# CORPORATION LICENSE TAX

## Revenue Description

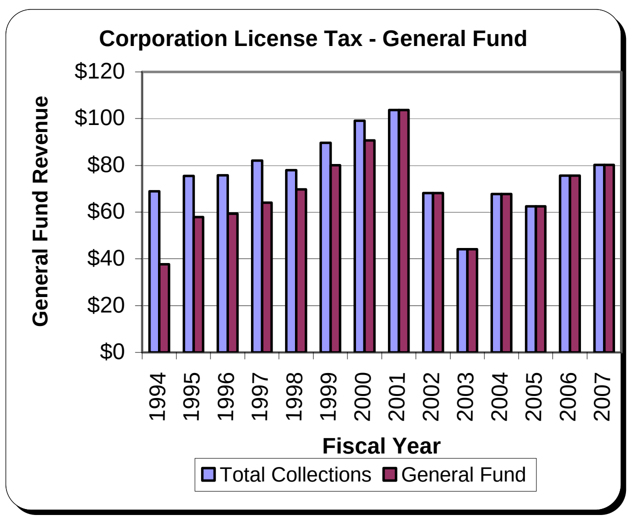
The Corporation License Tax is a tax on corporate income apportioned to Montana. The tax is levied at a flat rate of 6.75% of net income; however corporations making a "water's edge" election are taxed at 7%. Beginning in FY 2001, revenues are deposited 100% into the general fund.

## Historical and Projected Revenue

Table 1 shows total and general fund revenue from corporation license taxes for FY 1994 through FY 2004 and projections through FY 2007. Revenue grew fairly steadily during the 1990s as the national economy had a prolonged expansion. Revenue dropped by about 35% in FY 2002 and again in FY 2003 and increased by 53% in FY 2004. Revenue is projected to decrease in FY 2005 and then to be higher in FY 2006 and FY 2007 but to be significantly below peak collections of FY 2001.

**Table 1**
**Corporation License Tax - General Fund Collections**
**($ millions)**

| | Fiscal Year | Total Collections | General Fund | Percent Change |
|---|---|---|---|---|
| A | 1994 | $68.872 | $37.698 | -26.5% |
| A | 1995 | $75.520 | $57.918 | 53.6% |
| A | 1996 | $75.762 | $59.360 | 2.5% |
| A | 1997 | $81.999 | $64.079 | 7.9% |
| A | 1998 | $77.928 | $69.725 | 8.8% |
| A | 1999 | $89.625 | $80.142 | 14.9% |
| A | 2000 | $99.089 | $90.683 | 13.2% |
| A | 2001 | $103.670 | $103.670 | 14.3% |
| A | 2002 | $68.173 | $68.173 | -34.2% |
| A | 2003 | $44.138 | $44.138 | -35.3% |
| A | 2004 | $67.723 | $67.723 | 53.4% |
| **F** | **2005** | **$62.448** | **$62.448** | **-7.8%** |
| **F** | **2006** | **$75.666** | **$75.666** | **21.2%** |
| **F** | **2007** | **$80.269** | **$80.269** | **6.1%** |




Corporation license tax is more volatile and less predictable than most revenue sources. This volatility is even more apparent when corporation license tax revenue is broken down into its components: quarterly estimated payments; payments with returns; audit revenue, including penalties and interest; and refunds.

Table 2 shows FY 2000 through FY 2004 quarterly estimated payments, payments with returns or extensions, and payments of audit revenue, including penalties and interest. It also shows total collections, which is the sum of the three types of payments. The two rightmost columns show refunds and net revenue, which is total collections less refunds.

**Table 2**
**Corporation License Tax Collections and Refunds**
**FY 2000 through FY 2004**

| | Quarterly Estimated Payments | | Payments with Returns or Extensions | | Audit, Penalty and Interest | | Total Collections | | Refunds | | Net Revenue | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Fiscal Year | $ million | % Chg | $ million | % Chg | $ million | % Chg | $ million | % Chg | $ million | % Chg | $ million | % Chg |
| 2000 | 86.070 | | 13.186 | | 1.208 | | 100.464 | | -11.199 | | 89.264 | |
| 2001 | 62.945 | -27% | 50.038 | 279% | 0.000 | -100% | 112.983 | 12% | -9.312 | -17% | 103.670 | 16% |
| 2002 | 46.986 | -25% | 31.879 | -36% | 4.927 | N/A | 83.792 | -26% | -16.607 | 78% | 67.185 | -35% |
| 2003 | 46.788 | 0% | 18.723 | -41% | 7.876 | 60% | 73.388 | -12% | -29.452 | 77% | 43.936 | -35% |
| 2004 | 50.447 | 8% | 23.222 | 24% | 13.689 | 74% | 87.359 | 19% | -20.115 | -32% | 67.244 | 53% |

