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

SPONSOR Wirth **DATE TYPED** 3-07-2005 **HB** 320/aHBIC

SHORT TITLE Mandate Combined Corporate Tax Returns **SB**

ANALYST Taylor

REVENUE

Estimated Revenue		Subsequent Years Impact	Recurring or Non-Rec	Fund Affected
FY05	**FY06**			
	$12,000.0	$24,000.0	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION
LFC Files
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of HBIC Amendments

The House Business and Industry committee amendments provide an exception to the requirement that all corporations file combined returns for unitary corporations whose principal business activity is manufacturing. The amendments include a definition of manufacturing that excludes construction, farming, processing natural resources and "power generation, except for electricity generation at a facility other than one for which both location approval and a certificate of convenience and necessity are required prior to commencing construction or operation of the facility, pursuant to the Public Utility Act".

Fiscal Impact of HBIC Amendments

The Taxation and Revenue Department reports that the exclusion provided for manufacturing reduces the full-year fiscal impact from $30 million to $24 million.

Synopsis of Original Bill

House Bill 320 amends the corporate income and franchise tax act by requiring all corporations subject to the act to file combined returns.

The provisions of the bill are applicable beginning January 1, 2006.

FISCAL IMPLICATIONS

The Taxation and Revenue Department (TRD) estimates that requiring combined returns would increase general fund revenues by $15 million in FY06 and by $30 million on a full year basis. The fiscal impact estimate assumes that the change will increase corporate income tax revenues by 15 percent as has been the case of some other states that have adopted this measure, according to TRD.

The current forecast for Corporate Income Tax revenues in FY06 is $200 million. A 15 percent increase implies revenues will grow by $30 million. The impact in FY06 is assumed to half of this because of the applicability date, which falls in the middle of the fiscal year.

ADMINISTRATIVE IMPLICATIONS

TRD reports that the administrative impact of the proposed change would be modest.

TECHNICAL ISSUES

TRD submitted the following as a technical issue:

> As a result of Conoco and Intel v. TRD (1997), the Department may not include foreign dividends and subpart F income in the tax base for separate filers, but the Department can and does include foreign dividends and subpart F income in the tax base for combined and consolidated filers. (Subpart F income is income earned by controlled foreign corps in tax haven countries. It is treated as a "deemed dividend" by the U.S. Internal Revenue Code since it may never be formally repatriated.) There is no good economic reason for the distinction between dividends received by separate and combined filers; it's just a result of how that case was decided.

OTHER SUBSTANTIVE ISSUES

TRD provided the following background and discussion of policy issues related to the bill.

> Current Practice and Probable Basis for the Proposed Legislation.
> Under current law, each member of an affiliated group of corporations may file as a separate entity in New Mexico. Only the entity with a taxable presence ("nexus") must file a return in the state. This filing method creates opportunities for controlled groups of corporations to shift profits to their out-of-state affiliates by inflating inter-company charges to the in-state entity. Because affiliated corporations almost always file a single "consolidated" return for federal purposes, the inter-company charges are not subject to federal audit scrutiny. Policing the legitimacy of these inter-company charges (for instance, the proper amount of rent for an in-state store charged by a Delaware subsidiary) is very difficult and time-consuming for state tax auditors. 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 composite return, eliminating all inter-company charges. The states impose their apportioned tax on a larger tax base, likened by some to taxing a smaller share of a bigger pie. The Blue Ribbon Tax Commission endorsed the concept of mandating combined filing in 2003.

Eastern states have not generally adopted combined filing, although in response to some well-publicized “tax planning” techniques, 13 Eastern states have recently adopted “add-back” or “anti-PIC” legislation. These laws require taxpayers to disallow the amounts of royalty and interest amounts paid to “intangible holding companies” based in low-tax states like Delaware. New York allows its tax commissioner to “force” mandatory combining to avoid income distortion. The discretionary powers necessary to properly implement both the “add-back” provisions and the “forced combination” techniques have generated significant litigation. Vermont has recently enacted mandatory combined filing, and other Eastern states are considering it in response to budget shortfalls. Pennsylvania’s tax department recently estimated that adoption of combined filing in that state would increase corporate income tax revenues by $120 million to $550 million per year. Although there is some anecdotal evidence that the “federal consolidated” method has led to some revenue losses from particular taxpayers with highly profitable in-state operations, use of the option gives both the states and the taxpayers absolute certainty as to which entities must be included on a return, eliminating disputes as to whether two business segments or separate entities are interdependent.

