Corporate Income Tax Apportionment

Presentation to the New Mexico Legislature
Revenue Stabilization and Tax Policy Committee
By Helen Hecht, Uniformity Counsel, Multistate Tax Commission
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Bio

Work:

- 2020 – Current - Uniformity Counsel for the Multistate Tax Commission
- 2014 – 2020 - General Counsel for the Multistate Tax Commission (Washington, D.C.)
- 2009 – 2014 - Tax Counsel for the Federation of Tax Administrators (Albuquerque, NM)
- 2003 – 2009 - Of Counsel – Sutin, Thayer & Browne law firm (Albuquerque, NM)
- 1995 – 2003 - Senior Manager (and various) - KPMG accounting firm (Albuquerque, NM)
- 1984 – 1995 – Bureau Chief (and various) - New Mexico Taxation and Revenue Department (Las Cruces, Santa Fe, and Albuquerque, NM)

Education:

- Juris Doctor, University of New Mexico
- Masters in Accountancy, New Mexico State University
- Bachelors in Accountancy, New Mexico State University

Other:

- Member of the New Mexico and U.S. Supreme Court Bar
- New Mexico Licensed CPA
- Founding member of the New Mexico Tax Research Institute

Multistate Tax Commission

The Multistate Tax Commission (MTC) is an intergovernmental state tax agency formed in 1967. New Mexico is a founding member of the MTC, enacting the Multistate Tax Compact in June of that year. In addition to compact members, states can also participate in the Commission as "sovereignty" or "associate" members. The overarching goal of the MTC is to facilitate states working together. The MTC's uniformity committee drafts model state tax regulations and statutes. The joint audit and nexus programs provide services to participating states. (New Mexico participates in these programs.) The MTC also provides training, research, litigation support, and other services, as requested. See the MTC's website at www.MTC.gov.

Unless indicated, the views expressed in this testimony are my own and not the official positions of the Multistate Tax Commission or any of its member states.

Why tax business income—and how?

- Takes profitability into account –
    - Promotes investment in new activities that are higher risk and more likely to be unprofitable
    - Makes it easier to tax the value of certain items that are hard to value directly, such as intangible property, ideas, or goodwill
    - Matches the tax with the ability to pay
- Tax at the entity level is easier (see presentation on pass-through taxation).
- Tax can also be, but doesn't have to be, imposed at the owner level, when profits are distributed.
- Some research indicates the combined tax on corporate income has led to growth in pass-through entities and reliance on debt financing. But effective tax rates on business profits of taxable corporations and pass-through entities varies significantly, depending on a number of factors.
- Not all corporate income is taxed twice—especially income that flows to investment entities like pension and educational funds where it may also be used in a non-taxed manner.

Taxing income requires sourcing it

Geographic Accounting	Apportionment
• Traditional method • Used internationally and by federal government • Determines the source of all the individual items making up the calculation of taxable income	• Innovation by the states • Used by all states that tax business income • Determines source of income based on factors – traditionally property, payroll, and sales (or receipts).

A brief history

- Most states adopted their corporate income tax between 1901 and 1939. (Hawaii was the first – before it was even a state.)
- The federal government and other nations enacted similar taxes during the same period.
- As business expanded within the U.S., states quickly found that geographic sourcing of individual items of income and expense was unworkable.
- They developed a method of apportioning income which was eventually made into a model state law by the ULC in 1957 – the Uniform Division of Income for Tax Purposes Act, UDITPA.
- UDITPA used an average ratio of the business's property, payroll, and "sales" (receipts) in the state to its total property, payroll, and sales everywhere in order to determine the share of the business's total income subject to tax in the state.
- States often apply apportionment to corporate groups and some states began applying it to the worldwide income of multinational groups.
- The U.S. Supreme Court upheld this worldwide method but the Reagan administration pressured states to restrict apportionment to domestic income—determined using geographic sourcing.

A brief history

- There was a problem with UDITPA. Unlike receipts from transactions involving real or tangible property, which were attributed to the state where the business's customer was located, receipts from services and intangibles were attributed to the location of the "income producing activity" based on the "predominant cost of performance."

- Not only was UDITPA's receipts-sourcing method difficult to apply, it often duplicated the effect of the property and payroll factors, rather than representing the market of the business.