Corporations expecting to have tax liability of at least $5,000 are required to make quarterly estimated payments. Returns are due five months after the end of the tax year, but a corporation may have an automatic six-month extension and the Department of Revenue may grant additional extensions. Corporations taking an extension and expecting to have tax liability greater than their estimated payments generally make a tentative payment when their return is due. When a corporation files its return, it makes a final payment if its liability is more than the sum of its estimated and tentative payments. It claims a refund if its liability is less than it has paid.

Payments and refunds for a corporation's tax year may be spread over two or more fiscal years. Corporation license tax is paid for a twelve-month period. Many corporations start their tax years on January 1, but some start their tax year later in the calendar year. This means that collections during a fiscal year will be of taxes from at least four calendar years. For example, collections in FY 2004 would include quarterly estimated payments for parts of calendar years 2004 and 2003, and payments and refunds based on returns for tax years beginning in 2003, 2002, and the last months of 2001.

The minimum corporation tax payment for a year is $50. When a corporation has a loss, it must still pay the minimum. However, it can carry the loss back to the previous three tax years and request a refund of taxes paid for those years. If the loss is more than can be carried back to the three previous years, it can be carried forward up to seven years.

The volatility of collections is due to unpredictability of taxes paid by individual corporations, not to instability in the number of corporations. Table 3 shows C-corporation tax returns filed for tax years 1996 through 2002. The second column shows the number of C-corporations that had filed a return for each of these tax years by the end of calendar 2003. To give a valid comparison, this needs to be adjusted for additional C-corporations that will file returns for the later years. The third column shows the percentage of additional returns expected to be filed by seven years after each tax year, and the fourth column shows the number of C-corporations expected to file a return for each tax year.

Slightly less than 70% of returns for a tax year are filed by the end of the following calendar year. Thus, the last row of Table 3 shows that 30.4% more returns are expected for tax year 2002 and 16,229 C-corporations ultimately are expected to file returns. After adjusting for the time to file returns, the number of C-corporations filing returns appears to have been stable from 1996 through 1998 and then to have grown steadily through 2002.

**Table 3**
**C-Corporations Filing Tax Returns**
**Tax Years 1996 through 2002**

| Tax Year | Returns Filed Through 2003 | Additional Returns Expected by Seven Years After Tax Year | Returns Expected by Seven Years After Tax Year |
|---|---|---|---|
| 1996 | 15,360 | 0.00% | 15,360 |
| 1997 | 15,306 | 0.11% | 15,323 |
| 1998 | 15,299 | 0.22% | 15,333 |
| 1999 | 15,423 | 0.73% | 15,535 |
| 2000 | 15,479 | 1.61% | 15,729 |
| 2001 | 15,408 | 3.60% | 15,963 |
| 2002 | 12,446 | 30.40% | 16,229 |

The average growth of corporation tax revenue is correlated with a number of measures of state and national economic performance. This makes it possible to predict average growth of collections. However, year-to-year variations in collections are only weakly correlated with variations in state or national economic performance. This makes it impossible to predict whether collections will grow faster or slower than average in any year with much precision.

Part of the volatility of collections in the last few years was caused by unusual events affecting a few taxpayers. Collection trends were estimated with the effects of these events removed. However, similar events may cause significant deviations from the trend in the future.

Changes in federal tax laws affect corporation license tax revenue because the base for the tax is Montana's share of taxable profits for federal corporate income tax. The Job

Creation and Worker Assistance Act of 2002 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 allowed first year depreciation to be increased by 30% for purchases between September 10, 2001 and May 5, 2003 and by up to 50% for purchases between May 6, 2003 and December 31, 2004. This temporary change in accounting rules shifts profits and taxes from tax years 2001 through 2005 to later years.

## Forecast Methodology

The following steps are used to forecast corporation license tax revenue:

1) Separate past collections into normal current collections and extraordinary collections, including collections from audits and one-time and other extraordinary events.
2) Separate normal collections from Step 1 into collections from corporations doing business solely within the state ("domestic" corporations) and multi-state corporations.
3) Forecast collections from domestic corporations.
4) Forecast collections from multi-state corporations.
5) Forecast audit and other extraordinary collections and sum the forecasts for domestic corporations, multi-state corporations and extraordinary collections to obtain the forecast of total collections.

