Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

November 30, 2009

CORPORATE LOBBYIST'S CASE AGAINST COMBINED REPORTING IN NEW MEXICO: A REBUTTAL

By Michael Mazerov

Introduction and Summary

Richard Minzner, a corporate lobbyist and former Secretary of the New Mexico Department of Taxation and Revenue, has recently written a number of memos for state legislators and columns in New Mexico newspapers criticizing a corporate tax reform measure that has been under consideration in the state for several years.[1] Minzner's writings contain a number of false, misleading, or factually-unsupported statements. This analysis sets the record straight.

Minzner is criticizing proposed legislation that would require many large multistate corporations to use an accounting method known as "combined reporting" when they compute their New Mexico income taxes. Combined reporting requires a corporation that is taxable in New Mexico to add its income to the income of its parent, sister, and subsidiary corporations, and then calculate its New Mexico taxable income as a share of that combined income. The share is based on the corporation's economic activity in New Mexico (property, payroll, and sales) compared to the economic activity in other states of the overall corporate group. Combined reporting is a comprehensive approach to nullifying an array of tax shelters corporations have developed that involve artificially shifting income that would normally be taxable in one state onto the books of related corporations in other states.

Combined reporting is required in every state west of the Rockies with a corporate income tax except New Mexico. It is also mandatory in a majority of *all* states with corporate income taxes.[2] Some corporations already use combined reporting in New Mexico, because current law allows them to do so as an option. The proposed legislation would broaden the current law to require all corporations taxable in New Mexico that are members of multi-corporate groups to use this time-tested approach to corporate taxation.

[1] See, for example: "Combined Reporting: Questions and Answers," undated, and " 'Combined Reporting' Unfair," *Albuquerque Journal*, October 18, 2009.

[2] See: Michael Mazerov, "A Majority of States Have Now Adopted a Key Corporate Tax Reform — 'Combined Reporting'," Center on Budget and Policy Priorities, April 3, 2009; www.cbpp.org/files/4-5-07sfp.pdf.

Minzner claims that combined reporting unfairly taxes corporate profits not actually earned in New Mexico, will hurt New Mexico's economy, and is unnecessary and ineffective as a revenue-raising strategy. In reality:

- The U.S. Supreme Court has rejected the claim that combined reporting unfairly taxes corporate income earned outside the taxing state and has *upheld* combined reporting as a fair means of measuring the portion of income that a member of a corporate group earns in a state.

- Adopting combined reporting is essential to nullifying a wide variety of aggressive tax-sheltering strategies that large multistate corporations are able to implement to reduce or even eliminate their income tax payments. The targeted measure Minzner recommends as an alternative addresses only one of those strategies, some of which can *only* be shut down effectively by combined reporting.

- The states that have had combined reporting in effect for the past 15-20 years have been disproportionately successful in retaining manufacturing jobs – the jobs theoretically most likely to be moved in response to state tax policies corporations find objectionable. For example, 9 of the 11 states that performed better than New Mexico in manufacturing job growth between 1990 and 2007 mandated combined reporting.

- Mandating combined reporting would raise substantial new revenue for New Mexico, particularly when corporate profits begin recovering from the recession. The state's Legislative Finance Committee estimates a 20 percent corporate tax revenue increase would result – funds that will be available to preserve education, health or other services that are good for the state's economy. A revenue estimate of this order of magnitude is consistent with estimates done in other states, including an especially careful estimate recently made in Maryland.

- Mandatory combined reporting would mitigate the competitive disadvantage that some small businesses now face relative to multistate, multi-corporation groups that can lower their taxes by artificially shifting income into other states.

Rebutting Minzner's Key Claims on Combined Reporting

Claim: "The principal effect of combined reporting in New Mexico would be to tax corporate income which is earned in other states by corporations not doing business in New Mexico and which income has not been moved or 'shifted' from New Mexico."

