MINUTES
of the
FOURTH MEETING IN 2009
of the
REVENUE STABILIZATION AND TAX POLICY COMMITTEE

September 14-15, 2009
The Lodge Resort at Cloudcroft
Cloudcroft, New Mexico

The fourth meeting of the Revenue Stabilization and Tax Policy Committee (RSTP) for 2009 was called to order by Senator John Arthur Smith, chair, at 9:12 a.m. in the Lodge Resort in Cloudcroft, New Mexico.

Present	**Absent**
Sen. John Arthur Smith, Chair	
Rep. Edward C. Sandoval, Vice Chair	
Sen. Carlos R. Cisneros	
Rep. Nathan P. Cote	
Rep. Anna M. Crook	
Sen. Dianna J. Duran	
Sen. Tim Eichenberg	
Rep. Keith J. Gardner	
Sen. Timothy Z. Jennings	
Sen. Timothy M. Keller	
Sen. Gay G. Kernan	
Rep. Ben Lujan	
Rep. Rodolpho "Rudy" S. Martinez (September 14)	
Sen. Howie C. Morales (September 14)	
Rep. Henry Kiki Saavedra	
Sen. William E. Sharer	
Rep. Thomas C. Taylor	
Rep. Jim R. Trujillo	

Designees

Sen. Peter Wirth	Sen. Mark Boitano
	Rep. Donald E. Bratton
	Rep. Zachary J. Cook
	Sen. Kent L. Cravens
	Rep. Miguel P. Garcia
	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

Other Legislators Attending
Rep. Dennis J. Kintigh
Sen. Mary Kay Papen (September 14)

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

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

Monday, September 14

Welcome — Local Issues

David Venable, mayor of the Village of Cloudcroft, welcomed the committee to Cloudcroft and suggested renaming the committee the "Missing Revenue and Hold Harmless Tax Policy Committee". He reported on the state of Cloudcroft's economy and government budget and said that the village has already cut spending this fiscal year by 10 percent. Voters recently adopted a one-fourth percent gross receipts tax (GRT) increment, which has helped the village. As a small measure, village officials are also paying their own expenses for any out-of-town trips. Mayor Venable expressed frustration at some of the regulatory and paperwork burdens erected in order to qualify for federal stimulus grant funding, citing the thousands of pages of federal guidance that his secretary has had to sort through in addition to her other regular duties. He mentioned a nearly completed project funded by federal stimulus grants, the rebuilding of the Mexican Canyon Trestle, a historic landmark. That project was granted $249,000, and Mayor Venable said that the project was expected to be finished within the week.

Questions from committee members included:

- Not including the recent tax increase, how much are GRT collections reduced? (Gross receipts in the village are down 12 percent to 13 percent from last year; occupancy tax collections are also down by the same percentage. Cloudcroft has not bonded against any GRT, however.)

- Has Cloudcroft applied for other stimulus funds? (The village has applied for five grants and has also applied with the state for colonias funding.)

- Has Cloudcroft imposed any mill levy taxes? (Yes, to a limited extent. The village council views increasing property taxes as a last resort because local schools already have imposed high mill levies.)

- What is the size of the police force and other village offices? (Cloudcroft has a three-member police department, and the village has a total of 17 staff members.)

- Is there any lumber activity in the area? (Only a few small companies operate in the area, mostly involving U.S. Forest Service clearing projects; the Mescalero Apache Tribe has some lumber operations.)

Taxation and Revenue Department Legislative Proposals

Rick Homans, secretary of taxation and revenue, Jim Nunns, tax policy director, Taxation and Revenue Department (TRD), and Michael Sandoval, director, Motor Vehicle Division (MVD), TRD, presented to the committee eight legislative proposals for its consideration. The proposals include one tax bill and seven motor vehicle-related bills:

- <u>Simplification of Personal Income Tax (PIT).</u> The bill would simplify the PIT, making it easier for taxpayers to file their returns; make the PIT fairer by ensuring that people are not taxed unfairly by inflation; remove obsolete language and clarify definitions; and maintain fiscal responsibility by designing the tax changes to be revenue neutral. The bill is similar to legislation endorsed by the committee in 2008.

- <u>Recompilation of the Motor Vehicle Code and Technical Changes.</u> The New Mexico Compilation Commission has agreed to recompile the Motor Vehicle Code as requested by the TRD without requiring the introduction of legislation. The proposed bill will make dozens of technical and cleanup changes to the code, without attempting to delve into substantive issues. Substantive changes to the code will be proposed for the 2011 legislative session.

- <u>Allow Driver's Licenses and Identification Cards To Be Renewed Via the Internet or by Mail.</u> This bill will reduce significantly wait times in MVD offices. The bill also eliminates the requirement that a person take a vision test every time the person renews a license. Persons over the age of 75 still are required to take an annual vision test.

- <u>Clarify Expiration Dates for Driver's Licenses of Individuals under Age 21.</u> Currently, a driver's license is issued in a vertical format to a person under age 21, which format signifies that the person is not allowed to purchase alcohol. When a four-year license expires for a person who is still under 21 years of age, a new license is issued in the vertical format, which often causes inconveniences for those people once they turn 21. The proposed legislation provides that certain vertical format licenses would be extended to expire 30 days after the person's twenty-first birthday, which would allow issuance of a regular horizontal-format license. In addition, people who turn 21 but still have several years remaining on their license tenure may get a replacement horizontal-format license issued for a minimal charge.

