Opportunities within New Mexico's Tax System

A Presentation to the
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Thank you Mr. Chairman and members of the Committee for granting me some of your time to comment on opportunities to improve the state's tax system.

WHY "REFORM"?

New Mexico's tax system is unusual in that in was consciously designed by a handful of people and enacted over the period 1965 through 1974. It has served New Mexico well for many years thereafter.

So why can't we leave well enough alone?

(1) Both the state and national economies have evolved considerably over the last thirty years. Potentially serious mismatches between the tax system and the economy are appearing. The economic importance of intangibles, particularly various forms of knowledge, is growing rapidly yet the gross receipts tax is poorly structured to handling such business. Further, the income tax allocation and apportionment rules for income derived from intangibles are at best quaint. Interstate and international competition is intensifying but the fundamental concept of the gross receipts tax implies a heavier tax overhead for New Mexico firms than for their out-of-state competitors.

(2) In both the 1980 and 1981 fiscal years, New Mexico ranked 42nd in per capita personal income. New Mexico ranked 47th in both 2000 and 2001. If New Mexico is to reverse this trend, all of its major policies need to be re-considered, including tax policy. Other goals of the state (such as economic development and health) clearly have become more important than holding true to the design principles of the current tax system. This illustrates simply and clearly two things. First, tax policy cannot be designed and carried out in a vacuum. Second, a tax policy shift has already occurred but the implications for the system's design have not been worked out. It is past time to work on this.

Must we throw out the existing system and start over? No, but the tax system does need a make-over. The usual annual tinkering won't do. A broader view has to be taken. We need to look at how the whole system works, how the pieces inter-relate and the interaction with other policy goals. Please note that it took about a decade the last time we thoroughly reformed our tax system. There is no reason *a priori* that you have to tackle the whole thing at once. Having a good idea at the start of where you want to go would of course be very helpful.

I suggest four major areas to start with.

1. Re-think the gross receipts tax base
2. Decide the basis of corporate income tax
3. Get more from the property tax
4. Update tax administration.

RE-THINK THE GROSS RECEIPTS TAX BASE

There are two major reasons why New Mexico should consider re-casting the basis for its gross receipts tax. A tax designed as a tax on sales to final consumers (conventionally regarded as households and governments) may be a better bet for the future.

(1) The first reason is that **the current design may be unnecessarily costly to New Mexico businesses**. Its fundamental principle is straightforward: the tax attaches to the transaction in which the good or service leaves the stream of commerce. It is imposed on the seller for the privilege of engaging in business.

Businesses consume lots of tangible personal property and services. These goods and services "leave the stream of commerce" when sold to the using business. Therefore a lot of these transactions, particularly services, are subject to gross receipts. Exemptions and deductions screen out most inter-business transactions involving property but not those involving services, the most rapidly expanding sector. (Construction services are an exception.) One type of property, however, that is not protected is capital goods (machinery and equipment used to make other products). Few other states tax such property.

Let's take a moment to look at his idea more closely. New Mexico taxes inter-business services and capital goods. Both can be considered to be tools used by the purchasing business and the gross receipts tax applies to sale of tools. At least this is consistent. In the larger picture, however, this is a design flaw. The gross receipts tax is intended to apply to output of businesses, not to business inputs. Wages of employees are specifically exempted for this reason (payment to labor) as are payments of interest and dividends (payment to invested capital). Merchandise and services acquired for re-sale are also inputs and are deductible. But capital goods and inter-business services consumed by a business in the course of its activities are also inputs. Why the difference in treatment?

A typical sales tax imposes tax on sales to final consumers, generally households and governments. Capital goods usually are not taxed; they are not sales to final consumers. Further, since most states do not generally tax services, most do not tax inter-business services. Obviously since no tax scheme is pure, some business-to-business transactions will be taxed in other states too. The difference is a matter of degree, which can be substantial, as for example when professional fees are not taxed.

