F I S C A L   I M P A C T   R E P O R T

		ORIGINAL DATE	2/3/06		
SPONSOR	Silva	**LAST UPDATED**	2/10/06	**HB**	501/aHBIC
SHORT TITLE	BUSINESS-RELATED SERVICE GROSS RECEIPTS			**SB**	
				ANALYST	Schardin

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY06	**FY07**	**FY08**		
	($9,600.0)	($10,080.0)	Recurring	General Fund
	($19.0)	($19.0)	Recurring	Small Cities Assistance Fund
	($19.0)	($19.0)	Recurring	Small Counties Assistance Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

Relates to SB334.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY06	FY07	FY08	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total		$200.0		$200.0	Non-Recurring	General Fund
		$200.0	$200.0	$400.0	Recurring	General Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Economic Development Department (EDD)

SUMMARY

Synopsis of HBIC Amendment

The House Business and Industry Committee amendment to House Bill 501 increases from $300 thousand to $1 million the limit on total annual receipts a company will be able to have and still be eligible for the credit.

The amendment also adds "research and development services" to the list of services that do not qualify for the credit.

Synopsis of Original Bill

House Bill 501 creates the business services tax credit. The credit may be claimed against the state gross receipts tax or compensating tax. A credit that exceeds a taxpayer's tax liability may be carried forward for up to three years.

The credit on "qualified expenditures" will be equal to 3.775 percent of gross receipts in municipalities and 5 percent in unincorporated areas of New Mexico counties. In other words, "qualified expenditures" will receive a 100 percent credit against the state share of gross receipts tax.

"Qualified expenditures" are defined as the amount paid by the taxpayer for business services eligible for a federal income tax deduction pursuant to Section 162 of the Internal Revenue Code, which pertains to trade or business expenses (see Significant Issues for a description of what expenditures are deductible under Section 162). However, qualified expenditures do not include services for linen supply, entertainment or recreation, intrastate telephone and telegraph, janitorial, landscaping, repair and maintenance, sewer and solid waste disposal, or services whose price is eligible for any other New Mexico tax credit.

Taxpayers eligible for the business services tax credit include anyone liable for payment of any tax or anyone who owes a tax. The business will also be required to have total receipts of less than $300 thousand per year to qualify for the credit. Governmental entities, nonprofit facilities and other entities that are exempt from the gross receipts tax such as retirement homes and insurance companies are not eligible to receive the credit.

The effective date of these provisions is July 1, 2006 (see technical issues).

FISCAL IMPLICATIONS

Based on analysis of "Report 80-Analysis of Gross Receipts Tax by Industrial Classification" and Implan input-output data of the New Mexico economy, TRD estimates that business to business services for companies with total receipts under $1 million per year will total $275 million in FY07. Assuming a statewide average tax rate of 3.9 percent, expenditures qualifying for these credits will total $10.7 million per year. TRD's analysis assumes that about 90 percent of eligible credits will be claimed, bringing the fiscal impact to $9.6 million in FY07.

Because the bill can be claimed against the compensating tax, of which 20 percent is distributed to the small cities and counties assistance funds, revenues to each of these funds will be reduced by about $19 thousand per year.

Because the credit applies only to the state share of gross receipts tax liability, the bill does not impact local governments.

SIGNIFICANT ISSUES

House Bill 501, as amended, attempts to reduce the tax burden on businesses caused by pyramiding, which results when transactional taxes such as New Mexico's gross receipts and compensating taxes are charged on the sale of business services from one business to another. As services are sold from one business to another in the course of production, the tax is levied multiple times and results in higher business costs and final product prices.

Pyramiding is a somewhat unique tax dilemma in New Mexico because the gross receipts tax is a fundamentally different structure than the sales tax used by most other states. While sales taxes are imposed on the <u>buyer</u> of consumer goods, the gross receipts tax is imposed on the <u>seller</u> of goods and services, whether that product is a finished good or an input used by another business.

