Before the New Mexico Legislature
Revenue Stabilization and Tax Policy Interim Committee

Testimony of Helen Hecht
General Counsel,
Multistate Tax Commission

July 27, 2018

Helen Hecht – Bio

- 2014 – Current
  - General Counsel for the Multistate Tax Commission (Washington, D.C.)
- 2009 – 2014
  - Tax Counsel for the Federation of Tax Administrators (Albuquerque, NM)
- 2003 – 2009
  - Of Counsel – Sutin, Thayer & Browne law firm (Albuquerque, NM)
- 1995 - 2003
  - KPMG accounting firm (Albuquerque, NM)
- 1984 – 1995
  - New Mexico Taxation and Revenue Department
(Las Cruces, Santa Fe, and Albuquerque, NM)
- Education
  - Juris Doctor, University of New Mexico
  - Masters in Accountancy, New Mexico State University
  - Bachelors in Accountancy, New Mexico State University
- Other
  - Member of the New Mexico Bar
  - New Mexico Licensed CPA
  - Founding member of the New Mexico Tax Research Institute

MULTISTATE TAX COMMISSION

The Multistate Tax Commission (MTC) is an intergovernmental state tax agency formed in 1967. New Mexico is a founding member of the MTC, enacting the Multistate Tax Compact in June of that year. In addition to compact members, states can participate in the Commission as "sovereignty" or "associate" members. The overarching goal of the MTC is to facilitate states working together. The MTC's uniformity committee drafts model state tax regulations and statutes. The joint audit and nexus programs provide services to participating states. (New Mexico participates in the joint audit program.) The MTC also provides training, research, litigation support, and other services, as requested. See the MTC's website at www.MTC.gov.

Unless indicated, the views in this testimony are my own and not the official positions of the Multistate Tax Commission or any of its member states.

Corporate Taxes; Uniform Division of Income for Tax Purposes Act; and How the States Are Collaborating (The State of State Taxation – 2018)

I'm going to vary slightly from the general topic and focus more broadly on major business tax developments affecting states. With respect to each of these developments, however, I think the most important take-away is—*how the states are collaborating*.

So the first thing I have to do is to thank you for New Mexico's long support of both the Multistate Tax Commission (MTC) and the Federation of Tax Administrators (FTA), two organizations that do great work in the state tax area. New Mexico is a founding member of the MTC and active in in the programs of the MTC and the FTA. These organizations represent one of the best things about our federal system—which is that states governments can benefit by sharing their experiences and learning from each other.

Second, the states are dealing with some unprecedented issues in terms of their complexity and/or importance. Some people are skeptical that the states can handle these issues. I'm not one of those people. I know that if states are willing to help each other, they have all the expertise and resources necessary to find and implement the right approaches and solutions for their citizens.

Finally, I'm a tax administrator first, a lawyer second, and an accountant third. I don't pretend to be a policy wonk, or an economist, or a politician. So I'm not going tell you what I think you should tax or not tax. Instead, want to talk about how best to tax what you choose to tax so that the tax can be effectively and efficiently administered and enforced

Here are some basic principles for lawmakers to think about if you want a tax system that can be effectively and efficiently administered:

- Reduce unnecessary complexity—so that taxpayers can know and understand the rules and so that disputes are minimized.
- Strive for fairness—because our tax systems depend on voluntary compliance and voluntary compliance depends on perceived fairness.
- Be responsible—don't expect the tax agency, or the courts, to make the hard policy choices.
- Be supportive—tax administrators have a very, very difficult job and they need resources and direction to be able to do it properly.

Big Issues Affecting State Taxation of Businesses

I've heard it said that what works in every other state won't work in New Mexico. I think that's wrong, especially in the tax area. States are all different and their tax systems vary for good reasons. But when it comes to implementing those taxes, there are some approaches and methods that clearly work better than others. And with respect to the issues I'm going to talk about, not only are these best practices there for New Mexico to adopt, but by participating in the development of new solutions and approaches, the state can gain additional insights and information.