I believe the difference in design concept is important; New Mexico's gross receipts tax imposes a higher fiscal drag on its economy than the sales taxes imposed by other states do on their economies. At the level of the average business, it means that a New Mexico company pays more transaction taxes through its overhead and capital purchases than similar businesses in other states do. How significant this effect is probably varies by industry. New Mexico businesses in intensive price competition with outfits in other states are handicapped to a greater or lesser extent.

(2) A second reason is that big brother in **Washington, D.C., has discovered state sales taxes**. The federal government has begun its ponderous process of completing the integration of our national market. Complying with the wildly varying state general excise taxes really does impose extra administrative costs on companies operating in many or all states. Some observers (rightly or wrongly) believe this impedes America's ability to attract capital and jobs. The European Union and some other trade blocs are seen as offering more coordinated (and therefore less administratively burdensome) taxes. Washington now will pressure states both to align their excise taxes more closely with each other and to streamline tax reporting. And the carrot? The federal government will enact legislation to bring mail order and Internet sales within the orbit of state taxation. This is no trivial amount of bucks.

A working group of 33 states NOT including New Mexico) is exploring how to create a tax base that is standardized across states but still would allow each state freedom to choose the categories of items it desires to tax. Somewhat surprisingly, a good deal of progress has been made crafting a draft compact to breathe some life into the concepts. A copy of a few selected pages from the working draft[1] completed last month are attached to give you the direction this train is taking. A full copy is available at:

http://66.28.69.53/sline/Final%20SSTIS%20Agreement%2011-12-02.pdf

New Mexico's gross receipts tax differs in many ways from the sales or gross receipts taxes imposed by other states. New Mexico is a small state. If the other states were presented with a choice between getting to tax Internet and mail order sales versus preserving New Mexico's unique structure, which way do you think they (and their Congressional delegations) would go?

Are there features we ought to fight to preserve? Yes! The vendor should remain the person primarily responsible for reporting and paying in the tax. It makes no sense to do anything else. In addition, as other states have noted, imposing the tax on the vendor allows taxation of federal contractors. Nevertheless, this even so might be an uphill battle.[2] We should keep the broad base of consumer and professional services. Most other states envy New Mexico's extensive tax base. Besides, the services and knowledge-based sectors are where the economy is growing.

In summary, look to convert the gross receipts tax into more of a straightforward consumption tax by allowing exemptions or deductions for capital goods and for inter-business services.

Other gross receipts tax issues−in brief:

(a) The nontaxable transaction certificate system enforces the key deductions. It is overly rigid. Alternative proofs for these deductions ought to be permissible. What is lacking is an alternative way to penalize businesses for failing to register. (Easing the NTTC rules entails some work on the compensating tax as well.)

(b) Compensating tax is supposed to complement the gross receipts tax. It functions to prevent unfair, that is untaxed, competition from vendors outside New Mexico. It also enforces the nontaxable transaction certificates by requiring compensating tax to be paid when a buyer mis-uses an NTTC. Given that the compensating tax rate is a flat 5% but the gross receipts tax rate can be over 7%, equalization of in-state versus out-of-state tax burden is less than fully achieved. The rate difference also presents opportunities for tax gaming by the less scrupulous. The missing element is the local-option compensating tax. Other states have negotiated the federal constitutional issues and authorized local rates. New Mexico can too.

DECIDE BASIS OF CORPORATE INCOME TAX

New Mexico's corporate income tax has always been something of an unwelcome step-child. It is complex. Not only is it based on the complicated federal tax but there is a whole layer of rules and limitations at the state level that does not apply to federal taxation. Because of this, processing and database building has never been fully automated. Auditing is difficult, expensive and often quite litigious. Accounting firms and others market strategies to keep income out of higher-tax jurisdictions. On top of all that, New Mexico allows corporate groups to choose whether to report on a company-by-company basis or as one of two types of groups. This is as close to a truly voluntary tax as you could find among the major taxes.

