COST

COUNCIL ON STATE TAXATION

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House Taxation and Revenue Committee
New Mexico Legislature

VIA EMAIL

Re: COST Comments on Certain Provisions in H.B. 6—Opposition to Combined Reporting and Inclusion of GILTI in New Mexico's Tax Base

Dear Chair Trujillo, Vice-Chair Martinez and Committee Members:

I am writing on behalf of the Council On State Taxation (COST) in opposition to certain amendments to H.B. 6, including mandatory unitary combined reporting and the provisions that would conform New Mexico to certain portions of the federal Tax Cuts and Jobs Act (TCJA). COST generally opposes mandatory combined reporting because it is based on vague definitions, generates winners and losers in the tax code, and encourages cherry-picking by taxpayers and auditors in determining or assessing the unitary group composition. However, we realize that political realities in New Mexico may override our principled objections to combined reporting. If that is the case, we strongly urge you to decouple from the inclusion of global intangible low-taxed income (GILTI) in the New Mexico tax base. We fear that adoption of two significant anti-competitive aspects at the same time will do serious damage to New Mexico's ability to attract new jobs and investment to the State.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of approximately 550 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

COST's Objection to Mandatory Unitary Combined Reporting

The COST Board of Directors has adopted a formal policy statement on MUCR. COST's policy position is:

Mandatory unitary combined reporting ("MUCR") is not a panacea for the problem *of how to accurately determine multistate business income attributable to economic activity in a State. For business taxpayers, there is a significant risk that MUCR will arbitrarily attribute more income to a State than is justified by the level of a corporation's real economic activity in the State. A switch to MUCR may have significant and unintended impacts on both taxpayers and States. Further, MUCR is an unpredictable and burdensome tax system. COST opposes MUCR.*

Problems with Mandatory Unitary Combined Reporting

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and business taxpayers is how a state should determine the corporate income tax base. The first approach, "separate entity reporting," treats each corporation as a separate taxpayer. This is the method New Mexico currently allows. The second approach, MUCR, treats affiliated corporations (parents and subsidiaries) engaged in a "unitary business" as a single group for purposes of determining taxable income.[1] MUCR has several serious flaws.

- **Reduces Jobs –** Proponents of MUCR have focused on the benefits in terms of reducing tax planning opportunities, but they fail to acknowledge the evidence that adopting MUCR hinders investment and job creation. Even if MUCR results in only a relatively small increase in net corporate tax revenue, there will be significant increases and decreases in tax liabilities for specific businesses. Depending on the industry distribution of winners and losers, adopting MUCR may have a negative impact on a state's overall economy. Moreover, economic theory suggests that any tax increase resulting from adopting MUCR will ultimately be borne by labor in the State through fewer jobs (or lower wages over time) or by in-state consumers through higher prices for goods and services. States that use separate entity reporting have experienced higher job growth than have states with MUCR. From 1982-2006, job growth was 6% higher in states without MUCR than in states with it (after adjusting for population changes).[2]

- **Uncertain Revenue –** Implementing MUCR would have an unpredictable and uncertain effect on New Mexico's revenue. The corporate income tax is the most volatile tax in every state in which it is levied, regardless of whether MUCR is employed. A study conducted by the University of Tennessee found no evidence that states with MUCR collect more revenue, and then in a later study found that MUCR may or may not increase revenue.[3] The Indiana Legislative Services Agency conducted a study in 2016 finding that any potential positive revenue impact from adopting MUCR would be only short-term and would likely decline to zero in the long-term.[4]

- **Administrative Complexity –** MUCR is, by definition, complex, requiring extensive fact-finding to determine the composition of the "unitary group" and to calculate combined