Federal Move to Centralize Audits of Audit Partnership Income

This is a good example of how states may face significant challenges where they, and their taxpayers, would clearly benefit from a consistent, collaborative approach to the solution.

First, some background. Traditionally, if you wanted to grow a business, you had two choices—taking out loans from financial institutions or selling ownership shares. To get big, you generally had to be a C corporation. Today, partnership structures are being used to create large investment vehicles that can provide more flexibility to investors and more types of funding for new businesses.

In recent years, according to IRS data, the total business income generated in this country that is reported by entities taxed on a pass-through basis (partnerships and S corporations) surpassed the income reported by entities taxed as C corporations. While S corporation taxation is fairly straight-forward, partnership taxation is much more complex. And the growth of partnerships combined with the complexity of the income tax rules for partnerships created a tax-administration crisis.

As you know, corporate income is taxed twice—once to the entity when it is earned, and once to the owner when it is distributed. But the income of partnerships is taxed once, in a hybrid manner, so that it is tax when earned, but the tax is determined at the partner level. Partnerships have flexibility under the tax rules to structure deals in any number of different ways, including multi-tiered structures, and to allocate items of income and expense to the partners in different proportions.

I'm not going to talk about all the complexity that surrounds taxing the income of partnerships. I can boil it down by telling you this: A few years ago, the U.S. Treasury Department attempted to take all the income earned by partnerships and reported to the IRS on the partnership returns and trace that income through to the owners to see if it was properly reported by the direct or indirect owners. And it also tried the reverse—tracing all the income on the returns of the owners back to the partnership returns. The result was that it found that 15-20% of the income could not clearly be traced one direction or the other, in part because the structures involved were so complex.[1]

Suffice it to say, the IRS has long recognized that it is unable to audit the income of partnerships effectively. And even if it audits the partnership and finds a problem, it is not feasible to assess the taxpayer-partners if there are more than a few dozen. And today, it is not unusual for a large partnership to have thousands of partners.

So in 2015, Congress passed the Bipartisan Budget Act which gave the IRS new authority to audit partnerships and assess tax on audit adjustments at the entity level.[2] If the partnership decides it doesn't want to pay the tax on the audit adjustments at the entity level, then it will have to "push-out" that liability to the partners to be reported on their returns in the year that the adjustments are final (rather than having the partners file amended returns). This is a whole new system for assessing audit adjustments related to partnership income.

States that would impose state income taxes on the same federal partnership audit adjustments will have to make changes in their laws in order to pick up the state tax due on these adjustments. For the last two years, the MTC has been working with with several taxpayer and practitioner groups—including the America Bar Association, the American Institute of Certified Public Accountants, the Council on State Taxation, the Tax Executives Institute, and the Institute for Professionals in Taxation—to create a process so that states can assess the state tax due on federal partnership audit adjustments. That model legislation is currently being finalized by the MTC.

Information on the project and the proposed model is here: http://www.mtc.gov/Uniformity/Project-Teams/Partnership-Informational-Project. New Mexico is a state that will be impacted by this new federal approach to partnership audits and it should consider adopting this model legislation once it is final.

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[1] Richard Prisinzano, U.S. Treasury Dep't., and others, "Business in the United States: Who Owns It and How Much Tax do They Pay?", p. 3, available here: http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Partnership-Informational-Project/NYU-2016-Business-in-US-Analysis-of-tax-paid.pdf.aspx

[2] See a copy of the legislation here: http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Partnership-Informational-Project/Bipartisan-Budget-Act-of-2015.pdf.aspx.

Dealing with the Recent Federal Tax Changes Affecting Business Income

The Federal Tax Cuts and Jobs Act made dozens of changes to the federal individual and corporate income taxes. Below and on the following page is a list of the biggest federal tax changes in terms of their total effect on federal revenues over the next ten years.[3] The list also estimates the percentage difference that each change will make.[4] But while some changes will affect state taxes, because they will affect the tax base, others will have no effect. They are shown shaded darker gray. Still other changes may not affect the tax base of some states (including New Mexico) because the state does not conform completely to the federal tax base. They are shown here in lighter gray.