- For the last 50 years, states have slowly been adopting what is called market-based sourcing of all receipts. The MTC asked the ULC to amend UDITPA to create a uniform model for sourcing receipts from intangibles and services, but the business community opposed this. So the MTC developed a model which several states, including New Mexico, have adopted.

- States have also slowly been moving to eliminating the property and payroll factors from the apportionment formula. The U.S. Supreme Court has found that using only receipts to apportion income is generally constitutional. See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

What does it mean to tax apportioned income?

- One expert on income tax apportionment has famously said – a tax on income apportioned by factors is a tax on the factors, measured by income—in other words—it is a tax on the factors where the rate of tax is measured, or determined, by profitability relative to the factors.

- Example: Assume a state used a single property factor to apportion income –
  - In-state property = $500
  - Total property = $1,000
  - Total taxable income = $100
  - Tax rate = 10%

  - Tax on income apportioned by factors
  - Apportioned income = $100 X ($500/$1,000) = $50
  - Tax = 10% X $50 = $5

  - Tax on the factors measured by income
  - Rate of tax measured by income = 10% X ($100/$1,000) = 1%
  - Tax = 1% X $500 = $5

- So, in a very real sense, a state that apportions income using in-state property, payroll, and/or receipts is taxing the property, payroll, and receipts.