Eliminate Separate Corporate Entity Reporting: Arguments For and Against
Arguments in favor of eliminating separate corporate entity (SCE) reporting include:
1) Its elimination will reduce corporate tax planning that cost states corporate income tax revenues
2) Elimination of SCE will make state corporate income tax practices more uniform than they currently are

Arguments against the approach:
1) Eliminating SCE filing would discourage economic development by discouraging firms from locating in a particular state

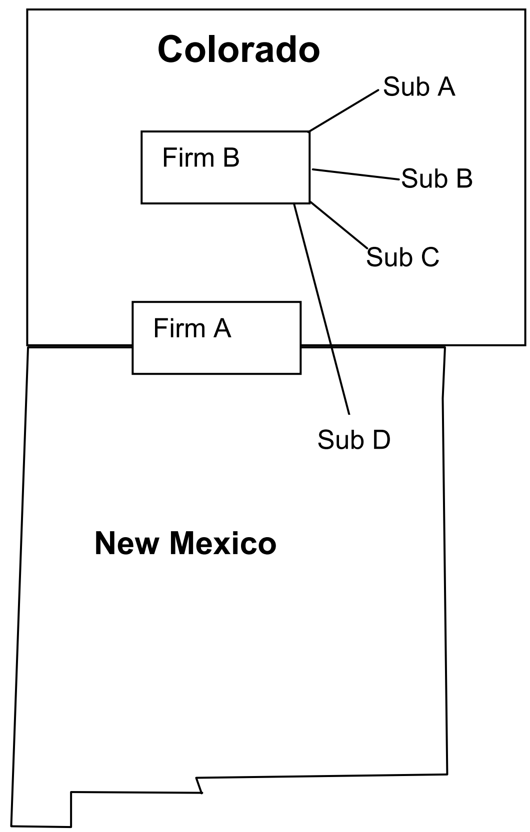
Eliminate Federal Consolidated Reporting: Arguments For and Against
The primary argument for eliminating consolidated reporting is based on a belief that states lose substantial amounts of corporate income tax revenues by allowing the consolidated filing method. The primary argument against eliminating consolidated filing is that it is extremely easy to enforce by simply requiring firms to submit copies of their federal tax returns when filing state corporate income tax returns.

Description of Reporting Methods
Current statutes allow groups of affiliated firms to file as "separate corporate entity" (SCE), "unitary combined" and "federal consolidated group". This option is sometimes referred to as "the ladder" because when moving from separate corporate entity to combined, then federal consolidated reporting, firms include greater amounts of corporate income in amounts of income reported. All three filing options require allocation and apportionment under the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA and associated regulations provide rules whereby corporations or groups of corporations operating in more than one state divide income and expenses among the states in which they operate. It provides special rules, for example, for airlines, railroads, construction contractors, trucking companies, broadcasters, and to firms in the publishing and financial industries. In tax years following the first one in which corporations report, they are allowed to employ a different filing method without permission from the Department so long as they select a higher position on the "ladder". In other words, they

are allowed to change from separate corporate entity to combined or consolidated without permission from the Department. But they may not change from combined to separate corporate entity without permission from the Department; and the Department does not generally allow the election unless the proposed new reporting method is a better reflection of industry practices than the one the firm currently employs.

