MONTANA CORPORATION LICENSE TAX

A Report Prepared for the

Revenue and Transportation Interim Committee

By
Terry W. Johnson
And
Catherine Duncan

September 9, 2004

Legislative Fiscal Division

www.leg.state.mt.us/css/fiscal/

MONTANA CORPORATION LICENSE TAX
TABLE OF CONTENTS

MONTANA CORPORATION LICENSE TAX

INTRODUCTION

Montana's corporation license tax is one of the most volatile state general fund revenue sources. As seen in the graph below, corporate taxes can and do vary by tens of millions of dollars in any given year. From year to year, the change in corporation taxes can be as small as 0.32 percent, as seen between fiscal 1995 and fiscal 1996, or as great as 53.44 percent, between fiscal 2003 and 2004. The purpose of this report is to aid the Revenue and Transportation Interim Committee in understanding nature of Montana's corporation license tax. As a second purpose of this report, the Legislative Fiscal Division (LFD) attempts to determine whether there is an identifiable corporate tax base in Montana, and if any changes may have occurred to that base in the recent past. The LFD has approached this subject from two directions. We analyzed historic accounting data and specific return data to determine if changes have occurred within the corporation tax base. The analysis shows that there has been deterioration to the corporation tax base. While the LFD cannot conclusively prove causation, there are indications that the base has been negatively affected by economic events and federal tax policies.

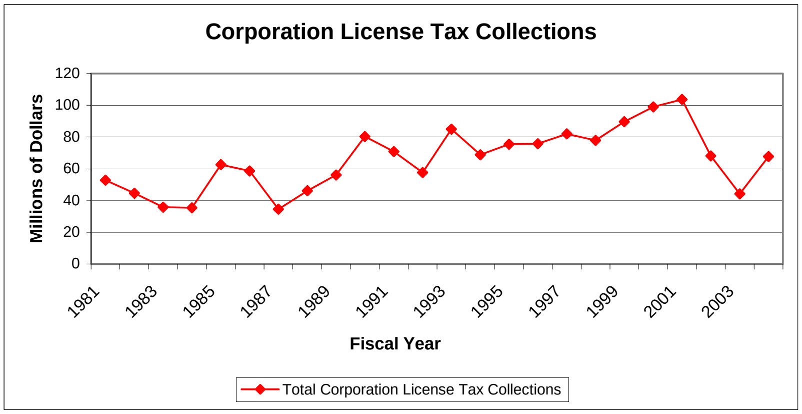

Figure 1

This report provides a thorough analysis into the corporation license tax. Section one contains background information and statutory references for the tax. Section two contains a brief analysis of corporate tax collections in the period of fiscal 1981 through fiscal 2004. In section three, we discuss the analysis of tax returns for each type of corporation, including minimum pay corporations, domestic corporations, and multi-state corporations. This section also includes a brief study of Montana's largest taxpayers and the impact of changes in specific industries. Section four ties the analysis of sections two and three to economic factors. Finally, section five discusses conclusions drawn from the analysis presented in the earlier sections.

This report provides the committee with analysis and conclusions drawn from both SBAS and SABHRS data and data provided by the Department of Revenue (DOR) over the period of 1981 through 2004. While numerous factors were tracked in this period, for example total tax collections, corporate credits, audit collections, and corporation refunds, there is limited data available for some of the currently relevant factors that the LFD used in this analysis. Some examples of limited data sets include net operating loss carry backs (NOL), penalty and interest collections, and collections by corporate size and operating structure. We make note of data limitations whenever that is the case.

One factor that hinders an all-encompassing presentation of a corporate analysis is the confidentiality statute. The statutory corporate confidentiality clause, contained in 15-31-511 MCA, is as follows:

> *(1) Except as provided in this section in accordance with a proper judicial order or as otherwise provided by law, it is unlawful to divulge or make known in any manner:*
> *(a) the amount of income or any particulars set forth or disclosed in any return or report required under this chapter or any other information relating to taxation secured in the administration of this chapter; or*
> *(b) any federal return or information in or disclosed on a federal return or report required by law or rule of the department of revenue under this chapter.*

The statute prohibits the LFD from using any corporate names or information singularly in this report. While we know there are occasions where large corporations have had a significant impact on the collections of the tax, we cannot refer to any such events or inform the legislature that one corporation has created such impacts. In the end, these occurrences must be combined with other effects, which tends to distort the exact nature of both negative and positive impacts.

SECTION ONE: BACKGROUND

Statutory Definition

Montana's corporation license tax, first enacted in 1917, is a tax imposed on corporate business net income for the privilege of conducting business in the state. In 15-31-101, MCA, a corporate business is defined as and includes for the purpose of taxation:

> *an association, joint-stock company, common-law trust or business trust that does business in an organized capacity, all other corporations whether created, organized, or existing under and pursuant to the laws, agreements, or declarations of trust of any state, country, or the United States, and any limited liability company, limited liability partnership, partnership, or other entity that is treated as an association for federal income tax purposes and that is not a disregarded entity.*

A corporation is the most complex form of business organization. It is an independent legal entity, separate from its owners or shareholders. There are numerous types of corporations including non-profit corporations established for the benefit of charitable, religious, educational, or scientific purposes; professional corporations which allow individuals with trades such as law, accounting, or medicine to preserve both a personal and professional relationship with their clients; statutory closed corporations where the business can eliminate many of the formalities of a standard corporation; and "S" corporations which are small corporations where the profits/losses are passed on to the individual shareholders who are then taxed under the individual income tax provisions.[1]

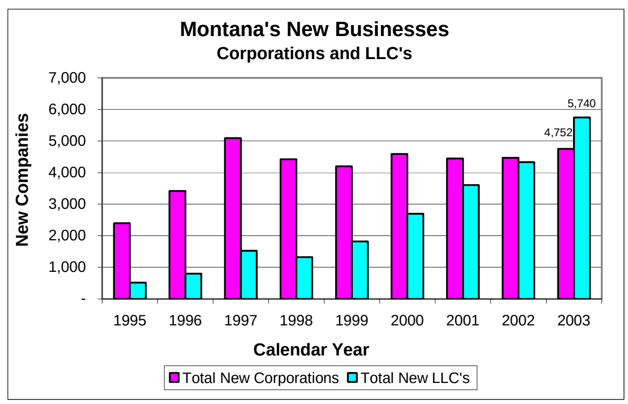

Figure 2

Limited liability companies and partnerships, LLC and LLP respectively, are a relatively new business organizational option whose importance has increased in Montana. The legislature passed the Limited Liability Company Act in 1993, allowing the formation of LLC's and LLP's in the state. Businesses that prior to 1993 might have organized as corporations now have the option to organize as an LLC instead. The LLC organizational form provides companies with both the protections from personal liability of a corporation and the favorable tax treatment of a partnership. The limited liability alternative has become an increasingly important organizational choice in Montana. For the first time in 2003, formation of LLC's outpaced the formation of traditional corporations in Montana by 988 businesses. As more businesses choose LLC organization, potential corporation license tax revenues are replaced with increased personal income tax revenues. An exact measure of the potential loss of corporation tax revenues resulting from the alternative business form of the LLC is beyond the scope of this analysis.

Federal Connection

Montana's corporation net income calculations are directly tied to the federal tax form. The starting point for the calculation of Montana corporate income is the federal taxable income (line 28, Form 1120).[2] Consequently,

[1] Business organization information from the Secretary of State's office internet web site.
[2] Refer to the July 9, 2004 presentation of Brian Staley, MT DOR for further information on Federal tie.

federal tax changes can impact the amount of taxes paid by corporations in Montana. Some recent noteworthy examples where changes in federal tax law impacted taxes collected in Montana are the bonus depreciation provisions of the last two economic stimulus acts. This topic will be discussed in greater detail later in this report. Federal tax changes will be an ongoing concern for the Montana corporation tax as long as the tie to the federal tax form exists.

