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

SPONSOR Cisneros
ORIGINAL DATE 03/01/13
LAST UPDATED
HB

SHORT TITLE Corp. Tax, Reporting, Single Sales & Repeals
SB 59

ANALYST Smith

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY13	**FY14**	**FY15**	**FY16**	**FY17**		
$0.0	$890.0	($960.0)	($9,140.0)	($15,970.0)	Recurring	Combined Reporting and Rate Change – General Fund
$0.0	$0.0	($45,000.0)	($45,000.0)	($45,000.0)	Recurring	Single Sales Factor Apportionment – General Fund
$0.0	$26,000.0	$65,000.0	$65,000.0	$65,000.0	Recurring	Repeal of Credits – General Fund
$0.0	$26,890.0	$19,040.0	$12,860.0	$7.030.0	Recurring	Total – General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 59 amends Section 7-2A-5 NMSA 1978, to reduce the corporate income tax rates. Section 7-2A-8.3 NMSA 1978 is amended to mandate combined reporting of income for unitary corporations. Section 7-4-10 NMSA 1978 is also amended to provide for the use of a single sales factor by certain taxpayers in apportioning corporate income to the state. Additionally, the bill repeals the rural job tax credit, the investment credit act, the technology jobs tax credit act, the high-wage jobs tax credit and the research and development small business tax credit act.

Effective Date: January 1, 2014

FISCAL IMPLICATIONS

The TRD assumes that mandatory combined reporting would increase corporate income tax revenues before credits between 5 percent and 10 percent (see Estimated Revenue Impact – Detailed Discussion for more detail). 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 -5 percent (no increase in revenue) to 20 percent. Revenues are expected to increase by 10 percent initially and the rate of increase is expected to slow down to 5 percent during the later years as taxpayers adjust their corporate structures and transactions to avoid taxation. 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.

2010 New Mexico corporate income tax data was used to estimate the change in CIT revenues due to the rate decrease. Micro-simulation was used in obtaining the impact due to the combined reporting requirement and rate decreases. To estimate the impact due to using the single weighted sales factor apportionment, the NM CIT data for manufacturing industries (NAICS code 31 through 33) was used. There are approximately 1,750 corporations with file under the manufacturing NAICS code with a total gross NM CIT of $75 million being paid to the state. Of these corporations, the top 10 corporations account for over 80 percent of the revenue. Since the investment level to qualify for using the single sales factor apportionment is small, it is assumed that most of the large corporations would take advantage of this incentive resulting in a revenue loss of about $45 million per year. The repeal of the credits is expected to result in additional revenues of about $65 million per year to the general fund (note that FY14 is a partial year based on effective date of legislation). All these numbers were summed up to obtain the estimated fiscal impact.

Different states have taken the mandatory combined route and have had widely different experiences with respect to revenues. The range of estimates has varied from a 5 percent decline in revenues to a 20 percent increase in revenues depending on the corporate landscape in that state. However, in most states the increase in the growth rate of revenue was not permanent and the growth rate decreased over time due to the corporations restructuring their operations to minimize their tax liability.

In order to better determine the impact to New Mexico, NM Corporate Income Tax data was used in this analysis. According to tax year 2010 New Mexico Corporate Income Tax data, about 75 percent of the total NM CIT was paid by top 100 corporations. Since 2010, gross CIT revenues were lower and the consensus NM gross CIT revenues from FY14 through FY17 are much higher, 2007 tax year data was also analyzed to determine the percent of NM gross CIT paid by the top 100 corporations. It was found that top 100 corporations contributed about 73 percent in 2007. Therefore, characteristics of the top 100 corporations in 2010 were used to estimate the majority of impact. Of the top 100 corporations, only 4 corporations are New Mexico based entities. The remaining 96 of them are multi-state corporations with some of their operations in New Mexico. By requiring mandatory combined reporting, most of these corporations will end up paying a higher NM tax. This is because typically, NM operations are smaller and have smaller profit when compared to all operations of the entity. It is to be noted that this is not true for all corporations but only for a majority. Therefore, we expect to see an initial increase in revenue for the top 100 corporations due to the mandatory combined reporting requirement.

