NEW MEXICO VOICES FOR CHILDREN

Fiscal Policy Project

The Corporate Income Tax: A Declining But Essential Part of New Mexico State Revenues

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The complete elimination of the corporate income tax as a meaningful revenue source for the state of New Mexico appears, unfortunately, to be within sight. Making significant changes to the corporate income tax (CIT) structure has been popular with state leaders of late. A bill that makes corporate net operating losses deductible for twenty years was passed in the recently concluded 2014 legislative session and signed into law. An omnibus tax bill that made several changes to the state's CIT code was enacted in 2013. The reasoning behind recent CIT legislation was to encourage economic development. In general, however, the academic literature is skeptical about the efficacy of using the tax system for such purposes.

Introduction

Constructing a tax system that meets accepted tax principles and supports an adequate budget is the subject of never-ending debate here and across the nation. However, tax principles such as fairness, efficiency, and adequacy are often pushed aside as policy-makers attempt to use the tax system to achieve other goals such as economic development.

While job creation by way of corporate tax cuts is dubious at best, what is far more certain is that such legislation will lead to less revenue in the state budget for critical programs and services like education, health care, and public safety, which are absolutely necessary for economic development of any kind. When corporations aren't required to pay their share of taxes to support these services, either individuals end up paying more to make up the difference or those services are cut. Cutting such services is likely to end up hindering a state's ability to entice new businesses and keep existing ones. Despite the questionable value of cutting taxes to achieve job creation and retention, New Mexico policy-makers continue to pursue this strategy.

The most recent of these bills, SB-106, which makes corporate net operating losses deductible for twenty years, will result in a loss of some $6 million beginning in 2018.[1] The 2013 omnibus tax bill, HB-641, will have a much higher price tag. The bill both lowered the CIT rate and eliminated up to three-quarters of the CIT paid by manufacturing corporations. Before legislators voted, they were told that HB-641 would be revenue-positive—meaning it would bring in more revenue than it cut. However, estimates made shortly after the bill was passed indicated that HB-641 would cost more money than it would bring in.

These post-session fiscal impact reports showed CIT revenue declining through fiscal year 2017. Estimates made later in the year by the Consensus Revenue Estimating Group showed CIT revenues continuing to fall through FY18. The rationale for this is mysterious given the state's ongoing, albeit very slow, recovery from the Great Recession. As corporate profits continue to recover, it would seem that revenues from the CIT would continue to hold up well.

Besides lost revenue, the 2013 tax cut compromises important tax principles. (See page 5 for the Legislative Finance Committee's tax principles.) Only time will tell whether it plays any meaningful or measurable role in providing good-paying jobs.

This report provides some clarity on how the CIT in New Mexico works and who pays it, as well as draws attention to the different impacts that HB-641 will have on state CIT revenues.

CIT and the States

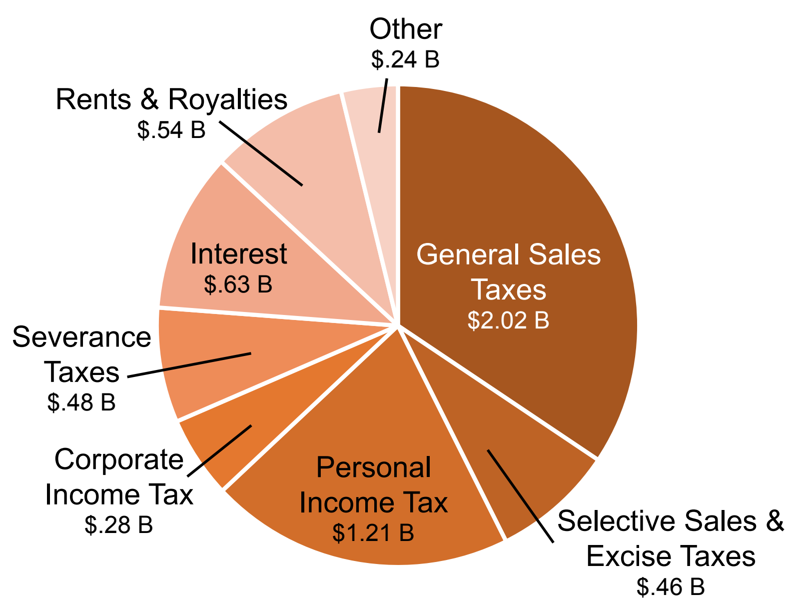
The existence of a corporate income tax is a fairly typical part of a state's tax system. All 50 states except Nevada, South Dakota, Washington, and Wyoming tax the net income of the corporations earning profits there.[2] The Texas franchise tax is, arguably, also a form of corporate income tax. In 2009, the U.S. Census Bureau found that corporate income taxes accounted for some $40 billion in state government revenues.