Revenue Reducers:	10-year Effect (Billions)	Percentage Effect (Rounded)
1. Lowering corporate rates (which has a bigger effect on corporate tax revenues—since those revenues are a much smaller share of the total).	($1,348)	(4%)
2. Lowering individual rates (sunsets 2025).	($1,214)	(4%)
3. Increasing the standard deduction (sunsets 2025), but see the elimination of certain itemized deductions below.[1]	($720)	(2%)
4. Increasing the individual AMT phase-out (sunsets 2025).[2]	($637)	(2%)
5. Increasing the child tax credit (sunsets 2025).	($573)	(2%)
6. 20% special itemized deduction for qualified business income of pass-throughs (sunsets 2025).[3]	($415)	(1%)
7. 100% deduction for foreign dividends (but see other changes (No.'s 3, 6, and 8 below.)	($224)	(.7%)
8. Changes in bonus depreciation and immediate expensing (sunsets 2026).	($86)	(.2%)

[1] Some states do not conform to the standard deduction, or may do so by specifying the same amount in their own laws.

[2] Most states do not have an alternative minimum tax.

[3] Most states, including, it appears, New Mexico, do not conform to this deduction which is taken from adjusted gross income.

[3] Based on the Joint Committee on Taxation's estimates as of January, 2018.

[4] Current federal revenues are about $3.2 trillion in total, annually. The percentages are calculated assuming they would have been about $32 trillion over the same ten years.

Revenue Raisers:	10-Year Effects (Billions)	Percentage Effect (Rounded)
1. Elimination of the personal exemption amounts for individual filers (sunsets 2025).[1]	$1,211	4%
2. Limiting or eliminating certain itemized deductions for individual filers (sunsets 2025), but see the increase in the standard deduction above.	$668	2%
3. Repatriation tax (one time, 2017, inclusion of accumulated foreign income, net) for corporations and individuals.[2]	$339	1%
4. Limiting the interest expense deduction (with carryforward), allowing net expense of 30% of adjusted gross income.	$253	1%
5. Changes to net operating losses (capping annual deduction to 80% of income and allowing unlimited carryforward).[3]	$201	.6%
6. Base erosion and anti-abuse tax (BEAT)[4]	$149	.4%
7. Elimination of the deduction for domestic production activities.	$98	.3%
8. Inclusion of global intangible low-taxed less related 50% deduction (GILTI).[5]	$49	.2%

[1] Many states conform to the number of federal exemptions allowed, but not necessarily to the amount per exemption. The federal change zeroed out the amount of the federal exemption.
[2] This tax is imposed effective for the 2017 tax year.
[3] Most states, including New Mexico, decouple from the federal net operating loss deduction.
[4] This is a separate 10% minimum tax imposed on certain deductions for payments to foreign entities and will generally not affect the tax base for state taxes.
[5] Netting $112 billion in increase revenue from inclusion of so-called GILTI income and $63 billion in special deductions related to that income (which will lower the effective federal rate).

The states are still considering the federal changes and how those changes will affect the state tax base, whether the state conforms or does not conform. The Multistate Tax Commission does not have a position on whether to conform or not conform to federal tax law changes. Nor am I here as an expert to tell you what New Mexico does or should do. But I would encourage you to check in with what other states are doing and their reasons for what they are doing and how, which may vary. And I think there are a handful of issues illustrate some of the complexity that states are, together, considering.

The first issue has to do with the deduction from adjusted gross income for individuals for a portion of qualified business income not from C corporations—the change in IRC Sec. 199A (No. 6 on the list of revenue reducers). The purpose of this deduction was to effectively lower the federal rate on business earnings of these non-corporate entities. And why was this necessary? Because Congress lowered the tax rates on corporations (which, of course, are also taxed twice).

