's how the PIC loophole works: suppose the Acme Corporation is based in State A, which uses separate accounting. If Acme has sales of $100 million and expenses of $70 million, its taxable profits ought to be $30 million. If Acme sets up a subsidiary – commonly referred to as a passive investment company (PIC) – in a state, like Delaware, that does not tax intangible property such as trademarks and patents and makes that subsidiary the owner of Acme's intangible property, then the

subsidiary can charge Acme for the use of these trademarks. Although Acme's payment to the PIC is basically a transfer of funds within the company, under separate accounting, this expense counts as a cost of doing business—and can therefore be subtracted from Acme's income in determining its taxable profits in State A. Since the subsidiary can charge Acme whatever it wants for the use of the trademarks, Acme may actually be able to zero out its taxable profit through this sham "expense."

In the example below, Acme's subsidiary (i.e. its PIC) charges it $30 million for the use of the trademarks, which reduces Acme's taxable profit in State A to zero. Because the subsidiary exists only to lease trademarks to Acme, none of the subsidiary's sham "income" is taxable in Delaware. Furthermore, because the PIC does not have nexus in State A, Acme pays no tax to State A on the profits generated by the PIC. A wide variety of major corporations currently use the PIC loophole in separate accounting states, including K Mart, Home Depot and Toys R Us.

How the PIC Loophole Creates a "Zero Tax" Corporation

Revenue and Expenses	Combined Reporting	Separate Accounting	
		Acme	Subsidiary
Revenues	**$100**	**$100**	
Normal Expenses	**($70)**	**($70)**	
Sham Revenues			**$30 (not taxed)**
Sham Expenses		**($30)**	
Taxable Profits	$30	$0	$0

Unfortunately, the PIC loophole is one of just many tax avoidance techniques available to corporations operating in separate accounting states. For example, a February 2007 *Wall Street Journal* article notes that Wal-Mart may have been able to avoid as much as $350 million in state corporate income taxes between 1998 and 2001 due to another, similar loophole know as "captive real estate investment trusts (REITs)".

Combined Reporting: A Simple Approach to Preventing Tax Avoidance

In a combined reporting system, all of the income and expenses of Acme and its subsidiaries would be added together, so that PICs and other loopholes would have no impact at all on the company's taxable profits. For example, if Acme tried to use the PIC loophole, the subsidiary's $30 million of income from the sham transaction would be canceled out by Acme's $30 million of expenses, with a net impact of zero on Acme's taxable profits.

Of course, combined reporting is not the only option available to states seeking to prevent the use of accounting gimmicks such as the PIC loophole. States can also close these loopholes one at a time. For example, several states have enacted legislation that specifically prohibits shifting income to tax haven states through the use of passive investment corporations. The main shortcoming of this approach is that in the absence of combined reporting, multi-state corporations will always be able to develop new methods of transferring profits from high-tax to low-tax states. The only limit to the emergence of new approaches to transferring income to tax haven states is the creativity of corporate accountants. Combined reporting is a single, comprehensive solution that eliminates all potential tax advantages that can be derived from moving corporate income between states.

Combined Reporting Levels the Playing Field

Combined reporting is fairer than separate accounting because it ensures that a company's tax should not change because its organizational structure changes. It creates a level playing field between smaller and larger companies: small companies doing business in only one state can't use separate accounting to reduce their tax because they have no business units in other states to shift their income to. Large, multi-state corporations will find it easier to avoid paying taxes using separate accounting because they have business units in multiple states.

Conclusion

Strategies that broaden the corporate income tax base by eliminating loopholes can ensure that profitable corporations pay their fair share for the public services they use every day, can level the playing field between multistate corporations and locally-based companies that can not avail themselves of tax avoidance schemes, and can help balance state budgets without requiring unpopular increases in tax rates. Requiring combined reporting is the single best strategy available to lawmakers seeking to stamp out accounting shenanigans by large and profitable corporations.

For more information on Combined Reporting, see the Center on Budget and Policy Priorities' report, **A Majority of States Have Now Adopted a Key Corporate Tax Reform- "Combined Reporting".**