MINUTES
of the
THIRD MEETING IN 2012
of the
REVENUE STABILIZATION AND TAX POLICY COMMITTEE

August 30, 2012
Intel Building RR5, Rio Rancho

August 31, 2012
Mid-Region Council of Governments
Albuquerque

The third meeting of the Revenue Stabilization and Tax Policy Committee (RSTP) for 2012 was called to order by Representative Edward C. Sandoval, chair, on Thursday, August 30, 2012, at 10:22 a.m. in Room 114 of Intel Building RR5 in Rio Rancho.

Present
Rep. Edward C. Sandoval, Chair
Sen. Tim Eichenberg, Vice Chair
Rep. Donald E. Bratton
Sen. Carlos R. Cisneros
Rep. Anna M. Crook
Sen. Clinton D. Harden, Jr.
Sen. Timothy Z. Jennings, Senate President Pro Tempore
Sen. Timothy M. Keller (8/30)
Rep. Rodolpho "Rudy" S. Martinez
Sen. Howie C. Morales
Rep. Henry Kiki Saavedra
Rep. Thomas C. Taylor (8/30)
Rep. Jim R. Trujillo
Rep. Bob Wooley (8/31)

Absent
Sen. Mark L. Boitano
Sen. Gay G. Kernan
Rep. Ben Lujan, Speaker of the House
Sen. John Arthur Smith

Designees
Rep. Thomas A. Garcia
Sen. William E. Sharer

Sen. Rod Adair
Rep. Ray Begaye
Sen. William F. Burt
Rep. Zachary J. Cook
Rep. Brian F. Egolf, Jr.
Rep. Miguel P. Garcia
Rep. Roberto "Bobby" J. Gonzales
Sen. Eric G. Griego

Sen. Phil A. Griego
Rep. Sandra D. Jeff
Rep. Antonio Lujan
Rep. Antonio "Moe" Maestas
Sen. George K. Munoz
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

Guest Legislators
Rep. Conrad D. James (8/30)
Sen. David Ulibarri

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

Staff
Pam Ray, Staff Attorney, Legislative Council Service (LCS)
Ric Gaudet, LCS
Pam Stokes, Staff Attorney, LCS

Guests

The guest list is in the meeting file.

Handouts

Handouts and other written testimony are in the meeting file.

Thursday, August 30

Intel Tour

Members of the committee went on a tour of the Intel manufacturing plant prior to the meeting being called to order.

Corporate Income and Franchise Tax Revenue Update and Trends

Demesia Padilla, secretary of taxation and revenue, and John Tysseling, chief economist, Taxation and Revenue Department (TRD), gave a presentation to the committee on the structure of the corporate income tax (CIT) and possible changes to the tax. The CIT is imposed on the taxable income of a corporation, which is based on federal taxable income with a few differences: New Mexico allows only five years for a business to carry forward net operating losses (NOLs); and the state does not tax interest from United States debt obligations or foreign dividends. A corporation's business income tax is then computed on its income from all business activities worldwide and then apportioned to the New Mexico portion of that activity. New Mexico uses the standard three-factor apportionment formula, which evenly weights a corporation's payroll, sales and property factors in New Mexico compared to its total of those factors worldwide.

CIT revenue has historically been volatile, and it has recently seen large fluctuations. CIT revenue peaked in fiscal year 2007 at $460 million, followed by a fiscal year 2010 slump to $170 million. CIT revenue has been steadily increasing since that year and is expected to reach $293 million in fiscal year 2012. The CIT generally accounts for only five percent of general fund revenues. Secretary Padilla said that the state may be sending the wrong message to the business community about locating in New Mexico due to the high tax rates and complexity of the tax.

Approximately 20,000 corporations file CIT returns annually in the state. CIT growth sectors, based on the number of companies filing returns, include manufacturing; wholesale trade; finance and insurance; and professional, scientific and technical services. However, the sectors that generate the most CIT revenue include the oil and gas, manufacturing and management sectors. As an example, the oil and gas sector accounts for nearly one-fourth of CIT revenues, but it has only four percent of the total number of corporations in the state.

