Description of Revenue Options for the 2010 Legislative Session

Presentation to the

Revenue Stabilization and Tax Policy Committee

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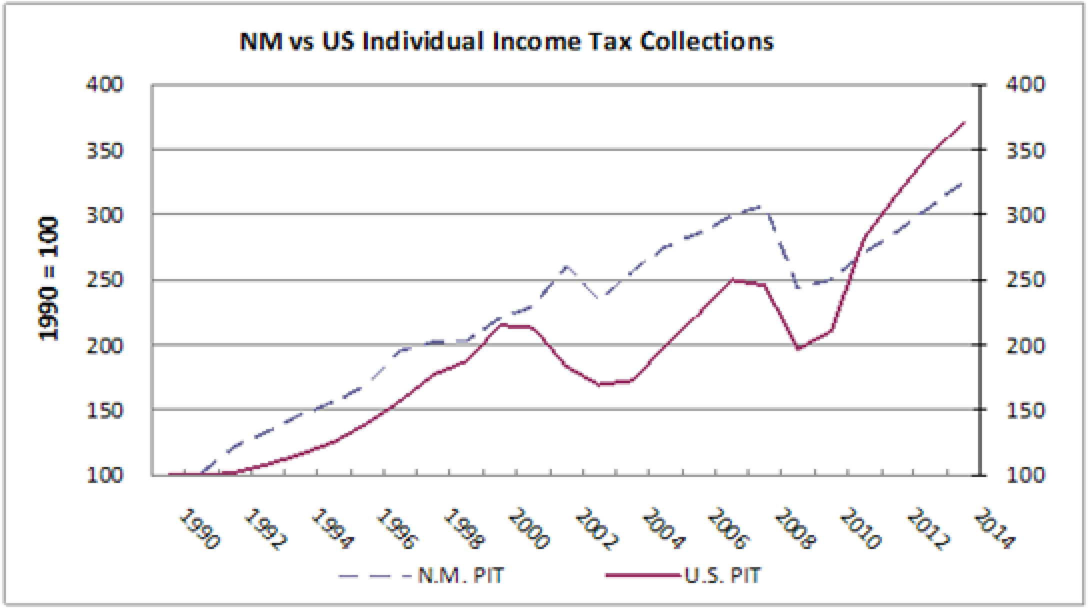
N.M. Legislative Finance Committee

Personal Income Tax Options

Background:

- FY07 personal income tax ("PIT") was 15 percent of total state and local tax collections, down from over 18 percent in FY03
- PIT comprised 20 percent of general fund recurring revenue in FY10, down from 24 percent in FY03.
- NM collections tripled between 1990 and 2008, fell 15% in 2009



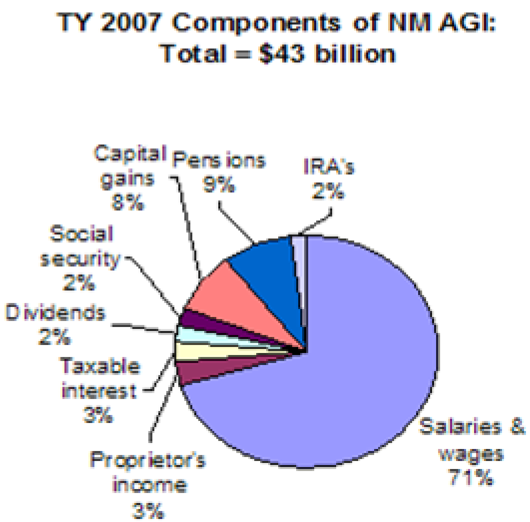
PIT Western States Rate Comparison

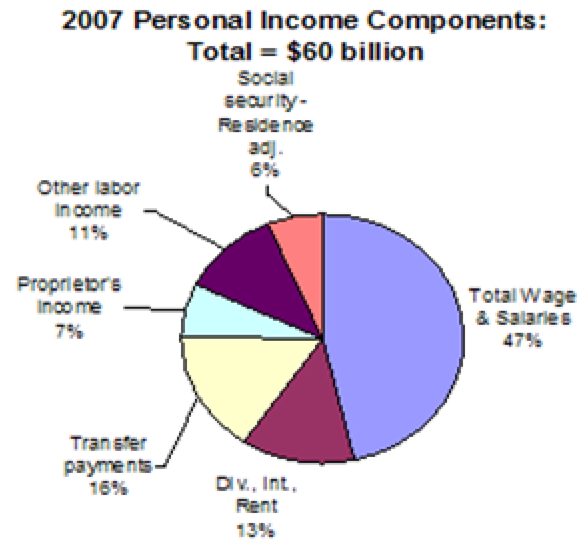
State	Range of Tax Rates*	Top Bracket Single/Married	Income Tax as % of Personal Income**
Arizona	2.59% to 4.54%	$150,000/$300,000	1.54%
California	1% to 10.3%	$1 million/$1 million	3.07%
Colorado	4.63%	All Income	2.17%
Idaho	1.6% to 7.8%	$25,440/$50,881	2.6%
Montana	1% to 6.9%	$15,600/$15,600	2.56%
New Mexico	**1.7% to 4.9%**	**$16,000/$24,000**	**2.11%**
Oklahoma	0.5% to 5.5%	$8,700/$15,000	2.49%
Utah	2.3% to 6.98%	$5,500/$11,000	2.85%