- Require a New Mexico Driver's License To Be Obtained Within 30 Days of Establishing Residency. Many new residents who have past DWI offenses in other states, once they learn of New Mexico's ignition interlock laws, defer applying for a driver's license for several years. The proposed law would require all new residents to apply for a New Mexico driver's license within 30 days of establishing residency, which would increase compliance with the ignition interlock statutes. The legislation would include exemptions for college students, military personnel and others.

- Cancel Ignition Interlock Driver's License for Noncompliance. The legislation would give the MVD authority to cancel the ignition interlock driver's license of a person who, after installing an ignition interlock device in order to receive the limited driver's license, removes the device before the required period of time has passed.

- Reform the "Drive Insured" Program. Several changes are proposed, including directing law enforcement officers at traffic stops to verify through an electronic database whether a vehicle is insured and prohibiting an officer from citing a person for failure to carry proof of insurance if the database confirms that the vehicle is insured; giving law enforcement officers the discretion to remove a vehicle's license plate for a violation of driving without proper liability insurance; clarifying that the issuance of a temporary operation sticker given to drivers who have been cited for not maintaining proper insurance does not create any liability for the state or the local government involved in the citation; allowing a person cited for lack of insurance to pay a penalty assessment fine of $75.00 rather than requiring the person to appear in court; and increasing the registration reinstatement fee after a violation of the Mandatory Financial Responsibility Act from $25.00 to $100, with indigency waivers and 50-day notice requirements before a registration is canceled.

- Update and Clarify Rules for Off-site Sales of Vehicles and Recreational Vehicles. The legislation would clarify the statutory language that regulates the program of off-site vehicle sales. The TRD is working closely with motor vehicle dealers to draft the legislation and will report its results to the committee in November.

Questions and comments from committee members included the following the following:

- How can the TRD ensure the security of internet driver's license renewals? Secretary Homans said that the department is working with an interstate trade group to resolve security issues. Key issues involve facial recognition software and password protections. If the legislation is enacted, the department will be using current best practices available to the industry.

- The state should look into insurance and licensing requirements for boat operators.

- How does the bill clarifying expiration dates of driver's licenses for under-21 drivers mesh with provisional driver's licenses for first-time young licensees? Secretary Homans said that the department will research that issue to ensure there are no conflicts.

- Do drivers over 75 years of age have to demonstrate their ability to drive safely in order to be issued a license? Mr. Sandoval said that the only requirement for drivers over 75 is a yearly vision test. A person who is concerned about somebody's ability to drive can send a letter to the MVD, which can then contact that person. Without such a letter, the MVD is prohibited from asking a person about physical conditions other than eyesight.

- Perhaps the state should require everyone to get a new driver's license within 30 days of turning 21 as a simpler method of fixing the expiration date problem.

- Giving police officers discretion to remove a license plate for noncompliance with insurance requirements may lead to unfair treatment of certain population groups. Secretary Homans said that language may need to be clarified.

- Many municipal MVD offices have a hard time providing good service to customers, mostly because they lack high-speed internet services. Secretary Homans agreed and said that the TRD is working to provide high-speed internet access to the 12 municipalities that are still using dial-up connections for MVD services.

- The TRD should not sell driver information to the private sector.

- The newly enacted laws regulating all-terrain vehicles are too strict.

- Some municipalities are financially burdened by having MVD services. Secretary Homans agreed and said that the state could take over some of those operations if so requested. He said that municipalities typically recoup $6.00 to $7.00 per transaction, but the private MVD Express charges about $20.00 per transaction.

- Any MVD legislative proposals need to be revenue neutral because the state is facing large budget shortfalls.

Fair Share Program Update

Secretary Homans and Phillip Salazar, director, Audit and Compliance Division (ACD), TRD, briefed the committee on the division's Fair Share Enhanced Delinquent Tax Collections program, which attempts to collect some of the tax obligations owed the state. New Mexico, which has a voluntary system of tax compliance, has a "tax gap" estimated to be $818 million annually. A tax gap is the difference between the amount of taxes owed and what is voluntarily paid. The division since 2003 has directed additional state resources toward collecting more tax obligations, focusing primarily on measures that bring in much more tax revenue than they cost to implement. Some of those measures include the creation of a call center to increase tax collection efforts; the creation of a desk audit unit for credit reviews; the expansion of audit coverage to smaller tax programs; the increase in the overall number of auditors and collectors; the posting of a delinquent taxpayer list on the TRD web site; the use of private collection agencies; the expansion of combined reporting system (CRS) workshops; the implementation of the treasury offset program, which offsets federal income tax refunds to state income tax debt; the expansion of the bankruptcy unit; and the implementation of a data warehouse to enhance audits and collections.

In 2009, the legislature enacted legislation that funded the Fair Share program to allocate more resources to collect tax obligations. With a recurring cost of $5.1 million, the program is expected to bring in an additional $29.2 million in fiscal year 2010 and $44.4 million in fiscal year 2011. The increased appropriations funded 82 new staff positions, including auditors, collections agents, refund and credit reviewers and information technology staff to manage the data warehouse.

Mr. Salazar described some of the enhanced programs funded in the Fair Share program. In the auditing program, the data warehouse is being used to score candidates for auditing, which will result in better collections; desk audits are being implemented to match other tax-related documents with collection information; the department is promoting managed audits; the department can pursue leads from the Multistate Tax Commission about unregistered businesses in New Mexico; the department can pursue taxpayers who over-claim deductions for tangible property on projects funded by industrial revenue bonds; and the department can pursue taxpayers who use the incorrect tax rate code to avoid paying local option taxes.