### Step 1: Separate Normal and Extraordinary Collections

For forecasting purposes, it is useful to separate corporate tax receipts into those due to current operating profits, which are affected by current economic conditions, and receipts due to audits and extraordinary events, which are not tied to current economic conditions.

The Department of Revenue audits a percentage of corporate taxpayers every year and collects revenue from audits every year. Each audit typically covers returns for several past years for the purpose of verifying and correcting the income and deductions reported on those returns. When the department determines that a return was incorrect, it notifies the taxpayer that additional tax, possibly with penalties and interest, is due or it issues a refund. Audit revenue for a year depends on the number of audits and the corrections made to returns from previous years and not on current economic conditions.

A corporation's profits during a year depend on current operations and on one-time transactions and accounting adjustments. When a firm sells assets, it may have a capital gain or loss. When a firm has assets that have lost value, it may write off that loss against current revenues. In either case, the firm's profits, which are the base for corporate tax, are affected by factors other than current operations.

When a corporation has losses in one year, it can carry those losses back to the three previous years and claim a refund of taxes paid in those years. If profits in the three previous years were less than the current loss, it can carry the loss forward to future tax years. In this case, corporate tax receipts in one year are affected by economic conditions in other years.

The Department of Revenue examined records of corporate tax payments from FY 1993 through FY 2003 and identified revenue and refunds from audits and known large extraordinary events. For FY 2004, audit collections were taken from the state accounting system, and the effects of temporary changes in federal depreciation rules were estimated by recalculating tax liability from returns for earlier years as if the temporary depreciation rules had been in effect.

Table 4 shows net collections from audits and one-time events, other collections, which are assumed to be from current operating profits, and total collections.

**Table 4**
**Audit and One-Time Collections and Other Collections**
**FY 1993 through FY 2004**
**($ millions)**

| Fiscal Year | Audit and One-Time Collections | Other Collections | Total Collections |
|---|---|---|---|
| 1993 | $31.314 | $53.740 | $85.054 |
| 1994 | $12.022 | $56.850 | $68.872 |
| 1995 | $13.916 | $61.604 | $75.520 |
| 1996 | $10.266 | $65.496 | $75.762 |
| 1997 | $15.634 | $66.365 | $81.999 |
| 1998 | $11.790 | $66.138 | $77.928 |
| 1999 | $37.042 | $52.582 | $89.625 |
| 2000 | $30.609 | $68.479 | $99.089 |
| 2001 | $25.267 | $78.404 | $103.670 |
| 2002 | $10.216 | $57.957 | $68.173 |
| 2003 | ($12.922) | $57.060 | $44.138 |
| 2004 | $3.777 | $63.946 | $67.723 |
| average | $15.744 | $62.385 | $78.129 |
| high - low | $49.964 | $25.822 | $59.533 |

Over the twelve fiscal years shown in Table 4, audit and one-time revenue averaged $15.7 million but ranged from a high of $37.0 million in FY 1999 to a low of ($12.9) million in FY 2003. Other collections showed less variation. While other collections averaged almost four times more than audit and one-time collections, the difference between the highest and lowest was almost twice as large for audit and one-time collections.

