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

SPONSOR Garcia, M.P. **ORIGINAL DATE** 02/10/10 **LAST UPDATED** **HB** 215

SHORT TITLE Tax Rate Changes & Combined Reporting **SB**

ANALYST Clifford

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY10	FY11	FY12		
$11,700.0	$186,500.0	$176,400.0	Recurring	General Fund (Personal Income Tax)
NFI	$5,700.0	$ 32,200.0	Recurring	General Fund (Corporate Income Tax)

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

House Bill 215 makes the following changes in the personal income tax:

- Repeals the itemized deduction for state and local taxes;
- Adds three tax brackets, with the top rate increased from 4.9% to 6.9%;
- The capital gains deduction is limited for taxpayers with taxable income greater than $200,000 to not exceed $1,000; and
- A temporary provision removes the tax due as a result of the income tax rate changes from the computation of estimated payment penalty.

House Bill 215 also requires a unitary corporation to file a combined return for corporate income tax purposes. The option to file on a federal consolidated basis is repealed.

The itemized deduction and income tax rate changes apply to taxable years beginning on or after January 1, 2010. The capital gains and corporate income tax changes apply to tax years beginning on or after January 1. 2011.

FISCAL IMPLICATIONS

TRD:

Revenue impact for changes to the Income Tax Act uses federal income tax return data for 2007 to estimate, by income class, state and local tax deductions as a percent of total itemized deductions and state and local tax refunds claimed as income as a percent of adjusted gross income (AGI). A simulation model based on 2007 New Mexico income tax returns (the most recent year for which complete tax return data is available) was then used to estimate each tax liability at 2007 income levels under the law in effect in each calendar year, 2010 through 2014. For purposes of the simulation, itemized deductions were reduced by state and local tax deductions (adjusted pro rata for the federal limitation on itemized deductions, beginning in 2011), and AGI was reduced by state and local tax refunds as a percent of AGI (beginning in 2011). (See Technical Issues for changes that are assumed to have been made in the bill for purposes of the estimate.) Personal income growth factors were used to increase the liability estimates to the relevant year's income levels. In general, tax year liability changes were converted to fiscal year revenue estimates by applying historical payment patterns to tax year liabilities. However, it was assumed that in tax year 2010 the only adjustment made by taxpayers would be an adjustment to estimated payments.

The estimate for mandatory combined reporting assumes that it would initially increase corporate income tax revenues before credits by 10%. The overall effect of mandatory combined reporting on revenues is assumed to decline fairly rapidly over time, to zero after four years, as corporations adjusted their operations to avoid the impact of the change. This assumed decline in revenues is consistent with recent econometric research using multiple years of data across states, which indicates that mandatory combined reporting has no effect on state corporate income tax revenues. Revenues in FY 2012 reflect collection of most revenue from 2011 liabilities, as well as two estimated payments on 2012 liabilities.

SIGNIFICANT ISSUES

TRD notes:

Top tax rates for single filers in surrounding states are provided in the table below. Of the 44 states with a personal income tax, New Mexico's top tax rate ranks 37th highest. The bill would cause New Mexico's top tax rate to be higher than that of all surrounding states and to rank 18th among states with a personal income tax.

Top Tax Rates for Single Filers in Surrounding States

State	Top Tax Rate
Arizona	4.54%
Colorado	4.63%
New Mexico	4.90%
Oklahoma	5.50%
Texas	n/a
Utah	5.00%

TRD provided the following table showing impacts by income.

Distribution of Change in Tax Year 2011 Tax Liability
(2007 Income Levels)

Adjusted Gross Income	Number of Affected Returns	Change in Tax Liability		
		Total ($000)	Average	Percent Distribution
Under 50,000	33,059	1,527	46	2.7%
50,000 - 75,000	72,033	4,292	60	7.5%
75,000 - 100,000	57,302	4,475	78	7.8%
100,000 - 200,000	63,678	7,712	121	13.5%
200,000 - 500,000	72,791	17,899	246	31.3%
500,000 or more	20,518	21,244	1,035	37.2%
Total	319,381	57,150	179	100.0%

TRD notes:

All other Western states with a corporate income tax currently mandate combined reporting, under which controlled groups of "unitary" (interdependent) U.S.-based corporations must file a single return that eliminates all inter-company transactions. Texas recently adopted mandatory combined reporting for their tax. The Blue Ribbon Tax Commission endorsed the concept of mandatory combined reporting in 2003.

Eastern states have not generally adopted combined reporting, although in response to some well publicized "tax planning" techniques, a number of these states have recently adopted "add-back" or "antipassive investment company" legislation. These laws require taxpayers to disallow the amounts of royalty and interest amounts paid to "intangible holding companies" based in low-tax states like Delaware. The discretionary powers necessary to properly implement both the "add-back" provisions and the "forced combination" techniques have generated significant litigation. Massachusetts, New York and West Virginia recently enacted mandatory combined filing, and other Eastern states are considering it in response to budget shortfalls.

See the chart on the following page for the states that currently mandate combined reporting.
The consolidated filing method reduces tax compliance costs for electing corporations, reduces administrative cost for TRD, and allows corporations and TRD to rely on the results of IRS audits to determine the effect of audit adjustments on NM corporate income tax liabilities. These benefits would be lost under the bill, which repeals the option of filing a consolidated return.

TECHNICAL ISSUES

TRD notes:

The bill should stipulate that the limitation on itemized deductions, which is restored under current federal law in 2011 (Section 68 of the Internal Revenue Code), would be applied pro rata to state and local taxes in determining the amount of the deduction disallowed for New Mexico income tax purposes.

The bill should also stipulate that state and local tax refunds for taxes deducted covering tax years prior to 2010 that are reported as income for federal income tax purposes are to be excluded from adjusted gross income for New Mexico income tax purposes.

Although the bill does contain a provision that will hold taxpayers harmless for underpayment of estimated taxes, taxpayers will be under-withheld for the first five months of the year.

Page 2, line 10: “$9,996” should be changed to $12,646. Page 2, line 12: “$24,996” should be changed to $27,646. Page 13, line 10: “taxable income” should be changed to “adjusted gross income”. (These corrections were assumed for purposes of the estimating the revenue impact.)

TC/mew