ECONOMIC DEVELOPMENT COMMITTEE
of the
BLUE RIBBON TAX REFORM COMMISSION

TAX REFORM PROPOSALS
TO THE BLUE RIBBON TAX REFORM COMMISSION

ECONOMIC DEVELOPMENT COMMITTEE:
OPTIONS FOR TAX REFORM PROPOSALS
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This document contains recommendations for tax reform presented to the Economic Development Committee of the Blue Ribbon Tax Reform Commission or discussed by members of the Economic Development Committee. The italicized options for tax reform included in this document are those endorsed by the Economic Development Committee. The options are organized according to the categories that the committee was charged with examining, including issues involving gross receipts tax pyramiding, corporate income taxes, franchise tax fees, economic development tax incentives and tax administration.

GROSS RECEIPTS TAX PYRAMIDING

Gross Receipts Tax on Power Plant Fuels

Gross receipts tax is owed on fuels used in electricity-generating stations in New Mexico. Fuels that are exported from the state do not accrue gross receipts tax liability unless the title to the fuel is transferred in the state. Since the sale of electricity is also taxable under the gross receipts tax, the tax imposed on the fuel is incorporated as a cost and pyramided in the price of electricity. According to the Taxation and Revenue Department (TRD), this pyramiding can be compounded in the case of electricity sold to a business because the tax on the business inputs becomes an overhead cost that is pyramided into the price of the business' outputs. According to national input-output data, approximately 50 percent of electricity nationwide is purchased by businesses.

In addition to the pyramiding of tax within the gross receipts tax, excise taxes are imposed on fuels that are produced within the state. These include severance tax, oil and gas emergency school tax, etc. These taxes average a rate of five percent to 10 percent of taxable value, depending on the nature of the fuel, production methods and other factors.

Fuels produced on Native American reservations and pueblo grants are often subject to sales taxation by the tribe or pueblo. The state currently allows credits against severance tax and gross receipts tax for similar taxes paid to Indian entities on certain fuels.

Although other states in the western region also impose sales tax on fuels and electricity, most provide some relief for fuels used in power plants. Some states also provide relief for sales of electricity to industrial customers.

OPTION #1: PROVIDE A GROSS RECEIPTS TAX DEDUCTION TO WHOLESALE POWER PLANTS FOR ELECTRIC POWER EXPORTED FROM NEW MEXICO.

According to TRD estimates, the fiscal impact of providing a gross receipts tax deduction for power plants dedicated to the wholesale power market would be about **$4 million per year**.

OPTION #2: PROVIDE A GROSS RECEIPTS TAX DEDUCTION FOR FUEL USED TO PRODUCE EXPORTED ELECTRICITY.

Such a deduction might be targeted to fuel purchased and used in the generation of electric power. An annual reconciliation might be required of taxpayers claiming the deduction to document the total power generated less the power delivered in New Mexico.

Engineering and Architectural Services Sold to Construction Businesses

Section 7-9-52 NMSA 1978 permits a deduction for the sale of construction services to a person engaged in the construction business. The services must be performed on a construction project that is subject to the gross receipts tax or is located on Indian tribal territory. Pursuant to TRD regulations, "construction services" is defined to exclude indirect services. Indirect services are defined to include architectural, engineering and drafting services and other services such as accounting. Industry representatives have argued that architectural and engineering services should be eligible for the same deduction.

OPTION: MAKE ARCHITECTURAL AND ENGINEERING SERVICES SOLD FOR CONSTRUCTION ELIGIBLE FOR THE GROSS RECEIPTS TAX DEDUCTION PURSUANT TO SECTION 7-9-52 NMSA 1978.

According to TRD estimates, the fiscal impact of removing pyramiding of engineering and architectural services to the construction industry in fiscal year 2005 is estimated to be $4 million to the state and $3 million for local governments, for a total of **$7 million**.

Temporary Employment Services

TRD has promulgated regulations that provide gross receipts tax relief for employee-leasing businesses. TRD rationale provides that an employee-leasing business is a joint employer with the lessor business and, thus, employee-leasing business sales are appropriately treated as a form of wages and salaries, which are exempt from the gross receipts tax. Temporary service companies have asked for the same treatment as employee-leasing businesses on the grounds that their businesses are effectively the same.

OPTION: TAX EMPLOYEE-LEASING COMPANIES IN THE SAME MANNER AS TEMPORARY EMPLOYMENT AGENCIES.