There are several rationales for the corporate income tax. A common one is that it preserves the integrity of the personal income tax. If there were no corporate income tax, the argument goes, individual taxpayers could simply use the corporate tax form to shelter personal income.[3] With the corporate income tax, this shelter is unavailable. The most common rationale for the corporate income tax, however, is the benefit principle:

> "Corporations use public services provided by the state as much as individuals and unincorporated businesses [do]. They benefit from a state's transportation infrastructure—the roads, railways, airports and harbors used to receive materials and to move products to market. Corporations also benefit from public safety operations, including police, fire and medical emergency services. In addition, the state judicial system protects their contractual, intellectual property, and other legal rights. Corporations also depend on the state's school system to produce an educated work force—an especially important role in this highly specialized age of electronic commerce. High quality school systems also help attract qualified employees."[4]

Despite their need for an educated workforce and quality infrastructure, corporations have played the states against each other in a bid—a largely successful one in recent years—to extract tax breaks in exchange for the promise of jobs. Besides being a dubious economic development deal for states, such strategies

Chart I
General Fund Revenue Sources (FY14)
(in billions)



Source: New Mexico Voices for Children analysis of *April 2013 Post Session Review*, New Mexico Legislative Finance Committee also rob them of the very revenue needed to provide the public services and supports corporations demand. For New Mexico, the cost of the CIT is largely exported—meaning most of it is paid by people not living in New Mexico. The cost of a corporation's CIT is passed along to its shareholders by way of reduced dividends. While most people who have a 401K retirement account own some corporate shares, the vast majority of all corporate shares are held by a relatively small percentage of people. A corporation's main fiduciary responsibility is to maximize profits for their shareholders, and one way to do that is to minimize corporate taxes.

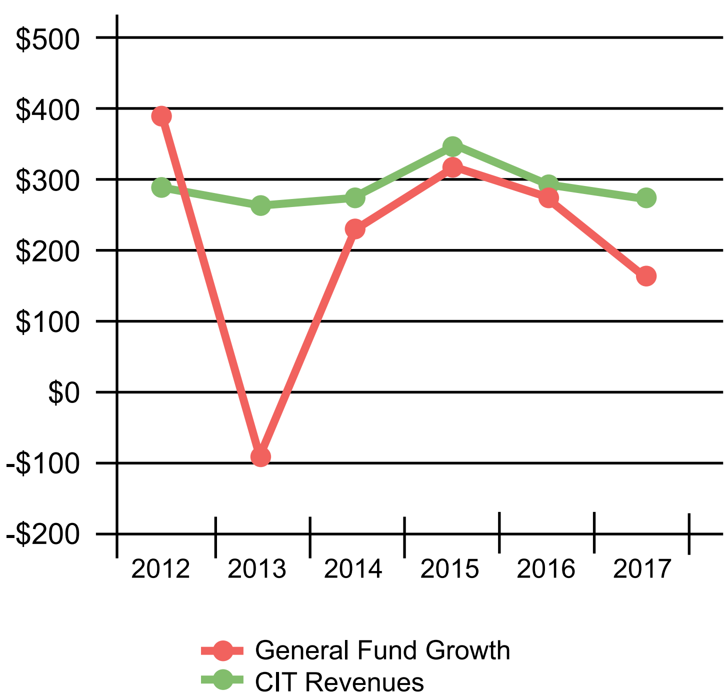
A Small but Crucial Role

The CIT plays a small—but crucial—role in New Mexico's revenue structure. Overall, New Mexico state revenues come largely from sales and excise taxes, mineral production, and income taxes. In FY13 (July 2012 – June 2013) New Mexico's sales taxes—the gross receipts, compensating, excise, and selective sales taxes—accounted for the largest share of state revenues at 41 percent of the total, as shown in Chart I (page 2).

The second largest share of state revenues (about 27 percent in FY13) came from the state's mineral production—severance taxes, interest from mineral-based investment funds, and rents and royalties from the leasing and sales of state mineral lands. Mineral production is mostly oil and natural gas extraction, although a small share is from potash and copper production.

Personal income taxes accounted for about 21 percent of total revenues in both FY13 and FY14. The CIT accounted for 4.6 percent of the state's revenues in FY12 and FY13, rising very slightly to 4.8 percent as the economic recovery gained a little steam in FY14. The CIT in New Mexico is paid largely by the mining, manufacturing, and management of companies sectors, with those three sectors accounting for about two-thirds of corporate income tax receipts.

Graph I
CIT Revenues versus General Fund Growth
(in millions)



Source: New Mexico Voices for Children analysis of December 2012 General Fund Revenue Estimates

> "The annual growth in general fund revenues has been quite unstable in recent years."

Some forms of taxation are more stable than others—meaning they fluctuate less over time. As Graph I (at left) shows, the growth of CIT revenues has been very stable compared to the erratic growth of the general fund as a whole. The annual growth in general fund revenues has been quite unstable in recent years and will continue to be choppy in the near future. General fund growth was almost $400 million in FY12 but then fell to -$100 million in FY13. Revenues from the CIT, on the other hand, have risen smoothly since FY12, and are expected to increase slightly through FY15. The CIT helps to stabilize general fund revenues and this is a feature that policy-makers should be aware of when thinking about making changes that could destabilize this revenue source.

