NEW MEXICO
TAX RESEARCH
INSTITUTE

Corporate Income Tax – A Primer and Recent Issues

Presented to the Revenue Stabilization and Tax Policy Committee

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NMTRI Principles of Good Tax Policy

N.M. Tax Research Institute is a non-profit, non-partisan member-supported organization dedicated to advancing the following principles of good tax policy in New Mexico:

- ***Adequacy***
  - Revenues should be sufficient to fund needed services
- ***Efficiency***
  - Interference with the private economy should be minimized
- ***Equity***
  - Taxpayers should be treated fairly
- ***Simplicity***
  - Laws, regulations, forms and procedures should be as simple as possible
- ***Comprehensiveness***
  - All taxes should be considered when evaluating the system
- ***Accountability***
  - Exceptions should be rare and should be carefully evaluated and justified

State Corporate Income Tax-General

- 46 States and the District of Columbia impose some type of income-based tax on corporations ("CIT")
  - Nevada, South Dakota, Washington and Wyoming do not
  - California, Florida, New York and several other states technically impose a "franchise tax" for the privilege of engaging in business, but the value of the franchise is measured by income
  - Washington imposes a Business Activity Tax (BAT), a gross receipts tax, in lieu of a tax measured by income
  - Ohio replaced it's corporate income tax with the Commercial Activity Tax (CAT), also more of a gross receipts tax
  - Michigan imposes a modified gross receipts tax and a business income tax
    - MI is in the process of switching back to a CIT
  - Texas imposes a Margin Tax, which is a hybrid of a generic income and gross receipts taxes

State Corporate Income Tax-General

- Corporate income tax is a tax on profits
  - Subchapter C corporations and NFPs with UBI only
- Corporations pay tax on profits at the corporate level and owners again as individuals
  - Economic incidence is less clear and "depends" based on facts
    - Follow "path of least resistance" to owners, employees, product price, other costs or reduced investment
- Small to medium businesses typically don't pay corporate income taxes – so their owners only pay tax once.
  - Corporate taxes were formally a general tax on most business activity, however that is increasingly not the case with the expansion and increasing utilization of pass through entities (PTEs)
- Federal rules often apply determining proper income/expenses and taxable income (although many states have adjustments – additions and subtractions from the federal- decoupling, US obligations, etc.)

State Corporate Income Tax-Calculation

- **Filing methods (options and elections as to what corporations are included in a return)**
- Taxable income (base of the tax)
- **Apportionment Method (what share does NM get of taxable income)**
- **Tax Rate**
- Incentives and Credits

State Corporate Income Tax-Calculation

- Because it takes all elements to calculate the corporate income tax, no one element of the corporate income tax can be analyzed separately from the other elements – they all matter.

Tax Due = Taxable Income x State % x Tax Rate

Adequacy and Stability - Generally

- Most state's generate a fairly small portion of their general fund revenue from corporate income taxes (NM's percentage is around 5-6%). There are exceptions (i.e. Alaska)
- Corporate income taxes are one of the most unstable tax revenue sources. In part this is because the tax is based on income and corporations generate losses as well as income depending on the circumstances.

NM Filing Groups/Methods

- Separate Entity
  - Default method – single legal entity
- Combined
  - “unitary” group of related companies as defined by application of the unitary business principle (determined by predetermined degree of common ownership plus consideration of other inter-relationships or commonalities of related members)
- Consolidated
  - Group of related companies as defined by the Internal Revenue Code.

Equitable Treatment - Generally

- Because small to medium sized businesses can avoid corporate income tax, the tax is more likely to burden larger multi-state businesses.

- Policy reasons for this different tax treatment of corporations may have existed at one time but are less clear now. States provide services to corporations but they also provide services to all other non-taxed entities. Justifications included:
  - Liability limitations
  - Access to capital markets

Ease of Administration

- State corporate income tax is very complex to administer and to comply with – in addition to complication at the Federal level.
  - State corporate income tax is as complicated as every other state tax combined.
  - Different approaches (i.e. separate filing versus combined filing) present differing complications, but complications nevertheless

- Compared to the revenue generated, this complexity is relatively significant, rendering this form of taxation exceptionally inefficient.

Impact on Economic Activity

- Within very broad boundaries, states are free to structure their corporate income taxes in various different ways – and they do.

- Because the tax generally falls on larger, multi-state companies, the impact of a particular state's corporate income tax may impact the amount of activity or investment a corporation makes in that state, depending on tax profile, sensitivity, and other business costs and priorities. This would be more true with investments by "mobile capital" versus more "captive" business (i.e. retail)

Filing Method

- In general, states may allow or require corporations to report and pay tax on a separate entity basis or may allow or require corporations to report and pay tax on a unitary combined basis.
  - Our election to file on a federal consolidated bases is not constitutional as a mandated approach, and thus can only be an election.

