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

SPONSOR Sharer **ORIGINAL DATE** 2/13/15
LAST UPDATED 2/24/15 **HB**

SHORT TITLE Tax Reform **SB** 346/aSCORC

ANALYST van Moorsel

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY15	FY16	FY17	FY18	FY19		
Indeterminate – See "Fiscal Implications"						

(Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY15	FY16	FY17	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	High Impact – See "Administrative Implications"				Recurring	TRD

Parenthesis ( ) indicate expenditure decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of SCORC Amendment

The Senate Corporations and Transportation Committee amendments make several technical changes to the bill to address technical errors, including changing an erroneous use of "Medicaid fund" to "Safety Net Care Pool" and excluding some sections of statute from repeals included in the original bill. The amendments also restore net rents to the definition of modified gross income.

Synopsis of Original Bill

Senate Bill 346 implements wide ranging reforms to New Mexico's tax structure by creating a flat transaction tax. The bill aims to significantly broaden the tax base and reduce tax rates by

eliminating several taxes, repealing exemptions and deductions, and reducing rates at which the GRT and income taxes are imposed. Specifically, the bill:

- reduces the following tax rates:
  - the Gross Receipts Tax (GRT) to 1.0 percent;
    - exempts receipts from donations to 501(c) (3) organizations.
    - includes wages and investment income in gross receipts, includes GRT liability in Withholding Tax Act;
    - provides for a refundable, nontransferable tax credit to refund GRT paid based on the relation of income for federal purposes to federal poverty guidelines.
    - Requires TRD to report annually to recommend to RSTP and LFC legislation that may be necessary to keep the state GRT at or below one percent and the local option gross receipts taxes, in the aggregate, at or below one percent.
  - the governmental gross receipts tax (GGRT) to 1.0 percent; and
  - the municipal and county local option GRT to ½ percent each for an aggregate maximum local GRT rate of 1.0 percent.
    - References to specific local government GRT increments are replaced with reference to local option GRT revenue.

- imposes a flat income tax rate of 2.5 percent on taxable income of married individuals filing separately if income is at least $141,975, heads of houses/married individuals filing jointly if income is at least $283,950, and single individuals or estates and trusts if income is at least $189,300, effective in taxable years beginning on or after January 1, 2016. The tax:
  - excludes bond interest from income;
  - excludes net rents and gifts from modified gross income; and
  - exempts donations to 501(c) (3) organizations.

- repeals the following taxes and acts:
  - the compensating tax;
    - Distributions to the small cities and small counties assistance funds from certain percentages of the compensating tax are changed to different percentages of the GRT.
  - the Corporate Income and Franchise Tax Act;
  - the Estate Tax Act;
  - the Motor Vehicle Excise Tax Act;
  - the Leased Vehicle Gross Receipts Tax Act;
  - the tax on boats;
  - certain local option gross receipts taxes;
  - the Supplemental Municipal Gross Receipts Tax Act;
  - the Local Hospital Gross Receipts Tax Act;
  - the County Correctional Facility Gross Receipts Tax Act;
  - the Special County Hospital Gasoline Tax Act;

- replaces the county obligations to the county-supported Medicaid fund and the safety net care pool (SNCP) with the following state obligations of GRT:
  - .014 percent to the Medicaid Fund; and
  - .018 percent to the Safety Net Care Pool Fund; (Technical Issue – refers to Medicaid fund, needs amendment to refer to SNCP fund.)

- repeals certain credits, deductions, and exemptions against PIT and GRT and removes statutory references to these tax preferences;
- removes permission of Tax Increment Development Districts (TIDDs) to issue bonds against a GRT increment;
- provides temporary amnesty from penalties and interest on taxes not paid; doubles the civil penalty for tax evasion from 50 percent of the liability to 100 percent of the liability; and
- provides the repeal of certain taxes shall not impair outstanding bonds or loan guarantees.

The bill also:

- strikes additional distributions from the small counties assistance fund as the county GRT impositions are repealed.
- Creates new definition sections for statutes governing municipal and county revenue bonds.
- Repeals certain distributions of GRT revenue to state aviation fund;
- Amends the calculation of the county equalization distribution.
- Creates the "boat suspense fund;" makes distributions of GRT attributable to boat sales. 50 percent of the revenue in the fund is to be transferred to the State Parks Division of EMNRD to improve and maintain lakes and boating facilities and for enforcement of the Boat Act.

