

Efficiency and Safeguard Provisions of Tax Incentives

John Monforte, Acting Secretary
Taxation & Revenue Department
New Mexico Finance Authority Oversight Committee Hearing,
November 1, 2017

Tax Policy Principles

- ▶ Principles of Good Tax Policy
 - Adequacy
 - Equity
 - Efficiency
 - Simplicity
 - Accountability



Tax Expenditures

- ▶ Tax Expenditure is a particular type of exemption, deduction, or credit.
- ▶ A tax expenditure is:
 - (1) a deviation from the baseline system of taxation under the tax program;
 - (2) that provides special or preferential treatment to a taxpayer or group of taxpayers.

Exclusions, Exemptions, Deductions and Credits

- ▶ **Exclusions** – amounts of gross receipts, gross income, or other amount that is removed in order to define the tax base.
 - Example: Taxpayers exclude certain amounts of their “base income” to derive “net income” on which tax is imposed. § 7-2-2(N).
- ▶ **Exemptions** – eliminate a legal obligation to register, report, and/or pay.
 - Exemptions can hinge on the nature or character of the taxpayer.
 - Insurance companies exempt from CIT because they pay premium tax; § 7-2A-4;
 - Nonprofits and disabled street vendors exempt from GRT. § 7-9-29.
 - Exemptions can hinge on the nature of the transaction.
 - Gross receipts from sales of livestock or unprocessed agricultural products exempt from GRT. § 7-9-18.
 - Exemptions can be full or partial.
 - Generally, if the exemption is full and applies to the nature of the taxpayer, or if a taxpayer solely engages in exempt transactions, there is no registration or filing obligation.
 - For GRT, if a taxpayer is required to register and file returns, but some of its transactions are exempt, the exempt amounts are not included anywhere on the return.

Exclusions, Exemptions, Deductions and Credits (Cont.)

- ▶ Exemptions –Not required to be reported on tax returns
- ▶ Not required to be registered with the Department if all business is exempt
- ▶ Most efficient for the taxpayer.

Exclusions, Exemptions, Deductions and Credits (Cont.)

- ▶ **Deductions** – reduce liability by deducting certain transactions or income from taxable income.
- ▶ Deductions deviate from the normal tax base and lower the tax base before calculating tax due.
 - For GRT, taxpayers report a gross amount on the face of the return, then also show the amount deducted.
 - Some deductions are “lumped” on a return; others are separately itemized by code.
 - Many GRT deductions statutorily require the seller to be in possession of a Nontaxable Transaction Certificate (NTTC) at the time the return is filed or within sixty days of a TRD audit request.

Exclusions, Exemptions, Deductions and Credits (Cont.)

- ▶ **Credits** – dollar for dollar credit against the determined amount of tax due.
 - Most credits are business activity credits that require an application for approval to either TRD or another certifying agency before the credit is allowed.

Tax Incentive Context: Shaking Hands with Goldilocks

- ▶ Progress Report: October 30, 2017 Tax Gap, Audit & Compliance, and Fraud
 - “State general fund revenues declined \$1 billion between FY15 and FY16, primarily driven by changes in the energy market.”
 - “Tax expenditures, as part of the state’s overall economic policy require continuous review.”
 - “By providing tax incentives, the state foregoes revenue to the general fund, and when a tax expenditure has weaknesses, foregone revenue can impact the general fund much more significantly.”
- ▶ “The State of New Mexico and its communities offer employers aggressive incentives to encourage job creation and investment.”
- ▶ “The Albuquerque metro area and the State of New Mexico offer aggressive business incentives to help reduce your overall cost of doing business. From corporate income tax rates to workforce training, we offer excellent programs with a business friendly attitude.”
- ▶ Tool kit for economic developers.

General Fund Perspective

Economic Development Perspective

Tax Incentive Safeguards

- ▶ Clear qualifications in statute
- ▶ Nontaxable Transaction Certificates (NTTCs)
- ▶ Pre-qualifications (credits)
- ▶ Certification by other Departments
- ▶ Recaptures
- ▶ Penalty for possible misuse
- ▶ Audits
- ▶ Caps
- ▶ Clear evaluation-driven decision making
- ▶ Simplification
- ▶ GASB77

Efficiency

- ▶ Efficiency: Is the tax incentive the most cost-effective way to achieve the desired outcome?
- ▶ In general, the Department is unable to determine how efficient or effective the end result of the tax incentive due to the limited information received through tax returns.