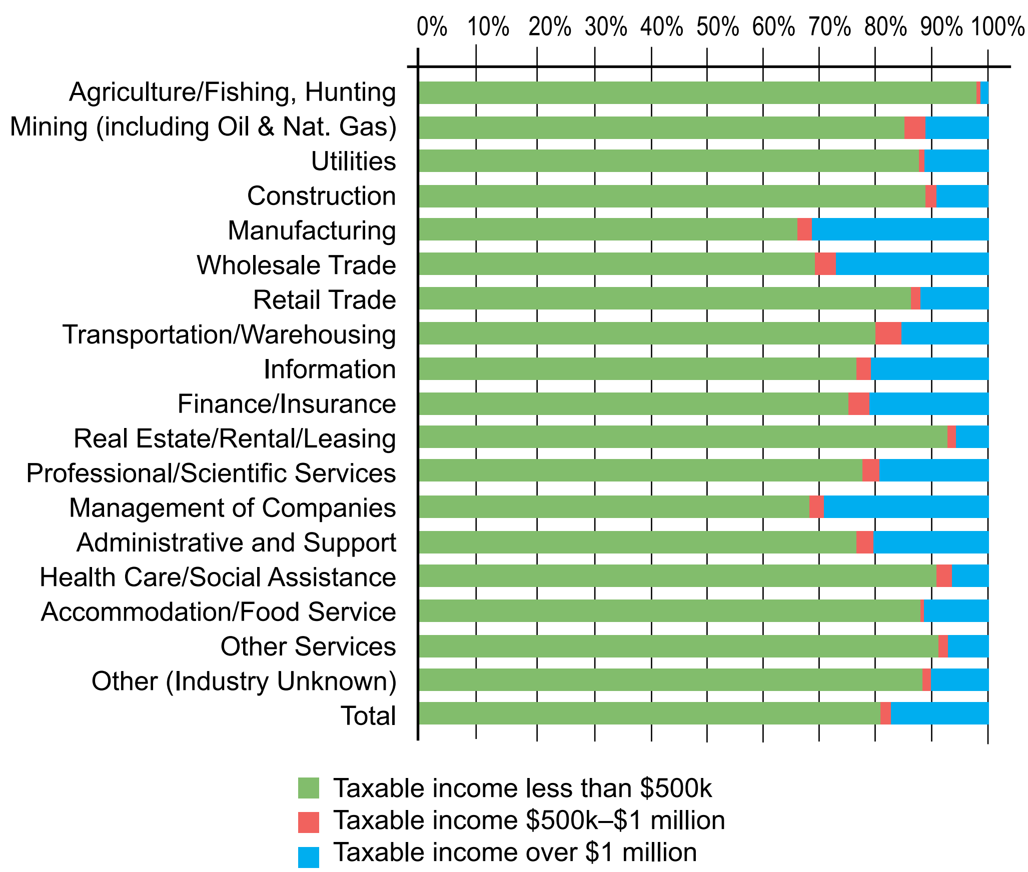
Rates, Returns and Revenues: Select Characteristics of CIT Filers

There are several ways of looking at the universe of corporate income tax filers. This report will examine CIT filers by: number of returns by industry sector; taxes paid by industry sector; taxes paid by CIT tax bracket; and taxes paid by filing method.

As with the personal income tax, corporate tax rates rise as incomes rise. Corporations with income below $500,000 pay 4.8 percent on their profits; those earning $500,000 to $1 million pay $24,000 plus 6.4 percent; and those with income over $1 million pay $56,000 plus 7.6 percent. The Legislature dropped the top CIT rate in 2013 as part of HB-641. The decrease is phased in over time until 2018 when the tax rate for income over $400,000 will be $24,000 plus 5.9 percent. Most the corporations in New Mexico are small, with net incomes below $500,000 (indicated by the green portion of the bars in Chart II, below). Together, manufacturing, wholesale trade, and management of companies make up about 30 percent of all New Mexico corporations with net income of $500,000 to $1 million.

How much CIT a corporation pays is impacted by more than tax rates—especially for corporations that do business in multiple states. As very few New Mexico-based businesses are organized as corporations, most of the corporations doing business in New Mexico

Chart II
Percent of Corporations by Income Bracket (Tax Year 2010)



Source: New Mexico Voices for Children analysis of *Discussion of TRD Analyses of Corporate Income Tax*, New Mexico Legislative Revenue Stabilization and Tax Policy Committee presentation, August 30, 2012

also do business in other states. As each state has its own set of tax laws, corporations must use formulas to determine how to apportion their income in each of the states where they operate. Some formulas take into account just the sales made in the state, but others also account for the proportion of the company's payroll and property used.

In general, the income of multi-state corporations is taxed using three factors—the company's payroll, property, and sales in New Mexico—in proportion to the corporation's total income.

