New Mexico Corporate Income Tax Distortion and Cures for Distortion

Testimony of Helen Hecht
Tax Counsel, Federation of Tax Administrators
Before the Legislative Finance Committee
Interim Meeting – July 22, 2010

Introduction

Helen Hecht is the Tax Counsel for the Federation of Tax Administrators. The Federation of Tax Administrators is a non-profit membership organization made up of the tax agencies of all 50 states, the District of Columbia, New York City and other associate local tax officials. The purpose of the FTA is to represent the interests of state and local tax agencies before Congress and to monitor Congressional actions that might have an impact on state taxes. FTA also facilitates the sharing of information between states and with the IRS and other federal agencies, fosters discussion on issues of interest to state tax administrators and provides training programs for state tax personnel.

Before working for the FTA, Ms. Hecht was previously with the law firm of Sutin Thayer & Browne in Albuquerque and also worked for the accounting firm of KPMG and for the New Mexico Taxation and Revenue Department.

The views expressed herein are not necessarily the views of FTA or its members.

State Corporate Income Tax

A total of 46 states currently impose some type of corporate income tax. Most of those states base the tax on the federal corporate income tax rules, using income determined under those federal rules, with some adjustments, depending on the state.

There are a few things to keep in mind concerning state corporate income tax:

- THE TAX IS COMPLICATED: Because of the number of variables and calculations that go into computing taxable income and determining income by state, state corporate income tax is arguably the most complicated and complex tax to administer and to comply with.
- STATE RULES NEED NOT BE UNIFORM: Because every state has the freedom to vary the tax and how it is computed within broad limits, the amount of state corporate tax a business pays in total depends on what states the business operates in.
- RESULTS DEPEND ON THE BUSINESS: Types of business activities and business results may have a significant effect on the tax outcome from business to business and from year to year.

Therefore, the examples in this presentation have been greatly simplified to illustrate the issues so that they can be discussed more easily.

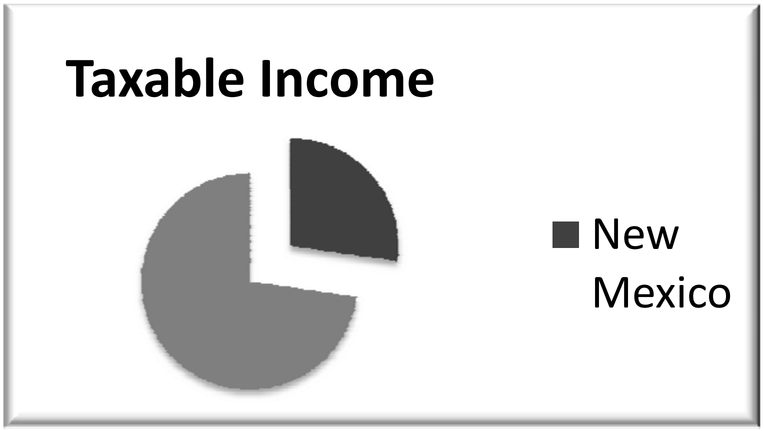
State Corporate Income Tax – One reason it's complicated.

A fundamental fact that complicates the state corporate income tax is that corporations may have activities in and may derive income from multiple states. (This is true of individuals too, but it is generally easier to tell where an individual earns his or her income.)

The U.S. Constitution prevents any one state from simply taxing 100% of the income of a multi-state business. Instead, the Constitution requires that states use some reasonable method of apportionment, applied fairly by that state, to determine the portion of income earned by the corporation from activities within the state.

The Supreme Court has said that there is no need for states to use the same apportionment method or to use one particular method. States have therefore adopted different methods although there are some similarities.

