FISCAL IMPACT REPORT

LAST UPDATED 02/15/23
SPONSOR Harper/Maestas **ORIGINAL DATE** 02/14/23
SHORT TITLE Flat Corporate Income Tax Rate **BILL NUMBER** House Bill 322

ANALYST Faubion

REVENUE*
(dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY23	**FY24**	**FY25**	**FY26**	**FY27**		
--	--	$7,000.0	$7,200.0	$7,400.0	Recurring	General Fund – CIT rate change
--	Indeterminate but likely positive				Recurring	General Fund – Single sales

Parenthesis ( ) indicate revenue decreases
*Amounts reflect most recent version of this legislation.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT*
(dollars in thousands)

	FY23	FY24	FY25	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
	--	$27.8	--	$27.8	Nonrecurring	TRD/ITD

Parentheses ( ) indicate expenditure decreases.
*Amounts reflect most recent version of this legislation.

Conflicts with SB189

Sources of Information
LFC Files

<u>Responses Received From</u>
Taxation and Revenue Department

SUMMARY

Synopsis of House Bill 322

House Bill 322 (HB322) creates a single corporate income tax rate of 5.9 percent and requires all business income to be apportioned by the single sales factor.

The effective date of this bill is January 1, 2024. The provisions in this bill apply to taxable years beginning on or after January 1, 2024.

FISCAL IMPLICATIONS

Currently, there are two corporate income tax rates: 4.8 percent for corporations making less than $500 thousand; and 5.9 percent for corporations making more than $500 thousand. According to the 2022 Tax Expenditure Report, there were approximately 71,200 corporate income taxpayers in tax year 2020 and 67,359 of those taxpayers have $0 or less in income and did not pay any corporate income tax. Additionally, 3,543 taxpayers made less than $500 thousand in income and paid the 4.8 percent rate currently in statute, accounting for only 7.7 percent of total corporate income taxes paid. The remaining 331 taxpayers made over $500 thousand in income and therefore paid the 5.9 percent rate currently in statute. As the corporate income is a marginal tax, all corporate taxpayers will experience a tax increase under this bill. High-earning taxpayers already at the 5.9 percent tax rate will pay a higher rate on their first $500 thousand of earnings.

LFC used the corporate income tax tables in the 2021 Tax Expenditure Report to estimate the fiscal impact of the tax increase on businesses in tax year 2020. LFC grew the figures by the gross corporate income tax growth rate estimated in the December 2022 Consensus Revenue Estimating Group through the forecast period. This assumes CIT growth is equal throughout the income distribution. A more robust analysis from TRD using more recent and detailed corporate income tax data is needed for a more accurate fiscal impact estimate of the proposed corporate income tax rate.

The Taxation and Revenue Department (TRD) notes the following methodology for its estimated revenue impact:

> The directional positive impact is based on reviewing corporate income tax (CIT) tax return data from tax years 2019 through 2021. The taxpayer liability was modeled applying the single-sales factor and then applying the single tax rate of 5.9 percent. On an individual basis, the impact is diverse among taxpayers, but in aggregate the impact is a revenue increase to the state. The increase is due to the fact that New Mexico imports and consumes more than it produces and exports; New Mexico is a "market" state. Therefore, eliminating the two other factors of property and payroll increases the amount of income apportioned to New Mexico, overall. Additionally, the majority of taxpayers currently pay CIT at a tax rate of 4.8 percent, although at a lower taxable income, thus also producing a positive increase to revenue by increasing their rate to 5.9 percent.
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> CIT is an extremely challenging revenue to forecast in times of relatively instability. Given the current economic instability due to consumer demand, supply-chain bottlenecks, energy market uncertainty and inflation, the estimate has been presented as a positive revenue gain but without a point estimate or a range to emphasize the uncertainly of the magnitude of the impact.

SIGNIFICANT ISSUES

HB322 repeals the use of the three-factor formula apportionment of multi-state income in favor of a single sales factor formula apportionment for all corporations and pass-through entities. This puts most corporations on equal footing, not just manufacturing corporations or corporations with headquarters in New Mexico. However, this proposal would have uneven effect between primarily New Mexico corporations and national/multinational corporations with limited sales in New Mexico and would not impose any additional liability on non-nexus corporations with any level of sales in New Mexico.

Currently, with a few exceptions for corporate headquarters or manufacturing, corporations and pass-through entities (PTEs) apportion their U.S. income to New Mexico using the average of property, payroll, and sales factors. Essentially, each of these factors is the percentage of New Mexico property, payroll, or sales to the corresponding U.S. total property, payroll, or sales. This bill proposes to abandon this three-factor apportionment formula and only consider sales ratios. This will, in general, provide additional liability for national and international corporations with moderate physical presence, but will provide very substantial tax deductions for businesses that have relatively large ratios of property and payroll ratio relative to the sales ratio. This provision is intended to incentivize national and international corporations to build plants and facilities in New Mexico and hire New Mexico workers, but export the New Mexico produced products or services out of the state. However, the bulk of the tax reductions in the state will affect the OGAS sector that has very large property and payroll factors, but very low sales factor.