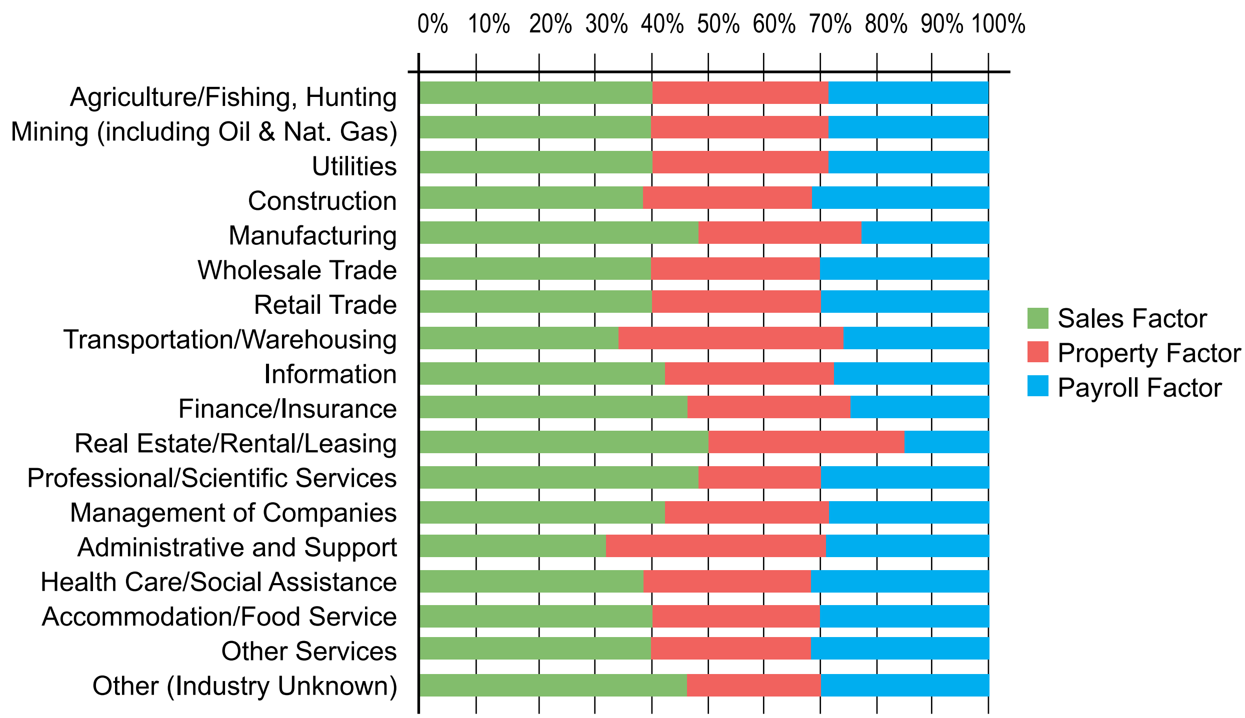
Chart III (below) shows the share of corporate income tax paid from each of the three factors in tax year 2010. On average, about 30 percent of taxes paid come from the property factor, 40 percent come from the sales factor, and 30 percent come from the payroll factor. In 2013, however, HB-641 changed the apportionment method for manufacturing and retail trade. Under this legislation, the manufacturing sector is allowed to disregard its property and payroll in New Mexico and apportion solely based on sales. This so-called single sales factor apportionment method is a real boon to manufacturers that may have a large payroll and property holdings in

The New Mexico Legislative Finance Committee tax policy principles are:

- **Adequacy**: Revenue should be adequate to fund needed government services.
- **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
- **Equity**: Different taxpayers should be treated fairly.
- **Simplicity**: Collection should be simple and easily understood.
- **Accountability**: Preferences should be easy to monitor and evaluate.

Chart III

Percent of Corporate Income Tax Paid by Tax Factor (Tax Year 2010)



Source: New Mexico Voices for Children analysis of *Discussion of TRD Analyses of Corporate Income Tax*, New Mexico Legislative Revenue Stabilization and Tax Policy Committee presentation, August 30, 2012

New Mexico but sell most of what they make here in other parts of the country, since about three-quarters of the manufacturing sector's corporate income tax payments were based on payroll and sales in tax year 2010.

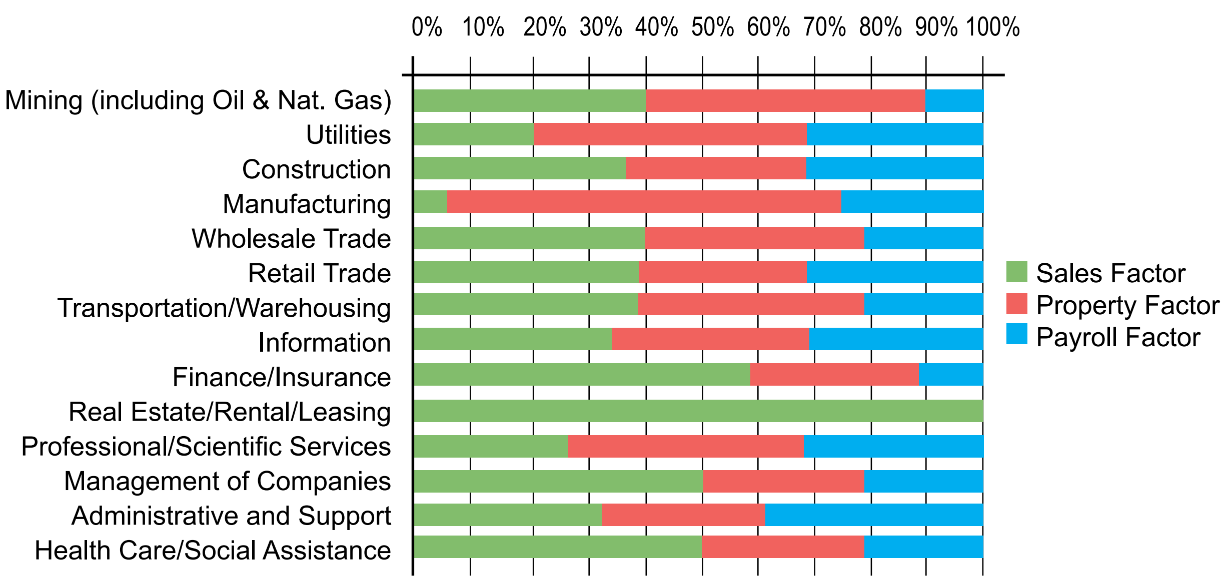
For many big-box retailers that operate in multiple states, HB-641 will require them to file their returns using the 'combined' filing method, which keeps them from sheltering their New Mexico profits in a state that does not collect CIT. This change is expected to increase tax revenue from the retail sector somewhat.

