Corporate Income and Franchise Tax Review and Alternatives

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Corporate Income and Franchise Tax Review and Alternatives

Overview

My presentation will cover three areas:

1. **Policy issues raised by the corporate income tax;**
2. **Mandatory combined reporting and corporate income tax revenues; and**
3. **Alternatives**

Policy Issues Raised by the Corporate Income Tax

- **New Mexico's corporate income tax generally conforms to the basic design and provisions of the federal tax**

- **The federal corporate income tax operates as a separate tax from the federal individual income tax**

- **This means that corporate income is taxed twice:**

  - **First at the corporate level as it is earned, and**

  - **Again at the individual shareholder level when (after-tax) corporate income is distributed to shareholders as dividends or shareholders realize capital gains on the sale of the corporation's stock**

- **Three significant economic distortions arise from this "double tax" design:**

  - **<u>First</u>, because partnerships, LLCs and other non-corporate businesses are only taxed once, at the individual owner level, the corporate income tax discourages forming a business as a corporation**

  - **<u>Second</u>, because undistributed corporate income is taxed at a lower rate than distributed corporate income, the corporate income tax distorts the decision away from distributing income in favor of retaining income**

Policy Issues Raised by the Corporate Income Tax – Cont.

- **<u>Third</u>, because corporate income (the return to equity holders) is generally taxed at a higher rate than interest on loans (the return to lenders, many of which are tax exempt), the corporate income tax distorts the decision away from financing with equity in favor of financing with debt**

- **There are also significant economic distortions in the current federal corporate income tax base**

  - **Most important among these distortions are provisions that result in mistiming of deductions and income, which generally result in an understatement of net income**

  - **The largest of these mistiming provisions are those for accelerated forms of cost recovery for investments, including the "bonus depreciation" provisions of the 2008 and 2009 stimulus bills**

  - **In addition to understating certain types of income, these provisions also differentially reduce the effective tax rate on alternative forms of investment, distorting investment choices**

Policy Issues Raised by the Corporate Income Tax – Cont.

- **Another important economic distortion in the current federal income tax is the deduction for domestic production activities, which favors certain activities over others, distorting business decisions**

- **New Mexico's corporate income tax largely incorporates the design distortions in the federal corporate income tax**

- **However, at the State level the "double tax" issue differs between large and small corporations**

  - **For large corporations, the "double tax" primarily arises from the taxes of different states -- the corporate-level tax of the state in which the corporation operates, and the individual-level tax of the state(s) in which the shareholders reside**

  - **The corporate-level tax imposed on a <u>large</u> corporation by New Mexico when the corporation operates here is necessary to equalize the tax treatment of corporations and non-corporate businesses operating in the State**

    - **The entire income earned in the state by non-corporate businesses is taxed by the State, regardless of where the owners reside**

Policy Issues Raised by the Corporate Income Tax – Cont.

    - **For this reason, a separate State corporate-level tax has a separate justification from the federal corporate income tax**

    - **This is true even if the New Mexico tax can be thought of as resulting in a "double tax" because another state or states tax the dividends and capital gains of shareholders**

  - **For <u>small</u> corporations, however, both the corporation and the shareholders are likely to be taxed by New Mexico**

    - **So, New Mexico can design its tax system to mitigate the "double tax" on the income of small corporations**

- **The New Mexico corporate income tax also largely incorporates the other economic distortions due to provisions in the federal corporate income tax**

  - **Some states avoid the effect of some provisions by "decoupling" from portions of the federal tax**

  - **New Mexico has only partially decoupled from the federal net operating loss (NOL0 rules**

Policy Issues Raised by the Corporate Income Tax – Cont.

- **In addition to economic distortions due to conformity with the federal tax, other distortions arise from the New Mexico corporate income tax provisions that determine the appropriate amount of tax to impose on the income of multi-state businesses**

  - **These businesses are typically part of a large number of related entities that may have multiple transactions among them**

  - **Such transactions include sales, asset transfers, cost sharing arrangements, charges for services and royalties for the use of intangibles**

  - **The number and complexity of these transactions make the determination of the income attributable to New Mexico very difficult**

  - **New Mexico and other states have introduced provisions that attempt to properly match the income and expenses of a multi-state corporation to the activities in a state**

  - **These provisions include:**
    - **Mandatory combined reporting;**

Policy Issues Raised by the Corporate Income Tax – Cont.

