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FISCAL IMPACT REPORT

ORIGINAL DATE 2/11/16
 SPONSOR Sharer LAST UPDATED 2/12/16 HB _____
 SHORT TITLE Tax Reform SB 145
 ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY16	FY17	FY18	FY19	FY20		
	***	***	***	***	Recurring and Non-Recurring	General Fund, Road Fund, Other State funds
	***	***	***	***	Recurring	Local Governments

Parenthesis () indicate revenue decreases

See attached TRD ABA for discussion of fiscal effects.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY16	FY17	FY18	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total						

Parenthesis () indicate expenditure decreases

See attached TRD Bill Analysis and Fiscal Impact Report for discussion of fiscal effects.

Conflicts with HB-324 – Representative Varela’s bill to repeal 43 tax expenditures.

SOURCES OF INFORMATION

LFC Files

Responses Received From

Taxation and Revenue Department (TRD)

Higher Education Department/Education Trust Board (HED/ETB)

SUMMARY

Synopsis

Senate Bill 145 proposes massive tax reform, with primary emphasis on the Gross Receipts tax. See attached TRD ABA for discussion of the effective date of this bill and whether the

provisions could be implemented.

FISCAL IMPLICATIONS

See attached TRD ABA for discussion of fiscal impacts of this bill.

Without further study, it seems doubtful that a 2 ½% tax on income and a 1% + 1% (local) turnover tax would generate sufficient revenue to cover the broad range of repealers.

One general purpose of this bill is to sustain the LFC tax policy principles of adequacy, efficiency and equity. The recent collapse of oil and natural gas prices and production volumes have brought home that the increasing cost of tax expenditures revenues may be insufficient to cover growing recurring appropriations.

Just as the estimate of the direct, indirect and induced effects of this bill will be exceptionally difficult, estimating the cost of tax expenditures is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. The statutory criteria for a tax expenditure may be ambiguous, further complicating the initial cost estimate of the expenditure's fiscal impact. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures. However, if this bill were to pass, we would effectively have a GRT tax expenditures reset and the concern about unaccountable tax expenditures would be solved..

SIGNIFICANT ISSUES

See attached TRD ABA for discussion of policy implications of the bill.

HED/ETB has concerns. See "Other Substantive Issue" below.

PERFORMANCE IMPLICATIONS

This bill, by providing a reset on numerous GRT, CIT and PIT tax expenditures, would sustain the LFC tax policy of accountability. Since most of the state's revenue needs would be met with the 2½% income tax, is met with the bill's requirement to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the deduction is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

See attached TRD ABA for discussion of administrative and IT implications of the bill.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

HB 324 which repeals 43 tax expenditures has been tabled on 2/11/16 in the HOUSE BUSINESS & EMPLOYMENT COMMITTEE.

TECHNICAL ISSUES

See attached TRD ABA for discussion of policy implications of the bill.

OTHER SUBSTANTIVE ISSUES:

HED/ETB has concerns as follows:

(Pages 135 and 136 of this bill deletes Section 7-2-2 (B) (4) NMSA 1978. This analysis is directed only to Section 43 of the proposed legislation, which relates to the calculation of base income for New Mexico state income tax purposes).

This bill is a complex tax reform bill, but the analysis of the New Mexico Higher Education Department (NMHED) is limited to pages 135 and 136. The deletions on those two pages affect the Education Trust Board (ETB), which is administratively attached to NMHED.

The ETB manages the 529 College Savings Program for New Mexico. “529” refers to the section of the federal Internal Revenue Code that established a tax-free method for families to save for college education expenses.

Current Section 7-2-2(B) (4) provides two important inclusions in "base income" that protect the New Mexico 529 College Savings Program and the integrity of New Mexico's income tax system. Section 43 of Senate Bill 145 would remove these inclusions in base income and adversely affect both the revenue necessary to support New Mexico's 529 College Savings Program and the state's tax revenue.