On the other hand, even with its faults the tax pulls in revenue in the $100,000,000-plus range.

The inventors of New Mexico's modern tax system understood the argument that if the income of one group of legal persons−families and individuals−were to be subject to income taxation, then the income of the remaining "persons"−corporations−had to be taxed as well. Evidently they did not wholeheartedly embrace this precept. New Mexico's corporate income tax in its modern form has always allowed corporate groups to pick the tax reporting basis. This freedom was openly touted as an economic development incentive. It makes no tax policy sense. Few, if any, other states allow a New Mexico-style option.

Some commentators have asked whether states should stop trying to tax corporate income. After all, the tax accounts for only 5% on average of state revenue collections. Existing tax structures do not handle well the proliferation of pass-through entities. There is a huge legal and academic debate concerning nexus for "business activity tax" (the newest buzzword for corporate income and similar taxes) purposes. State economic developers look on the tax merely as a source of "incentives" to waggle in front of recruits. For instance the race away from the standard, equally-weighted 3-factor formula is driven solely by economic development motives.

If New Mexico believes that tax ought to play a real role in the state's fiscal future, then it needs to act to make the tax administrable. First and foremost, it should decide whether to tax corporate groups on either a company-by-company basis or a group basis. There are strong pros and cons to each approach.

Combined reporting conceptually establishes the best picture of the taxpayer corporation(s). If the decision is to pursue a mandatory combined reporting basis, then you must revisit the statutory definition of what that is. The existing language really isn't adequate. For fairness, you should also examine ways of including pass-through entities (such as limited liability companies and limited partnerships) that may be part of a business empire.

Whatever the decision on reporting basis is, care should be taken to stay within the framework of the Multistate Tax Compact because so many corporate groups are multi-state or trans-national. New Mexico does not and will not have the resources to get out of step.

Other corporate income tax issues−in brief:

(a) New Mexico and a few other states impose a progressive rate structure on corporate income. I'm not aware of any widely accepted theoretical justification for this. New Mexico went down this path only to recapture the large property tax cut that accrued to a handful of big companies under the 1981 "Big Mac" tax cut. That was twenty years ago. Further, a single flat rate also removes the incentive to fracture a business into numerous component corporations simply to lower the effective tax rate─or, in some cases, to resist combination. A single rate also means that you get the same tax answer whether you apportion income or tax.

(b) The Uniform Division of Income for Tax Purposes Act (UDITPA) sets out the apportionment and allocation rules for both personal and corporate income tax reporting. Although some of these rules have been tweaked since they were initially adopted in the 1960s, some additional revision could be beneficial. Most especially the rules on siting income from intangibles do not favor market states like New Mexico.

GET MORE FROM THE PROPERTY TAX

There are three general types of tax base: consumption, income and wealth. New Mexico relies far more heavily on its consumption taxes (gross receipts taxes and special excise taxes on tobacco, alcohol, gaming, fuels, etc.) and far less on wealth taxes (property and severance) than the typical state. (New Mexico's mix is less extreme when severance taxes are counted as taxes on wealth.) Clearly this is grounded on strongly-held convictions of the voting populace. Nonetheless, if the Legislature wanted to re-shape the overall system so that it looked more like that of the typical state, how could it do so?

Only two major taxes are mentioned in the state constitution: property tax and severance tax.

As to the severance tax, neither the base nor the rates are limited. Only the disposition of the revenue is controlled. Yet the revenue that can be squeezed from this source is limited to the extractive industries, whose fortunes are controlled by international markets. New Mexico is very much a price-taker in highly competitive markets both for the products themselves and for the capital to exploit these resources. Accordingly New Mexico must present a competitive tax structure if it wants to stay in the game. There is not much freedom for maneuver here. Perhaps the most important consideration is that the resource base is depleting; it might be too thin a reed to rely on in the long-term.