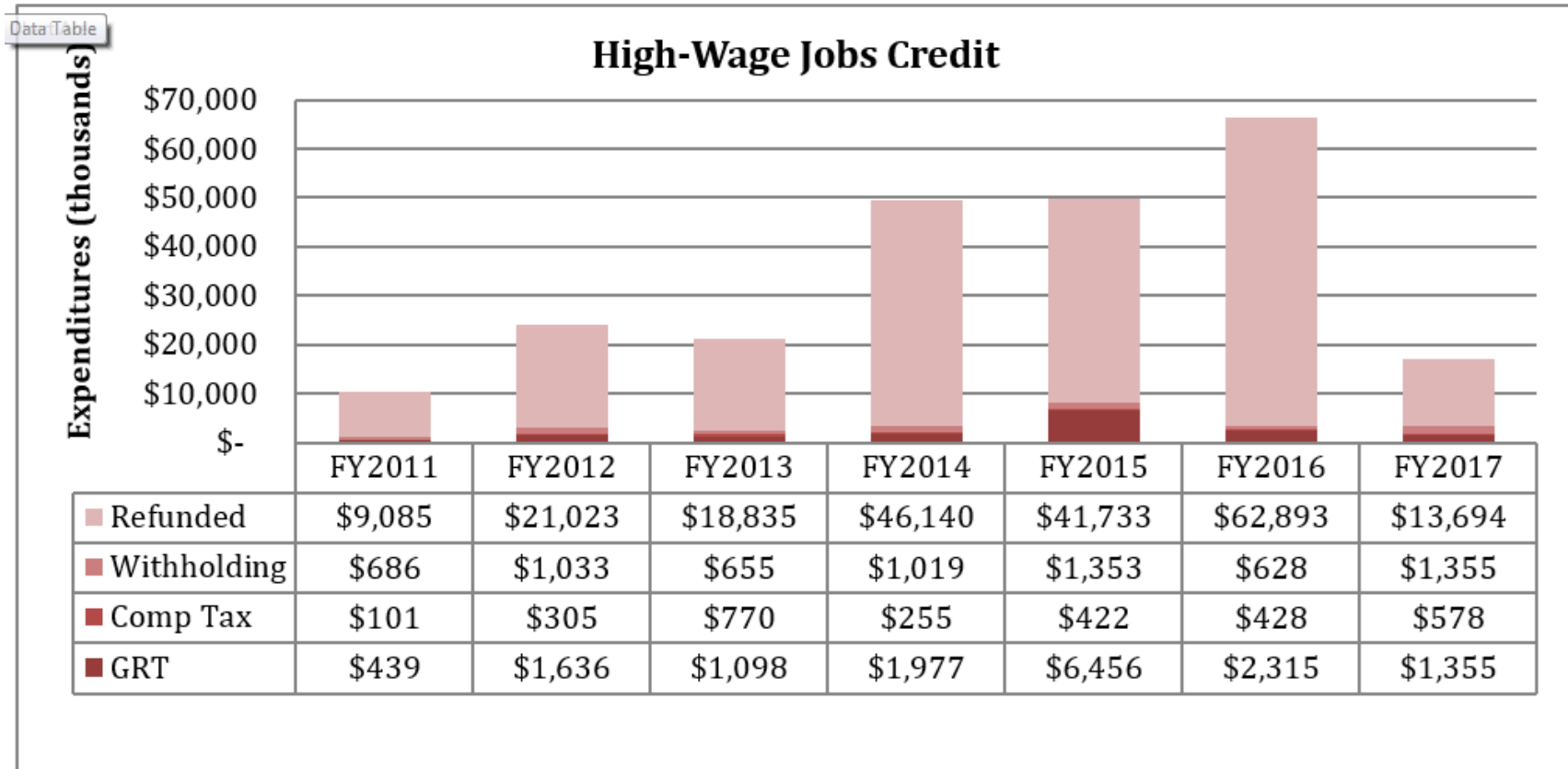
High Wage Jobs Tax Credit: Purpose

- ▶ Enacted in 2004 to incentivize the creation and filling of high wage jobs in New Mexico.
- ▶ Eligible employers who create high-wage jobs in New Mexico may apply for a tax credit against GRT (less local option GRT), compensating tax and withholding tax.
- ▶ The credit is equal to 10 % of eligible wages up to \$12,000 per employee.
- ▶ High Wage Job is \$60,000 in urban and \$40,000 in rural.

