

Corporate Income Tax and Policy Considerations

Presentation by Richard Anklam, Executive
Director, New Mexico Tax Research Institute

To

The Interim Revenue Stabilization and Tax Policy
Committee

September 15, 2009
Cloudcroft, NM

Corporate Income Tax - General

- Corporate income tax is a tax on profits
- Owners of corporations pay tax on profits at the corporate level and as individuals
- Small to medium businesses typically don't pay corporate income taxes – so their owners only pay tax once.
- In most states and in New Mexico, IRS rules primarily determine “taxable income.”

Corporate Income Tax – Calculation

- **Filing methods (options and elections as to what corporations are included in a return)**
- Taxable income (base of the tax)
- **Apportionment Method (what share does NM get of taxable income)**
- **Tax Rate**
- Incentives and Credits

Corporate Income Tax

- Because it takes all elements to calculate the corporate income tax, no one element of the corporate income tax can be analyzed separately from the other elements – they all matter.

Good Tax Policy - Considerations

- Adequacy and stability of revenue source
- Equitable toward similarly situated taxpayers
- Ease of administration and compliance
- Impact on economic activity and development

Adequacy and Stability - Generally

- State corporate income taxes nationwide raise, on average, 6% of state revenues (NM's percentage is around 5%).
- Corporate income taxes are one of the most unstable tax revenue sources. In part this is because the tax is based on income and corporations generate losses as well as income depending on the circumstances.

NM Filing Groups/Methods

- Separate Entity
 - Default – single legal entity
- Combined
 - “unitary” group of related companies as defined by application of the unitary business principle
- Consolidated
 - Group of related companies as defined by the Internal Revenue Code.

Adequacy and Stability

- Mandatory combined filing has been predicted to generate additional revenue. In a recession, however, not only is the incremental revenue that could be generated greatly reduced by combined filing is likely to pull in losses from out of state.
 - The exception is if no losses are allowed to be offset – which could cause severe problems for businesses struggling in the recession.

Equitable Treatment - Generally

- Because small to medium sized businesses can avoid corporate income tax, the tax is more likely to burden larger multi-state businesses.
- Policy reasons for this different tax treatment of corporations may have existed at one time but are less clear now. States provide services to corporations but they also provide services to other non-taxed entities.

Ease of Administration

- State corporate income tax is very complex to administer and to comply with.
 - State corporate income tax is as complicated as every other state tax combined.
- Compared to the revenue generated, this complexity is relatively significant.

