MINUTES
of the
FIFTH MEETING IN 2016
of the
REVENUE STABILIZATION AND TAX POLICY COMMITTEE

November 28, 2016
Jemez Rooms, Santa Fe Community College
Santa Fe

The fifth meeting of the Revenue Stabilization and Tax Policy Committee for the 2016 interim was called to order by Representative Jason C. Harper, chair, on Monday, November 28, 2016 at 9:15 a.m. in the Jemez Rooms of Santa Fe Community College in Santa Fe.

Present
Rep. Jason C. Harper, Chair
Sen. Carlos R. Cisneros, Vice Chair
Sen. Lee S. Cotter
Rep. Antonio Maestas
Rep. Rod Montoya
Rep. Debbie A. Rodella
Sen. Clemente Sanchez
Sen. William E. Sharer
Sen. John Arthur Smith
Rep. James R.J. Strickler
Rep. Carl Trujillo
Rep. Jim R. Trujillo
Sen. Peter Wirth

Absent
Sen. Ted Barela
Rep. David M. Gallegos
Rep. Tim D. Lewis
Sen. Mark Moores
Sen. George K. Munoz

Designees
Rep. Bill McCamley (attending as guest)
Sen. James P. White

Rep. David E. Adkins
Sen. William F. Burt
Sen. Jacob R. Candelaria
Rep. Sharon Clahchischilliage
Rep. Randal S. Crowder
Rep. Brian Egolf
Rep. Miguel P. Garcia
Rep. Stephanie Garcia Richard
Rep. Bealquin Bill Gomez
Sen. Stuart Ingle
Rep. Conrad James
Sen. Gay G. Kernan
Rep. Idalia Lechuga-Tena
Rep. Javier Martínez
Sen. Nancy Rodriguez

Rep. Tomás E. Salazar
Sen. John M. Sapien
Rep. Jeff Steinborn
Rep. James G. Townsend
Sen. Pat Woods

Minutes Approval

Because the committee will not meet again this year, the minutes for this meeting have not been officially approved by the committee.

Guest Legislator

Sen. Linda M. Lopez

Staff

Pam Stokes, Staff Attorney, Legislative Council Service (LCS)
Jeff Eaton, Research and Fiscal Policy Analyst, LCS
Ric Gaudet, Researcher, LCS
Tessa Ryan, Staff Attorney, LCS

Handouts

Handouts and other written testimony are in the meeting file.

Guests

The guest list is in the meeting file.

Monday, November 28

Overview of the Income Tax Act and the Corporate Income and Franchise Tax Act

Frank Crociata, tax policy director, Taxation and Revenue Department (TRD), and James Kaminsky, senior economist, TRD, discussed with the committee the structure and mechanics of the personal income tax (PIT) and corporate income tax (CIT) in New Mexico. Mr. Crociata began by discussing the CIT program, which mostly parallels the federal income tax program. The CIT is imposed on the net income of every corporation that transacts business in or derives income from New Mexico. "Net income" is defined as federal base income, with a few caveats. New Mexico has a slightly different definition for net operating loss (NOL) than the Internal Revenue Service (IRS), but as long as a corporation's federal NOL meet the state's definition, the NOLs are treated the same way. New Mexico has a top marginal tax rate of 6.9 percent, but that rate is being reduced over the next three years to 5.9 percent. He cautioned against comparing CIT rates across the country because many factors affect the actual tax paid by a corporation, including whether the company is filing a combined tax return and the staggered tax rates at different income levels. It is more accurate to compare effective tax rates, which measure the actual taxes paid by a corporation on its pre-tax profits.

