MINUTES
of the
THIRD MEETING IN 2010
of the
REVENUE STABILIZATION AND TAX POLICY COMMITTEE

August 23-24, 2010
Room 322, State Capitol
Santa Fe

The third meeting of the Revenue Stabilization and Tax Policy Committee (RSTP) for 2010 was called to order by Representative Edward C. Sandoval, chair, on August 23, 2010 at 9:45 a.m. in Room 322 of the State Capitol in Santa Fe.

Present
Rep. Edward C. Sandoval, Chair
Sen. John Arthur Smith, Vice Chair
Sen. Carlos R. Cisneros (8/23)
Rep. Nathan P. Cote
Rep. Anna M. Crook
Sen. Dianna J. Duran (8/23)
Sen. Tim Eichenberg
Rep. Keith J. Gardner
Sen. Timothy Z. Jennings
Sen. Timothy M. Keller
Sen. Gay G. Kernan
Rep. Ben Lujan, Speaker of the House
Rep. Rodolpho "Rudy" S. Martinez
Rep. Henry Kiki Saavedra
Rep. Thomas C. Taylor
Rep. Jim R. Trujillo

Absent
Sen. Howie C. Morales
Sen. William E. Sharer

Designees
Sen. Mark Boitano
Sen. Phil A. Griego

Rep. Ray Begaye
Rep. Donald E. Bratton
Rep. Zachary J. Cook
Sen. Kent L. Cravens
Rep. Miguel P. Garcia
Rep. Roberto "Bobby" J. Gonzales
Sen. Clinton D. Harden, Jr.
Rep. Sandra D. Jeff
Sen. Carroll H. Leavell
Rep. Antonio "Moe" Maestas

Sen. Steven P. Neville
Rep. Debbie A. Rodella
Sen. Nancy Rodriguez
Sen. Bernadette M. Sanchez
Sen. John M. Sapien
Rep. James R.J. Strickler
Rep. Don L. Tripp
Rep. Luciano "Lucky" Varela
Sen. Peter Wirth

(Attendance dates are noted for those members not present for the entire meeting.)

Staff
Pam Ray, Legislative Council Service (LCS)
Doris Faust, LCS
Ric Gaudet, LCS

<u>Monday, August 23</u>

Tax Incentives — Other-Than-Business Incentives

Dorothy Rodriguez, secretary-designate of taxation and revenue, and Al Maury, acting chief economist, Taxation and Revenue Department (TRD), reviewed for the committee more than 230 tax credits, exemptions and deductions found in New Mexico statutes. Secretary-Designate Rodriguez said that these tax expenditures are a substitute for direct government spending and should be evaluated on policy grounds periodically. Statutes usually do not state the purpose of tax incentives, and sometimes the TRD does not have enough information to interpret the language of an incentive. The TRD wants to establish uniform guidelines for all incentives and standard language. For example, the words "apply" and "claim" are used interchangeably in the statutes, but they often have very specific meanings, depending on whether the TRD has the authority to grant or deny an incentive.

Secretary-Designate Rodriguez recommended that Section 7-1-29.2 NMSA 1978 be repealed. That section automatically grants a credit to a taxpayer if the TRD has not granted or denied a credit within 180 days of making the application. The TRD does not always have enough time to evaluate the legitimacy of some complicated credit applications.

The TRD wants to establish model statutes governing business tax incentives. The existing credits have myriad rules regarding certification, recapture, transferability and refundability.

Questions and comments from committee members included the following:

- What type of project qualifies for the film production tax credit? Lisa Strout, director, New Mexico Film Division, Economic Development Department (EDD), said that a project generally qualifies for the credit if it is intended for commercial exploitation. Regional and national advertising qualify, but local advertising and news programs do not. The division was asked for a list of all entities and individuals receiving the credit.

- LCS staff was directed to review the tax incentive chart provided by the TRD, and committee members were requested to provide comments to staff on individual incentives.

- Why is the TRD unable to specify the amount of an individual deduction? Mr. Maury said that many deductions are reported as a group, and there is no way of determining exactly how much an individual deduction costs the state. Patricia Herrera of the TRD Tax Information Office said that there are specific line-item deductions for personal income tax (PIT) filers, but most deductions for gross receipts tax (GRT) filers are aggregated onto a single line.

- A system to individually identify all GRT deductions and exemptions needs to be established, and a tax expenditure budget should be created each year.

- Does the state ever audit tax-exempt organizations? Secretary-Designate Rodriguez said that the TRD does not, unless there is evidence warranting an audit for a specific entity.

- How does the TRD account for residual metal valuation to correctly impose extraction taxes? Secretary-Designate Rodriguez said that her staff will research that question and provide an answer.