Rather than permitting a gross receipts tax deduction for temporary employment service companies as a means to promote equity with employee-leasing agencies, it is possible to promote the same goal by taxing employee-leasing companies in the same manner as temporary employment agencies. This option would also permit the state to raise additional tax revenue.

Sales of Services to Businesses

Sales of services to businesses are subject to the gross receipts tax with certain exceptions. The sale of a service for subsequent resale is deductible if the subsequent sale is in the ordinary course of business and is subject to the gross receipts tax. The sale of a service in interstate commerce is also deductible. However, since most sales of services to businesses are taxable under the gross receipts tax, tax pyramiding adds to overhead costs of New Mexico businesses. Pyramiding of the gross receipts tax on services creates a competitive disadvantage for New Mexico businesses that compete with out-of-state businesses.

OPTION #1: PERMIT A DEDUCTION FOR CERTAIN INDUSTRIES.

Targeting gross receipts tax deductions to industries such as manufacturing and research and development industries might attract key industries to the state.

OPTION #2: REMOVE THE "NEXT SALE TAXABLE" PROVISION FROM SECTION 7-9-48 NMSA 1978.

According to TRD estimates, removing the "next sale taxable" provision from Section 7-9-48 NMSA 1978 would result in a fiscal year 2005 impact of **$50 million**, including $30 million in state revenue and $20 million in local revenue. TRD has submitted a proposed bill draft to the committee that would attempt to minimize windfalls for certain exempt entities, including out-of-state buyers and hospitals.

CORPORATE INCOME TAX

Filing Methods

New Mexico permits corporations to report in one of three ways. In addition to separate company reporting, a family of corporations forming a single unitary business enterprise might elect to file using the unitary domestic combined reporting method. State law also permits a family of corporations that file a federal consolidated income tax return to elect to file a New Mexico corporate income tax return using federal consolidated reporting.

A corporation must file using the separate company method unless it elects to file using one of the other two methods. Once another method is elected a corporation cannot go back without the permission of the secretary of taxation and revenue. A corporation that elects to file using the domestic combined reporting method may file under the federal consolidated reporting without the secretary's permission.

OPTION #1: REQUIRE ALL CORPORATIONS TO FILE USING THE UNITARY FILING METHOD.

Combined filing is based on the unitary business principle, which holds that flows of value between commonly controlled and operated corporations make accurate estimation of individual "profits" of the separate affiliated corporations impossible. An accurate measure of profits, losses and apportionment factors is achieved by combining profits and losses of interdependent corporations on a single return, and subjecting the combined group to a single apportionment formula. Administrators believe that combined filing discourages tax avoidance through favorable transfer pricing and measures that minimize tax obligations. Many administrators also believe that most small taxpayers would be unaffected by its elimination, since they do not have to combine "families of firms". Large taxpayers currently file combined returns in many states. It is easy for large taxpayers to modify their returns for filing in New Mexico. The Economic Development Committee discussed making this requirement effective in fiscal year 2005 and members agreed that phase-in issues will require further study.

OPTION #1A: CHANGE THE DEFINITION OF A UNITARY CORPORATION TO AN OBJECTIVE STANDARD, SUCH AS THAT OF COLORADO.

OPTION #1B: ADOPT THE FACTOR PRESENCE NEXUS STANDARD FOR BUSINESS ACTIVITY TAXES SUGGESTED BY THE MULTISTATE TAX COMMISSION.

The factor presence nexus standard established by the Multistate Tax Commission states that substantial nexus is established if any of the following thresholds is exceeded during the tax period:

1. a dollar amount of $50,000 of property;
2. a dollar amount of $50,000 of payroll;
3. a dollar amount of $500,000 of sales; or
4. 25 percent of total property, total payroll or total sales.

Corporate Income Tax Rate Structure

The New Mexico corporate income tax is levied against federal taxable income. All corporate income tax revenues flow to the state's general fund. A rate of 4.8 percent is imposed on the first $500,000 in taxable income, 6.4 percent against income between $500,000 and $1 million and 7.6 percent on income over $1 million. Some have criticized progressive taxation of corporations. One argument is that as corporations shift tax burdens to consumers, wage earners and corporate owners, that income might be redistributed from poor to more wealthy individuals. Another argument is that during periods of high profits, corporations can employ earnings to accumulate capital and invest. Progressive taxation might encourage corporate owners to employ their resources inefficiently. Progressive taxation might additionally act as a barrier to market entry as out-of-state firms refuse to move capital to a state where the results of their efforts are likely to be taxed. Additionally, most states do not impose progressive corporate income tax rates. Keeping a progressive corporate income tax system might contribute to a perception that New Mexico has an unfriendly business climate. Another reason for eliminating the current rate structure is that as long as New Mexico allows separate entity reporting, corporations can avoid higher tax rates simply by creating subsidiaries to receive the income.