In the collection program, improvements in the data warehouse will allow collectors to use income documents to identify taxpayers that owe personal income tax and to identify different levy sources of delinquent taxpayers. In addition, collectors can now access all debt information associated with a taxpayer and implement payment plans across tax programs.

In the refund and credit program, the department has expanded auditing capacity to review tax credits associated with the film industry and for high-wage and advanced energy tax credits. The ACD is also working with the Revenue Processing Division of the department to expand the number of credit claims that will be reviewed. Finally, the division is working to get credit information filed electronically in order to prevent duplicate credits from being allowed.

Secretary Homans then described the managed audit program, which is designed to promote compliance and to benefit taxpayers who discover a past filing obligation and liability and wish to correct it. If a taxpayer under the managed audit program discovers taxes that are owed, the taxes can be paid without penalty or interest if the entire amount is paid within 180 days of the assessment. Taxpayers that wish to enter a managed audit must apply with the department and meet eligibility requirements, including that they have not already been selected for audit, that they are not currently being pursued for collections, that they demonstrate a willingness and ability to comply with New Mexico tax laws and that they have not been the subject of a criminal investigation or are in a legal dispute with the department.

Questions and comments from committee members included the following:

- Does New Mexico have the ability, similar to the authority the Internal Revenue Service (IRS) has, to negotiate the amount of tax liability owed the state? Mr. Salazar said that the department cannot compromise on a tax liability except when there is a dispute over how much is actually owed.

- How much of the estimated $600 million per year that is deemed uncollectible could be recouped by the state if it had the authority to negotiate tax liabilities? Mr. Salazar said that there are too many variables to give an accurate projection, and he said that the $600 million figure is an IRS estimate.

- Perhaps the TRD should establish an independent arbitration process to settle tax disputes rather than using the current practice of appointing hearing officers who are also TRD employees. Secretary Homans said that the TRD gives complete independence to its hearing officers, but he also acknowledged that there is still an appearance of a conflict of interest in the system.

- What types of businesses are having difficulty paying taxes during the current economic recession? Mr. Salazar said that businesses across the spectrum are having trouble meeting their tax liabilities.

Statewide Municipal and County Legislative Priorities

Paul Gutierrez, executive director, New Mexico Association of Counties (NMAC), and Bill Fulginiti, executive director, New Mexico Municipal League (NMML), discussed with the committee their organizations' legislative priorities. Mr. Gutierrez began with a list of potential legislative changes, including:

- the expansion of the definition of felony offender to include county inmates awaiting transport to prison, in order to reimburse counties for the cost of housing state inmates;
- an increase in the amount of retirement distributions made on behalf of volunteer firefighters;
- an increase in the term limits of elected county officials from two terms to three;
- resolving the discrepancies throughout the state involving payments to county officers;
- allowing an increase in the county correctional facility GRT;
- the establishment of a statewide system for hazardous material route designations;
- requiring that county sheriffs also be certified peace officers;
- fixing the issues surrounding residential property tax valuations; and
- resolving problems counties have with voting machine maintenance contracts.

Mr. Fulginiti presented a preliminary list of legislative proposals and general principles that he anticipated would be adopted by the NMML at its October meeting. The first principle is that the league opposes federal and state legislation that preempts local authority, and the second principle is that the NMML endorses the protection of municipal revenues due to any changes in tax structure. Three specific legislative proposals are also expected to be endorsed, including:

- establishing a uniform system of assessing franchise fees on utility companies;
- the removal of the restriction that municipalities must enact all other GRT increments before they can enact a municipal capital outlay GRT;
- allowing all municipalities to impose the municipal environmental services GRT at a rate of one-half of one percent of gross receipts; and

- the passage of a general obligation bond bill for $18 million for libraries, for approval by the voters at the 2010 general election.

Questions and comments from committee members included:

- Will increased franchise fees that energy companies may pay to the counties result in an increase in customer bills? Mr. Gutierrez said that fees will probably be passed on to their customers. He said the NMAC wants to have one statewide rate for franchise fees rather than the current practice of each county negotiating franchise fees with energy companies. John Gillis of the New Mexico Gas Company said that while municipalities can collect a franchise fee from energy companies based on a percentage of the sales in the municipality, counties are restricted to receiving only "reasonable expenses". He said that his company supports the proposed change.

- What problems are counties facing with their correctional centers? Mr. Gutierrez said that counties are required by law to house inmates, yet they are not adequately compensated by the state or municipalities to cover their expenses. Some counties are spending 40 percent of their annual budgets on correctional centers.

- Volunteer firefighters should be compensated for some of their training activities. The NMAC needs to work with the Public Employees Retirement Association (PERA) to ensure that volunteer firefighters are properly credited for their service.

- What is the reason behind increasing the term limits for county officers? Mr. Gutierrez said that an extra term would provide more stability for county governments because more time in office would be helpful to develop the skills of elected officials.

- Is Santa Fe County allowed to remove the sole community provider designation of Christus St. Vincent Medical Center since voters have already enacted a one-eighth percent GRT increment for that purpose? Mr. Gutierrez said he will research that question for the committee.

- Some counties are over-bonding GRT revenues and are laying off employees at the same time they are creating new costly initiatives.