Under current Subsection(4) (a) base income includes amounts for which New Mexico taxpayers took NM income tax deductions in prior years for contributions to the 529 program and then, in the current year, rolled over their NM 529 assets into the 529 program of another state.

The present tax deduction was intended to encourage the formation of college savings accounts in the New Mexico program. By deleting this provision, New Mexico is supporting the 529 program of the state receiving the rollover money. This results in a loss of revenue to ETB and a loss of tax revenue to New Mexico by allowing the rollover with no tax consequence.

Under current Subsection (4) (b) base income includes amounts withdrawn from the New Mexico 529 plan and **not** used for "qualified education expenses" as defined by federal law. Withdrawals used for qualified education expenses are tax free.

The proposed deletion would provide tax protection for amounts **not** used for qualified education expenses. It is contrary to the public policy that rewards saving for college expenses and that led to the creation of 529 plans. The proposed amendment would result in a violation of public policy, loss of revenue to ETB and lost tax revenue to New Mexico.

It should be noted that under federal law, such non-education withdrawals are subject to income tax and a ten per cent (10%) tax penalty.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

Does the bill meet the Legislative Finance Committee tax policy principles?

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

LG/jle

BILL ANALYSIS AND FISCAL IMPACT REPORT
Demesia Padilla, Secretary, Taxation and Revenue Department

February 11, 2016

Bill: SB-145

Sponsor: Senator William E. Sharer

Short Title: Tax Reform

Description: This bill proposes the following:

- 1) reduce the rates for the gross receipts tax and governmental gross receipts tax to one percent;
- 2) reducing the municipal gross receipts tax and county gross receipts tax rates;
- 3) reducing the income tax rate of 2.5% on taxable income above certain levels;
- 4) removes permission of a tax increment development district to issue bonds against an increment of the gross receipts tax;
- 5) Repeals the following:
 - compensating tax
 - certain credits, deductions and exemptions related to the income tax act and gross receipts tax act
 - corporate income and franchise tax act
 - estate tax act
 - motor vehicle excise tax act
 - leased vehicle gross receipts tax act
 - tax on boats
 - certain local option gross receipts taxes
 - supplemental municipal gross receipts tax act
 - the local hospital gross receipts tax act
 - the county correctional facility gross receipts tax act
 - special county hospital gasoline tax act
- 6) replaces county obligations to the county supported Medicaid fund and safety net care pool fund with state obligations
- 7) provides a temporary amnesty from penalties and interest on taxes not paid
- 8) provides that the repeal of certain taxes does not impair outstanding bonds or loan guarantees and
- 9) amends, repeals and enacts several sections of the NMSA 1978.

Effective Date: The effective date of the provisions of Section 1 through 96 is January 1, 2017; the effective date of the provisions of Section 97 is January 1, 2018; the provisions of Sections 43 and 44 apply to taxable years beginning on or after January 1, 2017.

Estimated Revenue Impact*					R or NR**	Fund(s) Affected
FY2016	FY2017	FY2018	FY2019	FY2020		
***	***	***	***	***		

* In thousands of dollars. Parentheses () indicate a revenue loss. ** Recurring (R) or Non-Recurring (NR).

Methodology for Estimated Revenue Impact:

*** Not Estimated by the Taxation and Revenue Department (TRD). The Bureau of Business and Economic Research was contracted to conduct a study to attempt to determine the impact of this bill. The study is entitled: “Gross Receipts Tax Base Study, Development of Modeling Tool to be Used in Evaluating Alternatives to the Current Gross Receipts Tax.”

Policy Issues: This bill provides for the comprehensive revision, repeal, and/or replacement of

numerous, but not all current tax programs. As such, it represents a massive overhaul of the State's tax code that would necessitate significant changes in reporting requirements by taxpayers, significant reformation and/or repeal of the New Mexico Administrative Code's tax-related provisions, and significant changes in tax administration, including, but not limited to, changes in monitoring software, forms, and publications. As an initial observation, and given the massive changes, it may be preferable to comprehensively repeal various sections of the tax code, such as the Gross Receipts and Compensating Tax Act, and re-write the code from scratch to avoid inconsistencies and unintended consequences. For example, the proposed bill repeals the compensating ("use") tax, but leaves the definition of "use," as contemplated by the compensating "use" tax, in the statutes. See Section 7-9-3(M) NMSA 1978 at p. 179.