Apportionment



Today, while there is no one “typical” apportionment formula, each state’s formula is designed to calculate the portion of the taxable income “pie” of a multi-state business that the state will tax. Because other states are free to use a different method to determine their own shares of that pie, one state’s method does not control what another state can tax. (So multistate businesses can be taxed on more than or less than 100% of their income.) The basic apportionment formula is:

Total Taxable Income of the Multistate Business

X

Percentage Representing Activity in the State

Apportionment – Simple Example

New Mexico uses the so-called “three-factor” formula except in the case of some manufacturing businesses. The factors used in this formula are the business’s payroll, property and sales. The formula first computes the percentage of in-state payroll, property and sales to total payroll, property and sales of the business. The average percentage is then used to calculate income taxable in New Mexico.*

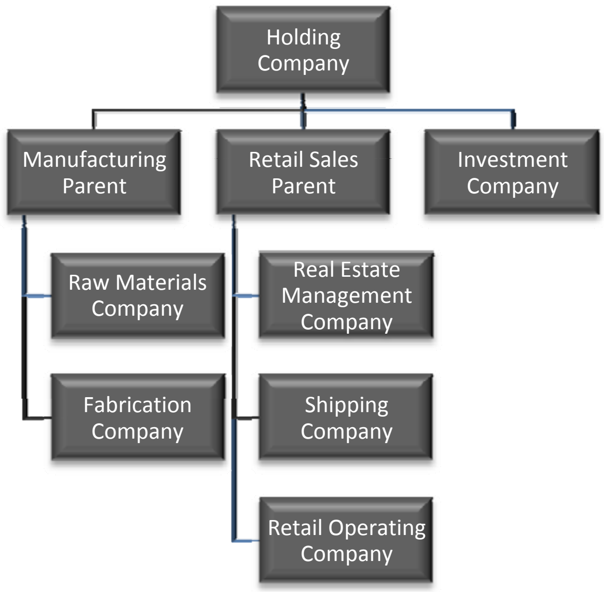
So assume a multistate corporate business has $100M of income and the following factors:

	In New Mexico	Total Everywhere	Percentage
Payroll	$10M	$200M	5%
Property	$10M	$20M	50%
Sales	$100M	$500M	20%
	Average Percentage =		25%

New Mexico Taxable Income = $100M x 25% = $25M

*New Mexico actually calculates tax on total income and then apportions the

Corporate Groups – Another reason the tax is complicated.



A business can be organized as a single corporate entity, with different internal divisions, or as separate but affiliated corporate entities. Common ownership and control are keys to creating an affiliated group.

The affiliated members of a corporate group might all have completely separate businesses – but more often than not, the members participate together in common businesses and have related activities. The revenue generated by one member of the group might help to support another member. Expenses incurred by one member might benefit the operations of another. So, when you have this kind of group of related affiliates, all engaging together in the same businesses, the question is this—what is the right way to determine and apportion taxable income?

Question – Why does it matter how we treat corporate groups?

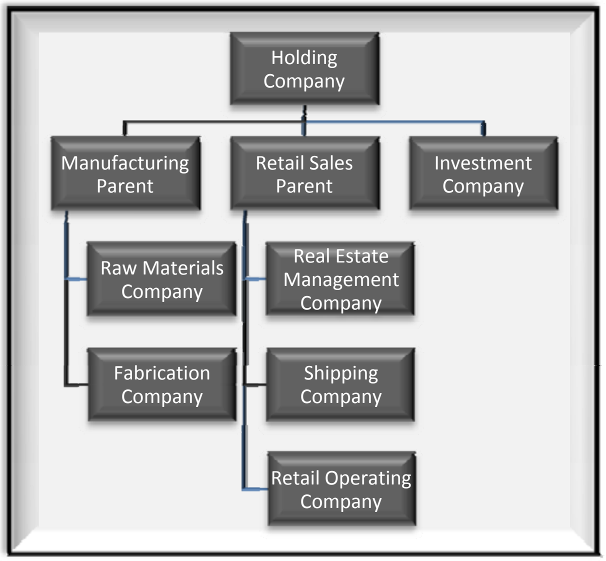
Answer – "Distortion."