The state constitution abounds with provisions controlling the property tax, the general tax on wealth. Rules are laid down on the tax base, assessment practices to some extent, the rates[3] and which jurisdictions may impose them. These numerous provisions reflect a popular uneasiness with this revenue. It is the only tax in which failure to pay can directly entail the loss of one's home.

It is unlikely that any constitutional amendment would be adopted removing any of the more significant controls on the property tax. Hence any increased reliance will have to be within the existing framework.

One way this could be done is to reserve the state severance tax revenues primarily to address water and education capital needs and to fund other state projects such as state highways and state office buildings. That part of the severance tax revenue now consumed by what are essentially local projects could be funded through the property tax instead−if the local folks really wanted them. Whether or how to do this is not entirely a tax question. This process very much implicates the degree of control the state wishes to exercise over its local governments.

Another might be to look at Sections 7-36-22 through 7-36-33 NMSA 1978. These set out "special methods" of valuation for commercial and industrial properties. They were enacted in the mid-70s. The affected industries, particularly telecommunications, have changed since then. Perhaps these methods ought to be studied to see how closely they come to generating appraisal values close to market value.

Another property tax issue− in brief

Property tax, to be well-administered, demands more professional skills and judgment than the other major taxes. Yet the current system for selecting those administrators prohibits use of professional standards in the selection process. Further, the financial resources of the several counties frequently are not of a level commensurate with attracting and holding the needed talent. The administrative system should be re-thought.

UPDATE TAX ADMINISTRATION

Tax administration consists of two primary pieces: procedural rules embedded in statute and the actual practice of the tax agency. A lot of work could be done in both areas. The general idea is to make Taxation and Revenue Department easier to deal with. A review of the administrative provisions and practices of other states and of the federal government should turn up a number of ideas for emulation–ideas that have been tested.

The first objective is to restore focus to the Department. Its motor vehicle functions ought to stripped off and placed elsewhere.[4] More specific suggestions follow.

(1) **The law**: Administrative provisions are set out in the Property Tax Code and in the Tax Administration Act, which covers all taxes administered by the Department except property tax. Because property tax is so different from the other taxes, there should be no attempt to combine the Code's administrative provisions with those of the Tax Administrative Act. Where the two laws are parallel, however, it may help taxpayers to have similar provisions. For example, is there any reason to have different interest rates?

The Tax Administration Act was enacted originally in 1965. Some part of it has been amended virtually every year since then. From the beginning, it laid down rules requiring fair treatment of taxpayers. Examples: taxpayers have a choice of pre-deprivation and post-deprivation remedies, including hearings; interest rates paid by the state equal the interest rates charged the taxpayer. All of this occurred decades before the first federal taxpayer bill of rights legislation. Notions of fairness, however, evolve.

In more recent times, the Department's hearing officers have been made semi-independent of the Secretary, refund periods have been more closely aligned with permissible audit periods, interest is to be calculated on a daily (instead of monthly) basis and managed audits have been permitted. That is all very nice but more needs to be done.

There is a perception abroad that the deck is stacked in favor of the state. The perception proceeds from the fact that the deck *is* stacked in favor of the state. It would be silly of any government not to. Further, both the basic structure of the current statutory scheme and Taxation and Revenue Department's internal ethos derive from the sad experience of the 1960's. The tax agency at the time, the Bureau of Revenue, was dysfunctional; tax cheating by the public was widespread. The Legislature commissioned Franklin Jones to clean all this up and he did. Part of his technique was to instill in his employees a strong sense of mission and righteousness about the tax system. Although no longer missionary in intensity, those traits still inform the Taxation and Revenue Department's conception of its duties. The external world has changed quite a bit over the years (not a little due to the Department's rigorous enforcement) but the Department seems not to have noticed. Most taxpayers do try to comply but not infrequently get tripped up by some of the tax systems's intricacies. Considerations of fair play and our democratic traditions suggest that it is time to lax up a bit. I mention only a few areas.

