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

SPONSOR Wirth **ORIGINAL DATE** 01/28/11 **LAST UPDATED** **HB**

SHORT TITLE Combined Tax Reporting for Some Corporations **SB** 6

ANALYST Golebiewski

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY11	**FY12**	**FY13**		
	$0.0-$5,550.0	$17,000.0-$34,500.0	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY11	FY12	FY13	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total		($75.0)	($75.0)	($150.0)	Recurring	Taxation and Revenue Department

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department

SUMMARY

Synopsis of Bill

Senate Bill 6 would require unitary corporations to file combined returns for corporate income tax purposes. Manufacturing corporations would be exempted from the requirement to file on a combined basis, if they have not previously filed on a combined basis.

FISCAL IMPLICATIONS

According to TRD:

> The estimate assumes that mandatory combined reporting would increase corporate income tax revenues before credits between 5% and 10%. This estimate reflects a range derived from a review of several studies of combined reporting, but the range of

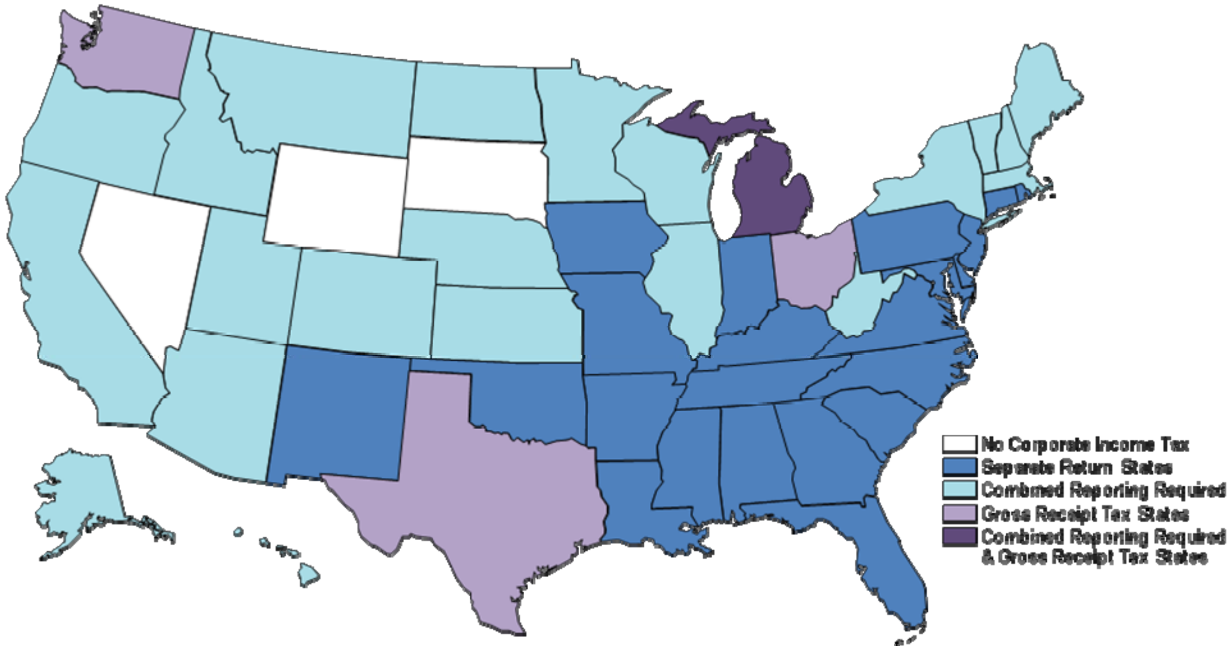
estimates in general is very wide, from 0% (no increase in revenue) to 20%. Separate entity filers engaged in manufacturing in 2008 reported 21.2% of total corporate income tax revenues, the estimated revenue increase was reduced by 21.2% to reflect the exclusion of manufacturers from the requirement. The estimate assumes that the initial revenue gain diminishes somewhat in the future. 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. Although it is possible, the proposal could negatively impact economic growth and thereby the state's revenue base, that impact is not incorporated in the estimates due to uncertainty of its magnitude.

SIGNIFICANT ISSUES

According to TRD:

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 the Department. 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 [if] their New Mexico start-up operation was not profitable.

- All other Western states with a corporate income tax currently mandate combined reporting.
- Texas recently adopted mandatory combined reporting for their [LFC: Margin] 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.]
- Before 2000, combined reporting was imposed almost exclusively by states west of the Mississippi River (eastern states had separate reporting).
- Recent adoptions of CIT combined reporting were made by Vermont (2006), New York (2007), West Virginia (2009), Michigan (2009), Wisconsin (2009), and Massachusetts (2009); separate reporting is still used primarily in the Southeast and Midwest.



Source: National Conference of State Legislatures, Report by William Fox and Leann Luna
http://www.ncsl.org/documents/standcomm/sccomfc/CombinedReportingFinalDraft.pdf

ADMINISTRATIVE IMPLICATIONS

TRD notes:

> The proposal will require the Department 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.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Senate Bill 7, which relates to add-backs to the corporate income tax, is related.

TECHNICAL ISSUES

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'.

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 (NOL's). Since many corporations have been accruing NOL's 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 NOL's recorded by unitary corporations prior to combination would <u>not</u> 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 NOL's may be effectively denied. In this case, a potentially significant financial asset is being eliminated in what is essentially a retroactive legislative action.

JAG/bym

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