New Mexico VOICES for Children

Taking a closer look at tax and budget policies affecting New Mexico's quality of life

New Mexico Fiscal Policy Project

Corporate Shell Games

How Wal-Mart and Others Shield Their Profits from New Mexico Taxes

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Updated January 2009

Introduction

The state of New Mexico is losing the tax revenue of major multi-state corporations because of a flaw in the state's tax policy. Profitable corporations doing business in multiple states can avoid paying corporate income tax (CIT) to New Mexico because of the state's failure to require unitary combined reporting for multi-state corporations. This puts a strain on the state's ability to provide critical services like public safety, education and health care for kids.

The extent of this problem has become public due to press coverage of recent court cases involving Kmart and Wal-Mart. However, as soon as the state Taxation and Revenue Department rules out one corporate income tax avoidance method, another takes its place. The Kmart and Wal-Mart cases, for example, involved passive investment companies, or PICs, which the court rulings disallowed. As soon as PICs were disallowed, Wal-Mart began using a real estate investment trust, or REIT. This paper will discuss how requiring unitary combined reporting would block corporations from future methods of corporate tax avoidance, as well as how much this tax avoidance costs New Mexico in lost revenue.

Corporate Income Tax and Unitary Combined Reporting

In the current fiscal year, the CIT will yield $403.5 million for New Mexico's general fund. Total general fund revenues are expected to be about $6.04 billion, so the CIT is a significant source of state government revenue. Currently, New Mexico law allows corporations doing business in two or more states to select the most advantageous method of allocating taxable income between those states. The state allows the corporation to select reporting on either a 'separate entity' basis or a 'combined' basis. For the past four legislative sessions, bills have been introduced that would require corporations doing business in several states to file their New Mexico corporate income tax return on a 'combined reporting' basis. These bills have failed every year.

The states must apportion taxable income because the US Supreme Court has ruled that no one state can tax all of the income of a corporation that is doing business in several states. States must select a formula to determine the share of total profits that the state will tax. A formula apportioning income is an appropriate short-cut, because the matching of actual in-state sales and in-state expenses would be subject to manipulation and would pose an extreme auditing burden on the state.

The 'combined reporting' and 'separate entity reporting' methods differ in how they treat the taxable income of a parent corporation and its subsidiary corporations. Separate entity reporting applies the allocation formula to the profit of each separate corporation as calculated by the corporation itself. The state of New Mexico allows corporations to select the separate entity method if they wish.

The 'combined reporting' method adds together the profits of parents and subsidiaries before applying the allocation formula. In order for parents and subsidiaries to be combined for apportionment, they must be engaged in a 'unitary' business – an integrated economic enterprise. The most often cited example of a unitary business is a commonly owned oil business made up of oil field, pipeline, refining, and marketing corporations. The state cannot require combined reporting unless the individual corporations in a group of corporations are a unit.

Goals of Unitary Combined Reporting for CIT

The goal of unitary combined reporting for the CIT is to stop some commonly used methods of tax avoidance. These methods are: artificially shifting income between states; shifting income to commonly owned corporations in low-tax or no-tax states; or moving income beyond the reach of the New Mexico corporate income tax. The goal of unitary combined reporting of taxable income is to ensure that a corporation's income tax liability is not affected artificially by the corporation's legal structure.

Several common tax avoidance strategies are ruled out by combined reporting. These are: passive investment companies; transfer pricing; intangible asset spin offs; and isolating profitable activities from their connection with the state (called 'nexus').

Passive investment companies are known as PICs, Delaware Holding Companies (DHCs), or Intangible Holding Companies (IHCs). Passive investment companies are most often set up in Delaware, Nevada, and Michigan because of their CIT laws. The most famous PIC case is the 'Geoffrey Giraffe' Delaware subsidiary of Toys R Us. The 'Geoffrey Giraffe' Toys R Us case set the precedent that PICs are not an acceptable tax avoidance device. PICs are essentially shell corporations – the headquarters of some 500 PICs are located in a single Delaware office building.

PIC shelters work like this:

Step 1.) Parent corporation sets up a PIC in a state without a corporate income tax (such as Nevada) or does not tax corporations whose only income is from intangible assets (such as Delaware or Michigan);

Step 2.) Parent corporation transfers licenses, patents, trademarks and 'know-how' to the PIC;

Step 3.) PIC transfers the right to use the licenses, patents, trademarks, etc., back to the parent corporation in exchange for royalty payments. The result is that the payment of royalties reduces or even eliminates the taxable profit of the parent corporation. Also, the PIC is not subject to income tax on its profit.