Sources: *2009 State Tax Handbook, CCH publishing. ** U.S. Census.

- *NM top tax rate is around the midpoint among states in the western region.*
- *Like several other states, NM has a relatively flat tax rate structure.*
- *NM tax as percent of income toward low end of states with income tax.*

Composition of Taxable Income





- *Taxable income is about 70% of total personal income*
- *Wages & salaries are about 70% of taxable income*
- *Taxable income is much more volatile than personal income*

Income Distribution of PIT for New Mexico Residents

Gross Income Per Return	Number of Returns	Share of Total Returns	Share of State Income Tax	Gross Income Per Return	State Income Tax Per Return*	State Tax Percent of Gross Income
Under $50,000	719,183	73%	12%	$17,262	$346	2.0%
$50 to $75,000	112,179	11%	15%	$61,360	$1,595	2.6%
$75 to $100,000	63,897	7%	14%	$86,239	$2,586	3.0%
$100 to $200,000	66,476	7%	26%	$132,075	$4,521	3.4%
$200,000 and up	18,499	2%	33%	$498,138	$23,775	4.8%
All returns	980,234	100%	100%	$43,666	$1,823	4.2%

Source: I.R.S. Statistics of Income Division.

*Excludes approximately 300,000 returns with no liability.

- *The income distribution of the PIT is mildly "progressive," i.e. high income households pay a higher share of their income in PIT.*
- *The table does not reflect the impacts of refundable rebates and credits for low-income households*
- *Roughly one-third of the tax is paid by 2% of households (over $200,000); 59% is paid by the 9% earning more than $100,000.*

PIT Recent Legislative Changes

Session:		**General Fund FY11 ($ millions)**
2003	Income tax deduction for capital gains	(36.0)
2003	Reduce income tax rates	(360.0)
2003	Withholding on oil and gas distributions	30.0
2005	Low & Moderate Income Tax Exemption	(30.0)
2007	Working Families Tax Credit	(40.0)
2007	Rural health care practitioner tax credit	(5.0)
2007	Armed forces income tax exemption	(10.0)
	Total	(451.0)

- *Impacts of capital gains relief have fallen by more than half over the past two years.*
- *Tax rate impacts have fallen more than 10 percent due to the recession.*
- *Impacts of oil and gas withholding requirements are due to an apparent improvement in compliance.*

Possible PIT Increase Options

Estimated General Fund Fiscal Impacts

($million)

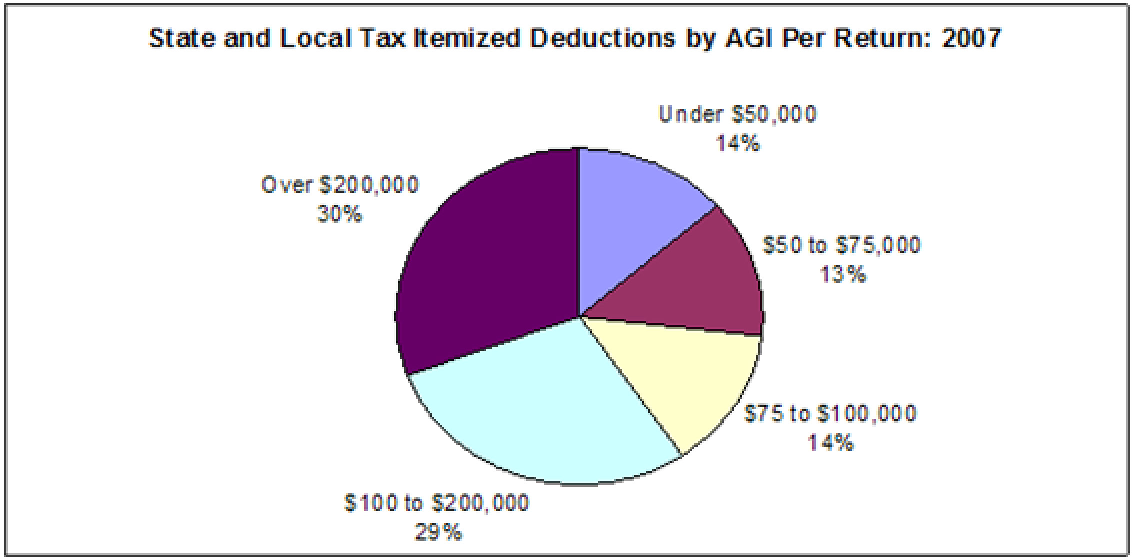
Option:	Description	FY10	FY11
1	Increase top income tax rate by 1% (married $100,000/single $67,000)	7.8	74.6
2	Increase top income tax rate by 1% (married $150,000/single $100,000)	5.1	56.1
3	Increase top income tax rate by 1% (married $250,000/single $167,000)	3.1	41.3
4	Addback income tax deduction for state & local taxes	-	60.0
5	Reduce deduction for capital gains from 50% to 25%	-	18.0