TRD notes the following:

> The reduction of the CIT rates to one rate moves the majority of taxpayers who have tax liability to the higher tax rate. In tax year 2020, of those that had tax liability, the majority, approximately 94 percent, incurred that liability with taxable income less than $500 thousand placing them at the 4.8 percent current tax rate. This now places smaller income companies on par with larger corporations. But while for personal income time (PIT) there is progressivity tied to the 'ability to pay" and fairness with vertical equity, that association of ability to pay is not readily applied to corporate income tax policy. The Tax Foundation quotes Jeffrey Kwall, a professor of law at Loyola University Chicago School of Law that 'Graduated corporate income rates are inequitable – that is, the size of a corporation bears no necessary relation to the income levels of the owners.'[1] Additional arguments that the Tax Foundation puts forth for a single-rate, is that it minimizes the effort by corporations to avoid the tax liability at the higher marginal tax rates. New Mexico would join 29 other states who have a corporate income tax in enacting a single-rate corporate income tax.
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> A single-sales factor and one tax rate reduces the complexity of the CIT code. This change would support the tax policy principle of simplicity. Taxpayers incur compliance burdens as they prepare, submit, and keep records about tax returns. Likewise, TRD incurs administrative costs to collect taxes, review the accuracy of tax returns and tax payments, and bring taxpayers into compliance. The reduction of apportionment from three factors to one simplifies the tax code for both taxpayers and TRD.
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> Some policy makers have argued that using a single sales factor method of apportionment incentivizes corporations to increase payroll in a state. However, the data regarding increase in local employment from adopting the single sales factor are inconclusive. Furthermore, the large majority of states have now adopted the method, diluting any potential positive impact on employment substantially.
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> Changing to a single sales factor will place New Mexico as a more competitive environment compared to other states with a similar application of a single sales factor or no corporate income tax at all. Most states have moved to a single sales factor for

[1] https://taxfoundation.org/publications/state-corporate-income-tax-rates-and-brackets/

purposes of income apportionment. As of January 2022, of states with CIT, only four states, including New Mexico, used the traditional three-factor formula, while 30 states and the District of Columbia used only sales in their apportionment formula[2]. The remaining states with a corporate income tax used a formula that gave greater weight to sales. "By using the portion of a corporation's sales rather than employment or property to determine tax liability, states hope to encourage companies to relocate or to expand their production operations within the states they operate in."[3] By shifting the burden of taxation to out-of-state companies, the single sale factor apportionment method encourages companies to set up their physical plant and locate employees in states that do not apportion based on these two factors. In a competitive environment, New Mexico's continuing use of the three-factor apportionment test places it at a disadvantage for companies to form or relocate here. However, it is also true that corporations look to more than just the tax code when considering operations. These include among other things, the work force skill-level and education, infrastructure, and education systems.

The change from a property-payroll-sales formula to a sales-only formula substantially reduces the corporate tax burden of businesses that arguably are benefiting the most from public services in a state and unfairly shifts the tax burden to out-of-state businesses that benefit from state services to a lesser extent.[4] The shifting of the tax burden to out-of-state companies counters a fundamental principal of tax equity and to an extent adequacy of tax revenues, as in-state corporations benefit from the expenditures of state government revenue: roads, health care, K-12 education and higher education State revenues also help support local government expenditures for public safety.

The three factors were meant to represent the profits attributable to labor (employment), capital (physical plant), and market (sales). In an economy increasingly service-oriented and based on the internet, investment in physical plant no longer has the importance in generating profit for companies that it once did. Profits are less attributable to the location of physical plant in one state, and therefore assume less importance in deciding how to apportion income to each state. Increases in productivity also mean that businesses can do more with a smaller payroll, decreasing the importance of the payroll factor.

Overall, to the extent that New Mexico remains more weighted to consumption than the presence of corporate operations, then the single-sale factors will remain revenue positive to the state.

Making changes to apportionment under Section 7-4-19 NMSA 1978 does not only impact Corporate Income Tax. These changes impact all income tax programs when calculating net taxable income, including Personal Income Tax, fiduciary filers, S-CORP filers and non-income pass-through entity.

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[2] Federation of Tax Administrators, January 2022

[3] https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-and-local-backgrounders/corporate-income-taxes

[4] Mazerov, Michael (2005), 'The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?' Center on Budget and Policy Priorities, Washington, D.C.

ADMINISTRATIVE IMPLICATIONS

TRD will need to make information system changes and update forms, instructions and publications. These changes will be incorporated into annual tax year implementation for tax year 2024. Implementation of this bill will have a moderate impact on TRD's Information Technology Division (ITD) of approximately 500 hours or about three months and $27,770 of staff workload costs. This work will include updates to GenTax, the tax system of record and the Taxpayer Access Point for Corporate Income Tax (CIT), Sub-Chapter S Corporate Income and Franchise Tax Return (S-Corp) and Pass-Through Entities (PTE).

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

This bill conflicts with SB189 which creates a flat corporate income tax credit at a rate of 6.9 percent.

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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