When looking at just the 100 top tax-paying corporations in New Mexico, we see a different pattern emerge. As Chart IV (below) shows, the property factor plays a large role in the manufacturing, mining, and utilities sectors, while the sales factor dwindles in importance. In the case of real estate, and rental and leasing, the sales factor accounts for all of the tax liability of the largest taxpayers.

Corporate income tax returns show a fairly smooth distribution by industry sector (Chart V, page 7). The mining sector accounted for only about 4 percent of total returns, while construction and manufacturing were about 8 percent each. In only two sectors did the number of returns reach above 10 percent: finance and insurance (10.6 percent), and professional and scientific services (12 percent). The real estate sector had about 9.2 percent of the returns. All of the other sectors had less than 4 percent of the returns.

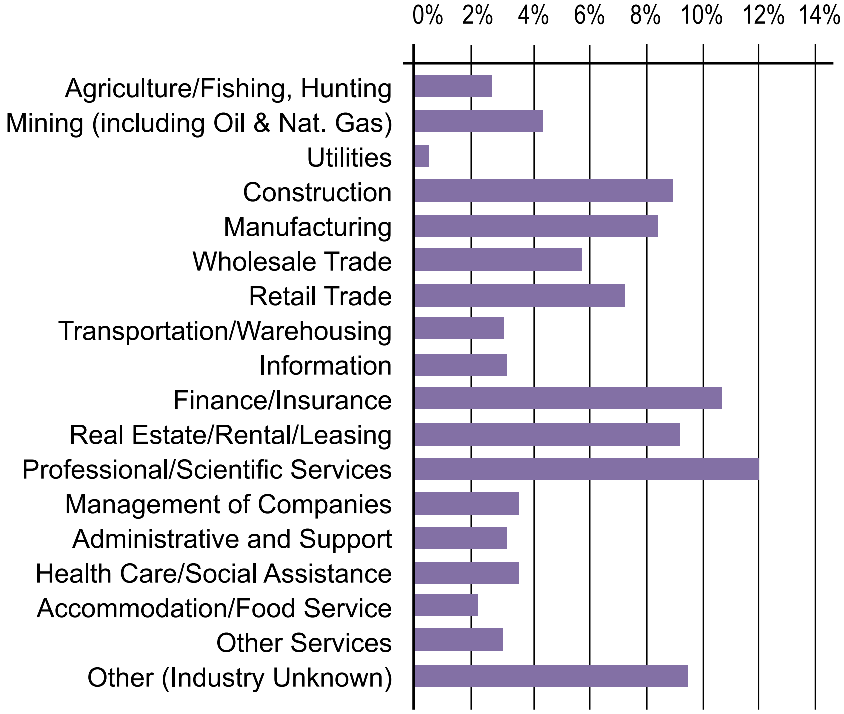
Tax receipts by industry sector (Chart VI, page 7) tell a different story than the distribution of returns by sector, however. Despite accounting for only 4 percent of CIT returns, the mining sector accounted for 30 percent of state revenues from the CIT over the 2006-2010 period. Manufacturing was second, with about 22 percent of state tax revenues, despite accounting for only 8.2 percent of returns. Construction's 2 percent share of revenues, on the other hand, was far smaller than its 8 percent share of returns. Management of companies was the only other sector that showed a significant share of revenues at 15 percent, despite accounting for only 3.8 percent of returns. Finance and insurance accounted for about 5 percent of revenues and 10 percent of returns. The CIT in New Mexico is paid largely by the mining, manufacturing, and management of companies sectors, with those three sectors accounting for about two-thirds of corporate income tax receipts. Changes to the CIT apportionment factor affecting the manufacturing sector will reduce CIT receipts from this sector.

Chart IV
Percent of Tax Paid by Top 100 Corporations by Tax Factor (Tax Year 2010)



Source: New Mexico Voices for Children analysis of *Discussion of TRD Analyses of Corporate Income Tax*, New Mexico Legislative Revenue Stabilization and Tax Policy Committee presentation, August 30, 2012

Chart V
Percent of Corporate Income Tax Returns by Industry
(2006-2010 Five-Year Average)



Source: New Mexico Voices for Children analysis of *Discussion of TRD Analyses of Corporate Income Tax*, New Mexico Legislative Revenue Stabilization and Tax Policy Committee presentation, August 30, 2012

Chart VI
Percent of Corporate Income Tax Receipts by Industry
(2006-2010 Five-Year Average)