- *Options 1 through 3 estimated by TRD*
- *Options 4 & 5 estimated by LFC*
- *Options in the table are additive, i.e. if the second option is adopted as well as the first, total revenue would increase by approximately $130 million.*

Policy Implications of PIT Options: Rate Increases

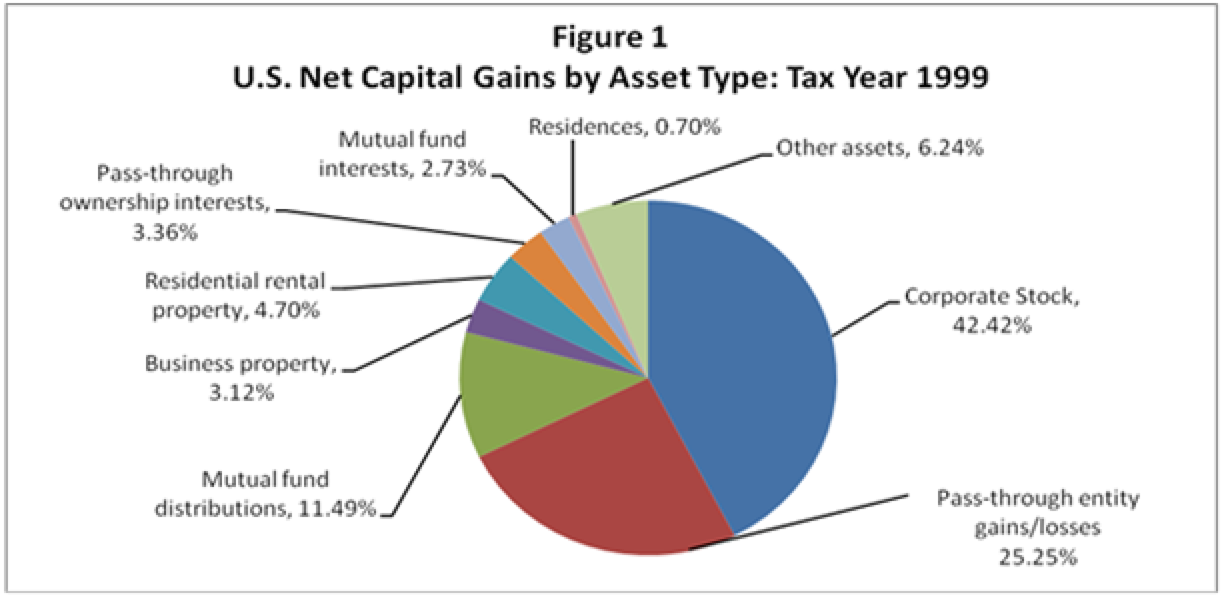
- Trade-off between efficiency and vertical equity.
- NM income tax burdens are not high but combined burden of all taxes is above regional average, thus higher rates could discourage workers and businesses from locating in NM.
- As long as the rate changes are not too large, these effects are less likely to occur.
- Since NM taxes are deductible on the federal tax return for those who itemize deductions, taxpayers’ will save a portion of the tax increase in reduced federal liability. Savings depends on their federal tax bracket.

Policy Implications: Itemized Deduction Addback



- 250,000 NM residents claimed $1.4 billion in deductions for S&L taxes in 2007. The figure shows the distribution of deductions by AGI per return.
- Five other states allow either state and local income or sales taxes to be claimed as itemized deductions. Eleven more permit deductions for sales taxes only.
- Present law deduction reduces effective tax rates for taxpayers who itemize deductions, thus reducing the NM disadvantage vs. states with no income tax.

