



March 8, 2012

## **CORPORATE INCOME TAX TALK**

The only corporate income tax proposal to pass out of the Legislature was Senator Wirth's [SB 9](#) mandatory unitary combined reporting proposal ("MUCR"), which was vetoed Tuesday (veto message [here](#)). MUCR requires companies with sufficient relationships/interdependencies with one another under a few different tests, to file as if the companies were single organization. (Although not a great legal analogy, think of it theoretically as a multi-cellular organism being treated as an organism rather than on a cell by cell basis). While the original bill was much broader, applying to all corporations, the final version, the Senate Finance Committee substitute as amended on the Senate floor, is the version that landed on the Governor's desk. She vetoed the bill, however there are variety of interests actively promoting its passage on an ongoing basis. The bill mandates combined filing for a unitary corporation:

*"that provides retail sales of goods in a facility of more than thirty thousand square feet under one roof in New Mexico shall file a combined return with other unitary corporations as though the entire combined net income were that of one corporation.*

The requirement does not point specifically to retail, and is not necessarily limited to retail, but the proposal is generally viewed to be targeted at "big box" stores. It is "revenue neutral", as the proposal reduces the top rate .1% to 7.5% from 7.6%.

New Mexico's corporate income tax is fairly generic corporate tax, and conforms to most of the standard provisions under the Uniform Division of Income for Tax Purposes Act ("UDIPTA"), a uniform state law, including three-factor standard apportionment. New Mexico has a three tiered rate structure, with 4.8% applying to taxable income up to \$500K, 6.4% applying up to \$1M dollars, and 7.6% being the top marginal rate, applying to all income above.

While generating lots of political interest, the corporate income tax generates relatively little revenue, around 5-6% of the general fund (which is about average for most states that impose a similar tax). It's somewhat volatile and often fickle, adding revenue in good times that may contribute to imprudent budget growth, while also virtually disappearing when you need it most. In the recent downturn, it did however recover more quickly than other revenue sources, although it's flattened lately relatively to the budget and its own prior growth.

Corporate income tax at the federal level is a regrettably complicated and inefficient structure that is costly and complex to administer. It's been made worse over time. Like New Mexico,

most states are tied to the hip with the federal tax because federal taxable income is typically the starting point before certain state specific adjustments are made. On the downside, this means states can be subject to the whim of federal tax policy changes (i.e. bonus depreciation), and must sometimes act to legislate around unwanted or unaffordable changes. (While the feds can reduce current taxes at the expense of future generations, but that's harder for the states.) The upside is there is more certainty around the federal tax code, and it's use provides an administrative benefit to taxpayers and tax agencies as who can simply rely on the federal government to maintain one overarching body of law and rules. Once taxable income is determined under federal rules, then the state laws create a new layer of complication and inefficiency.

### ***Should we get rid of it? Who pays it?***

Because the tax can be litigious, controversial, volatile, not attractive to business, and otherwise more trouble than it's worth, some have suggested getting rid of it. Although the idea has some merit, one needs to step back and look at the big picture. It's been pointed to as a hindrance to economic development, and even in our own recent tax competitiveness study it is clear that corporate income tax was a significant contributor to New Mexico's extremely high effective tax rate on new investment before incentives. Further, it doesn't really represent a business tax anymore, as most businesses can organize outside the C-corporation form and not pay the duplicative level of tax at all. (And small businesses could often "manage" their taxable income to reduce or eliminate this problem, however larger businesses cannot.) This wasn't the case forty years ago when you had only sole proprietors and general partnerships – and all the legal liability that go with them, or C-corporations. It is well established in the current age that liability limitation can be achieved through vehicles such as LLC's, LLP's, S-corporations and the like.

Another argument for corporate level taxation – access to capital markets – is still valid today, but even that world is changing somewhat. (Try explaining with a straight face how Chrysler, an LLC owned by a hedge fund, should be taxed less than General Motors across the street.) The question of economic "incidence", that is who actually bears the burden of the tax (i.e. capital/shareholders in reduced profits, higher prices buyers, or reduced wages or raises for workers) is also an uncertain one. It's tough to establish the proper tax policy when you don't know what/who is actually being taxed. Some academics assume that the tax "rolls back" to capital. While that might work in a laboratory under assumptions of perfect knowledge and information, it's never the case in the real world. Even if it were, shareholders vary dramatically. (Some are billionaires, some are living on fixed incomes, and the largest is the California state pension plan.) But in the real world, it depends on circumstances. Think of it as electricity following the path of least resistance. It's generally unknowable ahead of time. While the tax certainly can hit capital, the entire corporate form of organization is dedicated to managing all costs and ensuring that profits are not affected.