- GRT "hold harmless" provisions designed to protect municipalities from the deduction on food items are hurting the state more and more as municipalities continue to expand GRT taxes. Clinton Turner, senior economist, TRD, said that the state froze the municipal distribution rate at January 1, 2007 levels, but Albuquerque subsequently reduced its GRT rate. The effect was that the city still gets a distribution at the 2007 level, which has a negative fiscal impact on the state.

- To what extent do taxpayers benefit from multiple overlapping incentives? Secretary-Designate Rodriguez said that overlapping tax incentives are widespread throughout the tax code. Very few incentives specify that if one credit is taken, then no other incentive can be granted for the same activity. In general, if a taxpayer qualifies for two different incentives for the same activity, then both incentives are granted.

Modified Combined Tax Liability — Definition

James O'Neill, tax consultant, recommended standardizing the definition of "modified combined tax liability" in various tax credit statutes and codifying in statute a 30-year-old TRD interpretation of how to determine the tax base against which the credit can be claimed. Many tax credit statutes allow a taxpayer to claim a credit against various combined reporting system (CRS) taxes. Mr. O'Neill suggested eliminating the ability to take a credit against six of the smaller CRS taxes, which will greatly simplify the administration of the credit but without substantially affecting the taxpayers. He suggested that those credits instead be counted only against GRT, compensating tax and withholding tax due. Tax credits would not be allowed against local option GRTs.

The TRD has allowed credit claimants to take a credit against the entirety of the specified taxes due, even though some of those taxes have specific earmarked distributions associated with them. The department then computed the distribution to those earmarked revenue streams as if the credit had been disallowed. Mr. O'Neill suggested putting into statute that interpretation of the law.

Finally, Mr, O'Neill pointed out that there are now two tax withholding acts in statute, and he clarified that claiming credits against wage withholding pursuant to Section 7-3-3 NMSA 1978 will ensure that the maximum amount available to a taxpayer will be allowed.

Assessment of Tax Incentives

Dr. Thomas Pogue, professor emeritus of economics, University of Iowa, Mr. O'Neill and Richard Anklam, executive director, New Mexico Tax Research Institute, reviewed for the committee 13 tax incentives.

<u>Biodiesel Blending Facility Tax Credit (Dr. Pogue)</u>:

- No stated purpose.
- Credit against the GRT and compensating tax of 30 percent of the cost and installation of biodiesel blending equipment.
- Not transferable or refundable.
- Precertification by the Energy, Minerals and Natural Resources Department (EMNRD).
- No reporting requirements.
- Full recapture of the credit in the first year.
- Carryforward allowed for four years.
- May overlap with the alternative energy product manufacturers tax credit.
- Overall cap of $1 million per year for all facilities.

This credit seems to encourage a more environmentally friendly energy source for use in vehicles. Thus, the tax credit is a "stand-in" for the external benefit the state desires. However, not all scientists agree that biodiesel is necessarily an improvement in energy conservation, especially if the fuel is corn-based. The $1 million annual limit on claims means there will not be a significant budgetary impact from the credit. Before policymakers consider raising the annual cap, the actual benefit derived from biodiesel should be established and the EMNRD should report on its effectiveness in developing new facilities.

Craig O'Hare from the EMNRD said that the tax credit has not been used by any entity, but there has been some interest.

A committee member suggested providing a tax credit for engine modification of vehicles for high-content biodiesel.

High-Wage Jobs Tax Credit (Dr. Pogue):

- No stated purpose.
- Credit of 10 percent of wages and benefits of employees up to $12,000 for four years.

- Credit can be taken against all CRS taxes except local option GRTs.
- Credit available for increases in employees, and employees must earn more than $40,000 annually in municipalities larger than 40,000 population or $28,000 in the rest of the state.
- Businesses must have more than 50 percent of sales outside the state or be eligible for development training assistance.
- The EDD provides an annual report of the credit's effectiveness.
- No recapture.
- Fully refundable.
- No carryforward.
- No overall annual cap.
- No control for overlap with other incentives.

Whether the credit is effective in actually increasing wages is difficult to determine. The number of high-wage jobs created by the credit cannot be determined without knowing what would have happened in the absence of the credit. Continuation of the credit should be based on a systemic review of this and related credits on New Mexico's economy as a whole. Recapture provisions should be enacted for businesses that cease operations within two years of receiving a credit. The out-of-state sales requirement is an unnecessary complication for qualifying for the credit. The credit is allowed only for new high-wage jobs; it does nothing to help businesses retain high-wage jobs.

John Clark of New Mexico Partnership said that his organization discusses the high-wage jobs tax credit every day with clients. New Mexico Partnership is a private, state-funded entity that serves as the EDD's business location agency. The tax credit is cited as the second most important reason businesses locate in the state; even more important is the Job Training Incentive Program (JTIP), which provides funding for employee training. He said that the reason out-of-state sales were put into the statute was to draw new money into the state. The state needs to export goods, he said.