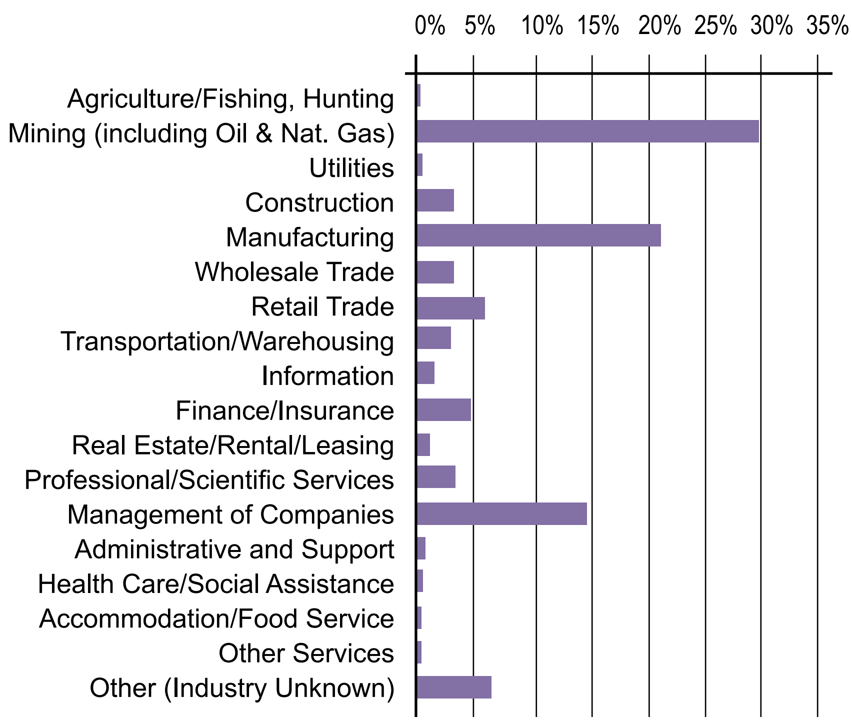
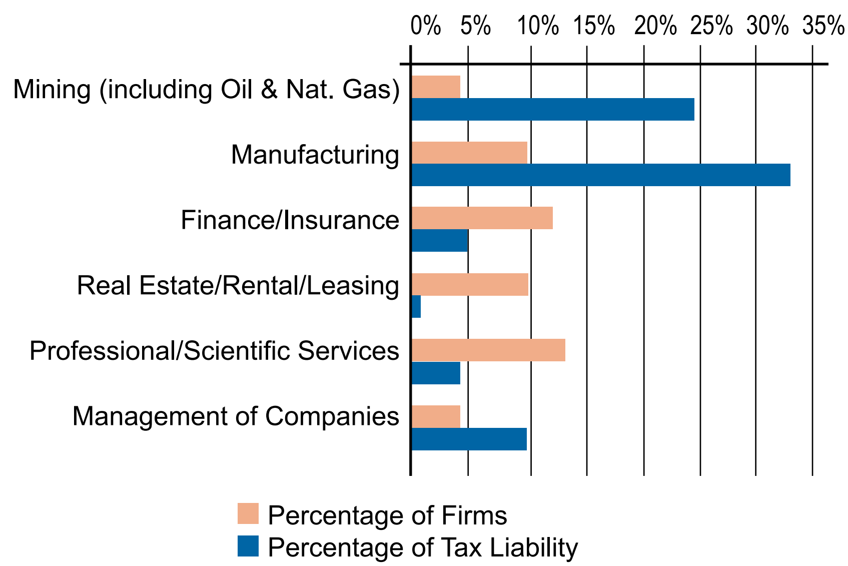


Chart VII (below) shows the distribution of CIT returns and revenues in tax year 2010, the latest year for which these data are available. In 2010, in contrast to the 2006-2010 five-year average, revenues from manufacturing outpaced those from mining. Mining accounted for about 4 percent of returns and 25 percent of revenues, while manufacturing accounted for about 8 percent of returns, but almost 35 percent of revenues. Management of companies accounted for another 10 percent. The other sectors with significant shares of returns were finance and insurance, real estate sales, rental and leasing, and professional and scientific services. In 2010, mining, manufacturing, and management of companies accounted for almost 70 percent of total CIT revenues, with less than 20 percent of returns. Although the proportions can vary somewhat depending on the year, the CIT is largely a tax paid by three sectors: mining, manufacturing, and management of companies.

