

Corporate Tax Reform Proposal

Presentation by:

**Jim Nunns, Tax Policy Director
and
Swaroop Chary, Senior Economist
N.M. Taxation and Revenue Department**

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Corporate Tax Reform Proposal

Overview

Our presentation will cover a revenue-neutral version of Senator Wirth's proposal (SCROC Substitute for SB-389 and SB-648):

- 1. Description of Proposal;**
- 2. Impact of Proposal on Example Corporations and on all Corporations by Industry in 2012; and**
- 3. Issues That Have Been Raised About the Proposal**

The presentation is not included in your books, but separate copies are available and it will be posted on TRD's web site

Please note that the proposal we are discussing today is simply a revenue-neutral version of Senator Wirth's proposal, and is not endorsed by TRD

We see today's discussion of this proposal as simply a way to open a broader dialogue on how, or whether, the current method of taxing corporations should be reformed

Corporate Tax Reform Proposal

Description of Proposal

The proposal is a revenue-neutral reform of the Corporate Income and Franchise Tax that over the 2009 – 2012 period: (1) Reduces corporate income tax rates in steps; and (2) Phases in the rate of a new corporate franchise tax

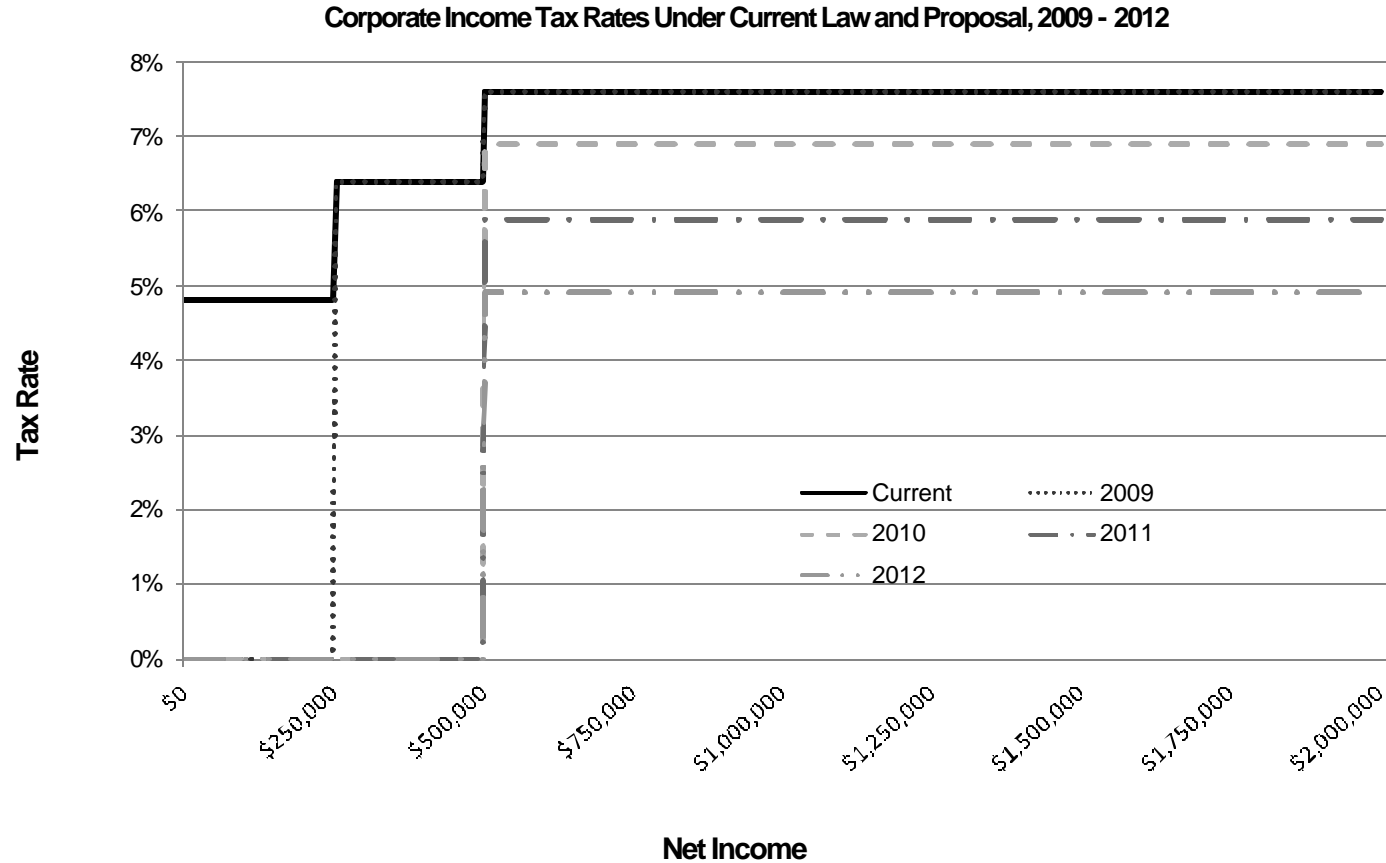
Corporate Income Tax

- **Corporate income tax rates are reduced, with the tax base unchanged**
- **Current corporate income tax rates are:**
 - **4.8% on the first \$500,000 of net income;**
 - **6.4% on the next \$500,000 of net income; and**
 - **7.6% on net income over \$1 million**
- **The proposal reduces corporate income tax rates over the 2009 – 2012 period:**
 - **In 2009, the rate on the first \$250,000 of net income is reduced to zero**
 - **In 2010, the zero rate extends to \$500,000 and the top rate is reduced to 6.9%**
 - **In 2011, the rate for net income in excess of \$500,000 is reduced to 5.9%**
 - **In 2012, the rate for net income in excess of \$500,000 is reduced to 4.9%**