OPTION: IMPLEMENT A SINGLE CORPORATE INCOME TAX RATE.

Creating a flat corporate income tax rate would eliminate the economic development disincentives associated with a progressive rate system. Economic Development Committee Chairman Brian McDonald has suggested employing a single corporate income tax rate, equal to the top personal income tax rate of 4.9 percent that would become phased-in similarly to the personal income tax rate cuts. Further study of the rate phase-in is required.

Apportionment Formulas

An apportionment formula is the common measure employed to gauge income that a particular state might tax. The New Mexico apportionment formula attempts to source income in the state through the single-weighted three-factor formula. The formula measures business activity as a proportion of three equal factors, including payroll, property and sales.

$$\frac{\text{Business Activity in NM}}{\text{Total Business Activity}} = \frac{1\ \text{NM Payroll}}{3\ \text{Total Payroll}} + \frac{1\ \text{NM Property}}{3\ \text{Total Property}} + \frac{1\ \text{NM Sales}}{3\ \text{Total Sales}}$$

Several states modified the traditional three-factor formula to allow the sales factor to play as large a role in apportioning income as the combined effects of in-state wages and property. The business activity portion of the double-weighted three-factor formula appears as the following:

$$\frac{\text{Business Activity in State Z}}{\text{Total Business Activity}} = \frac{1\ \text{State Z Payroll}}{4\ \text{Total Payroll}} + \frac{1\ \text{State Z Property}}{4\ \text{Total Property}} + \frac{1\ \text{State Z Sales}}{2\ \text{Total Sales}}$$

This approach tends to reward firms with high proportions of their product sales flowing to other states. In 1992, a law was enacted that allowed manufacturing firms the option of employing a double-weighted sales factor formula. Its purpose was to encourage manufacturing firms to locate or expand plants in New Mexico as a means of creating jobs and increasing income.

OPTION #1: MAKE THE DOUBLE-WEIGHTED SALES APPORTIONMENT FORMULA AVAILABLE TO ALL CORPORATIONS.

Service industries are currently at a disadvantage because they do not have the option of using the double-weighted sales formula. These industries are not encouraged to expand or locate property or employ workers in New Mexico. Their inability to use the double-weighted sales formula might contribute to a perception of inequitable treatment of service industries. Adding the formula as an option for all industries might rectify such problems..

OPTION #2: DEFINE SALES TO INCLUDE TANGIBLES AND INTANGIBLES SUCH AS SERVICES, ROYALTIES AND TRADEMARK INCOME.

This option is consistent with the Multistate Tax Commission's factor presence nexus standard for business activity taxes. The sales allocation factor should source all sales to the destination. The Economic Development Committee recommends further study of this issue.

OPTION #3: MAKE THE COLORADO TWO-FACTOR APPORTIONMENT FORMULA AVAILABLE TO ALL CORPORATIONS.

The Colorado formula includes plant and sales as apportionment factors.

FRANCHISE TAX

New Mexico imposes a $50.00 annual corporate franchise fee on domestic and foreign corporations conducting business in the state and on corporations possessing or exercising a corporate franchise in New Mexico, irrespective of whether they conduct business in the state. New Mexico's franchise fee is, therefore, essentially unrelated to the extent of business activities conducted by firms.

OPTION #1: INCREASE THE FRANCHISE FEE.

According to TRD, it is not clear that the $50.00 fee covers the cost of registering firms and other costs associated with providing a firm with the right to exercise its franchise. It was enacted in 1986. The department indicates that if the franchise fee had been indexed to the rate of inflation in 1986, it would be approximately $84.00 today and generate approximately $4.2 million, $1.7 million more than the $2.5 million it currently generates. Since New Mexico's tax is unrelated to business activity, it provides little incentive for businesses to undertake activities to avoid it.

OPTION #2: IMPOSE THE FRANCHISE FEE ON LIMITED LIABILITY CORPORATIONS AND OTHER PASS-THROUGH ENTITIES.

