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

SPONSOR SCORC

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HB

SHORT TITLE Public Peace, Health, Safety & Welfare

SB 639/SCORCS

ANALYST van Moorsel

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY13	**FY14**	**FY15**	**FY16**	**FY17**		
$22,500.0	($35,604.0)	($48,582.0)	($90,105.0)	($90,671.0)	Recurring	General Fund
$7,500.0	$1,994.0	$11,415.0	$7,450.0	$17,154.0	Recurring	Local Governments
		$15.0	$47.0	$93.0	Recurring	Small Counties Assistance Fund
		$15.0	$70.0	$140.0	Recurring	Small Cities Assistance Fund
		$5.0	$23.0	$47.0	Recurring	Municipal Equivalent
$30,000.0	**($33,610.0)**	**($37,137.0)**	**($82,514.0)**	**($73,236.0)**	**Recurring**	**Total**

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

The Senate Corporations and Transportation Committee substitute for Senate Bill 639 (SB 639) amends several provisions of the Tax Code to change several tax programs. The bill amends the Corporate Income and Franchise Tax Act to lower the corporate income tax (CIT) rate, require combined reporting for certain corporations, phase in the use of an optional single sales factor, and exclude certain sales from being apportioned as sales in New Mexico. The bill amends the provisions governing the high-wage jobs tax credit (HWJTC) to tighten a host of high wage tax credit definitions and to cap the HWJTC at $50 million per year. Finally, SB 639 restricts the phase-in of the GRT deduction for tangible personal property consumed in the manufacturing

process at 50 percent, beginning January 1, 2015.
Section 1 of the bill amends the Corporate Income and Franchise Tax Act to reduce the CIT rate structure as shown in the table below.

Net Income	Current Law	SCORC/SB639
Less Than $500 thousand	4.8%	4.2%
Between $500 thousand and $1 million	$24,000 plus 6.4% of excess over $500k	$21,000 plus 5.8% of excess over $500k
Greater than $1 million	$56,000 plus 7.6% of excess over $1m	$50,000 plus 6.6% of excess over $1m

Section 2 of the bill amends the Corporate Income and Franchise Tax Act to require combined reporting for a unitary corporation that provides retail sales of goods in a facility of more than 30 thousand square feet under one roof in New Mexico.

Section 3 of the bill amends the Uniform Division of Income for Tax Purposes Act to phase in over five years an optional single sales business income apportionment factor for businesses engaged in manufacturing. To elect the apportionment formula created in the bill, the taxpayer must notify the TRD in writing before first filing a return using the new apportionment formula. Once opting into this apportionment formula, the taxpayer must use the formula for three years before being able to opt back out. The bill also amends the definition of a "business engaged in manufacturing" to mean a business classified within the manufacturing sector as described in the official 2012 United States North American industry classification system manual. The single sales factor provided for in the bill would be phased in over five years as follows:

Tax Year	Apportionment Formula
2013 (current law)	$\frac{\text{(sales factor)+(property factor)+(payroll factor)}}{3}$
2014	$\frac{\text{(2Xsales factor)+(property factor)+(payroll factor)}}{4}$
2015	$\frac{\text{(3Xsales factor)+(property factor)+(payroll factor)}}{5}$
2016	$\frac{\text{(7Xsales factor)+(1.5Xproperty factor)+(1.5Xpayroll factor)}}{10}$
2017	$\frac{\text{(8Xsales factor)+(property factor)+(payroll factor)}}{10}$
2018	$\frac{\text{(total sales in New Mexico)}}{\text{(total sales)}}$

Section 4 of the bill also amends the act to exclude certain sales from being apportioned as sales in New Mexico.

Section 5 amends the Gross Receipts and Compensating Tax Act to restrict the phase-in of the GRT deduction for tangible personal property consumed in the manufacturing process. Fifty percent of receipts received on or after January 1, 2015 can be deducted from gross receipt.

Section 6 amends the provisions governing the high-wage jobs tax credit to tighten a host of high wage tax credit definitions. The most important changes to the law are:

- Limiting the application period to one year. Currently there is no limitation.
- Limiting the aggregate annual amount of the credits approved to $50 million.
- Limiting eligible employers to those certified by the Economic Development Department to be eligible for job training program assistance, commonly known as "JTIP" The bill also removes the requirement that export more than 50 percent of their sales to be eligible.
- Requiring HWJTC recipients to report annually on the effectiveness of the credit and requiring HWJTC recipients to authorize revelation of some taxpayer information to the Legislative Finance Committee (LFC) and to the Revenue Stabilization and Tax Policy Committee.
- Increasing the wage requirements for jobs created after January 1, 2013 to qualify for the HWJTC. These jobs must pay wages of $65 thousand if performed or based in a municipality with a population of at least 60 thousand, and $40 thousand if performed or based in a municipality with a population less than 60 thousand or in an unincorporated area of a county.