- If a state allows or requires combined filing, it may have different rules for how to determined the proper combined group.

Right to Apportion Income

- In most states, allocation and apportionment provisions are applicable to taxpayers **having income** from business activity that is taxable both **within and without the state**.
- When is a taxpayer taxable within and without the state?
  - Engaged in business;
  - Doing business;
  - Carrying on business; or
  - Be taxable in another state (note state-specific meanings to these terms)

The Standard Apportionment Formula

- Under both UDITPA and the MTC regulations, business income is apportioned to a state using a three factor, equally weighted, formula that compares the ratio of in-state to overall property, payroll and sales.

- The apportionment for a given state, "state X", is typically computed as follows:

$$\frac{\dfrac{\text{State X Property}}{\text{Total Property}} + \dfrac{\text{State X Payroll}}{\text{Total Payroll}} + \dfrac{\text{State X Sales}}{\text{Total Sales}}}{3}$$

- Standard formula reasonable yet arbitrary

- Goal was uniformity among states

  - Note: “standard” formula now minority

Corporate Income Tax and a Changing World

- New Mexico's corporate tax structure has been substantially the same for decades
  - But, other states have been changing quite a lot
    - Rate reductions more common than rate increases
    - Alternative apportionment methods becoming the norm
    - Mandatory combined filing becoming more prevalent
      - Legislation introduced in NM 9 years in a row
- NM's corporate tax structured to favor local business (dating back to when most local businesses were subject to CIT)
  - Tiered rate structure
    - No economic justification in the context of a business income tax
  - Apportionment of tax rather than income
    - Ensured multi-state businesses paid at highest rate regardless of earnings in NM
  - Smaller businesses can more readily manipulate income than large
- Other less friendly features
  - NOL limitations
  - Throwback rule

Corporate Tax Reform Options

Numerous options, targeted or broad based, can reduce the ETR, however other trade-offs, costs, and policy issues arise. Most discussed reform options and obvious alternatives when looking at other states include:

- Rate reduction
- Apportionment alternatives
- Mandatory combined filing
- Other clean-up and reform

Caveat: How you tax matters, but tax impacts on economic growth vary, taxes aren't the only determinative factor for business investment, and tax reductions don't always pay for themselves - particularly in the short run.

Corporate Tax Reform Options – Rate Reduction

Rate Reduction

- New Mexico CIT rate is higher than national average and highest in the region except for California
- Most fair/equitable approach to tax relief
- Most expensive approach if meaningful relief is desired
  - Poorly targeted if targeting certain groups/industries is desired
- Can be phased-in easily over time

Corporate Tax Reform Options – Apportionment

Alternative Apportionment

- All states in region allow or require apportionment methods different from the standard 3-factor formula
- Single weighted sales factor (SSF) receives most discussion, but varying degrees of weighting relative to other factors possible
- Can be phased-in easily over time
- Approach can vary dramatically
  - Mandatory single sales factor
  - Elective single sales factor
  - Elective singe sales factor for some (i.e. manufacturers)

Note: a mandatory regime' is more representative of a general policy towards apportionment, whereas elective options are more representative of economic development incentives (although they have an identical effect for some). Sales factor apportionment is a mercantilist approach to tax policy.

Corporate Tax Reform Options – Mandatory SSF

Alternative Apportionment – Mandatory SSF

- Favors those with higher property /payroll in NM relative to other states, and exporters.
- Disfavors those using NM as a market state for their sales of goods or services without commensurate property/employment representation
- Creates “winners” and losers”
- “Losers” offset some cost of making “winners” – not most expensive

Note: Multistate Compact may not allow NM this option without repeal. See: The Gillette Company & Subsidiaries et al. v. Franchise Tax Board

Corporate Tax Reform Options – Optional SSF

Alternative Apportionment – Optional SSF

- Favors those with higher property /payroll in NM relative to other states, and exporters.
- Creates only "winners"
- Consistent with Multistate Compact
  - Requires taxpayers have option of 3-factor apportionment
- Most expensive approach
  - Allow anyone to elect their most favorable method

- Note: elections should not be year-to-year

Corporate Tax Reform Options – Optional SSF for some

Alternative Apportionment – Optional SSF for some

- Favors those with higher property /payroll in NM relative to other states, and exporters.
- Creates only "winners"
- Limits "benefit" to certain favored/targeted industries (i.e. manufacturers) and therefore not most expensive approach
  - Targeted approach can improve cost/benefit or ROI – if you shoot straight and hit the target – but less fair/equitable from a broad perspective.