If a state corporate income tax is imposed strictly on the taxable income of each separate legal entity, then the tax results may be artificially distorted if the separate legal entity represents only one piece of the total business operation of a corporate group.

For example, a business may be comprised of two legal entities, one that operates a retail sales business and another that invests the cash generated by that business until that cash is needed for operations. The investment entity, which here exists only to serve the retail business and may even be controlled by the retail business, may generate a different level of profit or loss than the retail entity. The investment entity may also have different apportionment factors in different states than the retail entity. In this case, apportioning and taxing the income of the investment entity separately from the retail business will lead to tax results that are different than if the entities were treated as one business.

While there may be debate over whether this is the kind of "distortion" that ought to be addressed, states that allow separate corporate filing, like New Mexico, have been most concerned with the kind of artificial tax result that comes from certain transactions between the members of a corporate group that can effect the taxable income of each separate entity in the group.

Federal treatment of corporate groups.



<u>Consolidated Filing</u>:

Typically corporate groups will file a consolidated return for federal purposes. This means that the corporate group will essentially be treated as a single entity. The group is determined based on ownership and control.

To convert separate company incomes to a consolidated income amount, transactions between group members ("inter-company transactions") are ignored or "eliminated." For example, if one affiliate sells to another, the sales revenue on the books of that entity and the expense on the books of the other entity will be eliminated in consolidation. The result is that only the group's activity involving unaffiliated third parties will be reflected on the tax return. Inter-company transactions will not affect the taxable income of the group.

For constitutional reasons, states may allow but cannot require consolidated filing, but they can require combined filing which works similarly.

State treatment of corporate groups.

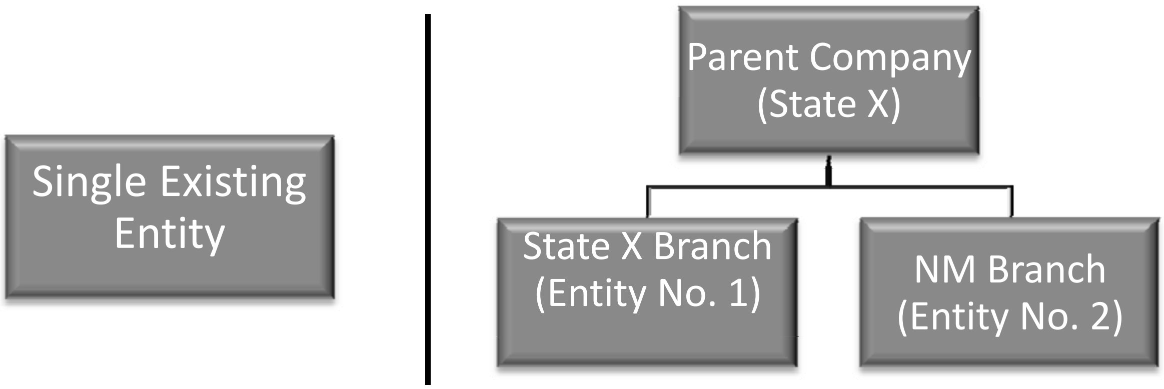
- Separate Filing – Twenty-two states require (or allow) corporations that are members of a group to file on a separate entity basis. The majority of these states have recognized, however, that determining the taxable income for a separate entity may not be as easy as taking the amount of income from the separate entity's books or as determined under federal tax rules. Instead, these states have concluded that adjustments may need to be made to "regular" book or tax income to properly reflect the taxable income as intended under state law. This is commonly done through "Add-Back" Statutes.

- Combined Filing - As noted, states can impose a requirement for affiliated corporate groups to file on a combined basis, and twenty-four have done so. In order to be included in the combined filing group, the member must be part of a "unitary" business with other corporations in the group. In other words, rather than focusing on each separate legal entity and attempting to determine each entity's income, the states that require combined filing first identify the unitary business (or businesses) that the corporations are engaged in and then determine income and apportionment factors for that business, regardless of whether the business is conducted by multiple corporations.

