OPTIONS FOR BUSINESS TAX REFORM AND RELIEF

BLUE RIBBON TAX REFORM COMMISSION
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GROSS RECEIPTS TAX PYRAMIDING

Gross receipts tax pyramiding occurs where successive stages in a series of related transactions are taxed. Gross receipts tax pyramiding often occurs with respect to the taxation of services and power plant fuels.

Although some pyramiding might occur in other states that impose sales and use taxes, New Mexico taxes services more broadly than most states. As a result, gross receipts tax pyramiding often exacerbates costs with respect to business services. This pyramiding creates a competitive disadvantage for in-state businesses that compete with out-of-state businesses that enjoy lower tax burdens. Although businesses have the legal freedom to pass additional tax costs to consumers, that ability is limited by competition. The ability of in-state businesses to generate profit and expand is thus reduced.

The commission determined that eliminating all pyramiding would cause severe revenue reductions when it examined switching to a value-added tax. A more practical approach is to solve more discrete instances.

Although many gross receipts tax pyramiding problems result from the taxation of services, many stem from the taxation of certain products. The power plant industry is an example of an industry that perceives the taxation of certain products as a pyramiding problem. Gross receipts tax is owed on fuels used in electricity-generating stations in New Mexico. Since the sale of electricity is also subject to the gross receipts tax, the tax imposed on the fuel is incorporated as a cost and pyramided into the price of electricity. According to the Taxation and Revenue Department (TRD), this pyramiding might be compounded when electricity is sold to a business. The pyramiding might occur because the tax on business inputs becomes an overhead cost that is added to the price of business outputs.

OPTION 1. Permit a Deduction for Certain Industries.
This option creates gross receipts tax deductions for certain service industries such as manufacturing and research and development.

PROS

- This option attracts businesses characterized by high-paying jobs and high economic growth potential.

- Many in-state businesses will benefit from lower costs and reinvest in property or employ additional workers.

CONS

- Reduction in tax revenue might be too costly.

- The deduction might attract some additional businesses, but investment in other incentives, such as education, might create the same effect.

OPTION 2. Remove the "Next Sale Taxable" Provision from Section 7-9-48 NMSA 1978.
Section 7-9-48 NMSA 1978 states that receipts from selling a service for resale may be deducted from gross receipts if:

- the sale is made to a person who delivers a nontaxable transaction certificate to the seller;

- the buyer delivering the nontaxable transaction certificate resells the service in the ordinary course of business; and

- the resale is subject to the gross receipts tax.

The required taxability of the subsequent resale of a service is known as the "next sale taxable provision". The provision prevents a service from being resold without tax in two consecutive transactions, which causes multiple incidences of tax when long chains of subcontractors are involved, such as in defense work. Removing the next sale taxable provision is an option to prevent excessive taxation of a service for resale.

PROS

- Reduces pyramiding in the gross receipts tax and prevents economic distortion.

- Simplifies the tax code, making treatment of resold services more consistent with goods and materials.

- Promotes fairness.

CONS

- Reduction in tax revenue might be too costly.

- This option might eliminate taxes on the first tier of service contractors of 501(c)(3) organizations such as Los Alamos National Laboratory and hospitals competing with for-profit competitors subjected to taxation directly.

ISSUES

The option of holding local governments harmless might be explored.

OPTION 3. Make Architectural and Engineering Services Sold for Construction Eligible for the Gross Receipts Tax Deduction Pursuant to Section 7-9-52 NMSA 1978.

Section 7-9-52 NMSA 1978 permits a deduction for the sale of construction services to a person engaged in the construction business. The services must be performed on a construction project that is subject to the gross receipts tax or is located on Indian tribal territory. Pursuant to TRD regulations, "construction services" is defined to exclude indirect services. Indirect services are defined to include architectural, engineering and drafting services and other services such as accounting. Permitting some of these services to be considered construction services and eligible for the deduction is an option to reduce tax pyramiding in the construction sector.

PROS

- The option helps eliminate pyramiding in the gross receipts tax.