Response: The courts have emphatically rejected this claim. States are prohibited by the Due Process Clause and Commerce Clause of the U.S. Constitution from taxing corporate income that is earned in other states.[3] The U.S. Supreme Court has twice upheld combined reporting as a fair and legal means of calculating the share of income that is earned within a state by a corporation that is

[3] "The principle that a State may not tax value earned outside its borders rests on the fundamental requirements of both the Due Process and Commerce Clauses that there be 'some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax.' " U.S. Supreme Court decision in *Allied Signal, Inc.* vs. *New Jersey Division of Taxation* (1992), quoting *Miller Brothers* vs. *Maryland* (1954).

clearly doing business within that state.[4] When a corporation conducts in-state and out-of-state production and sales activities that contribute to its overall profitability, each state determines the share of the corporation's profit that is deemed to be earned within its borders by applying a formula to the corporation's *nationwide* profit. The courts have upheld combined reporting as a logical extension of such "formula apportionment." Without combined reporting, corporations could negate a state's use of formula apportionment simply by placing or isolating their out-of-state activities in separate subsidiaries.

Claim: "A national company, profitable in other states, setting up a New Mexico subsidiary, would pay a substantial tax price under combined reporting. The new subsidiary may lose money in the early years. . . However, that company could owe substantial corporate income tax in New Mexico because of the income other members of the corporate family earn in other states."

Response: It is a longstanding principle of state corporate tax law — quite apart from the issue of combined reporting —that multistate corporations pay state taxes based on their nationwide profitability, multiplied by a simple apportionment factor based on some combination of sales, property, and payroll. This is how every state, including New Mexico, calculates corporate income tax.

The main reason corporate taxes work this way is that it is rarely possible to separate the profitability of a corporation's investments in one state from those in other states in a definitive or reliable way. Consider, for example, a "vertically-integrated" oil company that owns oil fields in California, Texas and North Dakota, refineries in Louisiana and New Jersey, and pipelines and gas stations in 20 other states. If the firm develops a new oil field in New Mexico, its impact on the company's profit has as much to do with the refineries, pipelines and gas stations in other states as it does with the New Mexico operation itself. There is no practical or objective way to determine how much profit was earned in each part of the operation — and thereby determine the relative profitability of the new oil field in New Mexico as compared to the rest of the enterprise. The New Mexico expansion might cost more than the value of the drilled oil but still enhance the profitability of the pre-existing operation (for example, by helping ensure that the refineries always had sufficient oil to be run at optimal capacity). Assigning the additional profit attributable to this economy of scale to a particular state would arguably be completely arbitrary.

In Minzner's example, the parent company has gone one additional step: it has filled out the paperwork to make its New Mexico operations a legally independent corporation. The New Mexico operations may show a loss on paper, but for the reasons described above they may be contributing to the overall profits of the parent corporation. But since New Mexico doesn't mandate combined reporting, the New Mexico operation doesn't pay taxes. Combined reporting would restore the tax liability that the legal maneuver of separate incorporation has taken away.

In sum, combined reporting is based on the conclusion that the profit that an integrated multistate enterprise earns in a specific state generally cannot be objectively measured, a conclusion with which

---

[4] *Container Corporation of America* vs. *California Franchise Tax Board* (1983); *Barclay's Bank PLC* vs. *California Franchise Tax Board* (1994).

many economists and the courts have concurred.[5] And the tax liability that results from combined reporting is merely due to the application of existing apportionment formulas to nationwide taxable income, the standard approach; the only difference that combined reporting makes is to prevent the corporation from negating that tax liability by separately incorporating the New Mexico operations. Minzner is free to take issue with the formula apportionment approach to state corporate taxation, but he should do so forthrightly rather than implying that his criticism only applies to combined reporting.[6]

Finally, even if it were assumed for the sake of argument that it is possible to determine objectively that a new New Mexico operation will be "money-losing" in a true economic sense in its start-up phase, it by no means necessarily follows that the adoption of combined reporting would create a disincentive for a profitable out-of-state corporation to expand into the state. Any out-of-state corporation with significant operations in combined reporting states — and recall that a majority of states mandate combined reporting — would pay *less* tax in those states as a result of being able to combine the purported losses of the New Mexico expansion with the profits of the pre-existing enterprise. This could substantially or entirely offset the impact of having a positive tax liability in New Mexico, and thereby substantially or completely eliminate the "disincentive" Minzner hypothesizes.