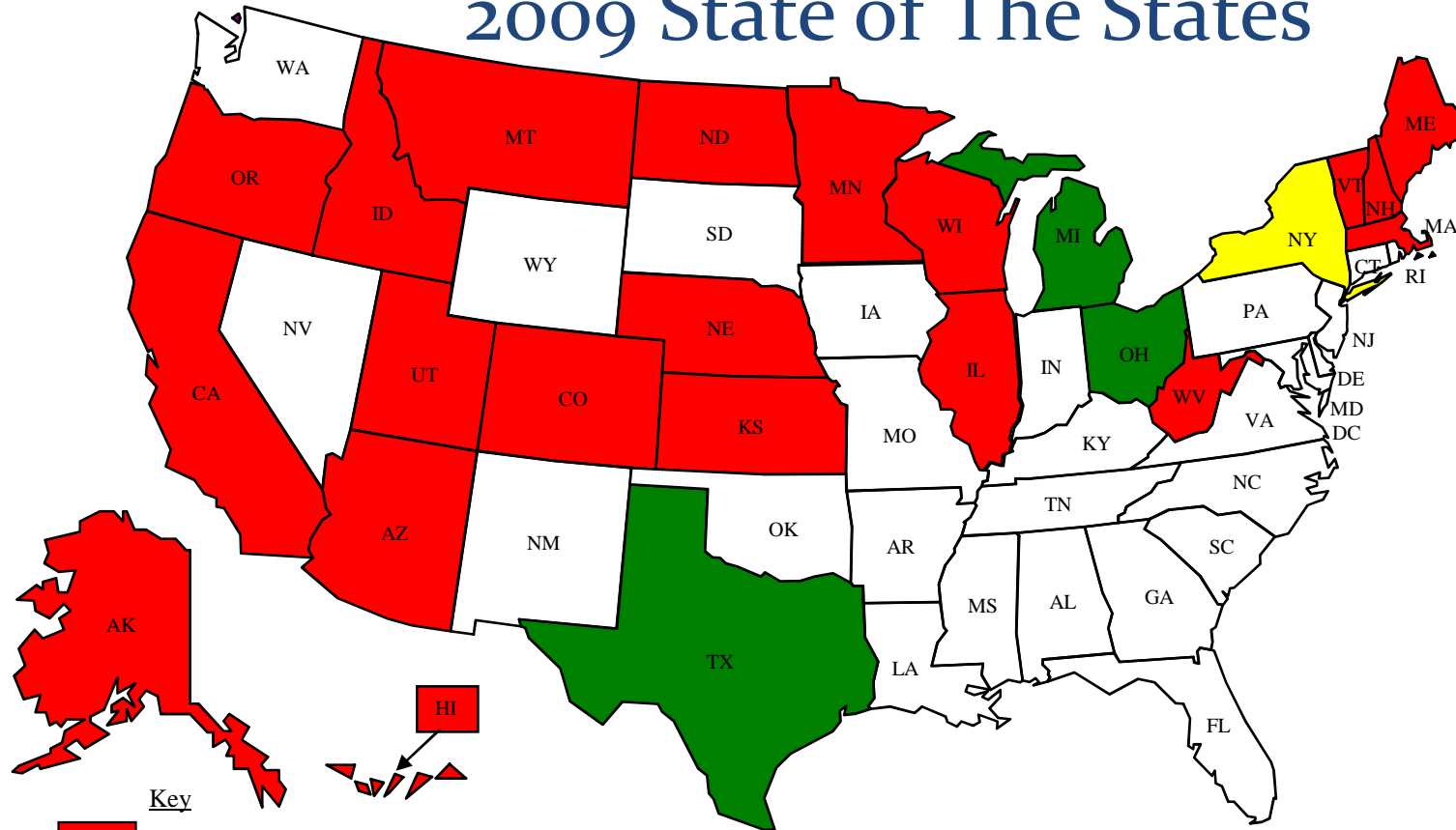
Impact on Economic Activity

- Within very broad boundaries, states are free to structure their corporate income taxes in various different ways – and they do.
- Because the tax generally falls on larger, multi-state companies, the impact of a particular state's corporate income tax may impact the amount of activity or investment a corporation makes in that state.

Filing Method

- In general, states may allow or require corporations to report and pay tax on a separate entity basis or may allow or require corporations to report and pay tax on a combined or allow the consolidated basis.
- If a state allows or requires combined filing, it may have different rules for how to determine the proper combined group.

Combined Reporting: 2009 State of The States



Key

- Mandatory unitary combined reporting
- Combined reporting – not on a unitary basis – “substantial intercorporate transactions”
- Provide for combined filing, but taxes are in the form of gross receipts or other hybrid taxes
- Separate entity reporting or no corporate income tax

Filing Method

- Adequacy/stability – estimators expect that combined filing may generate additional revenue, although the exact amount is very difficult to predict. Stability is not likely to be improved, so the total revenue will continue to be unstable, year to year.

Filing Method

- Equitable Treatment – While eliminating filing options and requiring all taxpayers to use one method of filing would create more *uniformity*, it would not necessarily create equity. Allowing options is a benefit for taxpayers in that it lets them choose the best method for their circumstances, and in NM's case may to some extent offset uncompetitive rate.

Filing Method

- Ease of Administration/Compliance – Of the three filing methods NM allows currently, consolidated filing is easiest because it conforms to federal. Single entity is the next easiest because it is clear what a single entity is. Combined, because of the definition of what is a “unitary” business, is the hardest.

Filing Method

- Ease of Administration/Compliance – The separate filing method has been abused in the past. TRD has one two important cases allowing them to address this abuse and we understand that dozens of companies have since settled with the department. So the question is whether the abuse is still continuing or whether it has already been addressed.

Filing Method

- Impact on Economic Development – All things being equal, given NM's current income tax, the separate filing method is a significant incentive for large, *profitable* companies located elsewhere to expand into or make investments in New Mexico that may not initially be profitable.

Filing Method

- Impact on Economic Development – All things being equal, allowing companies to elect the combined filing methods allows affiliated companies, some with losses and others with profits, to offset profits and losses if they choose, and *if the businesses are unitary*.

Apportionment Method

- States can choose a wide variety of formulas for determining what portion of a multistate company's income is taxable in that state.
- The “traditional” formula, is the so-called “three factor formula.” That formula uses the multistate company's property, payroll and sales everywhere and in that particular state to come up with a percentage that is applied to taxable income.

Apportionment Method

- New Mexico uses the traditional three factor formula. (There is a minor exception for electing manufacturers that is generally of little benefit to taxpayers.)
- The traditional formula increases the NM tax on a company when it makes investments or creates jobs in the state.

Apportionment Method

- Some states have adopted apportionment formulas that reduce the emphasis on property and payroll and increase the emphasis on sales – making it more advantageous for companies to create “economic base jobs” in the state. Of the surrounding states, Arizona, Colorado, Utah and Texas have adopted such formulas.

Apportionment Method

- A change in NM's apportionment method to attract investment would likely reduce total corporate income tax revenue.

Tax Rate

- New Mexico has the highest marginal tax rate of any surrounding/competing state at 7.6%.
 - AZ is second at 6.968%
 - Followed by OK 6%
 - UT 6%
 - CO 4.63%
 - TX (rate is applied to different base so comparison is difficult).

Blue Ribbon Tax Reform Commission

BRTC suggested:

- Reducing the tax rate;
- Mandating combined filing; and
- Clarifying “combined” definitions

Other Considerations

- Lots of clean-up and clarification is necessary in current law
- A change in rules will put more pressure on current law
- If we change the rules, we should address or clarify rules in conjunction with changes
- Don't fail to consider ED implications
- Who is really the taxpayer?