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NEW MEXICO CORPORATE INCOME TAX
(Including Apportionment, Combined Reporting and Add Backs)

A. Executive Summary

1. Nearly all of New Mexico's corporate income tax is paid by large out-of-state companies. Most local businesses pay none at all. The idea that New Mexico law contains a substantial "corporate tax loophole" permitting out-of-state companies substantially to avoid taxation is a myth.

2. The most important feature of the corporate income tax law for many taxpayers is the "apportionment formula", which determines how much of the income of a corporation doing business in multiple states is taxed in New Mexico. New Mexico uses an old formula which has been abandoned by most states. It discourages employment and investment in New Mexico.

3. If New Mexico were to mandate combined reporting, the adverse impact of our apportionment formula would be magnified for many companies.

4. The articulated concern about tax avoidance by corporate groups reporting on a "separate corporate entity," basis, rather than on a "combined" basis, is exaggerated. Further, other states have addressed this issue with "add back" legislation which directly attacks practices determined to be inappropriate tax avoidance or the use of "loopholes".

B. Facts About New Mexico's Corporate Income Tax

1. There is a myth that New Mexico has a substantial "corporate tax loophole" favoring large out-of-state corporations. However, large corporations, whether in-state or out-of-state, pay more income tax in New Mexico than in most other states. There are very few local New Mexico businesses that pay any corporate income tax at all. Therefore, nearly all of our $300 - 350 million corporate income tax revenues come from out-of-state corporations or New Mexico subsidiaries of out-of-state corporations. We have a burdensome corporate income tax system that heavily taxes large businesses, especially businesses investing and employing people in New Mexico. Their taxes are high, whether compared with taxes in other states or with taxes upon small local New Mexico businesses. Our system does include, however, a provision which permits some corporations to reduce their taxes slightly. This provision alleviates, to a limited extent, the heavy burden imposed by the other elements of our corporate income tax. Some people call this provision a "loophole".

2. New Mexico's revenues show the heavy burden of our corporate income tax on corporations, especially on out-of-state companies. Despite having few local businesses paying significant corporate tax, New Mexico usually generates about 6% of its general fund revenue from this tax, and over 7% is estimated for this year. The national average is around 5%, which, of course, includes states with substantial local corporate taxpayers. (In a recent tax year, New Mexico corporate tax payments by companies principally located out-of-state exceeded payments by companies principally located in New Mexico by more than ten to one.)

3. New Mexico's substantial corporate income tax receipts are due to several features unusual among the states and unfavorable to taxpayers (in particular the large out-of-state companies who make up nearly the entire tax base).

a. We use an "apportionment formula" (discussed subsequently) which taxes heavily those industries which invest in New Mexico and employ New Mexicans and sell their goods and services out-of-state. Almost all other states use an apportionment formula which treats such businesses more favorably.
b. Our 7.6% corporate tax rate is high, particularly for our region. The national average is about 6.4% and our neighboring states average about 5%. Several states currently are reducing their tax rates.
c. We have a very short period (5 years) during which companies can use net operating losses to offset taxable income. Most states permit such offsets for 15 or 20 years.
d. We have an aggressive "throw-back" rule which attributes to New Mexico some sales actually made elsewhere and computes New Mexico's corporate income tax in part based on those sales.

4. There is a notable feature of our corporate income tax favorable to some taxpayers; corporate subsidiaries have an option to report their income on a "separate corporate entity" basis or a "combined reporting" basis. This option partially compensates for the tax disadvantages imposed by the burdensome features of New Mexico's law listed above. Conceptually, the "separate corporate entity" reporting method bases the New Mexico tax on the income of a corporate subsidiary doing business in New Mexico. Conceptually, the combined reporting method computes the nationwide income of all of the related companies[1] of parent and subsidiary corporations, whether or not doing business in New Mexico, and assigns a portion of that combined income to New Mexico according to a formula. That formula does not attempt to determine the actual profitability or income of the New Mexico subsidiary.