Claim: "Combined reporting is not the most direct way to prohibit inappropriate income shifting. . . . To prevent the shifting of income it regards as illegitimate, New Mexico could pass. . . 'add back' legislation."

Response: Minzner is referring here to a narrow type of legislation that some non-combined-reporting states have enacted to nullify one particular type of tax shelter to which they are vulnerable

---

[5] As economist Charles McLure wrote more than 25 years ago:

> [S]ubstantial transactions between affiliated firms can make it administratively difficult, and perhaps impossible, to verify that transfer prices are not being manipulated to shift income between affiliated firms, and therefore between jurisdictions. This problem is most likely to be significant where there are vertical transactions in goods and services with no uncontrolled market price, and it becomes insuperable as vertical integration becomes complete. Second, various kinds of interdependence may make it conceptually impossible to determine the income of the individual firms [in a corporate group]. Particularly important are shared costs and other economies of scale and scope and shared know-how. Though interdependence exists particularly in vertically integrated production and distribution, it can also explain horizontal diversification and demand a finding of unity [in the latter circumstance as well].

Charles E. McLure, Jr., "Defining a Unitary Business: An Economist's View," in Economic Perspectives on State Taxation of Multijurisdictional Corporations, Tax Analysts, 1986, p. 68.

Or, as the U.S. Supreme Court famously stated in its 1983 *Container* decision: "[a]llocating income among various taxing jurisdictions bears some resemblance . . . to slicing a shadow."

[6] The same can be said with respect to Minzner's claim in another recent memo that "Combined reporting would impose tax costs on increasing New Mexico payroll or investment and would provide tax reductions for subjecting New Mexicans to layoffs." For a refutation of this argument, see: Michael Mazerov, "The Single Sales Factor Formula for State Corporate Income Taxes," Center on Budget and Policy Priorities, pp. 24-27; www.cbpp.org/3-27-10sfp.pdf, p. 38. In any case, this is an argument against the inclusion of property and payroll in the apportionment formula and has nothing to do with combined reporting. Given his background as a former Secretary of Revenue, Minzner presumably knows this, and it is disingenuous of him to make this argument.

— the so-called "Delaware Holding Company."[7] While enacting an addback statute is indeed something New Mexico should have done years ago, it is no substitute for combined reporting because there are numerous tax-avoidance strategies such statutes cannot nullify — but that combined reporting *can*. These include stashing income-earning assets in subsidiary corporations located in states like Nevada that have no corporate income taxes and so-called "transfer pricing" — in which parent and subsidiary corporations located in different states manipulate the prices at which they buy goods and services from each other.[8]

Many of the addback statutes states have enacted are themselves full of loopholes and/or subject to constitutional challenge; in contrast, the Supreme Court has upheld the constitutionality of combined reporting. New York and Massachusetts both initially enacted addback statutes but soon thereafter proceeded to mandate combined reporting. Addback statutes may have been a reasonable stopgap measure at one time, but combined reporting is a more effective, comprehensive, and fully court-approved policy for minimizing state corporate tax avoidance.

Claim: "Combined reporting would be harmful to economic development because it would impose substantial tax obligations on successful businesses simply for establishing New Mexico subsidiaries."

Response: Combined reporting is good for state economies because it creates a more equitable business tax structure. States that require combined reporting are well-represented among the most economically-successful states in the country. For example, 9 of the 11 states that performed better than New Mexico in manufacturing job growth in the 1990 to 2007 period — including Arizona and Utah —were combined reporting states.[9]

Large multistate corporations are unlikely to avoid New Mexico as a location for future investments if the state mandates combined reporting, nor are current New Mexico corporations likely to leave. Studies of major employers in Wisconsin, North Carolina, and Iowa — some of which had raised the possibility of leaving those states if they enacted combined reporting — found that most of

---

[7] Under the "Delaware Holding Company" (DHC) tax shelter, a corporation transfers ownership of its trademarks and patents to a subsidiary located in a state that does not tax royalties, interest, or similar types of "intangible income." The subsidiary charges a royalty to the rest of the business for the use of the trademark or patent. The royalty is a deductible expense for the corporation paying it, so it reduces the corporation's profits in the states in which it is taxable. Moreover, the DHC often loans its "profits" back to the rest of the corporation, which can then reduce its taxable profits further by taking a tax deduction for the interest it pays on the loan. DHCs are set up in Delaware because the state has a special income tax exemption for corporations whose activities are limited to owning and collecting income from intangible assets. They are also often set up in Nevada because that state has no corporate income tax at all.