Tax Rates

The corporate tax rate, found in 15-31-121, MCA, has been amended repeatedly over time. When enacted in 1917, the tax rate was set at 1 percent. The rate was increased on eight occasions, in 1933, 1937, 1957, 1965, 1967, 1969, 1971, and finally in 1973 (retroactive to 1971) when the current rate of 6.75 percent was set. In 1987, a surtax of 4 percent was attached to the corporate tax for tax year 1988. Then again in 1989, a 5 percent surtax increased collections in tax year 1990. No changes have been made to the corporation license tax rate of 6.75 percent since it was adopted.

Alternative Taxation Options

Montana law includes several alternative taxation options that corporations may consider. First, corporations whose only activity in Montana consists of sales, do not own or rent real estate or tangible personal property, and whose annual gross volume of sales made in Montana does not exceed $100,000, may elect to pay a tax of 1/2 of 1 percent of gross sales (15-31-122, MCA). Second, as adopted in 1987, multinational corporations may choose a "water's edge" election. The water’s edge designation allows an exclusion of corporations operating almost exclusively outside the United States (80% rule). This is a three-year renewable election, and corporations that elect the “water’s edge” designation are required to pay a tax at a rate of 7 percent of their net income (15-31-121, MCA). Third, prior to the 1997 repeal of 15-31-204, MCA, businesses that met certain requirements could elect to be taxed as a small business. These corporations, defined as S Corporations, were required to pay a $10.00 corporation license fee, in addition to paying business income taxes through the individual income tax. Since the repeal, S Corporations are only required to pay business income taxes. Corporations with net annual income of less than $740 (including those with NOL) must pay a minimum tax of $50. A corporation is not required to pay any tax if its net income is less that $740 and the business has no physical nexus in the state.

Payment Schedule

Corporations are required to make quarterly estimated payments on their tax liability and are required to make adjusting payments (or refund requests) at the due date of their annual return. All taxpayers are required to remit their tax liabilities on the 15th day of the 5th month following the close of the taxable period. Beginning in tax year 1990, corporations with annual tax liabilities of $5,000 or more are required to make estimated tax payments in quarterly installments (15-31-502, MCA) by the 15th of the month following their quarter’s end. Although the tax is due on the above-mentioned dates, a corporation is allowed an automatic extension of up to 6 months following the prescribed filing date to file its return (15-31-111, MCA). Most corporations take advantage of the filing extension.

Exempt Corporations

A number of corporate types are exempt from Montana’s corporate license tax. The specific listing of exempt corporate types is found in 15-31-102, MCA, and includes:

1) Labor, agricultural, or horticultural organizations
2) Fraternal beneficiary, society, order, or lodge system associations
3) Certain qualifying cemeteries
4) Qualifying non-profit corporations or associations
5) Qualifying insurance companies
6) Qualifying utility corporations (rural and governmentally owned)
7) Qualifying property title and property management corporations
8) Qualifying domestic international sales corporations
9) Qualifying foreign capital corporations

Corporation Income Reductions

There are three factors that corporations use to reduce their taxable income: deductions, credits, and NOL.

Corporate income deductions reduce income at the federal level. These items become important as changes are mandated at the federal level. A comprehensive list of items was included in the July presentation by Brian Staley. The following description of allowable deductions is taken from 15-31-114, MCA, which states:

> *(1) In computing the net income, the following deductions are allowed from the gross income received by the corporation within the year from all sources:*
> *(a) all the ordinary and necessary expenses paid or incurred during the taxable year in the maintenance and operation of its business and properties, including reasonable allowance for salaries for personal services actually rendered, subject to the limitation contained in this section, and rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title or in which it has no equity. A deduction is not allowed for salaries paid upon which the recipient has not paid Montana state income tax. However, when domestic corporations are taxed on income derived from outside the state, salaries of officers paid in connection with securing the income are deductible.*
> *(b)(i) all losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the wear and tear and obsolescence of property used in the trade or business. The allowance is determined according to the provisions of section 167 of the Internal Revenue Code in effect with respect to the taxable year. All elections for depreciation must be the same as the elections made for federal income tax purposes. A deduction is not allowed for any amount paid out for any buildings, permanent improvements, or betterments made to increase the value of any property or estate, and a deduction may not be made for any amount of expense of restoring property or making good the exhaustion of property for which an allowance is or has been made. A depreciation or amortization deduction is not allowed on a title plant as defined in 33-25-105 (15).*

There are 18 different types of tax credits available to qualifying corporate taxpayers for reducing their net income[3]. They include:

1) Contractors' Gross Receipts Tax Credit (15-50-207, MCA, e. TY1968)
2) Charitable Endowment Credit (15-31-161 - 162, MCA, e. TY1997 t. TY 2008)
3) Qualified Research Tax Credit (15-31-150, MCA, e. TY1999)
4) Recycling Credit (15-32-601 through 15-32-611, MCA, e. TY1991 t. TY2006)
5) Alternative Fuel Motor Vehicle Conversion Credit (15-31-137, MCA, e. TY1993)
6) College Contribution Credit (15-30-163, MCA, e. TY1991)
7) Employer Disability Insurance Credit (15-31-132, MCA, e. TY1991)
8) Dependent Care Assistance Credit (15-31-131, MCA, e. TY1990)
9) Historic Building Preservation Credit (15-31-151, MCA, e. TY1998)
10) Montana Capital Company Credit (90-8-202, MCA, e. TY1984)
11) Infrastructure User Fee Credit (17-6-316, MCA, e. 1/20/1995)
12) Mineral Exploration Credit (15-32-501 - 510, MCA, e. TY2000)
13) Affordable Housing Revolving Loan Account Credit (15-31-170, MCA, e. 4/28/2001 t. TY2005)
14) Developmental Disabilities Contribution Credit (15-30-187, MCA, e. 5/9/2003)
15) Empowerment Zone New Employees Tax Credit (15-30-182, MCA, e. 10/1/2003)
16) Alternative Energy Generation Credit (15-32-401 - 407, MCA, e. FY2002)
17) New/Expanded Industry Credit (15-31-124 - 127, MCA, e. 4/27/1991)
18) Interest Differential Credit (15-32-107, MCA, e. TY1978)

Note: (e) denotes effective date of the credit
(t) denotes termination date of the credit

The most recent additions to the list of credits are the *Affordable Housing Revolving Loan Account* credit, passed in the 2001 legislative session (applicable only for tax years 2001 through 2004), the *Developmental Disabilities Contribution* credit, passed in the 2003 legislative session (applicable only for tax years 2003 through 2006), and the *Empowerment Zone New Employees* credit, passed in the 2003 legislative session. The most widely used of

[3] A description of each of the corporation tax credits is available through the LFD.

the credits are the *Contractor's Gross Receipts* tax credit, claimed by 109 corporations in fiscal 2003 and the *Charitable Endowment Contributions* credit, claimed by 78 corporations in fiscal 2003 (scheduled to expire after tax year 2006).