New Mexico has three levels of income reporting, and most corporations are not required to use any particular method. Separate reporting is when each company transacting business in the state files its own state CIT return, regardless of the total corporate structure and ownership. Only the profit and loss from the entity doing business in the state is reported. Combined reporting, sometimes called "unitary reporting", is when a group of commonly owned corporations that engage in a unitary business file one CIT return that includes all unitary members, if at least one of the members transacts business in the state. Combined reporting is optional, except for New Mexico retailers selling goods from facilities that exceed 30,000 square feet. Those entities must file combined returns in New Mexico. Combined returns include New Mexico's proportionate share of profits and losses for the entire business entity. Finally, corporations that have unrelated business entities have the option of filing a consolidated return, which otherwise mirrors the combined return system. Although combined and consolidated reporting uses the entire company as the basis for computing tax liability, many more factors are also included. It is very difficult for the TRD to estimate the fiscal impact of requiring combined reporting because the situation in each company is unique. Mr. Crociata said that 25 states require combined reporting. In states that allow separate reporting, such as New Mexico, some corporations have been able to shift much of their in-state income to a holding company located in another state that does not impose a CIT or in which it files a combined return. This enables a corporation to greatly reduce its tax burden to New Mexico and also to reduce its overall tax burden.

The process of dividing income of multistate businesses is governed by the Uniform Division of Income for Tax Purposes Act (UDITPA), which was enacted by New Mexico in 1965. Business income of a corporation, consisting of transactional income, liquidations and sales of integral property related to the business, is apportioned according to a formula that assigns a certain amount of income to each state in which the company is operating. Nonbusiness income is typically allocated to one state, usually where the property is located or where the business is domiciled. When the UDITPA was formulated in 1957, it established a three-factor formula to apportion business income, which New Mexico still uses for most businesses. The proportion of property owned and payroll expenses and sales made in New Mexico compared to a business's total in each of those categories are added and then divided by three to get the business income apportioned for the state. The sales factor is calculated using different methods, depending on whether the property is tangible or intangible. Sales of tangible personal property are sourced based on the destination of the property being sold, but sales of intangible property, including services, are sourced to the state where the business expends the greatest "cost of performance". The payroll factor in New Mexico is calculated only using actual employees and does not include contractors.

Recently, New Mexico added optional apportionment formulas for manufacturers and headquarters operations to allow for just the sales factor to be used in computing the state's business income apportionment. These special apportionment factors were enacted to entice those sectors to locate in or remain in New Mexico, since the formula usually results in a reduction in New Mexico CIT liability for the company. The UDITPA also allows for deviations from the standard three-factor formula when the results do not fairly reflect the extent of a taxpayer's business activities in the state. Over the years, the Multistate Tax Commission (MTC) has developed rules for certain industries, such as construction contractors, railroads, airlines, trucking companies, financial institutions and broadcasting and publishing companies, and the TRD has adopted most of those special rules. Nineteen states have changed their apportionment laws to allow for a single sales factor for most or all businesses; 22 states use market-based sourcing, rather than cost-of-performance sourcing, for sales of services; and 19 states also use market-based sourcing for sales of other intangible property.

Mr. Crociata then discussed the mechanics of how the CIT is calculated for a business in New Mexico. First, the company's total income is reported, based on its federal reported base income, and then any New Mexico-specific NOLs are subtracted. The tax is calculated, using the CIT tax rates. Next, the company's income is allocated and apportioned to reach a percentage for the state, and that percentage is applied to the total theoretical CIT liability. Finally, any New Mexico tax credits are applied to the state CIT liability.

Finally, Mr. Crociata discussed the PIT program in New Mexico, which is structurally much less complex than the CIT program. The PIT program imposes a net income tax on New Mexico residents and nonresidents who derive income from New Mexico sources. The program also imposes tax liability on individuals who receive distributive shares of various kinds of pass-through entities (PTEs), including S-corporations, partnerships and certain kinds of limited liability companies. The top marginal PIT rate is 4.9 percent, set at a relatively low threshold, which makes New Mexico's income tax fairly flat. Mr. Crociata said that the TRD has been attempting to quantify the impact on PIT revenue from PTEs. However, it is difficult to determine exactly what source an individual's income is attributed to because the taxable event only occurs when a PTE makes an earnings distribution to its owners. PTEs typically only file federal informational returns, and it is not always possible to follow distributions to a liable individual or corporation.