Single Sales (Receipts) Factor

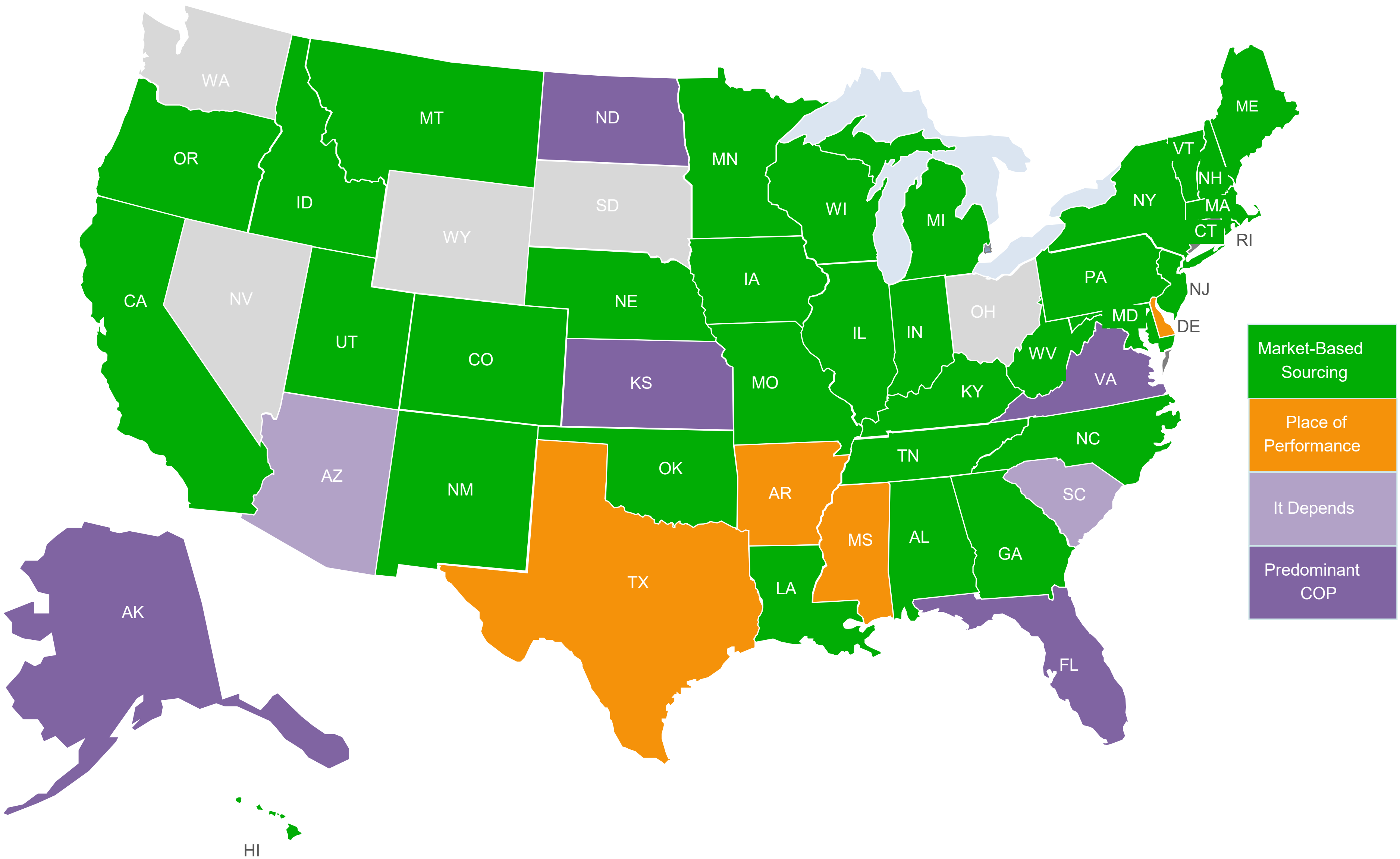
Policy Reasons Against

- Some claim that eliminating property and payroll factors is simply a way for states to lower the tax burden on businesses located in the state and "export" the tax to businesses that have a greater percentage of their property and payroll outside the state relative to their percentage of in-state receipts.
- Others see this as an unproven economic incentive.
- The sales or receipts factor is the most difficult to determine because it is harder to source receipts than property or payroll.