According to TRD, about 21,000 domestic limited liability corporations and 3,000 foreign limited liability corporations are currently registered with the Public Regulation Commission. The number of new limited liability corporation registrants has totaled about 2,000 to 3,000 annually in recent years. A $50.00 fee imposed on 24,000 limited liability corporations would thus generate about $1.2 million. If imposed at a rate of $84.00, the revenue total would be approximately $2 million.

Other business forms that might be required to pay the franchise fee include limited partnerships and limited liability partnerships. These entities are required to register with the secretary of state. Representatives of the secretary of state's office report that only about 200 firms organized as limited partnerships and limited liability partnerships are registered. As a result, franchise fee revenue potential from those business forms is low.

ECONOMIC DEVELOPMENT TAX INCENTIVES

OPTION #1: EXPAND THE LABORATORY PARTNERSHIP WITH SMALL BUSINESS TAX CREDIT.

The laboratory partnership with small business tax credit is a tax credit enabling Sandia National Laboratories to provide technical or business assistance to a small business that supports the growth of the state's economic base. Lenny Martinez, vice president of process engineering and manufacturing at Sandia National Laboratories, presented the many benefits of the laboratory partnership with small business tax credit. Mr. Martinez stated that in 1991, for each dollar spent on an assistance project, $.98 was recovered by the state through taxes within the first year. Over a one-year period, 44 jobs were retained and 68 new jobs were created. Participating New Mexico small businesses reported a total of $3,380,000 of increased revenue and a $1,703,500 decrease in operating costs. Participating small businesses spent $2,147,500 to expand operations and $828,600 on local goods and services.

OPTION #2: EXEMPT TELECOMMUNICATIONS EQUIPMENT FROM THE GROSS RECEIPTS TAX.

Further study of what the definition of telecommunications equipment might include is required.

OPTION #3: CREATE A GROSS RECEIPTS TAX DEDUCTION FOR SALES OF TANGIBLE PERSONAL PROPERTY TO MICRO ELECTRO-MECHANICAL SYSTEMS MANUFACTURERS.

The deduction would be limited to the sales of property consumed in the manufacturing business to manufacturers that have been in operation for three years or less and that employ thirty or fewer persons. Further study of the definition of micro electro-mechanical systems is required.

OPTION #4: CREATE DEDUCTIONS FOR RESEARCH AND DEVELOPMENT COMPANIES THAT ARE EMPLOYED BY THE FEDERAL GOVERNMENT.

> *OPTION #4A: CREATE A GROSS RECEIPTS TAX DEDUCTION FOR RESEARCH AND DEVELOPMENT COMPANIES THAT ARE EMPLOYED BY THE FEDERAL GOVERNMENT.*
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> *OPTION #4B: CREATE A DEDUCTION FOR THE COMPENSATING TAX DUE ON PURCHASED EQUIPMENT AND CONSUMABLES FOR COMPANIES THAT ARE EMPLOYED BY THE FEDERAL GOVERNMENT.*

OPTION #5: DIRECT A STUDY OF ALL ECONOMIC DEVELOPMENT INCENTIVES TO DETERMINE WHETHER THEY SHOULD BE RETAINED OR EXPANDED.

TAX ADMINISTRATION

Hearing System

OPTION: IMPLEMENT AN INDEPENDENT HEARING PROCESS.

New Mexico is one of nine remaining states that employ an internal hearing system. TRD reviews its own decisions. The nationwide trend is toward independent review of actions by a tax administrative agency. ACI representatives contend that a perceived lack of impartiality exists in the multistate tax world with respect to New Mexico's prepayment remedy because the only remedy is to ask TRD to change its mind. Implementing an independent hearing process that is separate from TRD might solve this problem. The creation of a state tax court to review final determinations of TRD might facilitate the process.

OTHER RECOMMENDATIONS

OPTION: AMEND SECTION 7-9-55 NMSA 1978.

Section 7-9-55 NMSA 1978 permits a gross receipts tax deduction for exported goods. Most states use a "delivery" rule for exports. New Mexico uses a more complicated standard that includes taking title and risk of loss passing to the customer outside of New Mexico. To remedy this, Chairman McDonald suggests amending Section 7-9-55 NMSA 1978 to permit receipts from the sale of tangible personal property or licenses to be deducted from gross receipts if the property is delivered to an out-of-state buyer for initial out-of-state use. Chairman McDonald further suggests eliminating the requirement that title and risk of loss pass to the customer outside of New Mexico. This change will make the export deduction for goods similar to the export deduction for services pursuant to Section 7-9-57 NMSA 1978. It is also likely that the delivery standard will be contained in the streamlined sales tax project effort.