- The option might encourage architects and engineers to do more of their work in New Mexico, thus fostering economic growth. Since there is no compensating tax on services, one way around the existing rules is to have as much work as possible done outside New Mexico.

- Knowledgeable persons in the field often can avoid the double taxation by contracting indirect services directly with the project's customer. The tax result should not depend on every service provider being an expert in the nuances of the tax code.

CONS

- Permitting the deduction might not be necessary. The taxation of indirect services might not necessarily affect competitiveness.

ISSUES

The option of holding local governments harmless might be explored.

OPTION 4. Provide a Gross Receipts Tax Deduction for Fuel Used by Merchant Power Plants to Generate Electric Power Exported from the State.

A significant percentage of electricity generated by New Mexico's power plants is competitively sold into a regional wholesale market. For instance, an average of 25 percent of PNM's generated electricity is sold into the wholesale market. One way to eliminate gross receipts tax pyramiding in the electric power industry is to provide a gross receipts tax deduction for fuel (coal and natural gas) sold to merchant power plants used to generate electric power exported from the state. The deduction might apply to total electric power production less the electric power consumed in New Mexico.

PROS

- This option promotes exports of electricity, which increases electric company revenues and might lead to cuts in electric rates in New Mexico.

- Power plants have traditionally been excluded from favorable tax treatment because utilities held monopolies. Ten years ago, however, federal legislation created a competitive wholesale market. Today, megawatt hours are sold in a regional wholesale market and gross receipts tax pyramiding serves as a competitive disadvantage to New Mexico electric companies. Permitting this deduction might help eliminate gross receipts tax pyramiding that creates competitive disadvantage.

- This option might make New Mexico's taxation of fuels more comparable to other states in the region. Currently, New Mexico and Arizona are the only states in the region that apply gross receipts or sales tax to boiler fuel. Arizona, however, does not impose a severance tax. Colorado exempts coal and electricity sold to industrial consumers because they are deemed to be raw materials in a manufacturing process.

CONS

- Reduction in tax revenue might be too costly.

- The percentage of sales of electricity exports might not be sufficient to justify a tax deduction at this time.

- Calculating the eligible percentage of receipts from selling fuel will be complicated since the fuel seller will not necessarily know what percentage of the power generated is exported.

OPTION 5. Provide a Gross Receipts Tax Deduction for Fuel Used to Produce Exported Electricity.
This deduction might be targeted to fuel purchased and used in the generation of electric power. An annual reconciliation might be required of taxpayers claiming the deduction to document the total power generated less the power consumed in New Mexico.

PROS

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CORPORATE INCOME TAX

The New Mexico corporate income tax is imposed on all corporate entities that pay federal corporate income tax, except insurance companies. With a few adjustments, New Mexico's corporate income tax is levied against federal taxable income. All corporate income tax revenues flow to the state's general fund. A rate of 4.8 percent is imposed on the first $500,000 in taxable income, 6.4 percent is levied against income between $500,000 and $1 million and 7.6 percent is imposed on incomes in excess of $1 million.

In New Mexico, corporations may report income in one of three ways. In addition to separate company reporting, a family of corporations forming a single unitary business enterprise might elect to file using the unitary domestic combined reporting method. State law also permits a family of corporations that file a federal consolidated income tax return to elect to file a New Mexico corporate income tax return using federal consolidated reporting.

A corporation must file using the separate company method unless it elects to file using one of the other two methods. Once another method is elected, a corporation cannot go back without the permission of the secretary of taxation and revenue. A corporation that elects to file using the domestic combined reporting method may file under the federal consolidated reporting method without the secretary's permission.