- **Authority to reallocate income, deductions, and other items between related entities;**
- **“Add-back” and “anti-passive investment company” legislation;**
- **Minimum taxes; and**
- **Significant franchise taxes**

- **The table on the following two pages shows current corporate income tax rates, reporting methods, minimum taxes and franchise taxes by state**

- **These rules tend to be complex, requiring significant compliance resources from both corporations and state tax agencies**

- **They also have generated significant litigation**

- **In addition, the actual or perceived “business climate” of a state may be heavily influenced by the presence and nature of such rules**

State Income Tax Rates, Filing Methods, Rallocation Authority Between Related Parties, Alternative Minimum Tax and Franchise Tax

	State Corporate Tax Rates	If Multiple Rates:		Combined and Consolidated Reporting				Authority to Reallocate Income & Expenses Among Related Parties	Alternative Minimum Tax	Franchise Tax Base and Rate[4]
State	Top Rate	Lowest Rate	Number of Brackets	Mandatory	State May Require	State May Permit	Taxpayer May Elect			
Alabama	6.5						Consolidated	Yes		Max. of $100 or graduated percentage of Net Worth
Alaska	9.4	1.0	10	Both				Yes	Tax ("AMT")	$100
Arizona	6.968			Combined	Consolidated	Consolidated	Consolidated	Yes	Flat $50	$45
Arkansas	6.5	1.0	6			Consolidated		Yes		0.3% of Capital Stock
California	8.84			Combined	Combined	Combined	Combined	Yes	6.65% of Alternative Minimum Taxable Income ("AMTI")	8.84% of Taxable Income from business transacted in state
Colorado	4.63			Combined			Consolidated	Yes		
Connecticut	7.5					Consolidated	Combined	Yes	Greater of $250 or .31% of Capital	
Delaware	8.7							Yes		Graduated amount based on authorized shares
District of Columbia	9.975				Consolidated			NR	$100	
Florida	5.5						Consolidated	Yes	3.3% of Florida AMTI	
Georgia	6.0				Consolidated	Consolidated		Yes		Graduated amount based on Net Worth
Hawaii	6.4	4.4	3		Both	Consolidated		Yes		
Idaho	7.6			Combined				No	Flat $20	$20
Illinois	7.3			Combined				Yes		0.1% of Paid-in Capital
Indiana	8.5				Both	Combined		Yes		
Iowa	12.0	6.0	4		Consolidated		Consolidated	Yes	7.2% of Iowa AMTI	
Kansas	7.1	4.0	2		Combined	Consolidated	Combined	No		
Kentucky	6.0	4.0	3	Consolidated				Yes	.75% of gross profits	$2.10 per $1,000 of Total Capital
Louisiana	8.0	4.0	5		Both			Yes		$3.00 per $1,000 of Equity and Borrowed Capital
Maine	8.93	3.5	4	Combined				Yes	5.4% of Maine AMTI	
Maryland	8.25							Yes		
Massachusetts[1]	9.5			Combined	Consolidated		Combined	Yes	Flat $456	
Michigan	4.95				Consolidated	Consolidated		Yes		
Minnesota	9.8			Combined				Yes	5.8% of Minnesota AMTI	
Mississippi	5.0	3.0	3			Combined		Yes		$2.50 per $1,000 of Capital
Missouri	6.25					Consolidated		Yes		
Montana	6.75			Combined		Consolidated	Consolidated	No	Flat $50	
Nebraska	7.81	5.58	2	Both				No		Graduated amount based on Capital
Nevada	----- *No Corporate Income Tax* -----									$25 per Employee
New Hampshire	8.5			Combined				No		
New Jersey	9.0	6.5	3		Consolidated			Yes	$500 plus Assessment at Graduated rates on gross receipts or gross profits	
New Mexico	**7.6**	**4.8**	**3**				**Both**	**No**		**$50**
New York[2]	7.1			Combined				Yes	2.5% of minimum taxable base	
North Carolina	6.9				Both			Yes		0.15% of greater of: Capital, Tangible Property or 55% of Tangible Property plus Intangible property
North Dakota	6.5	2.6	5	Combined				No		
Ohio	8.5	5.1	2		Combined	Combined		Yes	$50 or $1,000 if gross receipts exceed $5 million or employment exceeds 300	
Oklahoma	6.0					Consolidated	Consolidated	Yes		Fixed amount of Investment or Employment
Oregon	6.6			Consolidated				Yes	Flat $10	
Pennsylvania	9.99							Yes		Percentage of Capital
Rhode Island	9.0							No	Flat $500	Fixed dollar amount of Capital