Continue Research and Development Tax Credit

Matthew Woodlee, director, Division of International Trade, Economic Development Department (EDD), discussed a legislative proposal to extend the research and development small business tax credit until 2014. He said that the bill has been introduced in the legislature the past two years and has not received any opposition, yet it was unable to make it through the legislature either year. He said that five to seven companies each year have received the credit, and it has a fiscal impact of about $140,000 per year. Although the credit is relatively small, it has attracted research and development companies to the state, said Mr. Woodlee.

Questions and comments from committee members included the following:

- Why has the research and development small business tax credit not been used very much? Mr. Woodlee said that the credit was specifically designed to benefit research and development companies that may sell a few items but have not yet begun full production.

- Which companies have benefited from the credit and for how much? Mr. Nunns said that the TRD is only allowed to disclose the names of taxpayers if a credit is granted for $10,000 or more.

- The committee requested a list of companies receiving the credit along with a list of all other credits and investment benefits those companies are receiving from the state.

Film Production Tax Credit Legislative Proposal

Lisa Strout, director, New Mexico Film Office, EDD, presented proposed legislation to the committee to change and clarify certain provisions of the film production tax credit. The bill gives the division more flexibility to determine whether all creditor claims have been satisfied before approving the credit for the company, provides for withholding of income taxes by pass-through entities acting as film performing artist entities and provides a corresponding exemption from the GRT for those entities.

Questions and comments from committee members included the following:

- Changing the requirement for satisfying creditor claims from a specific date to a date that is at the discretion of the division may open up the state to uncertainties in how it approves the tax credit. Ms. Strout said that the language change was an attempt to give the division some flexibility rather than having a fixed date at which all creditor claims must be satisfied. The change is also attempting to strengthen protections of employees and vendors against unscrupulous film production companies.

- Perhaps the division should put some of these proposed changes into rule rather than statute.

- A recent listing of film production companies receiving the tax credit revealed that one-third of those companies are not registered with the Public Regulation Commission. Ms. Strout said that a company is not required to be a New Mexico company in order to receive the credit.

- Expenditures by film production companies need to be disclosed. Ms. Strout said that some information is confidential. The division is now requiring companies to disclose amounts spent by expense category.

- Have other states increased their film production tax credits recently? Ms. Strout said that the credit percentage is 42 percent in Michigan, 44 percent in Alaska and 50 percent in Iowa, compared to New Mexico's 25 percent.

- Why does the proposed legislation exempt the GRT for film performing artist entities? Ms. Strout said that imposing the GRT on those entities, when they are already paying income tax, would lead to tax pyramiding. Mr. Nunns said that there would be no net fiscal impact, except for a one-time speed up of income tax collections.

Pyramiding and Other Gross Receipts Issues

Mr. Nunns gave a presentation to the committee about pyramiding issues within the GRT. Pyramiding occurs whenever a business' receipts are subject to the GRT and some of the business' purchases from other businesses are also subject to the GRT or the compensating tax. Examples of pyramiding include most services, utilities and equipment sold to businesses. Some of the pyramiding is offset by certain targeted credits, like the investment tax credit, and many transactions are not subject to the tax because of existing exemptions, deductions or credits. Pyramiding is a problem because it causes economic distortions that reduce business activity in New Mexico. Small businesses can be especially affected by pyramiding, because they often need to purchase many services, which are taxed, while large companies can often provide that same service in-house. Another problem with pyramiding is that businesses that purchase from other businesses have an incentive to purchase out of state.

Tax pyramiding can be addressed in several ways, including allowing a general deduction or credit for sales to other businesses or allowing purchasing businesses a general deduction or credit for taxed purchases. Pyramiding represents a large portion of the GRT base, so addressing it comprehensively would require substantial replacement revenues. Some estimates place pyramiding as high as one-third of the entire GRT base, said Mr. Nunns.

Exemptions from the GRT have been enacted in order to reduce pyramiding. Some exemptions are general exemptions, such as wages, because virtually all business sales require the use of some employees. Other exemptions and deductions are targeted to remove from the GRT base items that in principle "should" be taxed, but that are subject to other taxes or are exempted for specific policy goals. For example, motor fuels are exempt from gross receipts taxation because they are already taxed. Deductions from gross receipts for food are allowed to reduce the regressivity of the GRT. The medical deduction can be considered a way of avoiding pyramiding because medical services that can be deducted are also subject to the premium tax.

Another issue that has developed within the GRT system is that rate differentials exist between municipalities and counties and between in-state sales and out-of-state sales. GRT rate differentials between municipalities and the remainder of county areas average one percent but are as high as 2.4 percent, which could lead to businesses locating outside municipalities to avoid higher taxation. When comparing in-state purchases to purchases from out of state, the rate differentials are even larger. An out-of-state purchase from a seller without a nexus in New Mexico is subject only to the compensating tax of five percent, which automatically gives out-of-state sellers a competitive advantage of between one and two percent for all sales. However, due to a loophole in the compensating tax structure, if a New Mexico business makes a purchase from a seller without a nexus in New Mexico, and takes delivery of the items in New Mexico, no tax is due on that purchase. This can result in a differential as much as 8.5 percent, which can lead to significantly reduced business activity in the state. It should be noted, however, said Mr. Nunn, that taxing those out-of-state purchases, although making the tax system more equitable for in-state businesses, will also further compound the tax pyramiding problem.