[8] Some of the tax-avoidance strategies to which non-combined reporting states are vulnerable are described in Michael Mazerov, "State Corporate Tax Shelters and the Need for Combined Reporting," Center on Budget and Policy Priorities, October 25, 2007, www.cbpp.org/10-25-07sfp.pdf.

[9] Michael Mazerov, "Most Large North Carolina Manufacturers Are Already Subject to 'Combined Reporting' in Other States," Center on Budget and Policy Priorities, January 15, 2009, p. 6; www.cbpp.org/1-15-09sfp.pdf. Manufacturing corporations were chosen for this comparison because, in theory, manufacturing jobs are more likely than are service jobs to be moved in response to state tax policies corporations find objectionable. (Manufacturing activity can often be conducted far from the location of customers, while service businesses more often have to be in close proximity to their customers.)

them quite willingly maintained facilities in *numerous* combined reporting states.[10] For example, 60 of the 75 largest North Carolina manufacturers maintained facilities in at least one combined reporting state, almost half had facilities in five or more combined reporting states, and 18 maintained their *headquarters* in combined reporting states.

Minzner suggests that some corporations may be deterred from locating in New Mexico if they have to pay taxes under a combined reporting requirement, but state corporate income taxes simply are not high enough to drive business location decisions. Total state and local taxes paid by corporations average less than three percent of corporate expenses, and state corporate income taxes represent less than 10 percent of that three percent on average.[11] So it is highly unlikely that the adoption of combined reporting would have a significant enough impact on most corporations' "bottom lines" to affect decisions about whether to invest in New Mexico; those decisions will continue to be driven by the fundamental economics of the investment.[12]

Corporate executives typically rank taxes low on their list of site selection factors, well below the availability of a high-quality workforce and infrastructure.[13] As discussed in the next section, the adoption of combined reporting would generate revenue and could thereby mitigate cuts in education and other state services that might otherwise be made. Such cutbacks could lead to further deterioration in the quality of these services and thereby make New Mexico a *less* desirable place for businesses to locate. By forestalling the need for some cuts in services demanded by businesses, the adoption of combined reporting thus could actually have a net positive impact on New Mexico's economy.

---

[10] See the source cited in the previous note. See also: Michael Mazerov, "Almost All Large Iowa Manufacturers Are Already Subject to 'Combined Reporting' in Other States," Center on Budget and Policy Priorities, April 3, 2008, www.cbpp.org/4-3-08sfp.pdf; Jack Norman, "Combined Reporting: How Closing Corporate Loopholes Benefits Wisconsin," Institute for Wisconsin's Future, February 2009, www.wisconsinsfuture.org/publications_pdfs/tax/iwf_combined_report_feb09.pdf.

[11] See the source cited in Note 9.

[12] In his memorandum to state legislators, Minzner identifies one of his clients as Psychiatric Solutions, Inc., a private, for-profit chain of inpatient behavioral health care service facilities. If such a company wants to tap into the New Mexico market for such services effectively it probably has to have facilities in the state since most people would be reluctant to have family members treated in a distant facility. And, indeed, the company quite willingly does business in other combined reporting states; its annual report to the Securities and Exchange Commission for 2008 indicates that it has facilities in such other long-time combined reporting states as Illinois, Colorado, Utah, Arizona, Minnesota, and California. The annual report also indicates that the company's *nationwide* total state corporate income tax expense in 2008 was approximately $5 million, representing just 0.3 percent of its total business expenses for the year. (The tax figure was its "provision" for state corporate income taxes, not its actual liability, but it is a reasonable proxy for the latter amount.) Thus, it seems highly unlikely that New Mexico's adoption of mandatory combined reporting would have a large enough impact on this company's "bottom line" to affect its willingness to invest in the state.

