

## 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%. Since FY 2001, revenues have been deposited 100% in the general fund with the exception that, in FY 2005, \$375,000 of the tax collected from water’s-edge corporations was deposited in the state special revenue fund to the credit of the Department of Public Health and Human Services (15-31-121, MCA).

### Historical and Projected Revenue

Table 1 shows total and general fund revenue from corporation license taxes for FY 1996 through FY 2006 and projections for FY 2007 through FY 2009.

<b>Table 1</b>				
<b>Corporation License Tax - General Fund Collections</b>				
<b>(\$ millions)</b>				
Fiscal Year	Total Collections	Percent Change	General Fund	Percent Change
A 1996	\$75.762	0.3%	\$59.360	2.5%
A 1997	\$81.999	8.2%	\$64.079	7.9%
A 1998	\$77.928	-5.0%	\$69.725	8.8%
A 1999	\$89.625	15.0%	\$80.142	14.9%
A 2000	\$99.089	10.6%	\$90.683	13.2%
A 2001	\$103.670	4.6%	\$103.670	14.3%
A 2002	\$68.173	-34.2%	\$68.173	-34.2%
A 2003	\$44.138	-35.3%	\$44.138	-35.3%
A 2004	\$67.723	53.4%	\$67.723	53.4%
A 2005	\$98.589	45.6%	\$98.214	45.0%
A 2006	\$153.675	55.9%	\$153.675	56.5%
<b>F 2007</b>	<b>\$176.963</b>	<b>15.2%</b>	<b>\$176.963</b>	<b>15.2%</b>
<b>F 2008</b>	<b>\$185.933</b>	<b>5.1%</b>	<b>\$185.933</b>	<b>5.1%</b>
<b>F 2009</b>	<b>\$190.314</b>	<b>2.4%</b>	<b>\$190.314</b>	<b>2.4%</b>

Fiscal Year	Total Collections	General Fund
1996	75.762	59.360
1997	81.999	64.079
1998	77.928	69.725
1999	89.625	80.142
2000	99.089	90.683
2001	103.670	103.670
2002	68.173	68.173
2003	44.138	44.138
2004	67.723	67.723
2005	98.589	98.214
2006	153.675	153.675
F 2007	176.963	176.963
F 2008	185.933	185.933
F 2009	190.314	190.314

Revenue grew fairly steadily during the second half of the 1990s as the national economy experienced a prolonged expansion. Revenue dropped by about 34% in FY 2002 and dropped by 35% in FY 2003. In FY 2004 revenue increased 53%. Revenue increased by 45% in FY 2005, bringing revenue collections almost to the FY 2000 level. In FY 2006 revenue increased by an unprecedented 56.5%, bringing total corporate revenue collections to \$153.675 million. Revenue is projected to continue growing in FY 2007 through FY 2009, but at a much slower rate than over the past three fiscal years. In FY 2007 revenue is forecast to increase by 15.2%. In FY 2008 and FY 2009 revenue is forecast to increase by 5.1% and 2.4% respectively as growth in the economy and national corporate profits slows.

As can be seen in the graph in Table 1, corporation license tax is more volatile and less predictable than most revenue sources. This volatility is also 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 2001 through FY 2006 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. The percent change column for each revenue category and refunds shows wide variations between years and no consistent trend over time.

<p style="text-align: center;"><b>Table 2</b>  <b>Corporation License Tax Collections and Refunds</b>  <b>FY 2001 through FY 2006</b></p>												
Fiscal Year	Quarterly Estimated Payments		Payments with Returns or Extensions		Audit, Penalty and Interest		Total Collections		Refunds		Net Revenue	
	\$ million	% Chg	\$ million	% Chg	\$ million	% Chg	\$ million	% Chg	\$ million	% Chg	\$ million	% Chg
2001	62.945	-27%	50.038	279%	0.000	N/A	112.983	12%	-9.312	-17%	103.670	16%
2002	46.986	-25%	31.879	-36%	5.916	N/A	84.780	-25%	-16.607	78%	68.173	-34%
2003	46.788	0%	18.723	-41%	8.078	37%	73.589	-13%	-29.452	77%	44.138	-35%
2004	50.442	8%	23.222	24%	14.174	75%	87.838	19%	-20.115	-32%	67.723	53%
2005	61.916	23%	36.035	55%	10.597	-25%	108.547	24%	-10.333	-49%	98.214	45%
2006	109.666	77%	44.164	23%	10.830	2%	164.660	52%	-10.985	6%	153.675	56%

<sup>1</sup>FY 2001 audit, penalty and interest collections were \$9,677,154. FY 2005 revenue is general fund only.

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 year on January 1, but some start their tax year later in the calendar year. Thus collections during a fiscal year will be of taxes from at least four calendar years. For example, collections in FY 2005 would include quarterly estimated payments for parts of calendar years 2004 and 2005, and payments and refunds based on returns for tax years beginning in 2005, 2004, and the last months of 2003.