Apportionment formulas are another important aspect of the corporate income tax. When a corporation (or group of corporations filing together) operates in more than one state, it is necessary to attribute income to each state. Because there are no generally applicable ways to identify how much income is earned in each state, apportionment formulas are commonly used to produce reasonable estimates of the income that a state might tax. New Mexico follows the Multistate Tax Compact's single-weighted three-factor formula to source income to New Mexico. This formula measures business activity as a proportion of three equal factors, including payroll, property and sales.

$$\frac{\text{Business Activity in NM}}{\text{Total Business Activity}} = \frac{1 \text{ NM Payroll}}{3 \text{ Total Payroll}} + \frac{1 \text{ NM Property}}{3 \text{ Total Property}} + \frac{1 \text{ NM Sales}}{3 \text{ Total Sales}}$$

Several states modified the traditional three-factor formula to allow the sales factor to play as large a role in apportioning income as the combined effects of in-state wages and property. The business activity portion of the double-weighted three-factor formula appears as the following:

$$\frac{\text{Business Activity in State}}{\text{Total Business Activity}} = \frac{1 \text{ State Payroll}}{4 \text{ Total Payroll}} + \frac{1 \text{ State Property}}{4 \text{ Total Property}} + \frac{1 \text{ State Sales}}{2 \text{ Total Sales}}$$

In 1992, New Mexico began to permit manufacturing firms to employ a double-weighted sales factor formula. Its purpose was to encourage manufacturing firms to locate or expand plants in New Mexico as a means of creating jobs and increasing income. Several options presented below could be grouped together as a package.

OPTION 1. Implement a Single Corporate Income Tax Rate That Would Be Phased In to a Rate Equal to the Top Personal Income Tax Rate of 4.9 Percent. This option would eliminate the progressive rate table. Fully implemented, the flat 4.9 percent rate would raise the corporate income tax rate by one-tenth percent for corporations with under $500,000 of income. Corporations reporting at least $500,000 in income would receive a tax cut.

PROS

- This option is a tax cut for businesses earning over $500,000, encouraging them to do more business here.

- This option eliminates progressive taxation of businesses. Many have criticized progressive taxation of corporations because as they shift tax burdens to consumers, wage earners and corporate owners, income might be redistributed from poor to wealthy individuals.

- A single, lower corporate income tax might improve the perception of New Mexico's business climate.

CONS

- This option imposes a tax raise of one-tenth percent for corporations with incomes equal to or less than $500,000. The option might be viewed as unfair to small business.

- Since this option cuts taxes for a significant number of taxpayers, the option might be too costly to employ by itself.

OPTION 2. Require All Corporations to File Using the Unitary Filing Method. Combined filing is based on the unitary business principle, which holds that flows of value between commonly controlled and operated corporations make accurate estimation of individual profits of the separate affiliated corporations impossible.

PROS

- This option might achieve a more accurate measure of profits, losses and apportionment factors by combining profits and losses of interdependent corporations on a single return, and subjecting the combined group to a single apportionment formula.

- Tax administrators believe that combined filing discourages tax avoidance through favorable transfer pricing and measures that minimize tax obligations.

- Many administrators also believe that most taxpayers would be unaffected by this option because:

  - small businesses do not have to combine "families of firms";

  - many small businesses operate only in New Mexico; and

  - large taxpayers already must file combined returns in other states and it is not difficult to modify their returns for filing in New Mexico.

CONS

- This option does not necessarily encourage economic growth. The New Mexico business climate might become perceived as less friendly, particularly if the tax administrators are viewed as aggressive.

- Corporations will lose some freedom to manage their tax obligations. Many corporations will face increased tax obligations.

- Some argue that a movement toward mandatory combined filing will not reduce litigation and uncertainty but merely change the subject matter of the arguments.

- The tax collector will certainly face greater problems of administration (and so many taxpayers), especially in the transition to mandatory filing methods.

ISSUES

This option must be phased in or given a delayed starting date to accommodate businesses that have relied upon single entity reporting in crafting their business plans and to allow the TRD to issue crucial regulations and instructions. The method of the phase-in and a time period in which combined filing would be required of all corporations must be considered.

OPTION 2A. Change the Definition of a Unitary Corporation to an Objective Standard, Such as That of Colorado.