Pyramiding affects some facets of New Mexico's business community more than others. First, businesses that compete with other businesses outside of New Mexico may experience a competitive disadvantage because their competitors don't pay multiple taxes on their inputs. Second, small businesses that contract with other businesses may experience a competitive disadvantage relative to larger firms. To exemplify this point, consider a small New Mexico firm that outsources its payroll function to another New Mexico firm. While this small business would pay gross receipts tax on its payroll services, a larger firm with its own payroll division would not pay gross receipts tax. By targeting the business services tax credit to businesses with gross receipts under $1 million, House Bill 501 targets tax relief to small businesses most in need of relief from pyramiding. However, by increasing this limit from $300 thousand to $1 million, the House Business and Industry Committee amendment reduces how targeted the tax relief is.

The business services tax credit would be available for business expenditures that are deductible when calculating net income according to Section 162 of the Internal Revenue Code (IRC). This Section of the IRC states that all ordinary and necessary expenses paid or incurred in the course of business may be deducted, including a reasonable allowance for salaries and compensation, travel expenses, rentals or other payments used for business, and capital contributions to the Federal National Mortgage Association. Some items that will not be eligible for the business services tax credit, pursuant to Section 162 of the IRC, are charitable contributions, illegal bribes and kickbacks, lobbying and political expenditures, application and dues of tax-exempt organizations, fines or penalties, damage payments under antitrust laws, foreign advertising, stock reacquisition expenses, and group health plan payments.

ADMINISTRATIVE IMPLICATIONS

TRD reports that House Bill 501 would require major changes to the Combined Revenue System (CRS) through which approximately $3.5 billion of state and local revenues are processed annually. Because an estimated 95 thousand firms will be affected by the amended bill, credits could not be processed manually like other existing credits. Automated credit processing will require form revisions return processing changes. These administrative changes would be costly and cause slower revenue processing. TRD estimates nonrecurring system changes would cost about $200 thousand. TRD cautions that these changes could not be completed by House Bill 501's July 1, 2006 effective date.

In addition, about four additional FTE would be required for the additional workload imposed on TRD's revenue processing division. The salaries, benefits, and other recurring costs associated with these four FTE are estimated to cost $200 thousand.

Automated processing would also mean that the only enforcement tools available to ensure compliance would be audits. Audit frequency is limited, so inaccuracies and non-compliance will be more common than in other tax credits.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

House Bill 501 relates to Senate Bill 334, which provides a gross receipts tax credit for the same business services, but does not limit the credit to businesses with gross receipts under $300 thousand per year. An additional difference is that Senate Bill 334 allows the credit to be taken against an employer's withholding payments on behalf of employees, in addition to gross receipts and compensating tax liability.

TECHNICAL ISSUES

TRD claims that major administrative changes necessary to implement the provisions of this bill could not be accomplished by July 1, 2006. TRD recommends changing the effective date of the bill to July 1, 2007.

On page 3, line 6, TRD recommends deleting the word "taxes" to conform to the intent of the bill.

TRD also notes that the broad reach of the proposal warrants authorizing TRD to promulgate rules and regulations to implement the new credit.

OTHER SUBSTANTIVE ISSUES

New Mexico's state and local governments are heavily dependent on the gross receipts tax as a large and stable revenue source. In FY06, general fund gross receipts tax revenues are expected to total $1,595 million, or roughly 30 percent of revenue. Tax changes that narrow the gross receipts tax base should be expected to increase revenue volatility.

ALTERNATIVES

TRD notes that the business services tax credit is designed to provide partial relief from pyramiding to the buyer of taxable services. This is a major departure from the traditional design of New Mexico's gross receipts tax, which is imposed on the seller. The proposal assumes that sellers pass the entire burden of the gross receipts tax on to the buyer of their services. In reality, the incidence of the gross receipts tax falls partially on sellers and partially on buyers. Therefore, the proposal is not clearly targeted at those businesses that are most burdened by pyramiding. A more effective way to target pyramiding tax relief would be to provide a deduction for the sale of a service.

SS/mt:yr