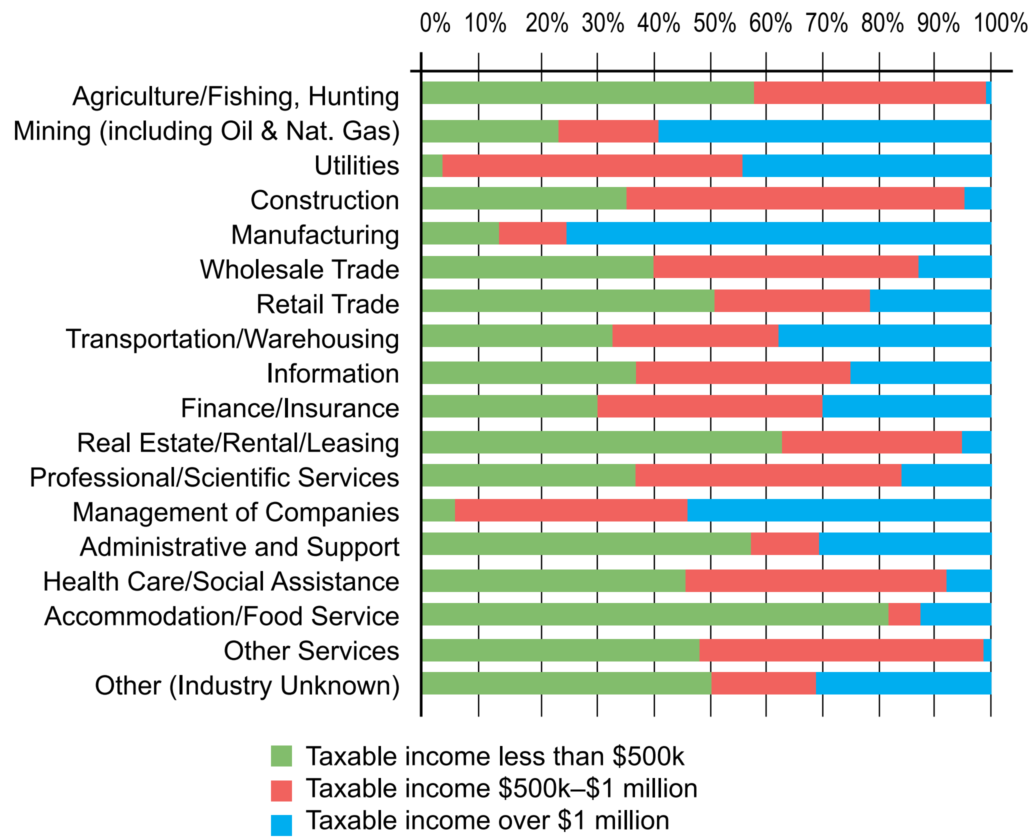
Chart VII
Percent of Firms versus Percent of Tax Liability
(Tax Year 2010)



Source: New Mexico Voices for Children analysis of *Discussion of TRD Analyses of Corporate Income Tax*, New Mexico Legislative Revenue Stabilization and Tax Policy Committee presentation, August 30, 2012

The pattern of corporate income tax paid (Chart VIII, below) shows a different distribution. Although most corporations report fairly modest levels of income, there are several sectors that pay tax on much higher profits. Looking at the blue segment of the bar, significant revenues from income over $1 million were reported by the mining, manufacturing, and management of companies sectors. Mining and manufacturing stand out, as 60 percent of tax revenues were paid on taxable income over $1 million in the mining sector and 75 percent of CIT was paid on income over $1 million in the manufacturing sector. In the management of companies sector, about 50 percent of taxes were paid on income over $1 million. In these three sectors, net income was concentrated in the top bracket. Again, the CIT rate reductions passed in 2013 will provide a tax cut to the most profitable corporations operating in New Mexico. It is clear that the rate reduction will add to the most lucrative corporations' bottom lines, but whether there will be any beneficial results for the New Mexico economy remains an open question. There is no evidence that the CIT rate cuts will result in added employment or wages for New Mexico workers.

Chart VIII
Percent of Tax Paid by Tax Bracket (Tax Year 2010)



Source: New Mexico Voices for Children analysis of *Discussion of TRD Analyses of Corporate Income Tax*, New Mexico Legislative Revenue Stabilization and Tax Policy Committee presentation, August 30, 2012

HB-641 reduced corporate income taxes in two ways. First, the CIT rate was reduced from 7.6 percent to 5.9 percent in stages, with a complete reduction taking place in tax year 2018. The second measure was to allow manufacturing corporations to base their CIT apportionment solely on the corporations' sales in New Mexico. This change in the manufacturer's apportionment formula is also scheduled to fully take effect in FY18. The bill's post-session fiscal impact report showed these two changes to the CIT were expected to cost $32 million in FY15, $71 million in FY16, and $111.6 million in FY17 (see Graph II, below).

The August 2013 revenue estimates, however, reduced the revenues from the CIT by another $13 million in FY15, $30 million in FY16, and $20 million in FY17, as well as $20 million in FY18 (see Graph III, page 11).

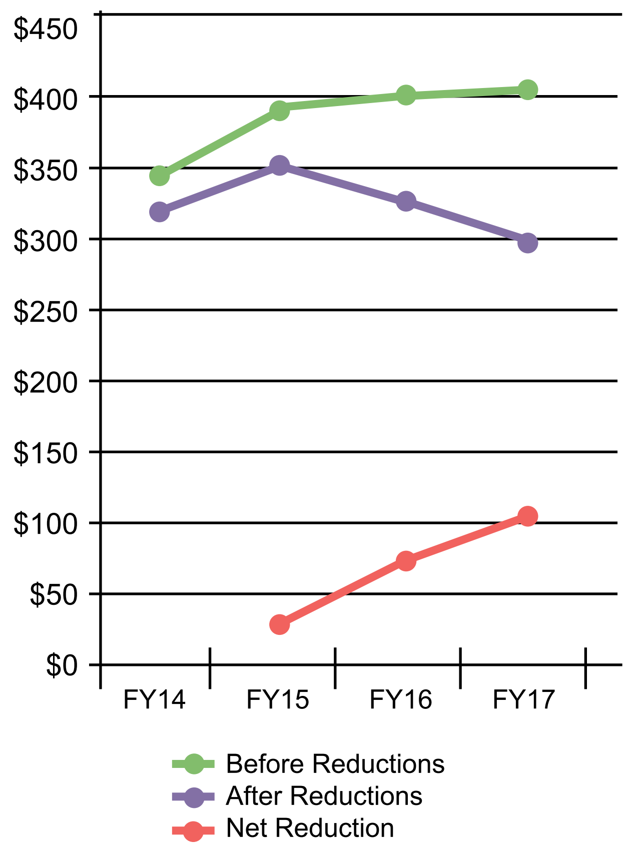
The August 2013 revenue estimates for the CIT show that the Consensus Revenue Estimating Group expects revenues from the corporate income tax to decline beyond the changes wrought by HB-641. This is surprising, considering that the state's economy, as measured by personal income and gross domestic product, is expected to be growing during those years.