 - **The 2012 rate structure applies in all future years**
- **The following graph shows current and proposed rates**

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Description of Proposal – Cont.

Corporate Income Tax – Cont.



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Description of Proposal – Cont.

New Corporate Franchise Tax

- **The new franchise tax amount is based on a corporation's property, payroll and sales in New Mexico in excess of these thresholds:**
 - **Property -- \$5 million;**
 - **Payroll -- \$1.2 million**
 - **Sales -- \$9.3 million**

- **Property, payroll and sales in New Mexico are the same amounts used for apportionment of corporate income tax**

- **The property, payroll and sales of related business entities are included**
 - **Related business entities are defined as partnerships and LLCs not taxed as corporations in which the corporation holds (directly or indirectly) more than a 20 percent ownership interest**
 - **Business entities with a common owner (of more than 20 percent) are deemed related**
 - **Ownership of 80 percent or more would be treated as 100 percent ownership**
 - **Property, payroll and sales would be taken into account only once**

Corporate Tax Reform Proposal

Description of Proposal – Cont.

New Corporate Franchise Tax – Cont.

- **The rate of the new franchise tax would be phased in to maintain revenue neutrality of the proposal:**
 - **In 2009, the rate would be 0.05%**
 - **In 2010, 0.11%**
 - **In 2011, 0.15%**
 - **In 2012, 0.18%**
 - **The 2012 rate might need to be adjusted to maintain revenue neutrality in future years**

- **The tentative franchise tax (New Mexico property, payroll and sales times the applicable rate for the year) would be reduced, but not below zero, by the corporation's income tax liability for the year**

The new franchise tax calculation in 2009 is illustrated in the following form:

Corporate Tax Reform Proposal

Description of Proposal – Cont.

New Corporate Franchise Tax – Cont.