More than 18,000 corporations use the separate filing method, with the remaining companies filing combined or consolidated returns. Sixty percent of corporations reported an NOL in 2010. Seventeen percent reported taxable income greater than $1 million, generating $215 million in revenue for the state. The remaining 23 percent of corporations reported smaller earnings and generated only $7 million in revenue. The top 100 corporate taxpayers in the state in 2010 paid $167 million in taxes, which accounts for 75 percent of the CIT revenue. Of those 100 companies, only four have corporate headquarters in the state. Those companies also have a different distribution of taxes paid according to each apportionment factor. Most of the liability is not due to the sales factor but, instead, to the property factor.

Changing the CIT rate from a top bracket of 7.6 percent to 6.4 percent would cost the state around $60 million annually. Changing the rate to a flat 4.8 percent would cost the state about $150 million.

Questions and comments from committee members included the following.

- Have there been any studies of the offset to state revenue loss from a lowering of CIT rates by a potential increase in corporate activity? Secretary Padilla said that there have not been any specific studies in New Mexico to analyze that question. However, every dollar lost in CIT revenue shows up as a proportional increase in personal income tax (PIT) revenue.

- When Intel chose to build a new manufacturing facility in Arizona instead of New

Mexico, was the availability of computing the CIT using a single-sales factor an important factor in that decision? Liz Shipley, government relations manager, Intel, said that the single-sales factor apportionment formula was a consideration in the company's decision, but it was not the only one. Intel expects to have about $10 billion in property assets in the state within 10 years. Allowing a single-sales factor would significantly reduce the company's tax liability.

- What percentage of the oil and gas and other mining category can be attributed to mining? Mr. Tysseling said that the oil and gas sector accounts for the great majority of that category.

- What accounts for the large increase in CIT revenue in fiscal year 2011 but a projected slight drop in revenue for fiscal year 2012? Swaroop Chary, economist, TRD, said that many companies still have NOLs on their books, so they can continue to reduce their tax liability.

CIT Overview

Richard Anklam, president and chief executive officer, New Mexico Tax Research Institute, gave a presentation to the committee about how the CIT operates in New Mexico. Forty-six states impose some type of income-based tax on corporations. Corporations pay tax on profits at the corporate level, and owners of corporations pay taxes as individuals. Small- to medium-sized businesses typically do not pay the CIT, mostly due to the fact that many businesses are organized as some form of pass-through entity. A state income tax calculation is based on the filing method, taxable income, apportionment method, tax rate and available incentives and credits.

The state CIT is very complex to administer and to comply with. Compared to revenue generated, this complexity is significant, rendering the CIT an exceptionally inefficient form of taxation. Because the CIT is generally imposed on larger, multistate companies, the impact of a state's CIT may affect the amount of economic activity or investment a corporation makes in that state.

Many states, including New Mexico, allow multistate corporations to file their tax returns as separate entities. Many states require multistate corporations to file on a unitary combined basis, which captures a portion of the entire company's earnings, apportioned to the state share of the business. The filing method for multistate corporations must be considered along with the apportionment method. New Mexico uses the standard apportionment formula, in which the three factors of property, payroll and sales are equally weighted. This formula was developed many decades ago to provide a uniform method for states to tax multistate corporations. The formula is reasonable, but it is somewhat arbitrary.

New Mexico's CIT structure has been substantially the same for decades, but other states have been changing their CIT structure dramatically. Rate reductions, alternative apportionment methods and requiring combined reporting are all common in the western states. These developments, in addition to the NOL limitation of only five years and the tiered rate structure of the CIT, have made New Mexico less business-friendly over time. There are several CIT reform options, but each one has policy and revenue considerations. The most equitable approach to CIT reform would be to enact CIT rate reductions, but that approach is also the most expensive approach if meaningful relief is desired. Another reform idea is to provide alternative apportionment formulas, such as a single-weighted sales factor (SSF). Some states have mandated that apportionment formula, but others have allowed companies to elect which apportionment formula to use. This would allow those industries, such as utility companies, to continue to use the standard three-tier formula rather than being penalized by switching to the SSF formula. Mr. Anklam suggested that if New Mexico were to allow such an election, those elections should not be allowed on a year-to-year basis. Another, more targeted, CIT reform approach would be to allow an optional SSF for certain industries deemed important to the state's economic development goals.