- Note: elections should not be year-to-year

Corporate Tax Reform Options – Mandatory Combined Filing

Mandatory Combined Filing

- Constitutional method, academically desirable, and employed by all other states in the region that impose CIT and can limit some tax planning; but
- Complex and presents other challenges, issues and concerns
  - NOL treatment and phase-in
  - Foreign dividend treatment
    - Many multi-nationals concerned about foreign earnings exposure
  - Lots of technical issues to be addressed
    - NOL treatment and phase-in
    - Foreign dividend treatment
    - Definitional, administrative and detailed technical issues
      - Combined group better defined
      - Water's edge
      - Joyce/Finnegan
      - TRD resources
      - MTC might help

Corporate Tax Reform Options – Mandatory Combined Filing

Mandatory Combined Filing

- Even under most aggressive approach won't raise lots of revenue
  - Creates "winners" and "losers", although to lesser extent in NM than other states because of present law elections
  - Revenue gain, if any, can offset cost of other reform
- Continual legislative debate on combined filing, creates tremendous uncertainty/"chilling effect" on at least some outside investment
  - Even though nothing material has changed in CIT for decades

Corporate Tax Reform Options – Other Clean-up and Reform

Other "business friendly" reform

- If legislating changes to CIT, "clean-up" should be considered
- Elimination of throwback rule
- Extension of NOL carryforward rule from present law 5 years
  - Feds generally allow 2yr carryback/20 yr carryforward
  - Some taxpayers certainly losing benefit of NOLs
- Consider retention of federal consolidated election
  - Clarity and certainty on who's in the group
  - Consistent with taxpayer's federal filing
- Independent hearing officers
  - Addresses perception or fact of unfairness in process

Note: if a separate filing regime' is maintained in NM, a "reasonable" addback provision should be considered

Lots of Activity in the States – Why?

State Budget Deficits – Projected Shortfalls

Figure 1

31 States Have Addressed or Have Projected Shortfalls for Next Year

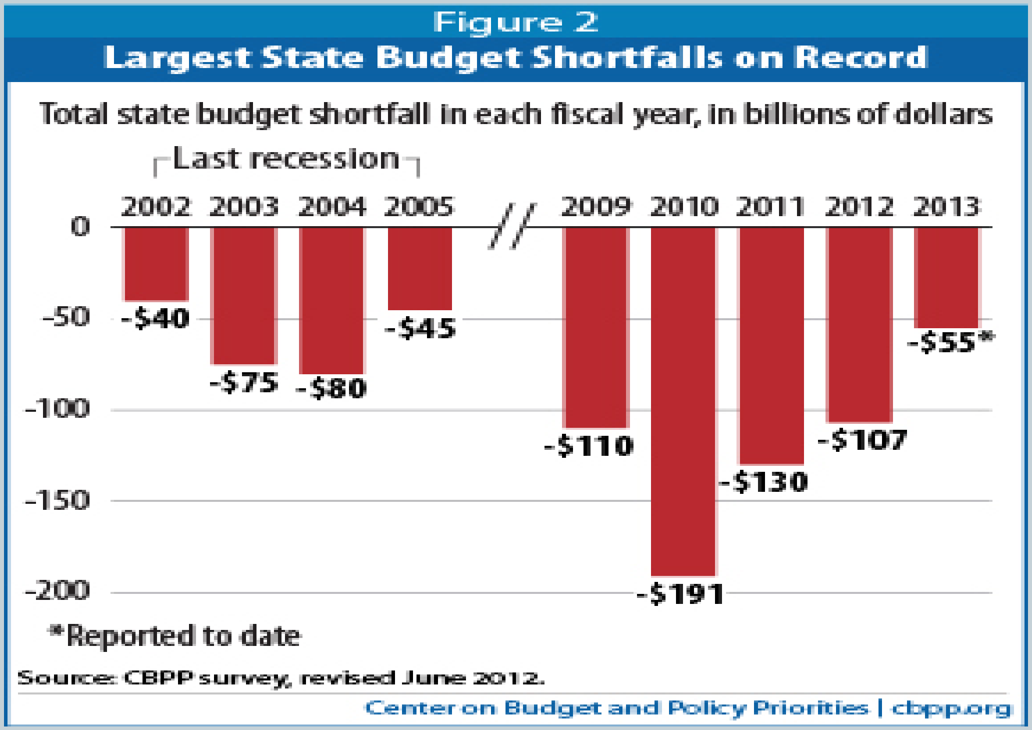
Source: CBPP survey

Center on Budget and Policy Priorities | cbpp.org

Source – Mai, Chris; Oliff, Phil; and Palacios, Vincent, "States Continue to Feel Recession's Impact." ***Center on Budget and Policy Priorities****. 27 June 2012 <www.cbpp.org>.*