Section 4 also clarifies that eligible jobs cannot be recycled through mergers or acquisitions and that wages are calculated exclusive of benefits. The bill increases the population level that would classify a municipality as urban for purposes of the credit from 40 thousand to 60 thousand.

Section 7 amends the Income Tax Act to repeal the deduction of net capital gains from net income, effective January 1, 2014.

The provisions of sections 1 through 4 and section 7 are applicable to taxable years beginning on or after January 1, 2014. The provisions of section 6 are applicable to taxable years beginning on or after January 1, 2013.

The effective date of sections 1 through 5 is January 1, 2014. The effective date of sections 6 is January 1, 2013.

FISCAL IMPLICATIONS

CIT Rate Reduction: The January 1, 2014, effective date for the CIT rate reduction creates a 60 percent impact in FY14. There is no phase-in period, rates changes are fully implemented immediately on January 1, 2014.

	FY2013	FY2014	FY2015	FY2016	FY2017
Impact, CIT Rate Changes		($65,008.0)	($126,901.0)	($132,534.0)	($135,847.0)

Manufacturers Sales Factor Apportioning: The TRD used 2010 New Mexico CIT data for manufacturing corporations (NAICS code 31 through 33) in its estimate of the impact due to the single weighted sales factor apportionment election. There are approximately 1,750 corporations which file under the manufacturing NAICS codes with a total gross NM CIT of $75 million. The impact was estimated assuming that all manufacturing corporations whose sales factor is less than an average factor would make the election. Since not all eligible corporations will make this election due to the 36 consecutive month election requirement, the impact was reduced by 10%.

February forecast estimates were used to estimate the fiscal impacts from FY14 through FY17.

	FY13	FY14	FY15	FY16	FY17
Impact, Manufacturing SS Factor	0	($46.0)	($6,839.0)	($18,892.0)	($31,407.0)

Mandatory Combined Reporting for Certain Unitary Corporations: The TRD's estimate assumes mandatory combined reporting for the entire retail population would increase corporate income tax revenues before credits about $5 million, or roughly 1/3 of the amount collected, on average, for the last several tax years from all retailers. This estimate reflects the mid-point of a range derived from a review of several studies of combined reporting, but the range of estimates in general is very wide, from 0 percent (no increase in revenue) to 20 percent. Revenues are expected to increase initially and the rate of increase is expected to diminish during the later years as taxpayers adjust their corporate structures and transactions to avoid taxation. Part of the initial gain is due to one-time factors like the disallowance of losses earned by separate entities. Once taxpayers realize they are subject to combined reporting, they are more likely to restructure their business operations to reduce their liability. Impacts from this change are in the table below.

	FY13	FY14	FY15	FY16	FY17
Impact, Combined Reporting		$1,200.0	$7,500.0	$5,800.0	$4,600.0

HWJTC Changes: The changes to the HWJTC have the effect of tightening the eligibility requirements for both employers and employees. The TRD reports the 17 companies filing the greatest number of HWJTC applications account for about 75 percent of all credits by dollar amount during the period analyzed. Growth in new qualified jobs was estimated using BBER FOR-UNM forecast employment growth for the applicable sectors.

Applications for the HWJTC surged in FY12 and in FY13 (to-date), which the TRD reports appears to be due to a "mining" of potential claims by several consulting accounting firms, and due to an increasing awareness of the potential claims under the existing HWJTC statutes. At present, approximately $110 million in pending HWJTC claims are under evaluation by the TRD. In order to estimate the fiscal impact, the TRD adjusted claims to a "normal" level, assuming the current surge in claims reflects anticipation of proposed amendments to the HWJTC.

The TRD estimates the "normal" applications per year under the current law to be approximately $65 million. Assuming one third of claims are not approved, the total amount approved would be $43.3 million per year. Further, analysis of historic claims suggests approximately 30 percent of applications are from JTIP-qualified entities. Finally, of the 30 percent of JTIP-qualified applications, 60 percent represent "new" jobs as defined by the proposed legislation. These assumptions suggest approved credits from the "normal" level of applications would be reduced by 85 percent under the proposed statutory criteria for HWJTC qualification.