Policy Implications: Reduce Capital Gains Deduction



- Figure 1 presents I.R.S. estimates of net capital gains by asset type for tax year 1999 for all U.S. individual income taxpayers.
- Gains on corporate stock are the single largest component at 42%. Pass-through entity distributions are next at 25% and mutual fund distributions are next at 11.5%.

Policy Implications: Reduce Capital Gains Deduction (cont.)

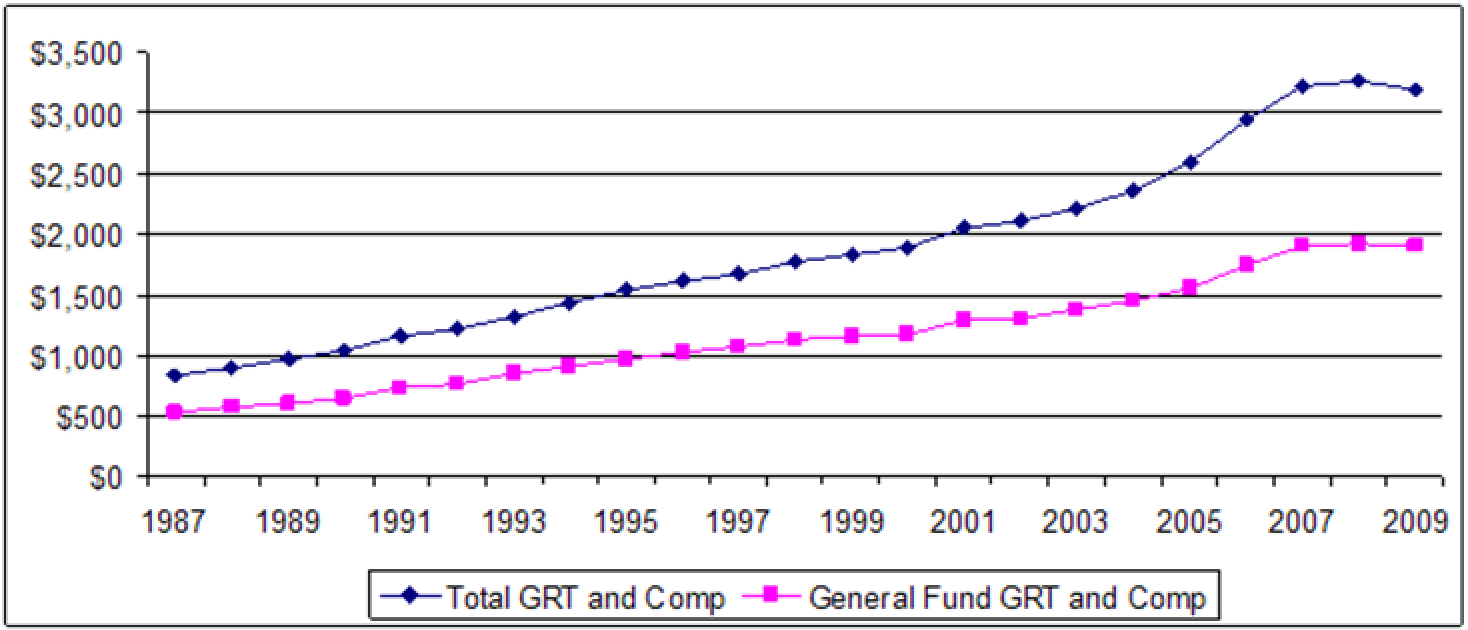
Individual Income Tax Returns of New Mexico Residents: 2006

Item	All returns	Size of adjusted gross income: Under $50,000	$50,000 under $75,000	$75,000 under $100,000	$100,000 under $200,000	$200,000 or more
Total number of returns	887,176	646,552	106,295	59,336	58,554	16,439
Share of all returns	100.0%	72.9%	12.0%	6.7%	6.6%	1.9%
Returns with net capital gains	134,822	55,303	22,337	17,712	27,015	12,455
Amount of net capital gains ($1,000)	$2,781,309	$152,308	$106,855	$132,899	$417,364	$1,971,882
Share of all capital gains	100.0%	5.5%	3.8%	4.8%	15.0%	70.9%
Capital gains as percent of AGI	7.1%	1.3%	1.6%	2.6%	5.4%	24.7%

Source: I.R.S. Statistics of Income division.