Section 39-22-303(11)(a) CRS provides that an affiliated group of C corporations that satisfy three of six tests of unity for the current tax year and the two preceding tax years may join in the filing of a combined report. The following are Colorado's tests of unity:

- 50 percent or more of the gross operating receipts of one affiliated C corporation is from sales or leases to another affiliated C corporation; or if 50 percent or more of the cost of goods sold and leased by one affiliated C corporation is paid to another affiliated C corporation;

- 50 percent or more of the value of five or more of the listed services used by one C corporation during the tax years is furnished by an affiliated C corporation at less than an arm's length charge;

- 20 percent or more of the long-term debt (debt lasting more than one year) is owed to or guaranteed by an affiliated C corporation;

- one affiliated C corporation substantially uses the patents, trademark, service marks, logo-types, trade secrets, copyrights or other proprietary materials owned by the other;

- 50 percent or more of the board of directors of one affiliated C corporation are members of the board of directors or are corporate officers of another affiliated C corporation; and

- 25 percent or more of the 20 highest-ranking officers of one affiliated C corporation are members of the board of directors or are corporate officers of an affiliated C corporation.

PROS

- The definition of unitary corporations pursuant to Subsection Q of Section 7-2A-2 NMSA 1978 is ambiguous. This ambiguity might create administration problems and excessive litigation. Employing an objective standard such as that of Colorado could preempt such problems.

- Employing an objective standard might simplify the tax code.

CONS

- The transition to an objective standard might create additional administration issues.

- The six categories listed in the Colorado standard might overlook other factors that should be considered as characteristic of unitary corporations. Such factors might include centralized purchasing, advertising, accounting, management and other dependencies.

- The objective standard creates additional factors to define unitary corporation and might complicate the tax code.

ISSUES

- This option complements Option 1.

- Phase-in issues might be considered.

OPTION 2B. Adopt the Factor Presence Nexus Standard for Business Activity Taxes Suggested by the Multistate Tax Commission.

Under current law, both in-state and out-of-state businesses doing business in a state pay a business activity tax on the income earned in that state. "Doing business within the state" provides the necessary connection — the nexus in legal jargon — to justify the state taxing authority. The nexus standard originates in the Commerce Clause and is interpreted inconsistently among the states. To reduce inconsistency, the Multistate Tax Commission has proposed that a uniform standard defining nexus be adopted by all states. The standard states that substantial nexus is established if any of the following thresholds is exceeded during the tax period:

- $50,000 of property in the state;

- $50,000 of payroll in the state;

- $500,000 of sales to customers in the state; or

- 25 percent of total property, total payroll or total sales of the business are in the state.

PROS

- The factor presence nexus standard would provide a clear and simple definition of nexus. Clear standards can enhance a corporation's ability to objectively determine when taxes are to be paid.

- If other states adopt the standard, New Mexico's standard would be uniform with those states.

- A definite standard such as that adopted by the Multistate Tax Commission might reduce litigation.

- Adopting a relatively clear standard might fend off potential federal preemption.

CONS

- There might be too much confusion with respect to this issue to take action. The definition of substantial nexus has been interpreted to include physical presence in some states, yet the United States Supreme Court has not ruled on whether nexus must include physical presence. In *Quill Corp. v. North Dakota*, the court set out a bright-line test of "physical presence" to satisfy substantial nexus. However, the court limited that test to the duty of mail order houses to collect use tax from customers.

- In response to the ambiguity surrounding this issue, proposals have come before Congress to limit state authority to impose income taxes only on businesses that have a substantial physical presence in a state. If the Multistate Tax Commission standard is adopted in New Mexico, it might later become preempted by federal law used as a regulation of interstate commerce. It might be prudent to define the standard when debate involving the nexus issue is resolved.

ISSUES

- This option complements Option 1.

- Phase-in issues might be considered.

OPTION 3. Make the Double-Weighted Sales Apportionment Formula Available to All Corporations.
Service industries currently are not permitted to use the double-weighted sales apportionment formula when filing corporate income tax returns. This option permits manufacturing and service industries alike the ability to use the double-weighted sales apportionment formula.