The TRD assumed $120 million in HWJTC applications are pending review in the last half of FY13. The proposed legislation would only be applicable to applications reviewed after July 1, 2013. The bill's annual cap of $50 million dollars in aggregate would take effect with respect to claims approved in FY13 but not yet paid out by July 1, 2013. The $30 million in estimated credits would be carried forward to FY14, but the estimated credit in FY14 is small enough that the combined total should not reach $50 million.

Beginning with jobs created on or after January 1, 2013, the bill raises the threshold wages to

$40 thousand in rural jobs and $65 thousand for urban jobs. Based on analysis of the most recent two years of claims, the TRD estimates this would cause a 25 percent reduction in the amount of the credit (5 percent of credits issued are tied to jobs below $40 thousand that would be eliminated, and 20 percent of credits issued are estimated to arise from urban jobs between $40 thousand and $65 thousand that would be eliminated). The total estimated revenue impact of the HWJTC portion of SB 639 is in the table below.

	FY2013	**FY2014**	**FY2015**	**FY2016**	**FY2017**
General Fund Impact	$22,500.0	$6,349.0	$29,529.0	($4,754.0)	($4,849.0)
Local Government Impact	$7,500.0	$1,994.0	$9,274.0	($1,493.0)	($1,523.0)
Net Impact, HWJTC Changes	$30,000.0	$8,343.0	$38,803.0	($6,248.0)	$6,371.0)

GRT Sales to Manufacturers Phase-in Changes: The TRD notes its estimates for this portion of the analysis include a high degree of uncertainty for several reasons which make it difficult to estimate the baseline level of the deduction, as well as the impacts from the proposed changes:

- The deduction is not separately stated, and the historical size of the deduction is not known.
- 2012 amendments to the law governing the deduction are expected to greatly increase the size of the deduction; the changes have not been in effect long enough to assess their impact.
- Given the current and proposed definitions of manufacturing, it is difficult to identify with certainty the pool of firms that will be eligible for the credit.
- Insufficient data exists to directly analyze the percentage of New Mexico production that is sold outside of New Mexico, at the aggregate or individual firm level.
- To establish a baseline level of the manufacturers' consumables deduction, the TRD relied on DFA's revised analysis of a REMI Input-Output model of manufacturer consumption. This model estimates the size of the deduction under current law as described in the table below.

Current Law Deduction	**FY13**	**FY14**	**FY15**	**FY16**	**FY17**
Total	($16,545.0)	($30,748.0)	($53,304.0)	($77,846.0)	($104,324.0)

This bill modifies the phase-in of changes enacted in 2012, currently scheduled to occur in 20 percent increments up to 100 percent. The impact of capping the phase-in at 50 percent starting January 1, 2015, is depicted in the table below.

	FY13	**FY14**	**FY15**	**FY16**	**FY17**
General Fund GRT			$3,055.0	$12,725.0	$26,533.0
General Fund Comp			$110.0	$450.0	$910.0
Local Governments			$2,141.0	$8,944.0	$18,677.0
Small Counties Assistance			$10.0	$40.0	$80.0
Small Cities Assistance			$10.0	$60.0	$120.0
Muni Equivalent on Comp			$10.0	$30.0	$60.0
Total			**$5,335.0**	**$22,249.0**	**$46,379.0**

Repeal Net Capital Gain Income Deduction: The TRD reports $11.5 billion in total unapportioned capital gains claimed in the 2010 tax year, resulting in an estimated capital gains tax liability to New Mexico of $36.1 million. Assuming a growth rate of 5% to estimate the future year growth in capital gains, and forecasting fiscal impacts as a value equal to the forecasted tax liability under current law (i.e., additional tax liability from elimination of 50%

deduction would double capital gains tax revenue collected), the total tax revenue lost in Tax year 2014 due to this deduction would be $43.9 million. TRD assumed FY14 would have half of the full tax year impact due to the January 1, 2014 effective date, and estimated additional tax year liability was distributed accordingly

	FY13	FY14	FY15	FY16	FY17
Impact, Capital Gains Deduction Repeal		$21,900.0	$45,000.0	$47,200.0	$49,600.0

This bill may be counter to the LFC tax policy principle of adequacy, efficiency and equity. Due to the increasing cost of tax expenditures revenues may be insufficient to cover growing recurring appropriations.