Illustration of Calculation of New Franchise Tax in 2009

| Factor | Amount in New Mexico (a) | Threshold (b) | Amount Over Threshold [(a)-(b), or 0] (c) | Tax [= amount in (c) x .0005] (d) |
|--|---|--------------------------|--|--|
| 1. Property | | \$5,000,000 | | |
| 2. Payroll | | \$1,200,000 | | |
| 3. Sales | | \$9,300,000 | | |
| 4. Total (add amounts in column (d), lines 1-3) | | | | |
| 5. Corporate Income Tax Due | | | | |
| 6. Franchise Tax Due (subtract line 5 from line 4; enter zero if line 5 is greater than line 4) | | | | |

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Impact of Proposal

Impact on Example Corporations in 2012

The four example firms are composites based on information reported on New Mexico corporate income tax returns filed for 2006

The following table shows the 2012 impact of the proposal on example firms

| Example | Current Law Tax | Tax Under Proposal | Change in Tax |
|--|------------------------|---------------------------|----------------------|
| 1: Small NM Company | \$50 | \$50 | \$0 |
| 2: Medium-Sized NM Company | \$16,850 | \$50 | -\$16,800 |
| 3: Large Multi-State Manufacturer | \$1,156,963 | \$783,813 | -\$418,150 |
| 4: Large Multi-State Big-Box Retailer | \$643,229 | \$971,150 | +\$327,921 |

The examples illustrate how corporate tax liabilities would be altered by the proposal, with a shift of liabilities to large corporations that are paying disproportionately less under current law

The characteristics of the example firms, which apply under both current law and the proposal, are shown in the following tables

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Example 1: Small New Mexico Corporation in 2012

Corporate taxable income: **\$0**

Apportionment factors and ratios:

| Factor | In New Mexico | In All States | Ratio |
|------------------------------------|----------------------|----------------------|--------------|
| Property | \$300,000 | \$300,000 | 1.0 |
| Payroll | \$90,000 | \$90,000 | 1.0 |
| Sales | \$350,000 | \$350,000 | 1.0 |
| Average Apportionment Ratio | | | 1.0 |

Example 2: Medium-Sized New Mexico Corporation in 2012

Corporate taxable income: **\$350,000**

Apportionment factors and ratios:

| Factor | In New Mexico | In All States | Ratio |
|------------------------------------|----------------------|----------------------|--------------|
| Property | \$3,000,000 | \$3,000,000 | 1.0 |
| Payroll | \$625,000 | \$625,000 | 1.0 |
| Sales | \$3,500,000 | \$3,500,000 | 1.0 |
| Average Apportionment Ratio | | | 1.0 |

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Example 3: Large Multi-State Manufacturing Corporation in 2012

Corporate taxable income (total reported to New Mexico): **\$25,000,000**

Apportionment factors and ratios:

| Factor | In New Mexico | In All States | Ratio |
|------------------------------------|----------------------|----------------------|--------------|
| Property | \$120,000,000 | \$171,500,000 | 0.70 |
| Payroll | \$25,000,000 | \$56,000,000 | 0.45 |
| Sales | 140,000,000 | 200,000,000 | 0.70 |
| Average Apportionment Ratio | | | 0.62 |

Example 4: Large Multi-State Big-Box Retail Corporation in 2012

Corporate taxable income (total reported to New Mexico): **\$14,000,000**

Apportionment factors and ratios:

| Factor | In New Mexico | In All States | Ratio |
|------------------------------------|----------------------|----------------------|--------------|
| Property | 160,000,000 | \$240,000,000 | 0.67 |
| Payroll | \$25,000,000 | 48,000,000 | 0.52 |
| Sales | 370,000,000 | 560,000,000 | 0.66 |
| Average Apportionment Ratio | | | 0.62 |

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Impact of Proposal – Cont.

Impact on All Corporations by Industry in 2012

- **The following tables show the impact of the proposal by industry in 2012 (three tables)**
- **These tables are based on New Mexico corporate income tax returns filed in 2006, extrapolated to 2012**
- **The first table in the set shows the impact by industry for all corporations operating in New Mexico**
- **The second table shows the impact on companies with a tax reduction**
- **The third table shows the impact on companies with a tax increase**