Corporate Income and Franchise Tax
Review and Alternatives

State Income Tax Rates, Filing Methods, Rallocation Authority Between Related Parties, Alternative Minimum Tax and Franchise Tax -- Continued

State	State Corporate Tax Rates: Top Rate	If Multiple Rates: Lowest Rate	If Multiple Rates: Number of Brackets	Combined and Consolidated Reporting: Mandatory	State May Require	State May Permit	Taxpayer May Elect	Authority to Reallocate Income & Expenses Among Related Parties	Alternative Minimum Tax	Franchise Tax Base and Rate[4]
South Carolina	5.0					Consolidated	Combined	No		$15 plus 1 mill per $1 of Capital Stock and Surplus
South Dakota	----- *No Corporate Income Tax* -----									
Tennessee	6.5				Both	Both		Yes		Fixed amount per dollar of Net Worth
Texas	----- *No Corporate Income Tax* -----									
Utah	5.0			Combined				No	Flat $100	
Vermont	8.5	6.0	3	Combined			Consolidated	No	Flat $250	
Virginia	6.0					Consolidated		Yes		
Washington	----- *No Corporate Income Tax* -----									
West Virginia[3]	8.75			Combined			Consolidated	No		Greater of $50 or 0.7% of Capital
Wisconsin	7.9							Yes		
Wyoming	----- *No Corporate Income Tax* -----									Greater of $50 or 0.02% of sum of Capital, Property and Assets

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

March 1, 2009

Notes:

[1] Massachusets Combined Reporting requirement is effective for tax years beginning January 1, 2009.
[2] New York Combined Reporting requirement is effective for tax years beginning January 1, 2007.
[3] West Virginia's Combined Reporting requirement is effective for tax years beginning January 1, 2009.
[4] Excludes organizational and entrance fees and reporting fees.

Mandatory Combined Reporting and Corporate Income Tax Revenues

- **At the Committee's last meeting in Raton, several members asked about the revenue effects of adopting mandatory combined reporting**

- **Today, I will provide some background information concerning such revenue effects, but not a specific estimate since no specific proposal has been made**

- **Corporate income and franchise tax receipts are currently forecast to be $201 million in FY10, a decline of over 55% from actual revenues in FY07 of $461 million**

- **Some of this large reduction in corporate income and franchise tax revenues is due to higher film and other credits, but even pre-credit revenues declined by over 40%**

- **No other major General Fund revenue source, including oil and gas taxes, have changed this much over the past three years**

- **The underlying volatility of corporate income tax revenues in itself introduces uncertainty about the revenue effect of adopting mandatory combined reporting**

Mandatory Combined Reporting and Corporate Income Tax Revenues – Cont.

- **Greater uncertainty, however, arises from the proposal itself**

- **There is no information on current tax returns concerning the income that would be reported to New Mexico if the corporation were required to report on a combined basis**

- **Absent such information, revenue estimates for mandatory combined reporting proposals have relied on the experience of other states that have adopted mandatory combined reporting**

- **In the past, the experience of other states has been interpreted to indicate that (pre-credit) New Mexico corporate income tax revenues would increase by 20% if mandatory combined reporting was adopted**

- **Three recent studies, however, suggest that this 20% assumption may be unrealistic**

- **One study was prepared by Robert Cline of Ernst & Young for the Council on State Taxation (COST), "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting" (May 2008)**

Mandatory Combined Reporting and Corporate Income Tax Revenues – Cont.

