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

ORIGINAL DATE 1/18/08
SPONSOR Wirth **LAST UPDATED** 1/31/08 **HB** 51

SHORT TITLE Corporate Income Tax to Public School Fund **SB**

ANALYST Francis

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY08	FY09	FY10		
$11,000.0	$90,000.0	$90,000.0	Recurring	General Fund
	($112,500.0)	($112,500.0)	Recurring	General Fund
	$112,500.0	$112,500.0	Recurring	Public School Fund

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Public Education Department (PED)
Department of Finance and Administration (DFA)

SUMMARY

Synopsis of Bill

House Bill 51 distributes 20 percent of corporate income tax to the public school fund. Current law allows unitary corporations, corporations that are made up of at least two integrated corporations, to choose to file either as “combined” corporations or “consolidated” corporations. HB51 repeals 7-2A-8.4 which allows consolidated returns and makes combined reporting mandatory.

The provisions are effective with tax year beginning January 1, 2008.

FISCAL IMPLICATIONS

TRD estimates that requiring mandatory reporting would generate an additional 20 percent in corporate income tax (CIT) collections. Using the December 2007 projection of CIT revenue, the fiscal impact would be $90 million all of which would go to the general fund. It is assumed that one quarter of FY08 would be subject to the new mandate.

	Current Projections of CIT ($M)	Additional Due to Mandatory Combined Reporting ($M)	20 percent to Public School Fund ($M)
FY08	440.0	11.0	90.2
FY09	450.0	90.0	108.0
FY10	450.0	90.0	108.0
FY11	447.0	89.4	107.3

Source: Consensus Revenue Group Dec 2007 estimate

The Public School Fund is a separate fund that receives appropriations from the general fund and the current school fund and distributed to school districts based on the state equalization guarantee, transportation and supplemental appropriations. The amount to the Public School Fund is 20 percent of the CIT so it is 20 percent of the base consensus forecast plus the new revenue generated by HB51. This means that there will be a negative impact on the general fund.

The LFC has concerns with including continuing appropriation language in the statutory provisions for funds outside of the general fund, as earmarking reduces the ability of the legislature to establish spending priorities.

SIGNIFICANT ISSUES

The 2007 funding formula study task force sponsored HB51 as a way of providing additional funding for a new public school funding formula. This option provides about 25 percent of the estimated $360 million in new revenue deemed necessary by the task force to achieve sufficient funding of all public school districts.

According to data from TRD, mining and manufacturing account for 12 percent of the returns but 63 percent of the tax payments for all 19,875 CIT taxpayers. Of all taxpayers, 92.25 percent file as "separate entities," 2.43 percent file as "combined" and 5.32 percent file as "consolidated." The industry sector with the highest percentage (8.84 percent) of combined reporting is the "Management of Companies" sector which accounts for about 10 percent of the total amount of tax payments. Illustration one shows the details.

Combined Reporting: Most corporations only do business in one state and so their CIT filing is relatively straight-forward and combined reporting is not an issue for them. Where combined reporting is an issue is where companies have significant operations in a state but very little income when they file as separate entities, an option for NM CIT reporting. The use of subsidiaries called "passive investment companies," or PICs, has proliferated in the last decade which is the primary reason states are moving towards requiring combined reporting. A PIC generally has no economic activity other than the ownership of intangibles like trademarks, logos, copyrights and patents. The PIC is a subsidiary of the parent corporation so only the parent corporation benefits from the proceeds of the PIC.

Illustration 1: State Corporate Income Tax Returns and Tax Payments by Filing Method and Major Industry in 2005*