5. As this paper will discuss subsequently, the separate entity reporting method offers some corporate groups some opportunities for tax planning which critics label a "loophole." On the other hand, as will be discussed, the combined reporting method imposes disincentives to economic growth. In any event, the fiscal result of providing companies the option to report on either basis is modest, reducing by perhaps 5% to 10% the state's corporate income tax revenues. By way of comparison, our 7.6% tax rate yields about 20% more revenue than would be produced by a 6.4% rate, the national average. Further, our rate yields about 50% more revenue than would a 5% rate, the average of our neighboring states.

[1] This paper uses the term "related companies" to describe the statutory concept of "unitary corporation" which involves companies with common ownership and which are in the same line of business.

C. How New Mexico's Corporate Income Tax Functions.

1. Taxation of Local Businesses - Most Pay No Corporate Tax

New Mexico's corporate income tax only applies to corporations called "subchapter C" corporations under the federal Internal Revenue Code. These are usually larger corporations with numerous stockholders. Very few are based in New Mexico.

The overwhelming majority of local New Mexico businesses pay no corporate income tax. They are organized as "pass-through entities", such as partnerships, limited liability companies or "subchapter S" corporations, specifically for the purpose of avoiding this tax. Included in this group are nearly all the businesses which testify in the legislature that multistate and out-of-state corporations are undertaxed. Also included in this group are fairly substantial local businesses. In last year's discussion of Senator Wirth's corporate income tax bill, the main presentation on the House floor included the contention that competition between Walmart and Baillio's is unfair, because Baillio's, which has several locations in Albuquerque and Santa Fe, has to pay corporate income tax and Walmart escapes this tax. This assertion is exactly wrong. Baillio's is a limited liability company, a pass-through entity, and, therefore, pays no corporate income tax. Walmart is one of the largest corporate income taxpayers in the state.

The owners of businesses that are pass-through entities pay personal income tax on the profits of the business. Those profits are "passed through" to the owners and reported on their personal income tax returns. The maximum personal income tax rate is 4.9%, considerably below the maximum corporate rate of 7.6%. Further, the stockholders in large corporations additionally pay personal income tax when they take money out of the corporation as dividends or capital gains.

There are a few medium-sized local New Mexico businesses that do pay corporate income tax, but even they have a preference over large taxpayers. Corporations benefit from reduced tax rates on the first one million dollars of net taxable income. They pay a 4.8% rate on the first $500,000 of taxable income and a 6.4% rate on the next $500,000 of taxable income. Therefore, they must reach a substantial size before paying the 7.6% rate. Most of the taxpaying New Mexico corporations do not reach this threshold.

2. Taxation of Single Corporations Operating in Multiple States - Our Apportionment Formula Discourages Investment and Employment in New Mexico

There are many "subchapter C" corporations which operate in multiple states but which do not use subsidiaries. Southwest Airlines does business nationwide as a single corporation. Further, many corporations with a physical location in only one state sell their products in other states. If they are "subchapter C" corporations (generally large corporations with many stockholders) with either sales or locations in New Mexico, they will pay some New Mexico corporate income tax. (If they are "pass-through entities", they do not pay corporate income tax regardless of where they do business.)

Any "subchapter C" corporation doing business in multiple states (having property, payroll or sales in more than one state) is subject to an "apportionment formula" which determines how much of its corporate income is taxed by each state. Every state with a corporate income tax has an apportionment formula, but they differ from state to state. There are about six different formulas in use. (It is possible that a corporation is taxed on more than 100% of its income, or less than 100% of its income, if it does business in states which use different formulas.) New Mexico's apportionment formula averages three factors: the percentage of a corporation's total sales that occur in New Mexico, the percentage of a corporation's total payroll that is in New Mexico, and the percentage of a corporation's total property (or assets or investment) that is in New Mexico. For example, if a corporation has 5% of its sales in New Mexico, 10% of its payroll in New Mexico and 15% of its property in New Mexico, the apportionment formula would equally weight and average 5%, 10% and 15%, to produce a result of 10%. This means 10% of the corporation's income would be subject to taxation in New Mexico. (That income, of course, would be taxed at our 7.6% tax rate.)

