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

ORIGINAL DATE 03/01/13
SPONSOR Ivey-Soto **LAST UPDATED** **HB**

SHORT TITLE Manufacturing Single Sales Tax Factor **SB** 545

ANALYST van Moorsel

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY13	**FY14**	**FY15**	**FY16**	**FY17**		
$19,500.0	$33,421.0	$26,450.0	($21,855.0)	($38,279.0)	Recurring	General Fund
$6,100.0	$12,377.0	$15,282.0	$8,000.0	$11,200.0	Recurring	Local Governments
	$25.0	$42.0	$60.0	$78.0	Recurring	Small County Assistance Fund
	$38.0	$63.0	$90.0	$117.0	Recurring	Small City Assistance Fund
	$13.0	$21.0	$30.0	$39.0	Recurring	Municipal Equivalent Distrib.
$25,600.0	$45,873.0	$41,858.0	($13,675.0)	($26,845.0)	Recurring	Total

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 545 makes several amendments to the Tax Code. The bill phases in an optional single sales factor business income apportionment formula over five years, amends the gross receipts tax (GRT) deduction for tangible property consumed in the manufacturing process to narrow the qualifications for the deduction, and amends the high-wage jobs tax credit (HWJTC) to extend the credit and add criteria for the qualifications for the credit.

Section 1 of SB545 amends the Uniform Division of Income for Tax Purposes Act to phase in over five years an optional single sales business income apportionment factor for businesses engaged in manufacturing. To elect the apportionment formula created in SB545, the taxpayer must notify TRD in writing before first filing a return using the new apportionment formula. Once opting into this apportionment formula, the taxpayer must use the formula for three years before being able to opt back out. The single sales factor provided for in SB545 would be phased in over five years as follows:

Tax Year	Apportionment Formula
2013 (current law)	$\frac{\text{(sales factor)+(property factor)+(payroll factor)}}{3}$
2014	$\frac{\text{(2Xsales factor)+(property factor)+(payroll factor)}}{4}$
2015	$\frac{\text{(3Xsales factor)+(property factor)+(payroll factor)}}{5}$
2016	$\frac{\text{(7Xsales factor)+(1.5Xproperty factor)+(1.5Xpayroll factor)}}{10}$
2017	$\frac{\text{(8Xsales factor)+(property factor)+(payroll factor)}}{10}$
2018	$\frac{\text{(total sales in New Mexico)}}{\text{(total sales)}}$

Section 2 of the bill also amends the act to and to exclude certain sales from being apportioned as sales in New Mexico.

The effective date of sections 1 and 2 is January 1, 2014, and the provisions of the sections apply to taxable years beginning January 1, 2014.

Section 3 of SB545 amends the Gross Receipts and Compensating Tax Act to change the provisions governing the deduction of receipts from selling tangible personal property that is consumed in the manufacturing process. The amendments specify that the tangible personal property must be a consumable, and the sale of the property must be to a business engaged in manufacturing that product "in New Mexico, who exported for sale or use outside of New Mexico at least 50 percent of the product manufactured in New Mexico in the previous taxable year."

The bill includes the following definitions:

- "business engaged in manufacturing" is a business classified within the manufacturing sector as described in the official 2012 United States North American industry classification (NAICS) system manual.
- "consumable" is tangible personal property that is incorporated into, destroyed or transformed in the process of manufacturing a product, including electricity, fuels, manufacturing supplies, chemicals, gases and other tangibles used to manufacture a product.

The effective date of section 3 is July 1, 2013, and the provisions of the section apply to gross receipts received on or after July 1, 2013.

Section 4 of SB545 amends the provisions governing the high-wage jobs tax credit to tighten a host of high wage tax credit definitions and to extend the sunset to the end of FY20. The two most important changes to the law are:

- Limiting the application period to one year. Currently there is no limitation.
- Limiting eligible employers to those certified by the Economic Development Department to be eligible for job training program assistance, commonly known as "JTIP". Currently, employers are eligible if they export more than 50 percent of their sales.

Section 4 also clarifies that eligible jobs cannot be recycled through mergers or acquisitions and that wages are calculated inclusive of benefits. The bill increases the population level that would classify a municipality as urban for purposes of the credit from 40 thousand to 60 thousand. The section also increases the wage requirements for jobs created after July 1, 2015 to qualify for the HWJTC. These jobs must pay wages of $65 thousand (if in an urban area) and $40 thousand (if in a rural area) as opposed to $40 thousand and $28 thousand, respectively.

The provisions of section 4 of the bill apply to credit claims received on or after January 1, 2013, and to reporting periods beginning on or after January 1, 2013.

SB545 contains an emergency clause, it would become effective immediately upon signature by the governor.

FISCAL IMPLICATIONS

Single Sales Factor: The TRD used 2010 New Mexico corporate income tax (CIT) data for manufacturing corporations (NAICS code 31 through 33) in its analysis of the impact of the single-weighted sales factor apportionment election. Approximately 1,750 corporations file under the manufacturing NAICS codes with a total gross NM CIT of $75 million. The impact was estimated assuming that all manufacturing corporations whose sales factor is less than an average factor would make the election. Since not all eligible corporations will make this election due to the 36 consecutive month election requirement, the impact was reduced by 10%. February forecast estimates were used to estimate the fiscal impacts from FY14 through FY17.