Major Industry**	All Returns: Number Of Returns	All Returns: Tax Payments ($000)	Separate Entity: Number of Returns	Separate Entity: Tax Payments ($000)	Combined: Number of Returns	Combined: Tax Payments ($000)	Consolidated: Number of Returns	Consolidated: Tax Payments ($000)
Number and Amount								
Mining***	857	91,347	753	21,735	21	23,375	83	46,237
Manufacturing	1,569	117,180	1,389	97,962	63	3,441	117	15,776
Wholesale Trade	1,131	9,402	1,033	5,091	37	1,803	61	2,508
Retail Trade	1,548	11,739	1,436	7,065	36	1,092	76	3,581
Transportation and Warehousing	543	10,436	502	1,797	10	7,330	31	1,310
Finance and Insurance	1,713	11,083	1,581	8,636	52	243	80	2,204
Real Estate, Rental and Leasing	1,870	9,742	1,798	9,207	16	178	56	356
Management of Companies and Enterprises	588	31,693	391	2,195	52	4,007	145	25,491
All Other	10,056	37,890	9,452	25,114	196	4,520	408	8,256
Totals	19,875	330,511	18,335	178,803	483	45,989	1,057	105,720
Percentage Distribution of Number and Amount by Filing Method								
Mining***	4.31	27.64	4.11	12.16	4.35	50.83	7.85	43.74
Manufacturing	7.89	35.45	7.58	54.79	13.04	7.48	11.07	14.92
Wholesale Trade	5.69	2.84	5.63	2.85	7.66	3.92	5.77	2.37
Retail Trade	7.79	3.55	7.83	3.95	7.45	2.37	7.19	3.39
Transportation and Warehousing	2.73	3.16	2.74	1.01	2.07	15.94	2.93	1.24
Finance and Insurance	8.62	3.35	8.62	4.83	10.77	0.53	7.57	2.08
Real Estate, Rental and Leasing	9.41	2.95	9.81	5.15	3.31	0.39	5.30	0.34
Management of Companies and Enterprises	2.96	9.59	2.13	1.23	10.77	8.71	13.72	24.11
All Other	50.60	11.46	51.55	14.05	40.58	9.83	38.60	7.81
Totals	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Percentage Distribution of Number and Amount by Size of Tax Payment								
Mining***	100.00	100.00	87.86	23.79	2.45	25.59	9.68	50.62
Manufacturing	100.00	100.00	88.53	83.60	4.02	2.94	7.46	13.46
Wholesale Trade	100.00	100.00	91.34	54.15	3.27	19.18	5.39	26.67
Retail Trade	100.00	100.00	92.76	60.19	2.33	9.30	4.91	30.51
Transportation and Warehousing	100.00	100.00	92.45	17.22	1.84	70.23	5.71	12.55
Finance and Insurance	100.00	100.00	92.29	77.92	3.04	2.19	4.67	19.88
Real Estate, Rental and Leasing	100.00	100.00	96.15	94.51	0.86	1.83	2.99	3.66
Management of Companies and Enterprises	100.00	100.00	66.50	6.93	8.84	12.64	24.66	80.43
All Other	100.00	100.00	93.99	66.28	1.95	11.93	4.06	21.79
Totals	100.00	100.00	92.25	54.10	2.43	13.91	5.32	31.99

Taxation and Revenue Department   August 27, 2007   Tax Research and Statistics Office

* Tax payments are the total of estimated quarterly payments and payments with final returns for returns with fiscal years ending in 2005. Payments are before any business tax credits.

** Industries as defined by the North Americal Industry Classification System (NAICS). "Major" industries are those with state corporate income tax payments in excess of $7 million in 2005.

*** Firms engaged in oil and natural gas production-related activities are typically classified in mining, but may be classified in a number of other industries including transportation, retail trade, and professional, scientific and technical services.

For example, if two companies have competing retail operations in the state. Company A is local and so all of their income is accounted for on their CIT return. Company B has a PIC in Delaware (the host of many PICs since there is no corporate income tax) which owns the logo and trademark that Company B uses to market its products. Company B leases the intangible property from the PIC for an amount that roughly equals its net income. Company B now has a competitive advantage over Company A because they have not paid any income tax in NM since they shifted it to their PIC in a state where there is no income tax.

Table 2: PIC Example		
	Company A	Company B
Revenue	1,000,000	1,000,000
Operating Costs	500,000	500,000
Lease Costs for Intangibles and property (logos, trademarks, REITs)	0	350,000
Net Income in NM (@ 5.8%)	500,000	150,000
NM Income Tax	**29,000**	**8,700**

As Table 2 shows, Company A has a competitive disadvantage since it is paying three times the corporate income tax as company B. This is a very simplistic example to demonstrate the problem. Actual corporate income tax filings are infinitely more complicated but the advent of mandatory combined reporting occurred because of the aggressive tax planning multi-state corporations have engaged in.

During testimony at the Revenue Stabilization and Tax Policy Interim Committee (RSTP) in 2006, TRD indicated that approximately 2 percent of corporations would be affected by requiring combined reporting. Most corporations in New Mexico are single location companies who will not be affected at all by combined reporting.

At the same RSTP meeting, representatives of the Association on Commerce and Industry (ACI) indicated that the proposal unnecessarily complicates the tax system and would make New Mexico uncompetitive in attracting economic development. Economic development professionals have reported that this is one of the tools that they use to attract large companies to the state and that companies use the flexibility of reporting as a factor in their location decisions.