Montana corporations are also allowed to reduce their income by losses experienced in both past and current tax years. The NOL provisions of Montana's statutes allow NOL's to be carried back up to three years and carried forward up to seven years (15-31-119, MCA). The statute establishes the requirements that allow corporations to take NOL carrybacks and carryforwards in sections 4 through 12:

> *(4) A net operating loss for any taxable period ending after December 31, 1975, in addition to being a net operating loss carryback to each of the three preceding taxable periods, must be a net operating loss carryover to each of the seven taxable periods following the taxable period of the loss.*
> *(5) Except as provided in subsection (11), the portion of the loss that must be carried to each of the other taxable years must be the excess, if any, of the amount of the loss over the sum of the net income for each of the prior taxable periods to which the loss was carried. For purposes of this subsection, the net income for the prior taxable period must be computed with the modification specified in subsection (6)(b) and by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss period or any taxable period after the loss period, and the net income so computed may not be considered to be less than zero.*
> *(6) The modifications referred to in subsection (2) are as follows:*
> *(a) The net operating loss deduction may not be allowed.*
> *(b) The deduction for depletion may not exceed the amount that would be allowable if computed under the cost method.*
> *(c) Any net operating loss carried over to any taxable year must be calculated under the provisions of this section effective for the taxable year for which the return claiming the net operating loss carryover is filed.*
> *(7) A net operating loss deduction may be allowed only with regard to losses attributable to the business carried on within the state of Montana.*
> *(8) In the case of a merger of corporations, the surviving corporation may not be allowed a net operating loss deduction for net operating losses sustained by the merged corporations prior to the date of merger. In the case of a consolidation of corporations, the new corporate entity may not be allowed a deduction for net operating losses sustained by the consolidated corporations prior to the date of consolidation.*
> *(9) Notwithstanding the provisions of 15-31-531, interest may not be paid with respect to a refund of tax resulting from a net operating loss carryback or carryover.*
> *(10) The net operating loss deduction must be allowed with respect to taxable periods.*
> *(11) A taxpayer entitled to a carryback period for a net operating loss may elect to forego the entire carryback period. If the election is made, the loss may be carried forward only. The election must be made on or before the date on which the return is due, including any extension of the due date, for the tax year of the net operating loss for which the election is to be in effect. The election is irrevocable for the year made.*
> *(12) Notwithstanding any other provision of this section, the net operating loss deduction is not allowed in the case of a regulated investment company or a fund of a regulated investment company, as defined in section 851(a) or 851(b) of the Internal Revenue Code of 1986, as that section may be amended or renumbered.*

Corporation Audit Program

The DOR corporation audit program employs 11 field and desk auditors. Authority for this activity is given in 15-31-504, MCA.

> *For the purpose of ascertaining the correctness of any return or for the purpose of making an estimate of net income of any corporations where information has been obtained, the department shall also have power to examine or to cause to have examined by any agent or representative designated by it for that purpose any books, papers, records, or memoranda bearing upon the matters required to be included in the return and may require the attendance of any officer or employee of the corporation rendering such return or the attendance of any other person having knowledge in the premises and may take testimony and require proof material for its information.*

Most field audit payments are a result of incorrect filing status, which leads to an increased tax liability, typically from prior years. Often, corporations file as multiple entities when they should file as unitary corporations.[4] Another action that forces audit payments occurs when corporations incorrectly claim business deductions.

SECTION TWO: HISTORICAL CORPORATION DATA

Corporation Tax and the General Fund

Corporation tax is typically the fourth largest revenue source to the general fund. Only the property tax, individual income tax, and vehicle tax contribute more money. Because of its importance, large changes in corporation tax collections can cause significant shocks to the general fund revenue stream, both positive and negative.

Over time, total corporate tax collections as a percent of the total general fund collections has not changed substantially. The historic average of corporation tax to total general fund is 6.5 percent.[5] However, low corporation tax collections in the past three fiscal years have caused the ratio to drop. In fiscal 1984 and fiscal 1987 the significance of the corporation tax to general fund fell below five percent, yet there has never been a period where this situation has lasted for such a long time as experienced in fiscal years 2002 through 2004. In all three years, total general fund was approximately $1.4 billion dollars, while total corporation tax collections were $68.2 million, $44.1 million, and $67.7 million. Low collections resulted in corporation tax to general fund ratios of 4.9 percent, 3.1 percent, and 4.9 percent respectively. For the corporation tax to resume a more normal average of 6.5 percent in relation to total general fund, collections would have to increase to approximately $90 million.

General Fund Corporation Tax
as a Percent of Total General Fund

Fiscal Year	Total General Fund Revenue	Total Corporation Tax Revenue	Percent of Corp Tax to Total GF
1981	$509,032,938	$52,900,964	10.39%
1982	568,652,381	44,630,472	7.85%
1983	568,915,017	35,830,832	6.30%
1984	741,416,280	35,396,240	4.77%
1985	831,868,711	62,609,205	7.53%
1986	789,450,771	58,584,784	7.42%
1987	762,335,358	34,566,361	4.53%
1988	860,736,869	46,200,104	5.37%
1989	885,374,442	56,139,749	6.34%
1990	948,696,372	80,315,504	8.47%
1991	1,047,366,583	70,784,279	6.76%
1992	1,145,401,399	57,682,672	5.04%
1993	1,192,112,437	85,054,483	7.13%
1994	1,147,579,514	68,871,909	6.00%
1995	1,197,676,981	75,519,940	6.31%
1996	1,236,024,769	75,761,891	6.13%
1997	1,278,622,410	81,999,138	6.41%
1998	1,259,703,392	77,928,498	6.19%
1999	1,295,741,445	89,624,560	6.92%
2000	1,404,972,990	99,088,867	7.05%
2001	1,521,453,852	103,670,487	6.81%
2002	1,396,406,967	68,173,253	4.88%
2003	1,407,554,961	44,137,518	3.14%
2004	1,381,564,648	67,722,940	4.90%

Figure 3

Corporation Tax Collections

Total corporation license collections are extremely volatile. During the time period analyzed, fiscal years 1981 through 2004, total collections have varied between a low of $34.6 million in fiscal 1987 and a high of $103.7 million in fiscal 2001. The state experienced revenue shock when corporate tax revenues dropped by $35.5 million in fiscal 2002 to $68.2 million. Another shock was felt in fiscal 2003 when collections dropped to $44.1 million, a level of collections not seen since fiscal 1987. In fiscal 2004, corporation tax revenues returned to a more expected dollar level of $67.7 million.

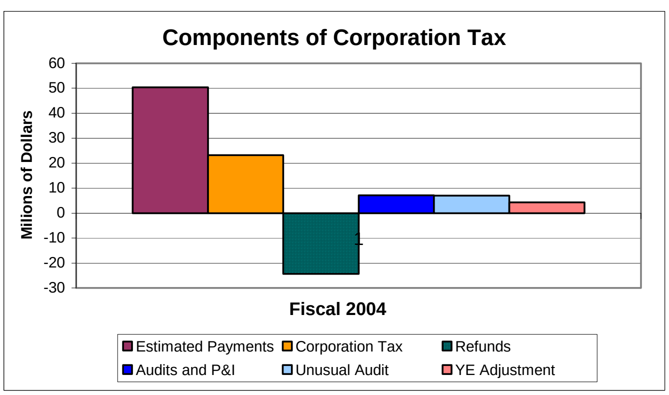

Figure 4

When observed in aggregate, corporation tax collections include several measurable components. SABHRS provides the LFD with the amounts of each corporation's payments, estimated payments, refunds, audit collections, and penalty and interest. Also captured in the aggregate data are the effects of credits and unusual events. Analysis of the individual factors can provide insight into some of the volatility seen in the corporation tax. Each of these areas are

[4] Refer to the July 9, 2004 presentation of Brian Staley, MT DOR, for further information on unitary tax filing.
[5] The average of corporation tax to general fund from 1982 to 2001 is 6.47 percent.

discussed later in this section.

The growth of corporation license tax collections is difficult to measure at best. Simply looking at annual data cannot provide any insight into growth in total corporation tax collections. For example, a comparison between collections of fiscal 1981, $54.9 million, and fiscal 2004, $67.7 million, shows compound growth rate of 1.1 percent annually. Any comparison of year-to-year total collections would produce similarly skewed growth rates. As seen in the accompanying chart, the period between 1994 and 2001 lacked the volatility experienced in other periods and had an unusually high rate of growth, 6.0 percent per year. But by all standards, that was a time of unusual corporate profitability in the United States and Montana alike. To gain a real appreciation for the growth in corporation tax, adjustments must be made to the aggregate data series.