Corporate Tax Reform Proposal

Corporate Tax Reform Proposal in 2012 -- All Companies Operating In New Mexico

| Industry | Number of Companies | Under Current Law ⁴ | | Change in Corporate Tax Liability | | |
|--|---------------------|--------------------------------|----------------------|-----------------------------------|---------------|--------------|
| | | Number of Returns | Amount (\$ millions) | Income Tax | Franchise Tax | Total |
| Oil and Gas | 185 | 110 | 80.6 | (29.1) | 27.1 | (2.0) |
| Other Mining | 694 | 410 | 55.1 | (21.0) | 5.6 | (15.4) |
| Utilities ¹ | 101 | 38 | 10.4 | (3.9) | 14.2 | 10.3 |
| Manufacturing | 1,605 | 699 | 73.1 | (29.0) | 20.6 | (8.4) |
| Retail Trade | 1,536 | 715 | 18.2 | (8.8) | 26.9 | 18.1 |
| Information ² | 614 | 207 | 46.1 | (17.2) | 10.9 | (6.3) |
| Finance and Insurance | 1,819 | 505 | 15.7 | (7.1) | 9.0 | 1.9 |
| Professional, Scientific & Technical Services ³ | 2,319 | 878 | 6.4 | (3.8) | 8.3 | 4.5 |
| All Other Industries | <u>10,507</u> | <u>4,214</u> | <u>84.8</u> | <u>(40.4)</u> | <u>37.7</u> | <u>(2.7)</u> |
| Total | 19,380 | 7,776 | 390.4 | (160.3) | 160.2 | 0.0 |

| Industry | Corporate Tax Liability Under Proposal | | | | | |
|--|--|----------------------|----------------------------|----------------------|-------------------|----------------------|
| | Corporate Income Tax | | Franchise Tax ⁵ | | Total | |
| | Number of Returns | Amount (\$ millions) | Number of Returns | Amount (\$ millions) | Number of Returns | Amount (\$ millions) |
| Oil and Gas | 26 | 51.5 | 32 | 27.1 | 45 | 78.6 |
| Other Mining | 66 | 34.1 | 50 | 5.6 | 105 | 39.7 |
| Utilities ¹ | 9 | 6.5 | 12 | 14.2 | 16 | 20.6 |
| Manufacturing | 120 | 44.1 | 219 | 20.6 | 286 | 64.8 |
| Retail Trade | 72 | 9.4 | 126 | 26.9 | 158 | 36.3 |
| Information ² | 43 | 28.9 | 54 | 10.9 | 86 | 39.8 |
| Finance and Insurance | 55 | 8.6 | 83 | 9.0 | 125 | 17.6 |
| Professional, Scientific & Technical Services ³ | 42 | 2.6 | 115 | 8.3 | 142 | 10.8 |
| All Other Industries | <u>331</u> | <u>44.4</u> | <u>650</u> | <u>37.7</u> | <u>861</u> | <u>82.1</u> |
| Total | 764 | 230.1 | 1,341 | 160.2 | 1,824 | 390.3 |

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Corporate Tax Reform Proposal in 2012 --Companies with a Tax Reduction

| Industry | Number of Companies | Under Current Law ⁴ | | Change in Corporate Tax Liability | | |
|--|---------------------------|--------------------------------|-------------------------|-----------------------------------|------------------|----------------|
| | | Number of Returns | Amount (\$ millions) | Income Tax | Franchise Tax | Total |
| Oil and Gas | 102 | 102 | 70.4 | (25.4) | 2.4 | (23.0) |
| Other Mining | 395 | 395 | 53.6 | (20.4) | 0.0 | (20.4) |
| Utilities ¹ | 32 | 32 | 4.6 | (1.8) | 0.1 | (1.7) |
| Manufacturing | 651 | 651 | 69.8 | (27.3) | 8.7 | (18.6) |
| Retail Trade | 668 | 668 | 11.0 | (5.8) | 1.3 | (4.5) |
| Information ² | 200 | 200 | 45.4 | (16.9) | 0.2 | (16.7) |
| Finance and Insurance | 490 | 490 | 12.6 | (5.9) | 0.2 | (5.7) |
| Professional, Scientific & Technical Services ³ | 862 | 862 | 5.0 | (3.3) | 0.3 | (3.0) |
| All Other Industries | <u>4,069</u> | <u>4,069</u> | <u>72.8</u> | <u>(35.1)</u> | <u>4.7</u> | <u>(30.4)</u> |
| Total | 7,469 | 7,469 | 345.2 | (141.9) | 17.9 | (124.0) |