On the other hand, while corporate income tax isn't the driver of our general fund budget, it still pays some bills and would cost real money to eliminate. Contrary to wishful thinking by some, tax cuts don't always pay for themselves, and eliminating the corporate tax wouldn't. While eliminating the tax would make New Mexico more attractive to new investment, it would

undoubtedly also result in foregone revenue . There is an historic perspective in state tax policy that states were being economically exploited by corporations, and the tax was a way to get something in return. Lastly, an argument can be made for corporate taxes on the basis of incidence. While we think the economic incidence is hard to know, one thing for sure is it doesn't recognize state lines. So, while New Mexico shareholders, buyers or employees are likely bearing some burden of, for example, California's tax, if we don't impose a tax ourselves, we can't return the favor.

So, when weighing issue of return on investment, revenue adequacy, fairness, competitiveness, etc., it probably doesn't make sense to get rid of the corporate income tax. However, something should be done to address competitiveness.

### ***So what's attractive about our tax and why do some call our babies ugly?***

#### *The good . . .*

As state corporate income taxes go, New Mexico's tax is better than many in that it is fairly vanilla and straightforward. As a small state, there's not a lot of guidance in the form of case law or rulemaking that's taken place, but New Mexico has not drifted too far from the original UDITPA rules either. The most sensational issue of the last 20 years was the litigation with K-Mart Properties Inc. over intangible holding companies and their use to reduce separate company tax liabilities. The state won that fight, and many companies entered into settlement agreements with the state. (Assuming, however, there are similar problems still, this is one of the primary issues MUCR best addresses.) New Mexico also has a double weighted sales factor option (see *Section 7-4-10 NMSA 1978*), although it's very narrowly applicable as it has several conditions that virtually no company can meet continually. But importantly, New Mexico still offers taxpayers the option of filing on a separate company, unitary combined, or federal consolidated group basis, despite the *K-Mart* case. Separate company is the default method, with taxpayers electing "up the ladder" if they choose. The filing group option was created for economic development purposes, allowing taxpayers the option of the method that would result in the lowest tax. In practice however, the benefit is poorly targeted and may encourage certain forms of aggressive tax planning (like that at issue in *Kmart*). Some taxpayers pay more than they would otherwise just to preserve their election. Others likely made elections without realizing what they were doing many years ago, and are now stuck filing with that method. In any case, because there is an annual debate about abolishing the separate filing method under MUCR, as an economic development tool, it has been essentially rendered ineffective.

#### *The bad . . .*

New Mexico's top tax rate at 7.6% is significantly higher than the national average of 6.7%, and higher still relative to competing states in the relatively low tax Western region. While most recent rhetoric tends to focus on "fairness" to local businesses, the corporate tax was structured to "home town" or disadvantage multi-state businesses relative to local business. Tiered rate structures make little if any economic sense in the context of corporate taxes. Tiered rates are utilized to create progressivity with personal income taxes, where taxable income tends to be relatively representative of household income. A Fortune 500 company that has a net operating loss cannot be likened to household near the poverty level. That said, tiered rates do benefit small companies that can't manage to zero-out their taxable income by year-end. In that case,

they face a smaller liability. With multi-state corporations, we employ the dirty little trick of apportioning *tax* rather than *income*. That means the multi-state corporation's income from *everywhere* is subjected to our rate structure, so that multi-state companies earning very little in New Mexico can still be subject to our highest rates, whereas the local company is likely not to be. Lastly, New Mexico strictly limits the use of net operating loss carryovers (NOLs), relative to the federal government and many states. NOLs are what make a net income tax a net income tax, as arbitrary filing periods are merely snapshots of the ebbing and flowing of income. The federal government allows NOLs to be carried back five years and forward 20. Many states, with their balanced budget requirements, experienced budgetary difficulties with carrybacks in bad economies and limited NOLs relative to the feds. New Mexico is among the most limiting, not allowing carrybacks at all and limiting carryforwards to five years.