Rate differentials between the GRT and other taxes also exist. For example, the motor vehicle excise tax is imposed at three percent, compared to an average 6.7 percent GRT rate. In principal, all goods and services purchased by households should be taxed at the same rate, unless a rate differential helps achieve some other policy goal, said Mr. Nunns.

Committee members discussed medical service deductions and made several comments, including that:

- giving a GRT deduction for medical services under contract with an insurance plan but taxing individuals who purchase the same services is not fair;

- medical providers, and not patients, are forced to pay the GRT for insurance co-payments, which are subject to the GRT; and

- enactment of medical services deductions has increased the number of providers in rural areas.

Update of Legislative Finance Committee Review of Film Credit Studies

Tom Clifford, chief economist, Legislative Finance Committee (LFC), gave the committee an update on the LFC's evaluation of film production tax credit policy. The amount of credit paid by the state since the increase of the credit allowed in 2005 has risen from just a few million dollars in fiscal year 2005 to $80 million in fiscal year 2009. However, fiscal impact reports presented to the legislature anticipated far less of an impact than was actually realized. Mr. Clifford said that with such a large fiscal impact, it is important to re-evaluate that particular incentive. The net impact of the film production tax credit has been previously studied and reported to the RSTP, and Mr. Clifford reviewed findings of New Mexico State University's Arrowhead Center and Ernst and Young (E & Y), which reached different conclusions. While the Arrowhead study found that the return on investment (ROI) of state tax expenditures for the film credit was 14 cents return to the state for every dollar spent, the E & Y study concluded that the state had an ROI of 96 cents, plus an additional 56 cents realized in local tax revenue. As previously reported, the LFC had several concerns with the E & Y study, including that the study included unusually high incomes for New Mexico employees; the study included a very large one-time capital expenditure related to the construction of Albuquerque Studios; and the study extrapolated tourism-related effects from a small number of survey responses. Without getting too far into the details of either study, Mr. Clifford concluded that the actual ROI of the tax credit is probably less than 50 cents.

The LFC had additional concerns with the E & Y study, since not all state and local subsidies were included in the study. For example, the State Investment Council made $229 million in no-interest loans to film production companies during that period, but those loans were not included in the study. Also not included were $27 million in direct capital expenditures, $9 million in job training partnership funds and an undetermined amount of GRT deductions. Mr. Clifford estimated that those subsidies would add a cumulative $10 million to $20 million annually to the amount of the state subsidy for the film industry.

Mr. Clifford said that the opportunity cost of the film production tax credit needs to be evaluated. The state is required to offset tax credits and other subsidies in its budgeting process, and reduced spending by the state has indirect effects on jobs, incomes, etc., similar to the increase in economic activity resulting from the film industry's increased presence. One way of evaluating the opportunity cost is to calculate the cost per job of film industry subsidies and compare that to other industry subsidies. Taking 2008 figures, Mr. Clifford estimated that each job created by the film industry tax credits costs $30,000 per year to the state. The investment credit costs the state between $25,000 and $50,000 per job, but that is a one-time expense. Another way of looking at the benefits of the tax credits is to calculate what could be done using that lost revenue to the state in other programs. For example, using the revenue to support the Medicaid program would generate three times as much money from the federal government as was spent, in addition to the benefits of providing more health coverage to New Mexicans. Other questions that need to be asked in evaluating a subsidy include "Why this particular industry?"; "What are the specific goals: i.e., if the policy goal is to create new jobs, should that be a requirement prior to receiving the credit?"; and "How much of a subsidy is appropriate, and for how long?". In conclusion, Mr. Clifford said that analysis of the current film production tax credits shows that the credits do not generate enough economic activity to offset their fiscal impact.

Mr. Clifford then briefly reviewed a summary of revenue impacts from changes in tax law since 2003. In summary, revenue-increasing changes are expected to add $385 million to the state revenues in fiscal year 2011, while revenue-decreasing measures will reduce state coffers by $913 million, for a net fiscal year 2011 loss of $528 million. Mr. Clifford categorized tax law decreases into five broad categories: low-income tax relief ($268 million), medical services ($108 million), economic development ($508 million), renewable energy incentives ($11 million) and other incentives ($18 million). Tax increases included transportation funding tax changes ($68 million), premium tax changes ($52 million), income tax withholding changes for oil and gas distributions ($30 million), GRT credit changes ($184 million) and other tax increases ($51 million).

Questions and comments from committee members included the following:

- Mr. Nunns was asked if he concurred with the conclusions made by Mr. Clifford. Mr. Nunns said that economic impact studies are always difficult to perform, and they have many variables that can be adjusted, depending on one's assumptions.

- Why was there such a large increase in oil and gas withholding? Mr. Clifford said that when the increased requirements took effect, a large number of tax obligors began withholding taxes for the first time. The TRD did not expect such a large increase, he said.

- In order to present an accurate picture of net revenue changes, fee changes need to be presented, as do tax law changes.

- The impact of what would happen to the film industry in New Mexico if the film production tax credit were repealed needs to be studied. Rather than studying opportunity costs, a bottom-up supply-side analysis needs to be performed.

- Are there any other economic development subsidies that are as large as those given to the film industry? Mr. Clifford said that industrial revenue bonds account for a large amount of tax expenditures for local governments.

- Is the tax credit refundable? Mr. Clifford said that it is, regardless of whether a tax liability exists. Mr. Nunns said that refunding credits is the most efficient method of administering a credit.