Fred Mondragon, secretary of economic development, said that the high-wage jobs tax credit differentiates New Mexico from other states and has attracted many new businesses to the state.

Angel Investment Credit (Mr. O'Neill):

- No stated purpose, but appears to bridge the funding gap between an entrepreneur's own fiscal resources and venture capital funds.
- PIT credit.
- Up to $25,000 for investment by an accredited investor in a qualified business.
- EDD issues certificates of eligibility.

- Annual cap of $750,000.
- EDD reports annually.
- Nonrefundable.
- Carryforward allowed for three years.
- Credit expires in 2012.

One effect of this incentive is to lower the rate of return necessary to attract investment. If the credit is extended, the carryforward provisions should be standardized, with full balance payout in the last year. The angel investment credit should require recapture of the credit if the money invested is returned within a short period of time. This credit effectively replaces the unsuccessful venture capital investment credit, which has very complicated certification processes.

John Chavez, president, New Mexico Angels, said that the tax credit is a valuable tool for economic development. He said that individual investors are still investing in businesses, but venture capital fund investments have slowed down.

Secretary Mondragon said that the angel investment credit only applies to New Mexico start-up companies. The state has granted $790,000 in credits, which investment has been leveraged multiple times.

<u>Cultural Properties Preservation Tax Credit (Mr. O'Neill)</u>:

- Stated purpose is to encourage the restoration, rehabilitation and preservation of cultural properties.
- Nonrefundable PIT credit.
- Carryforward allowed for four years.
- Tax credit of up to 50 percent of the costs of a preservation project, with a maximum $25,000 per claim, or $50,000 if the project is in an arts and cultural district.
- Approval of plans by the Cultural Properties Review Committee and certification that the project was completed is required for issuance of the credit.

The projects are all on privately owned properties. This credit may be in conflict with the antidonation provisions of Article 9, Section 14 of the Constitution of New Mexico. There needs to be better reporting from the Cultural Properties Review Committee to gauge the credit's effectiveness. The carryforward terms should be standardized. Recapture provisions are not needed because the credit is not granted until the project is completed.

Alan Watson, chair of the Cultural Properties Review Committee, said that the tax credit performs a number of positive functions, including the preservation of important cultural properties, the use of high-skilled labor, the increased use of local materials and the revitalization of many communities. He said that the credit often magnifies the size of a restoration project.

Robyn Powell, tax credit and financial incentive manager of the Historic Preservation Division of the Cultural Affairs Department, said that the division has overseen 800 completed restoration projects, but some of those projects did not involve the tax credit.

Questions and comments from committee members included the following:

● How long does a completed project need to be maintained in order to keep the credit? Ms. Powell said that there are no recapture provisions in statute.

● Do municipalities provide any tax credits for cultural property preservation? Ms. Powell said that only the state provides a tax credit.

<u>Film Production Tax Credit (Mr. O'Neill)</u>:

- No stated purpose, but appears to promote direct production and post-production film work in New Mexico.
- Credit equals 25 percent of amounts spent in New Mexico and 20 percent if the film receives a federal new markets tax credit.
- No single film limit or overall annual cap.
- TRD certifies the credits; the New Mexico Film Division of the EDD first determines whether a film production company is eligible for the credit.
- Fully refundable credit against PIT or corporate income tax (CIT) liabilities.

In order for the credit to come close to benefiting the New Mexico economy overall, the multiplier effects from film production expenditures would have to be more than three. Competition with other states may mean that New Mexico will have to increase the tax credit to higher percentages in order to maintain the film production level. The state should require much more in-depth reporting from the New Mexico Film Division to determine whether the state is benefiting. Placing limitations on the annual amount of credit allowed may make other states' incentives more attractive.

Ms. Strout said that more than 250 businesses are working full time in the film industry in the state. The film industry is very different from other traditional industries. She estimated that the New Mexico economy has gained $1 billion in direct revenues from the film industry.

Questions and comments from committee members included the following:

● How does the state determine resident job creation? Ms. Strout said that employees must have a residence in the state and sign a declaration of residency.

● For each job created by the film industry, the state pays $30,000 in tax credits.

● The $70 million the state is expected to pay in film production tax credits is money that does not go into education or health care. There should be an annual cap of $30 million for the credit.

● The division was asked to provide a report on the number of New Mexicans that have received professional training in the film industry.

● The economic multiplier effect of three seems impossible. A factor close to 1.2 is more realistic.

● Although the film industry receives a large income tax credit, the industry pays many other kinds of taxes in the state.

● Would it be beneficial for the state to sunset all of its tax credits so the legislature can periodically review their effectiveness? Mr. O'Neill said that periodic review is a good idea; however, short sunset periods may dissuade businesses from locating in the state.

<u>Affordable Housing Tax Credit (Mr. Anklam)</u>:

- No stated purpose, but presumably to encourage affordable housing projects in counties with populations less than 100,000.
- Credit can be claimed against CRS taxes.
- Transferrable.
- Carryforward allowed for five years.
- Certification required by the New Mexico Mortgage Finance Authority.