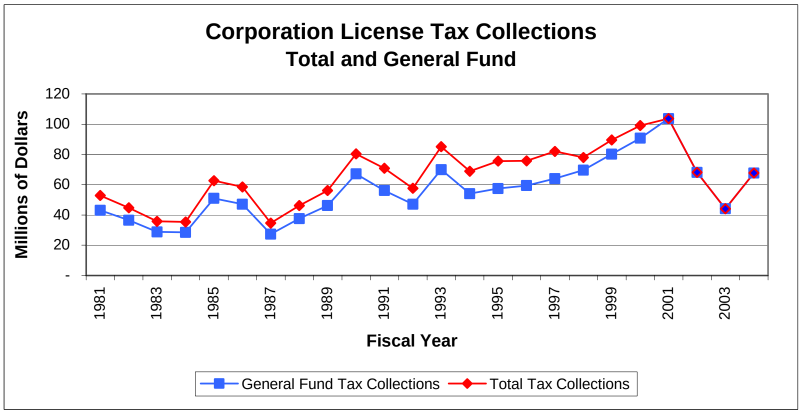

Figure 5

Estimated Payments

Estimated corporation tax payments make up the largest portion of total corporation payments. Corporations with expected annual net income of greater than $5,000 are required to make estimated corporation tax payments. The LFD uses SABHRS data from 1994 for this analysis. As seen in the chart, a relatively constant average of 83 percent of all collections are paid as estimated corporate payments.

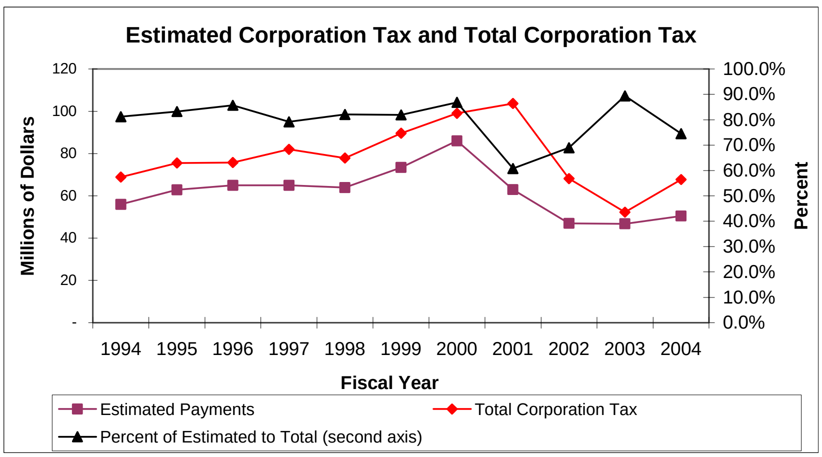

Figure 6

Exceptions have occurred in the past four fiscal years. In fiscal years 2002 and 2003, the exceptions resulted from high refunds and low adjusting corporation payments. Another exception to the constant percentage happened in fiscal 2004 when a significant audit payment increased overall corporation tax collections. When total corporation tax revenues are reduced by the unusual audit, the percentage of estimated taxes to total taxes increased to 83.1 percent.

Estimated payments provide the best measure of the growth in corporation tax collections. Estimated payments are not exposed to the unusual events that are found in the total collections data (white noise), so conclusions on total growth can be drawn from this data. Between the period of fiscal years 1994 and 2001, estimated payments sustained a compound growth rate of 1.7 percent annually. Computing the rate of growth using these years effectively bypasses periods of unusual collections due to economic events that occurred in the U.S. and Montana (fiscal years 1999, 2000, 2002-2004). During this same period of time, inflation averaged 2.6 percent annually. The conclusion is that corporation tax collections in Montana have decreased in real terms.

Corporation Tax and Refunds

In SABHRS, both the corporation tax and corporation refund account classifications serve in large part as adjustments to corporation estimated payments, yet both categories contain payment activity from outside the current tax period. Although corporation tax collection data also contain items such as the minimum payments of qualifying corporations, a large part of these collections can be attributed to corporation net income that is greater than anticipated. Conversely, refunds are issued to corporations that have overestimated their net income. However, refunds are also issued when corporations experience NOL and choose to carry the losses back to prior years.

NOL carrybacks are captured in the refund data. Corporations are allowed to carryback losses for three years and carryforward losses for seven years. Corporations are required to carryback losses to the greatest extent possible before carrying any such losses forward, unless a corporation elects to forego the carryback. SABHRS accounts cannot be altered to show the prior year impacts of NOL's. As a result, NOL carrybacks can have an extreme impact on collections for any given fiscal year. One example of a large impact from NOL carrybacks is observed in fiscal year 2003 which explains the very large amount of refunds in that year. During the recessionary period in fiscal year 2001, many corporations experienced net losses in tax years 2001 and 2002. Corporations filed the losses in fiscal 2002 and 2003, so NOL carrybacks to prior years would be accounted for in those periods. Because of a lack of data for fiscal 2003, an exact measure of the difference in refunds resulting from NOL carrybacks is not possible. Potentially, carryforward of losses will have some impact on estimated payments over the next six years.

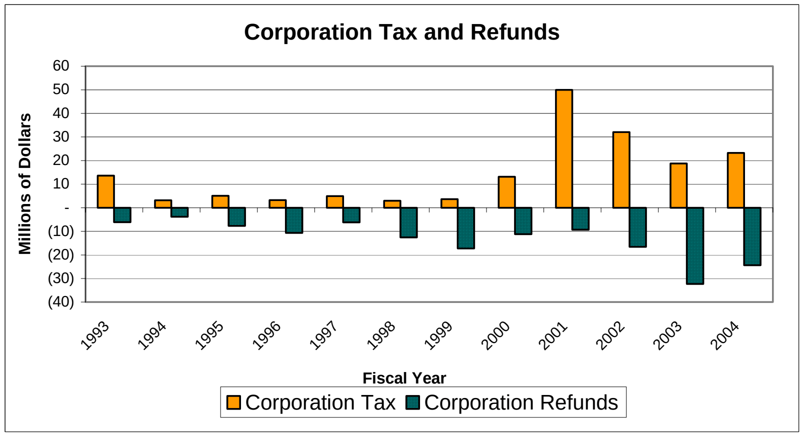

Figure 7

Typically, the corporation tax and refunds payments amount to an offset in their combined impact on the total tax collections. In recent years the offset has been aggravated by both Montana and U.S. economic factors. In fiscal years 2001 and 2002, corporation tax was greater than its offset in refunds. In those years, corporation tax was \$50.0 million and \$32.1 million respectively, while refunds were a negative \$9.3 million and \$16.6 million. This was a reflection of the increased Montana corporate profitability stemming from the large Montana corporate asset sales of several corporations in that period. In 2003, refunds were greater than the offset in corporation taxes, negative \$32.3 million and \$18.7 million respectively. This was a result of the impact of the national recession that occurred in calendar 2001. Fiscal 2004 saw the return to a near equal offset with corporation tax equal to \$23.2 million and refunds equal to a negative \$24.4 million. Because corporate tax and refunds tend to offset, they do not provide insight into what is occurring in the corporation tax base, yet they do offer an explanation into the variation in total tax collections.

