

## WINNERS AND LOSERS: THE SINGLE SALES FACTOR FORMULA IN NEW MEXICO

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The corporate income tax is a tax on corporate profits. Of the 50 states, 45 (including New Mexico) have some version of a corporate income tax (CIT). Corporations that operate in multiple states can also be subject to state CIT, but each state can tax only the share of a corporation's profits that is attributable to activity in that state. Apportionment formulas are used to determine a multi-state corporation's profitability in any given state. Three different formulas are widely used: the three factor formula, the double-weighted sales factor formula, and the single sales factor formula. New Mexico currently uses the double-weighted sales factor formula for manufacturers and the three-factor formula for all other multi-state corporations.

The Martinez administration is discussing shifting to the single sales factor formula (SSFF), with the stated reason that it will improve New Mexico's 'business climate.' However, there is no evidence to support that the use of SSFF leads to significant growth in employment in the two industries that benefit the most from it.<sup>1</sup> In fact, the decline in revenue is likely to lead to job losses, as the state would forfeit as much as half of the CIT revenue it now collects. There is also no clear relationship between SSFF and corporate location decisions.<sup>2</sup> What's more, shifting to the SSFF would definitely result in corporate 'winners' and 'losers.' The extraction industries (oil and natural gas) and manufacturing would be the big winners because their

taxes would decrease the most. Multi-state retailers and some corporations that do business solely in New Mexico would be the big losers. Retailers would pay more and mining and manufacturing corporations that do business only in New Mexico will receive no benefit, which will put them at a competitive disadvantage with the corporations that will benefit.

### THREE FACTOR FORMULA

A three-factor formula has been the most commonly used method of allocating corporate profits by state since the 1950s and it is currently used in New Mexico for multi-state corporations that are not manufacturers. This formula distributes the net income of multi-state corporations on the basis of three factors: a corporation's payroll, property and sales within that state. These factors take into account the benefits that a corporation is receiving from a state's government—this is called the 'benefit principle.' These benefits include public education, infrastructure such as roads and highways, the legal system, police and fire protection, etc. Each of the three factors—payroll, property (land, plant and equipment), and sales—is weighted equally. They are added together and the result is divided by three.

For example, if a multi-state corporation had 20 percent of its payroll, 30 percent of its property, and 10 percent

of its sales in New Mexico, the three-factor formula would look like this:

$$\begin{array}{r} 20\% \text{ payroll} \\ 30\% \text{ property} \\ + 10\% \text{ sales} \\ \hline 60\% \text{ total} \\ \div 3 \\ \hline 20\% \end{array}$$

Since the end number is 20 percent, 20 percent of the corporation's net profit would be taxed by New Mexico.

## DOUBLE-WEIGHTED SALES FACTOR FORMULA

The double-weighted sales factor is the formula for CIT used by New Mexico for manufacturing. This formula takes into account the same three factors—property, payroll and sales (and, therefore, includes the benefit principle). The difference is that the sales factor is doubled and the total is divided by four instead of three.

In the above example, the double-weighted sales factor formula would look like this:

$$\begin{array}{r} 20\% \text{ payroll} \\ 30\% \text{ property} \\ + (10\% \text{ sales} \times 2) \\ \hline 70\% \text{ total} \\ \div 4 \\ \hline 17.5\% \end{array}$$

The double-weighted sales factor drops the final number from 20 percent to 17.5 percent. Thus, New Mexico would tax just 17.5 percent of the corporation's net profit.

## SINGLE SALES FACTOR FORMULA

The SSFF bases the distribution of profits only on the corporation's sales in that state. In the above example, the SSFF would look like this:

$$\begin{array}{r} ~~20\% \text{ payroll}~~ \\ ~~30\% \text{ property}~~ \\ + 10\% \text{ sales} \\ \hline 10\% \end{array}$$

Under SSFF, just 10 percent of the corporation's net profit would be taxed instead of 20 percent under the three-factor formula or 17.5 percent under the double-weighted sales factor.

By not taking into account a corporation's payroll and property, SSFF ignores the benefit principle. All corporations rely upon public structures in order to do business. They would have no payroll without an educated workforce. Their physical properties require protection by police and firefighters, as well as access to water, sewage, and other infrastructure. They also need roads and highways for moving goods and customers, and a legal system for enforcing contracts. The benefit principle holds that because businesses rely on these benefits, they should help pay for the cost of providing them. Not only are these public structures necessary for businesses, but the quality of these benefits—an educated workforce in particular—are among the factors companies consider when they are deciding where to locate a new facility. A state that short-changes its investments in public structures in order to lure corporations may, in fact, end up making itself less attractive to business, especially those with high paying jobs requiring a well-educated workforce.



## JOB-KILLING TAX CUTS

Tax cuts mean a loss of revenue and that often leads to a loss of jobs. Changing the formula for calculating CIT to a single sales factor would amount to a significant loss of funding for the state—as much as half of its annual CIT revenue. It’s difficult to say just how much money that would be from year to year, as CIT revenues have been unstable recently due to the impact of energy prices and the great recession on corporate profits. For example, revenues from the CIT were \$125 million in FY10 but had been up to \$450 million a few years earlier. (See the table below for CIT revenues and estimates from 2003 to 2016.) As the economy continues to recover, corporate profits—and the CIT they generate—will bounce back. But if the state implements SSFF, it will collect as much as half of what it otherwise would have—meaning as little as \$62.5 million in FY10.