### Step 2: Separate Collections from Domestic and Multi-State Corporations

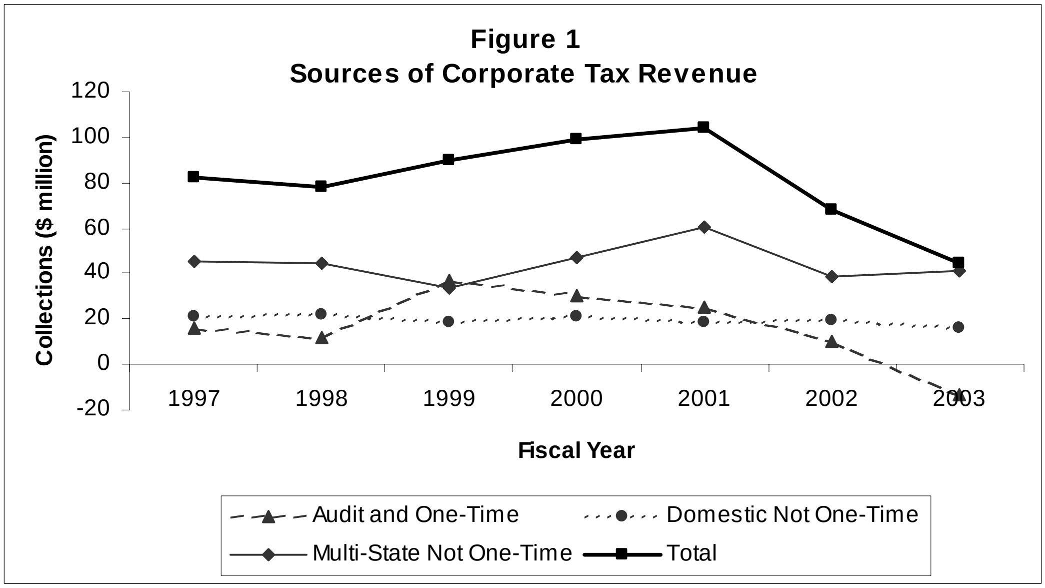
Corporations doing business in more than one state apportion their income among the states for corporate tax purposes. This provides an easy way to differentiate between multi-state corporations and corporations that only do business in Montana, which are referred to as domestic corporations. The Department of Revenue examined returns from FY 1997 through FY 2003 and separated the other corporate tax payments shown in Table 4 into domestic and multi-state corporations.

Table 5 shows collections not attributable to audits or one-time events from domestic corporations and multi-state corporations for FY 1997 through FY 2003. It also shows the averages and the range from highest to lowest. Revenue from multi-state corporations has the most variation. On average, it is more than twice the revenue from domestic corporations, but the range from highest to lowest is almost five times as large. In fact, the range of collections from multi-state corporations is greater than the range of total collections (not attributable to audits or one-time events).

**Table 5**
**FY 1997- FY 2003 Domestic and Multi-State Corporation Collections**
**($ millions)**

| Fiscal Year | Domestic Corporations | Multi-State Corporations | Total Not Audit or One-Time |
|---|---|---|---|
| 1997 | $20.729 | $45.636 | $66.365 |
| 1998 | $21.580 | $44.559 | $66.138 |
| 1999 | $18.781 | $33.801 | $52.582 |
| 2000 | $21.076 | $47.404 | $68.479 |
| 2001 | $18.279 | $60.125 | $78.404 |
| 2002 | $19.223 | $38.735 | $57.957 |
| 2003 | $16.097 | $40.963 | $57.060 |
| average | $19.395 | $44.460 | $63.855 |
| high - low | $5.483 | $26.324 | $25.822 |

Figure 1 shows total corporate tax collections on the top line, comprised of audit and one-time collections; collections from domestic corporations not due to audits or one-time events; and collections from multi-state corporations not due to audits or one-time events. Collections from domestic corporations are by far the most stable of the three sources of revenue.




**Step 3: Forecast Collections from Domestic Corporations**

As shown in Table 5 and Figure 1, collections from domestic corporations were fairly stable from FY 1997 through FY 2003, with small variations from year to year and no trend. The forecast assumes that this will continue to be true. Collections from domestic corporations are forecast to equal the average from FY 2001 through FY 2003, which is $17.866 million.

### Step 4: Forecast Collections from Multi-State Corporations

Multi-state corporations pay Montana corporate tax on a percentage of their total income. This percentage is the average of the percentages of the corporation's property, payroll, and sales that are in Montana. Figure 2 shows U.S. pre-tax profits and corporate tax receipts from multi-state corporations.

**Figure 2**
**US Pre-Tax Profits and Corporation Tax Collections from Multi-State Corporations**


U.S. pre-tax profits and corporate tax collections from multi-state corporations generally move together. From FY 1997 through FY 2003, they moved in the same direction in five out of seven years.

A statistical model was developed to forecast collections from multi-state corporations based on a time trend and U.S. corporate profits. The model with the best fit to the data predicts that collections will equal $44.314 million, which is average collections from FY 1993 through FY 2003, plus $0.086 million for each year since FY 1998, plus $16.441 million for each trillion dollars by which U.S. corporate profits exceed $0.710 trillion, their average from FY 1993 through FY 2003.