Questions and comments from committee members included the following.

- What needs to change in the CIT structure to encourage businesses to relocate in New Mexico? Mr. Crociata said he does not think that New Mexico's overall CIT structure is out of sync with other states. He said that the state could allow companies to use a single sales factor and allow market-based sourcing of intangibles. He said that the gross receipts tax (GRT) is more of an economic disincentive than the CIT.
- Adopting a single sales factor for manufacturing companies did not do much to entice Intel, which instead chose Chandler, Arizona for a new chip manufacturing plant, to expand its operations in the state. Mr. Crociata said that people always look to Arizona and wonder how it succeeds when New Mexico keeps falling behind. However, Arizona's tax structure is not an ideal economic development tool, and it has been ranked poorly in some nationwide surveys. Arizona's economic development success has to be attributed to other factors than its tax structure.

- What is the rationale for adopting single sales factors and market-based sourcing? Mr. Crociata said that single sales factors are typically adopted to encourage businesses to locate or stay in a state. However, without adopting market-based sourcing for intangibles in calculating the sales factor, service-based companies would be discouraged from engaging in business in the state. For example, if a software company located in New Mexico is required to use cost-of-performance sourcing for its sales, all sales of the company would be attributed to New Mexico because that is where the majority of the costs would have been incurred. That would mean that the company would have a very distorted CIT liability in New Mexico.
- The reduction of the PIT rates in 2003 has cost the state more than $450 million annually. As the state continues to struggle to find revenue to pay for basic services, the legislature needs to reconsider those rate cuts. The state needs to have a more progressive PIT structure.
- The more progressive the tax code, the more volatile state revenues will be. However, paying 4.9 percent of net income is much more difficult for a low-income person than for a rich person. There is also no good reason for progressivity in the CIT rates.
- How can a state encourage businesses to locate in the state by offering a favorable tax climate and still accurately capture the economic base in its tax program? Mr. Crociata said that it is probably impossible to both. Single sales factors are really tools to encourage business activity and do not accurately reflect economic realities. However, requiring the use of a single sales factor will end up punishing other industries.
- Could the TRD do a better job of collecting premium taxes than the Office of Superintendent of Insurance (OSI)? Recent audits revealed that the OSI has more than $190 million in uncollected taxes that were due over the past several years. Mr. Crociata said that he does not know very much about the tax collection structure at the OSI and that the TRD would be hard pressed to take over that responsibility given current staffing levels. However, he said that there could be some administrative and regulatory benefits in having one agency administer different tax programs.
- The huge cash economy in New Mexico means that many businesses never pay GRT to the state. The TRD needs to make GRT collection a priority.

Adoption of Minutes

The minutes from the October 13-14 committee meeting were adopted without changes.

National Trends in PIT and CIT Policy and an Update from the Council on State Taxation's (CST's) Forty-Seventh Annual Meeting

Helen Hecht, general counsel, MTC, and Richard Anklam, president and executive director, New Mexico Tax Research Institute, discussed with the committee national trends relating to the PIT and CIT. Ms. Hecht said that in 2015, income taxes accounted for 42 percent of state-level taxes in the nation. State income taxes are generally tied to federal income taxes, and many states do not audit the numbers reported to the IRS, making adjustments only if a taxpayer is audited by that agency.

Ms. Hecht next discussed national trends related to the PIT. Some states have increased the top marginal PIT rate recently, and a few states imposed a "millionaire tax" on high-income individuals. Other states have reduced PIT rates or have begun phasing out the CIT. Many states increased their version of the earned income tax credit (EITC) to address tax regressivity issues that negatively affect low-income households. She cautioned that states are seeing increased levels of tax filing fraud, partly because EITCs are generally refundable, which makes that kind of fraud more attractive.