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[1] The concept of a "unitary business" is a constitutional requirement that limits the states' authority to determine the income of a multistate enterprise taxable in a state. Due to varying state definitions and case law decisions, the entities included in a unitary group are likely to vary significantly from state to state.
[2] Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Ernst & Young, May 30, 2008, p. 16.
[3] *Ibid*. 3, p. 34.
[4] A Study of Practices Relating to and the Potential Impact of Combined Reporting, Office of Fiscal and Management Analysis, Indiana Legislative Services Agency, October 1, 2016.

income. This complexity results in unnecessary and significant compliance costs for both taxpayers and the State. Further, the bill inappropriately delegates many details of the administration of the tax that should be codified in New Mexico's law. The bill does not clearly specify how the tax should be administered; instead, it gives the Department broad authority to adopt regulations to enforce the collection of the tax using MUCR.

- *Determining the Unitary Group*: The concept of a "unitary business" is uniquely factual and universally poorly-defined. It is a constitutional (Due Process) concept that looks at the business as a whole rather than individual separate entities or separate geographic locations. In order to evaluate the taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation's operational and tax staff to gather this operational information. In practice, however, auditors routinely refuse to make a determination regarding a unitary relationship on operational information and instead wait to determine unitary relationships until after they have performed tax computations. In other words, the tax result of the finding that a unitary relationship exists (or does not exist) often significantly influences, or in fact controls the auditor's finding. Determining the scope of the unitary group is a complicated, subjective, and costly process that is not required in separate filing states and often results in expensive, time-consuming litigation.

- *Calculating Combined Income***:** Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most MUCR states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In addition to variations in apportionment formulas among the states that apply to all corporate taxpayers, further compliance costs related to MUCR result from variations across states in the methods used to calculate the apportionment factors. From a financial reporting perspective, adopting MUCR is a significant change that requires states to consider ways to mitigate the immediate and negative impact those tax changes have on a company's financial reporting.[5]

- **Arbitrary –** Although proponents of MUCR argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under MUCR create new distortions in assigning income to different states. The MUCR assumption that all corporations in an affiliated unitary group have the same level of profitability is not consistent with either economic theory or business experience. Consequently, MUCR may reduce the link between income tax liabilities and where income is actually earned. Many corporate taxpayers may conclude that there is a significant risk that MUCR will arbitrarily attribute more income to a State than is justified by the level of a corporation's real economic activity in the State.

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[5] ASC 740 (formally FAS 109) requires a recordation of tax expense under certain circumstances that can negatively impact a company's stock price and value.

New Mexico Should Reject the Inclusion of Foreign Source Income, Including Global Intangible Low-Taxed Income (GILTI)

Although we object to the adoption of combined reporting, the noncompetitive aspects of the State's adoption of combined reporting would be exacerbated greatly by the inclusion of foreign source income, including GILTI. Over the last 30 years, states have generally limited their corporate income tax base to the water's edge (*i.e.*, to only income earned in the U.S.). With federal tax reform, the federal government is moving from the taxation of all foreign source income primarily on a "deferred" basis to taxing a more limited range of foreign source income – including global intangible low taxed income (GILTI) – primarily on a "current" basis. However, federal taxation of GILTI is very different than state taxation of GILTI from both a policy and a practical outcome perspective.[6] Additionally, GILTI is not the traditional foreign dividend income that New Mexico has previously included in its corporate income tax base.

First, Congress is raising $324 billion over 10 years from the international tax reform provisions (including GILTI) to help pay for $654 billion over 10 years in other business tax reform cuts. The states, by contrast, do not conform to the federal corporate tax rate cuts. Therefore, the states have no reason to expand their tax base to make up for the lost revenue. Conforming to the GILTI provisions would represent a selective and arbitrary conformity that harms a segment of New Mexico businesses competing internationally, without advancing any compelling tax policy goal for the State. Second, at the federal level, the focus of the GILTI provision is to include in the federal income tax base "low-taxed" foreign source income – basically income that is taxed in foreign countries at less than 13.125 percent. To achieve this practical outcome the federal government imposes a tax rate of 10.5 percent (one-half of the federal statutory rate) on the GILTI income and allows a credit for 80 percent of foreign taxes paid on such income.