Comparison of Separate Versus Combined Filing
Case 1 – Separate Branches

- Assume that a profitable business in state X is considering expanding into New Mexico. It expects:
  - ½ of the assets, employees and sales will be in state X and ½ in N.M.
  - Results in early years
    - State X branch = $3M income
    - NM branch = $1M loss
    - Total = $2M income
- For illustration purposes – assume the effective tax rate in both state X and NM is 5%.

Comparison – Case 1



There are a number of non-state tax reasons, including administrative, risk management, financing and investment reasons, why this business might decide to organize itself using separate corporate entities. In some cases, these other business reasons may dictate the structure the business will use.

For ease of discussion, we assume that the entity can ether make the investment in the New Mexico branch as part of the same existing corporate entity or that it can separate the New Mexico branch and the existing branch into two different corporate entities owned by a holding company. (We also assume that the two branches can and will operate fairly independently of one another.) How will this decision affect the corporate tax paid by the business?

Case 1 – Comparison
Some Possible Tax Outcomes

No. 1: Combined Entity Treatment in Both States – If business doesn't split or if it does and files combined in both states – business pays:

$50,000 tax to state X and NM

(½ of $2M times 5% each)

Total = $100,000

No. 2: Separate Entity Treatment in Both States – If business split and files separately in both states – business pays:

$150,000 to state X (all of $3M separate income times 5%)

$0 to NM with a $1M loss carry-forward worth $50,000 in tax in the future

Total = $100,000 (but NM gets $0)

No. 3: Combined Entity Treatment in State X, Separate Entity Treatment in NM – If business splits, files combined in state X, separately in NM – it pays:

$50,000 to state X (½ of $2M times 5%)

$0 to NM with a $1M loss carry-forward worth $50,000 in tax in the future.

Total = $0 (and NM gets $0 in tax)

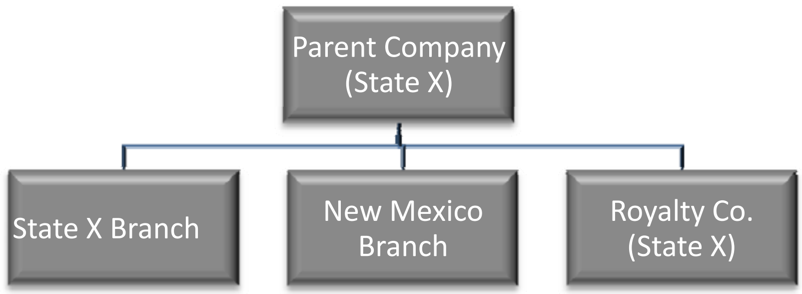
Lessons from Case 1

- Depending on how other states tax a business that is operating in New Mexico, it may or may not make any difference to the business's total state tax liability whether the business operates as a single entity or as a group of separate entities – but it may make a difference in the business's New Mexico tax liability. (Result No. 2 on the prior page.)

- When a profitable business in a combined state is considering expanding into New Mexico and expects to generate losses from that New Mexico based business for at least some period of time – it may benefit that business to be able to file separately in New Mexico, if all other things are equal. The cost of the tax benefit received by the business is borne entirely by New Mexico. (Result No. 3 on the prior page.)

- A choice of filing methods, where the taxpayer can choose the one that results in the least tax, may therefore be viewed as an incentive to certain taxpayers, depending on the circumstances.

Comparison of Separate Versus Combined Filing
Case 2



Now assume that the business in Case 1 were to split in two in order to obtain the benefit illustrated in Case 1, but in addition, the business engages in a particular type of state tax planning involving a royalty company (sometimes called an "intangible holding company").

To accomplish this, the parent makes a tax-free contribution of intangible property (copyrights, trademarks, etc.) to the separate royalty company subsidiary. The royalty company charges the branches for the use of the intangible property. These intercompany charges reduce the taxable income of the branches as separate corporate entities.