- The total amount of film production tax credit should be capped each year.

The committee recessed at 4:55 p.m.

<u>Tuesday, September 15</u>

The committee reconvened at 9:08 a.m. on Tuesday, September 15, 2009, at the Lodge Resort in Cloudcroft.

Corporate Income and Franchise Tax Review and Alternatives

Richard Anklam, director, New Mexico Tax Research Institute (NMTRI), and Mr. Nunns presented reviews of the corporate income tax system in New Mexico and alternatives to the current system. Mr. Anklam began by describing the basic tenets of the corporate income tax. The corporate income tax is a tax on profits that is paid by the corporation. Profits are also taxed at the individual level. Most small- to medium-sized businesses have converted to limited liability companies or a similar structure and are not subject to double taxation, said Mr. Anklam. Using four principles of good tax policy — adequacy and stability, equitable treatment, ease of administration and compliance and impact on economic development — Mr. Anklam evaluated the corporate income tax generally and a proposal to require combined filing of tax returns.

Adequacy and Stability of Revenue Source

Generally, the corporate income tax in New Mexico provides about five percent of state revenues, but the tax is also the most unstable revenue source because the tax is only collected when corporations earn a profit. More specifically, if corporations are required to use combined filing of their tax returns, although the requirement has been predicted to bring in additional revenue to the state, during a recession, the state may actually lose more money because corporations will be pulling in losses from out of state. Requiring combined reporting will not significantly affect the stability of corporate tax revenues.

Equitable Treatment of Similarly Situated Taxpayers

Because small- to medium-sized businesses can avoid corporate income tax, the tax is more likely to burden larger multistate businesses. Although policy reasons for this different treatment may have existed in the past, those reasons are no longer clear. Regarding mandatory combined filing, while requiring all taxpayers to use one method of filing would create more uniformity, it would not necessarily be equitable. Allowing filing options is a benefit for taxpayers in that it lets them choose the best method for their circumstances and may to some extent offset New Mexico's uncompetitive tax rate.

Ease of Administration and Compliance

State corporate income tax is very complex to administer and comply with. Compared to the revenue generated, this complexity is relatively significant. Requiring combined filing will only add to the complexity of the tax. Mr. Anklam said that there have been a few corporations that have abused the separate filing method as a means of avoiding corporate tax in the state. However, those abuses have been dealt with in court, and dozens of companies have since settled tax disputes with the TRD. Mr. Anklam suggested that the problems associated with the separate filing method have already been resolved, and there is no need to require combined filing.

Impact on Economic Activity and Development

Because the corporate income tax generally falls on larger, multistate companies, the impact of a particular state's corporate income tax may affect the amount of activity or investment a corporation makes in that state. The separate filing method currently allowed in New Mexico is a significant incentive for multistate, profitable companies to expand into or make investments in New Mexico if those investments are not expected to be initially profitable.

Next, Mr. Anklam discussed the apportionment method used to tax multistate companies that have elected to use combined filing. The traditional formula of apportionment uses a company's property, payroll and sales in all locations and in the state to come up with a percentage that is applied to taxable income. New Mexico uses the traditional three-factor formula in even portions. As a result, when a company makes investments or creates jobs in New Mexico, its tax increases in New Mexico. Some states have adopted apportionment formulas that reduce the emphasis on property and payroll and increase the emphasis on sales, making it more advantageous for companies to create "economic base jobs" in the state. Arizona, Colorado, Utah and Texas have adopted such formulas. He cautioned that a change in New Mexico's apportionment method to attract investment would likely reduce the state's total corporate income tax revenue.

Mr. Nunns then provided the committee with a review of policy considerations regarding the corporate income tax. The double tax design of the corporate income tax creates significant economic distortions for three principal reasons. First, because non-corporate forms of business are only taxed at the individual level, the corporate income tax provides a disincentive from forming a corporation. Second, because undistributed corporate income is taxed at a lower rate than distributed income, corporations have an incentive to retain income rather than distributing it. Finally, because corporate income is generally taxed at a higher rate than interest on loans, corporations have an incentive to finance with loans rather than finance with equity. There are additional distortions created by the current structure of the federal corporate income tax, including provisions that result in mistiming of deductions and income, which generally result in an understatement of net income. The most significant are those provisions that allow accelerated forms of cost recovery for investments. Another economic distortion in the current federal income tax is the deduction for domestic production activities, which distorts business decisions.

The New Mexico corporate income tax largely incorporates the economic distortions found in the federal tax. However, the issue of double taxation typically differs between large and small corporations at the state level. Large multistate corporations operating in New Mexico tend to have their income taxed at just the corporate level because most of their shareholders tend to live out of the state. Small New Mexico corporations, however, are more likely to have their shareholders living in the state, which results in income from that corporation being taxed twice by the state. New Mexico can design its tax system to mitigate the double tax issue of small corporations, said Mr. Nunns.

Other distortions arise in the New Mexico corporate income tax due to the complex methods of determining the appropriate amount of tax to impose on the income of multistate businesses. These companies are typically part of a large number of related entities that may have multiple transactions between themselves, including sales, asset transfers, cost-sharing arrangements, charges for services and royalties. These transactions make the determination of income attributable to New Mexico very difficult. In an attempt to match the income and expenses of multistate corporations properly, many states, including New Mexico, have introduced legislation to require combined reporting; to reallocate income, deductions and other items between entities; to tax passive investment companies that have been created to avoid taxes; to establish minimum taxes; or to enact significant franchise taxes. All of these attempts to catch taxes owed a state are complex, requiring significant state and corporate resources, and have also generated litigation.