- *70% of benefits of deduction accrue to households over $200,000*
- *Most gains are from investments with no connection with NM; deduction may not be well targeted to provide economic stimulus for the state.*
- *Of states in the region imposing an income tax, California and Arizona do not provide tax preferences for capital gains whereas Oklahoma, Colorado, and Utah do. Those three states provide more limited relief than New Mexico.*

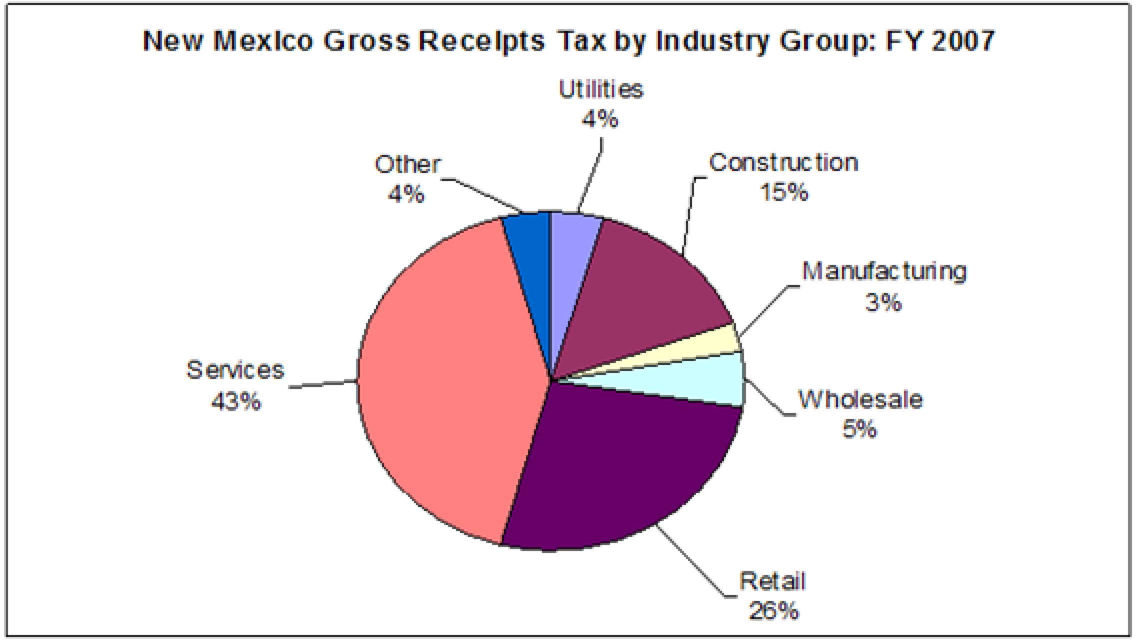
Gross Receipts Tax Options: Background



- *Collections of GRT and compensating tax have grown at a compound annual rate of 6 percent per year since 1990, slightly higher than personal income.*
-
- *General fund share decreased from 64 percent to 59 percent over 20 years. Increased share of transactions in municipal areas and increased local option taxes.*

- *Local rates range from 5% (out of state) to 8.5625% (Taos Ski Valley)*

GRT Options: Background



- *Largest category of tax base is services*
- *Construction makes a significant contribution*
- *A minority of the tax base for the GRT is retail transactions.*

GRT: Western States Rate Comparison

State:	Combined State & Average Local Sales Tax Rate*	State & Local Sales Tax as % of Personal Income**
Arizona	7.92%	5.32%
California	9.06%	3.81%
Colorado	7.24%	3.43%
Idaho	6.0%	4.08%
Montana	--	1.86%
Nevada	7.59%	6.47%
New Mexico	**6.4%**	**5.5%**
Oklahoma	8.44%	3.9%
Texas	7.39%	4.61%
Utah	6.61%	4.67%

* Source: Tax Foundation. ** Source: U.S Census Bureau, includes excise taxes as well as GRT & Comp.

NM's higher relative share of personal income due to broader tax base

GRT Options: Recent Legislative Changes

Session:		Estimated Impacts General Fund FY11 ($ millions)
2003	Tricare services, gross receipts deduction	(1.0)
2003	Clinical labs, gross receipts deduction	(2.0)
2004	Managed Care Reimbursement GRT Deduction	(65.0)
2004	Repeal 0.5% credit in municipal areas	170.0
2004	Food Gross Receipts Deduction	(228.0)
2005	Aircraft services GRT deduction	(1.6)
2005	Back-to-school GRT holiday	(2.7)
2007	Hospital GRT credit	(15.0)
2007	Unpaid health services GRT credit	(1.8)
	Total	(147.1)

- *Food, medical deductions plus 0.5% credit repeal reduce General Fund by $123 million per year.*