PROS

- The single-weighted three-factor formula does not encourage service industries to expand, locate property or employ workers in New Mexico. Unlike the single-weighted formula, the double-weighted formula taxes payroll and property at a lower rate and, thus, might encourage businesses to employ workers and locate property in New Mexico. This option thus promotes economic development.

- The inability of service industries to use the double-weighted sales formula might contribute to a perception of inequitable treatment of service industries. Adding the formula as an option for all industries might improve this perception.

- Most states assign greater weight to sales than to other factors. The national trend appears to add weight to the sales factor. According to the TRD, about half of the states currently employ a double-weighted sales factor apportionment procedure. More than half assign greater than one-third weight to sales.

CONS

- Revenue losses stemming from transition to the double-weighted sales factor might be too costly. A 1992 study by the TRD found that an optional double-weighted formula for all firms would result in an approximate eight percent loss in revenues.

- The double-weighted sales formula is particularly burdensome upon firms that have a high proportion of sales in comparison to property and payroll. These firms will not opt to file using the double-weighted formula and they will not be encouraged to invest in property or employ additional workers.

OPTION 4. Define the Sales Apportionment Factor to Include Intangibles Such as Services, Royalties and Trademark Income.
The sales factor apportionment formula might be expanded to include intangibles for primary use by a purchaser known by the seller to be in New Mexico. If an intangible is used in multiple states, the seller might apportion the receipts according to usage in each state. Under existing rules, intangibles are normally assigned to the state in which the corporation is domiciled.

PROS

- This option is consistent with the Multistate Tax Commission's factor presence nexus standard for business activity taxes. If other states adopt the standard, uniformity among the states might result.

- This option permits New Mexico to tax intangible property sold to New Mexicans regardless of where the corporation is domiciled.

CONS

- If other states do not adopt the sales allocation factor definition that includes intangibles sourced to the destination, New Mexico's law will be inconsistent with other state corporate income tax laws. It might be prudent to find out whether states will adopt the Multistate Tax Commission's recommendations.

OPTION 5. Make the Colorado Two-Factor Apportionment Formula Available to All Corporations.
The Colorado apportionment formula in Subsection (2) of Section 39-22-303 CRS 1978 consists of equally weighted property and sales factors. This option would make the same apportionment formula available to all corporations subject to the New Mexico corporate income tax.

PROS

- The single-weighted three-factor formula does not encourage service industries to employ workers in New Mexico. Alternatively, the Colorado approach eliminates the payroll factor from the formula. That approach might reward firms that employ workers in New Mexico and foster economic growth.

- The inability of service industries to use the double-weighted sales formula might contribute to a perception of inequitable treatment of service industries. The addition of a two-factor formula as an option for all industries would improve fairness between manufacturing and service industries.

- This option promotes uniformity among states. The national trend appears to add weight to the sales factor. Most states assign greater weight to sales than to other factors. According to the TRD, about half of the states currently employ a double-weighted sales factor apportionment procedure. More than half assign greater than one-third weight to sales.

CONS

- Revenue losses stemming from transition to the two-factor formula might be too costly.

- Unlike the double-weighted sales formula, the two-factor formula does not encourage firms to locate property in New Mexico.

ISSUES

- If the commission chooses to make the two-factor apportionment formula available to all corporations, it must consider the likely impact of the change on manufacturing industries (that use the double-weighted sales formula).

- Phase-in issues might need consideration.

ECONOMIC DEVELOPMENT TAX INCENTIVES

Certain gross receipts tax deductions and credits might be created to attract key industries and retain those important to economic growth in New Mexico. The following options target gross receipts tax deductions to such industries.

OPTION 1. Expand the Laboratory Partnership with Small Business Tax Credit. The laboratory partnership with small business tax credit enables Sandia National Laboratories to provide technical or business assistance to small businesses that support the growth of the state's economic base. Sandia currently pays $55 million in gross receipts taxes and is eligible for a tax credit up to $1.8 million. Pursuant to the program, New Mexico rural small businesses can use up to $10,000 of the laboratories' expertise and Bernalillo County small businesses can use up to $5,000. Expanding the tax credit would enable the laboratories to provide additional assistance to small businesses.