TRD:

The availability of the election to use the SCE reporting method under current law is considered a tax incentive to attract firms to New Mexico. Eliminating the election might discourage some firms from locating or expanding in New Mexico.

TRD has provided additional information included as an appendix.

ADMINISTRATIVE IMPLICATIONS

TRD:

The allowance of "separate corporate entity" (SCE) reporting under current law creates opportunities for controlled groups of corporations to shift profits to their out-of-state affiliates by inflating or creating artificial inter-company charges to the in-state entity. Because affiliated corporations almost always file a consolidated return for federal income tax purposes, the inter-company charges are not subject to federal audit scrutiny. Determining 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 TRD auditors.

The consolidated filing method reduces tax compliance costs for electing corporations, reduces administrative cost for TRD, and allows corporations and TRD to rely on the results of IRS audits to determine the effect of audit adjustments on NM corporate income tax liabilities. These benefits would be lost under the bill, which repeals the option of filing a consolidated return.

TECHNICAL ISSUES

TRD:

Making the changes applicable to tax years beginning on or after January 1, 2008, would change the tax reporting method required from many corporations for their current tax year, which is already underway. These corporations would be required to change their tax computations almost immediately in order to make estimated payments by June 15, 2008. TRD would not be able to provide much guidance to affected companies; significant lead time would be required to develop regulations and other guidance. A delayed applicability date would allow corporations time to implement the change and TRD time to provide crucial guidance.

DFA has provided an analysis of the legal terminology and possible technical issues:

It is unclear how the mandatory grouping of unitary corporations to be taxed by the state will be determined. It would be quite easy to determine the grouping by referring to all corporations included in a federal consolidated return. However, section 3 of the bill repeals the current section permitting elective filing of a New Mexico return showing all members of the federal consolidated group. We are left with the vague phrase, "combined return with other unitary corporations" with no further hints about how the combined group will be determined.

The concept of nexus is important here. It is likely that some members of a federal consolidated group will not have direct or vicarious nexus with the unitary corporation subject to the mandatory combined filing proposed in the bill. The state cannot tax corporations that have no nexus with the state. Therefore, a mandatory consolidated rule is not reasonable.

From the definitions section, "unitary corporations" means two or more integrated corporations, other than any foreign corporation incorporated in a foreign country and not engaged in trade or business in the United States during the taxable year, that are owned in the amount of more than fifty percent and controlled by the same person and for which at least one of the following conditions exists:

(1) there is a unity of operations evidenced by central purchasing, advertising, accounting or other centralized services;

(2) there is a centralized management or executive force and centralized system of operation; or

(3) the operations of the corporations are dependent upon or contribute property or services to one another individually or as a group.

That definition seems to be useful for all concerned. Tax the unitary group as though it were one corporation. Eliminate transactions among the members of the unitary grouping by applying the federal consolidated filing rules. With this approach, the nexus is clear through the control of the in-state member of the group, even though the holding company or parent has no other connection with the state. The 50% ownership plus the other tests should be sufficient to establish nexus for the unitary group. It is not clear if the phrase, "combined return with other unitary corporations" on lines 7 and 8, pg. 2 of the bill intends to extend the reach of the New Mexico corporate income tax to a grouping larger than the unitary group so carefully defined.

ALTERNATIVES

To ensure that there is no negative impact on the general fund, the percentage going to the public school fund could be lowered.

ADDITIONAL POLICY DISCUSSION FROM TRD

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 that eliminates all inter-company transactions. Texas recently adopted mandatory combined reporting for their tax. The Blue Ribbon Tax Commission endorsed the concept of mandatory combined reporting in 2003.

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 royalty and interest amounts paid to "intangible holding companies" based in low-tax states like Delaware. The discretionary powers necessary to properly implement both the "add-back" provisions and the "forced combination" techniques have generated significant litigation. New York and West Virginia recently enacted mandatory combined filing, and other Eastern states are considering it in response to budget shortfalls.