Description of GRT Options

Option:	Description	FY11 General Fund Impacts ($ millions)
1	Increase statewide GRT rate by 0.25%	126
2	Repeal GRT deduction for food	228
3	Eliminate GRT Sales tax holiday	3
4	Exclude soda from GRT deduction	6
5	Eliminate hold harmless distribution on muni distribution of 1.225% of State's 5% GRT	40
6	Eliminate hold harmless distribution for food	90
8	Repeal food deduction and re-instate 0.5% muni credit	46
9	Repeal managed care reimbursement GRT deduction	65
10	Repeal Hospital GRT credit	15
11	Repeal unpaid health services GRT credit	2

- *Options 1and 2 estimated by TRD, remainder by LFC*
- *Estimates assume full year impacts in FY11*

Policy Implications: Increased GRT Rate

- Raising the GRT rate meets the adequacy criteria because the revenue raised is predictable and stable.
- The proposal has negative efficiency and equity implications because it would exacerbate the pyramiding problem, which puts NM businesses at a competitive disadvantage and also imposes a heavier burden on small businesses.
- Local option tax currently averages 2.16%. The statewide tax rate is therefore 7.16%. This option would increase to 7.41%.

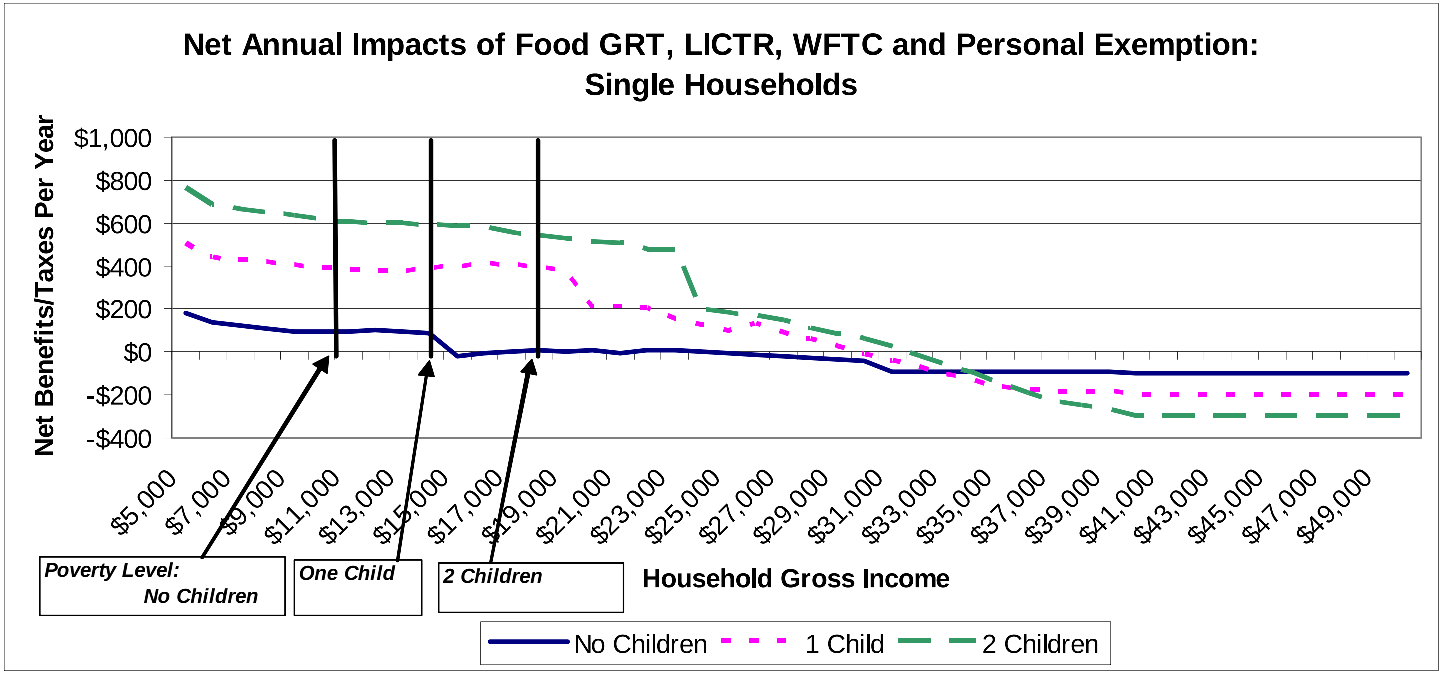
Policy Implications: Food Deduction Repeal