The provisions of the sections of law repealed in Section 98 of the act shall not apply to taxable years beginning on or after January 1, 2016. The repeals in section 98 are effective January 1, 2017. The provisions of section 44 and 45 (imposing the flat personal income tax rate) of the bill apply to taxable years beginning on or after January 1, 2016. The effective date of Sections 1-97, including the majority of the repeals (Section 97) of the bill is January 1, 2016.

FISCAL IMPLICATIONS

This bill makes significant and wide-ranging changes to the tax code, estimating the bill's fiscal impact is extremely difficult and subject to a high degree of certainty. As such, the revenue table states the impact as indeterminate. The Taxation and Revenue Department also reports it did not estimate the fiscal impact of the bill.

During the 2014 interim the Legislative Council Service contracted with UNM's Bureau of Business and Economic Research to perform a study of the gross receipts tax base. Dr. Lee Reynis, Research Professor of Economics and Director of the Institute for Applied Research Services at UNM, presented the results of the study to the Revenue Stabilization and Tax Policy Committee in December 2014 (See other Substantive Issues for more detail).

Modeling the impact of a proposed transaction tax, Dr. Reynis reported first that the model estimated a transactions tax base of $248.7 billion. Applying a 2.125 percent transaction tax would yield revenues of $5.3 billion. These revenues would need to replace the following general fund revenues:

General sales taxes:	~$2.00 billion
Certain excise taxes:	~$0.12 billion
Income taxes:	~$1.51 billion.
Total	~$3.63 billion

BBER estimated the revenue balance would be a positive $1.66 billion, but added the state gross

receipts tax is shared with municipalities thru a 1.225 percent distribution. Keeping local governments whole in 2012 would require a distribution of $418 million, leaving $1.24 billion.

Although the transaction tax modeled by BBER projected a surplus, it is unclear whether the tax reform proposed in this bill imposing a 1 percent state and 1 percent local GRT rate and a 2.5 percent income tax rate on income above certain levels would generate sufficient revenue to maintain state government and local government services.

Perhaps the biggest risk to such a proposal is the broad nature of the changes. The bill makes many significant changes whose fiscal impact would be difficult to model in isolation. Making these changes at the same time as other equally significant tax policy changes introduces uncertainty that makes estimating the fiscal impact impossible given the short timeframe and limited resources available.

Revenue Adequacy. A concern arising from such uncertainty is whether the reformed tax code would generate sufficient revenues to maintain the services provided by state government. The LFC tax policy principle of adequacy states that revenue should be adequate to fund needed government services. Should the rates proposed in this bill generate insufficient revenue, the state would be forced to cut services pending further legislation to adjust tax rates to generate additional revenue. Uncertainty about state revenue sufficiency could contribute to uncertainty about the state's ability to provide basic services such as public safety and education or pay its debt obligations, which could in turn discourage investment in New Mexico.

The uncertainty concerning revenue adequacy also applies to local governments – it is unclear whether the lower local option GRT rate limit would provide counties and municipalities with sufficient revenue to operate.

On the other hand, generating too much revenue could have negative effects as well. A sharply increased tax burden could discourage investment in New Mexico whiling place additional financial pressure on low-income taxpayers. The increased revenues could also take a large amount of money out of the economy, slowing economic growth.

SIGNIFICANT ISSUES

The intent of the legislation to significantly reform New Mexico's tax system by implementing a transaction tax. The bill does so by removing tax credits, deductions and exemptions to significantly broaden the tax base while lowering the tax rate. This supports the LFC tax policy principle of efficiency which states the tax base should be as broad as possible.

Pyramiding. GRT base erosion has contributed to increased GRT rates at the state and local levels. The increase in these rates has also exacerbated the effect of pyramiding, which occurs when the GRT is applied to business-to-business purchases of supplies, raw materials, and equipment, creating an extra layer of taxation at each stage of production. This is a critical issue for New Mexico because the GRT taxes professional services not taxed in other states, such as legal services, accounting services, transportation, and similar services. This pyramiding can force price increases and make New Mexico industries less competitive compared with other states. The 2011 New Mexico Tax Research Institute/Ernst & Young business competitiveness study calculated the effective New Mexico tax rates for business support services, electrical equipment manufacturing and aerospace products and parts were in excess of 20 percent before

considering tax incentives. After incentives, food products manufacturing, business support services, and electrical equipment manufacturing sectors had effective tax rates in excess of 10 percent. In all these sectors, GRT pyramiding contributed to the high effective rate.