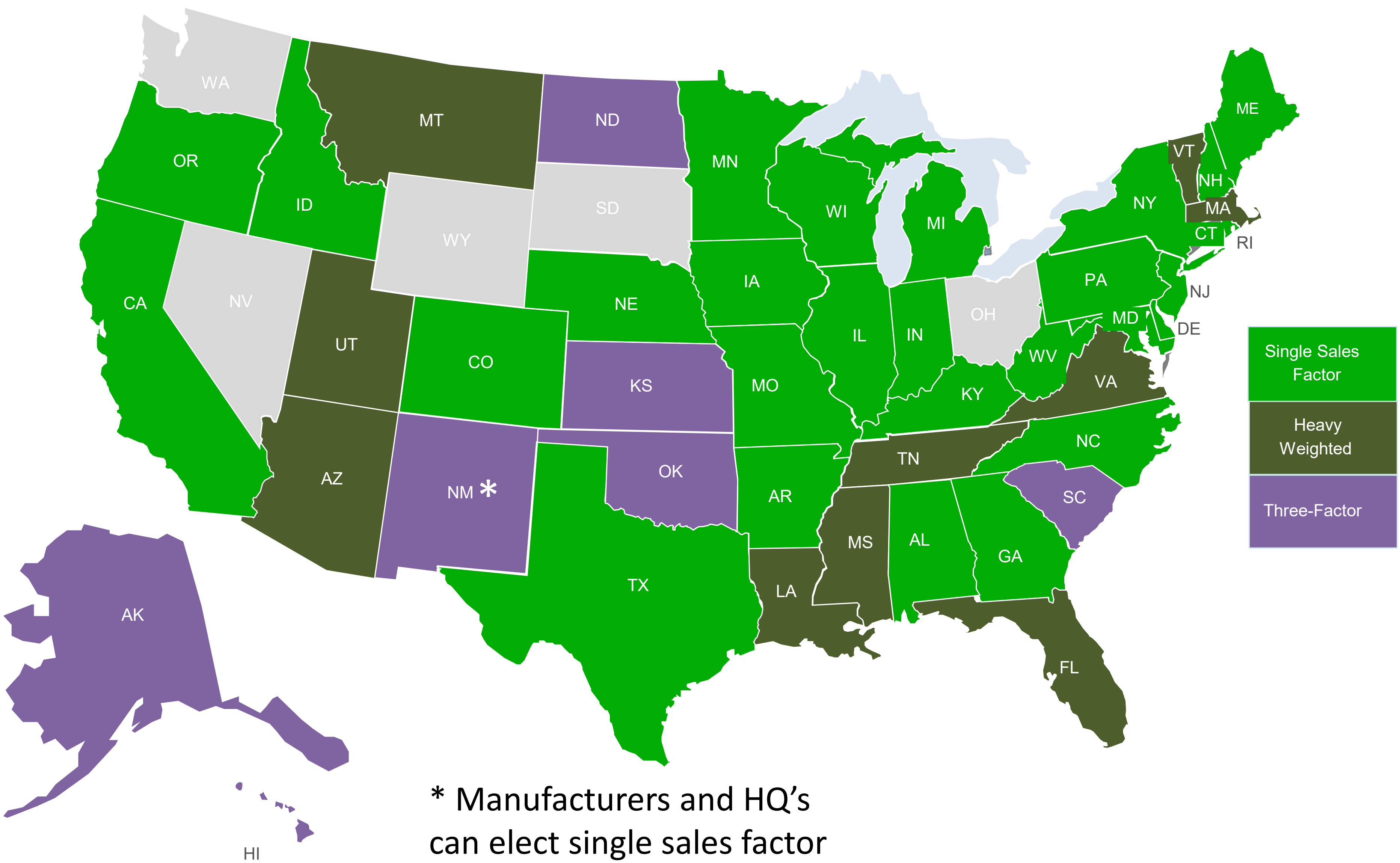
Policy Reasons For

- States may already tax tangible and real property – in the form of property taxes. What property taxes don't typically apply to is intangible property. But that property is also excluded from the property factor because it is very difficult to value and source.
- State may already tax payroll – in the form of income taxes, workers comp, unemployment, etc.
- Some states have a narrow sales tax base so using receipts to apportion income is an indirect way of taxing other types of receipts.

States Sales/Receipts Factor Sourcing - Services



States Sales Factor Weighting (Generally)



* Manufacturers and HQ's can elect single sales factor

A brief history, continued . . .

- Meanwhile, as the service and intangible segments of the economy grew, it became increasingly difficult to apply the traditional geographic accounting approach used internationally and to prevent artificial income shifting.
- The OECD finally recognized the problem and in the last decade has been studying it. In the meantime, some countries have begun imposing general gross receipts taxes on certain kinds on highly-profitable digital advertising.
- One proposal the OECD is now attempting to implement is a special alternative tax on global income of certain businesses that rely heavily on digital services or intangible property, apportioned by a single sales factor using market-based sourcing.
- After Maryland enacted a digital advertising tax last year, similar to taxes imposed by some foreign countries, the Council On State Taxation argued that it would be better for Maryland to simply apply an apportionment formula using a receipts factor that employs market-based sourcing for services and intangibles.

Effect on tax revenue

- It's difficult to say how the use of a single receipts factor for apportioning income will affect state corporate income tax revenues, especially over the long term—it depends on the state, it's industry, and other factors.
- MTC does not take a position on whether states should adopt such an approach and has not done any economic or revenue analysis. A number of surveys that have been done show declines in revenues. However, the difficulty is that the change to single sales factor was often accompanied by other changes in the state tax. Also, declines in revenue over time may be due to a number of factors.
- That said, a particular state may be able to develop fairly accurate estimates of the effect on its own revenues in the short term.
- Some states traditionally produce more products and services relative to their consumer base, which means they will see a decline in tax revenue.
- Other states consume more relative to their in-state production, which means they may see less of a decline, or potentially even an increase in revenue.
- The effect on a particular state will also depend on the industries in that state and on the method used to source receipts.
- States that allow an election for some or all taxpayers will see a decrease in tax revenues which may be harder to predict.

Examples of how single sales factor affects tax

- Business X is engaged in the production of natural resources. A significant amount of X's property and payroll are in State 1, relative to all other states. But X's sales of those resources are spread out more evenly around the country. If State 1 changes from an apportionment formula using property, payroll, and receipts to one using only receipts, X will pay less tax to State 1, all other things being equal.

- Business Y provides online access to various content and uses data obtained from this to develop and sell digital advertising to other businesses. Those ads are generally meant to be viewed by certain consumer groups – regionally or nationally. The question is where should the advertising receipts be sourced—that is—where is the "delivery" of the service or its benefit? Is it where the business customer is located? Or is it where the ad is ultimately viewed? The answer may affect how the receipts are sourced and how income is apportioned.

Other considerations

- Constitutional limits – states cannot discriminate against business conducted in interstate commerce so as to favor similarly situated in-state businesses or to impose an inherently duplicative tax on interstate commerce.

- Complexity – considerable attention needs to be given to making sure that the rules for sourcing receipts to a state for apportionment purposes is clear.

Questions

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