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

ORIGINAL DATE 02/10/10
SPONSOR Wirth **LAST UPDATED** **HB**

SHORT TITLE Net Taxable Income Determination Changes **SB** 259

ANALYST Clifford

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY10	**FY11**	**FY12**		
	$2,400.0	$13,700.0	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 259 would require corporate income taxpayers to add-back to their taxable income otherwise deductible expenses paid to related companies for the use of intangibles like trademarks, patents, etc. Intangible expense add-back would not apply (a) To expenses undertaken for a valid business purpose and which are subsequently paid to an unrelated company; (b) If the recipient of the spending is subject to equivalent tax on the receipts in another state; (c) If the recipient is subject to equivalent tax on the receipts in a country with a tax treaty with the U.S.; or (d) The taxpayer and the Taxation Department agree on an alternative method of calculating taxable income. The bill would also require add-back otherwise deductible interest costs paid to a related company. Interest expense add-back would not apply (a) If the expenses were undertaken for a valid business purpose and reflect terms of an arm’s length relationship. (b) If the recipient of the spending is subject to equivalent tax on the receipts in another state; (c) If the recipient is subject to equivalent tax on the receipts in a country with a tax treaty with the U.S., the transaction was undertaken for a valid business purpose and was conducted under arm’s length terms; or (d) The taxpayer and the Taxation Department agree on an alternative method of calculating taxable income.

Provisions are effective July 1, 2011.

FISCAL IMPLICATIONS

TRD reports that the estimate is highly uncertain because data are not available on the transactions targeted by the proposal. The estimate assumes increases in corporate income tax liabilities totaling 50 percent of revenue likely to occur if New Mexico enacted a statute like SB 90 mandating combined reporting. No revenue impacts are likely to result from the provision requiring add-back of intangible royalties and similar payments due to the decision reached in *Kmart Properties v. N.M. Taxation and Revenue Department* in 2002.

SIGNIFICANT ISSUES

The proposal presents a trade-off between the tax policy goals of equity and efficiency. The equity goal would be advanced because the proposal could prevent tax avoidance by certain taxpayers. The efficiency goal could be impaired if the proposal denies deductions for expenses that have legitimate business purposes. The potential problem is identified in the following commentary from a popular law textbook, State Taxation by Jerome R. Hellerstein and Walter Hellerstein, 3rd Edition.

> "Although the impetus behind the expense disallowance statutes was usually the desire to eliminate trademark and similar royalty expense deductions paid by taxpayers in separate-company-reporting states to out-of-state affiliates located in jurisdictions where the payment would have no unfavorable tax consequences, most states' provisions disallow many additional types of expense deductions. Some of these disallowances, which extend to common business transactions, arguably go beyond the "loophole-closing" intent of these measures."

The Hellersteins go on to point out the following issues among others that arise with interest expense add-back provisions:

- The provisions are subject to a variety of interpretations and create considerable uncertainty as to their overall scope.
- Although several states have acknowledged that that intercompany financing does not always result in an expense disallowance, in practice, intercompany financing does not fit neatly into categories of taxable and non-taxable.
- Since many instances of intercompany financing have both a legitimate business purpose and generate tax benefits, it is impossible to predict whether the expense will be disallowed.

One particular source of concern with the proposed statute is that the disallowance of intangible expenses does not permit a general exception for transactions with a valid business purpose. The "valid business purpose" exception in the bill applies only if the related party itself incurs an equivalent expense with an unrelated party. This provision seems likely to result in disallowance of many transactions that are not primarily motivated by tax avoidance.

TRD:

> The bill would remove some of the avenues available to large, multi-state corporations to shift income from New Mexico to lower- and non-income tax states, thus helping to 'level the playing field" between large, multi-state corporations that may use aggressive tax planning and smaller, in-state corporations that operate only in New Mexico.

ADMINISTRATIVE IMPLICATIONS

TRD notes that the Department will be required to promulgate new regulations and to generate information and outreach for taxpayers, and also to develop audit procedures and training.

TECHNICAL ISSUES

TRD notes that the bill's title should be changed from "Deductible Tangible Expenses" to "Deductible Intangible Expenses." The phrase "adjustment required by this subsection" on, for example line 7 of page 12 should be changed to refer more specifically to the deduction requirements of the other sections of the statute.

ALTERNATIVES

The proposal could be thought of as an alternative to the bills like SB 90 that would require corporate income taxpayers to file on a unitary combined basis.

TC/mew

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