This credit is not for economic development purposes; presumably, it is to encourage an activity not being met by the marketplace. There should be periodic reporting and evaluation of the credit to determine its effectiveness. Making the credit refundable would make the administration of the credit more efficient. The cost of administration of the credit for the amount granted (less than $75,000 in fiscal year 2010) is probably too high. The state should consider changing the credit into a grant program.

<u>Business Facility Rehabilitation Credit (Mr. Anklam)</u>:

- Purpose to stimulate the creation of new jobs and revitalize economically depressed areas within New Mexico enterprise zones.
- Credit can be claimed against PIT and CIT liabilities and is in the amount of 50 percent of the cost of restoration, rehabilitation and renovation of business facilities, not to exceed $50,000 per facility.
- No certification required.
- Carryforward of four years allowed.
- Credit has not been used.

There is no periodic evaluation of the credit to determine its effectiveness. Carryforward provisions should be standardized. Because this credit has not been used, probably due to the lack of enterprise zones in the state, the credit should be redesigned or repealed.

Renewable Energy Production Tax Credit (Mr. Anklam):

- No stated purpose, but presumably to encourage investment in renewable energy generation projects.
- Credit can be claimed against PIT and CIT liabilities.
- Credit is $.01 per kilowatt-hour (kwh) for wind and biomass electricity generation and $.01 to $.04 per kwh for solar electricity generation for a 10-year period.
- For projects before October 2007, carryforward of five years and transferability are allowed.
- New projects have a fully refundable credit.
- Certification required from the EMNRD.
- Annual cap of $5 million.
- Credit is phased out for new projects in 2018.

This credit needs periodic evaluation and reporting to determine its effectiveness. There is also a significant opportunity for overlap with other tax incentives, which makes the overall effectiveness of the credit difficult to determine.

Mr. O'Hare said that there are three clean energy tax incentives in statute. All credits have annual statutory caps, but the caps have not been reached.

Allan Sindelar, president of Positive Energy, a solar energy design and installation company, said that he supports the clean energy tax incentives, especially the solar market development tax credit, which provides a 10 percent tax credit for solar photovoltaic systems. He said that when the federal government enacted a 30 percent tax credit for those systems, it did not enact certification requirements. The state subsequently adopted a smaller parallel credit, but it enacted certification standards that have ensured better standards in the industry.

Brendon Miller, green economy manager, EDD, said that New Mexico has vertical integration potential in renewable energy, i.e., the state has university training programs, manufacturing companies and consumer demand for the products and services of the industry.

Randy Trainor of the New Mexico Homebuilders Association said that the association is currently working on Uniform Building Code changes to reflect sustainable building and energy principles.

A committee member said that after construction of renewable energy projects, very few jobs remain. These tax credits really just shift tax burdens to other industries.

Investment Tax Credit (Dr. Pogue):

- Purpose to provide favorable tax climate for manufacturing businesses and promote increased employment in New Mexico.
- Credit amount equal to rate of compensating tax multiplied by the value of qualified equipment.

- Credit cannot exceed 85 percent of combined compensating, GRT and withholding taxes in a given year.
- Additional employment requirement for each $500,000 in qualified equipment costs.
- No reporting requirement.
- No recapture.
- Refundable credit under specific conditions.
- Unlimited carryforward allowed.
- No overall annual cap.
- Credit can overlap with the alternative energy product manufacturers credit, but credit cannot be claimed if a research and development small business tax credit has been claimed.

The economic impact of the investment credit is small because only a small number of businesses claim the credit. The credit essentially offsets the GRT and compensating tax for the purchase of equipment for manufacturing businesses in an attempt to reduce the pyramiding of those taxes. The legislature should consider imposing the same recapture provisions as are contained in the alternative energy product manufacturers credit and consider limiting the overlap of the two credits. Replacement of obsolete equipment would be covered by the credit and administration of the credit would be simplified if the employment requirement were removed.

Secretary Mondragon said that the EDD strongly supports the investment credit, which provides an 85 percent offset of sales taxes on new equipment. Most states do not tax the purchase of equipment. He said the EDD is in favor of attaching employment requirements to most economic development credits.

<u>Laboratory Partnership with Small Business Tax Credit (Dr. Pogue)</u>:

- Stated purpose is to bring the technology and expertise of the national laboratories to small businesses in New Mexico to promote the economic development of the state, with an emphasis on rural areas.
- Credit against the GRT for qualified expenditures incurred by a national laboratory, not to exceed $20,000 per year per small business in a rural area and $10,000 in other areas.
- Extensive reporting requirements, including economic impact study for each small business assisted.
- No recapture.
- No carryforward allowed.
- Annual cap of $2.4 million per national laboratory.