[13] For example, in *Area Development* magazine's 2008 annual survey of corporate executives concerning the key factors influencing their location decisions, highway accessibility ranked first, and the availability of skilled labor ranked fourth. The state corporate tax rate ranked ninth.

Claim: "Combined reporting will not produce much money."

Response: Combined reporting will produce substantial new tax revenues. Prior to the current recession, the Legislative Finance Committee estimated that the enactment of combined reporting would result in a 20 percent increase in corporate income tax collections, or approximately $90 million annually.[14] In the current economic climate, the *short-term* revenue yield of mandatory combined reporting is likely to be lower in dollar terms, simply because there are less corporate profits to tax. Nonetheless, recently-released data from Maryland suggest that the 20 percent figure is quite plausible for periods of normal economic growth. Like New Mexico, Maryland is not a combined reporting state, but it required corporations to file hypothetical or "pro-forma" combined reporting-returns for tax year 2006. Newly-released data from those returns indicate a revenue gain from combined reporting of either 13 percent or 20 percent (depending upon which of two alternative approaches to combined reporting were implemented).[15]

These revenue gain estimates for Maryland are the net result of increased liability for some corporations partially offset by reduced liability for others. Unlike Maryland, New Mexico *already* allows corporations to elect to file on a combined reporting basis and many do so when they pay less tax as a result.[16] Accordingly, there are unlikely to be many *new* combined reporting filers with reduced liabilities to offset the revenue gain from corporations paying more income tax under the combined reporting mandate in the proposed legislation. The revenue gain estimates from Maryland therefore suggest that the Legislative Finance Committee's 20 percent revenue impact estimate for New Mexico for a year of normal economic and corporate profit growth is quite credible.

Claim: "The companies that will feel most unfairly treated by mandated combined reporting may be companies, such as renewable energy companies, who have come to New Mexico recently in response to specific tax incentives with the expectation of being taxed at a particular level."

Response: Combined reporting has been under serious discussion in New Mexico for years; indeed, the Blue Ribbon Tax Reform Commission recommended in 2003 that the state adopt it.[17] Companies accepting tax incentives to locate in New Mexico cannot realistically expect to permanently bind future legislatures against making tax changes that might increase their tax liabilities. States routinely raise and lower their taxes in response to changing economic conditions and other factors; in the last year alone, more than 30 states have raised taxes, including roughly a

---

[14] New Mexico Legislative Finance Committee Fiscal Impact Report for H.B. 51. H.B. 51 was the version of combined reporting legislation introduced in 2008 by (then) Representative Peter Wirth.

[15] business.marylandtaxes.com/pdf/Analysis%20of%20TY2006%20MD%20Corporate%20Information%20Reports.pdf.

[16] In 2005, 483 corporations elected to calculate their New Mexico corporate income taxes using combined reporting, and an additional 1057 corporations elected to file similar "consolidated returns." Together, these combined and consolidated returns accounted for 46 percent of all New Mexico corporate tax liability in that year. Source: New Mexico Legislative Finance Committee Fiscal Impact Report for H.B. 51, January 31, 2008.

[17] New Mexico Blue Ribbon Tax Reform Commission, table of recommendations (recommendation no. 9), available at http://legis.state.nm.us/LCS/bluetaxdocs/BRTRCTableofRecommendations.pdf.

dozen that have changed business taxes. In any case, those that accepted incentives within the last 6 years had fair warning that combined reporting might well be mandated.[18]

Claim: "The current corporate income tax system is not unfair to small local businesses. Most small businesses pay no corporate income tax or similar tax because they are organized as partnerships or sole proprietorships."