The prospect of requiring combined filing by multistate corporations has been a controversial subject in New Mexico for the past decade. All other surrounding states that have the CIT have required combined reporting. However, this approach is complex and may not bring in much more revenue to the state. Mr. Anklam suggested that if separate filing is continued, the legislature could consider providing reasonable "addback" provisions to capture some of the earnings of multistate corporations that can be attributed to the state. This law change would have substantially the same impact that requiring combined reporting would have.

Mr. Anklam mentioned several other CIT reform options, including much-needed technical clarification and cleanup; elimination of the "throwback" rule, which penalizes certain manufacturers; extension of the carryforward of NOLs for more than five years; and the establishment of independent hearing officers.

Perspective on CIT Structure

Richard Minzner, lobbyist, gave the committee his perspective on the CIT. Nearly all of New Mexico's CIT revenue is paid by large, multistate corporations. Most local businesses pay no CIT at all. The most important factor in the CIT law for many corporations is the apportionment formula. New Mexico uses the standard three-factor formula, which discourages investment and employment by corporations in the state. If New Mexico were to require combined reporting, the adverse impact of the apportionment formula would be magnified for many companies. That prospect, coupled with the state's very high CIT top-bracket rate of 7.6 percent, makes the state not very business-friendly and discourages new investment.

The recent attempts in the legislature to require combined reporting have shown how difficult it is to establish meaningful CIT reform. The current provisions allowing separate reporting is one of the few incentives the state provides for corporations to invest or stay in the state. Requiring combined reporting should not happen without a comprehensive approach — one that looks at changing tax rates and the apportionment formula. Mr. Minzner suggested that rather than requiring combined reporting, which would penalize many companies, the state could enact addback provisions, which would allow the state to recapture some legitimate tax revenue from some companies that attempt to evade paying the CIT through complex corporate structuring.

Questions and comments from committee members included the following.

- What should New Mexico do about NOL carryforwards? Mr. Minzner said that NOLs should be allowed to be carried forward for 10 to 15 years. He said that it would not be a good idea to allow companies to immediately monetize NOLs through refunds.

- How should New Mexico reform its CIT system? Mr. Minzner said that the state could lower the CIT rate, allow companies to elect to use an SSF apportionment formula and enact addback provisions. These three reforms would make the state much more business-friendly, while preventing illegitimate tax evasion strategies.

Intel — SSF Apportionment Formula

David Slater, State Taxation Division, Intel; Ms. Shipley; and Brian Rashap, site manager, Rio Rancho plant, Intel, discussed with the committee Intel's desire to be allowed to use an SSF in apportioning its income. Mr. Slater said that the current three-factor formula discourages corporations from making capital investments in New Mexico. In fact, it encourages in-state companies to invest outside of the state. Allowing an SSF apportionment formula would substantially change the investment environment in the state. New Mexico is already behind other states, being the only state in the region that does not have an SSF formula. Whenever Intel contemplates a new investment, it models the tax impact the new investment would have on the company. Investments in New Mexico cost more in taxes than investments made in other states.

Questions and comments from committee members included the following.

- How has Arizona recently changed its apportionment formula laws? Mr. Slater said that Arizona recently switched from a double-weighted sales factor formula to an SSF formula. That formula is being phased in over a five-year period, from 80 percent to 100 percent.

- What are the drawbacks to providing an SSF apportionment formula? Mr. Slater said that there certainly may be short-term revenue impacts, but the situation needs to be looked at dynamically. This change will encourage new capital investment and employment, which will increase tax revenues. If an SSF formula is required, rather than it being elective, some industries will end up pay more taxes, but the manufacturing sector will benefit.

- Intel has brought many high-wage jobs to central New Mexico. However, it needs to provide more outreach to rural areas. Ms. Shipley said that Intel is a major sponsor of the MESA program, which provides math and science programs to students. It also hosts approximately 100 students each summer at the plant to encourage students to study engineering.