There is a substantial drawback to the New Mexico apportionment formula. It penalizes activities we wish to encourage. If the hypothetical company described above increases its operations in New Mexico, its taxes in New Mexico would go up, even without additional sales in New Mexico. For example, if it doubled its payroll and investment in New Mexico, its New Mexico percentages for these two factors would increase to 20% and 30% respectively. Assuming its New Mexico sales remained at 5%, the apportionment formula would now average 5% (sales), 20% (payroll), and 30% (property), and would tax about 18% of the corporation's income. On the other hand, if its payroll in New Mexico were reduced, or its investment in New Mexico reduced, the corporation would receive a tax cut, because the payroll or property percentages would be reduced.

New Mexico's formula used to be the most common formula among the states. About 40 years ago, it was nearly universally used. However, because of its perceived adverse effect on economic development and employment as described above, most of the other states have abandoned it. Only about 10 states now use it. The formula becoming much more common, and now approaching a majority of the states with corporate income taxes, including our neighbors Colorado and Texas, is called the "single sales factor" or "sales only" formula. This formula apportions the corporate income based only on the percentage of the corporation's sales that are made in the state. For example, Colorado provides that if a company makes 5% of its sales in Colorado, then 5% of its income is taxed in Colorado, regardless of where its payroll and property is located. Increasing Colorado employment, or making additional investments in Colorado, does not increase the corporation's taxes. Laying off employees in Colorado or closing facilities there does not produce a tax cut. A large majority of the states either use the single sales factor formula or use some formula weighting the sales factor more heavily than the payroll and property factors in apportioning income to the state. If not basing apportionment entirely on sales, these states give the sales factor from 50% to 90% of the total weight in the apportionment formula. Also, some states use different formulas for different industries.

There would be "winners" and "losers" if New Mexico were to move to a "single sales factor" or "sales only" apportionment formula. In general, the principal winners would be companies with large employment and investment in New Mexico and limited sales in New Mexico. Clearly among these would be manufacturing and some extractive industries. Principal losers, if the sales factor were more heavily weighted, would be companies which use New Mexico as a market, without hiring many New Mexicans or investing in New Mexico. These would include Microsoft, Dell Computer, pharmaceutical companies, and similar sellers of goods and services. The reasons for these results should be clear. Manufacturing companies and extractive industries have large payrolls and investments, but few sales, in New Mexico. Under New Mexico's current three factor formula, two of the three factors are substantial and one very small. If sales were the only determinant of the percentage of total income assigned to New Mexico, that percentage would be small for these companies. On the other hand, Microsoft or similar companies may have substantial sales in New Mexico but little payroll or investment. Under our current three factor formula, two thirds of the factors probably approach zero. Under the sales-only formula, the sales percentage would govern. It would not be reduced by being averaged with the near-zero amounts. (See *Appendix A* for a short summary of these concepts.)

Most states have found this trade-off desirable. Taxing less heavily the creation of jobs and investment in the state, and more heavily the companies merely selling into the state, has economic development benefits. However, if New Mexico were to adopt the "sales only" formula, there would be some losers who might merit specific legislative attention. For example, because of investment decisions made years ago, PNM has substantial out-of-state property but nearly all of its sales in New Mexico and might be hurt by moving to a single sales factor approach.

3. Taxation of Corporate Groups - They Can Choose Separate Corporate Entity Reporting or Combined Reporting

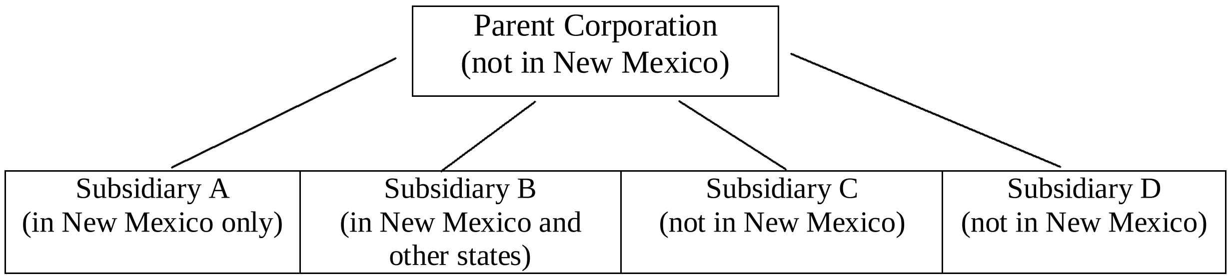
The taxation of corporate groups, or "families" of parent and subsidiary corporations, has received much attention recently with proposed "mandatory combined reporting" legislation.