Table 6 shows the calculation of the forecast for FY 2004 through FY 2007 using this model. The forecast of U.S. corporate profits shown in Table 6 is derived from Global Insight's September 2004 forecast. To avoid double counting the effect of federal bonus depreciation provisions, the U.S. profit forecast was adjusted to remove them. This was done by using profits in FY 2001 as the baseline and applying the growth rate of Global Insight's forecast of profits plus depreciation to this baseline.

**Table 6**
**Forecast of Collections From Multi-State Corporations**

| Fiscal Year | Average Collections FY 1993 - FY 2003 | | Growth per Year | | Years Since FY 1998 | | Increase per $1 Trillion in US Profits | | US Profits - FY93 to FY03 Average | | Model Forecast |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2005 | $44.314 | + | $0.086 | x | 7 | + | $16.441 | x | $0.466 | = | $52.582 |
| 2006 | $44.314 | + | $0.086 | x | 8 | + | $16.441 | x | $0.524 | = | $53.622 |
| 2007 | $44.314 | + | $0.086 | x | 9 | + | $16.441 | x | $0.587 | = | $54.736 |

**Step 5: Adjust Total Collections for Anticipated Audit and One-Time Impacts**

The final step in the revenue estimate is to add total collections from domestic and multi-state corporations and adjust this total for one-time or extraordinary adjustments and audit revenue. There are two extraordinary adjustments. One is for loss carryforwards continuing in FY 2005, and the other is for the impact of the accelerated depreciation provisions in effect through December 31, 2004.

During the economic slowdown of 2001 and 2002, many corporations had losses. Some of these losses were carried back to offset income in the previous three years. The resulting refunds of taxes paid in 1998 through 2000 reduced revenue in FY 2002 and FY 2003. Losses that cannot be carried back can be carried forward for up to seven years. An analysis of returns filed in FY 2004 indicates that corporations have accumulated significant unused loss carryforwards. As the economy continues to improve, more companies will have profits that they can offset with accumulated loss carryforwards. It is estimated that use of these loss carryforwards will result in a one-time decrease in collections of $9 million in FY 2005.

The Department of Revenue examined corporate tax returns for 1998, 1999, and 2000 and calculated what tax liability for those returns would have been if those returns had been filed each year when the bonus depreciation rules will be in effect. The changes from actual liability were used to estimate the impact of bonus depreciation. Through FY 2005, the accelerated depreciation reduces tax liability. After FY 2005, the remaining depreciation on capital goods purchased during the bonus depreciation window is lower than it would have been without the accelerated depreciation. This increases tax liability for several years beginning in FY 2006.

The Department of Revenue makes an estimate of the audit revenue the department will generate by fiscal year. They have estimated $3.5 million for FY 2005 and FY 2006, and $4 million for FY 2007.

Table 7 shows estimated collections from domestic and multi-state corporations, adjustments for extraordinary loss carryforwards and bonus depreciation, audit revenue, and total forecast collections for FY 2005 through FY 2007.

**Table 7**
**FY 2005 through FY 2007 Corporation License Tax Forecast**
**($ millions)**

| Forecast Item | FY2005 | FY2006 | FY2007 |
|---|---|---|---|
| Revenue from Multi-State Corporations | $52.582 | $53.622 | $54.736 |
| Revenue from Domestic Corporations | 17.866 | 17.866 | 17.866 |
| **Total Revenue Before Adjustments** | **$70.448** | **$71.488** | **$72.602** |
| **Adjustments:** | | | |
| Extraordinary Loss Carryforwards | ($9.000) | $0.000 | $0.000 |
| 30% Bonus Dep./Bus. Exp. Impacts | (2.000) | 0.678 | 3.667 |
| Audit Revenue | 3.000 | 3.500 | 4.000 |
| **Total Adjustments** | **($8.000)** | **$4.178** | **$7.667** |
| **Forecast Corporate Tax Collections** | **$62.448** | **$75.666** | **$80.269** |

Total collections are projected to be $5.2 million lower in FY 2005 than in FY 2004, primarily because adjustments are negative. Revenue before adjustments is projected to grow by slightly more than $1 million per year in FY 2006 and FY 2007. After adjustments, revenue is projected to grow by $13.2 million in FY 2006 and by $4.6 million in FY 2007.

## Forecast Risk

This forecast is based on the trends in collections that can be seen when extraordinary events in the past have been taken into account. On average, collections are expected to continue to follow the same trends in the future. However, extraordinary events are almost certain to occur in the future. In any year, collections may be significantly higher or lower than the trend.