- What is the average starting salary for engineers at Intel? Mr. Rashap said that, depending on the area of study, new engineers earn a starting salary of between $70,000 and $90,000.

- Was New Mexico's lack of an SSF formula the deciding factor in Intel's decision a few years ago to not build a new manufacturing facility in the state? Mr. Rashap said that was one factor in the decision. However, other factors, including work force readiness and infrastructure availability, played a role in the decision.

New Mexico Voices for Children Perspective on CIT Structure

Gerard Bradley, research director, New Mexico Voices for Children, discussed with the committee his organization's view of the CIT and current reform ideas. CIT revenue has historically been between three percent and eight percent of annual general fund revenues, and it is expected to be 6.5 percent of revenues in fiscal year 2013. Any change to the CIT structure to benefit businesses will cost the state money.

Mr. Bradley discussed requiring combined reporting by multistate corporations. The goals of requiring combined reporting include stopping CIT avoidance based on artificially shifting income to commonly owned corporations to other jurisdictions and ensuring that a corporation's CIT liability to New Mexico is the same, regardless of the corporation's legal structure. Currently, 23 states require combined reporting.

Mr. Bradley then discussed how various apportionment formulas affect tax liabilities of a company and how adopting an SSF formula would affect state revenues. By adopting an SSF formula, the only factor used in computing the CIT would be sales. Property and employment would be discounted completely. Using revenue estimates from 2008, he calculated that the CIT tax base would be reduced by more than 50 percent if an SSF formula were allowed, which in fiscal year 2013 would cost more than $175 million.

Finally, Mr. Bradley discussed the "throwback" rule, which provides that certain sales are classified as New Mexico sales in order to prevent the emergence of profits that are not taxed by any other state. He suggested that the legislature not eliminate this provision, which would lead to further tax avoidance by some corporations.

Questions and comments from committee members included the following.

- Tax policy in New Mexico does not favor the manufacturing industry.

- The previous large budgets New Mexico had were mostly based on the price of oil. Those surpluses should have been put into reserves rather than put into a recurring budget cycle.

- Can New Mexico provide revenue-neutral CIT reform by broadening the tax base and lowering the rate? Mr. Bradley said that the proposals he has seen thus far would not be revenue neutral. The $150 million to $175 million cost of switching to an SSF formula would not be offset by the most generous revenue estimates of $50 million from mandatory combined reporting.

- Forty years after adoption of the standard apportionment formula, New Mexico faces new economic realities. Adopting an SSF formula may cost the state some tax revenue, but it may also benefit from new job creation and capital investment.

- Intel may eventually close its Rio Rancho plant if New Mexico does not reform its tax policy.

Association of Commerce and Industry Concerns

Marcus Mims, chair, Tax Committee, Association of Commerce and Industry (ACI), and Timothy Van Valen, ACI board director, discussed with the committee the CIT-related issues with which the ACI is concerned. The ACI supports:

- enactment into law of an SSF apportionment formula for the CIT. An SSF formula is favorable to businesses that sell to out-of-state customers and tends to bring new money into the state by attracting business investment and job creation. Mr. Van Valen also said that an SSF formula would be broad-based and not pick winners and losers;

- elimination of the throwback rule for the sales factor computation. This law increases the sales factor of corporations and artificially attributes sales to New Mexico if the state in which a corporation's customer is based has no jurisdiction to tax the customer. Leaving this provision intact would thwart the goal of adopting an SSF formula;

- reduction of the highest CIT rate from 7.6 percent to 4.9 percent. This would make New Mexico more competitive with surrounding states and would tax all businesses at the same maximum rate. Currently, limited liability companies and other pass-through entities and sole proprietorships pay the CIT at a maximum 4.9 percent;

- clarification that the state's treatment of NOLs is governed by provisions of the federal Internal Revenue Code of 1986. New Mexico statutes do not expressly address whether the state follows federal rules for the use of the NOL deduction. The TRD rules tend not to follow federal rules on NOL deductions following a merger or acquisition of a company. In addition, New Mexico statutes allow a five-year NOL carryforward, but federal law allows a 20-year period;

