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

ORIGINAL DATE 01/27/10
SPONSOR Begaye & Wirth **LAST UPDATED** **HB** 62

SHORT TITLE Corporate Tax Reporting & Distribution **SB**

ANALYST Clifford

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY10	**FY11**	**FY12**		
	($31,587.0)	($36,550.0)	Recurring	General Fund
	$36,387.0	$63,750.0	Recurring	Public School Fund
	$4,800.0	$27,200.0	Recurring	Total

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Department of Finance and Administration (DFA)

SUMMARY

Synopsis of Bill

House Bill 62 would require unitary corporations to file combined returns for the corporate income tax. Manufacturing corporations would be exempted from the requirement to file on a combined basis. The option for corporations to file as a federal consolidated basis would be repealed. A new distribution would be made to the public school fund equal to 25 percent of corporate income tax receipts beginning with tax year 2011.

FISCAL IMPLICATIONS

According to TRD:

The estimate assumes that mandatory combined reporting would initially increase corporate income tax revenues before credits by 10%, except for manufacturing companies that can opt out of combined reporting. The effect of the opt-out for manufacturing companies that have not previously filed on a combined or consolidated basis is based on information from 2006 income tax returns for manufacturing companies. The single entity filers engaged in manufacturing in 2006 reported 15.6% of total corporate income tax revenues; this 15.6% figure was the assumed reduction from the provision to the net gain from mandatory combined reporting.

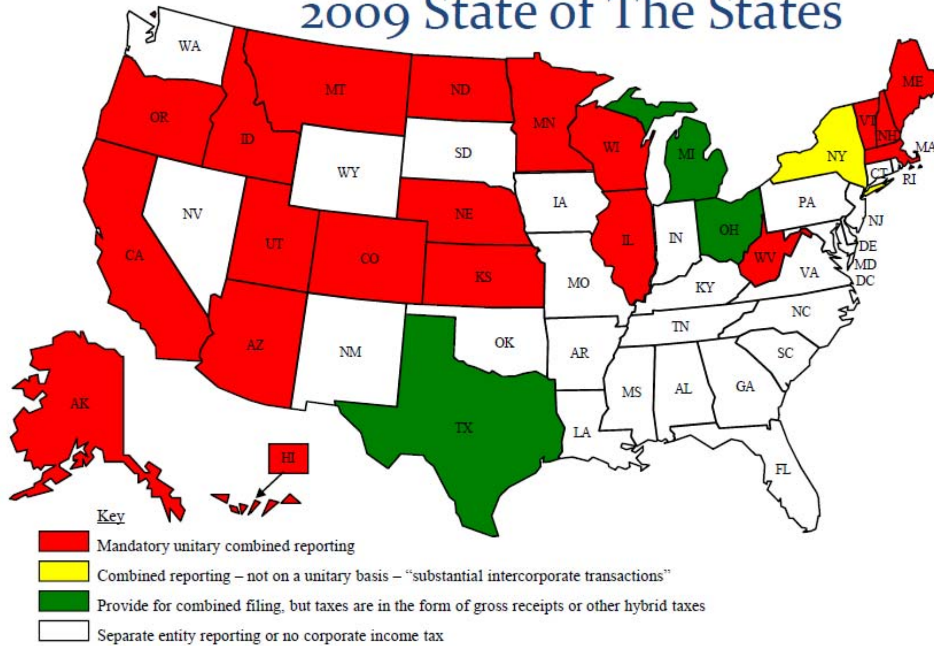
The overall effect of mandatory combined reporting on revenues is assumed to decline fairly rapidly over time, to zero after four years, as corporations adjusted their operations to avoid the impact of the change. This assumed decline in revenues is consistent with recent econometric research using multiple years of data across states, which indicates that mandatory combined reporting has no effect on state corporate income tax revenues. Revenues in FY 2012 reflect collection of most revenue from 2011 liabilities, as well as two estimated payments on 2012 liabilities.

This estimate is highly uncertain, both because of the uncertainty of the underlying forecast of corporate income tax revenues and because of the varying experiences of other states with mandatory combined reporting.

SIGNIFICANT ISSUES

According to TRD:

- All other Western states with a corporate income tax currently mandate combined reporting.
- Texas recently adopted mandatory combined reporting for their tax.
- The Blue Ribbon Tax Commission endorsed the concept of mandatory combined reporting in 2003. [LFC note: the Blue Ribbon recommendation suggested that the rate of the corporate income tax be reduced as part of a package that on net reduced corporate income tax revenue.]
- 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.



Council On State Taxation

- The consolidated filing method reduces tax compliance costs for electing corporations, reduces administrative cost for TRD, and allows corporations and TRD to rely on the results of IRS audits to determine the effect of audit adjustments on NM corporate income tax liabilities. These benefits would be lost under the bill, which repeals the option of filing a consolidated return.

