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

SPONSOR Silva **ORIGINAL DATE** 2/1/07 **LAST UPDATED** **HB** 396

SHORT TITLE Business-Related Service Gross Receipts **SB**

ANALYST Schardin

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY07	FY08	FY09		
	($3,815.1)	($4,005.9)	Recurring	General Fund
	($7.7)	($8.1)	Recurring	Small Cities Assistance Fund
	($7.7)	($8.1)	Recurring	Small Counties Assistance Fund

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY07	FY08	FY09	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total		200.0		200.0	Nonrecurring	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)

SUMMARY

Synopsis of Bill

House Bill 396 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. However, local option taxes of about 1 percent will still be charged on qualified expenditures.

"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, construction, research and development, sewer and solid waste disposal, or services of which price is the basis 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 bill states that the gross receipts of a group of entities under common control will be aggregated to determine the size of the credit.

The effective date of these provisions is July 1, 2007 (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 $300 thousand per year that are eligible for the new credit created in this bill will total $112 million in FY08. Assuming a statewide average tax rate of 3.8 percent and 90% utilization of the credit, expenditures qualifying for these credits will total $3,830.4 thousand per year.

TRD estimates that 98 percent of the credits, about $3,724.0 thousand, will be claimed against the state portion of gross receipts tax. The remaining 2 percent of the credits, or $76 thousand in FY08, will be claimed against the compensating tax. Eighty percent of the compensating tax loss ($60.8 thousand) will accrue to the general fund, while the remaining 20 percent loss will accrue evenly to the small cities and small counties assistance funds ($7.7 thousand each). Fiscal impacts of the provision are expected to grow by 5 percent each year.

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

SIGNIFICANT ISSUES

The bill 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 imposed by most other states. While sales taxes are imposed on the buyer of consumer goods, the gross receipts tax is imposed on the seller 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 and therefore have lower costs of production.

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 out-sources 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 $300 thousand, the bill targets tax relief to small businesses most in need of relief from pyramiding.

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.

LFC notes that while individual credits from the gross receipts tax may have small fiscal impacts, their cumulative effect significantly narrows the gross receipts tax base. Narrowing the gross receipts tax base increases revenue volatility and requires a higher tax rate to generate the same amount of revenue.

ADMINISTRATIVE IMPLICATIONS

TRD reports that the bill would require major changes to the Combined Revenue System (CRS). Because an estimated 84 thousand firms will be affected by the bill, credits could not be processed manually like other existing credits. Automated credit processing will require form revisions and return processing changes. These administrative changes would be costly and

cause slower revenue processing. TRD estimates these nonrecurring system changes would cost about $200 thousand. TRD cautions that these changes could not be completed by the bill's July 1, 2007 effective date, but could be completed by January 1, 2008.

In addition, about four additional permanent FTE would be required to accomplish 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.

TECHNICAL ISSUES

TRD claims that major administrative changes necessary to implement the provisions of this bill could not be accomplished by July 1, 2007. TRD recommends changing the effective date of the bill to January 1, 2008.

On page 3, line 6, consider deleting the word "taxes" to conform to the intent of the bill, which is for the gross receipts, not the gross receipts taxes, of entities to be aggregated for calculation of the credit.

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

SS/nt