High Wage Jobs Tax Credit: The changes to the HWJTC have the effect of tightening the eligibility requirements for both employers and employees. According to TRD data, the 17 companies filing the greatest number of HWJTC applications received approval of those claims in recent years. These companies account for about 75 percent of all credits by dollar amount during the period analyzed. Growth in new qualified jobs was estimated using BBER FOR-UNM forecast employment growth for the applicable sectors.

Applications for the HWJTC surged in FY12 and in FY13 (to-date), which TRD reports appears to be due to a "mining" of potential claims by several consulting accounting firms, and due to an increasing awareness of the potential claims under the existing HWJTC statutes. At present, approximately $110 million in pending HWJTC claims are under evaluation by TRD. In order to estimate the fiscal impact, TRD adjusted claims to a "normal" level, assuming the current surge in claims reflects anticipation of proposed amendments to the HWJTC.

TRD estimates the "normal" applications per year under the current law to be approximately $65 million. Assuming one third of claims are not approved, the total amount approved would be

$43.3 million per year. TRD estimates the new definitions would eliminate about 40 percent of HWJTC credits by dollar amount. Finally, of the 60 percent of qualified applications, only 60 percent are "new" jobs as defined by the proposed legislation. Under the proposed statutory criteria for HWJTC qualification, approved credits would be about 36 percent of what they would have been under current law.

SB545 would impose a limit on new qualifying jobs immediately. After the assumed effective date of April 1st, TRD assumes $60 million in pending applications will be analyzed pursuant to the more restrictive provisions of the legislation, resulting in a reduction from a two-thirds approval rate to a 23 percent approval rate ($14.4 million). Thus, the provisions of the bill would reduce the credits approved in FY13 by $25.6 million.

TRD notes the extension of the definition of urban jobs to within ten miles of a municipality with a population of 60,000, or in Los Alamos County would have a minimum impact because the wage limit of a qualified job in Los Alamos County and ten miles of its external boundaries would be $40,000 under the proposed law, which would potentially reduce the number of qualified jobs. However, the wage limit of a qualified job in other municipalities, for example Roswell (population: 48,366) and Farmington (population: 45,877) would be reduced from $40,000 to $28,000, causing a potential increase in the number of qualified jobs.

Beginning in FY16, the proposal raises the threshold wages to $40,000 for rural jobs and $65,000 for urban jobs, from $28,000 and $40,000 respectively. Based on analysis of the most recent two years of claims, TRD estimates that this would cause a 25% reduction in the amount of the credit (5% of credits issued are tied to jobs below $40,000 that would be eliminated, and 20% of credits issued are estimated to arise from urban jobs between $40,000 and $65,000 that would be eliminated). The total estimated revenue impact of the HWJTC portion of this bill is in the table below.

	FY2013	**FY2014**	**FY2015**	**FY2016**	**FY2017**
General Fund Impact	$19,500.0	$27,946.0	$28,281.0	($3,800.0)	($3,900.0)
Local Government Impact	$6,100.0	$8,777.0	$8,882.0	($1,200.0)	($1,200.0)
Total Impact, HWJTC Changes	$25,600.0	$36,723.0	$37,164.0	($5,000.0)	($5,100.0)

<u>Manufacturing Consumables Deduction Changes</u>: TRD notes its estimates for this portion of the analysis include a high degree of uncertainty for several reasons which make it difficult to estimate the baseline level of the deduction, as well as the impacts from the proposed changes:

- The deduction is not separately stated, and the historical size of the deduction is not known.
- 2012 amendments to the law governing the deduction are expected to greatly increase the size of the deduction; the changes have not been in effect long enough to assess their impact.
- Given the current and proposed definitions of manufacturing, it is difficult to identify with certainty the pool of firms that will be eligible for the credit.
- Insufficient data exists to directly analyze the percentage of New Mexico production that is sold outside of New Mexico, at the aggregate or individual firm level.

To establish a baseline level of the manufacturers' consumables deduction, TRD relied on DFA's revised analysis of a REMI Input-Output model of manufacturer consumption. This model estimates the size of the deduction under current law as described in the table below.

Current Law Deduction	**FY13**	**FY14**	**FY15**	**FY16**	**FY17**
Total	($16,545.0)	($30,748.0)	($53,304.0)	($77,846.0)	($104,324.0)

With the baseline established, TRD identified the proposed changes that are expected to have a significant revenue impact – the definition of manufacturing and the requirement that businesses export at least 50 percent of their production outside of New Mexico. The effect of each of these changes is to tighten the qualifying standards for businesses receiving this deduction.

The current broad interpretation of the definition of manufacturing could allow many types of firms to qualify despite not conventionally being considered a manufacturer. The proposed legislation would significantly reduce the number of firms that could qualify for the credit by restricting qualifying firms to those classified as manufacturers under NAICS 2012.

To estimate the proportion of proposed qualifying firms to current potential qualifying firms, TRD utilized 2012 Implan Institution Industry Demand table data. TRD estimates a reduction in claims from changing to the NAICS 2012 definition of manufacturing sector of approximately 21 percent.

