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

SPONSOR Snyder **ORIGINAL DATE** 1/27/06 **LAST UPDATED** **HB**

SHORT TITLE Business Services Tax Credit Act **SB** 334

ANALYST Schardin

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY06	FY07	FY08		
	(16,000.0)	(33,600.0)	Recurring	General Fund
	(30.0)	(80.0)	Recurring	Small Cities and Counties Assistance Funds

(Parenthesis ( ) Indicate Expenditure Decreases)

Relates to HB501.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

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

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 334 creates the business services tax credit to be in effect from FY07 to FY11. After FY11, the credit will sunset. The credit may be claimed against the state gross receipts tax, compensating tax, or withholding tax. A credit that exceeds a taxpayer's tax liability may be carried forward for up to three years.

For most businesses, the credit is equal to 0.5 percent of "qualified expenditures" in FY07, 1.0 percent in FY08, 1.5 percent in FY09, 2.0 percent in FY10, and 2.5 percent in FY11. However, for for-profit hospitals that receive a 50 percent deduction from gross receipts under Section 7-9-73.1, the credit is half as large: 0.25 percent of "qualified expenditures" in FY07, 0.5 percent in FY08, 0.75 percent in FY09, 1.0 percent in FY10, and 1.25 percent in FY11.

"Qualified expenditures" are defined as the amount paid by the taxpayer for 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 Section 162 does and does not allow to be deducted). 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, anyone responsible for withholding a payment for collection of any tax, or anyone who owes a tax. However, 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 eligible for the business services tax credit will total $3.2 billion in FY07. Assuming a tax credit of 0.5 percent, the fiscal impact is about $16 million ($3.2 billion X 0.005). The tax base for this credit is estimated to grow by 5 percent each year, leading to the following general fund revenue reductions: -$33.6 million in FY08 ($3.2 billion X $1.05 X 0.01), -$52.9 million in FY09, -$74.1 million in FY10, and -$97.2 million in FY11.

Fiscal Impact of Business Services Tax Credit (Dollars in Thousands)

	FY07	FY08	FY09	FY10	FY11	FY12
Tax Base	3,200,000	3,360,000	3,528,000	3,704,400	3,889,620	4,084,101
Credit	0.50%	1.00%	1.50%	2.00%	2.50%	0.00%
Impact	(16,000)	(33,600)	(52,920)	(74,088)	(97,241)	-

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 these funds will be reduced by about $30 thousand in FY07, $80 thousand in FY08, $120 thousand in FY09, $160 thousand in FY10, and $200 thousand in FY11.

As drafted, the credit expires after FY11, so in FY12 and beyond there will be no fiscal impact.

SIGNIFICANT ISSUES

Senate Bill 334 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.

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 Senate Bill 334 would require major changes to the Combined Revenue System (CRS) through which approximately $3.5 billion of state and local revenues are processed annually. Due to the large number of taxpayers affected by the 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 Senate Bill 334'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

Senate Bill 334 is related to House Bill 501, which would provide a gross receipts tax credit for the same business services, but only to businesses with total receipts of less than $300 thousand in the previous year.

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.

OTHER SUBSTANTIVE ISSUES

The bill would allow employers to claim the business services tax credit against the withholding tax they are required to pay on behalf of their employees. Withholding tax is not part of gross receipts or compensating tax, but rather is a mechanism by which personal income tax is collected from workers. Therefore, the business services tax credit would allow an employer to take a credit against a tax that is the liability of his or her employees. House Bill 501, which is similar to Senate Bill 334, does not allow its credit to be taken against withholding payements.

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 <u>buyer</u> 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.

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