Unless that lost revenue is collected from other sources, less funding will be available for important programs like education, public safety, and health care, which would mean more job losses for teachers, police officers, and first responders.

## WINNER AND LOSERS

There would be ‘winners’ and ‘losers’ from implementing the SSFF in New Mexico. Winners would be industries that have large amounts of

personnel and property in New Mexico, while losers would be corporations that have significant proportions of their sales in New Mexico. The two winners in New Mexico are clearly the mineral extraction and manufacturing sectors, because they are the two industries with the largest components of payroll and property in New Mexico and much of their sales are to out-of-state entities.

The retail sector would be the biggest loser, because sales are the largest component of this industry. SSFF would also disadvantage New Mexico corporations that operate only in New Mexico because apportionment of profits is only available to corporations that are operating in more than one state. Many multi-state corporations that are in competition with New Mexico

### A Corporate Tax Loophole

New Mexico corporations are already at a competitive disadvantage because multi-state corporations can avoid paying CIT due to the way the state allows them to file their tax returns. Most states in the Western U.S. require multi-state corporations to file their tax returns as one entity—meaning all the components in every state are combined (a filing method known as mandatory combined reporting). Another formula is then used to determine how much profit was earned in each state. New Mexico allows multi-state corporations to file as if they are separate and distinct entities from their parent and sibling operations in other states. Corporations take advantage of this loophole by using creative accounting methods to shift their New Mexico profits to a parent company in a state that does not collect CIT. New Mexico’s Taxation and Revenue Department has taken several multi-state corporations to court over this practice and won judgments against them, but this is a costly and inefficient way of collecting taxes. Implementing SSFF would put New Mexico corporations at an additional disadvantage.

**New Mexico Corporate Income Tax Revenues (Actual and Estimated), 2003-2016** (in millions)

FY03	\$101	FY10	\$125
FY04	\$138	FY11*	\$229
FY05	\$242	FY12*	\$310
FY06	\$377	FY13*	\$375
FY07	\$460	FY14*	\$410
FY08	\$354	FY15*	\$425
FY09	\$162	FY16*	\$400

\*Estimated revenue

Source: New Mexico General Fund Consensus Revenue Estimates Testimony, various editions

corporations would see their CIT payments decrease while corporations operating only in New Mexico would receive no benefit from SSFF.

The extraction industry would also be a big winner because they provide a large share of the state's total CIT revenue. In FY06, 44 percent of total CIT revenues came from mineral extraction industries, with just 6 percent coming from manufacturing, and 5 percent from retail.<sup>3</sup> It is unlikely that halving the CIT collected from oil and natural gas producers would impact employment in those industries, as jobs are more dependent on the presence (and to some extent, the price) of the natural resources they extract than on any other factor.

## THE BUSINESS CLIMATE

There is no conclusive evidence that adopting the SSFF leads to significant growth in manufacturing employment. Of the states with SSFF in place between 2001 and 2004, three of them (Iowa, Missouri and Nebraska) had a manufacturing employment performance better than the national average, while five (Connecticut, Illinois, Maryland, Massachusetts, and Texas) had a worse performance. There is also little evidence that adopting SSFF will lead to an influx of manufacturing plants. In the cases of Massachusetts and Texas, the electronics plants that opened up there during that time frame had ongoing relationships with the states. Texas also had some energy companies open facilities, but those were obviously related to the location of the energy resources. There is no clear relationship between SSFF and corporate location decisions.<sup>4</sup>

## CONCLUSION

Implementing the single sales factor formula in New Mexico is not likely to accomplish its stated goal of improving the business climate. There is no clear relationship between SSFF and manufacturing employment, and the evidence that corporate location decisions are linked to SSFF is also insubstantial. Instead, SSFF will very likely be expensive, costing the state as much as half of its annual corporate income tax revenue, which would no doubt result in job losses.

SSFF moves the state away from the benefit principle: namely, there should be a relationship between the benefits a corporation receives from state government and the taxes they pay to support those benefits.

Finally, SSFF will shift responsibility for corporate income taxes away from the manufacturing and mining sectors and onto the retail sector and manufacturing corporations that operate solely in New Mexico, putting New Mexico-owned corporations at a further competitive disadvantage.

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## ENDNOTES

- 1 "The Single Sales Factor Formula for State Corporate Taxes: A Boon to Development or a Costly Giveaway?," Michael Mazerov, Center on Budget and Policy Priorities, Washington, DC, September 2005; <http://www.cbpp.org/files/3-27-01sfp.pdf>
- 2 Ibid
- 3 New Mexico General Fund Consensus Revenue Estimates Testimony, January 7, 2008
- 4 "The Single Sales Factor Formula for State Corporate Taxes: A Boon to Development or a Costly Giveaway?"

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