| Industry | Corporate Tax Liability Under Proposal | | | | | |
|--|--|-------------------------|----------------------------|-------------------------|----------------------|-------------------------|
| | Corporate Income Tax | | Franchise Tax ⁵ | | Total | |
| | Number of Returns | Amount (\$ millions) | Number of Returns | Amount (\$ millions) | Number of Returns | Amount (\$ millions) |
| Oil and Gas | 21 | 45.0 | 8 | 2.4 | 21 | 47.4 |
| Other Mining | 61 | 33.2 | 13 | 0.0 | 68 | 33.2 |
| Utilities ¹ | 5 | 2.8 | 3 | 0.1 | 6 | 2.9 |
| Manufacturing | 95 | 42.5 | 59 | 8.7 | 126 | 51.2 |
| Retail Trade | 48 | 5.2 | 31 | 1.3 | 63 | 6.4 |
| Information ² | 40 | 28.5 | 10 | 0.2 | 42 | 28.7 |
| Finance and Insurance | 47 | 6.7 | 16 | 0.2 | 58 | 6.9 |
| Professional, Scientific & Technical Services ³ | 38 | 1.7 | 45 | 0.3 | 72 | 2.0 |
| All Other Industries | <u>283</u> | <u>37.7</u> | <u>173</u> | <u>4.7</u> | <u>384</u> | <u>42.4</u> |
| Total | 638 | 203.3 | 357 | 17.7 | 840 | 221.0 |

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Corporate Tax Reform Proposal in 2012 --Companies with a Tax Increase

| Industry | Number of Companies | Under Current Law ⁴ | | Change in Corporate Tax Liability | | |
|--|---------------------|--------------------------------|----------------------|-----------------------------------|---------------|--------------|
| | | Number of Returns | Amount (\$ millions) | Income Tax | Franchise Tax | Total |
| Oil and Gas | 24 | 8 | 10.2 | (3.7) | 24.7 | 21.0 |
| Other Mining | 37 | 15 | 1.6 | (0.6) | 5.5 | 4.9 |
| Utilities ¹ | 10 | 6 | 5.8 | (2.1) | 14.1 | 12.0 |
| Manufacturing | 160 | 48 | 3.3 | (1.6) | 11.9 | 10.3 |
| Retail Trade | 95 | 47 | 7.3 | (3.0) | 25.6 | 22.6 |
| Information ² | 44 | 7 | 0.6 | (0.3) | 10.7 | 10.5 |
| Finance and Insurance | 67 | 15 | 3.1 | (1.2) | 8.8 | 7.6 |
| Professional, Scientific & Technical Services ³ | 70 | 16 | 1.3 | (0.6) | 8.0 | 7.4 |
| All Other Industries | <u>477</u> | <u>145</u> | <u>12.0</u> | <u>(5.3)</u> | <u>33.0</u> | <u>27.7</u> |
| Total | 984 | 307 | 45.3 | (18.5) | 142.4 | 123.9 |