> "Tax cuts to lure companies to the state are a dubious form of economic development."

Policy Recommendations

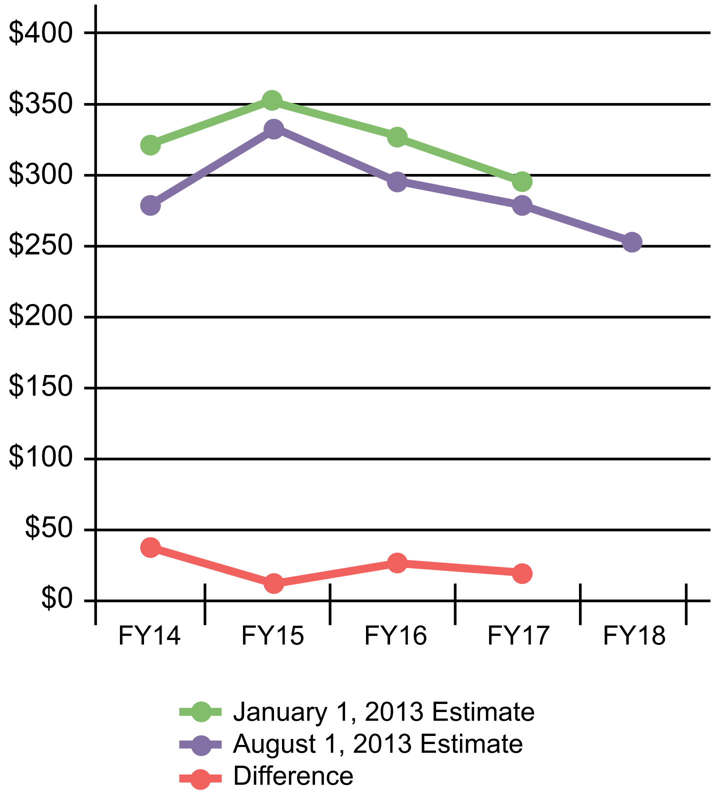
A state's economic development policy should not be driven by corporate income tax cuts. When such cuts are considered, they should be enacted carefully. Provisions such as triggers and performance measures are needed to ensure that tax cuts go into effect only when corporations actually set up shop here or hire

Graph II
CIT Revenues Before and After HB-641 Reductions (in millions)



Source: New Mexico Voices for Children analysis of Fiscal Impact Report CS/641/aSF1#1 Last Updated 4/15/13, New Mexico Legislative Finance Committee

Graph III
Corporate Income Tax Revenue Estimates
(January 2013 and August 2013; in millions)



more workers. Tax cuts also need to be as transparent as possible so determining which companies benefit and how is relatively easy.

The state should also:

- provide public access to yearly information on corporate taxes, including on the total amount collected, and amounts collected by industry and apportionment factor;
- require an annual and comprehensive tax expenditure report that accounts for all tax credits, deductions, and exemptions, and analyzes them for effectiveness;
- include sunsets for all tax expenditures; and
- expand the combined reporting provision in HB-641 to all multi-state corporations doing business in New Mexico. As enacted in HB-641, mandatory combined reporting only applies to big-box retailers that do not have a significant number of employees in a non-retail location, such as a warehouse. Requiring combined reporting by all multi-state corporations would draw in the large banks and other profitable corporations that are notorious for exploiting this loophole.

Conclusion

The corporate income tax plays a small but crucial role in New Mexico's tax structure. Receipts from the corporate income tax are expected to help to smooth out some of the choppiness of general fund revenues over the next five years. However, recent legislative changes have made the corporate income tax a smaller share of total state general fund revenues. These changes to the corporate income tax will have different impacts on different sectors and will lead to a loss in CIT revenue.

Tax cuts to lure companies and their jobs to the state are a dubious form of economic development. Corporations already doing business here will pay lower CIT rates whether they hire more employees or not. While corporations looking to set up shop may find the state's corporate tax code attractive, other more important factors—such as the quality of the workforce, availability of airline routes, and access to water—may outweigh tax considerations. Unfortunately, the loss of revenue that often accompanies such tax cuts leaves the state with less money to invest in education, public safety, and infrastructure—all of which actually do drive economic development. When corporate taxes are cut, the revenue losses are often made up by raising taxes on individuals.

Endnotes

1 Fiscal Impact Report, Feb. 10, 2014: http://www.nmlegis.gov/Sessions/14%20Regular/firs/SB0106.PDF
2 2013 State Tax Guide, Commerce Clearinghouse
3 *State Tax Policy: A Political Perspective*, David Brunori, Urban Institute Press, 2011, pg 96
4 *Ibid*

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