PROS

- This incentive promotes economic development and small business growth in rural areas.

- This incentive is an effective tool for economic development. Lenny Martinez, vice president of process engineering and manufacturing at Sandia National Laboratories, asserted that in 1991, for each dollar spent on an assistance project, $.98 was recovered by the state through taxes within the first year. Over a one-year period, 44 jobs were retained and 68 new jobs were created. Participating New Mexico small businesses reported a total of $33,380,000 of increased revenue and a $1,703,500 decrease in operating costs. Participating small businesses spent $2,147,500 to expand operations and $828,600 in local goods and services.

CONS

- Expansion of the tax credit might be too costly.

ISSUES

The commission must determine an exact credit amount.

OPTION 2. Exempt Telecommunications Equipment from the Gross Receipts Tax. Telecommunications equipment is currently subject to the gross receipts tax. Exempting this equipment is an economic development incentive for in-state telecommunications companies.

PROS

- This option retains and attracts telecommunications companies.

CONS

- This exemption might be too costly.

ISSUES

Telecommunications equipment must be defined. Some states that provide gross receipts tax relief for telecommunications equipment include in the definition computers, transformers, amplifiers, routers, bridges, repeaters, multiplexers, receivers, satellite equipment, microwave equipment, test equipment, towers, hearing equipment and other items performing comparable functions.

OPTION 3. Create a Gross Receipts Tax Deduction for Sales of Tangible Personal Property to Microelectromechanical Systems (MEMS) Manufacturers.
This deduction would be limited to the sales of property consumed by microelectromechanical systems (MEMS) manufacturers that have been in operation for three years or less and that employ 30 or fewer persons.

PROS

- This deduction might add to a favorable perception of New Mexico's business climate among small businesses.

- This deduction promotes growth in start-up high-tech industries.

CONS

- This deduction might encourage MEMS companies to stay small, which might ultimately limit economic growth among such industries.

- This deduction might not affect a significant enough portion of corporate income taxpayers to warrant legislation.

ISSUES
The commission might need more information, such as how many businesses might benefit from this deduction.

OPTION 4. Create Deductions for Research and Development Companies That Are Employed by the Federal Government.

OPTION 4A. Create a Gross Receipts Tax Deduction for Research and Development Companies That Are Employed by the Federal Government.

OPTION 4B. Create a Deduction for the Compensating Tax Due on Purchased Equipment and Consumables for Companies That Are Employed by the Federal Government.

Option 4 allows research and development companies to deduct their receipts from an agency, department or instrumentality of the United States for performing research and development services. Option 4 also permits a compensating tax deduction for equipment consumed in the performance of those services.

PROS

- This option might result in the creation in New Mexico of stable research and development jobs funded by the federal government.

- The creation of new jobs might offset costs of the deductions. According to J. Brad Steward, director of finance at Boeing-SVS, Inc., one of the federal labs in New Mexico will have over $170 million to spend on research and development with outside contractors during 2002. Typically, two-thirds of that will be spent out-of-state.

CONS

- This option might be too costly.
- With respect to Option 4B, it might be difficult and costly to define equipment consumed during research and development projects for the federal government.
- Why limit this kind of deduction to firms doing business with the federal government? It is a stated economic development goal to reduce the state's dependence on the federal government.

OPTION 5. Direct a Study of All Economic Development Incentives to Determine Whether They Should Be Retained or Expanded.

The Economic Development Committee discussed the option of directing an in-depth study of all economic development incentives to determine whether they should be retained or expanded. The commission might consider directing an interim committee to require such a study.

PROS

- This option will expand legislative knowledge of incentives that are effective and those that are costly and should be eliminated.

CONS

- This option may demonstrate that some incentives either do not work or are not used.