This credit enables small amounts of assistance to many small businesses around the state. The low cost of the credit compared to the amount of assistance provided makes this credit very effective. More detail on how economic impacts are studied needs to be given in the reports.

Mariann Johnston from the Business Assistance Program at Los Alamos National Laboratory (LANL) said that the laboratory has assisted more than 1,500 New Mexico companies. The laboratory's economic impact report is reviewed by an independent third party prior to it being published. Last year, LANL claimed $1.9 million from the credit.

Jackie Kerby Moore of Sandia National Laboratories said that New Mexico is fortunate to have two national laboratories, and the assistance that Sandia gives to small businesses leverages small businesses across the state.

Secretary Mondragon said that the credit is very helpful to a broad sector of New Mexico companies, especially in rural areas.

Questions and comments from committee members included the following:

● How many jobs have been created as a result of laboratory partnership with small business tax credit? Ms. Kerby Moore said that Sandia has helped create more than 1,000 high-wage jobs with average annual salaries over $39,000.

● What is the definition of a "rural area"? Dr. Pogue said that the definition of rural area for this credit is every area of the state except Bernalillo County.

<u>Job Mentorship Tax Credit (Mr. O'Neill)</u>:

- Stated purpose to encourage New Mexico businesses to hire youths participating in career preparation education programs.
- Credit can be claimed against PIT or CIT liabilities of 50 percent of the gross wages of qualified students, with a $12,000 annual cap per business.
- TRD issues certificates to high schools operating a career preparation program.
- School principal executes certificate when a qualified student gets a job.
- Carryforward of three years allowed.
- No recapture.
- No reporting requirement.
- Only 23 claims filed in five years.

This credit does not have any direct participation by the Workforce Solutions Department (WSD) or the Public Education Department (PED), which could explain its low use rate. Carryforward provisions should be standardized.

Questions and comments from committee members included the following:

● Staff was directed to report on the types of career preparation programs that qualify for the credit.

● How does information about the credit get disseminated? Mr. O'Neill said that information apparently does not get disseminated. He suggested that the PED be put in charge of operating the program, instead of the TRD.

Rural Health Care Practitioner Tax Credit (Mr. O'Neill):

- No stated purpose, but appears to subsidize medical professionals to encourage them to work in rural areas.
- Credit can be claimed against PIT liabilities up to $5,000 for doctors, dentists and certain other professionals and up to $3,000 for dental hygienists, physician assistants and certain nurse professionals who work in a designated rural health care underserved area.
- The Department of Health (DOH) determines eligibility to the TRD. Carryforward of three years allowed.

The DOH should report annually on the effectiveness of the credit. Some entity should certify the number of hours worked to claim the credit, rather than the applicant. The definition of "rural" is different from other tax credit definitions.

Questions and comments from committee members included the following:

● Most rural doctors are not self-employed. Hospitals get GRT credits and deductions, and doctors tend only to get a PIT credit for service in rural areas.

● Large corporate hospital chains cut corners, resulting in much higher Medicaid costs to the state. The legislature should consider giving rural health care practitioners larger tax credits and may wish to regulate "no-compete" clauses, which tend to drive health care practitioners away from rural areas when they stop service with a hospital chain.

Technology Jobs Tax Credit (Mr. O'Neill):

- Stated purpose is to provide a favorable tax climate for technology-based companies to promote increased employment and higher wages in those fields in New Mexico.
- Basic credit can be claimed against CRS liabilities for four percent of qualified expenditures and eight percent in rural areas.
- Advanced credit can be claimed against PIT and CIT liabilities at the same rates, but payroll expenses must also be increased in order to qualify.
- The TRD determines eligibility.
- The TRD reports basic information about the use of the credit.
- Recapture if a business ceases operations within two years of receiving the credit.
- Carryforward allowed indefinitely.

Responsibility for operation of the program should probably reside with the EDD. Additional reporting on the effectiveness of the program should be mandated. What exactly constitutes a "technology-based business" should be clarified in statute. Carryforward provisions should be standardized.

Alan Alder, deputy secretary of economic development, said that the EDD would welcome the opportunity to implement the technology jobs tax credit.

Rural Job Tax Credit (Mr. Anklam):

- No stated purpose, but presumably to encourage employment by those receiving JTIP funding in certain rural areas.
- Credit can be claimed against CRS, PIT and CIT liabilities in the amount of 6.25 percent of the first $16,000 of payroll for each qualifying job.
- Credit can be claimed for four years in very rural "tier-one" areas and for two years in "tier-two" areas.
- Carryforward of three years allowed.
- Transferable.
- Certification by the TRD.
- Reporting by the EDD, TRD and WSD on the effectiveness of the credit.