Taking into account the excluded industries from the definition of manufacturing, TRD used the 2012 Implan Institution Industry Demand table to estimate that approximately 93 percent of total demand from NAICS 2012 manufacturing firms is allocated to export outside of New Mexico. To estimate the impact, TRD assumed the modified definition in conjunction with the 50 percent export requirement will reduce the size of the deduction by about 30 percent. The table below shows the estimated impact to gross receipts tax and compensating tax.

	FY13	**FY14**	**FY15**	**FY16**	**FY17**
General Fund (GRT)	0	$5,400.0	$9,600.0	$13,800.0	$18,600.0
Local Governments	0	$3,600.0	$6,400.0	$9,200.0	$12,400.0
Net Gross Receipts Tax Impact	0	$9,000.0	$16,000.0	$23,000.0	$31,000.0
General Fund (Comp)	0	$175.0	$294.0	$420.0	$546.0
Small County Assistance Fund	0	$25.0	$42.0	$60.0	$78.0
Small City Assistance Fund	0	$37.5	$63.0	$90.0	$117.0
Municipal Equivalent Distrib.	0	$12.5	$21.0	$30.0	$39.0
Net Compensating Tax Impact	0	$250.0	$420.0	$600.0	$780.0
Total Impact	0	$9,250.0	$16,420.0	$23,600.0	$31,780.0

This bill may be counter to the LFC tax policy principle of adequacy, efficiency and equity. Due to the increasing cost of tax expenditures revenues may be insufficient to cover growing recurring appropriations.

Estimating the cost of tax expenditures is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. The statutory criteria for a tax expenditure may be ambiguous, further complicating the initial cost estimate of the expenditure's fiscal impact. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures.

SIGNIFICANT ISSUES

New Mexico's top corporate income tax rate of 7.6 percent is high, compared with the national average of 6.4 percent. New Mexico's CIT rate is especially high when considering a corporation can be taxed at the 4.9 percent personal income tax rate simply by organizing under another section of the IRS code. This violates the principle of tax equity. In 2011, the Council on State Taxation (COST) commissioned Ernst & Young to perform a 50-state study of effective tax rate/after-tax return on investment over a 30-year investment, New Mexico ranked last. The study found that tax rates and a complex tax credit incentive system are a burden on firms considering investments in New Mexico and are "almost certainly impeding economic growth."

Among other options, the New Mexico Tax Research Institute (NMTRI) noted a reduction in the top corporate rate would make New Mexico more appealing to business investment. The NMTRI also addressed the option of allowing corporations to apportion income with a single- or double-weighted sales factor. All states parse a multistate corporation's income into a state taxable base. New Mexico uses an "apportionment formula" that averages the percentage of a corporation's sales occurring in New Mexico, the percentage of payroll in New Mexico, and the percentage of property (or assets or investment) domiciled in New Mexico. The equally weighted corporate income apportionment formula creates a disincentive to expansion in New Mexico; if a company increases its operations in New Mexico, its taxes in New Mexico would increase, even without the benefit of additional sales, creating a disincentive to growth. Firms can lower exposure to New Mexico tax by firing workers and closing plants.

The "single sales" factor, by which income is apportioned only on the percentage of sales made in the state, is the alternative in favor nationally. This formula does not punish firms for investing or employing workers within a state. In New Mexico, a mandatory single sales formula would likely benefit extractive and manufacturing industries while penalizing direct sellers of goods and services and multistate banks. Mining and manufacturing pay well over half of New Mexico CIT, however, and this formula could result in lower revenues.

Legislation enacted in 2012 expanded the GRT deduction for tangible personal property to include property consumed in the manufacturing process. The deduction was intended to exempt the cost of electricity used in the manufacturing process, but it can be construed to cover refining, processing, restaurants, and even art. Further, the electric utilities report it will be difficult to identify electricity "consumed" during manufacturing. These issues doubled the original estimate of the deduction's general fund impact to $4.7 million in FY13, rising to $80 million when fully phased in by FY17.

The high-wage jobs tax credit provides qualifying employers with a 10 percent tax credit, up to $12 thousand, for each employee with annual wages and benefits totaling more than $28 thousand if in a rural area and more than $40 thousand if in an urban area. Eligible employers include those eligible for the Job Training Incentive Program (JTIP) or that earned more than 50 percent of their sales from out-of-state entities in the prior year. The cost of the credit is higher than initially estimated, with FY12 claims exceeding $48 million, and FY13 projected at $50 million. The credit is intended to create new jobs, but data suggests most of the claims are for jobs created from previous business activity. The TRD estimates as little as 19 percent of all FY12 credit applications were for jobs created during the current qualifying period. In the last two fiscal years, employers claimed credit for creating roughly 3,000 jobs. However, it should be noted that the UNM's Bureau of Business and Economic Research estimates employment actually declined by 258 jobs during that time.

CONFLICT

Conflicts with SB59, SB277, SB293, SB319, SB373, SB508, SB538, SB545, SB568, HB182, HB507, HB596, and HB616.

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

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