FRANCHISE TAX

New Mexico imposes a $50.00 annual corporate franchise tax on domestic and foreign corporations conducting business in the state and on corporations possessing or exercising a corporate franchise in New Mexico, irrespective of whether they conduct business in the state. New Mexico's franchise tax is thus essentially unrelated to the extent of business activities conducted by firms.

OPTION 1. Increase the Franchise Tax to $84.00.

PROS

- The franchise tax in its current form was enacted in 1986. The TRD indicates that if the $50.00 franchise tax had been indexed to the rate of inflation, it would be approximately $84.00 today.
- Since New Mexico's franchise tax is unrelated to business activity, there is no incentive for businesses to attempt to avoid it.
- According to the TRD, it is not clear that the current $50.00 tax covers the cost of registering firms and other costs associated with providing a firm with the right to exercise its franchise.

CONS

- The increased franchise tax might present an excessive burden to small firms, which would be the most affected by the additional cost.
- This option does not promote economic development and might contribute to a perception of an unfriendly business climate.

OPTION 2. Impose the Franchise Tax on Limited Liability Corporations and Other Pass-Through Entities.

According to the TRD, about 21,000 domestic limited liability corporations and 3,000 foreign limited liability corporations are currently registered with the Public Regulation Commission. The number of new limited liability corporation registrants has totaled about 2,000 to 3,000 annually in recent years. This option would impose the franchise tax on all limited liability corporations and other entities, such as limited partnerships and limited liability partnerships.

PROS

- This option generates additional tax revenue.
- Requiring pass-through entities to pay the franchise tax promotes equity with C corporations.

CONS

- Representatives of the secretary of state's office report that only about 200 firms organized as limited partnerships and limited liability partnerships are registered. As a result, franchise tax revenue potential from partnerships is low.
- Administrative burdens associated with the franchise tax might increase as additional entities must pay it.

TAX ADMINISTRATION

OPTION 1. Implement an Independent Hearing Process.
New Mexico is one of nine remaining states that employ an internal hearing system. The TRD reviews its own decisions. Implementing an independent hearing process gives the department less control over disputes that it is involved in.

PROS

- It might actually be a fairer system for the taxpayers.
- An independent hearing process will result in a greater perception of fairness in New Mexico's tax system.
- The nationwide trend is toward independent review of actions by a tax administrative agency.

CONS

- Creating an independent hearing process, such as a state tax court, will require consideration of administration, funding and employment issues that the commission might not have time to consider.

OPTION 2. Administrative Change Options.
The Tax Administration Act lays the rules by which the TRD administers the state and local gross receipts taxes, the income taxes, the estate tax, the oil and gas taxes and the various excise taxes on particular products or activities, like cigarettes and gaming. This act also spells out taxpayer rights and remedies and what legal actions the department may take to enforce tax collection. Five changes to the act are proposed.

OPTION 2A. Raise Minimum Amount at Which Assessments Must Be Issued to $25.00.
The current minimum is $10.00. When TRD records indicate that a taxpayer owes this amount, it is required to assess the taxpayer for the amount. This starts the clock on a number of procedures, including the taxpayer's right to protest the amount assessed. The proposal would change the minimum to $25.00.

PROS

- Ten dollars is a low amount at which to invoke the formal power of the state. Ten dollars may not cover the costs of preparing and issuing the assessment.
- The $10.00 amount was set decades ago. Inflation has made it an unreasonably low number.

CONS

- By not assessing amounts between $10.00 and $25.00, the state may end up not collecting some number of small amounts properly due New Mexico.

OPTION 2B. Allow Taxpayer to Elect Rules of Civil Procedure for the District Courts.
District courts rules do not apply to the administrative hearings conducted by TRD hearing officers on tax matters. Instead, hearings are required to be conducted so that both complaints and defenses are amply and fairly presented. The department by

regulation has issued a short set of relatively relaxed rules. Administrative hearings are supposed to be more informal than court proceedings so that the taxpayer representing himself is not disadvantaged.