Step 4.) The PIC loans its profit to the parent corporation in exchange for an interest payment. The interest payment from the parent to the PIC further reduces the parent's taxable income.

Definition of Terms

Apportionment The calculation by which the profit of a corporation doing business in two or more states is divided among those states.

Combined Reporting Adding together the profits of parents and subsidiaries before applying the allocation formula.

Doing Business Producing goods or services and/or making sales.

Intangible Asset Spin Off The transfer of a corporation's intangible assets to a PIC.

Isolate Profitable Activities Separating profitable activities that do not have to physically occur in a state from activities that do have to physically occur in that state.

Nexus A physical connection with a state (such as a building) for doing business.

Passive Investment Company (PIC) An intangible holding company set up in a state with low or no CIT.

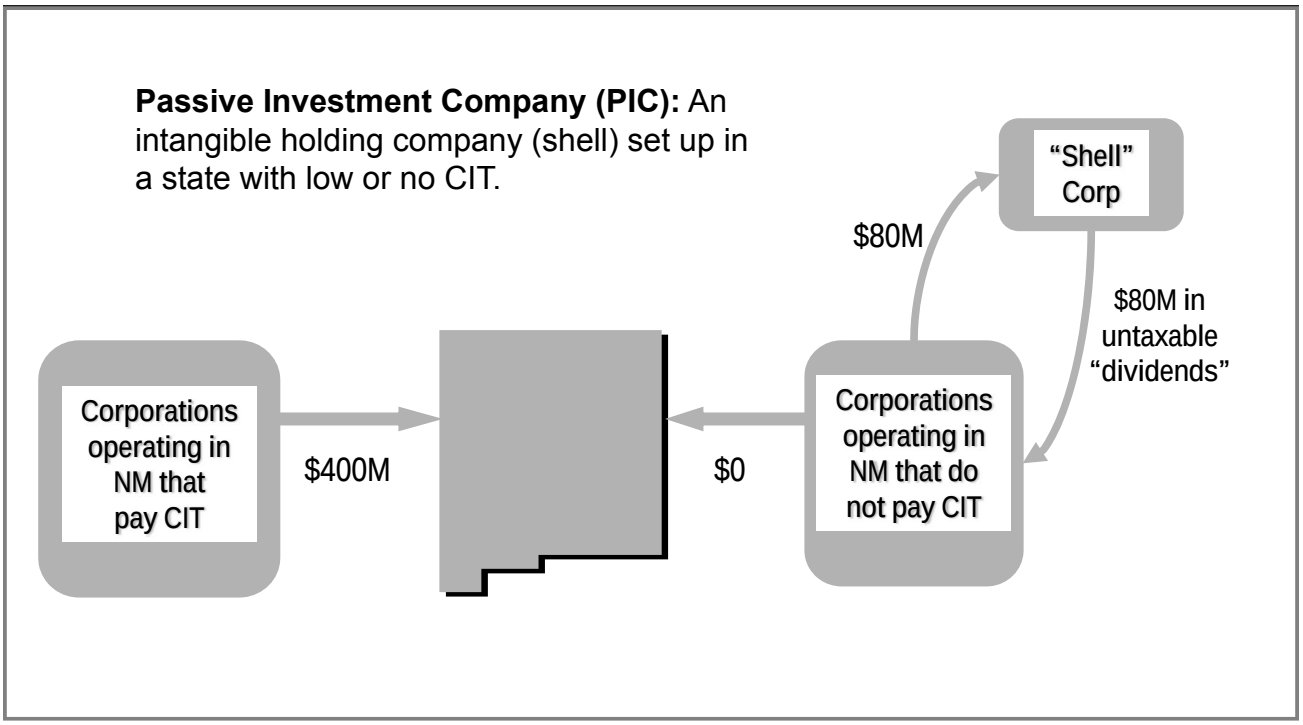
Real Estate Investment Trust (REIT) A trust set up with a subsidiary that owns the real estate and building to which the corporation pays rent.

Separate Entity Reporting Applying the allocation formula to the profit of each separate corporation as calculated by the corporation itself.

Transfer Pricing Using artificially high or low charges among affiliated corporations to shift income from states with high CITs to states with low or no CITs.

Unitary Business An integrated economic enterprise.