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, not on current economic conditions.

A corporation's profits during a year depend on current operations and 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 up to seven future tax years. In this case, corporate tax receipts in one year are affected by economic conditions in other years. The minimum corporation tax payment for a year is \$50. When a corporation has a loss, it must still pay the minimum.

The average growth of corporation tax revenue is correlated with measures of state and national economic performance. This makes it possible to predict the average growth of revenues. However, there are year-to-year variations in revenues due to a number of factors, including changes in federal and state law or unusual events affecting a few large taxpayers that reduce the accuracy of predictions and make it difficult to predict precisely whether revenues will grow faster or slower than average in any year.

Changes in federal tax laws affect corporation license tax revenue because the Montana tax base 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 corporate profits and taxes from calendar years 2001 through 2004 to later years.

### **Forecast Methodology**

Corporation license tax revenue is estimated using the Bureau of Economic Analysis (U.S. Department of Commerce) data on national corporate profits before taxes (shown in Table 3) and Global Insight October 2006 forecast of the same for FY 2007 through FY 2009. National profits before taxes from the **prior** year have a relatively good level of predictive power for Montana corporate tax revenues. Table 3 shows national pretax profits and total corporate revenues.

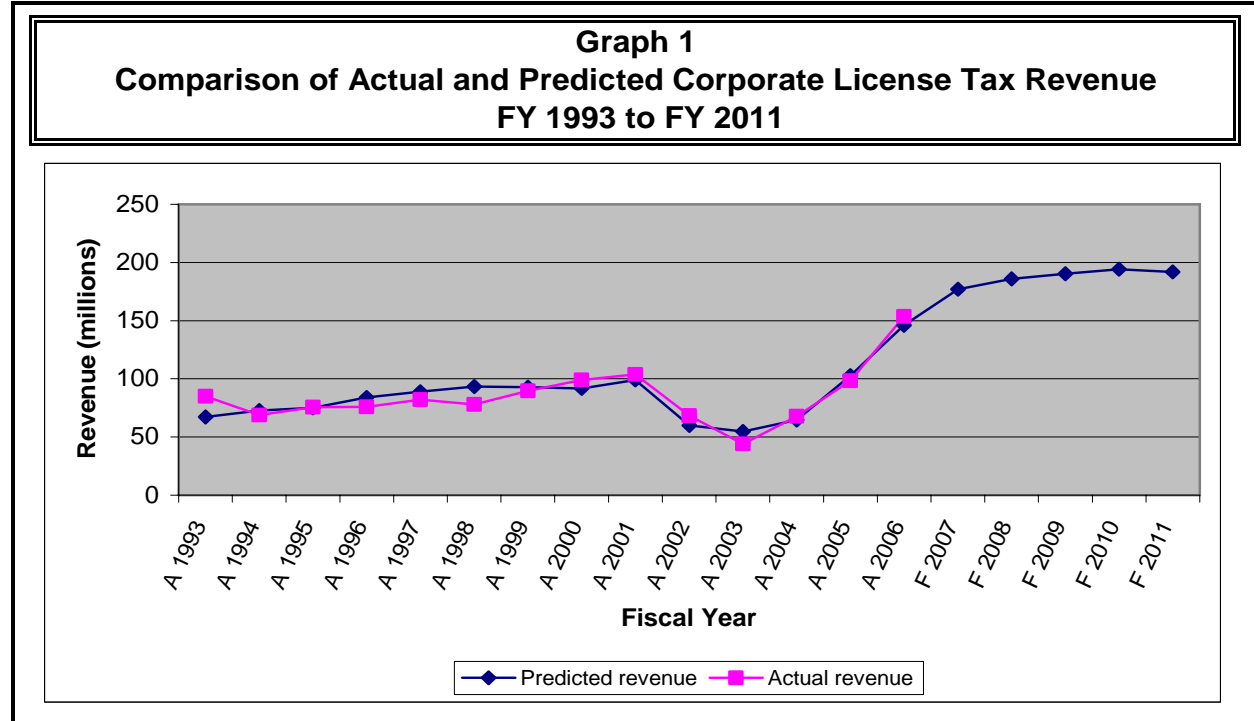
Total corporate license tax collections, including both general fund and non-general fund revenues, for FY 1993 through FY 2006 were regressed against prior year national corporate profits before taxes to produce an estimate of the relationship. The regression model also incorporates a time trend and a qualitative variable indicating the period over which the depreciation rules of the Job Creation and Worker Assistance Act of 2002 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 were in effect. The model is then used to estimate revenues based upon the Global Insight forecast of national before-tax corporate profits.

Graph 1 provides a comparison of actual total corporate revenues for FY 1993 through FY 2006 with estimated revenues over the same time period produced by the model. Also shown on the graph are forecast collections for FY 2007 through FY 2011.