To get the cash back to the branches for their use, the royalty company pays a nontaxable dividend to the parent and it, in turn, makes a non-taxable investment back into the branches. So the branches do not actually sacrifice any cash.

Case 2 - Comparison

- Now assume that it is five years after the business has invested in New Mexico and the New Mexico entity has $10M of sales and $1M of income before any inter-company charges.
- Also assume the royalty company charges an inter-company royalty equal to 10% of sales or $1M to the NM entity.
- Result Under Separate Filing with no Add-Back:
  - The NM entity will have separate company taxable income of $0 because of the charge by the royalty company.
  - The business will pay the same tax in state X because the income of the royalty company is eliminated when the business files on a combined basis. (In state X it's as though the royalty company doesn't exist.)
- If New Mexico required combined filing OR if it required such types of intercompany charges to be adjusted under an add-back statute, the effects of this tax planning approach would be reversed and the NM entity would have taxable income of $1M.

Lessons from Case 2

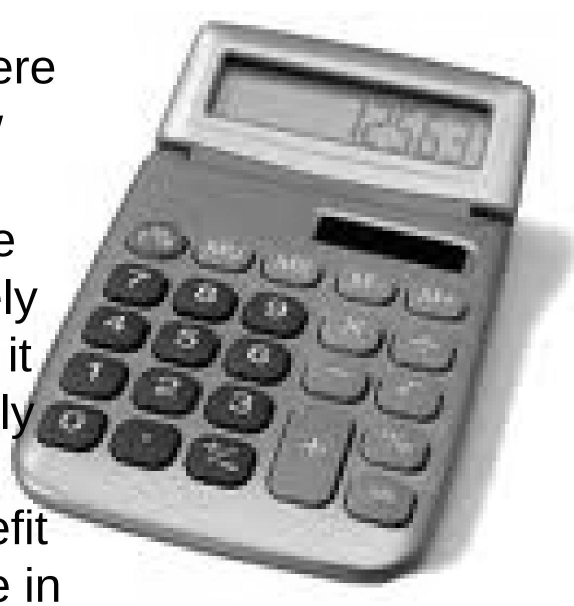
- Businesses can sometimes use a particular corporate structure and inter-company transactions to reduce taxable income in separate filing states without creating tax liabilities in any other states and without any real economic effect on the business.

- Most states that allow or require corporations to file on a separate entity basis have concluded that the kind of tax planning illustrated in Case 2 results in a tax benefit that was not intended under the law.

Case 1 Versus Case 2

There may be policy reasons why lawmakers would wish to provide tax benefits to certain corporations, for example, to encourage them to invest in the state as in Case 1. One way to provide such a tax benefit is to allow corporations to file on a separate basis. But note that the corporation in Case 1 only receives a benefit if the other state in which the corporation does business requires combined filing. Other variables may also affect whether a particular corporation will see a substantial benefit from being allowed to file separately in New Mexico. Therefore, allowing separate filing may not be the most efficient mechanism to provide such a benefit even if it is an intended benefit.

On the other hand, most separate filing states have concluded that there are no good policy reasons to allow the type of tax planning that is illustrated by Case 2. Not only is the tax benefit generated in Case 2 likely to be unintended by lawmakers but it is not the kind of benefit that is easily measurable and therefore it is impossible to say whether this benefit provides any advantage to the state in terms of economic development or other policy goals.



“Distortion.”

- Up to this point, this presentation has not ventured a specific definition of the term “distortion” – that is – an unintended result under the normal tax rules. What looks like distortion to a tax auditor may not look like distortion to a taxpayer. In particular, taxpayers have argued that just because something is done for tax reasons doesn’t mean that it is not legitimate. (Consider for example the election of Subchapter S corporation status.) Some state courts have sided with taxpayers in these disputes, but most have sided with the tax agencies especially where the following facts are shown:
  - The structure and/or transactions which result in the tax savings have no real economic impact on the corporations involved;
  - The structure is artificial or the transactions are merely “paper” transactions between controlled entities;
  - The transactions are entirely inter-company and are not the kinds of transactions that the company or group would engage in with unaffiliated third parties;
  - The sole purpose of the structure and the transactions is to reduce state taxes.