The U.S. Supreme Court recently ruled that if a state taxes income on both a residency and source basis, it must give a credit to residents for taxes paid in another state on a source basis. The court established a test to determine if the state tax laws violate the ruling: if every state had the same tax system as the home state, would that income be subject to double taxation? Ms. Hecht said that there may be future challenges to multistate taxation of income, including whether states must give credit for local income taxes paid.

Ms. Hecht discussed issues surrounding the collection and tracking of PTE income. More business income is now reported by PTEs than by corporations. Many PTEs have complex structures with multiple layers of partnerships, of other PTEs and of corporations. The IRS has had trouble auditing and enforcing income tax on partnership income because of the lack of transparency in those business entities. States may have separate issues in collecting tax from income reported by PTEs, including the ability to collect taxes from nonresident owners of PTEs. Ms. Hecht said that it is very difficult for taxing entities to determine if PTE income is being correctly reported by individuals who have some ownership interest in the company. Partnerships get to decide how to divide up their income, and there used to be no way to determine if that division was actually legitimate. In 2015, a new federal law was enacted to allow the IRS to compel partnerships either to pay taxes due or to assign that tax liability to individuals who are part of the partnership. The MTC is currently developing model legislation for states to have similar authority to collect state income tax due. Mr. Anklam said that the complex structure of many PTEs makes it impossible for states to match an individual or trust with a PTE tax liability.

Congress is considering other income tax reform, including proposals to lower rates and broaden the tax base, which would also expand the state income tax base. Ms. Hecht said that most proposals also eliminate the ability for individuals to deduct state income taxes paid on their federal tax return. This would have the net effect of increasing the cost of state income taxes because taxpayers would no longer be receiving an offsetting tax benefit.

Ms. Hecht then discussed national trends related to the CIT. Many states now require combined filing for most types of corporations, and many states allow the use of a single sales factor to apportion their income. Another major trend is to use market-based sourcing in the apportionment of intangible property. The courts have been weighing in on many state efforts to capture corporate income, especially regarding inter-company transactions that are used to avoid paying the CIT. This issue mostly affects states such as New Mexico that have the option of separate entity filing, but it also affects combined-entity-filing states because of the many multinational corporations in the world today. States have attempted many solutions to fix this problem, including: asserting that certain out-of-state affiliates have economic nexus in the state; requiring that inter-company transactions must have real substance in order to be legitimate; requiring that deductions for inter-company transactions be added back into the net income of a corporation; requiring that affiliates in overseas tax havens be included in the combined group of a company; and enacting anti-distortion transfer pricing remedies. The MTC has a special program to train and provide information to states on this issue. Some states are considering replacing their CIT with some version of a GRT, targeted exclusively at companies. Finally, Ms. Hecht said that there is proposed federal legislation to reduce or eliminate temporarily the imposition of income tax on assets held overseas by companies to stimulate investment in U.S. economic infrastructure.

Mr. Anklam reported to the committee topics discussed at the recent Council on State Taxation conference. Many state-level tax reform ballot initiatives failed at the general election, including a ballot measure in Oregon that would have imposed a 2.5 percent GRT on corporations. However, there were dozens of municipal tax proposals that were approved, many of which imposed higher taxes on their residents. Four states legalized the recreational use of marijuana, which is a huge potential revenue source for those states. Taxation of business-to-business transactions was also a major issue discussed at the conference. States are attempting to expand their sales tax base by imposing taxes on more such transactions, but the business sector tends to view these expansions as increasing the problem of tax pyramiding, which leads to economic distortions and stagnation.

Questions and comments from committee members included the following.