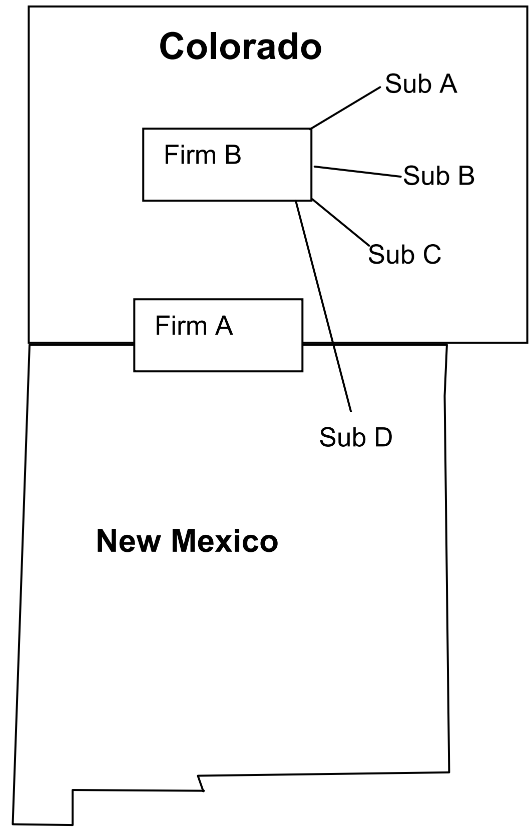
Background Information:
Current Law
Corporations with a taxable presence ("nexus") in the State must file a New Mexico corporate income tax return. A corporation may elect to file as a "separate corporate entity" (SCE), or file a return that includes affiliate corporations under one of two methods: "unitary combined" or "federal consolidated". These filing-method options are sometimes referred to as "the ladder" because when moving from SCE to combined to consolidated reporting, corporations generally include larger amounts of corporate income in their New Mexico corporate income tax return (before allocation and apportionment; see below). After the first filing year, corporations are allowed to elect a different filing method without permission from TRD if the new filing method is higher on the filing method "ladder". That is, a corporation is allowed to change from SCE filing to combined or consolidated filing, or from combined to consolidated, without permission. A corporation cannot, however, change from combined or consolidated to SCE, or from consolidated to combined, without permission, and TRD generally does not approve such an election unless the corporation has reorganized in a way that justifies the change or the proposed new reporting method would better reflect industry practices than the corporation's current method.

State Corporate Income Tax Rates and Reporting Methods

	State Corporate Tax Rates			Combined and Consolidated Reporting			
		If Multiple Rates:					
State	Top Rate	Lowest Rate	Number of Brackets	Mandatory	State May Require	State May Permit	Taxpayer May Elect
Alabama	6.5						Consolidated
Alaska	9.4	1.0	10	Both			
Arizona	6.968			Combined	Consolidated	Consolidated	Consolidated
Arkansas	6.5	1.0	6			Consolidated	
California	8.84			Combined	Combined	Combined	Combined
Colorado	4.63			Combined			Consolidated
Connecticut	7.5					Consolidated	Combined
Delaware	8.7						
District of Colum	9.975				Consolidated		
Florida	5.5						Consolidated
Georgia	6.0				Consolidated	Consolidated	
Hawaii	6.4	4.4	3		Both	Consolidated	
Idaho	7.6			Combined			
Illinois	7.3			Combined			
Indiana	8.5				Both	Combined	
Iowa	12.0	6.0	4		Consolidated		Consolidated
Kansas	4.0				Combined	Consolidated	Combined
Kentucky	7.0	4.0	3	Consolidated			
Louisiana	8.0	4.0	5		Both		
Maine	8.93	3.5	4	Combined			
Maryland	7.0						
Massachusetts	9.5				Consolidated		Combined
Michigan	4.95				Consolidated	Consolidated	
Minnesota	9.8			Combined			
Mississippi	5.0	3.0	3			Combined	
Missouri	6.25					Consolidated	
Montana	6.75			Combined		Consolidated	Consolidated
Nebraska	7.81	5.58	2	Both			
Nevada	----- *No Corporate Income Tax* -----						
New Hampshire	8.5			Combined			
New Jersey	9.0	6.5	3		Consolidated		
New Mexico	7.6	4.8	3				Both
New York	7.5			Combined			
North Carolina	6.9				Both		
North Dakota	7.0	2.6	5	Combined			
Ohio	8.5	5.1	2		Combined	Combined	
Oklahoma	6.0					Consolidated	Consolidated
Oregon	6.6			Consolidated			
Pennsylvania	9.99						
Rhode Island	9.0						
South Carolina	5.0					Consolidated	Combined
South Dakota	----- *No Corporate Income Tax* -----						
Tennessee	6.5				Both	Both	
Texas	1.0	0.5	2	Combined			
Utah	5.0			Combined			
Vermont	8.5	6.0	3	Combined			Consolidated
Virginia	6.0					Consolidated	
Washington	----- *No Corporate Income Tax* -----						
West Virginia	8.75			Combined			Consolidated
Wisconsin	7.9						
Wyoming	----- *No Corporate Income Tax* -----						

Sources: Federation of Tax Administrators; *2007 Multistate Tax Guide* , CCH Inc.; Web sites of State Tax Departments.