State cures for distortion.

Note – these “cures” are not mutually exclusive and may overlap:

Unitary Combined Filing – similar to consolidated filing. All inter-company transactions are eliminated, including those done for tax planning. Combined entities must be “unitary.”

“Add-Back” Statute – requires the separate filing entity to add back tax deductions taken for certain inter-company charges and expenses. For example, in Case 2, the royalty charges deducted by the New Mexico branch would have to be added back to calculate income subject to tax.

UDITPA Section 18 Powers – authority to alter how income from activities in the state is determined including the power to add-back deductions or change factors or require combined filing on a case-by-case basis.

“Economic Nexus” – judicially recognized authority to tax income of certain out-of-state affiliated corporations on a separate basis, for example, the royalty company in Case 2.

Sham transaction doctrine – judicially recognized authority to ignore transactions done solely for tax purposes and, in effect, add them back.

Transfer pricing rules – requiring that inter-company transactions be priced the same as “arms-length” transactions.

What powers does New Mexico have already?

- UDITPA Section 18 Authority – codified as NMSA Sec. 7-4-19 and recognized in the *Kmart* case. This power has been interpreted by other state courts as allowing tax agencies to add-back certain intercompany charges and to require combined filing on a case by case basis. This power also allows the state to vary the apportionment formula used by adding or subtracting factors used in that formula to better reflect activity in the state.

- The power to assert economic nexus – recognized by the NM Court of Appeal in *Kmart.* Applying economic nexus, a corporation that is part of a corporate group but operating outside the state may be taxed by New Mexico, in part, because of the connection between its activities to the activities of the group members that are operating in the state. (So, for example, the income of the royalty company in Case 2 could be taxed separately.)

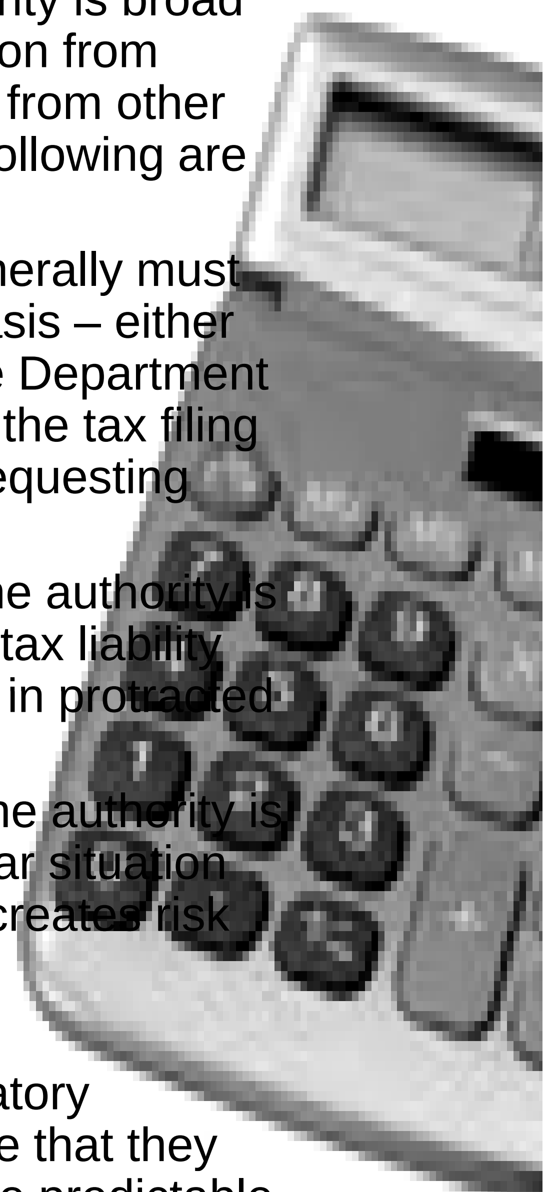
- As a result of these powers, NM has been able to settle and collect taxes in cases where royalty companies and other similar tax planning structures have been used.