The bill eliminates several tax preferences intended to minimize the effects of tax pyramiding. The intent appears to impose a rate low enough to minimize the anticompetitive effects of pyramiding even without anti-pyramiding tax preferences. It remains unclear whether the rate can be set low enough to minimize the effects of pyramiding, however, particularly in industries with many business-to-business transactions.

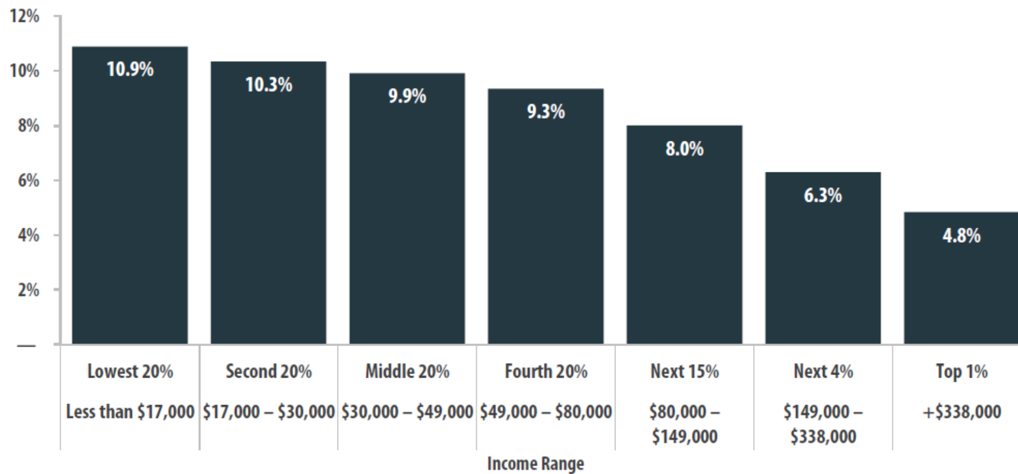
Legislation in 2012 to address pyramiding in the manufacturing and construction sectors was onerous to administer and more open-ended than intended, doubling its estimated fiscal impact and requiring legislation to reduce the revenue losses. Future anti-pyramiding legislation should be carefully constructed to avoid ambiguity and uncertainty.

Progressivity. A further uncertainty is the effect of the bill on progressivity of the tax system. The bill‘s provisions of tax rebates based on income levels made in varying proportions of the amount of GRT paid attempts to provide some progressivity of tax. The 2.5 percent income tax for taxpayers earning above certain income levels is another feature that could restore some progressivity.

However, it is unclear whether the proposed tax system could be considered more or less progressive than the existing tax structure. BBER discussed this in its GRT base study, noting it did not include analysis on “the re-distribution of income likely to occur should this new tax be implemented. Sales taxes have a disproportionately large burden on lower income people who spend a higher proportion of their income.”

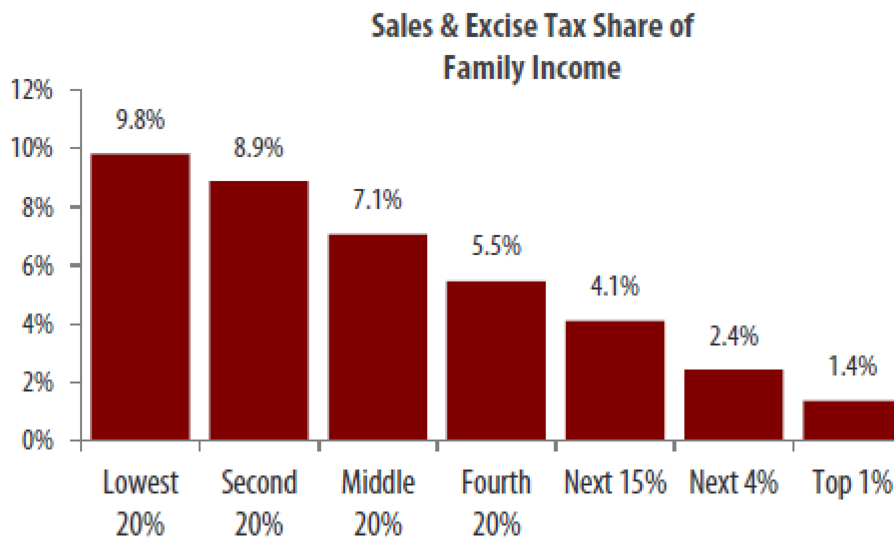
To illustrate the different incidences of sales and income taxes, the figures below from the Institute on Taxation and Economic Policy’s (ITEP) “Wo Pays” report published January, 2015 compare all New Mexico taxes, sales and excise taxes, and income taxes as a share of family income by income level. The report notes the figures show permanent law in New Mexico enacted through December 31, 2014 at 2012 income levels.