State corporate income tax laws in New Mexico, and in other states, however, do not allow for foreign tax credits. Thus, at the state level, GILTI income, from low and high-tax countries, would be subject to state corporate income tax. This would constitute a vast and unprecedented expansion of the state corporate income tax base to include previously untaxed foreign earnings. As a result, to date, 15 states have decoupled from GILTI either by legislation or regulation. Among the states fully (or 95 percent) decoupling from GILTI are Connecticut, Georgia, Hawaii, Illinois, Indiana, Kentucky, Massachusetts, Michigan, Missouri, North Carolina, Oklahoma, Pennsylvania, South Carolina, Virginia, and Wisconsin. Further, other states such as Idaho, Montana and North Dakota include 30 percent or less of GILTI in their corporate tax base. Finally, eight additional states have not yet conformed to the federal Tax Cuts and Jobs Act. For these reasons, COST would urge the committee to reject the provision that requires 100 percent of the net GILTI amount to be included in the New Mexico tax base.

If the state decides to conform to the taxation of GILTI, however, it is important that New Mexico also conform to the foreign derived intangible income (FDII) deduction, which is allowed for federal purposes under I.R.C. § 250. Although H.B. 6 specifically addresses the

[6] See generally: Joseph X. Donovan, Karl A. Frieden, Ferdinand S. Hogroian, and Chelsea A. Wood, "State Taxation of GILTI: Policy and Constitutional Ramifications," *State Tax Notes*, October 22, 2018; The Impact of Federal Tax Reform on State Corporate Income Taxes, by Ernst & Young LLP for the State Tax Research Institute, March 2018, available at: http://cost.org/globalassets/cost/state-taxresources-pdf-pages/coststudies-articles-reports/the-impact-of-federal-tax-reform-on-state-corporateincome-taxes.pdf.

I.R.C. § 250 GILTI deduction, it is not clear whether the FDII deduction is provided. Finally, the Committee should consider providing clarity on the issue of factor representation with respect to the GILTI income being included in the New Mexico tax base. In doing so, the Committee should adopt the position taken by New Mexico with respect to factor representation relating to the I.R.C. Section 965 transition tax. In that situation, New Mexico provided the taxpayer with factor representation of the "appropriate proportion of the payroll, property and sales of their foreign dividend payors". [7] The Committee should address both issues if it decides to include GILTI in the New Mexico tax base.

The Committee Should Consider Adding a Provision to Address Negative Financial Statement Impacts Resulting from H.B. 6

The COST Board of Directors has also adopted a formal policy position addressing the consequences of significant tax law changes on financial reporting, which provides

> *When enacting significant corporate tax law changes, states must mitigate the immediate and negative impact of those changes on a company's financial reporting. While it is evident that companies may experience a change in their actual tax liability as a result of some tax law changes, the financial impact of having to immediately recognize additional tax expense for financial reporting purposes is not always evident.*

Based on the sweeping changes being considered with H.B. 6, many companies' financial statements are likely to be negatively impacted. Thus, if the legislation is enacted, we would urge the Committee to allow taxpayers to take a deduction to mitigate some of the negative aspects of the legislation, particularly New Mexico's proposed combined reporting regime. Other states that have enacted combined reporting have provided similar deductions to mitigate the financial reporting impact on publicly traded companies by allowing a recovery of book/tax accounting differences, and we would urge New Mexico to do the same.

Conclusion

Based on the foregoing, we urge the Committee to consider carefully the negative impact of both mandating combined reporting and including GILTI in the New Mexico tax base. Finally, we would encourage you to consider providing a deduction for taxpayers who experience significant negative impacts to their financial statements due to the proposed implementation of combined reporting in H.B. 6.

Respectfully,

Douglas L. Lindholm   Nikki E. Dobay

cc: COST Board of Directors

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[7] New Mexico Bulletin B.300.17