Audit Payments and Penalties & Interest

For this section of the analysis, audit payments and penalties and interest are combined and referred to as "audits". While SABHRS has tracked audit payments for numerous years, before 1993 the audit data included penalties and interest, necessitating the combination of the two factors in more recent years. Audit collections vary considerably from year to year, from \$16.6 million in fiscal 1993 to \$1.2 million in fiscal 2000. When unusually large audits are collected, there is a major impact on total corporation taxes. The tax obligation

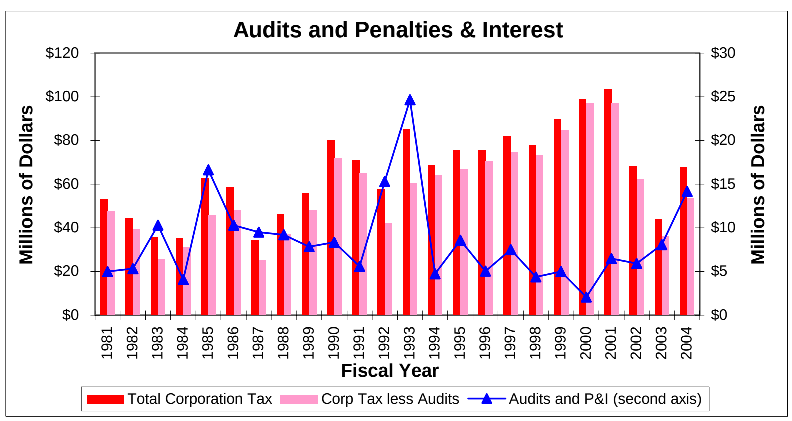

Figure 8

is typically a liability from prior year earnings. Audit collections in any given fiscal year are not treated as current tax liabilities in the LFD's estimation methodology. As observed in the graph, audits played a significant role in the total corporation tax collections in fiscal years 1985, 1992, 1993, and 2004. In fiscal 2004, one multi-million dollar payment was responsible for increased audit collections. Because audit payments provide a measure of past years' corporate accounting/payment mistakes, removal of these payments from total corporation tax collections helps to provide a "cleaner" data series, yet it does not offer information that can be connected to growth in the corporation tax base.

Credits

Total corporation tax is reduced by allowable credits. In fiscal 2004, there were 18 separate credits used to lower corporations' tax liabilities. As mentioned earlier in this report, the contractor's gross receipts tax credit and the charitable endowment contributions credit are the most widely used credits. For this tax credit analysis, the LFD used data provided by the DOR dating back to tax year 1989. In the period of fiscal years 1989 through 1998, corporate tax credits averaged $1.1 million annually. In the period of fiscal years 1999 through 2003, the average nearly doubled to $2.0 million annually, an increase of 82 percent. In tax year 2003, corporate credits exceeded $3 million.

Corporation Tax Credits

Fiscal Year	Total Credits	Total Corporation Tax Liabilities (with credits)	Reduction of Total Tax Liabilities by Credits
1989	$ 661,152	$ 56,800,901	1.16%
1990	884,911	81,200,415	1.09%
1991	1,084,557	71,868,836	1.51%
1992	1,211,764	58,894,436	2.06%
1993	1,317,876	86,372,359	1.53%
1994	1,211,444	70,083,353	1.73%
1995	1,180,560	76,700,500	1.54%
1996	1,332,573	77,094,464	1.73%
1997	1,252,929	83,252,067	1.50%
1998	1,004,573	78,933,071	1.27%
1999	1,567,179	91,191,739	1.72%
2000	1,437,744	100,526,611	1.43%
2001	1,563,266	105,233,753	1.49%
2002	2,547,502	70,720,755	3.60%
2003	3,022,063	47,159,581	6.41%

Figure 9

Most of the recent increase in corporation credits can be attributed to two new credits and increased use of the contractor's gross receipts tax credit. Qualifying corporations received credits of $13,031 for the *qualified research credit* in 2001. However, corporations reduced their incomes by $684,774 and $377,975 with this credit in the 2002 and 2003 tax years. In fiscal year 2003 corporations reduced their incomes by $407,261 with the *infrastructure user fee credit*, passed in 1995. Further credit increases were the result of accounting lags at the DOR of the *contractor's gross receipts tax credit*. Fiscal 2004 credit data has not been released as of the date of this report.

Identifiable Adjustments

In recent years the corporation license tax has had numerous unusual collections and refunds. The LFD tracks these unusual payments and refunds and uses them to adjust total corporation revenues with the intent of producing a less volatile revenue history. Several examples of identifiable adjustments are mentioned earlier in this section and include unusually high corporation taxes in fiscal 1999 through fiscal 2002, refunds in fiscal 2003, and audit collections in fiscal 2004. As seen in the chart to the left, the identified adjustments do smooth some of the extreme variations in corporation tax collections.

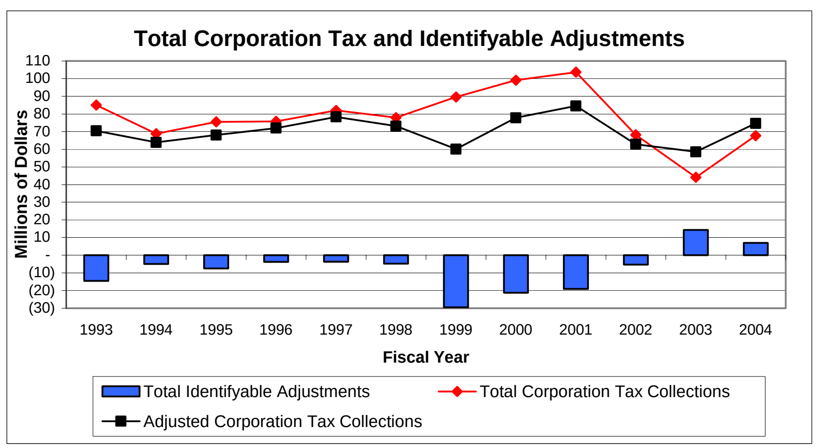

Figure 10

Along with the adjustments mentioned earlier, ongoing adjustments are made for federal corporation tax actions that directly affect Montana's corporation tax. The bonus depreciation provisions of the past two federal economic stimulus acts have created significant reductions in the corporation tax. Calculations provided in a study by the DOR indicated that the 2002 Job Creation and Worker Assistance Act caused a reduction in Montana corporation tax of $3 million in fiscal 2002 and $5 million in fiscal 2003, with a 30 percent bonus depreciation provision. The 2003 Jobs and Growth Tax Relief Reconciliation Act effectively reduced the cost in fiscal 2003 to $3 million, while extending and increasing the costs in fiscal 2004 to $8 million and in fiscal 2005 to $1 million.

Essentially, the two acts accelerated the allowable depreciation that corporations may take. As a result, beginning in fiscal 2006, taxes will increase.

The adjusted series shows slow positive growth, but negative real growth, in corporation taxes. The compound growth rate for the entire period of analysis, 1981 through 2004, is 2.98 percent. Using this period to calculate a growth rate removes a significant portion of the remaining unexplained variation in the adjusted data series. Average annual inflation for the same period was 3.7 percent, indicating that there has been a loss in real corporation tax during the period. Growth in earlier years of the corporation tax was greater than in more recent times. The compound growth for the period represented in the chart above, 1993 to 2004, is only 0.52 percent. This implies that the growth in the 1980's was much greater than recent growth trends have been. Inflation during the period from 1993 to 2004 was 2.5 percent. Consequently, corporation taxes have actually dropped by almost 2 percent from 1993 to 2004.

SECTION THREE: RETURN INFORMATION

Summary by Tax Year

Total Corporation

To better understand the implications of the historic corporation tax data, the LFD has analyzed return data in the period ranging from tax years 1996 through 2002. The data consists of individual return information aggregated into specific classes for each individual tax year. While the historic fiscal year corporation tax data was used in section two, section three contains tax year data. Consequently, dollar totals used in this portion of the analysis will not match the fiscal year data discussed earlier.