Household Gross Income	Average Money Income	Total Expenditures	Food at home	Food % of Total Spending	Food stamps	GRT on Food	GRT on Food % of Total Spending
Under $5,000	-$3,418	$27,503	$2,811	10.2%	$2,400	-$28	-0.1%
$5 to $10,000	$8,105	$21,731	$2,338	10.8%	$2,338	$0	0.0%
$10 to $15,000	$12,698	$22,550	$2,479	11.0%	$2,400	-$5	0.0%
$15 to $20,000	$17,332	$26,282	$2,654	10.1%		-$178	-0.7%
$20 TO $30,000	$24,932	$32,860	$2,905	8.8%		-$195	-0.6%
$30 TO $40,000	$34,688	$39,263	$3,336	8.5%		-$224	-0.6%
$40 TO $50,000	$44,568	$44,769	$3,705	8.3%		-$248	-0.6%
$50 TO $70,000	$59,617	$54,881	$4,047	7.4%		-$271	-0.5%
Over $70,000	$134,183	$88,600	$5,311	6.0%		-$356	-0.4%
All Households	$68,479	$55,873	$3,982	7.1%		-$267	-0.5%

Source: LFC calculations based on 2008 Consumer Expenditure Survey, U.S. Bureau of Labor Statistics.

- *30 of the 45 states with a general sales tax excluded food for home consumption from the tax base.*
- *Exemption for food stamp purchases means repeal will have minimal impact on households below the poverty level.*
- *Above poverty level, tax is roughly proportional.*

Policy Implications: Food Deduction Repeal (continued)



- *Combined effects of LICTR, Working Families Tax Credit and Low-income exemption create net transfers to many households above the poverty level, more than offsetting the GRT on food*

Policy Implications: Repeal Medical Tax Relief

- Provisions are intended to recruit and retain practitioners, hospitals, etc.
- Repealing would improve adequacy because they increase the future growth of the tax base.
- Repeal would expand the consumer's share of the tax base, reducing share borne by business-to-business transaction, improving efficiency.
- GRT relief to limited reimbursements has reduced the equity and simplicity of the tax system.
- Hold harmless provisions have reduced simplicity for taxpayers and for the Tax Department.
- Medical providers receive a large share of state spending, which is enhanced by the Medicaid match. Thus, the industry would receive a substantial portion of any tax increase back in increased government spending.

Policy Implications: Other GRT Options

- Back-to-school tax holiday is not well targeted; relief may be captured by vendors with little accountability.
- Tax on soft drinks reduces <u>simplicity</u> and increases <u>administrative</u> costs.
- Reduced local distributions:
  - Although local governments are undergoing fiscal difficulties, the state general fund is now down by 20% it has become necessary to review all uses of state funds, including revenue sharing provisions.
  - Property tax revenues have continued to increase during the recession, offsetting to some extent the revenue impacts that local governments are seeing from their GRT revenue.

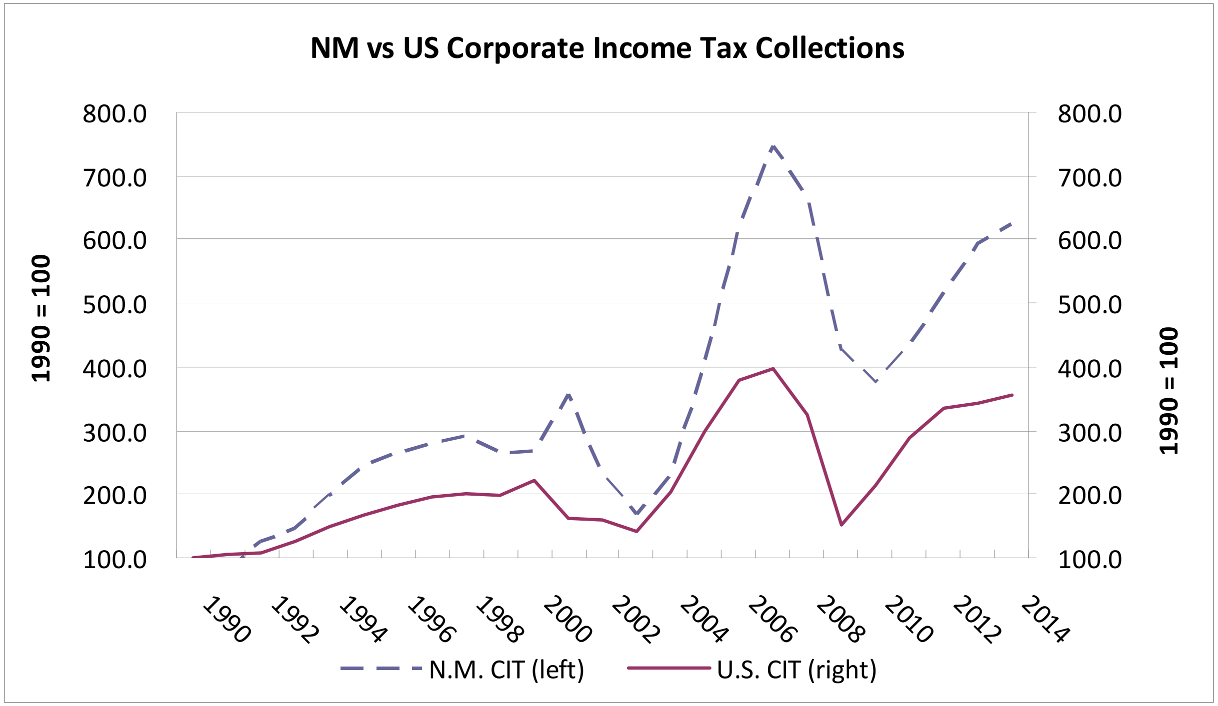
Corporate Income Tax Options: Background