Mr. Nunns discussed possible revenue effects to New Mexico if it adopts mandatory combined reporting for multistate corporations. Corporate income tax revenue is the most volatile taxation revenue source for the state, and requiring combined reporting will not change that volatility. Revenue estimates for the effect of mandatory combined reporting are difficult to make in New Mexico because it is uncertain how corporations will react to such legislation. Other states' experiences have previously indicated that New Mexico's corporate income tax revenues would increase by 20 percent if mandatory combined reporting was adopted. However, Mr. Nunns cited three recent studies suggesting that the 20 percent figure is unrealistically high. Some conclusions of the studies included that:

- combined reporting has uncertain effects on a state's revenues;
- switching from separate filing to combined reporting may have a negative impact on a state's economy;
- no evidence from statistical analysis of actual state revenues exists that combined reporting has affected state revenues; and
- combined reporting is not significantly associated with state corporate income tax revenues.

Given the revenue uncertainties and possible economic competitiveness issues surrounding mandatory combined reporting, Mr. Nunns said that other alternatives to tax multistate corporations effectively are worth serious consideration. One promising alternative is the new franchise tax proposal introduced in the 2009 regular legislative session by Senator Wirth. The new franchise tax amount would be based on a corporation's property, payroll and sales in New Mexico in excess of certain threshold amounts. Under the proposed legislation, the new tax would only affect the largest seven percent of corporations in New Mexico and would be offset by the amount of corporate income tax the business owes. This new tax would ensure that all large corporations pay some income or franchise tax related to their presence in New Mexico and the benefits they derive from that presence. In addition, the new tax would be a fairly reliable source of revenue because property, payroll and sales are more stable than a company's profits.

Questions and comments from committee members included the following:

- Why are there regional differences in the requirement of combined reporting? Mr. Anklam said that historically, eastern states developed their tax policy much earlier than western states. Also, western states tend to be signatories to multistate tax compacts.

- What is the best solution to the problem of taxing multistate corporations? Mr. Nunns said that mandatory combined reporting would help some, but that the franchise tax proposal would better match tax payments with services being provided by the state. Senator Wirth said that he sponsored the legislation because New Mexico-based companies were not being treated equitably compared to their multistate counterparts. New Mexico corporations are being taxed generally at 7.6 percent of net income, while some multistate corporations do not pay any state corporate income tax. This disparity is especially large in the tax treatment between local banks and multistate banks.

- If the franchise tax legislation included a manufacturing carveout to protect that industry, would the Richardson administration support the bill? Mr. Nunns said he is not sure if the governor would support that bill. Mr. Anklam said that if certain identifiable economic development sectors were protected, the NMTRI could support the bill.

- Is the film industry shifting profits from New Mexico to avoid corporate income tax? Mr. Nunns said that in general, he believes that is not happening, but he will confirm that information.

- Is the TRD actively pursuing corporations that are abusing the separate filing method to avoid paying the corporate income tax? Mr. Nunns said there are some current cases being pursued, which takes up a large part of the department legal staff's time.

- Multistate corporations are getting benefits from New Mexico but are not paying for those benefits.

- Does New Mexico allow carryforward losses on corporate income? Mr. Nunns said that carryforward deductions are allowed, but the period is shorter than what the federal government allows. Carryback loss deductions are not allowed in New Mexico.

- Are internet sales treated the same as catalog sales for tax purposes? Mr. Nunns said if a business has a nexus in New Mexico, then it is required to pay the GRT on sales in New Mexico. The real issue with taxing out-of-state sales for businesses without a nexus is whether the federal government will allow collection of those taxes.

- Bringing the property factor into a franchise tax could affect some companies' ability to pay their taxes, because property is not easily convertible into cash.

- Would "add back" provisions address the issue of multistate tax liability? Mr. Anklam said that most states that have separate filing for corporations also have such provisions to tax some of the profits that have been reported out of the state. The best solution, he said, is to go after companies that are actually abusing the tax laws rather than try to tax an entire class of law-abiding corporations. Mr. Nunns said that "add-back" laws could bring in more revenue to the state, but they would also use significant department resources to administer.

- Could the TRD reallocate multistate profits to the state, like many other states do? Mr. Nunns said that reallocation rules prevent companies from shifting profits to other states by underselling and other accounting practices. Although many states have such laws, they are difficult to enforce.

- Mr. Anklam was asked to provide the committee with data from other states on the enforcement of "add-back" laws.

Use of Fire Protection and Emergency Medical Services Funds

The committee heard a presentation about New Mexico's emergency medical services (EMS) and trauma system and a legislative proposal to fund the system. Leading the discussion was Mike Miller, city councilor, Portales. He was joined by Don McNutt, chair, Statewide Emergency Medical Services Advisory Committee, Jan Eliott, executive director, EMS Region III, Dr. Dale Kester, chair, Trauma System Fund Authority, Jim Stover, EMS director, Lincoln County, James Marshall, mayor, Silver City, and Mr. Fulginiti from the NMMI. Mr. Miller said that a task force has met for the past nine months to address funding for the statewide EMS and trauma system. In 1987, legislation was adopted, nicknamed "$1.00 for life", that assessed a $1.00 fee on motor vehicle registrations to fund the EMS system. Since 1992, money for the EMS system has been funded only from the general fund as part of the annual budget. The task force devised a plan to fund the EMS and trauma system permanently that includes imposing an additional one percent premium tax on home, rental and auto insurance policies. The increase in the tax would provide an additional $17 million annually to ensure the viability of the EMS and trauma system in the state. The legislation would also free up nearly $9 million in recurring general fund money, which can be used for other purposes. The premium tax would increase one-fourth percent every three years, up to a total increase of three percent in 2034, with the additional revenue being dedicated toward the EMS and trauma system.