The number of corporations filing yearly tax returns with the DOR has dropped from 16,390 in 1996 to 14,804 in 2002, a reduction of 1,586 corporations, or approximately 10 percent. On an annual basis, the total number of returns has dropped by 4.0 percent since 1996. Much of the reduction occurred during the same period when the U.S. was experiencing a recession, in 2001 and 2002. In this time period, changes were also occurring in the method of organization businesses were choosing. As seen in the chart on page two, beginning in 2000, larger numbers of businesses were electing to form LLC's. Unfortunately, there is no direct evidence to suggest that either of these factors played a role in the reduction of corporate filers in 2001 and 2002. Furthermore, the drop in corporate filers was seen in all the classes of taxpayers.

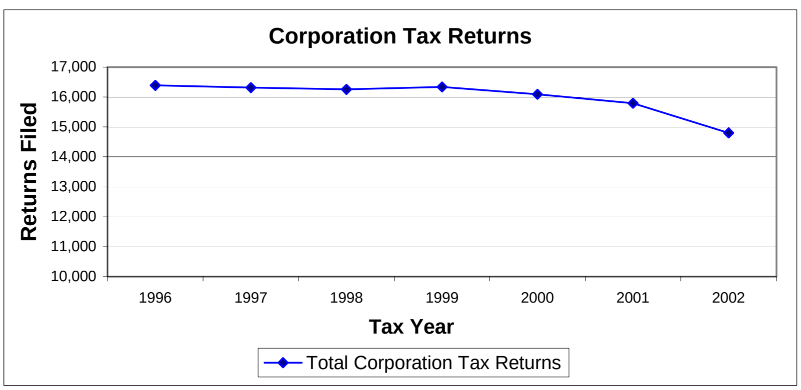

Figure 11

In the quantitative analysis of corporate taxpayers, the LFD has broken total returns into five distinct groups (classes) including returns with tax liabilities of $0.00 or less, $1 to $50, $51 to $1,000, $1,001 to $500,000, and greater than $500,000. In the chart below, observe that the reduction in numbers of returns was constant across the tax liability classes. In the class of returns filed with tax liabilities of $0.00 dollars or less, the compound growth between 2000 and 2002 was negative 2.6 percent. The class of payers with liabilities between $1 and $50, minimum payers, fell the least in the two years, 0.8 percent. The greatest loss in percentage terms was the experienced by the highest liability group, returns with liabilities greater than $500,000. In the period between 2000 and 2002, this class experienced reductions of 24.0 percent as the number of returns fell from 26 to 15.

Minimum Payment Corporations

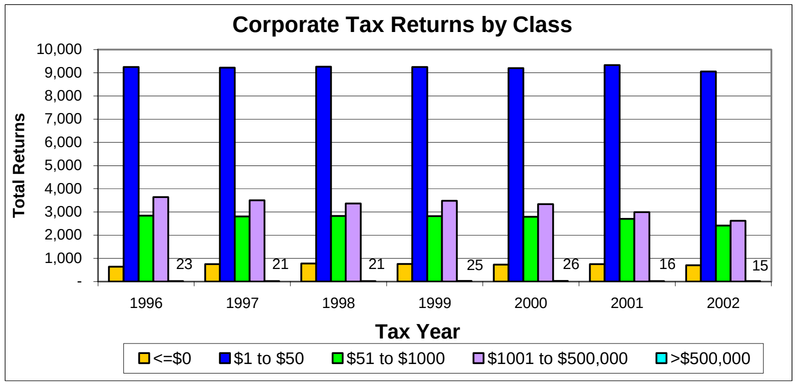

Figure 12

Note: The bars for the greater than $500,000 in tax liability returns are not visible, please refer to included labels.

Minimum pay corporations represent the largest class of Montana corporation taxpayers. The number of taxpayers filing as minimum payers and subject to a required payment of $50 annually has changed very little over the period of 1996 to 2002, lending credibility to the belief that no erosion of the corporation tax base has occurred within this class. In 1996, the number of minimum tax returns was 9,246. That number grew slightly between 1996 and 2001, when the number of returns was 9,329. A small decrease was observed in 2002 when 9,055 returns for minimum tax were filed. Generally, this class represents an important component of Montana's overall economy, the small corporation. While this class of taxpayers is less important in terms of tax revenue, it includes most of the corporations operating in Montana and forms the foundation of the corporation tax.

In-State and Multi-State Corporations

An analysis of in-state to multi-state corporations was performed for this report. Again, the data used for this analysis consists of the tax years of 1996 through 2002.

As seen in the chart to the right, there is a greater number of in-state than multi-state corporations here in Montana. While the number of in-state corporations has been dropping slowly over the period of analysis, a larger decrease was experienced between 2001 and 2002. The number of in-state corporations has dropped from 11,067 in 1996 to 9,660 in 2002, a decrease of 12.7 percent. The number of multi-state returns remained nearly constant throughout the period. In 1996, there were 5,323 returns filed by multi-state corporations and in 2002 there were 5,534. Similarly, the number of multi-state returns dropped to 5,144 in 2002, a reduction of 7.1 in only one year.

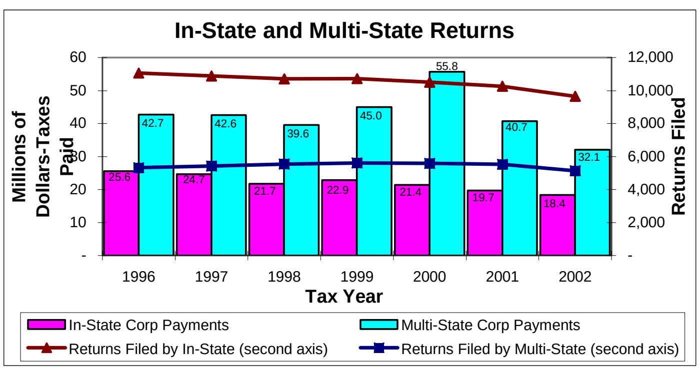

Figure 13

Observing the changes in the tax liabilities during this period may be more important than analyzing the numbers of filers for drawing conclusions concerning the profitability of corporations in Montana. The in-state total tax liability of $25.6 million in 1996 dropped to $18.4 million in 2002. While in-state liabilities had been falling over most of the period, the greatest reduction in liability is observed between 2001 and 2002, here the total liability of this class fell by 7.0 percent. Multi-state liabilities are far more volatile. This data set has been adjusted to remove know areas of volatility. We assume multi-state corporations have a closer relationship with national economic factors, causing higher variability. As seen in the chart above, the tax liability of multi-state corporations appears greater in periods when the U.S. economy is experiencing stability and growth and declines at times of economic contraction. This relationship will be explored in greater detail in section four. Multi-state tax liabilities dropped from $55.7 million in 2000 to $32.1 million in 2002, a reduction of 42.6 percent. The number of multi-state payers declined 14.7 percent in that same period, indicating that the existing corporations were experiencing lower liabilities. Again, this suggests that the profitability of multi-state corporations is more responsive to economic events at the national level.

Apportionment

Multi-state corporations pay the greatest part of Montana's corporation taxes. The income from these corporations is apportioned using a single weighted three factor apportionment formula. A specific group of multi-state corporations, corporations that at any point in the analyzed time range had Montana tax liabilities greater than $500,000, was evaluated to determine if any changes have occurred in their relative apportionment. As evident in the chart to the right, the average apportionment of this group of taxpayers has not changed significantly over time. The level has remained at approximately 0.3 percent of the total corporation income, and shows that large corporations who appear to have reduced their physical presence in Montana have not significantly changed the overall proportion of income attributable to Montana. Notice in the chart what has happened to the total Montana apportioned income. Because the apportionment factors have not changed substantially, it is clear that the amount of income for these large corporations has declined dramatically. The change from 2000 to 2001 is a reduction of more than $830 million dollars. In 2002, the Montana apportioned income of the highest taxpaying group actually went negative. This reduction coincides with the recession, which began in the third quarter of 2001 and lasted through the first quarter of 2002. It is logical to assume that as corporate incomes fell, corporate tax payments also fell. However, most of these corporations are still in operation, and as the U.S. economic climate improves incomes and tax payments will follow.

