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

**SPONSOR** Wirth **ORIGINAL DATE** 01/28/11 **LAST UPDATED** ______ **HB** ______

**SHORT TITLE** Net Taxable Income Determination Changes **SB** 7

**ANALYST** Golebiewski

## REVENUE (dollars in thousands)

| Estimated Revenue | | | Recurring or Non-Rec | Fund Affected |
|---|---|---|---|---|
| **FY11** | **FY12** | **FY13** | | |
| | $0.0-$2,800.0 | $8,500.0-$17,250.0 | Recurring | General Fund |

(Parenthesis ( ) Indicate Revenue Decreases)

## ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

| | FY11 | FY12 | FY13 | 3 Year Total Cost | Recurring or Non-Rec | Fund Affected |
|---|---|---|---|---|---|---|
| **Total** | | ($75.0) | ($75.0) | ($150.0) | Recurring | Taxation and Revenue Department |

(Parenthesis ( ) Indicate Expenditure Decreases)

## SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department

## SUMMARY

Synopsis of Bill

Senate Bill 7 would require corporate income taxpayers to addback to their taxable income otherwise deductible expenses paid to related companies for the use of intangibles like trademarks, patents, etc. Intangible expense addback would not apply (a) To expenses undertaken for a valid business purpose and which are subsequently paid to an unrelated company; (b) If the recipient of the spending is subject to equivalent tax on the receipts in another state; (c) If the recipient is subject to equivalent tax on the receipts in a country with a tax treaty with the U.S.; or (d) The taxpayer and the Taxation Department agree on an alternative method of calculating taxable income. The bill would also require addback otherwise deductible

interest costs paid to a related company. Interest expense addback would not apply (a) If the expenses were undertaken for a valid business purpose and reflect terms of an arm's length relationship. (b) If the recipient of the spending is subject to equivalent tax on the receipts in another state; (c) If the recipient is subject to equivalent tax on the receipts in a country with a tax treaty with the U.S., the transaction was undertaken for a valid business purpose and was conducted under arm's length terms; or (d) The taxpayer and the Taxation Department agree on an alternative method of calculating taxable income.

Provisions are effective January 1, 2012.

## FISCAL IMPLICATIONS

TRD reports:

> This estimate is highly uncertain because data is not available to the Taxation and Revenue Department pertaining to the amounts that would be added back to taxable income by taxpayers affected by the proposed legislation. The estimate assumes increases in corporate income tax revenues will total from 2.5% to 5% of total corporate income tax revenues before credits. This estimate is based on 50% of the revenue increase the state would receive New Mexico enacted a statute mandating combined reporting.

## SIGNIFICANT ISSUES

The proposal presents a trade-off between the tax policy goals of equity and efficiency. The equity goal would be advanced because the proposal could prevent tax avoidance by certain taxpayers. The efficiency goal could be impaired if the proposal denies deductions for expenses that have legitimate business purposes. The potential problem is identified in the following commentary from a popular law textbook, State Taxation by Jerome R. Hellerstein and Walter Hellerstein, 3rd Edition.

> "Although the impetus behind the expense disallowance statutes was usually the desire to eliminate trademark and similar royalty expense deductions paid by taxpayers in separate-company-reporting states to out-of-state affiliates located in jurisdictions where the payment would have no unfavorable tax consequences, most states' provisions disallow many additional types of expense deductions. Some of these disallowances, which extend to common business transactions, arguably go beyond the "loophole-closing" intent of these measures."

The Hellersteins go on to point out the following issues among others that arise with interest expense addback provisions:

- The provisions are subject to a variety of interpretations and create considerable uncertainty as to their overall scope.
- Although several states have acknowledged that that intercompany financing does not always result in an expense disallowance, in practice, intercompany financing does not fit neatly into categories of taxable and non-taxable.
- Since many instances of intercompany financing have both a legitimate business purpose and generate tax benefits, it is impossible to predict whether the expense will be disallowed.

One particular source of concern with the proposed statute is that the disallowance of intangible

expenses does not permit a general exception for transactions with a valid business purpose. The "valid business purpose" exception in the bill applies only if the related party itself incurs an equivalent expense with an unrelated party. This provision seems likely to result in disallowance of many transactions that are not primarily motivated by tax avoidance.

TRD:

> Determining which transactions are allowed or disallowed will likely result in litigation between the Department and taxpayers, increasing the administrative burden of what is already the most burdensome tax program…
>
> Representatives of the Council on State Taxation (COST),[1] a non-profit trade organization based in Washington D.C. have been critical of legislation similar to SB-7 for several reasons. First, because statutes similar to the proposed measure tend to be excessively broad and affect transactions that have nothing to do with improper sheltering or income shifting. They expressed particular concern about the disallowance of interest expenses because related party lending is a very common transaction and is usually not engaged in for tax avoidance purposes. Expense-add-back statutes adopted by states tend to vary widely, and are often interpreted differently, which tends to create uncertainty and compliance costs for multi-state corporations.

## ADMINISTRATIVE IMPLICATIONS

TRD notes:

New regulations, information and outreach for taxpayers, audit procedures, and training of auditors would be required to implement and enforce provisions of the proposed bill. The Department and taxpayers will have to go through a prolonged period of determining what transactions are affected by the proposal. The administrative cost estimate is based on one additional auditor for the corporate income tax.

## CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

The proposal could be thought of as an alternative to the bills like SB 6 that would require corporate income taxpayers to file on a unitary combined basis.

## TECHNICAL ISSUES

The phrase "adjustment required by this subsection" on, for example line 6 of page 12 should be changed to refer more specifically to the deduction requirements of the other sections of the statute.

JAG/bym

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[1] http://www.csg.org/.

***The Legislative Finance Committee has adopted the following principles to guide responsible and effective tax policy decisions:***

1. ***Adequacy:*** *revenue should be adequate to fund government services.*
2. ***Efficiency:*** *tax base should be as broad as possible to minimize rates and the structure should minimize economic distortion and avoid excessive reliance on any single tax.*
3. ***Equity****: taxes should be fairly applied across similarly situated taxpayers and across taxpayers with different income levels.*
4. ***Simplicity****: taxes should be as simple as possible to encourage compliance and minimize administrative and audit costs.*
5. ***Accountability/Transparency:*** *Deductions, credits and exemptions should be easy to monitor and evaluate and be subject to periodic review.*

***More information about the LFC tax policy principles will soon be available on the LFC website at www.nmlegis.gov/lcs/lfc***