- Graduated rates apply to taxable income (equal to federal taxable income with modifications):
  - 4.8% on the first $500,000, 6.4% on income over $500,000 up to $1 million, and 7.6% on income in excess of $1 million.

- Subject to certain restrictions, corporations may elect to report their income using one of three reporting methods:
  - separate corporate entity;
  - combination of unitary corporations; or
  - federal consolidated group.

- Income is apportioned to New Mexico using an equally-weighted three-factor formula – payroll, property and sales – except that manufacturers may elect a double-weighted sales factor in apportioning their income.

CIT Options: Background



- *NM's tax base grew strongly in the 1990's due to manufacturing*
- *Growth spurt in 2000's due to O&G*
- *Despite large drop, revenue still above 2002 floor*

Corporate Income Tax Options: Background

- Mineral extraction industry has traditionally been the largest single contributor to the tax base, with the manufacturing industry, utilities and financial companies also making major contributions.
- Approximately 20,000 companies pay some corporate income tax, compared with approximately 100,000 taxpayers in the gross receipts tax program.
- Corporate income tax revenue has declined sharply in recent years, due to the economic recession and in part due to the payment of film production tax rebates.
- Gross revenue is expected to fall to $210 million in FY10, and net revenue, after payment of almost $80 million in rebates, only $130 million in FY10.
- This compares with an historic high of $460 million in FY07. FY07 level is not expected to be reached in the foreseeable future.

CIT Western State Comparison

Tax Year 2008 Western States Corporate Income Taxes

State	Tax rate (percent)	Combined reporting required?	Federal consolidated allowed?
Arizona	6.968	Yes	Yes
California	8.84	Yes	No
Colorado	4.63	Yes	Yes
Idaho	7.6	Yes	No
Montana	6.75	Yes	Yes
New Mexico	4.8/6.4/7.6	No	Yes
Oklahoma	6	No	Yes
Oregon	6.6	No	Yes
Texas	1*	Yes	No
Utah	5	Yes	No

Source: CCH Group, *State Tax Handbook, 2009*
*Texas' franchise tax is imposed on a much larger base than most states' taxable income for corporate tax purposes.

- *NM's top rate is second highest in the region*

Description of CIT Options

Option:	Description	FY11 General Fund Impacts ($ millions)
1	Required combined reporting for corporate income tax	24.3
2	Increase franchise tax to $250 per year	7.5
3	Reduce film credit rate to 15%	32.0

- Estimates by LFC:
- Option 1 assumes 10% increase in pre-credit CIT collections; based on recent study by Maryland DOR
- Option 2 based on TRD data
- Option 3 based on Consensus Forecast assumptions

Policy Implications of CIT Options: Mandatory Combined Reporting

- Reduces <u>efficiency</u> by imposing higher taxes on investment by multi-state companies
- May improve <u>equity</u> by preventing some invalid tax avoidance
- Provision should permit federal consolidated election because it achieves the same purposes as combined and is substantially <u>simpler</u>
- Raises numerous issues upon implementation, potential for increased administrative cost and <u>complexity</u>
- Revenue increase is more uncertain than most, questionable from an <u>adequacy</u> standpoint

Policy Implications of CIT Options: Increased Franchise Tax

- $50 tax has not been increased in decades
- Many taxpayers pay no net income tax, in some cases despite substantial presence in the state

Policy Implications of CIT Options: Reduce Film Credit Rate

- LFC review of two film credit studies concluded state's return is less than $0.50 per dollar of credits
- Even that figure excludes other state and local subsidies to the industry
- Total subsidy of $30,000 per job (recurring) well above that offered to other industries
- Reduced credit rate may decrease level of industry activity in the state – state finances will still be better off because ROI is significantly less than $1
- Given decreased state revenues, necessary to re-visit all subsidies just as state spending is being reviewed