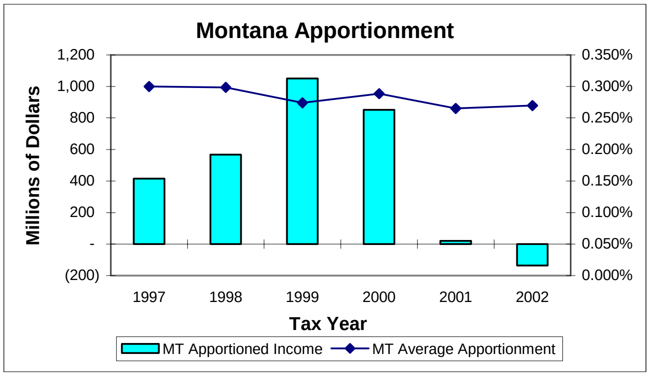

Figure 14

Sector Comparisons

The annual corporation tax revenues are directly related to occurrences in Montana's largest industries. Most of the large industrial businesses are incorporated. When any large industry or corporation experiences either increased or decreased sales, the effects are felt in similar revenue collections of the corporation tax. Historically, changes in mining, timber and lumber, and utility activities have had significant impacts on this tax.

The tax return database from the DOR contained an industry classification code for each return filed. However, after our analysis of this information, it was clear that these were missing values as well as only one code for a corporation that may have multiple business ventures.

To get some information on the mix of industries that pay the corporation income tax, a simple classification mechanism was developed for any corporation that had a tax liability greater than $500,000 over the period tax years 1996 through 2002. This information showed for tax year 2002 that approximately one-third of tax liability is from financial services, one-third from wholesale/retail trade and services, with the remaining one-third from natural resources, telecommunications, and utilities industries. Historical data prior to 1999 suggests the mix of industries was more heavily weighted towards the natural resource, telecommunications, and utility industry.

SECTION FOUR: CORPORATION TAX AND ECONOMIC CONDITIONS

More than any other Montana tax, the corporation license tax is responsive to the economic climate. National measures such as business cycle activity, stock market activity, gross national product, and U.S. corporate profitability provide clues into what will happen with future corporation tax collections. Montana's overall economy provides similar information about future tax collections. Consequently, gross state product and the activities of Montana's largest industries are observed for indications of future tax collections. This section will provide information on the responsiveness of Montana's corporation license tax to several key economic factors.

Corporation Tax and the Business Cycle

Montana's corporation license tax appears to be sensitive to the nations business cycle. As the national economy expands and contracts, corporation taxes follow suit with increased and reduced tax liabilities. The accompanying chart provides a visual indication of the corporation tax sensitivity to the business cycle. In the three periods of business cycle contractions analyzed for this report; quarter three of 1981 through quarter four of 1982, quarter three of 1990 through quarter one of 1991, and quarter one of 2001 through quarter four of 2001, corporation tax payments decreased for the following two years. During the 1982 and 1990 recessions, corporation began to reduce payments prior to the onset of the business contraction, indicating that corporations may experience a turn in business profitability the year preceding the onset of the contractive period. The ongoing reduction of tax payments occurs because of the lag presented by the tax filing system. The impact of the 2001 recession was exacerbated by the bankruptcies of several large Montana corporations, causing the drop to be greater than the size of the national recession would suggest.

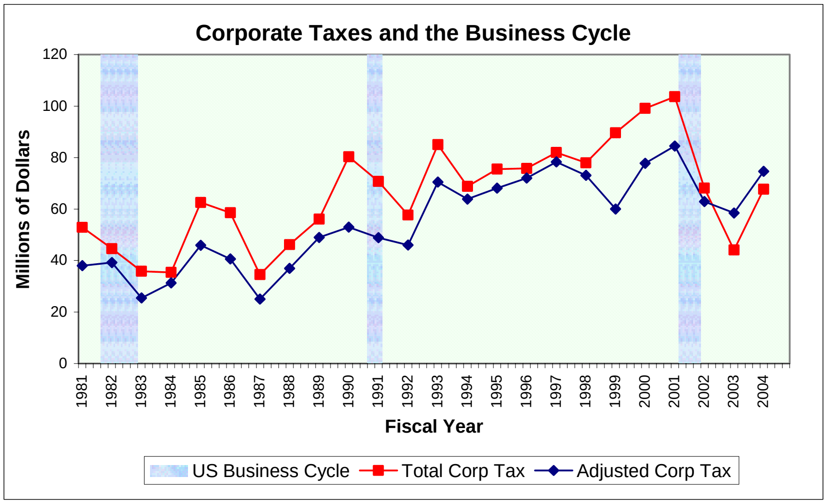

Figure 15

Corporation Tax and Stock Market Activity

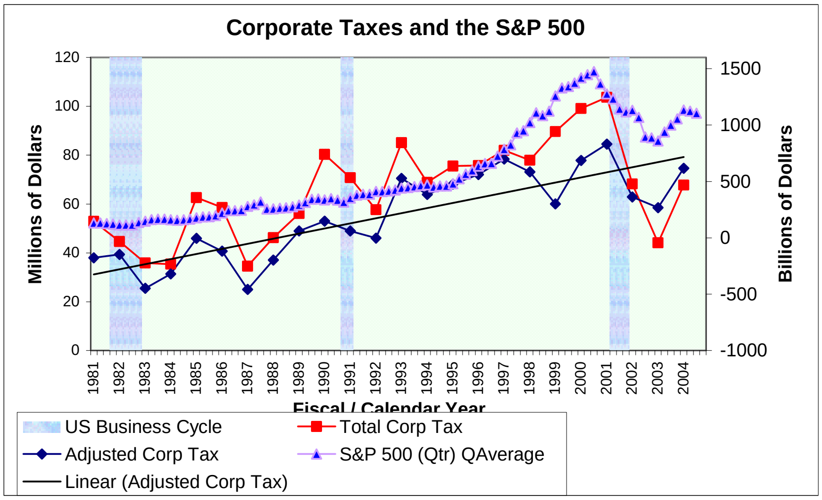

Figure 16

Logically, corporation tax collections are related to stock market activity. One indication is that tax revenues have retained a close relationship with the average annual value of the S&P 500 index. While during the period of 1983 through 1993 the ratio of Montana corporate tax collections and the S&P averaged approximately 0.02 percent, in more recent years it has been reduced. Since 1997, the ratio has been 0.007 percent. Although the ratio is very small, it is consistent. Notice in the chart to the left how average S&P values closely follow the linear trend line of the adjusted corporation tax until the late 1990's. Furthermore, notice that from the adjusted series follows extreme volatility of the S&P. These features lend credibility to the belief that there is a relationship between corporation tax collections and the activity of the stock market.

Corporation Tax and Gross National Product

There is also a close relationship between U.S. gross domestic product and Montana corporate license tax revenues. Typically, corporation tax collections are 0.0010 percent of nominal gross domestic product. The 0.0010 percent ratio is consistent as both a mean and mode average in this case. However in both fiscal year 2002 and 2003, the proportions dropped to 0.007 percent and 0.004 percent respectively.