There are several examples of the use of PICs to shelter corporate profits. According to the Center on Budget and Policy Priorities, such examples include Kmart, The Limited/Express/Victoria's Secret, and Worldcom. Kmart sheltered about $1 billion in profits over a three-year period in the early 1990s in its Michigan PIC. The Limited/Express/Victoria's Secret PIC sheltered about $1.2 billion in profits over a three-year period in the early 1990s in its Delaware PICs. Worldcom sheltered $19.5 billion in profits from 1999 to 2003. The tax savings are thought to be about 6 to 8 percent of the profits that have been sheltered. Combined reporting would rule out this strategy, since all of the corporations' profits would be shared between the states based on a standard allocation formula.



A second tax avoidance strategy used by corporations is 'transfer pricing.' Transfer pricing involves using artificially high or low charges among affiliated corporations to shift income from states with high CITs to states with low or no CITs. The corporation in a state with a high CIT would charge an artificially low price for a component, reducing its profit in the high-tax state. At the same time, this pricing strategy could increase the share of profit going to the state with a lower CIT or no CIT. When the product is sold, more of the profit would go to the lower-tax state and less of the profit would go to the higher-tax state. Again, requiring unitary combined reporting for corporate income tax purposes would rule out the practice of transfer pricing, since all of the company's taxable income would be shared among the states based on a standard allocation formula.

Intangible asset spin off – the transfer of a corporation's intangible assets to PICs – is another common practice used by financial corporations. The goal of this strategy is to isolate assets that are generating income from corporate income taxation. Financial institutions are major users of this tax avoidance technique. Typically, a bank would make loans and buy portfolio assets and transfer such loans and assets to a PIC. The earnings on the assets transferred to a PIC would accrue free of corporate income tax from the home state, while the bank could continue to deduct expenses from the deposits that generated the assets in the first place. These expenses would include interest on the deposits, depreciation on branch office buildings, and salaries of bank tellers. The bank can transfer the earnings of the PIC to the rest of the corporation through loans or dividends. A bank in Wisconsin stated that it had saved between $9 and $13 million a year through this strategy. This strategy has also been used recently by Provident Bankshares of Maryland. Mandatory combined reporting would require that the financial institution and its PICs report all profits as the profits of one unitary entity. The profits would then be allocated between the states.

Finally, corporations can isolate profits from a taxable connection or 'nexus' with a state by simply incorporating a separate corporation. Nexus means engaging in sufficient activity in a state to become subject to the CIT in the state. The baseline for determining nexus is a physical presence in the state, such as a building. If the only activity of a corporation in a state is soliciting and making sales, Public Law 86-272 excludes that corporation from corporate income taxation in that state. In separate reporting entity states like New Mexico, corporations work to separate profitable activities that do not have to physically occur in the state from activities that do have to physically occur in the state. Setting up separate corporations may enable a corporation to maximize the share of profit that may be sheltered by tax incentives available in a particular state. Incorporating a separate corporation may also

increase the share of profit that is taxed by the state with a lower rate. A good example of this strategy is the separate incorporation of a national cable network and a local cable television system. Although most of the profit is in the national network, the state may not be able to tax the profit from the national network, only that from the local cable system. A state requirement for combined reporting of corporate income would add the profits of in-state and out-of-state corporations if they were closely related. This would remove the advantage of shifting income from the in-state to the out-of-state corporation.

In Summary

1.) Requiring unitary combined reporting of corporate income removes the advantage of all four major tax avoidance methods.

2.) The legality of the combined reporting requirement has been upheld twice by the US Supreme Court.

3.) Requiring combined reporting for corporate income tax guarantees fairness to corporations doing business wholly within New Mexico. Such corporations lack the opportunity to engage in shifting income between states to avoid the corporate income tax. These corporations may be small, New Mexico-owned corporations.

The TRD's Wal-Mart Decision

In early 2006, the New Mexico Taxation and Revenue Department (TRD) issued a decision in a corporate income tax case involving a Wal-Mart PIC that was similar in content to the recently decided New Mexico Supreme Court case involving a Kmart PIC. In both Kmart and Wal-Mart, the parent company had set up a subsidiary for the purpose of holding the company's trademarks. In both cases, the subsidiary was an intangible holding company. The subsidiary PIC therefore appeared to be set up primarily as a tax avoidance strategy. In the case of Kmart, the New Mexico Supreme Court found that the royalty receipts of the Kmart PIC subsidiary were taxable under the New Mexico corporate income tax code insofar as the royalties resulted from the use of the trademarks in the state of New Mexico.