| Industry | Corporate Tax Liability Under Proposal | | | | | |
|--|--|----------------------|----------------------------|----------------------|-------------------|----------------------|
| | Corporate Income Tax | | Franchise Tax ⁵ | | Total | |
| | Number of Returns | Amount (\$ millions) | Number of Returns | Amount (\$ millions) | Number of Returns | Amount (\$ millions) |
| Oil and Gas | 5 | 6.5 | 24 | 24.7 | 24 | 31.2 |
| Other Mining | 5 | 0.9 | 37 | 5.5 | 37 | 6.4 |
| Utilities ¹ | 4 | 3.7 | 10 | 14.1 | 10 | 17.8 |
| Manufacturing | 25 | 1.7 | 160 | 11.9 | 160 | 13.6 |
| Retail Trade | 24 | 4.3 | 95 | 25.6 | 95 | 29.9 |
| Information ² | 3 | 0.4 | 44 | 10.7 | 44 | 11.1 |
| Finance and Insurance | 8 | 1.9 | 67 | 8.8 | 67 | 10.7 |
| Professional, Scientific & Technical Services ³ | 4 | 0.8 | 70 | 8.0 | 70 | 8.7 |
| All Other Industries | <u>48</u> | <u>6.7</u> | <u>477</u> | <u>33.0</u> | <u>477</u> | <u>39.7</u> |
| Total | 126 | 26.8 | 984 | 142.4 | 984 | 169.2 |

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Notes to Tables

¹ Utilities include electrical generation, electrical transmission, natural gas distribution and water supply.

² Information includes telecommunications (telephone, mobile phone, internet providers, cable and satellite), radio and television broadcasting and newspaper and magazine publishing.

³ Professional services include legal services, architectural services, accounting and business consulting; scientific and technical services include research, computer hardware and software services, and repair services for appliances and technical equipment.

⁴ Corporate income tax liability before credits. Excludes current \$50 franchise tax.

⁵ Franchise Tax Thresholds: \$5 Million for Property, \$1.2 Million for Payroll and \$9.3 Million for Sales; Franchise Tax Rate in 2012 is 0.0018 (0.18%).

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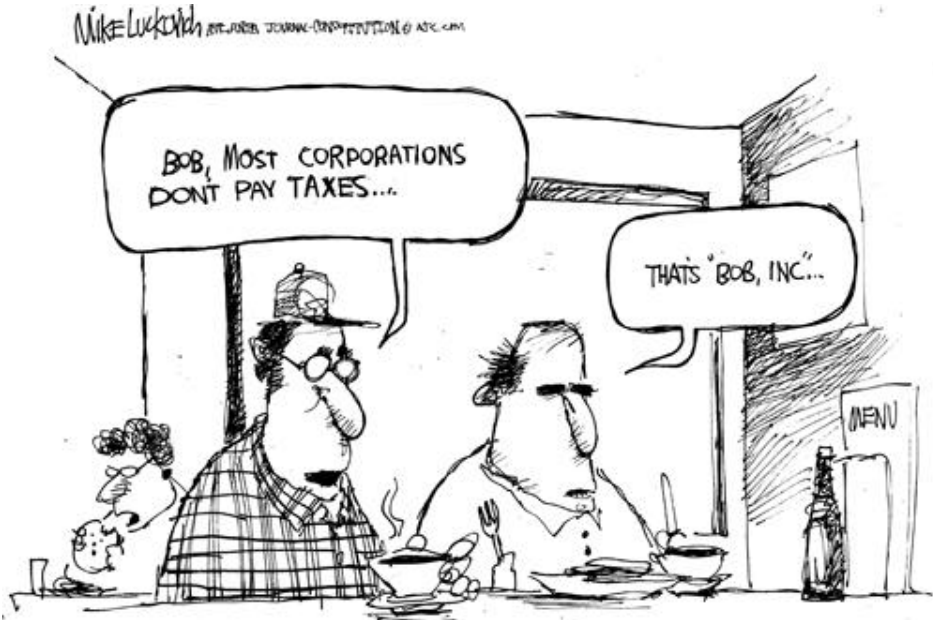
Impact of Proposal – Cont.

Impact on All Corporations by Industry in 2012 – Cont.