PROS

- Some taxpayers feel more comfortable with a structured set of standardized procedures. They should be allowed to have the hearing conducted in that manner.

- Some issues are quite complex and may involve large dollar amounts. They can overpower the more informal department rules. Using the district court rules will help manage the case and better protect the interests of the parties.

CONS

- Some taxpayers could use this choice as a technique to delay and otherwise hamper the proceedings.

OPTION 2C. Provide for Protective Claims.

A protective claim is a claim for refund filed by someone based on the arguments advanced by another person in a prior-filed claim, as yet unresolved. By agreement, the TRD takes no action on the protective claim until the lead claim is disposed of and resolves the protective claim in the same manner.

Although the department informally agrees on occasion to treat certain refund claims as protective claims, some administrative legerdemain is involved since the refund and protest provisions currently require action within strict time limits. In return, for classifying a claim as a "protective claim", no interest would run while the claim was dormant.

PROS

- Taxpayers will have another choice in how to proceed in contests with the TRD.

- By formalizing what is an informal practice, interests of taxpayers can be more thoroughly safeguarded and will not depend on the predilections of individual department attorneys.

CONS

- By formalizing the process, more taxpayers may file claims when they would not if they had to incur the full cost of pursuing the claim.

OPTION 2D. Go to Floating Interest Rates.

New Mexico currently charges 15 percent straight annual interest and also pays claims at 15 percent straight annual interest. This interest rate is well above current market rates. An interest rate above market is no longer merely a charge for the use of money but also acts as an implicit penalty.

The proposal would piggyback on one of the floating rates the Internal Revenue Service charges. A condition is that the same rate shall be used for interest charged by the state and for interest paid on refunds. Also, an interim fixed rate of 10 percent would be installed immediately with conversion to a floating rate once all of the department's tax system reprogramming is completed.

PROS

- A floating rate conceptually is more appropriate. It eliminates the penalty elements that can creep in with a fixed rate when market rates are low and also eliminates the incentive to use the state as a lending bank when market rates are above the fixed rate.

- A fixed rate could be made to mimic a floating rate if it were changed frequently enough. For a legislature that is not in session most of the year and has other business to attend to, a floating rate makes much more sense.

- Technology is clearly up to the task of implementing this.

CONS

- Interest rate reduction will reduce state revenues because the TRD collects several times more interest on underpayments than it pays out on refunds.

OPTION 2E. Raise the Minimum Penalty to $25.00.
The current minimum penalty is $5.00.

PROS

- The minimum was set decades ago. It no longer has sufficient sting to influence taxpayer behavior.

- It costs at least $5.00 to process a $5.00 penalty. The state should not lose money correcting taxpayer behavior or errors.

CONS

- This is a hidden tax increase.

- What did the taxpayers do to deserve a five-fold increase in the penalty? TRD programs automatically add penalty on all late returns and on all underpayments, regardless of the reason for late filing or underpayment. While many taxpayers may not fight the $5.00 penalty, a good many will protest the $25.00 penalty. The department's protest workload is sure to increase.

OPTION 3. Allow Taxpayers to Ask for Regulations.
The Taxation and Revenue Department Act establishes that department. Among other things, it sets out the department's authority to promulgate regulations and rulings. The act clearly allows taxpayers to ask for rulings but is silent on whether taxpayers may ask for or propose regulations or changes to existing regulations.

The TRD would be required to either initiate a regulation project or to decline to do so within 30 days of a taxpayer request for a regulation, or amendment or repeal of an existing amendment.

PROS

- This gives taxpayers another avenue to seek official guidance from the TRD.

- Because taxpayers have their eye on all of the areas touched by the tax system, they are more likely to notice when economic circumstances, federal law or procedure or changes in business practice render existing regulations obsolete or create the need for new guidance in uncharted waters. This is a way to tap that expertise.

CONS

- Some people are fascinated by minutiae and with trying to capture every possible situation within a structured set of rules. This could lead to excessive requests for rounds of rulemaking and litigation if the department refuses to play.