Estimating the cost of tax expenditures is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. The statutory criteria for a tax expenditure may be ambiguous, further complicating the initial cost estimate of the expenditure’s fiscal impact. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures.

SIGNIFICANT ISSUES

New Mexico’s top corporate income tax rate of 7.6 percent is high, compared with the national average of 6.4 percent. New Mexico’s CIT rate is especially high when considering a corporation can be taxed at the 4.9 percent personal income tax rate simply by organizing under another section of the IRS code. This violates the principle of tax equity. In 2011, the Council on State Taxation (COST) commissioned Ernst & Young to perform a 50-state study of effective tax rate/after-tax return on investment over a 30-year investment, New Mexico ranked last. The study found that tax rates and a complex tax credit incentive system are a burden on firms considering investments in New Mexico and are “almost certainly impeding economic growth.”

Among other options, the New Mexico Tax Research Institute (NMTRI) noted a reduction in the top corporate rate would make New Mexico more appealing to business investment. The NMTRI also addressed the option of allowing corporations to apportion income with a single- or double-weighted sales factor. All states parse a multistate corporation’s income into a state taxable base. New Mexico uses an “apportionment formula” that averages the percentage of a corporation’s sales occurring in New Mexico, the percentage of payroll in New Mexico, and the percentage of property (or assets or investment) domiciled in New Mexico. The equally weighted corporate income apportionment formula creates a disincentive to expansion in New Mexico; if a company increases its operations in New Mexico, its taxes in New Mexico would increase, even without the benefit of additional sales, creating a disincentive to growth. Firms can lower exposure to New Mexico tax by firing workers and closing plants.

The “single sales” factor, by which income is apportioned only on the percentage of sales made in the state, is the alternative in favor nationally. This formula does not punish firms for investing or employing workers within a state. In New Mexico, a mandatory single sales formula would likely benefit extractive and manufacturing industries while penalizing direct sellers of goods and services and multistate banks. Mining and manufacturing pay well over half of New Mexico CIT, however, and this formula could result in lower revenues.

Legislation enacted in 2012 expanded the GRT deduction for tangible personal property to include property consumed in the manufacturing process. The deduction was intended to exempt the cost of electricity used in the manufacturing process, but it can be construed to cover refining, processing, restaurants, and even art. Further, the electric utilities report it will be difficult to identify electricity "consumed" during manufacturing. These issues doubled the original estimate of the deduction's general fund impact to $4.7 million in FY13, rising to $80 million when fully phased in by FY17.

The high-wage jobs tax credit provides qualifying employers with a 10 percent tax credit, up to $12 thousand, for each employee with annual wages and benefits totaling more than $28 thousand if in a rural area and more than $40 thousand if in an urban area. Eligible employers include those eligible for the Job Training Incentive Program (JTIP) or that earned more than 50 percent of their sales from out-of-state entities in the prior year. The cost of the credit is higher than initially estimated, with FY12 claims exceeding $48 million, and FY13 projected at $50 million. The credit is intended to create new jobs, but data suggests most of the claims are for jobs created from previous business activity. The TRD estimates as little as 19 percent of all FY12 credit applications were for jobs created during the current qualifying period. In the last two fiscal years, employers claimed credit for creating roughly 3,000 jobs. However, it should be noted that the UNM's Bureau of Business and Economic Research estimates employment actually declined by 258 jobs during that time.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is met with the bill's requirement to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the deduction is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

The TRD reports that, due to the phase-in, taxpayers will need to adjust apportionment ratios each year over a five-year period. Combined with all other changes, taxpayer education will be needed, and the Department will need to modify forms, instructions and publications.

CONFLICT

Conflicts with SB 59, SB 277, SB 293, SB 319, SB 373, SB 508, SB 538, SB 545, SB 568, HB 182, HB 507, HB 596, and HB 616.

TECHNICAL ISSUES

The TRD reports Regulation 3.4.10.8(B) NMAC will need to be changed (or a new regulation added) to reflect that after January 1, 2013, a taxpayer that previously filed as a separate corporate entity, but is part of a unitary corporation, as that term is defined in Section 7-2A-2Q NMSA 1978, must file its New Mexico CIT returns using the combined unitary group method or the federal consolidated method.

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

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