Response: Some relatively small businesses are, in fact, organized as corporations subject to the corporate income tax.[19] When they are, they are likely to be organized as a single legal entity, and/or to be doing business solely in New Mexico. As such, they cannot take advantage of tax shelters based on establishing non-New Mexico subsidiaries that large corporations employ. Moreover, many large corporations are able to reduce their corporate tax payments substantially in New Mexico by *electing* to file on a combined reporting basis — an option small, single-entity corporations do not have. These tax advantages may enable some multistate corporations to undercut the prices of their small competitors or attract investment capital at lower cost. In short, some small businesses organized as corporations are likely to be at a disadvantage in competing with large corporations able to reduce their income tax expenses by setting up multistate tax shelters or electing to calculate their tax liability using combined reporting.

Even unincorporated businesses not subject to New Mexico's corporate income tax may well be at a disadvantage vis-à-vis their large multistate corporation competitors due to the absence of combined

---

[18] Minzner appears to be arguing here on behalf of one of his clients, NextEra Energy, which operates a wind farm in the eastern part of the state and may be eligible for renewable energy tax credits. Construction of that facility began in early 2003 before the Blue Ribbon commission issued its recommendation. Nonetheless, that facility likely has already received the credits for at least five of the ten years for which they may be claimed, and the adoption of combined reporting does not reduce the value of the remaining credits. Indeed, by boosting the company's tax liability, combined reporting may simply enable them to be claimed immediately rather than carried forward. In any case, it seems highly unlikely that New Mexico's enactment of combined reporting would significantly increase the company's New Mexico tax liability in dollar terms. (If the credits are substantially or completely eliminating the company's New Mexico tax liability, then of course even a small increase in tax liability resulting from combined reporting could represent a large increase in liability in percentage terms.) Press reports at the time it was built indicated that the facility was a $200 million investment; that is less than one-half of one percent of the total property of the corporate group of which it is a member — Florida Power and Light (FPL) — according to the latter's annual report to the Securities and Exchange Commission. It employs only 15 people (www.nexteraenergyresources.com/content/where/portfolio/pdf/newmexico.pdf), meaning that its payroll is likely an even smaller share of the corporate group's than is its property. Finally, it does not appear that FPL has significant electricity sales in New Mexico other than those made by NextEra. In short, it appears that NextEra's New Mexico "apportionment factors" are likely so miniscule that combined reporting would result in no more than a modest corporate tax liability for the company in the state notwithstanding that the corporate group's 2008 profit was $1.6 billion. It is worth noting that for the entire corporate group, its provision for *nationwide* state corporate income tax liability in 2008 was a mere $40 million— an effective rate of one-quarter of one percent.. Finally, it should be noted that NextEra already has facilities in 13 current combined reporting states — California, Colorado, Kansas, Maine, Massachusetts, Minnesota, New Hampshire, New York, North Dakota, Oregon, Texas, West Virginia, and Wisconsin. (See: http://www.nexteraenergyresources.com/content/where/portfolio/pdf/portfolio_by_fuel.pdf.)

[19] According to the Internal Revenue Service, in 2003, so-called "C" corporations (those subject to federal and state corporate income taxes) with less than $500,000 in gross receipts comprised almost two-thirds of all C corporations. See: www.irs.gov/pub/irs-soi/03ib01ty.xls.

reporting.[20] Although the profits of such businesses are not subject to New Mexico's corporate income tax, they *are* subject to the state's personal income tax. Individuals with capital to invest can choose to invest it in corporations or unincorporated businesses, and they expect a return on that investment in both cases.[21] Moreover, the return that matters to them is the return after taxes — whether those taxes take the form of personal income taxes, corporate income taxes, or the two combined. Accordingly, the possibility that the absence of combined reporting may result in corporate profits in New Mexico being taxed at a lower effective state tax rate than attaches to the profits of non-corporate businesses is an entirely relevant issue, and Minzer is simply wrong to dismiss it on the grounds that "small businesses pay no corporate income tax."