- a stable and predictable tax system. New Mexico suffers from a perception that it has an unstable and unpredictable tax system because legislation is often introduced to change business incentives and to change CIT reporting methods;

- fair tax administration. The TRD should not adopt retroactive rules. It also needs to provide effective advance notice to taxpayers of tax policies and develop those policies in a transparent public process rather than through an audit process or litigation;

- replacement of TRD hearing officers with independent, external hearing officers. New Mexico is one of the few states that do not have independent hearing officers. TRD hearing officers are perceived as being biased toward the TRD's position, which reduces confidence in the tax administration system;

- a comprehensive state economic development plan. Tax legislation too often inequitably picks winners and losers and is often geared toward political and economic special interests. There has been little effort to establish a comprehensive statewide economic development plan; and

- transparency and accountability for tax incentives that also protect taxpayer confidentiality and proprietary information. New Mexico is less likely to attract new business if proprietary information is made public by the acceptance of a tax incentive. Tax expenditure budgets can be crafted to give the public an incorrect view of exemptions or deductions that are not really tax expenditures versus those that are indeed created to incentivize a business activity.

The ACI opposes any attempt to eliminate the option for multistate corporations to file separately. Elimination of filing method options would make New Mexico even less attractive than it is now for new investment. Changing filing methods for businesses that are already in New Mexico would be fundamentally unfair.

Questions and comments from committee members included the following.

- Many corporate branches that start up in a new state are not profitable for a few years, yet the overall company may turn a profit. Requiring combined reporting in such a situation is not fair to the new company. Mr. Van Valen said that research data suggest that the state would not see much of a revenue increase from mandating combined reporting.

- The ACI representatives were asked to come up with a workable solution to help attract new business to the state and also maintain tax revenues to the state.

Transferable Tax Credits

Ethan Epstein, Tax Credit Alliance, LLC, presented a bill draft to the committee to allow several existing tax credits to be transferred to other taxpayers. He recommended that the angel investment credit, the credit for preservation of cultural properties, the job mentorship tax credit, the solar market development tax credit and the rural health care practitioner tax credit be made transferable, which would allow those credits to be sold to other taxpayers if their full value cannot be used by the original taxpayer.

The committee recessed at 4:36 p.m.

Friday, August 31

The committee reconvened on Friday, August 31, 2012, at 9:07 a.m. at the Mid-Region Council of Governments building in Albuquerque.

Revenue Forecast

Secretary Padilla; Leila Burrows, chief economist, Department of Finance and Administration; and Elisa Walker-Moran, chief economist, Legislative Finance Committee, presented to the committee the August 2012 consensus revenue forecast. Fiscal year 2012 revenues have been revised upward since the December 2011 forecast by $218 million, at $5.476 billion. Fiscal year 2013 estimates have been revised upward of $18 million, and fiscal year 2014 revenues have been revised upward by $120 million, at $5.922 billion. Fiscal year 2012 general fund ending balances are $706 million, or 12.9 percent of recurring appropriations, and fiscal year 2013 ending balances are estimated to be $736 million, or 13 percent of recurring appropriations. For fiscal year 2014, the state expects to see $272 million in new money, which is defined as fiscal year 2014 projected revenues less fiscal year 2013 recurring appropriations. However, scheduled changes to public employee retirement contributions and transfers from the Tobacco Settlement Permanent Fund will reduce the amount of new money to $198 million.

Secretary Padilla discussed the recently enacted gross receipts deduction for certain items consumed during the manufacturing process. She said that some rural electric cooperatives have indicated that they may not use the deduction because its requirements are too burdensome. She also said that the film production tax credit now requires the credit to be applied for when a taxpayer files its income tax return, which has caused some problems with the timing of the credit. The high-wage jobs tax credit has seen a large increase in use in the past two years, and there are some loopholes that need to be fixed with that credit. Some companies have claimed the credit after a merger in which no new jobs were created.

Questions and comments from committee members included the following.

- Is there a lookback limit to the high-wage jobs tax credit? Secretary Padilla said that some companies are going back to 2004 job creations to claim the credit. There should be a limit to when a company may claim a credit for previous activity.