Some key results shown in the tables:

- **Of the 19,380 corporations operating in New Mexico, 7,776 (40%) would pay corporate income tax under current law in 2012**
- **The proposal would reduce the corporate tax for 7,469 corporations, over 96% of all corporations that would pay corporate income tax under current law in 2012**
 - **Corporate income tax would be eliminated for 7,012 corporations**
 - **Only 764 corporations would continue to pay corporate income tax**
- **The new franchise tax would only apply to 1,341 very large corporations**
 - **About one-fourth of these corporations (357) would still have net tax reductions under the proposal because of the corporate income tax rate cuts**
 - **The remaining 984 corporations paying the new franchise tax would have net tax increases**
 - **Only 307, or less than one-third, of these corporations would pay corporate income tax under current law**

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Corporate Tax Reform Proposal

Issues That Have Been Raised About the Proposal

Listed below are some of the key issues various commentators have raised about the proposal, along with some observations on the issues

1. Why consider this proposal?

Observation: The proposal is intended to make the corporate tax more consistent with tax policy goals, by:

- Reducing the distortions of the corporate income tax by reducing rates;**
- Stabilizing corporate tax revenues;**
- Leveling the play field, particularly between smaller in-State companies and large multi-state companies using aggressive tax planning to avoid income tax**
- Align corporate tax liabilities with the benefits and privileges companies derive from the presence in New Mexico**

2. Why tax corporations with no net income?

Observation: Corporations derive benefits and privileges from their presence in New Mexico whether or not they report new income to the State, so net income should not be the sole determinate of the tax they pay.

In addition, the proposal stabilizes corporate tax revenues precisely because it is not based solely on net income

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Issues That Have Been Raised About the Proposal – Cont.

3. Why does the proposal apply the franchise tax only to corporate businesses?

Observation: New Mexico has imposed a separate corporate income tax since 1919. The proposal is a revenue-neutral shift of corporate taxes to a more stable and appropriate base. For large corporations whose shareholders mostly reside in other states, a corporate-level tax is the only specific tax on their activities whereas non-corporate business income of all owners is taxed.

4. Why does the proposal only apply to large corporations?

Observation: There are three reasons for this approach:

- The “zero bracket” in the income tax and the new franchise tax thresholds preserve the attractiveness of New Mexico for startup companies;**
- Smaller corporations likely would incur more costs complying with the new franchise tax than they would owe in tax if the thresholds were lower (or removed); and**
- The thresholds remove potential issues of taxability for corporations that have minor operations in the State.**

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Issues That Have Been Raised About the Proposal – Cont.

5. Doesn't the proposal narrow the corporate tax base?

Observation: While the “zero bracket” would effectively narrow the corporate income tax base by less than 7 percent, the franchise tax base (above the thresholds) is roughly 400 times as large as the corporate tax base.

6. By taxing property, payroll and sales in New Mexico, won't the new franchise tax discourage investment, hiring and expansion in New Mexico?

Observation: The proposal reduces or eliminates the corporate income tax for all corporations that pay any tax under current law, which should improve incentives to invest, hire and expand in New Mexico. Since disincentive effects rise with tax rate, the reduction of the top corporate income tax rate from 7.6% to 4.9% paid for with a franchise tax rate that rises only to 0.18% should reduce disincentives even for corporations that pay the franchise tax.

7. Won't the “zero bracket” encourage non-corporate entities to incorporate?

Observation: No, because any savings in New Mexico income tax would be more than offset by federal income tax liability.

Corporate Tax Reform Proposal

Issues That Have Been Raised About the Proposal – Cont.

8. Doesn't the proposal add significant complexity to corporate taxation?

Observation: The proposal simplifies corporate taxes for most corporations by removing them from New Mexico income tax. The few large corporations subject to the new franchise tax would be using apportionment factors they virtually all are using anyway to apportion corporate income tax, so would have little added compliance costs.

9. Isn't the requirement to include the apportionment factors of related business entities a complicated new "unitary" rule?

Observation: No, this requirement has nothing to do with the concept of "unitary" used for combined reporting for income tax purposes. The proposal uses a simple notion of related entities is very common throughout the tax law and is well understood and generally quite straightforward to apply.

10. Aren't the UDITPA definitions of apportionment factors outdated?

Observation: The definitions aren't new, and that in itself is a virtue. But the definitions should be periodically reviewed in a comprehensive way, and that is what the Uniform Law Commission (ULC, previously known as the NCCUSL) is considering. The definitions can be revisited when the ULC work is complete.