The TRD hearing officer made use of the same logic in the decision in the corporate income tax treatment of Wal-Mart and its PIC subsidiary WMR. Wal-Mart seemed to have set up the PIC subsidiary as part of a tax avoidance strategy, since the royalties paid to WMR would be deductible as a business expense by the parent corporation. WMR granted Wal-Mart a license to use the Wal-Mart trademarks in exchange for royalty payments. Wal-Mart filed its New Mexico CIT returns on a separate entity basis, so the royalty income of WMR (from the use of the Wal-Mart trademarks) would not be included in Wal-Mart's corporate income because WMR was a separate corporate entity located outside New Mexico. The royalty payments were based on a percentage of the gross revenue of Wal-Mart. Wal-Mart's position was that the royalty payments made to WMR were a deductible business expense, thereby reducing Wal-Mart's total income subject to New Mexico's CIT. At the other end of the transaction, WMR, the intangible holding company, had royalty income, but this income was not subject to New Mexico CIT because WMR was located outside the state and was not required to file CIT in New Mexico.

The TRD hearing officer took the position that WMR did have New Mexico taxable income liability. The rationale for this determination was that WMR's royalty income was the result of Wal-Mart's sales activity in New Mexico, and therefore the share of WMR's total royalty income to be allocated to New Mexico was the same as the share of Wal-Mart's total sales income allocated to New Mexico. Typically, the taxable income would have been allocated according to a three-part factor including payroll, property and sales. In allocating the income, the property and payroll factors were disregarded by the TRD as being too small to consider. Including the payroll and property factors along with the sales factor would have reduced the sales factor to one-third of the sales, which the TRD found unreasonable.

The most important conclusion to draw from the Wal-Mart decision by the TRD hearing officer is that the situation would not have arisen if the state had required combined reporting for the CIT. If mandatory combined reporting had been in effect, Wal-Mart would have had no motivation to set up the intangible holding company WMR, and no motivation to set up the chain of transactions in which it, in effect, paid itself for the use of its own trademarks.

Combined Reporting and the States

Of the 46 states that collect a corporate tax for which combined reporting is relevant, 23 now require combined reporting for corporate income tax purposes. New Mexico is one of just two western states with a

corporate income tax that does not require combined reporting. Until early 2007, Vermont had been the most recent state to adopt combined reporting, which it did in 2004. Texas and Michigan added the requirement for combined reporting in 2006. West Virginia and New York followed in early 2007. Texas has a 'corporate franchise tax,' which is closely related to a corporate income tax. Michigan has a 'gross receipts tax' which is structured to closely resemble a corporate income tax. States requiring combined reporting are: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Indiana, Kansas, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Texas, Utah, Vermont, and West Virginia. In recent legislative sessions, at least ten states have seen combined reporting bills introduced: Arkansas, Connecticut, Florida, Iowa, Kentucky, Maryland, Massachusetts, Missouri, New Mexico, Pennsylvania, and Wisconsin. Governor Tom Vilsack of Iowa included combined reporting in his budget for the 2006 fiscal year. New Mexico saw a combined reporting bill introduced in the 2005, 2006, 2007 and 2008 legislative sessions. In each case, the bill died in the House Business and Industry Committee.

New Mexico is one of only two states west of the Mississippi that does not require unitary combined reporting.

There are several possible reasons more states have not required combined reporting. As mentioned earlier, the US Supreme Court determined in 1983 that requiring combined reporting was constitutional. Until that decision, states were not inclined to risk that their statute would be found unconstitutional. Another reason more states have not enacted combined reporting is that the strong economic growth of the 1990s masked the underlying hollowing out of the corporate income tax. Even though revenues for CIT were growing in absolute terms, the base of the tax was eroding due to common tax avoidance strategies. Also, overall revenue growth was strong, especially in the latter half of the 1990s, and strong revenue growth makes it very difficult for state legislatures to enact any legislation that will increase revenues. In New Mexico, strong revenue growth resulting from high oil and natural gas prices led to the quadrupling of revenues from the CIT in a five-year period from FY 2000 to FY 2006. Revenues from the New Mexico CIT rose from $100 million in FY 2000 to $400 million in FY 2006.

In each of the last four New Mexico legislative sessions, the assertion was made by industry lobbyists that changing the current reporting requirements for the New Mexico CIT would negatively impact economic development. Industry lobbyists also raised the issue that limiting CIT reporting requirements to just combined reporting would be an unfair 'bait-and-switch' ploy in that the state would have changed the rules of the game after the corporation began doing business in the state. These arguments are an admission that some multi-state corporations are not currently paying their fair share of corporate income taxes.