- The threshold of $28,000 to claim a high-wage jobs tax credit is too low.

- The Department of Transportation will soon need to make a $500 million payment for the purchase of Burlington Northern Santa Fe Railroad tracks, and it will also soon need to invest $113 million for track repairs.

Minutes

The minutes of the July 16-17, 2012 committee meeting were adopted without correction.

PIT Revenue Update

Secretary Padilla, Mr. Chary and Jeff Bjarke, senior economist, TRD, discussed with the committee the PIT. New Mexico's top marginal PIT rate is 4.9 percent, which is very close to the rate imposed by surrounding states. The PIT is the general fund's second-largest revenue source, and it is expected to raise $1.6 billion in fiscal year 2013. Historically, PIT revenue has steadily increased since 1999, except during the 2008 economic recession when revenues dropped more than 20 percent.

Less than one percent of PIT filers file "married filing separately" because that tax bracket is more expensive than other brackets. Fifty-five percent file as "head of household or "married filing jointly", and the remaining 44 percent file as single individuals or estates or trusts. While those with taxable income under $50,000 make up 80 percent of PIT filers, they account for 55 percent of PIT revenue. Filers earning more than $100,000 account for six percent of PIT filers and 21 percent of its revenue. The average tax liability in New Mexico has hovered around $1,000 for the past four years, with an average $100 in tax credits applied to each person.

Questions and comments from committee members included the following.

- The PIT is not progressive enough and should have a higher tax margin than the current 4.9 percent. Secretary Padilla said that many people earning less than $25,000 take advantage of multiple credits available to low-income people.

PIT Structure Overview

Jim O'Neill, consultant, gave the committee a primer on the structure of the PIT. New Mexico's PIT is levied on every resident individual and on every nonresident deriving any income in the state. "Individual" includes estates, trusts and fiduciaries. The PIT is not imposed on Native Americans earning income within their tribe's territory. Also excluded from taxation is income earned by foreign diplomatic and military personnel. If a person has been employed in New Mexico 15 days or fewer, PIT payment and withholding are not required.

New Mexico piggybacks on federal law to calculate the PIT, with some important modifications. While this method makes calculation of income much simpler for taxpayers and preparers, a certain amount of sovereignty is ceded to the federal government with this practice. NOLs for PIT purposes are treated differently than the federal government, mainly by disallowing carrybacks of NOLs and allowing them to be carried forward for only five years.

New Mexico has a progressive income tax schedule, although the top margin rate was reduced to 4.9 percent in 2004, rendering the PIT essentially a flat tax. There are 28 PIT rebates and credits, many of which target low-income persons. The income tax system is designed to return to qualifying low-income persons a portion of other taxes paid to the state. Many people receive a refund from the state from PIT calculations of more than they have actually paid in income taxes.

The state requires employers to withhold income taxes from employee earnings, and it requires withholding from certain types of pass-through entities and proceeds from oil and gas operations. Against the recommendation of nearly all economists, most wage earners prefer to have too much in withholding in order to ensure a significant refund at the end of the tax season, which results in the state having a large interest-free cash flow boost most of the year.

Mr. O'Neill discussed the 11 plans in statute allowing taxpayers to donate a portion of their income tax refund to various worthy causes. He said it is not clear how much this system costs the state to implement compared to revenue generated. Finally, he identified several obsolete statutes in the Income Tax Act that could be repealed.

Questions and comments from committee members included the following.

- Does each agency that desires to intercept wages from identified individuals need to recertify its list of individuals to intercept wages? Mr. O'Neill said that process happens annually. Keeping individuals on a list indefinitely could raise due process concerns.

- Many state agencies do not pay their vendors in a timely fashion. Vendors who are owed money by state agencies should be allowed to use the Tax Administration Act's interest and penalty provisions to charge agencies fines for not paying on time.

- The Fort Bayard National Cemetery should be added to the list of tax refund beneficiaries because that cemetery is quickly running out of space and needs to acquire more land.

There being no further business, the committee adjourned at 11:00 a.m.