ADMINISTRATIVE IMPLICATIONS

TRD notes:

New regulations, information and outreach for taxpayers, audit procedures, and training of auditors would be required to implement and enforce mandatory combined reporting. If the effective date for distributions to the Public School Fund is not amended so that the distributions simply start on or after a prescribed date, significant systems changes would be necessary at a cost of over two full-time staff years plus contracting costs.

Estimated Additional Operating Budget Impact*				R or NR**	Fund(s) or Agency Affected
FY2010	FY2011	FY2012	FY 10-12		
	$200.0	$50.0	$250.0		

* In thousands of dollars. Parentheses ( ) indicate a cost saving. ** Recurring (R) or Non-Recurring (NR).

DUPLICATION

Senate Bill 90 is a duplicate.

TECHNICAL ISSUES

TRD notes that the new distributions to the Public School Fund under the bill are based on taxable years of corporations, but the Department does not track corporate taxable years in distributing corporate income tax receipts. TRD suggests making the distributions based on net receipts attributable to all corporate income tax collections as of a certain date, for example May 1, 2011, would reasonably capture the timing of revenue due to mandatory combined reporting, while avoiding significant systems costs for the Department.

LFC notes that the proposal does not contain a definition of a "unitary" corporation which would be required to file on a combined basis. It relies on a definition in present law. The definition in present law is extremely comprehensive and blends concepts derived from a variety of court cases and from statutes in other states. Very little guidance has been provided in regulation as to how these definitions will be applied in practice. The definition has not been as important in the past because taxpayers could elect to file on a combined basis. If combined reporting were to be required, the comprehensive definition could become a major source of litigation and conflict between taxpayers and the department.

OTHER SUBSTANTIVE ISSUES

LFC notes that a strong case can be made that mandating combined reporting for corporate income tax purposes could have negative consequences for the state's economic development. The proposal is directly targeted at companies with operations in multiple states. These companies are the most likely to compare New Mexico's business climate with that of other states when they make investment decisions. By increasing their effective tax rate, thereby reducing their after tax rate of return on investments in New Mexico, the proposal reduces the incentive to invest in the state. Since New Mexico's corporate income tax rate is already one of the highest in the region, eliminating the option to file on a separate entity basis may create a tax environment that is significantly less competitive than other states'.

State	Tax rate (percent)	Combined reporting required?	Federal consolidated allowed?
Arizona	6.968	Yes	Yes
California	8.84	Yes	No
Colorado	4.63	Yes	Yes
Idaho	7.6	Yes	No
Montana	6.75	Yes	Yes
New Mexico	4.8/6.4/7.6	No	Yes
Oklahoma	6	No	Yes
Oregon	6.6	No	Yes
Texas	1*	Yes	No
Utah	5	Yes	No

Source: CCH Group, *State Tax Handbook, 2009* *Texas' franchise tax is imposed on a much larger base than most states' taxable income for corporate tax purposes

At least one rationale for requiring combined reporting has already been successfully addressed through legal action by the Taxation and Revenue Department. In the *Kmart* decision, the New Mexico Supreme Court upheld the Department's denial of deductions for payments between two related parties that lacked economic substance. This decision eliminates the potential for related companies to file on a separate entity basis and artificially reduce their income tax liability through payments to a related company.

An illustration of the potential for negative impacts on taxpayers involves the treatment of net operating losses (NOLs). Since many corporations have been accruing NOLs in recent years, the likelihood is that they would be adding losses rather than profits when required to file a combined New Mexico corporate income tax return. The fiscal impacts shown above are based on the assumption that NOLs recorded by unitary corporations prior to combination would not be allowed on their New Mexico returns. While this increases the revenue gain for the state, it could be seen as unfair by taxpayers, since the deduction of some NOLs may be effectively denied. In this case, a potentially significant financial asset is being eliminated in what is essentially a retroactive legislative action.

TC/mew

The Legislative Finance Committee has adopted the following principles to guide responsible and effective tax policy decisions:

1. ***Adequacy:*** *revenue should be adequate to fund government services.*
2. ***Efficiency:*** *tax base should be as broad as possible to minimize rates and the structure should minimize economic distortion and avoid excessive reliance on any single tax.*
3. ***Equity****: taxes should be fairly applied across similarly situated taxpayers and across taxpayers with different income levels.*
4. ***Simplicity****: taxes should be as simple as possible to encourage compliance and minimize administrative and audit costs.*
5. ***Accountability/Transparency:*** *Deductions, credits and exemptions should be easy to monitor and evaluate and be subject to periodic review.*

More information about the LFC tax policy principles will soon be available on the LFC website at www.nmlegis.gov/lcs/lfc