All three filing methods require the allocation and apportionment of income under the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA and associated regulations provide rules whereby a corporation (or affiliated group of corporations) operating in more than one state divide income and expenses among the states in which they operate. Generally, non-business income is allocated whereas business income is apportioned using a three-factor formula based on the separate ratios of property, payroll and sales within a state to the total amount of the respective factor in all states. UDITPA provides special allocation and apportionment rules for certain industries, including airlines, railroads, construction contractors, trucking companies, broadcasters, and to firms in the publishing and financial industries.



Unitary Business

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. The income of a group of businesses that has been determined to be a unitary group can only feasibly be sourced among states by combining the incomes of all members of the group and apportioning that combined income among states by formula. 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. As illustrated in the figure below, the amount of business income subject to apportionment generally increases as a corporation moves from SCE to combined to consolidated reporting.

The figure shows two affiliated corporations, Firm A and Firm B. Firm A operates partially within both New Mexico and Colorado, but Firm B itself operates only in Colorado. However, Firm B has four subsidiaries, three of which (Sub A, Sub B and Sub C) operate only in Colorado, with the fourth (Sub D) operating in New Mexico. Firms A and B (but not necessarily B's subsidiaries) are assumed to be a unitary group (because of, for example, shared trademarks, ownership, purchasing or other activities), and also to be a consolidated group for federal income tax purposes.

Under "separate corporate entity" (SCE) reporting, Firm A is allowed to file its New Mexico corporate income tax return as if it were a separate entity totally unrelated to Firm B or its subsidiaries. All of Firm A's income would be included in its return, but its business income would be apportioned between Colorado and New Mexico using the three-factor apportionment formula. The income and apportionment factors of Firm B and its subsidiaries would be excluded from Firm A's return. (Sub D would be required to file a New Mexico corporate income tax return, which it is assumed would be filed using SCE reporting.)

Under "unitary combined" reporting, Firms A and B would combine their income and report as if they were a single firm. If any of the subsidiaries of Firm B are not considered part of the unitary business, their incomes would not be included, nor would their property, payroll and sale be included in the denominator of the apportionment factors. Under "federal consolidated" reporting, Firms A and B and all of B's subsidiaries would be included in the return (assuming they all formed a federal consolidated group). Under both "unitary combined" and "federal consolidated" reporting, the income of all included corporations would be included in the return, with transactions among the included corporations eliminated. The return would also include the apportionment factors of all the included corporations.

Effect of Reporting Method on Corporate Income Tax Liability
The movement from separate corporate entity to unitary combined to federal consolidated reporting generally increases the taxable income reported on a return, which in itself would increase income tax liability. However, as each affiliate's income is added to the return, the affiliate's apportionment factors are also added to the return, which would decrease income tax liability if the affiliate has no in-state activities. Whether a corporation's income tax liability increases or decreases under alternative reporting methods depends on whether the effect on taxable income outweighs the effect on apportionment factors. It also depends on whether an included affiliate has losses, which might reduce the taxable income that would be reported under a lower reporting method on the "ladder".

Eliminating one or more of the elective filing method options available under current law would be expected to increase revenues, on the assumption that firms have elected the filing method that minimizes their corporate income tax liabilities over time. However, if the elimination of a filing option resulted in some firms deciding to reduce their operations in the State, or new firms deciding not to locate in the State, there could be some partially offsetting negative revenue impact from eliminating options.

Numbers of Returns Filed by Reporting Method
As shown in the following table, in tax year 2005 approximately 18,000 firms filed New Mexico corporate income tax returns as separate corporate entities (SCE). Approximately 500 returns were filed as combined unitary, while 1,057 firms filed federal consolidated returns. SCE filers paid approximately 54 percent of the tax, combined filers paid approximately 14 percent of the tax obligations, and federal consolidated return filers paid approximately 32 percent of New Mexico's corporate income tax. SCE filers *tend* to be relatively small firms, although they can be quite large. The average tax liability among SCE filers was approximately $9,750, while combined filers averaged approximately $95,000 per return and consolidated filers averaged approximately $100,000 per return. Major SCE filers consisted primarily of firms in the mining extraction and manufacturing industries. Firms in mining industries are also heavily represented among combined and consolidated filers.

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