High Wage Jobs Tax Credit: Safeguards and Efficiency

- ▶ From July 2008 to July 2016, New Mexico paid over \$215 million in refunds.
- ▶ The statute language has been revised on multiple occasions to assure that unintended recipients would not receive the credit. For example:
 - JTIP eligible.
 - Make more than 50% of sales outside New Mexico.
- ▶ Define “new” job.
- ▶ Originally enacted in 2004 and amended in 2007, 2008, 2013, and 2016. This obviously should be avoided.

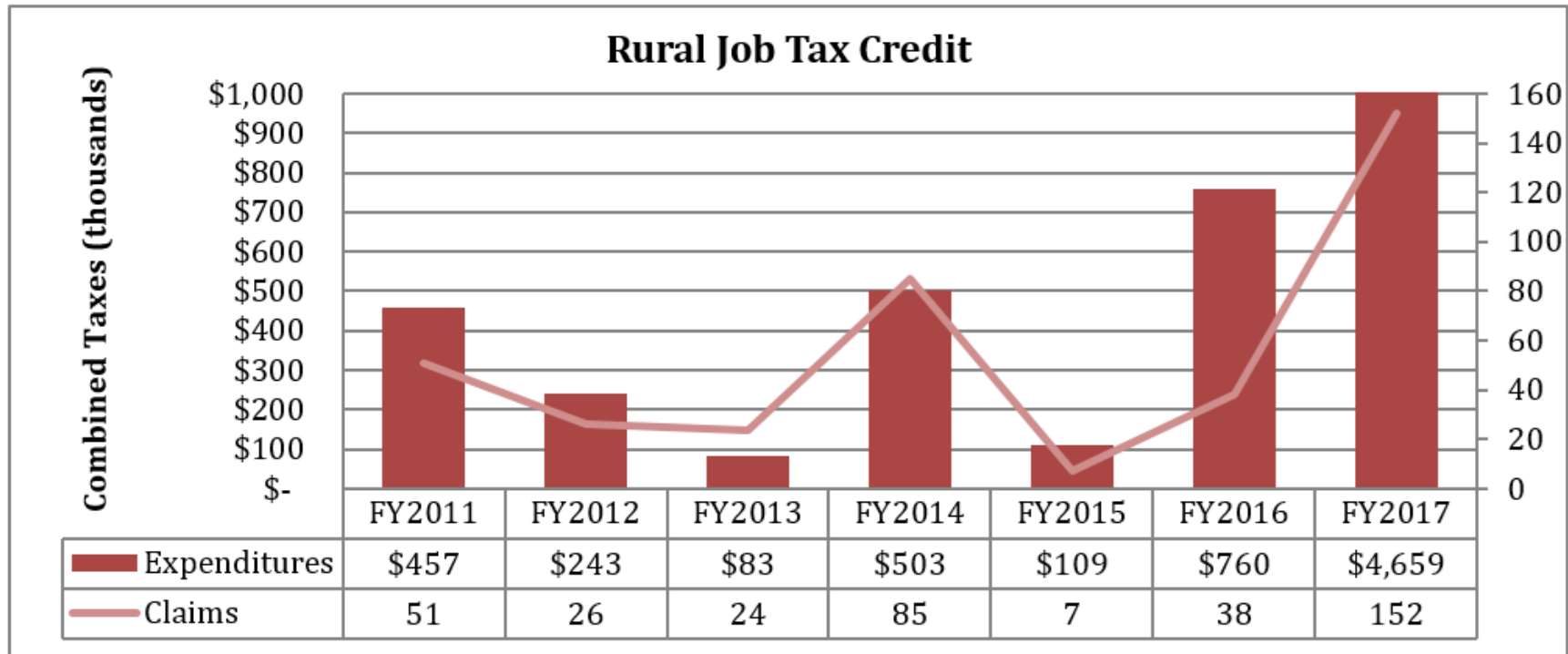
High Wage Jobs Credit



Rural Job Tax Credit

- ▶ Eligible employers may earn the rural job tax credit for each qualifying job created after July 1, 2000 applying it to GRT (less local option GRT), compensating tax, withholding tax, PIT or CIT.
- ▶ 25% of the first \$16,000 per job (Tier 1)
- ▶ 12.5% of first \$16,000 per job (Tier 2)