### *The ugly . . .*

If you understood or were already aware of the above, you are in a very small minority, and you're probably not a legislator, advocate, or lobbyist. The topic is complex enough that informed and enlightened discussions are extremely rare. Sometimes it seems that the MUCR debate is more about organized labor trying to punish Wal-Mart than good tax policy. The most common rhetoric heard today is "fairness" under the presumption that "local" businesses can't avail themselves to the filing elections New Mexico offers. Fact is, they can. But it only matters if they're a family of C-corporations doing business in more than one state, in which case every option will yield a different tax answer. As mentioned earlier, most "local" businesses aren't organized as C-corporations anymore at all, so the real truth is if anyone is disadvantaged from a tax perspective, it's the relatively few remaining corporate taxpayers who have to do business in that form, and they're mostly multi-state corporations. Current rhetoric to the contrary, if anyone's getting away with something, it's all the local businesses that used to pay a business income tax and don't have to if they adopt a non-corporate form.

### ***Bottom Line***

The Senate Finance Committee substitute for Senate Bill 9 was vetoed yesterday. The Governor said, in her lengthy veto message, that the proposal should have been heard in the House Taxation and Revenue Committee. She also said it would increase costs of goods, reduce salaries and payrolls, and make us less attractive and competitive. She also argued it was arbitrary in nature and lacked any "discernible rationale" for discriminating between those that would be harmed and those that would be helped.

There's some truth to the economics, however as we previously mentioned it's hard to know if it's New Mexicans who would bear the burdens or not. Combined reporting efforts are usually not viewed by the business community as friendly gestures, and passage would have been viewed as a "camel's nose under the tent" by other types of businesses making current investment decisions. However, the committee substitute represented very shrewd political strategy as it carved out most existing opposition by those who would see their taxes go up under a MUCR regime. It put a bill on the governor's desk that was revenue neutral, reducing the tax rate, albeit barely, for most. Finally it targeted the very group that labor and related interests have been at war with (i.e. Wal-Mart), and it galvanized some local businesses in support under the premise (albeit mostly false), that the big competitor they don't like to begin with was getting

away with something they couldn't. Retailers are also a good target in that they're one of the least likely to be sensitive to corporate tax burden as they tend to follow economic development and population, existing in every state with a litany of tax regimes. The rhetoric also preferred "out-of-state" terminology rather than "multi-state" to give the impression we were going after "outsiders", even if we were really going after some of the state's largest employers. While the narrow or broader MUCR proposal didn't impact that many locally headquartered companies, that's only because as a state we have very few – and fewer now than a decade or two ago (a very unfortunate trend). Apparently we now have corporation envy.

All that said, combined filing, in general, is inarguably a constitutional method, and would make some forms of aggressive planning difficult (such as the *K-mart* style "base shifting" that was in vogue in the 1990's). But all in all, it's just a different flavor of a regrettably flawed tax system that we're likely chained to until some game-changing event occurs at the federal level. It certainly isn't the broad based business activity tax it used to be, and so it's increasingly inequitable.

It would be good for this fight to be resolved. At the end of the day, it's not really about combined or separate reporting. Our rate is simply too high. The questionable efficacy of using the filing options to attract investment is negated by the uncertainty of the present environment. States have become more competitive and the marketplace more mobile, although not for everyone. We can't afford to get rid of the corporate income tax, and we're probably not at a point where we're ready to broadly tax all business activity again. So, we need to PICK A TAX STRUCTURE AND MOVE ON. We've put a lot of energy into this relatively tiny tax program, and in the meantime we're losing business in the current environment. Michael Mazerov of the Center on Budget Policy and Priorities favors MUCR and has testified before our legislative interim committees that New Mexico is the only non-MUCR state that Intel manufactures in, so how bad can it be? He's sort of right, but fails to mention that the other states Intel manufactures in have lower rates and/or more attractive apportionment schemes and other mitigating mechanisms, such that Intel pays less tax per chip or employee than they do here. So, adopt Arizona's or Oregon's tax structure, or keep the current structure and add a reasonable addback provision to address potential leakage. But in terms of sending the message that New Mexico is open for business, we need to get past this soon.

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