Moreover, there are reasonable grounds to believe that the profits of large multistate corporations subject to tax by New Mexico are, in fact, often taxed at a lower effective tax rate than are the New Mexico profits of their competitors *not* subject to the state's corporate income tax.[22] Although the top personal income tax rate (4.9 percent) is lower than the top corporate income tax rate (7.6 percent), owners of (and investors in) small unincorporated businesses are likely to pay tax on 100 percent of that income while multistate corporations can shelter substantial portions of their New Mexico profits from taxation through transfer pricing and other tax-avoidance strategies that exploit the absence of combined reporting.[23] Furthermore, corporate profits often escape taxation at the state level for reasons beyond corporate tax planning.[24]

---

[20] For the purposes of this discussion, "unincorporated businesses" also include Subchapter S corporations. Although S corporations are regular corporations from a business law standpoint, they are exempt from federal and state corporate income taxes.

[21] As the Congressional Budget Office observes: "Investments by noncorporate businesses also need to pay investors competitive rates of return. For debt finance, that would be the market interest rate. For equity, the investor-operator of a noncorporate business will want to earn on a marginal investment as much after tax as he or she could earn by buying corporate equity." Congressional Budget Office, "Taxing Capital Income: Effective Rates and Approaches to Reform," October 2005, p. 17.

[22] There are a number of reasons this may well be true notwithstanding the "double taxation" of corporate income that results from corporate profits being subject to the corporate income tax and then again to the personal income tax when paid out as dividends to investors. First, some of those dividends will be received by investors residing in states with no personal income taxes — meaning that the profits will only be taxed once at the corporate level. Second, many dividends will be paid to pension funds or IRAs and not taxed until withdrawn many years later by retirees — meaning that the effective tax rate is sharply reduced. Third, slightly less than half of corporate profits are never paid out as dividends — meaning that the return on the investment takes the form instead of a capital gain that is taxed at a sharply reduced rate by some states or not at all if the stock is transferred at the death of the owner. Finally, a larger share of corporate profits than of non-corporate profits is paid out as tax-exempt interest because corporations can more easily and cheaply obtain debt financing than can smaller unincorporated businesses. (Some of these issues are discussed in the Congressional Budget Office report cited in the previous note.) In sum, the effective rate at which corporate profits are actually taxed is well below the more than 60 percent rate that would apply if the top marginal corporate income and personal income tax rates were summed. Indeed, the CBO estimated that the average effective tax rates on corporate income in 2008 was 26.3 percent and that the effective rate on business income earned by unincorporated businesses was 20.6 percent. (p. 8). (It must be acknowledged that the differential would likely be somewhat larger at the state level due to preferential tax treatment of dividends that exists at the federal level but not the state level.)

[23] Some of the profits of unincorporated businesses received by individuals may also be sheltered from taxation by New Mexico's personal exemptions and itemized or standard deductions.

[24] The state in which the owner of an unincorporated business resides taxes 100 percent of the business's profit under the personal income tax and provides a credit for income taxes paid on any portion of that income taxable in a different state. In contrast, the profits of a corporation are divided among the states in which it is doing business by a formula,

In sum, the current corporate income tax system in New Mexico can indeed be quite unfair to some small businesses, as combined reporting proponents in New Mexico often argue. Small businesses generally cannot exploit the tax-avoidance opportunities afforded large multistate corporations by New Mexico's failure to require combined reporting. Likewise, most small businesses cannot *elect* combined reporting when it results in a lower tax liability, as large corporations can. Lower tax expenses for corporations may enable them to undercut the prices of or attract capital at a lower cost than their small-business competitors — placing the latter at an unfair disadvantage. Combined reporting helps level the playing field. Perhaps this is one of the reasons that a recent economic study conducted for the federal Small Business Administration concluded that "States with more aggressive corporate income taxes, specifically including combined reporting. . . tend to have higher entrepreneurship rates."[25]

---

and mismatches between these formulas can lead to "nowhere income" — profits that completely escape state taxation. (For a discussion of how this can occur, see pp. 24-27 of the source cited in Note 6.) The profits of a small unincorporated business are much less likely to "slip through the cracks" and escape taxation completely than are the profits of a corporation, even before taking into account the ability of multistate corporations to exploit the absence of combined reporting.

[25] Donald Bruce and John Deskins, "State Tax Policy and Entrepreneurial Activity," November 2006; www.sba.go/advo/research/rs284tot.pdf.