Mr. Fulginiti said that most municipalities in New Mexico do not have adequate EMS systems, and most EMS volunteers fund their own training.

Questions and comments from the committee included the following:

- How are trauma centers in the state designated? Dr. Kester said that the trauma system in New Mexico follows national guidelines. Each state can have one Level

I trauma center, which provides the highest level of care and research. Level II centers have the same medical care as Level I centers but without the research and education abilities. Level III centers have a moderate amount of trauma care abilities, and Level IV centers can provide basic stabilization of trauma patients before transport. Most trauma centers in the state are Level IV centers. Since the advent of New Mexico's trauma system, there has been a decrease in the amount of out-of-state transfers.

- Will the increase in the premium tax fund new trauma centers? Dr. Kester said that it will. Hospitals have contributed to trauma centers, but the state contribution has been flat. The increased funding will further encourage more contributions from private hospitals toward the system.

- Recent funding changes made by the governor that took $1 million from services to children with developmental disabilities and directed it toward the trauma system were not fair.

- A one percent increase in the premium tax is a large increase. Perhaps starting with a one-fourth percent increase instead would be a better idea.

- Are local governments contributing to the EMS and trauma system from local option GRT enactments? Mr. Miller said that most municipalities have enacted EMS taxes, but he was not sure about counties.

- Does combining 911 dispatch centers create problems? Mayor Marshall said that problems can arise when not all areas of an EMS area are known to dispatch employees, especially in larger counties.

Solvency Discussion Update

David Abbey, director, LFC, gave an update to the committee on the current status of fiscal year 2010 revenues and budget projections. The August 2009 consensus forecast, prepared by career economists at the Department of Finance and Administration, the Department of Transportation, the TRD and the LFC, estimates that fiscal year 2009 shortfalls would amount to $114 million and that fiscal year 2010 is currently projected to be $542 million short, for a total deficit amount of $656 million. Current reserves can cover some of the appropriation shortfall, but for the state to maintain a modest seven percent reserve level, $384 million needs to be found in nonrecurring savings, said Mr. Abbey.

Fiscal year 2009 shortfalls can be easily covered by legislation transferring money from the general fund reserves, but covering the expected fiscal year 2010 deficit will probably require significant reductions in budgets. A preliminary executive proposal for fiscal year 2010 budget reductions recommended cutting $454 million, but the LFC has advised the need for cutting $512 million. Revenue estimates in October will probably be even worse than the August estimate, which may necessitate further cuts. While the executive proposal cuts $100 million from state budgets, it leaves education alone. Other executive proposals include using $91 million in education stimulus funding; issuing $135 million in short-term severance tax bonds to be used for operational purposes; de-authorizing $68 million in capital outlay projects; suspending the increased state contribution to the Educational Retirement Fund for two years; and transferring $40 million from other state funds. The LFC recommends cutting all budgets, including educational budgets, by 3.5 percent, for $181 million in savings; using $75 million in executive and educational stimulus funding; swapping $10 million in general fund capital outlay appropriations for severance tax bonds; de-authorizing $80 million in unused capital outlay appropriations; and transferring $145 million from various state funds.

LFC staff members believe that the proposal to issue severance tax bonds for operating purposes may violate constitutional provisions specifying how severance tax revenues may be spent, said Mr. Abbey. Although the Public School Capital Outlay Council has the authority to issue short-term severance tax bonds for school projects and uses a portion of that money for operating expenses, he thinks that the executive proposal goes too far.

Questions and comments from committee members included the following:

- Revenue enhancements, including taxes, need to be considered in addition to cutting budgets. Mr. Abbey said that revenue enhancements enacted may not have much of an effect on fiscal year 2010 revenues. Revenue enhancements could play a large role in crafting the fiscal year 2011 budget, however.

- The legislature and executive need to be careful not to take money away from viable capital outlay projects.

- Can the executive transfer money to cover the budget shortfall without legislative action? Mr. Abbey said that only the legislature can authorize the transfer of funds.

- The executive hiring freeze ordered by the governor did not actually happen. The state will be in even worse shape in fiscal year 2011. The legislature needs to cut $500 million in recurring funding this fiscal year rather than trying to fill the budget void with transfers.

- Did state employees receive a pay increase in the fiscal year 2009 or 2010 budget? Mr. Abbey said that state employees actually had their effective salaries cut, since the state contribution to the PERA was reduced this year.

- The legislature has cut taxes over the past several years, and some estimates are that the state has foregone more than $2 billion in revenue during that period. Education funding should not be cut.

- A three percent cut in state agency budgets could result in employee layoffs, which could compound the economic downturn. Mr. Abbey said that both the executive and LFC scenarios do not contemplate layoffs.

The minutes of the August 27-28 minutes of the committee were adopted without changes.

There being no further business, the committee adjourned at 12:58 p.m.