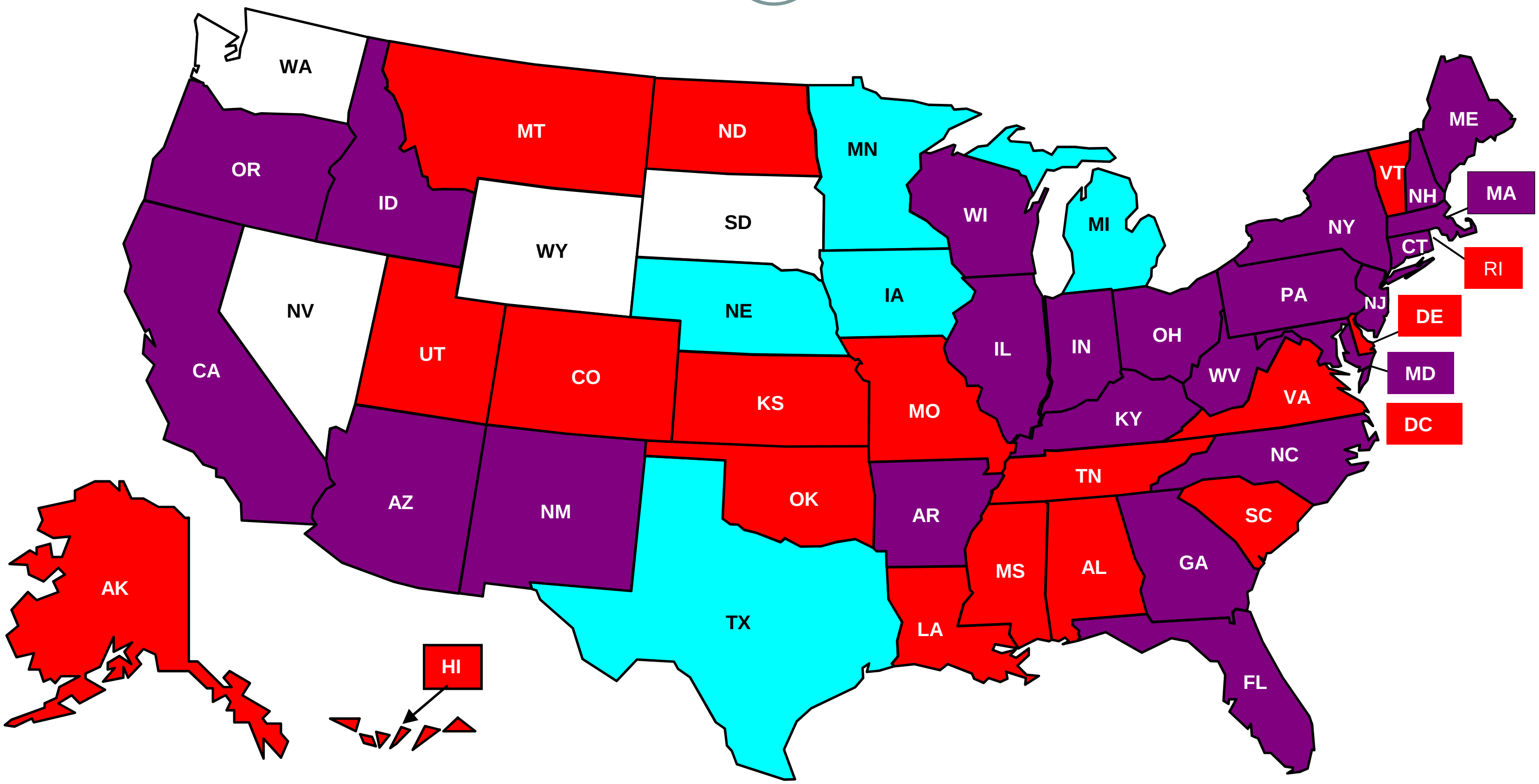
Lots of Activity in the States – Why?

State Budget Deficits – Largest on Record



*Source – Mai, Chris; Oliff, Phil; and Palacios, Vincent, "States Continue to Feel Recession's Impact." **Center on Budget and Policy Priorities**. 27 June 2012 <www.cbpp.org>.*