New Mexico only corporations with no related unitary combined entities will pay the same tax under the mandatory combined reporting regime. For NM only corporations using 'Separate Corporate Entity' (SCE) reporting method with related entities under unitary combined requirement, the net tax could go up or down based on the taxable income of each of the entities. For multistate corporations, generally, if the NM operations are larger (more taxable income and presence) than their out-of-state operations, they would end up paying more NM tax. On the flip side, multistate corporations whose NM operations are smaller than their out-of-state operations would end up paying lesser NM tax.

Taking all this into account, revenues are estimated to increase by 10 percent initially in our state, and the rate of increase is expected to slow down to 5 percent during the later years consistent with the experience of other states.

SIGNIFICANT ISSUES

The TRD believes that 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 though their New Mexico start-up operation was not profitable. The legislation eliminates tax credits that have wide-ranging benefits to a relatively large number of New Mexico businesses, and the mandatory combined reporting may further confound the structure and organization of business enterprises in New Mexico. A confusing message is sent to businesses when these generally "negative" tax policies actions are combined with a tax rate decrease, with the net effect of an inconsistent policy diluting the longer term positive intent of New Mexico's tax policies toward business.

All other Western states with a corporate income tax currently mandate combined reporting, under which controlled groups of "unitary" (interdependent) U.S.-based corporations must file a single return. Texas recently adopted mandatory combined reporting for their Margin Tax. The Blue Ribbon Tax Commission endorsed the concept of mandatory combined reporting in 2003, although the commission recommended that the added revenue from combined reporting be used to reduce the corporate income tax rate. New Mexico's corporate income tax rate is currently one of the highest among western states. Several western states allow "single-weighted sales factor" apportionment of income for their corporate income tax. For companies with a large portion of sales outside the state, this method has the effect of reducing their corporate income tax liability. New Mexico requires most companies to use "three-factor apportionment," including payroll, property and sales. Thus, the burden of New Mexico's corporate income tax is more likely to fall on payroll and property in the state than the corporate income tax in single-weighted sales factor states.

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. These laws require taxpayers to disallow the amounts of certain amounts paid to related companies located in other states. The add-back approach can be considered a more targeted approach to the potential for income shifting to avoid state tax. The discretionary powers necessary to properly implement both the “add-back” provisions and the “forced combination” techniques have generated significant litigation. Massachusetts, New York and West Virginia recently enacted mandatory combined filing.

TECHNICAL ISSUES

- The TRD notes the following technical issues:

- Definition of “unitary corporation” has not been specified in the bill. A definition in Section 7-2A-2(Q) would be useful.

- Under Section 3, Page 6, Subsection E, states that the taxpayer may not claim a credit pursuant to the Investment Credit Act, however, Section 4, on page 7, repeals the Investment Credit Act.

- Carry forward rules for already approved credits need to be clarified. The intent might be to use the definition in Section 7-2A-2(Q). Although current law Section 7-2A-2(Q) contains a definition of “unitary” corporation, the definition contains a number of terms that are subject to varying interpretation. In addition, lack of clarity in other areas of New Mexico’s corporate income tax creates uncertainty for taxpayers trying to determine the income and expenses of the unitary group. An example is the treatment of net operating losses incurred by companies that are currently not reported on New Mexico tax returns but would be included in a combined return under the proposal. New Mexico law is silent on this issue, although a regulation implies that these losses would not be allowed on the combined return. Although such treatment increases the potential revenue impacts of the proposal, it could also be punitive for some taxpayers, because their losses were incurred through business operations and not through tax avoidance behavior. Disallowing these losses effectively wipes out a valuable asset. If treatment of these issues is not clarified in the statute, it increases the likelihood there will be litigation of the issues in the future.

- Regulation 3.4.10.8(B) NMAC will need to be changed (or a new regulation added) to reflect that after January 1, 2013, a taxpayer that previously filed as a separate corporate entity, but is part of a unitary corporation, as that term is defined in Section 7-2A-2(Q), must file its New Mexico CIT returns using the combined unitary group method or the federal consolidated method.

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

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