The bill purports to simplify the State's tax structure by moving New Mexico to a predominantly broad-based gross receipts tax (GRT) system. Specifically, it:

- (1) lowers the GRT rate to one percent (state rate) but significantly expands the tax base by: (a) repealing a significant number of exemptions, deductions, and credits from the statute; and (b) broadening the GRT tax base to include "wages and receipts from "investments;"
- (2) repeals the Corporate Income and Franchise Tax Act;
- (3) imposes an individual income tax at the rate of 2.5% only on married individuals filing separately if income is at least \$141,975, heads of houses/married individuals filing jointly if income is at least \$283,950, and single individuals or estates and trusts if income is at least \$189,300; and
- (4) repeals the compensating tax.

Through the combination of how the proposed bill defines "wages" for GRT purposes and the repeal of the corporate income tax, the proposed bill may reduce the tax burdens for multistate businesses that avail themselves of the New Mexico market, and shift that burden more exclusively to New Mexico residents and businesses.

Technical Issues:

Repeal of the Compensating Tax:

While the GRT rate under the proposed bill is relatively low, repealing the compensating tax will produce an incentive for New Mexico residents to purchase products from non-New Mexico businesses, such as via mail order or over the internet. As no compensating tax is imposed, remote sellers or internet sellers would not have to collect and remit compensating tax on behalf of New Mexico customers even when they have substantial nexus with New Mexico. The proposed bill links the State's ability to generate revenue more closely to GRT. At the same time, the repeal of the compensating tax creates a pervasive incentive for New Mexico individuals and businesses to purchase products from out-of-state vendors. Thus, repealing the compensating tax may not only have an adverse immediate revenue impact, but may also adversely affect the competitiveness of New Mexico businesses and cause shrinkage to GRT tax base on which the State will more heavily rely under the proposed bill.

Gross Receipts Tax Changes:

Repeal of exemptions/deductions/credits: Unless a particular exemption, deduction, or credit was enacted to codify a constitutional or federal prohibition against state taxation, exemptions, deductions, and credits are matters of legislative grace. There may be instances, however, on particular facts where a taxpayer was enticed to locate a business in New Mexico in reliance on the availability of certain credits, deductions, or exemptions, and in which a taxpayer could conceivably, though not necessarily successfully, challenge the repeal on equitable estoppel grounds.

Including “wages” in the tax base:

Including wages in the GRT tax base raises several policy issues. First, the sourcing of wages under the proposed bill under Section 7-1-14(E) NMSA 1978 (page 109) may result in New Mexico residents bearing all of the tax burden, while removing a portion of the tax burden from companies that do business or perform services in New Mexico through employees that perform services in the State, but are not operating out of a New Mexico business location. For example, under the proposed bill, wages of a Texas technology company’s employees for setting up a network at a facility in New Mexico may not be subject to gross receipts tax if the employer does not have a New Mexico business location. Likewise, given the higher threshold for individual income tax reporting, the Texas employees may not be required to file individual New Mexico income tax returns. While the Texas company would be subject to gross receipts tax for services performed here, the wages paid to employees may escape both gross receipts and individual income tax.

Second, the compliance burdens on taxpayers and businesses should be considered. Subjecting W-2 wages to gross receipts tax, without adjusting return due dates, would subject regular W-2 wage earners to 12 monthly gross receipts tax returns, as opposed to one annual income tax return. Additionally, while a credit is given to address progressivity under the proposed bill, the credit also requires the separate filing of a refund claim. In short, individual wage earners may be required to make 13 separate filings as a result of including W-2 wages in the tax base. There may also be administration and compliance issues with respect to the gross receipts tax withholding required for wages as many businesses will have to withhold for New Mexico taxes differently than in other states.