**Table 3**  
**National Pre-tax Corporate Profits and Total Montana Corporate Tax Revenue**  
**FY 1993 through FY 2006**

Fiscal Year	National Pre-tax Profits (billions)	Total Collections (millions)
1993	\$474.125	\$85.054
1994	\$538.050	\$68.872
1995	\$636.025	\$75.520
1996	\$707.425	\$75.762
1997	\$758.625	\$81.999
1998	\$770.600	\$77.928
1999	\$736.125	\$89.625
2000	\$791.725	\$99.089
2001	\$755.750	\$103.670
2002	\$689.475	\$68.173
2003	\$837.100	\$44.138
2004	\$1,039.550	\$67.723
2005	\$1,335.325	\$98.589
2006	\$1,656.550	\$153.675
average	\$837.604	\$84.987

As shown in Graph 1, the model produces fairly accurate estimates for the period from FY 1999 through FY 2006 despite the relatively large deviation from trend after FY 2001.



The model overestimates collections somewhat in FY 1998 and underestimates collections in FY 1993. Some of the difference can be attributed to one-time revenue such as an

unusually large payment by one company in FY 1993. Overall, however, the model demonstrates a relatively good fit of predicted to actual collections. In the model statistics, one measure by which estimates are judged, the adjusted  $R^2$  is .875 (1.0 indicates perfect correlation).

<b>Table 4</b>				
<b>Corporation License Tax Revenue</b>				
<b>Actual FY 2006 and Forecast FY 2007 to FY 2009</b>				
<b>(\$ millions)</b>				
Revenue Source	Actual FY 2006	-----Forecast-----		
		FY 2007	FY 2008	FY 2009
Corporate Tax Revenue	<u>\$ 153.675</u>	<u>\$ 176.963</u>	<u>\$ 185.933</u>	<u>\$ 190.314</u>

Total corporate tax collections are projected to be \$176.963 million in FY 2007, \$185.933 million in FY 2008, and \$190.314 million in FY 2009.

### Data Sources

Data was obtained from SABHRS, the October 2006 Global Insight forecast, and the July (2006) Revised *Combined Effects of the Tax Acts of 2002 and 2003 on Selected Measures of Corporate Profits* by the Bureau of Economic Analysis, U.S. Dept. of Commerce.

### Risk Calculation

The volatility exhibited by corporate tax revenues necessitates a discussion of risk inherent in the estimates. It is possible that Montana may receive revenues less than what is estimated for several reasons. First, the estimate relies very heavily on the Global Insight baseline forecast of national corporate profits, before taxes. If economic conditions change significantly over the next months, Global Insight's forecast will likely change as well. Global Insight includes both a more optimistic and a more pessimistic scenario in its forecast service. The more pessimistic scenario has higher energy prices, a sharper downturn in the housing market, higher interest rates, and reduced consumer spending among other things. For the October forecast Global Insight assigns a probability of 25% to the more pessimistic scenario occurring. If actual economic conditions over the next several years are more in accord with the pessimistic scenario, then actual revenues from corporate tax collections for FY 2007 through FY 2009 will likely be lower than estimated.

History shows that corporate tax revenues can change significantly and can do so quite rapidly. One factor that can accelerate and deepen downward turns in revenues is the ability of corporations to claim losses against income in other years through the carry back and forward attributes of the tax code. If the declines in revenue seen in FY 2002 and FY 2003 were repeated in FY 2008 and FY 2009, corporate revenues could decline by as much as \$115 million.

**Table 5**  
**Comparison of Estimated Corporate Revenues and Revenues based on**  
**Percent Declines from FY 2002 and FY 2003**

<b>Fiscal Year</b>	<b>Current Best Estimate</b>		<b>If History Repeats Itself</b>		<b>Change in Revenue</b>
	<b>General Fund</b>	<b>Percent Change</b>	<b>General Fund</b>	<b>Percent Change</b>	
A 2006	\$153.675	-	\$153.675	-	
<b>F 2007</b>	<b>\$176.963</b>	<b>15.2%</b>	<b>\$176.963</b>	<b>15.2%</b>	<b>\$0.000</b>
<b>F 2008</b>	<b>\$185.933</b>	<b>5.1%</b>	<b>\$116.370</b>	<b>-34.2%</b>	<b>-\$69.563</b>
<b>F 2009</b>	<b>\$190.314</b>	<b>2.4%</b>	<b>\$75.342</b>	<b>-35.3%</b>	<b>-\$114.972</b>

Finally, in addition to economic conditions, another factor that can change quickly is federal legislation. As noted above, the Montana tax base is Montana's share of taxable profits for federal corporate income tax. It is not possible to anticipate all the possible changes to federal tax laws and rules between now and the end of FY 2009 that will affect the collection of corporate tax revenue in Montana. However, it should also be noted that it is probably more likely that Congress will provide temporary, or even permanent, tax reductions for corporations if there is an economic downturn.