Trends - Apportionment Formulas* - 1998



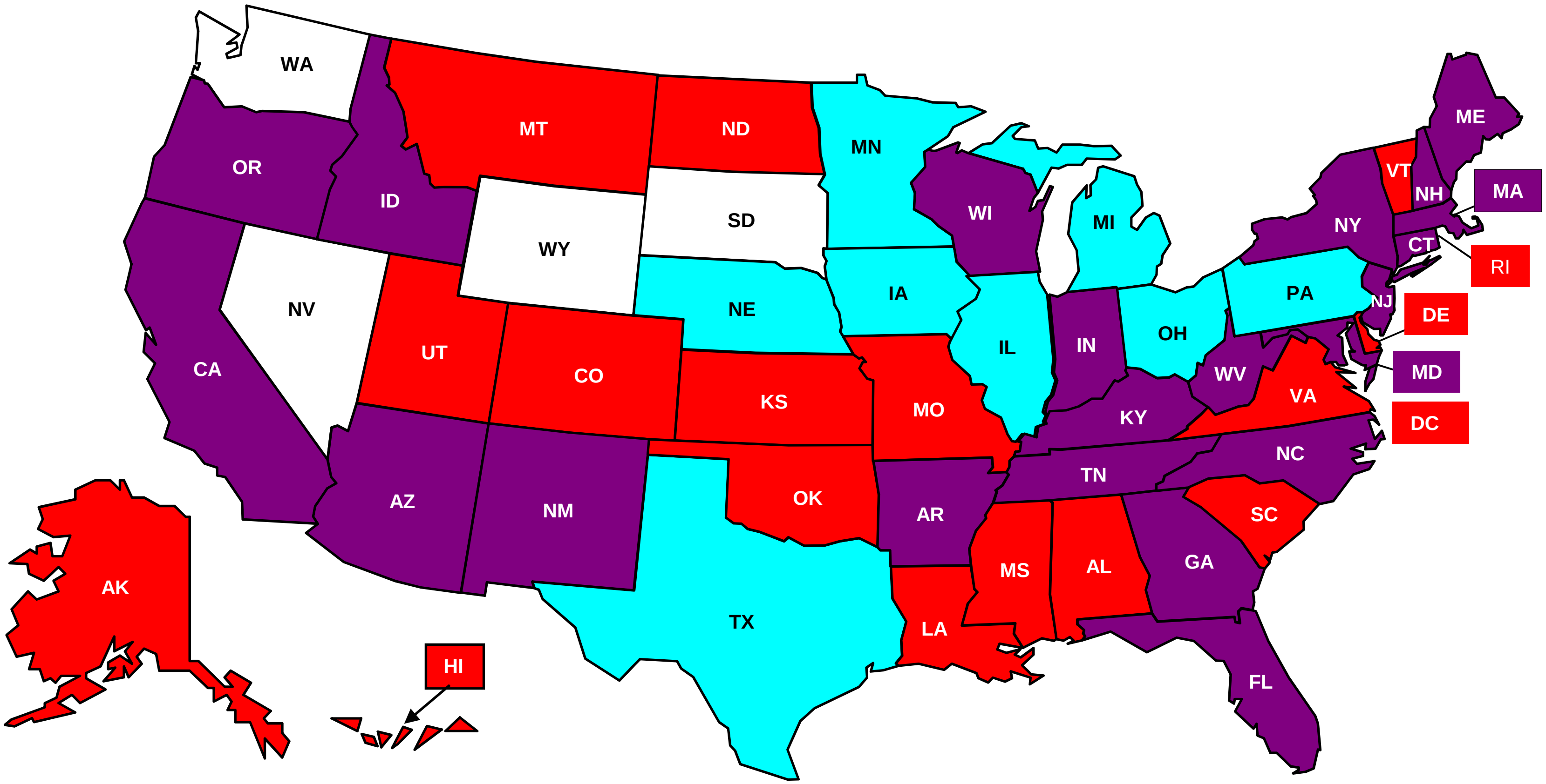
Equally weighted three factor formula

Double weighted sales factor

Triple or greater weighted or single sales factor

***Does not address industry-specific or optional formulas**

Trends - Apportionment Formulas* - 2003