- **This study reviews the revenue experience of states with combined reporting and factors that may affect estimated combined reporting revenues**

  - **These factors include identifying members of a combined ("unitary") group, the treatment of net operating losses (NOLs), apportionment factors of group members and whether a state already has addback statues or similar tools**

  - **The study examined estimates in nine states that have either adopted or considered combined reporting**

  - **The estimates (relative to current revenues) ranged from 3% in Maryland to New Mexico's 20%, with only one other state (Iowa) estimating more than 10%**

  - **The study concludes, "Combined reporting has uncertain effects on a state's revenues, making it very difficult to predict the revenue effect of adopting combined reporting"**

- **The study also examined the potential effects on a state's competitiveness from combined reporting**

Mandatory Combined Reporting and Corporate Income Tax Revenues – Cont.

- **The study concluded, "Economic theory, empirical studies and economic simulation modeling all suggest that switching from separate filing to combined reporting will have a negative impact on a state's economy"**

- **A second recent study was prepared by William F. Fox and LeAnn Luna of the University of Tennessee Center for Business and Economic Research, "An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes" (January 2009)**
  - **This study was prepared in response to Tennessee Senate Resolution 292**
  - **The study examined the revenue, economic development, administrative and compliance and base implications of mandatory combined reporting**
  - **Revenue effects were examined using statistically based regression analysis**
    - **Regression analysis is designed to isolate the effect of combined reporting on state corporate income tax revenues from all other factors that affect these revenues**

Mandatory Combined Reporting and Corporate Income Tax Revenues – Cont.

- **Revenue data for all states was included in the analysis**
- **The analysis covered the period 1994 through 2008**
- **The authors concluded, "we find no evidence in the statistical analysis that adopting combined reporting has affected state revenues, either by increasing them or decreasing them" (i.e., the revenue effect is zero)**

- **The study also examined the economic development effects of mandatory combined reporting using statistical regression analysis**
  - **The authors concluded, "[we] find no evidence that the existence of combined reporting affects GDP [state gross domestic product]"**

- **The most recent study was an article in the June 2009 <u>National Tax Journal</u> by Sanjay Gupta, Jared Moore, Jeffrey Gramlich and Mary Ann Hofmann (all are university professors), "Empirical Evidence on the Revenue Effects of State Corporate Income Tax Policies"**
  - **This study also use statistical regression analysis with data covering 1982 through 2002**

Mandatory Combined Reporting and Corporate Income Tax Revenues – Cont.

- **This study concludes, “somewhat surprisingly, combined reporting is not significantly associated with SCIT [state corporate income tax] revenues” (i.e., the revenue effect is expected to be zero)**

Alternatives

- **Corporate income tax policy issues and volatility of revenues, and the uncertainty of revenue and competitiveness effects of mandatory combined reporting suggest that alternatives are worth serious consideration**
- **One such alternative is the new franchise tax proposal included in SB 648 (Sen. Wirth)**
- **The new franchise tax amount in SB 648 would be based on a corporation's property, payroll and sales in New Mexico in excess of these thresholds:**
  - **Property -- $5 million;**
  - **Payroll -- $1.2 million; and**
  - **Sales -- $9.3 million**
- **Fewer than 1,400 (less than 7%) of all corporations operating in New Mexico have property, payroll or sales above these thresholds**
- **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, but would be taken into account only once**

Alternatives – Cont.

- **The rate of the new franchise tax would be set initially to achieve a revenue target**
  - **Because the base of the new franchise would be so large, the rate would be very low, a fraction of 1%**
  - **For example, a rate of 0.1% would raise ~ $50 million**
  - **In SB 648, some revenue from the franchise tax was used to reduce corporate income tax rates**
- **The tentative franchise tax (New Mexico property, payroll and sales in excess of their thresholds times the applicable rate) would be reduced, but not below zero, by the corporation's income tax liability for the year**

Illustration of Calculation of New Franchise Tax

Factor	Amount in New Mexico (a)	Threshold (b)	Amount Over Threshold [(a)-(b), or 0] (c)	Tax [= amount in (c) x rate] (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)				

Alternatives – Cont.

- **This new franchise tax would provide a quite reliable source of revenue, because its base (property, payroll and sales in New Mexico) are quite stable**

- **The new franchise tax would also insure that all large corporations pay some income or franchise tax related to their presence in New Mexico and the benefits they derive from that presence**