Under current New Mexico law a corporate family which has a member doing business in New Mexico has a choice. The member in New Mexico can pay taxes on a "separate corporate entity" basis, or the entire family or the group can pay on a "combined reporting" basis.

The separate corporate entity approach means that the corporate subsidiary doing business in New Mexico pays corporate income tax based on its earnings in New Mexico. If this subsidiary does business only in New Mexico, it pays corporate income tax on 100% of its income. If this subsidiary does business in multiple states, its total income is subject to the "apportionment formula" discussed above, and some fraction of it is taxed in New Mexico.

The combined reporting approach combines the nationwide income of all of the related companies, parent and subsidiary, including those not doing business in New Mexico. This total income is then subject to New Mexico's apportionment formula, and a fraction of this total income is taxed in New Mexico. When income from all the related companies is combined, it will usually produce a much larger figure than the income of the New Mexico subsidiary alone. However, under combined reporting, the apportionment formula considers the sales, payroll and property of all the related companies nationwide and compares those with the sales, payroll and property in New Mexico. Typically, the New Mexico percentage will be quite small. Therefore, under combined reporting, the apportionment formula taxes a smaller percentage of a larger total income than is taxed when the formula is applied only to the corporate entity doing business in New Mexico.

The following chart of a corporate family shows the difference between separate corporate entity reporting and combined reporting.



Under separate corporate entity reporting, New Mexico tax would apply to 100% of the income of Subsidiary A. A portion of the income of Subsidiary B would also be taxed. That portion would be determined by New Mexico's apportionment formula, which compares Subsidiary B's sales, payroll and property in New Mexico with its sales, payroll and property nationwide.

Under combined reporting, a portion of the total income of all five corporations in the corporate family would be taxed. That portion would be determined by New Mexico's apportionment formula. That formula would compare the entire family's sales, payroll and property in New Mexico with the entire family's sales, payroll and property nationwide. The total income of all five companies would usually be larger than the income of the subsidiaries doing business in New Mexico. However, the portion of that income actually taxed might be small because the sales, payroll and property in New Mexico would be compared with those factors in all the companies.

4. Drawbacks to Separate Corporate Entity Reporting - The Opportunity for Tax Planning

In some cases, some corporate groups using the separate entity approach have opportunities for tax planning. Some critics call this planning a "loophole." Some of them go so far as to suggest that this planning opportunity exempts these corporations from taxes. In fact, such planning has only a modest impact on the state's overall corporate income tax revenues, according to Tax Department and Legislative Finance Committee estimates.

All of the transactions that the critics call "loopholes" involve charges between related companies. One of the related companies might provide management services or legal services to another and receive a payment for those services. The company making the payment would incur an expense. If the paying company is reporting on the separate entity basis, this expense will reduce its taxable income. The company receiving the payment increases its income, but, if it is located in a state with no income tax, it may suffer no tax effect from this revenue.[2] Another example would be loans between related companies. Interest paid on the loan would be a deductible expense for the debtor company. Interest received by the lending company would be income, but the lender may not pay income tax. However, it is easy to overestimate the tax effect of these transactions. When a company reporting as a separate entity pays for services or goods, it experiences the same tax effect

[2] Even if the receiving company is in a state with a corporate income tax, this type of transaction would not increase its tax if it is reporting on a combined basis. A payment from a company reporting on a separate basis to a related company reporting on a combined basis may reduce the reportable income of one company without increasing the reportable income of the other.

whether the payment is to a related or unrelated company. Therefore, a "loophole" objection is valid only if the transactions with related companies are at inflated prices or have no business purpose. The Tax Department currently has some power to deal with such excessive and unjustified claims of deductions.