Most states, and I believe New Mexico is one of them, would not currently conform to IRC Sec. 199A. There appear to be many problems with Sec. 199A from an administrative standpoint. Consequently, we don't know exactly what the fiscal impact will be. In addition, as discussed above, the combination of complex partnership structures and complicated tax rules means it's already difficult for tax administrators to confirm that partnership income is being reported and taxed properly.

The second issue has to do with repatriation income (No. 3 on the list of revenue raisers), IRC Sec. 965, which is a one-time income item measured and reported for tax years ending in 2017. This is income earned by the foreign subsidiaries of U.S. shareholders over the last 30 years that has not yet been subjected to federal income tax (because it was deemed not to have been brought back into the U.S.). This one-time income has a related offsetting deduction (IRC Sec. 965(c)) which reduces the effective federal tax rate imposed. While this net repatriation income is a different "animal," many have equated it to a deemed foreign dividend. If that's what it is, and I think there are questions, then New Mexico would only apply its corporate tax to the income if the corporate shareholder is headquartered in New Mexico or files on a combined or consolidated basis in New Mexico. Also, New Mexico would appear to reduce the income by providing a dividend received deduction and would allow the corporation to include some amount of foreign based apportionment factors in its apportionment formula.

The third issue, the so-called GILTI provisions (No. 8 on the list of revenue raisers), is effectively the residual profit, over and above projected profit margins, that would otherwise be sourced overseas for federal tax purposes. GILTI assumes this extra income should be sourced to the U.S. and picks it up as part of the federal domestic tax base (IRC Sec. 951A). The inclusion of the amount of income estimated to have been earned in the U.S. is also accompanied by a 50 percent deduction which is meant to lower the effective federal rate on this income (IRC Sec. 250), and which will likely be reported under line 28. At the federal level, taxpayers will also be entitled to a credit for a portion of their foreign taxes paid on this same income.

There are a number of questions about how states might treat GILTI. The first is whether the related 50% deduction applies (and whether it should, assuming its role is to lower the federal tax rate). The second is whether GILTI income should be treated as a deemed dividend, for certain state tax purposes, or whether it is simply part of the current year's domestic tax base. The third is whether states need to allow taxpayers to include foreign apportionment factor amounts in their state apportionment factor in order to reflect the fact that this income is earned from activities overseas. The fourth is whether states should also give some sort of credit for foreign taxes paid (although they don't have to).

Like the one-time repatriation income, GILTI would not be included in the New Mexico tax base of a corporation filing separately unless the corporation was headquartered in the state. Even combined filing states can choose not to conform to the GILTI provisions (and some have). But, a state that determines it will not tax the income side of GILTI needs to make absolutely clear that it will also not allow the related 50% deduction.

These issues are sufficiently complex that all states can benefit from collaborating on exactly how they may be treated, even if the ultimate choice made by the state is based on its own policy goals.

States Continue to Move to Combined Filing for Corporate Income Tax

If there was one thing New Mexico could or should do to improve the ability to effectively administer and enforce the state corporate income tax it would be to eliminate separate corporate filing and adopt mandatory combined filing (with or without an elective consolidated filing option). There are two general mechanisms for determining how much of the income of a corporate group is earned in a particular taxing jurisdiction. One involves separate accounting or what is more commonly called "transfer pricing." The other involves combined filing and formulary apportionment.

The United States and other major countries use a type of separate accounting and transfer pricing. The U.S. has struggled to make transfer pricing work. The IRS has had to develop hundreds of pages of regulations to implement transfer pricing. Taxpayers have to hire experts to do transfer-pricing studies. Often, the IRS and taxpayers do not agree about the proper transfer pricing results and must litigate for years to get a final answer. It's not uncommon for disputes to involve differences that amount to hundreds of millions of dollars. But this is the system that most of the world uses, so the U.S. also uses it.