Periodic review of the credit's goals, outcomes and effectiveness should be performed. Population growth will reduce the applicability of the credit over time, so definitions of various rural areas should be standardized. The legislature should consider making the credit fully refundable or standardizing carryforward periods. The overlaps with other business subsidies should be thoroughly evaluated in order to understand the credit's effectiveness.

Secretary Mondragon said that the EDD would like to have standardized three-tiered definitions for rural and urban areas. Toni Balzano, administrator of the JTIP, said that the JTIP already has a three-tiered population definition.

Solar Market Development Tax Credit (Mr. Anklam):

- No stated purpose.
- Credit can be claimed against PIT liabilities for 10 percent of the cost of solar thermal or photovoltaic systems, not to exceed $9,000.
- Certification by the EMNRD.
- Carryforward of 10 years allowed.
- Annual cap of $2 million for solar thermal systems and $3 million for solar photovoltaic systems.
- Credit phased out for projects in 2018.

This credit should have periodic evaluation and reporting to determine its effectiveness. The legislature should consider establishing a standardized carryforward period, or making the credit refundable. The annual cap of $5 million makes this a low-risk credit to the general fund.

Sustainable Building Tax Credit (Mr. Anklam):

- No stated purpose. Credit can be claimed against PIT and CIT liabilities.
- Credit rates vary from $.30 to $9.00 per square foot, depending on size, type and efficiency rating.
- Carryforward allowed for seven years.

- Transferable.
- Annual caps of $5 million each for commercial and residential buildings and $1,250,000 for manufactured housing.

This credit should have periodic evaluation and reporting to determine its effectiveness. The legislature should consider establishing a standardized carryforward period or making the credit refundable. A policy question to ask is whether stricter building codes force builders to qualify for the credit.

Discussion of Tax Incentive Report

Ms. Ray discussed with committee members the upcoming report from the RSTP to the Government Restructuring Task Force (GRTF). She asked that members provide feedback to staff regarding specific restructuring proposals heard by the committee.

Questions and comments from committee members included the following:

- The RSTP will decide specific tax incentives and will make recommendations to the GRTF regarding the Motor Transportation Division (MTD) of the Department of Public Safety (DPS).

- The RSTP is not yet ready to make tax law recommendations, but it can make cost-savings recommendations to the GRTF.

- What is more important to the state: the film production tax credit or Medicaid and public schools?

- The RSTP should make specific systemic change recommendations to the GRTF.

- Formation of a subcommittee of members from the RSTP and the GRTF was suggested in order to discuss recommendations.

- The GRTF should examine the idea of sunsetting all credits in order to provide periodic review of incentives.

- Interim committees are not required to make recommendations to the GRTF, but they were requested by the New Mexico Legislative Council to do so if any come up during the interim.

- Some tax credits may not withstand constitutional scrutiny.

- The RSTP should investigate increasing distributions from the state's permanent funds.

The committee recessed at 4:58 p.m.

<u>Tuesday, August 24</u>

The committee was reconvened on Tuesday, August 24, 2010, at 9:38 a.m. by Representative Sandoval.

Review of Agency Operations

Ms. Ray and Lieutenant Colonel Mark Rowley, director, MTD, DPS, reviewed the operations and budget of the MTD. Ms. Ray began by reviewing the duties of the MTD, including providing law enforcement services; performing safety inspections on commercial motor vehicles; detecting and responding to radiological and nuclear exposure incidents; performing motor carrier compliance reviews and new entrant safety audits; providing motor carrier educational workshops; enforcing motor carrier size and weight restrictions; and enforcing compliance with motor carrier taxation and permitting. Overall, the taxes, fees and other revenues generated by MTD activity in fiscal year 2010 amounted to $9.5 million, down $1.2 million from the previous year. That revenue consisted of $6.2 million in port-of-entry revenue and $3.3 million in oversize/overweight permit revenue. The MTD also enforces compliance of the weight distance tax, which raised $72.2 million in fiscal year 2010.

The MTD has a budgeted allotment of 273 full-time-equivalent positions (FTEs), with 49 vacancies. In addition, 28 FTEs have been frozen during the recent economic downturn. The MTD fiscal year operating budget is $26.5 million, which is actually $2.2 million more than the previous fiscal year. The increase is due to a boost in federal stimulus funding and increases in other state fund revenue. The general fund budget for the MTD was reduced by $600,000 from fiscal year 2010.

Suggestions from the MTD for cost-savings and revenue enhancement include the following:

- elimination of the weight distance tax and substitution with an international registration plan for commercial motor vehicles;

- allowing civil citations to be issued by transportation inspectors;

- increasing the price for oversize/overweight single-trip permits;

- abolishing the ability for mobile home haulers to self-issue their permits;

- increasing the fines for overweight vehicle violations;

- cross-training transportation inspectors to issue driver's licenses; and

- transferring functions of the Radiation Control Bureau from the Department of Environment to the DPS.