- Has there been any progress on the issue of internet sales taxation? Mr. Anklam said that federal legislation on that issue is still stalled. Most of the business community is in favor of collecting sales tax from online transactions, but would prefer a uniform nationwide standard.
- The legislature should consider sharing a portion of the CIT and PIT with local governments. There has been much erosion of the local tax base over the past two decades, and that erosion was made worse when the deduction from gross receipts for the sale of food was enacted. The state has imposed many mandates on local governments but did not provide a method to pay for those mandates.
- Are there any special apportionment rules for the telecommunications industry? Ms. Hecht said that the MTC adopted apportionment rules for that industry in 2008. The MTC recommends that if a state begins using market-based sourcing for all services and intangible property, it also adopt the current MTC special rules for various industries. She said that telecommunications companies are already required by federal law to track the locations of customers, so it would not be a big burden for them to start calculating their sales based on location. The TRD has the authority to adopt the MTC telecommunications special apportionment rule, but it has not yet done so.

- The CIT is by far the most complex tax program New Mexico has, yet its revenues are only about the same as the motor vehicle excise tax.

Legislative Proposal: Determine In-State Sales of Intangibles and Services Based on Market Sourcing Instead of Cost of Performance

Senator Wirth and Mark Johnson, co-founder and chief executive officer, Descartes Labs, presented proposed legislation for the committee's consideration that would provide for the apportionment of the sales of intangible property and services for the purpose of calculating the CIT using a market-based sourcing method, rather than the cost-of-performance method currently required. When the UDITPA was enacted almost 60 years ago, its apportionment rules were designed to reflect the major economic industries of the time. The allocation rules for intangible property and services no longer reflect the current economy and can act as a deterrent for companies to locate in the state. The current cost-of-performance methodology can create situations in which a company that sells intangible property or services would be forced to pay its entire CIT liability in the state in which it is located, even though most of its sales are outside of the state. The cost-of-performance method apportions all sales of intangible property to the state that accounts for the most of the cost in creating the property. This model does not make sense in a service economy.

Senator Wirth said that he introduced legislation to allow for market-based sourcing of intangibles in 2014, 2015 and 2016. The legislation passed the senate in 2015 with little opposition but did not make it through the house of representatives before the session ended. In 2016, however, several industry groups suddenly opposed the legislation. Many out-of-state companies were concerned that they would have to start paying CIT to New Mexico. Senator Wirth said that perhaps the MTC special apportionment rules could provide a solution for the telecommunications industry.

Mr. Johnson discussed Descartes Labs with the committee. The company was founded in Los Alamos in 2014 and is expected to earn a profit in 2017. Descartes Labs uses "cloud"-based supercomputers to model complex planetary systems, including weather and agriculture. It currently has 25 employees and is looking to expand its operations soon. Its average employee salary is $131,000. Its modeling of worldwide corn and soybean production is the most accurate model in the world, which is of extreme value to investors and others in the agricultural sector. Mr. Johnson said that he expects to expand the company in the next few years, and a more favorable tax climate for companies like Descartes Labs would be one factor in the decision of where to locate the expanded company.

Questions and comments from committee members and the public included the following.

- What could New Mexico do to encourage more technology companies to locate in the state? Mr. Johnson said that there is not very much available commercial property in Santa Fe and Los Alamos that is suitable for a technology start-up. He said that technology infrastructure is woefully inadequate. It is incredibly expensive to get fast internet service in Los Alamos, the location of the premier scientific research laboratory in the nation. He also said that a seemingly simple thing, like having uninterrupted cell phone service between Santa Fe and Los Alamos, is currently not available. He said that getting venture capital companies to fund a start-up in New Mexico is very challenging because the state has very little history of such ventures. Finally, he suggested that the Job Training Investment Program be adjusted to allow training funds to be used for employees who recently moved to the state. The current one-year residency requirements are posing problems with Descartes Labs because of the difficulty in recruiting qualified New Mexico residents for jobs.