But when it comes to dividing income of a multistate business between the states, all of the U.S. states use formulary apportionment. And the majority of the states now apply that formulary apportionment approach on a combined corporate group basis. Two additional states, Kentucky and New Jersey, adopted combined reporting just this year. Combined reporting eliminates almost all of the need for transfer pricing.

States that still allow separate corporate filing, like New Mexico, must still rely on transfer pricing to a substantial extent. But none of these separate filing states have developed their rules to the extent the IRS has (nor do the federal rules address every issue that may come up at the state level). Nor have the separate filing states invested the same kinds of audit and litigation resources that the IRS has to address transfer-pricing. The reason is simple. There is a trade-off between the cost and the benefit of enhanced enforcement. In short, separate filing makes the state corporate income tax much less efficient.

For these and other reasons, the Multistate Tax Commission has generally taken the position that combined reporting is the better approach to state corporate income tax. The MTC has developed a model for states to use in implementing combined filing.[5] Since the adoption of that model, a number of states have taken an even simpler approach to implementing combined filing, and the MTC is looking at providing a model following that simpler approach as well. The MTC also provides training and support to states that have recently implemented combined filing for corporate income tax.

Use of Market-Based Sourcing in Apportioning Corporate Income

The second big trend in taxing corporate income is in using market sourcing to source all sales receipts in order to compute the sales factor portion of the apportionment formula. In the past, while sales receipts from selling tangible personal property were sourced to the market state, sales receipts from sales of services and intangibles might be sourced to a different state. Sometimes this meant that a corporation that had substantial numbers of customers purchasing services or intangibles in a particular state would apportion little or none of its income to that state.

[5] That model is available on the MTC website uniformity page here: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf.

States began moving to market sourcing for these types of sales over 10 years ago. State uniformity is more important here than it might be in other areas of state taxation. If states use different sourcing methods, some taxpayers might pay tax on the same income in multiple states, and other taxpayers might not pay tax on their income in any state.

In 2014, the MTC adopted a model for market sourcing all sales receipts.[6] In 2017, the MTC adopted model regulations for this purpose.[7] As part of those regulations, the MTC adopted a recommendation to states that they act to resolve issues where taxpayers might pay tax on the same income to multiple states as the result of states adopting differing sourcing rules. The MTC has, in the past, also drafted special industry rules that also take a market-sourcing approach and New Mexico has adopted many of these special industry rules.

Recently, Colorado and Kentucky adopted market sourcing, following the MTC's model. New Jersey adopted market sourcing using a slightly different approach. Roughly half of the states now have general market sourcing and it is likely other states will adopt the approach in the next few years. We expect that eventually all states will move to this approach.

Implementation of Sales and Use Tax Collection After *Wayfair*

Finally, just this week the MTC's uniformity committee agreed to undertake an urgent project to help states formulate uniform or compatible rules for rolling out the requirements for "remote" sellers (without physical presence in the states) to begin collecting and paying sales and use taxes. One aspect of these rules will be the development of an approach for having marketplace facilitators, like Amazon, collect the tax. Another aspect will be the principles for determining the minimum threshold for small out-of-state sellers and issues to consider in implementing those minimum thresholds. Not only will developing uniform rules help reduce the burdens on out-of-state sellers, it will reduce the chance that Congress might step in and attempt to limit state taxation. I would encourage New Mexico to participate in the discussions on this issue as they go forward.[8]

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[6] Available here: http://www.mtc.gov/The-Commission/Multistate-Tax-Compact#Article IV.
[7] Available here: http://www.mtc.gov/getattachment/Uniformity/Adopted-Uniformity-Recommendations/FINAL-APPROVED-2017-Proposed-Amendments-to-General-Allocation-and-Apportionment-Regulat.pdf.aspx.
[8] See information on the Wayfair discussion at the uniformity committee's meeting on July 24, 2018 on our the agenda for that meeting and related links, here: http://www.mtc.gov/Uniformity/Uniformity-Committee/2018/Agenda-7-2018.