Rural Job Tax Credit



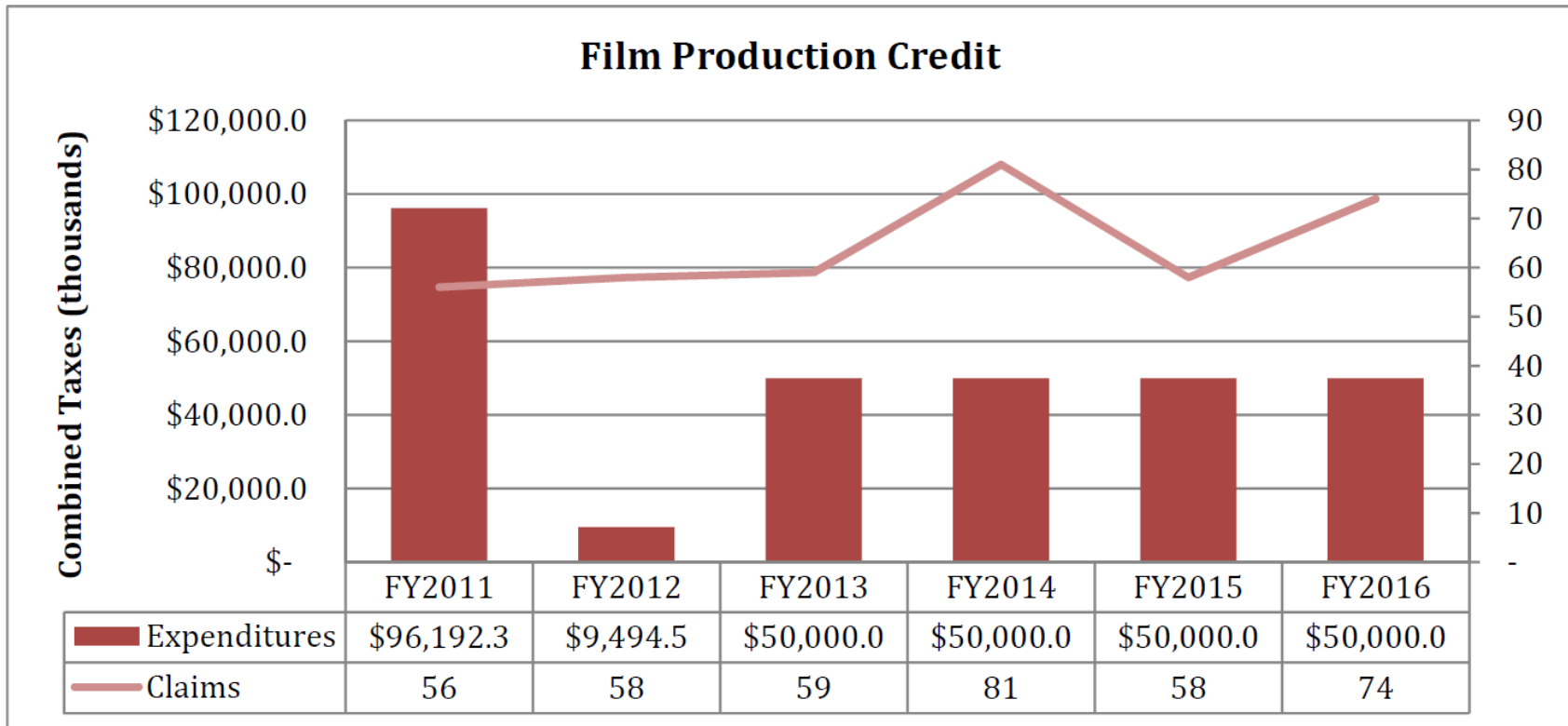
Film Production Tax Credit

- ▶ The purpose of the credit is to increase employment by establishing the film industry as a permanent component of New Mexico's tax base.

Film Production Tax Credit: Safeguards and Efficiency

- ▶ **Film Residency Certification Program:** allows a NM resident to get a department-issued certification card declaring residency to present to film companies when seeking employment.
- ▶ **CPA Certification:** If the amount of the requested tax credit is more than \$5,000,000; the tax payer must include with the application an audit conducted by a CPA licensed to practice in New Mexico.
- ▶ **\$50 million cap:** “The film production tax credit is an example of how a cap can be used successfully to ensure more predictability for both the state and the taxpayer.” LFC Program Evaluation October 26, 2016

Film Production Credit



Considerations for Tax Incentive Statute Construction

- ▶ Clear intent of the tax incentive
- ▶ Clear qualifications on:
 - Who can apply or claim the tax incentive
 - When the tax incentive should be claimed keeping in mind the three year statute of limitation
- ▶ Statute construction to develop the qualifications or proper use of the tax incentive
- ▶ When multiple Departments are involved, a clear separation of roles and duties

CRS Business Credits

- ▶ Business Credits Against GRT Only:
 - DOH-licensed hospitals;
 - Laboratory partnership with small business.