Questions and comments from committee members included the following:

- What accounts for the large decrease in MTD-generated revenue since 2006? Lieutenant Colonel Rowley said that there has been an overall decrease in truck traffic in the past few years. In addition, the slowdown in the oil and gas industry has meant less oversize/overweight revenue for the state. The reduction in FTEs at the MTD has also resulted in smaller revenue collections.

- Why are the data reflecting heavy commercial daily vehicle travel no longer available? Lieutenant Colonel Rowley said that the MTD no longer has a contract with a consultant who had access to Department of Transportation data.

- How would increases in commercial motor vehicle fees affect the oil and gas industry? Lieutenant Colonel Rowley said that other states charge much more for vehicle registration fees than New Mexico currently does, including the cost of the weight distance tax.

- Has the MTD imposed mileage limits for its officers? Lieutenant Colonel Rowley said that budget cuts have made it necessary to limit the number of miles driven by MTD officers to 2,500 miles per month.

- Mobile home haulers who obey the law should not be punished by the enactment of a law geared toward those few who use an oversize/overweight permit multiple times. State police officers should be trained to conduct motor vehicle identification inspections.

- Do other states have some form of weight distance tax? Lieutenant Colonel Rowley said that 46 other states have a heavy-vehicle registration system, rather than charging trucks per mile traveled. He said that the weight distance tax is essentially collected on the honor system and said that intrastate trucking companies do not like that tax.

- Does the MTD have citation quotas for its officers? Lieutenant Colonel Rowley said that the MTD does not have quotas, but it does have recommendations for expected activity of its officers. He said that the MTD issued 55,217 citations in fiscal year 2010, and 50 percent of those resulted in convictions. Many of those citations were issued as warnings rather than penalty violations. The division was asked to provide the actual conviction rate of citations, discounting warnings. Lieutenant Colonel Rowley said that state law does not allow for verbal warnings; some sort of written citation must be issued. He said that the MTD does not receive conviction data from the courts; it estimates conviction rates based on revenue received.

- Does the New Mexico State Police (NMSP) provide any assistance to the MTD? Lieutenant Colonel Rowley said that the two divisions share many resources. There was an unsuccessful effort in 2002 to train state police officers in commercial vehicle enforcement. A committee member said that because the MTD is performing many duties of the NMSP, it may have difficulty in performing its primary mission of commercial vehicle enforcement.

- Staff was directed to research the issue of the DPS canine unit being under the control of the NMSP, which sometimes causes difficulty in MTD drug interdiction efforts.

- Staff was directed to research the possibility of moving commercial transportation regulatory duties of the Public Regulation Commission to the MTD, including the regulation of school buses and intrastate motor carriers.

- Does the MTD share in revenue raised from drug confiscation efforts? Lieutenant Colonel Rowley said that drug forfeiture money first goes to the federal government, and then the MTD is eligible for a portion of the money. There are very strict rules about how that money can be spent, and the money cannot be used to support operating budgets.

- The state needs to direct more money for the operation of the MTD, which will raise more revenue for the state general fund. The division also needs its own canine unit.

- How would the transfer of functions of the Radiation Control Bureau affect the regulation of radiologist technicians, who are currently regulated by the bureau? Lieutenant Colonel Rowley said that the MTD is primarily concerned with radioactive material source security.

- Staff was asked to research how to improve the functioning of law enforcement communication systems, especially in rural areas.

Tax Incidence Models

Gerry Bradley, research director, New Mexico Voices for Children, presented a proposal to the committee recommending that the state track the tax incidence level on New Mexico households. Policymakers should know how regressive or progressive the overall tax structure is in the state. A tax incidence model would allow an objective look at the state's tax system in terms of income distribution and would allow policymakers to assess the regressivity or progressivity of proposed tax increases and decreases. Mr. Bradley also discussed how various states have implemented tax incidence models. Finally, he discussed a 2007 study by the Institute on Taxation and Economic Policy (ITEP) that showed that the poorest residents of the state pay a higher percentage of their incomes in state and local taxes than do their wealthier neighbors.

Questions and comments from committee members included the following:

- The property tax system is unfair in counties that have a high percentage of federal land. Industrial revenue bond issuance compounds the problem, because big businesses tend not to pay property taxes.

- Does New Mexico have a regressive or progressive tax structure? Mr. Bradley said that the state probably has a somewhat regressive system, but the actual tax incidence on residents needs to be studied in depth so that future tax law changes can be made with better information.

- Although the ITEP handout showed taxes paid as a percentage of personal income, it does not show the percentage of actual taxes paid by income category. The objectivity of the ITEP study was questioned. Mr. Bradley said that he would research all of the assumptions of that study and report back to committee members.