Unitary Businesses and Filing Methods

A unitary business is generally regarded to be one that operates as a unit; its branches are so dependent on the business as a whole that their activities cannot be separated from those of the main organization. A number of legal tests have been developed for determining whether a group of businesses constitutes a unitary business, yet the practical effect of the concept is that, once a group of businesses has been defined as a unitary group, the only feasible approach to sourcing their incomes is via combining incomes from all group members and subjecting them to formula apportionment. New Mexico statutes currently allow firms some freedom in defining the composition of their unitary businesses -- i.e., in defining whether affiliated firms are part of a unitary business and filing taxes accordingly. This discretion is contained in the three options allowed for filing returns. As illustrated in the figure below, the proportion of business activity subject to apportionment increases as a firm moves from separate corporate entity to combined and then federal consolidated group reporting. New Mexico statutes allow firms to move up the ladder, but not down without permission of the Taxation and Revenue Department Secretary.



Differences in the three filing methods can be understood with the aid of the figure. Assume, as illustrated in the figure, that two affiliated firms -- firm A and firm B -- operate in Colorado and New Mexico. Firm A operates partially within both states, but Firm B's physical presence is limited to Colorado. Firm B controls a number of subsidiaries -- three of which are in Colorado, while one is located in New Mexico. The firms are, in fact, related in some way -- via, for example, shared trademarks, ownership, purchasing or other activities.

Under separate corporate entity reporting, Firm A is allowed to report as if it were a separate entity totally unrelated to Firm B or the subsidiaries. That is, Firms A and B are not considered unitary. Total income produced by firm A would be taxable, but Firm A's business income would be apportioned between Colorado and New Mexico using the three-factor apportionment formula.1 Income and apportionment factors of Firm B and the various subsidiaries would be ignored. If Firm B is a subsidiary of A, Firms A

[1] In formula apportionment, firms are allowed to allocate their "non-business" income, or income that is not related to their normal business operations (e.g., dividend and interest income) to their "state of commercial domicile" or state in which the corporate headquarters are located. Normal business income is then apportioned among various states.

and B would each file separate returns based on the proportion of business conducted in New Mexico by each firm. Under a combination of domestic unitary corporations reporting system, firms A and B would combine their income and report as if they were a single firm. If subsidiaries of firm B are not considered part of the unitary business, their incomes would not be counted, nor would their activities be accounted for in the apportionment factor. If federal consolidated group reporting is employed, all firms and subsidiaries' incomes shown in the figure would be combined, including apportionment factors and incomes that are not considered part of the unitary businesses. Many intergroup transactions would be eliminated, however, because they would not reflect total business activity. Payroll, property and wages of all units would be accounted for in the apportionment factor.

Effects on Tax Obligations

The movement from separate corporate entity to combined, then consolidated reporting involves increasing taxable income from a group of business organizations attributable to a single taxpayer -- a factor that tends to increase tax obligation. As each subsidiary's income is added to the group, however, data from its activities also flows into the apportionment formula. To the extent that the subsidiary has no instate activities, it lowers the apportionment percentage, thus decreasing tax obligations. Whether the firm's total tax obligation increases or decreases depends on whether the former effect exceeds the latter one. Eliminating filing options is almost always expected to increase revenues, on the assumption that firms choose the filing method that generates the lowest tax obligations. To the extent that it causes firms to cease doing business in a particular state, it may have the opposite effect, however.

Numbers of Filers by Filing Method

In tax year 2003, approximately 16,000 firms filed New Mexico corporate income tax returns as separate corporate entities. Approximately 370 returns were filed as combined unitary, while 866 firms filed federal consolidated returns. SCE filers paid approximately 46 percent of the tax; combined filers paid approximately 10 percent of the tax obligations, while federal consolidated return filers paid roughly 44 percent of New Mexico's corporate income taxes. SCE filers tend to be relatively small firms, although they can be quite large. Of the firms with New Mexico base income greater than zero, the average tax liability among SCE filers was approximately \$4,000, while combined filers averaged approximately \$36,000 per return and consolidated filers averaged roughly \$62,000 per return. Major SCE filers consisted primarily of firms in the mineral extraction, manufacturing and retail industry. Firms in mineral extraction industries are also heavily represented among combined and consolidated filers; the reason for this is probably that firms in the mineral extraction industry currently pay a very high fraction of total corporate income taxes.

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