- ▶ Business credits against multiple programs, including GRT:
 - Advanced energy (against GRT, Comp, Withholding, PIT or CIT)
 - Affordable housing (against modified combined tax, PIT or CIT)
 - Alternative energy product manufacturers (against modified combined tax)
 - Biodiesel blending facility tax 30% credit (against GRT and Comp)
 - High-wage jobs (against modified combined tax)
 - Investment (against GRT, Comp, Withholding)
 - Research and development small business (against GRT or 50% credit against Withholding)
 - Rural job (against modified combined tax, PIT, and CIT)
 - Technology jobs and research and development (against GRT, Comp, Withholding, PIT or CIT)

Baseline System of Taxation

- ▶ Any program is the application of a “tax rate” against a “tax base.”
 - Common tax bases for New Mexico tax programs:
 - Gross receipts from sales of property or services or the purchase value of property (GRT/Comp);
 - Net income (CIT/PIT);
 - Taxable value (severance-related taxes);
 - Fair market value (Property tax).

Tax Expenditures

Requirement 1 – Deviation from the Tax Base

- ▶ Exclusions to derive at the tax base are not deviations.
- ▶ TRD analysis: structure of statute governs.
- ▶ Deviations can occur for many reasons:
 - “in lieu of” taxation;
 - US constitutional prohibition or federal pre-emption;
 - Government-to-government comity;
 - To “true” a tax base – anti-pyramiding, bad debts;
 - To provide special or preferential treatment to achieve a policy objective – i.e. a “tax expenditure.”

Tax Expenditures

Requirement 2 – Special Treatment

- ▶ Special treatment typically evidenced by a policy choice regarding:
 - a subset of the tax base;
 - a subset of the population; or
 - both.
- ▶ Policy choices:
 - To benefit all, or a specific subset, of citizens;
 - Economic development;
 - Conservation;
 - Special industries.

Tool: Reporting Tax Expenditures

- ▶ Annual Tax Expenditure Report (TER) has been produced by TRD since 2012;
- ▶ The report:
 - Separately identifies each “deviation” from the tax base;
 - Categorizes each deviation as expenditure, non-expenditure, or “arguable;”
 - Provides as description of each expenditure, the statutory reference, purpose, amendment history, cost, evaluation, and recommendations;
 - Categorizes each expenditure (citizen benefit, conservation, economic development, highly-specialized industries, health care).

Highlights of 2016 TER

- ▶ 244 deviations from the tax base.
 - 123 tax expenditures.
 - 98 not tax expenditures (the deviation serves a purpose other than special treatment).
 - 23 “arguable.”
- ▶ Of the 123 tax expenditures:
 - The cost of 69 derives directly from taxpayer-reported data and are reported at, or very close to, actual cost.
 - The cost of 15 is derived from taxpayer data but significant estimation is required.
 - The cost of 26 has to be estimated from non-TRD-sourced data;
 - Data for 13 is unavailable.

Top Ten Expenditures by Estimated Cost

| Name | Amount (000's) | reliability |
|---|-------------------|-------------|
| Sale of Food at Retail Food Stores GRT Deduction and Hold Harmless Distribution | 242,605 | 1 |
| Nonprofit Organizations Exemption from GRT | 90,000 | 4 |
| Prescription Drugs and Oxygen GRT AND GGRT Deduction | 74,000 | 3 |
| Health Care Practitioner Services GRT Deduction and Hold Harmless Distribution | 66,312 | 1 |
| Working Families Credit against PIT | 51,552 | 1 |
| High-Wage Jobs Credit against Modified Combined Tax | 50,902 | 1 |
| Film and Television Credit Against PIT and CIT | 50,000 | 1 |
| Capital Gain Deduction From PIT | 47,241 | 1 |
| Medical and Health Care Services GRT Deduction | 38,496 | 1 |
| Low-Income Comprehensive Tax Rebate and Property Tax Rebate against PIT | 20,746 | 1 |

Or.....

- ▶ Go back to the original tax policy principles.
- ▶ Look at tax reform that centers upon the overall tax climate as opposed to specific tax incentives.



Thank you!

Our Mission is to administer and enforce New Mexico's tax and revenue laws, vehicle and driver licensing, and transportation programs in a manner warranting the highest degree of public confidence.

<http://www.tax.newmexico.gov/>