A New Strategy: Real Estate Investment Trusts

According to the Feb.1, 2007, *Wall Street Journal* article "Friendly Landlord: Wal-Mart Cuts Taxes by Paying Rent to Itself," Wal-Mart and other banks and retailers have adopted a method of reducing state CIT payments that the federal government disallowed several decades ago. States have been slow to take measures against the use of real estate investment trusts (REITs) as a tax avoidance strategy.

The strategy is fairly simple in its essentials: after Wal-Mart (e.g. Wal-Mart Stores East) sets up an REIT (Wal-Mart Real Estate Business Trust), which owns the real estate and building, the Wal-Mart store pays rent to the REIT. The rent paid to the REIT is deductible as a business expense by the Wal-Mart store. The REIT is owned by another Wal-Mart subsidiary (Wal-Mart Property Inc.), a holding company that receives dividends from the REIT. The trustees of the holding company, who were actually Wal-Mart employees, were required to pay personal income tax on the dividend distribution, but Wal-Mart increased their salaries to compensate the trustees for their increased personal income taxes. The final result for the state is that the original Wal-Mart store deducted the rental payments to the REIT and neither the REIT nor the holding company paid state corporate income taxes on these payments.

The REIT strategy for avoiding state corporate income taxes seems to be a relative of the PIC strategy discussed earlier, in that the REIT strategy

also involves setting up a shell entity solely for tax avoidance purposes. It is ironic that the use of REITs as a tax avoidance strategy has been disallowed by the federal government for decades, while the states have had some trouble catching up. It is also clear from the situation in New Mexico that litigation around CIT avoidance strategy can be an endless highway – as soon as one tax avoidance strategy is invalidated, another method takes its place. When the state of New Mexico disallowed the PIC strategy in the Kmart case and the Wal-Mart decision, Wal-Mart promptly came up with the REIT approach.

The REIT strategy would also have been derailed if the state required combined reporting. The motivations for the creation of the REIT and the holding company would have been lacking if all of those entities were required to file a CIT return as a single entity. Again, requiring combined reporting would have kept Wal-Mart from creating shell corporations simply to minimize state corporate income tax.

Unitary combined reporting would recapture some $90 million a year in revenue. And it would require profitable multi-state companies to pay their fair share.

The Bottom Line: Combined Reporting Yields $90 Million

The most recent fiscal analysis of requiring combined reporting for CIT was done in February 2008 for Rep. Peter Wirth's House Bill 51, "Mandate Combined Reporting." According to the TRD, requiring combined reporting would increase revenues from the corporate income tax by $90 million per year in New Mexico. This would have been an increase of about 20 percent of the expected annual revenue from the CIT of $450 million. The TRD noted that the revenue estimate for requiring combined reporting is uncertain because of the cyclical character of the revenues from the CIT. The CIT revenues at $450 million are revenues from the top of the business cycle. In addition, as much as half of the current CIT revenues may be due to oil and natural gas prices at the top of their range. Revenues for the CIT are cyclical, and therefore revenues from requiring CIT combined reporting would also be cyclical. The fiscal impact of $90 million from combined reporting is probably a high-end estimate.

In the cited Fiscal Impact Report for HB 51 in the 2008 legislative session, the TRD provided valuable information about CIT filers in New Mexico. In tax year 2005, about 18,000 New Mexico CIT returns were filed as separate corporate entities (SCE). About 480 returns were filed as combined unitary, while 1,057 filed federal consolidated returns. The SCE filers paid about 54 percent of the state's total CIT revenue, combined filers paid about 13 percent, and the federal consolidated return filers paid 32 percent. Separate corporate entity filers tend to be smaller, but the TRD notes that they can be large in some cases. The average tax liability for SCE firms was $9,770, while unitary combined filers paid about $95,215 per return and federal consolidated returns averaged $100,019 per return. Major SCE filers included large national firms in the manufacturing, retail, and mineral extraction industries.

In accounting for the large fiscal impact of requiring combined reporting of CIT, it seems clear that there are SCE filers that would pay more if they were required to pay on a combined basis. Since the unitary combined filers pay on average $95,215, while the federal consolidated filers pay $100,019, it appears that moving an SCE filer from that category to one of the two combined filing categories would increase that taxpayer's liability. If there are SCE filers that should be filing on a combined basis, their liability could be quite a bit higher, judging from the average payments for firms paying on a combined basis.

The Fiscal Policy Project, a program of New Mexico Voices for Children, is made possible by grants from the Annie E. Casey Foundation, the McCune Charitable Foundation, the Public Welfare Foundation, and the W.K. Kellogg Foundation.

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