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

SPONSOR Lujan, B **ORIGINAL DATE** 01/28/10 **LAST UPDATED** 02/14/10 **HB** 120/aSFC

SHORT TITLE Tax Withholding Changes **SB**

ANALYST Clifford

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY10	**FY11**	**FY12**		
	$15,600.0	$9,800.0	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION

LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

Information received
N.M. Society of CPA's

SUMMARY

Synopsis of SFC amendment

Senate Finance Committee Amendment (HB120) Oil and gas remittees could agree to make payments in lieu of withholding by remitters. Remitters would be required to withhold for certain remittees if they are notified by the Taxation and Revenue Department that the remittee has failed to pay tax. Corporations as well as individuals would qualify for exemption from withholding if they agree to pay tax in lieu of the withholding. No penalty would be imposed for underpayment of withholding in tax year 2011.

Synopsis of Original Bill

Pass-through entities (PTE's) would be required to make quarterly withholding tax payments on net income distributed to their non-resident owners. Owners may agree to make the quarterly payments on their own behalf. PTE net income is defined as the income reported to an owner by the PTE for federal income tax purposes. Pass-through entities could base withholding on the prior taxable year's net income if that year was a full year. Deduction of certain expenses would be allowed in calculating oil and gas proceeds withholding. Trusts and estates that distribute income to beneficiaries would be treated as pass-through entities for withholding purposes. Oil

and gas withholding payments would count toward estimated payment requirements. A new minimum threshold for withholding requirements is established of $30 per quarter, corresponding to nearly $2,500 of annual income and equivalent to $10 of withholding per month (the threshold for pension and annuity withholding). The requirement for PTE's to withhold on net income of nonprofits or federal, state, local or tribal governments would be removed. Provisions apply to tax years 2011 and subsequent.

FISCAL IMPLICATIONS

According to TRD:
The revenue estimate is based on acceleration of PTE withholding (from annual to quarterly) and a compliance effect of 15% of forecast oil and gas proceeds and PTE withholding.

LFC notes that revenue impacts are more uncertain than for most bills. Estimates are based on a potential for improved compliance which is by its nature unknowable. Adding to the uncertainty is a lack of information on the number of pass-through entities and their net income. Using national data from the I.R.S., it appears that the total number of PTE's operating in New Mexico could be more than 25,000, and their net income could be as much as $6 billion. The portion of this income paid to out-of-state owners is unknown but if that percentage is 25 percent, the total withholding required by the bill would be on the order of $74 million. The new withholding requirements will primarily apply to out-of-state taxpayers for whom the Tax Department currently has limited tools to insure compliance. Thus, there is likely to be a significant improvement in compliance due to the new requirements. When the oil and gas proceeds withholding tax was created, the revenue gain was expected to be quite modest, but in practice the act appears to have increased annual collections by more than $30 million. Although the revenue yield is uncertain, it is possible the current proposal could generate even more revenue.

SIGNIFICANT ISSUES

House Bill 120 would impose new administrative burdens on PTE's with the goal of improving tax compliance by their owners. According to TRD, the current PTE withholding requirements may be ineffective because an owner can opt out by promising to file and pay tax on their own behalf. In the case of in-state residents, the Department has additional information returns it can use to verify compliance, but the same tools are not available for non-resident owners.

Under the bill, PTE's would be required to initiate new accounting procedures in order to calculate the withholding required by the bill. In addition, PTE's would pay withholding tax on behalf of their members. Although the requirements do not affect the owner's total liability, the PTE's may have difficulty calculating the correct withholding amount for some of their members. The result may be under-withholding – with resulting penalties – or over-withholding with the result that taxpayers have to file tax returns to claim refunds and forego the use of funds unnecessarily. These problems may be significant during the first few years of the new requirements.

ALTERNATIVES

The New Mexico Society of Certified Public Accountants noted that the new requirements will force PTE's to make a calculation of net income before that figure has been determined for federal income tax purposes. In certain cases, this will leave the PTE with the option of over-

withholding or risking a penalty. The Society provided the following suggestions for ways to reduce administrative burden on taxpayers:

- Base withholding requirements on amounts distributed to shareholders rather than on net income. In some periods the PTE may not be making cash distributions – and may not have cash available to make withholding payments -- even though it may have accrued income on behalf of its owners. This is the approach used by California on nonresident withholding and also how the IRS applies withholding to foreign partners in domestic partnerships.
- In addition to the entities already excluded from the requirements in the bill, there are several types of PTE's that are "disregarded entities" – i.e. do not face the usual reporting requirements – for federal income tax purposes. Examples include: Community property LLC's where the only partners are the husband and wife; Non-community property LLC's owned by husband and wife in which both materially participate; Partnerships with 10 or fewer partners, all of whom are natural persons, when there are no special allocations and the partners report their income. These partnerships are excepted from federal late-filing penalties which essentially permits them not to file a federal income tax return. If the state wishes to track federal requirements, it could exclude these entities from the withholding requirement.
- First-year PTE's could be exempted from the withholding requirements. This is similar to the treatment for individual income taxpayers, and new entities would be unable to take advantage of the prior year safe harbor provision in the statute. This treatment is allowed by the federal government for partnerships and S-corporations.

TC/mt:svb

The Legislative Finance Committee has adopted the following principles to guide responsible and effective tax policy decisions:

1. ***Adequacy:*** *revenue should be adequate to fund government services.*
2. ***Efficiency:*** *tax base should be as broad as possible to minimize rates and the structure should minimize economic distortion and avoid excessive reliance on any single tax.*
3. ***Equity****: taxes should be fairly applied across similarly situated taxpayers and across taxpayers with different income levels.*
4. ***Simplicity****: taxes should be as simple as possible to encourage compliance and minimize administrative and audit costs.*
5. ***Accountability/Transparency:*** *Deductions, credits and exemptions should be easy to monitor and evaluate and be subject to periodic review.*

More information about the LFC tax policy principles will soon be available on the LFC website at www.nmlegis.gov/lcs/lfc