What have other states been doing?

- In the last ten years, 7 separate filing states have adopted mandatory combined filing. Now there are 24 combined filing states and 22 that allow separate filing.
- All but 8 of the remaining separate filing states have statutory add-back provisions which give them the specific power to require that certain inter-company charges be added back before computing taxable income for each separate entity.
- Of the 8 without statutory add-back provisions, (including NM), all have one or more of the following:
  - UDITPA Section 18 authority
  - The ability to assert economic nexus*
  - The authority disregard sham transactions*

*These types of authority are typically granted to tax agencies by state courts.

Why might New Mexico consider additional measures?



- There are drawbacks to the use of UDITPA Section 18 Authority (and the authority to assert economic nexus). While this authority is broad and can cure most types of distortion from aggressive tax planning as well as from other unanticipated circumstances, the following are also true:
  – Application of the authority generally must be made on a case by case basis – either with the Taxation and Revenue Department requiring some modification of the tax filing on audit or with the taxpayer requesting some modification.
  – Often, because the extent of the authority is unclear, negotiations as to the tax liability are difficult and can easily end in protracted litigation.
  – Again, because the extent of the authority is unclear, the rules for a particular situation may not be predictable which creates risk for businesses.

- Both add-back statutes and mandatory combined filing have the advantage that they would apply generally and are more predictable.

Additional Considerations Mandatory Combined Filing

- Would eliminate potentially intended benefits, as illustrated by Case 1, that may have been relied on by businesses in the state.
- The question of what is a “unitary” group is a complex legal question and different states apply different standards. If New Mexico adopts combined filing, the legislature should also decide what standard to apply. This will lessen, but not eliminate, disputes and potential litigation over the application of the standard.
- There are a number of related issues that the legislature should also answer including, among others:
  - Whether net operating losses created by separate filing members of a group will be available for use by the combined group;
  - Whether tax credits earned by separate filing members of a group will be available for use by the combined group;
  - How will entities with special apportionment rules be combined.
- Taxpayers will need time to adjust and the Taxation and Revenue Department will need time to adapt the current administrative rules, procedures, forms, instructions, etc.

Additional Considerations
Statutory Add-Back Provisions

- There are a number of variations in these statutes from state to state. In general, the provisions need to apply broadly enough to cover all types of inter-company charges but they also need to have general exceptions for legitimate inter-company transactions that do not create distortion.
- On the one hand, add-back provisions can and are used even in combined states because not every member of an affiliated corporate group may be included in the unitary combined filing group, so add-back rules are useful to govern transactions with non-member affiliates. On the other hand, even if they are drafted broadly, statutory add-back rules may not address every possible situation where distortion may occur. Therefore, the add-back statute should be drafted so that it is clear that the state retains all other authority under UDITPA Section 18 to address other situations as necessary.

Comparison of Mandatory Combined Filing and Add-Back Provisions

Add-back provisions are a narrower alternative – addressing just the type of tax planning generally highlighted in this presentation. An add-back statute, therefore, may have no impact on a number of corporations doing business in New Mexico, although all large corporate groups will have to ensure that any regular inter-company transactions conform to the requirements and this will raise administrative and compliance issues, at least for the first few years.

Mandatory combined filing is a much broader alternative which may address other types of unintended effects of separate corporate filing, but may also have other impacts on many corporations doing business in New Mexico. Because every corporate group currently filing separately in New Mexico is potentially impacted by a change to mandatory combined filing, a discussion of this alternative necessarily raises other issues about New Mexico's corporate tax. Right or wrong, the separate filing method currently allowed may be viewed as a "trade-off" by businesses for other elements of the state's tax structure that are viewed more negatively and therefore the business community may want to see these other elements addressed if combined filing is adopted.