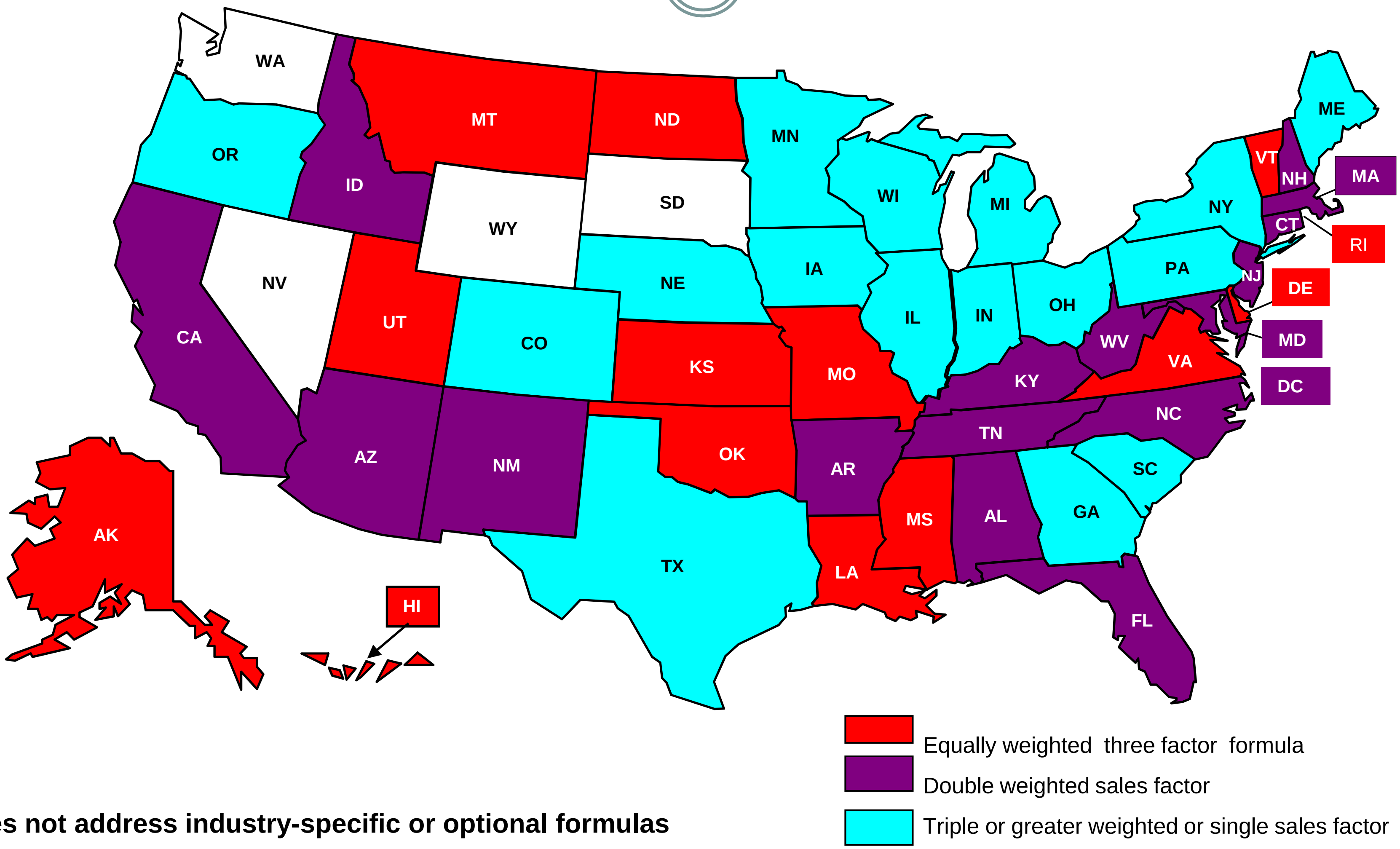
Equally weighted three factor formula

Double weighted sales factor

Triple or greater weighted or single sales factor

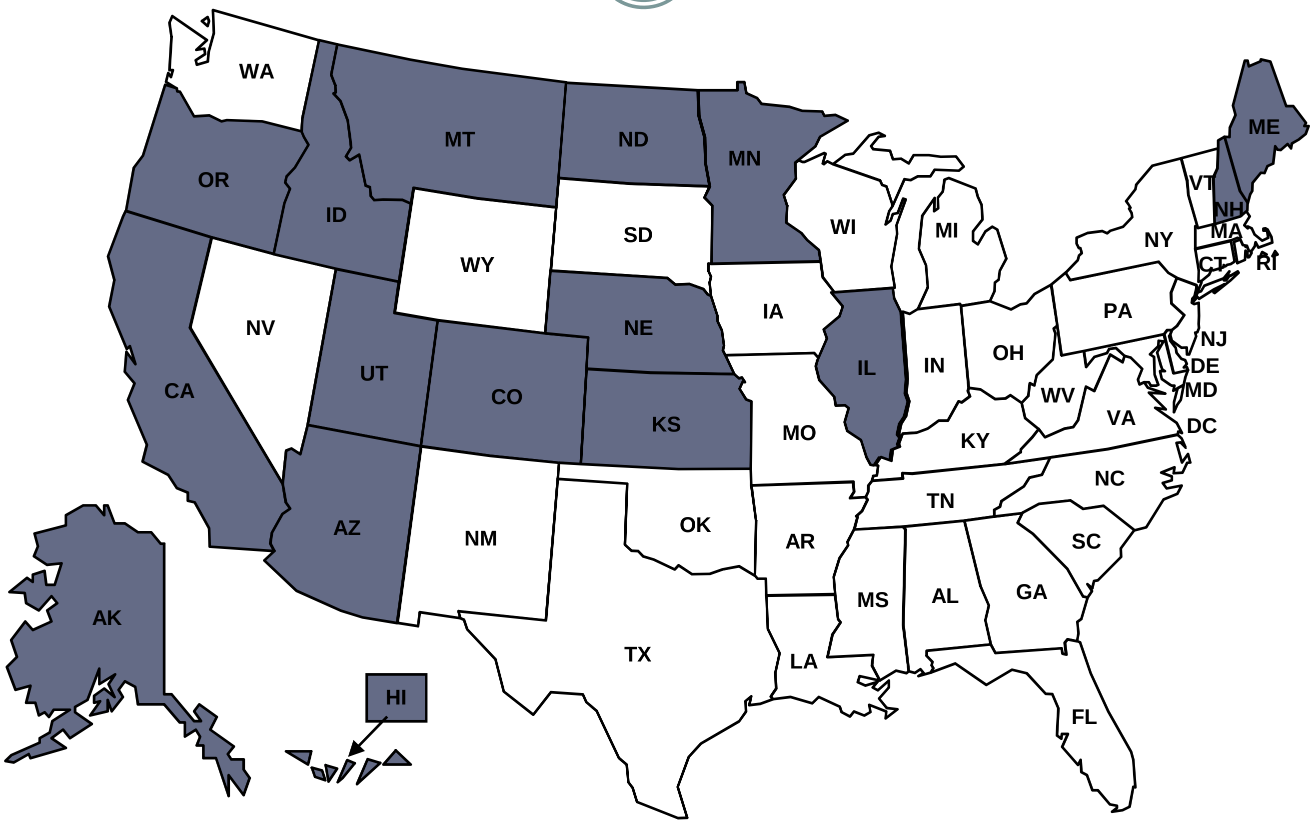
***Does not address industry-specific or optional formulas**