Taxpayers and most especially their advocates will never believe the protest resolution process is completely above-board until the hearing officers are in fact independent of the Secretary. Perhaps the most direct and least expensive route is to establish a tax court to which unresolved tax disputes are referred. Two or three judges would be required initially. Expertise in state taxes would have to be required as a qualification for these positions. Certainly other approaches should be looked into. For example, mediation channels could be established.

There needs to be formal finality to the refund-claiming process. Right now it is possible for claims to go off into limbo unless the taxpayer is paying close attention. Section 7-1-26 NMSA 1978 should simply declare that at some definite time any unresolved part of a protest is deemed denied and the taxpayer must be notified of the denial. Perhaps the law could also deem the denial to have been protested. This would save taxpayers time and anguish and simplify the statute. The Department might assert that such provisions might wind up swamping its protest resolution unit but this truly is a management problem.

One taxpayer complaint that has echoed through the years is the length of time the Department takes to arrive at an assessment or to resolve one. Not only is this frustrating in itself but it costs the taxpayer money because interest is running. In addition to whatever can be done to speeding the process, consider allowing interest to be abated (with the Attorney General's approval?) for any periods resulting from unreasonable delay by the Department.

No one should take the position that, whatever the issues between taxpayers and the Department, that it is always the Department's fault. Nothing could be further from the truth. You wouldn't need an audit function if all taxpayers were completely honest and knowledgeable about taxes. The Tax Administration Act imposes civil and criminal penalties to minimize bad conduct. They are essentially the same as they were back in the 1960s. Since then the federal government and other states have fashioned penalties that hone in on specific forms of taxpayer misbehavior. These more focused penalties seem to be much more effective tools that the general, and in some instances, weak penalties now on the books.

(2) **The Practice**: Today tax administration boils down to the proper management of massive amounts of data in relatively short time periods. Taxes cannot be collected without heavy reliance on computer programming. As the Legislature is well aware, just keeping up is expensive. The Legislature must satisfy itself that the Department comes out of its most recent bout of programming revision in decent shape. Make sure the Department keeps making reasonable progress on integrating the Internet and other electronic technologies into its reporting and processing.

As a way of creating tools to gauge the merits of complaints about f the Department's allegedly slow pace, the Legislature and Department might agree on a set of reports that measured time consumed by certain processes, like protest resolution, audit completion, resolution of unidentified receipts, issuance of rulings, etc.

It would be ideal if the Department could establish a liaison with taxpayers and taxpayer advocates on a regular basis to identify and get to the bottom of issues. The Department has made efforts from time to time. For example it maintains presently a loose but cordial relationship with the New Mexico Society of Certified Public Accountants. These contacts often serve as an early warning bell of potentially systematic processing concerns, particularly with income taxes. What would be more valuable through time, however, is a sounding board–for both the Department and the Legislature–that can look at the tax system and its issues on a more holistic and continuing basis. Relying on the relatively small group of practitioners (including lobbyists and former Department officers) to fulfill this function, while certainly cost-effective, won't get the job done in the long run. The lack of an outside resource also may handicap the Department in moving forward in the more esoteric technical areas.

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[1] The vote on the draft was 32 - 0, with one abstention. Since then, four more states have joined the effort. By conventional measurement, 45 states plus the District of Columbia impose general excise taxes. So the boxscore is 37 states participate, 5 others (including New York and California) participate as observers and only 3 (Colorado, New Mexico and Hawaii) do not participate.

[2] In most states the ultimate taxpayer is the same. For in-state transactions, the business is interposed as an intermediary to collect the tax on behalf of the state but the consumer bears the ultimate responsibility. Hence imposing use tax directly on the consumer (with respect to purchases from out-of-state merchants and other situations) simply moves only the reporting and payment function to the consumer.

[3] In the early 1930's the Legislature enacted the 20-mill limit as a trade for permission to levy a general excise tax.

[4] One way to accomplish this with minimal disruption is to make Motor Vehicle Division (together with, perhaps, some units from the Secretary's Staff and elsewhere) an administratively attached agency.