Combined reporting obviates this type of tax planning because the income of all members of the corporate group is included, even if they are in a state without an income tax. A deduction to one member of the group results in income to another, so transactions between members of the corporate group do not affect the total taxable income of the group. It is that total combined income that is subject to New Mexico's apportionment formula under combined reporting.

5. <u>Drawbacks to Combined Reporting</u> - It Magnifies the Effect of Our Apportionment Formula

Combined reporting would have two major adverse effects in New Mexico, which it does not have in many other states.

First, a corporation, successful elsewhere, considering establishing a New Mexico subsidiary, would have to be prepared to pay New Mexico corporate income tax based on the profits of all its affiliates nationwide, regardless of whether the New Mexico subsidiary is successful. All of the income of all related companies would be combined, and New Mexico's apportionment formula, which is based on property, payroll and sales, would attribute part of that income to New Mexico without attempting to determine whether the New Mexico subsidiary is individually profitable. This does not occur in those states with an apportionment formula based on sales only. A corporation setting up a new subsidiary in a "sales-only" state, or merely opening a new facility in that state, does not pay corporate tax based on its payroll and investment. Its corporate income tax is based only on the sales it makes in that state, and its tax would increase only if its sales in the state increased.

Second, combined reporting also imposes perverse incentives on subsidiaries already operating in New Mexico. Given New Mexico's apportionment formula, a subsidiary in New Mexico reporting on a combined basis will get a tax cut if it lays off New Mexicans or reduces their pay. (This will reduce the payroll factor in the apportionment formula.) Similarly, it will get a tax cut by closing facilities in New Mexico (reducing the property factor). Conversely, increases in New Mexico payroll and investment would produce a tax increase. None of these results occur in a state with the sales-only apportionment formula.

Because combined reporting subjects the total nationwide income of a corporate family to our apportionment formula (rather than only the income of the New Mexico subsidiary), the adverse affect of our apportionment formula can be multiplied by combined reporting. Further, because of New Mexico's high 7.6% tax rate, there is a further magnification of this adverse effect.

6. <u>Absent from New Mexico Law</u> – "Add Back" Provisions Addressing "Loopholes"

The principal result of requiring combined reporting is not the closing of "loopholes". The principal result is to base the New Mexico corporate income tax in part on the income of related companies not doing business in New Mexico. It is true that one effect of including the income of these companies in the New Mexico tax base is that it makes irrelevant any transactions between these companies and the related companies in New Mexico; therefore, such transactions cannot be used for tax planning or “loopholes”. However, mandating combined reporting would also affect the taxes of corporate groups which do not use any such tax planning or “loopholes”.

Nearly all the states which permit separate entity reporting, except New Mexico, have passed “add back” legislation, which directly attacks perceived loopholes. Add back legislation defines those transactions which are considered inappropriate loopholes and requires any deductions taken for such transactions to be “added back” into corporate income. Add back legislation is designed to directly attack “loopholes” without incurring the disadvantages of combined reporting. For example, if a state considers loans between related companies or charges for management services between related companies to be a likely source of abuse, it could require any deductions claimed for such transactions to be “added back” on the tax return.

It is not easy to define what constitutes a “loophole”. Critics of separate reporting frequently do not agree on the problems they claim need addressing. Therefore, drafting an appropriate add back statute is likely to be contentious. However, about 20 states, but not New Mexico, have passed such statutes. There are substantial differences among the state statutes. The Multistate Tax Commission has prepared a model statute, but no state has yet adopted it.

Under current law, the New Mexico Taxation and Revenue Department has some authority to challenge tax avoidance schemes. A frequently cited device involves parent companies which lease to their subsidiaries the right to use logos and trademarks. This scheme could shift income out of subsidiaries in separate reporting states. It was successfully challenged in New Mexico under existing law many years ago in the K-Mart cases. However, attacking such devices under existing law requires the tax department to discover them and take action. Add back statutes impose on the taxpayer an affirmative obligation not to claim specified deductions in the first place.