Corporate Income Tax Distortion and Cures for Distortion

Helen Hecht, tax counsel, Federation of Tax Administrators, discussed with the committee economic distortions within the CIT. A multistate corporation is taxed by each state that has a CIT according to its own apportionment formula to determine the portion of income earned by a corporation from activities within the state. While there is no one typical apportionment formula, each state's formula is designed to calculate the portion of the taxable income of a multistate corporation. Because other states are free to use a different method to determine their own shares of that income, multistate businesses can be taxed on more or less than all of their income. In New Mexico, the CIT is calculated by using the three factors of payroll, property and sales in the state compared to the company's total of those factors.

Many businesses are organized as affiliates operating as separate entities within one company. Expenses incurred by one affiliate might benefit the operations of another, which leads to difficulties in determining the right way to apportion taxable income for the business. If state CIT is imposed strictly on the taxable income of each separate legal entity, then the tax results may be artificially distorted if the separate legal entity represents only one piece of the total business operation of a corporate group. States that allow separate corporate filing, like New Mexico, have become concerned with the kind of artificial tax results that comes from certain transactions between the members of a corporate group that can affect the taxable income of each entity in the group.

The federal government generally treats such corporate groups as consolidated entities in which inter-company transactions do not affect the taxable income of the entire group. States are prohibited for constitutional reasons from requiring consolidated filing, but they can require combined filing, which works in a similar fashion. A state that requires combined filing treats an entity as part of a unitary business with other entities in the group and taxes the entire unitary business according to the apportionment formula of the state.

Ms. Hecht provided an example of how several tax results can be achieved by a business from choosing different filing methods in each state in which it does business. In the example, if the company files as a combined entity in both states, each state receives an equal portion of the tax due. If the company files as separate entities, the entity that had a profit will pay more tax to the state in which it is situated and none to the state in which the entity had a loss, plus a carryforward against future taxes. The total tax paid by the company is the same as in the separate filing method, but one state receives all of the tax. Finally, if the company chooses combined filing in the state in which there is a profit and separate filing in the state with a loss, the company ends up paying only a portion of its taxable income. The reason for that is that the company pays tax in the profitable state as if the company would be paying the rest of the tax due in the other state, but it actually claims a loss in the other state, because its separately treated entity in that state did not earn a profit. Ms. Hecht said that this choice of filing method can provide an incentive for a company to invest in certain states, depending on the circumstances.

The next example she cited used the same assumptions but dealt with a company that further divided its business by creating a separate royalty company. The parent company makes a tax-free contribution of intangible property rights, such as copyrights and trademarks, to the royalty company, which in turn charges branch companies in individual states for the use of those property rights. The royalty company pays a nontaxable dividend to the parent company, which then reinvests that money with the branch companies. The net effect is to keep the same cash at the branches, but from a tax standpoint, the branch companies suddenly have a huge expense item with which to reduce state tax liabilities. In the state with separate filing, the company would pay no tax because of the intra-company royalty charges. In the state with combined filing, the state would pay its apportioned share of tax, because only that state's total share of the company would be taxed. In effect, the royalty company would be treated as if it did not exist. This type of tax benefit is usually considered not to be an intended benefit for taxpayers by policymakers. Most state courts have sided with tax agencies in tax cases if the following facts have been shown:

- the structure or transactions that result in the tax savings have no real economic impact on the corporations involved;

- the structure is artificial, or the transactions are merely "paper" transactions between commonly controlled entities;

- the transactions are entirely intra-company and are not the kinds of transactions the company would engage in with unaffiliated third parties; and

- the sole purpose of the structure and transactions is to reduce state taxes.

States have many cures for this type of tax distortion, including requiring unitary combined reporting; requiring companies to add back certain intra-company charges and expenses; using the authority granted by the Uniform Division of Income for Tax Purposes Act (UDITPA) to add back deductions or to require combined reporting on a case-by-case basis; determining that certain companies have economic nexus within the state and taxing a portion of their income; determining that certain transactions are done solely for tax purposes and disallowing those transactions from being deducted from taxable income; and requiring that intra-company transactions be priced the same as third-party transactions.

Ms. Hecht said that although New Mexico has the authority through UDITPA to require combined reporting, this power can only be done on a case-by-case basis. Requiring combined reporting for interstate companies or providing for add-back provisions would apply more generally and would be more predictable for companies. If the state adopts combined filing, the legislature should also decide the standard to apply in determining whether a company is a unitary corporation; whether net operating losses of and tax credits granted to a separate entity will be available for use by the combined group; and how to combine entities with special apportionment rules. Add-back statutes can cure many types of distortion, but they are generally narrowly defined to catch the kind of loophole described in Ms. Hecht's presentation. An add-back statute may have no impact on a large number of corporations doing business in New Mexico.

A committee member asked if a company can change its filing status from year to year. Ms. Hecht said that a company can choose to switch from filing as a separate entity to either combined or consolidated, but once that determination has been made, a switch back to separate filing requires permission from the secretary of taxation and revenue.

There being no further business, the committee adjourned at 12:35 p.m.