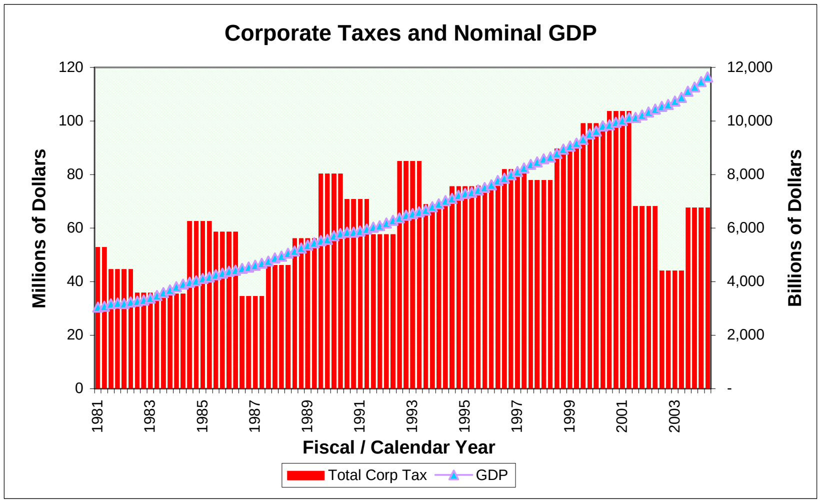

Figure 17

Multi-State Tax Liabilities and U.S. Corporate Profits

It has long been assumed that there was a relationship between Montana corporate tax collections and U.S. corporation profits. Furthermore, the LFD had assumed that a stronger relationship would exist between multi-state corporations' tax liability and profits. In an analysis of the two factors, both of these assumptions have proved questionable. As seen in the chart to the left, where U.S. Corporation profits (data series provided through the Bureau of Economic Analysis, Corporate Profits including inventory and capital consumption adjustments, lagged one year) are charted against the observations of multi-state tax liabilities, there is an inconsistent relationship between these two factors. For example tax year 1998, as U.S. profits were increasing, the tax liabilities of Montana's multi-state corporations were decreasing. Also note in 2000, while tax liabilities of the multi-state corporations spiked in that year, U.S. corporate profits remained constant.

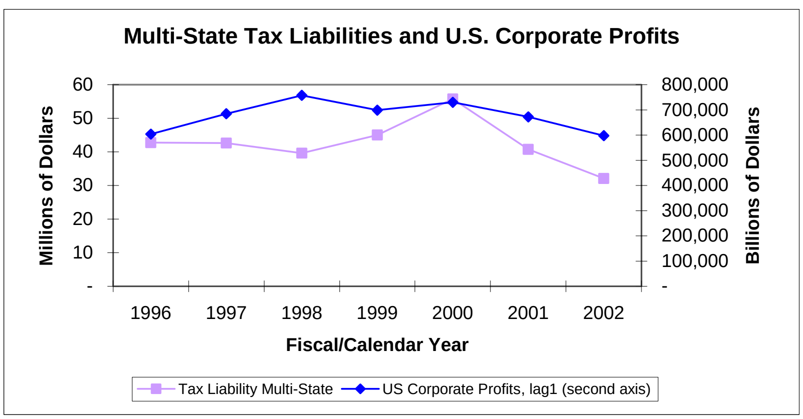

Figure 18

Corporation Tax and Gross State Product

In the same way corporation tax revenues appear to be related to GDP, they are closely related to Montana's gross state product (GSP). In this analysis of data back to 1981, corporate tax collections have varied been between 0.30 percent and 0.50 percent of GSP, averaging 0.44 percent. Notice in the chart to the right how GSP closely follows the trend line of adjusted corporation taxes. Release of GSP data is significantly lagged, and data for 2001 GSP has only recently been released, however the expectation is that the close relationship between Montana GSP and adjusted corporation taxes will continue into the future.

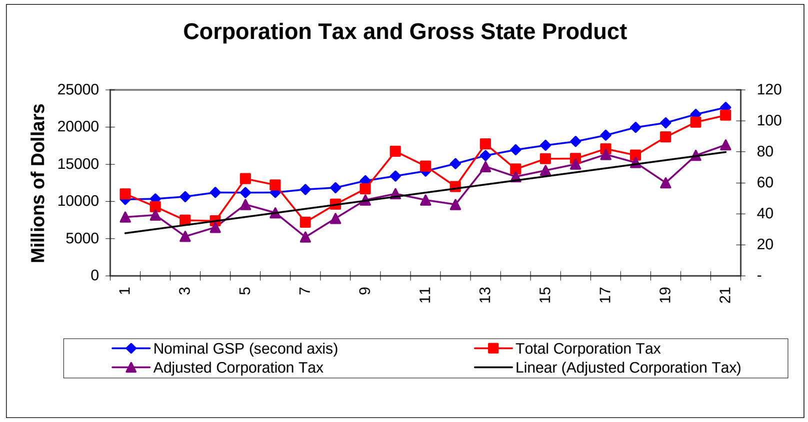

Figure 19

SECTION FIVE: SUMMARY AND CONCLUSION

Corporate taxes will always be a highly volatile revenue source. As demonstrated in this analysis, much of the volatility can be removed when factors such as audits, unusual payments and refunds, federal tax changes, and credits are removed from the data. National and Montana specific economic events that have a direct bearing on corporate business explain even more of the volatility. Explanations for the variability become essential when answering the question of concern; what changes have taken place in the base of the corporation license tax. The two areas of analysis presented in this report have provided numerous possibilities into what has been happening to the base.

In section two, two areas of analysis provided definite conclusions into the changes of the corporate tax base, estimated taxes and adjusted taxes. We observed that estimated taxes provide the best measure for the growth in total corporation tax collections. The analysis suggested that estimated payments have grown at a rate of 1.7 percent annually, in nominal terms. Unfortunately, growth in estimated payments has not kept up with inflation. While estimated payments were slowly growing, inflation was growing at an average rate of 2.6 percent. Through the analysis of the adjusted corporation tax data, we find that positive nominal growth of 3 percent was indicated for the 23-year period of analysis. However, again real growth was a negative 0.7 percent. Both areas of analysis point to the fact that the corporate base has lost some of its strength, yet the analysis of the collection data leaves a number of unanswered questions, the greatest of which is why this has occurred.

The analysis of return data in section three provides some of the answers to why the base of the corporation tax is shrinking. One key finding is that the number of total corporate returns has declined since 1999. Fewer corporate taxpayers directly equates to lower taxes. While there is no firm evidence to provide a reason for this decline, in the introduction we discussed the fact that more companies are opting to form as LLC's. While an in-depth investigation of business organization is beyond the scope of this report, research into this topic could provide correlation between the decreasing number of corporations and increasing number of LLC's. Please be aware that if LLC's are replacing corporations as new businesses form, the tax dollars are not totally lost, but instead are shifted to the individual income tax base.

Another important finding of the analysis of section three is observed in the apportionment analysis. For the last two years of data, 2001 and 2002, the apportioned income of Montana's largest corporations, responsible for the greatest portion of corporate tax payments, has decreased significantly. While this occurred, the average apportionment of the group's total income remained constant. Furthermore, most of the large corporations continue to operate. This indicates that the reduction in total tax liability is the result of reduced profitability. There is no question that the financial troubles suffered by these corporations are very diverse, but a broad-brush explanation of what happened to their profitability is explained by the recent recession and the impacts of federal tax policies. As the economy continues to grow stronger, the profitability of this group should increase, providing increased tax revenue to the state.

An explanation of what is happening with the corporation tax base becomes apparent when all the components are assembled. Historically, corporation tax collections have not kept pace with inflation and the number of corporation taxpayers has fallen. As a result, we would have to conclude that the corporate base has diminished. However, the extreme fall of total corporation tax collections seen in fiscal 2002 and 2003 is the result of the lack of corporate profitability, not of a diminishing tax base. In the coming years, corporation tax collections should continue to grow from the collection level experienced in fiscal 2003.

The return data provided by the DOR was invaluable in this analysis, but it was also very limited in its time span and captured data elements. As is always the case in an economic study, more data observations provide stronger and more efficient conclusions. The LFD hopes the Revenue and Transportation Interim Committee finds this report valuable and requests that as more data is collected in upcoming years, the committee request an update or re-examination of the base of the corporate license tax.