Repealing the Corporate Income Tax:

The proposed bill repeals the corporate income tax, but makes no amendments to New Mexico’s Uniform Division of Income for Tax Purposes Act (UDITPA). While the allocation and apportionment provisions of UDITPA expressly apply to individual income taxpayers that have sources of income both within and outside the State, some technical changes to UDITPA may be necessary since that act was drafted to apply to apportioning corporate income.

Another potential policy issue with repealing the corporate income tax (CIT) is the extent to which New Mexico wants to tax or immunize multistate or out-of-state businesses that exploit New Mexico customers or that derive income from New Mexico’s sources. There may be numerous circumstances in which an out-of-state taxpayer has New Mexico customers, but could avoid gross receipts tax (based on a lack constitutional nexus) and would be immune from corporate income taxation as a result of the repeal.

Individual Income Tax:

The differing income thresholds between single individuals and married individuals filing separately may, on certain facts, raise equal protection issues. Additionally, as a policy matter, the proposed bill eliminates certain types of income, such as net rents and gifts, from “modified gross income.” With net rents excluded, the proposed bill may preclude taxation of individuals that earn substantial income from rents on real property from taxation.

Section 94 is an amnesty program that applies to all tax programs. We currently have a managed audit program that can act as an amnesty, and is much less costly to implement.

Other Issues: The income tax thresholds on tax will be adjusted. The timing of the adjustments could complicate computation of personal income taxes, and development of the electronic filing of personal income taxes. The success of electronic filing requires notification of the taxability or New Mexico income to software developers and our development team, on a date prior to September 30th. Additionally, taxpayers who are required to estimate their income tax liability could be affected by this

late of a notice of the tax liability due. It will also affect withholding tax rates. It would be important for the adjustment to be estimated as closely as possible, earlier than the release dates identified in this paragraph.

There is a potential loss of revenue to the state for those who have previously donated to an education plan, and received a tax deduction, but the funds are refunded or transferred out of the New Mexico approved qualified plan.

Amendment: There are potential issues of conflict with federal taxability with repeal of exemptions to 501(c)(3) nonprofit organizations and of exemption of tribal member’s income earned on tribal land of their respective tribe.

Extremely high impact on ITD (more than 2000 hours and estimated cost of more than \$140,000) – Many changes need to be done to implement this bill.

- CRS, CIT, FID, PIT GenTax and Taxpayer Access Point return documents and configuration need to be modified.
- CRS rate structure need to be modified for each location.
- CRS daily and monthly revenue distribution model has to be modified.
- Many reports and letters need to be changed to support these changes.
- With this amount of changes it is not possible to meet the effective and applicability dates 1/1/2017 and 1/1/2018 proposed in this bill.

Administrative & Compliance Impact: High non-recurring impact. There may not be enough time to revise all systems, forms, instructions and publications impacted. The costs associated with revising the forms, instructions and publications could cost over \$100,000. All resources would be utilized to review and rebuild the filing and collection of taxes for New Mexico. All employees will need to be retrained. Taxpayers will need to be educated.

Tax credits are being repealed, but there is no transition rules included in the language. For example, can any carry forwards be applied to future taxes? Historically, this is problematic.

Significant impact to financial distribution business processes. Once programming changes due to reduced tax rates and reform are made to GenTax by IT, TRD’s Financial Distributions Bureau (FDB) staff will need to verify the changes by performing selected tests of data, functionality and reports, prior to authorizing IT to move changes into production. The effective date of the legislation is not realistic and should be extended at a minimum by one year. FDB testing should be completed no later than December 11, 2016, should the effective date not change. FDB time impact will be 160 hours or more.

Estimated Additional Operating Budget Impact*				R or NR**	Fund(s) or Agency Affected
FY2016	FY2017	FY2018	FY 16-18		
\$0	>\$140	High	>\$140	R	Taxation and Revenue Department

* In thousands of dollars. Parentheses () indicate a cost saving. ** Recurring (R) or Non-Recurring (NR).

Related Bills: HB-324