The first figure total state and local taxes as a share of income, post- federal offset.



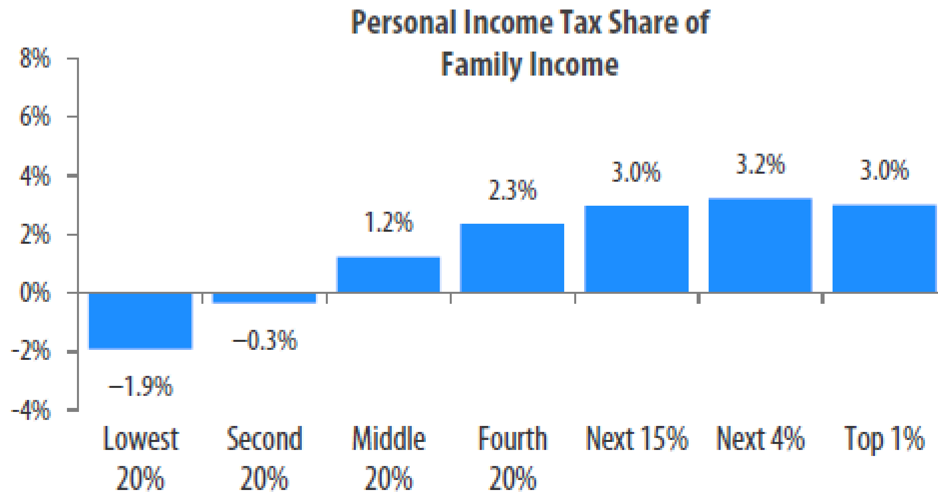
Source: ITEP – "Who Pays, 2015"

The second figure shows the lower income families spend a greater portion of their income on sales and excise taxes.



Source: ITEP – "Who Pays, 2015"

Finally, the third figure shows low income families send a smaller share their income on personal income taxes than do higher-income families. Because SB 346 replaces the progressive income taxes with a more regressive sales-type tax, the changes tend toward a more regressive system. The bill does include features to restore progressivity by refunding taxes paid by low-income families, but it is unclear whether the net change will result in a more or less regressive tax than the current system.



Source: ITEP – "Who Pays, 2015"

TRD's analysis of the legislation makes several comments concerning certain features of the bill:

Gross Receipts Tax Changes: TRD notes there may be instances where a taxpayer was enticed to locate a business in New Mexico in response to the availability of certain credits, deductions, or exemptions, and in which a taxpayer could conceivably, though not necessarily successfully, challenge the repeal on equitable estoppel grounds.

Repeal of Compensating Tax. TRD reports that, although GRT rate under the proposed bill is relatively low, repealing the compensating tax creates an incentive for New Mexico residents to purchase products from non-New Mexico businesses, such as via mail order or over the internet. As no use tax is imposed, remote sellers or internet sellers would not have to collect and remit use tax on behalf of New Mexico customers even when they have substantial nexus with New Mexico. Thus, TRD contends, repealing the use tax may not only have a revenue impact, but may also adversely affect the competitiveness of New Mexico businesses.

Including "wages" in the tax base. TRD points out including wages in the GRT tax base raises several policy issues. First, the sourcing of wages under the proposed bill under Section 7-1-14(E) (page 109) may result in New Mexico residents bearing all of the tax burden, while removing a portion of the tax burden from companies that do business or perform services in New Mexico through employees that perform services in the state, but are not operating out of a New Mexico business location. For example, TRD argues that under the proposed bill, wages of a Texas technology company's employees for setting up a network at a facility in New Mexico may not be subject to GRT if the employer does not have a New Mexico business location. Likewise, given the higher threshold for individual income tax reporting, the Texas employees may not be required to file individual New Mexico income tax returns. While the Texas company would be subject to GRT for services performed here, the wages paid to employees may escape both GRT and individual income tax.