D. Conclusion

The recent discussion of New Mexico corporate income tax has been inappropriately narrow. In simplified form, it has been:

1. Most states, including nearly all the western states, require combined reporting.
2. Combined reporting closes loopholes that out-of-state companies use.
3. New Mexico should require combined reporting so that out-of-state companies will pay their fair share and no longer have an unfair advantage over local businesses.

This argument overlooks some important facts and misstates others. Currently, smaller businesses, including many local businesses, have substantial tax advantages over larger businesses, or even pay no corporate tax at all. Combined reporting has effects other than closing loopholes. The direct approach to closing loopholes is add back legislation. The large corporate families which would be affected by mandatory combined reporting are already heavily taxed in New Mexico. They are taxed more heavily than they are taxed in most other states, including those which mandate combined reporting, and much more heavily than small local businesses are taxed.

The taxation of corporate families of parent and subsidiary corporations is based on the approach to three issues[3]:

1. Does the tax only apply to the income of the members of the corporate family doing business in New Mexico, or must it be applied to the combined income of all family members nationwide?
2. What apportionment formula is used to assign to New Mexico the portion of that income to be taxed?
3. What is the tax rate to be applied to the portion of the income assigned to New Mexico?

Most of the discussion in New Mexico has been directed at the first of these three questions. On that issue, New Mexico treats taxpayers more favorably than most states, giving taxpayers a choice between the combined and separate reporting methods. On the second issue, the apportionment formula, New Mexico, unlike most states, treats unfavorably taxpayers which have investments and employees in New Mexico and which have sales outside the state. Finally, New Mexico's 7.6% tax rate is high for the nation, very high for our region, and higher than most states that require combined reporting. This rate, of course, adversely affects all corporations paying corporate tax, but particularly it adversely affects those companies with a large amount of income assigned to New Mexico because of our apportionment formula.

The argument that we should adopt mandatory combined reporting because so many other states have adopted it should also imply that we should have the apportionment formula that is used in an ever-growing number of the states. Further, it suggests that our tax rate should not be so far out of line with the rates of other states. Instead of 7.6%, perhaps we should be closer to the national average of 6.4%, or the southwest average of about 5.0%.

At a minimum, no discussion of mandatory combined reporting should occur in a vacuum. The other elements of our corporate income tax law, which have a more substantial impact on the taxes paid by many companies, should be on the table as well.

[3] This assumes the corporate family has a subchapter C corporation doing business in New Mexico. Any family that can do business through a limited liability company or other pass-through entity can avoid corporate income tax entirely.

APPENDIX A

Apportionment Formulas (which apply to either “separate” or “combined” income)

A. Three factor formula (New Mexico’s) measures a company’s “footprint” in state.

What percentage of the company’s sales are in-state?

What percentage of the company’s payroll is in-state?

What percentage of the company’s property is in-state?

Average the above three factors. That gives the percentage of total income taxed by New Mexico.

This formula favors the companies with sales but no substantial locations in the state since the payroll and property factors will be very low. (e.g. Microsoft, pharmaceutical companies). It penalizes employment and investment in New Mexico.

B. Single sales factor (or “sales only” formula) seeks to encourage economic growth.

What percentage of the company’s sales is in-state?

That is the percentage of total income that is taxed.

With the single sales factor formula, increases in payroll or investment in-state do not result in a tax increase. Reductions in payroll or investment do not provide a tax cut.

This formula favors companies with locations in the state but nearly all sales out-of-state. The sales factor will be near zero. (e.g. some extractive industries, manufacturing)

C. All other formulas (e.g. “double-weighted sales” or “triple weighted sales”) are intermediate between the above two formulas.

They reduce, but do not eliminate, the disincentive to increasing payroll and investment in-state. But they keep in the tax base substantial portions of the income of extractive industries and manufacturing companies. Compared with a sales only formula, they tax less aggressively those companies with sales but no payroll or property in the state.