Trends - Apportionment Formulas* - 2012



***Does not address industry-specific or optional formulas**

Trends - Combined Reporting - 2001

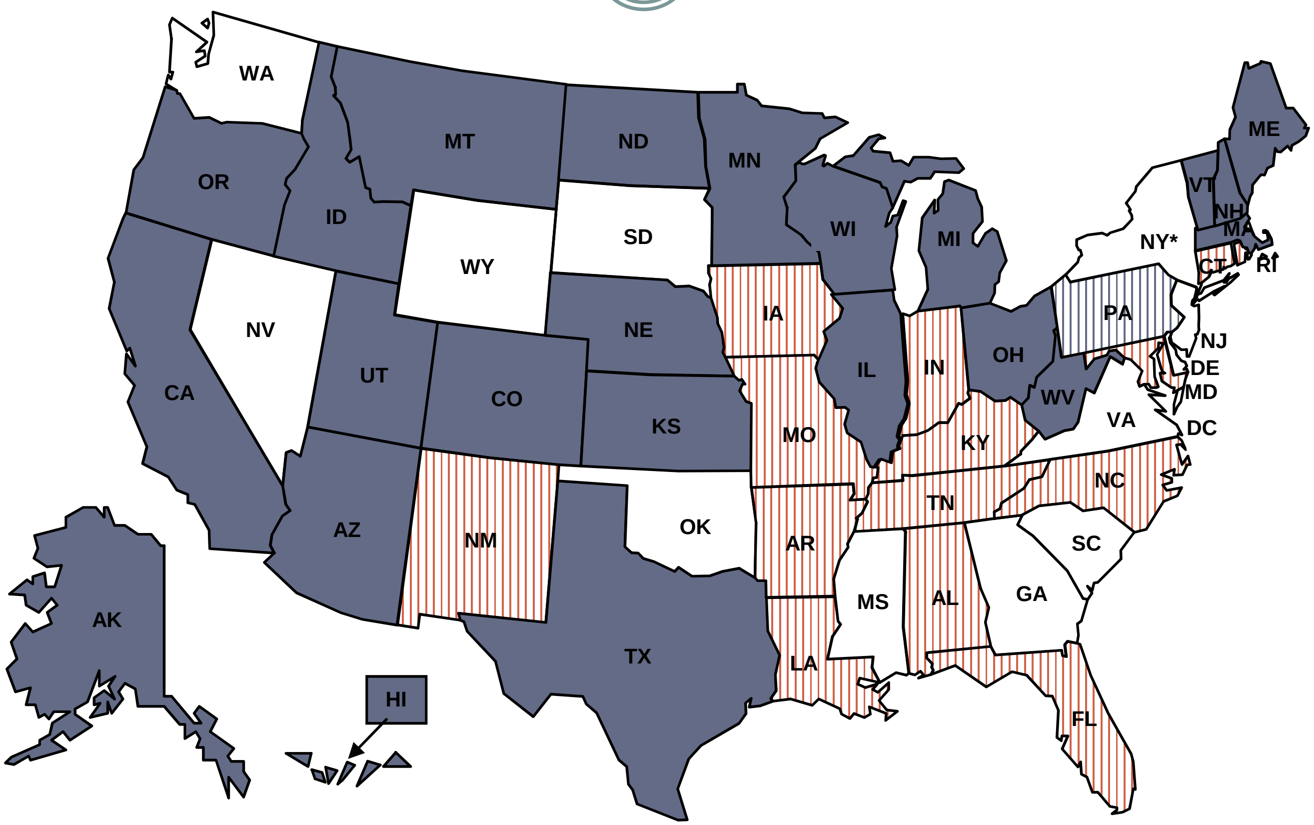


Combined Reporting Proposals

Unitary/Combined States

Remaining Separate Entity or Elective Consolidated Reporting/Other

Trends - Combined Reporting – 2012



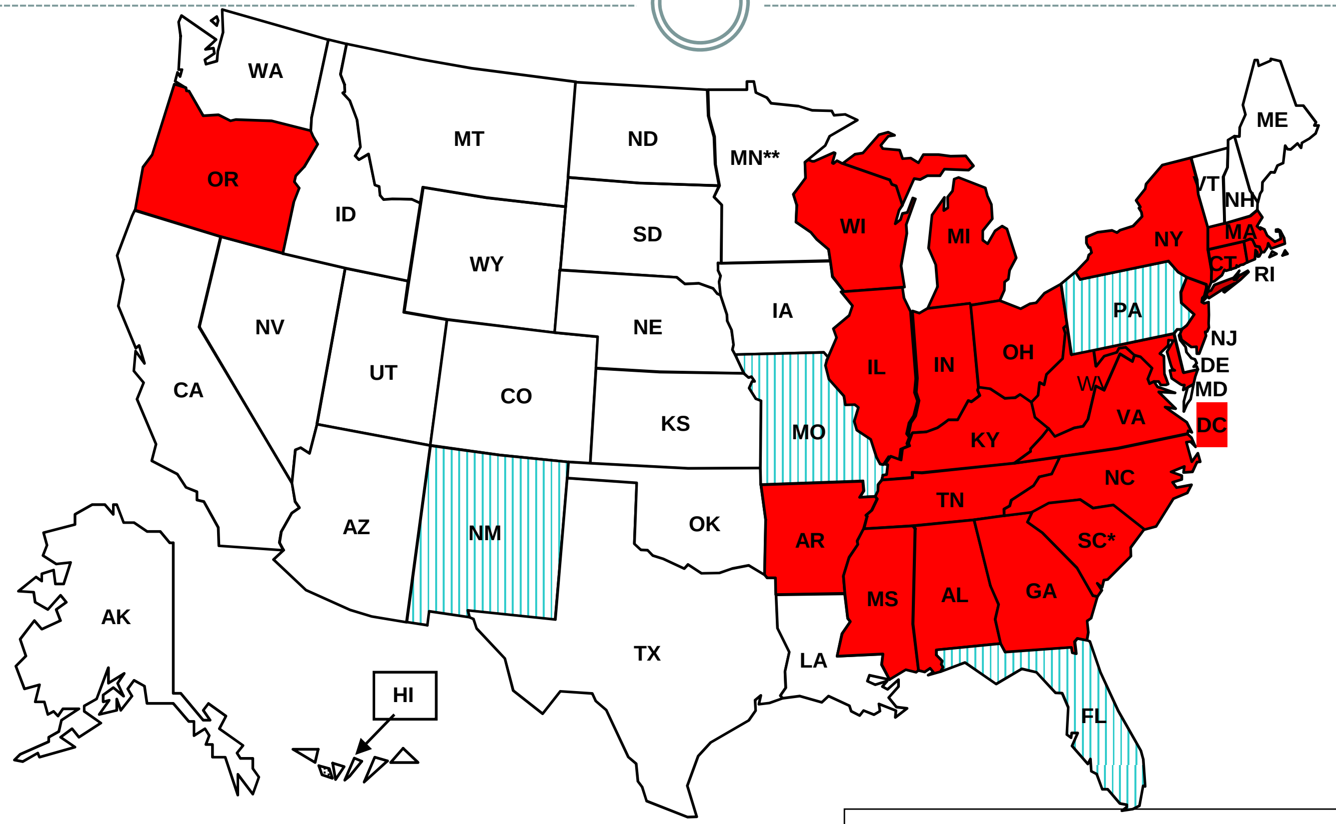
Combined Reporting Proposals Considered Recently and/or Currently Proposed

Unitary/Combined States *(now including the Ohio CAT, Texas Margin Tax and Michigan Business Tax)*

Remaining Separate Entity or Elective Consolidated Reporting/Other

**New York requires related corporations to file a combined report upon the existence of substantial intercorporate transactions*

Trends – Related Party Addbacks



Related member expense addback required (including DC, NYC)

Related member expense addback legislative proposals considered in recent years

No related party addback provisions imposed

*South Carolina disallows deductions for an expense between related parties where a payment is accrued, but not actually paid and on interest deductions on obligations issued as a dividend or paid instead of a dividend

**Minnesota requires addback of interest and intangible expenses, losses, and costs paid, accrued, or incurred by any member of the taxpayer's unitary group to a foreign operating corporation that is a member of the taxpayer's unitary business group,

Questions