Second, TRD adds compliance burdens on taxpayers and businesses should be considered. Subjecting W-2 wages to gross receipts tax, without adjusting return due dates, would subject regular W-2 wage earners to 12 monthly gross receipts tax returns, as opposed to one annual

income tax return. Although a credit is given to address regressiveness under the proposed bill, the credit also requires the separate filing of a refund claim. In short, individual wage earners may be required to make 13 separate filings as a result of including W-2 wages in the tax base. There may also be administration and compliance issues with respect to GRT withholding required for wages as many businesses will have to withhold for New Mexico taxes differently than in other states.

Repeal of Corporate Income Tax. TRD points out that although the bill repeals the CIT, it makes no amendments to New Mexico's Uniform Division of Income for Tax Purposes Act (UDITPA). While the allocation and apportionment provisions of UDITPA expressly apply to individual income taxpayers that have sources of income both within and outside the state, some technical changes to UDITPA may be necessary since that act was drafted to apply to apportioning corporate income.

Individual Income Tax. TRD states the differing income thresholds between single individuals and married individuals filing separately may, raise equal protection issues. Additionally, as a policy matter, the proposed bill eliminates certain types of income, such as net rents and gifts, from "modified gross income." With net rents excluded, the proposed bill may preclude taxation of individuals that earn substantial income from rents on real property from taxation (this second issue is addressed in the SCTC amendment).

ADMINISTRATIVE IMPLICATIONS

TRD reports the bill provides for the comprehensive revision, repeal, and/or replacement of numerous, but not all current tax programs. As such, it represents a massive overhaul of the state's tax code that would necessitate significant changes in reporting requirements by taxpayers, significant reformation and/or repeal of the NMAC's tax-related provisions, and significant changes in tax administration, including, but not limited to, changes in monitoring software, forms, and publications.

For instance, TRD projects the bill will have a very high impact on the Information Technology Division (2400 hours). To implement this bill, TRD reports it would need to change GenTax & Taxpayer Access Point documents of combined reporting system (CRS) and personal income tax return and configuration; CRS Rate structure and rates for all rate types on each location; Business Objects for CRS return pre-popping, daily and monthly distribution in revenue accounting model; and multiple CRS reports and letters.

OTHER SUBSTANTIVE ISSUES

Dr. Reynis stated BBER developed a modeling tool using an IMPLAN model and proprietary data bases for 2012. Dr. Reynis explained IMPLAN is a widely used regional economic model that is based on Input-Output analysis. She added the model databases that were used provide aggregates that can be used in estimating the gross receipts tax base as well as the tax base for alternative broad-based taxes, such as a tax on transactions. Data series include data on sales, on interbusiness purchases, on exports abroad and within US.

Dr. Reynis reported the effort to develop the model demonstrated the promise of I-O models like IMPLAN. However, she added:

- Activity was not always correctly classified;
- Misclassification creates problems if occurring in specific exemptions or deductions as they can exhaust tax base in a particular industry.
- Difficulty exists in aligning exemptions and deductions with specific industries, particularly in the case of deductions for manufacturing and construction.
- The lack of 2012 economic census data was a major issue, particularly for treatment of wholesale and retail trade.

Dr. Reynis also noted:

- the IO model is not a dynamic model, and IO model estimates of inter-business sales are not the same as capturing individual business transactions and having the tax pyramid as purchases move up the stages of production.
- The analysis only deals with the state's general fund. No analysis was done concerning the adequacy of revenues to municipalities and counties or concerning governmental gross receipts tax revenues.
- The analysis did not address the federal tax deductibility of receipts from this transaction tax.

ALTERNATIVES

The large amount of uncertainty surrounding the bill indicates implementation of the tax reform proposed within would come with considerable risk. An alternative would be to attempt to study the issue further. The General Appropriation Act of 2014 included an appropriation to perform such a study, but the appropriation was vetoed. Such a study may help to develop a tax reform proposal with safeguards against revenue insufficiency while also protecting against a sharp increase in the tax burden, particularly for low-income taxpayers.

TRD adds that, as an initial observation, given the massive changes, it may be preferable to comprehensively repeal various sections of the Tax Code, such as the Gross Receipts and Compensating Tax, and re-write the code from scratch to avoid inconsistencies and unintended consequences.

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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