- Why did the market-based sourcing bill face opposition in the 2016 legislative session? Terri Nikole Baca, director of external affairs, AT&T, said that AT&T has concerns that the legislation would have a disproportionate negative impact on wireless telecommunications providers. She said the industry does not favor a mandatory market-based sourcing approach. She said that if the TRD adopts the MTC special apportionment rule for the telecommunications industry, her company would no longer oppose the legislation. Bob Barberousse, representing the Motion Picture Association of America, said that the film industry has concerns with the 2016 legislation because it could negatively affect New Mexico's film industry. He said the industry is not opposed to the bill per se, but it needs protection from unwarranted tax liabilities.
- The current cost-of-performance apportionment rule for intangible property punishes service-based companies in the state.
- There might be too much subjectivity in special apportionment rules for each industry. Ms. Hecht said that the MTC has developed uniform rules for several industries, and most states have adopted them. The 25 states that have enacted market-based sourcing rules have also adopted the special industry rules.

Tax Policy Package Update and Whiteboard Session

Representative Harper moderated a discussion with the committee about the committee's work on a tax reform package for the legislature's consideration in the next session.

<u>PIT/CIT Reforms</u>

Ideas and proposals discussed by committee members included the following.

- The more complex a tax system is, the more difficult it is for companies to decide whether to locate in the state.
- The legislature has been shrinking the state government, rather than finding the means to fund it.
- The state's tax structure has picked winners and losers. It might be better to have some sort of flat tax system that does not favor any industry or population segment.
- If the GRT system were less regressive, the PIT structure could be flat, without harming the low-income population overall.

- The capital gains deduction for individuals is a very regressive tax policy that, if repealed or reduced, would be a huge revenue source for the state.
- Tax reform will have to proceed incrementally because nobody knows what state revenues will be in the next few years.

Remote Sales Tax Collection

Mr. Anklam discussed several developments regarding remote sales tax collection. He said that President-Elect Donald Trump's position on the imposition of sales taxes on online retailers is still unclear, but it appears that there is a general agreement that online sales should be taxed. Amazon has been open to paying sales taxes in several states that have enacted legislation encouraging agreements for the company to remit sales taxes, and it has begun requiring third-party sellers on its platform to collect and remit sales taxes in some states. Several members of the committee expressed a desire to have local governments receive a share of any tax collected from online retailers. Mr. Anklam said that could be possible but that there are some complicated factors to consider before that could happen.

Compensating Tax

The committee discussed aligning the compensating tax rate with the actual GRT rate in order to eliminate the disincentive for businesses to purchase from in-state vendors. However, there could be significant opposition from some industries, which will not like the idea of paying a higher tax rate.

Business-to-Business Pyramiding

Former Secretary of Finance and Administration Tom Clifford discussed various aspects to consider when trying to eliminate business-to-business pyramiding. He divided the pyramiding issue into three categories: tangible personal property, services and inputs. It is difficult to determine the revenue impact to the state from the elimination or reduction of pyramiding in each category. There are currently a few dozen anti-pyramiding statutes, mostly designed for specific industries. Trying to determine how to replace those deductions with more general deductions is very difficult. Another issue to resolve is what to do with the credit that manufacturers get from the purchase of equipment, which is intended to reduce the burden of the compensating tax for that industry. Policymakers will also have to determine which kinds of services should be eliminated from business-to-business taxation. Finally, it will be very difficult to calculate the fiscal impact of these changes because many of them are interconnected and operate in a dynamic economic model.

Representative Harper suggested that the legislature consider a list of services to be excluded from business-to-business taxation, based on what other states have enacted.

Nontaxable Transaction Certificates (NTTCs)

The committee discussed a proposal to modify the current statute and TRD rule that disallows a GRT deduction if a seller is unable to produce an NTTC from a purchaser within 60 days of a TRD audit. The proposal would allow for other types of evidence to demonstrate that the transaction was deductible from gross receipts.

New Mexico Sales Tax

The committee discussed the proposal to significantly restructure the GRT program and rename it the "New Mexico sales tax". Representative Harper said that the idea for this legislation is to simplify the GRT, rename it and, most importantly, reduce rates imposed by the state and by local governments by significantly expanding the tax base through the repeal of many deductions, credits and exemptions. Local governments would be free to impose new increments of the sales tax for general purposes, including for bonding. Local referenda would still be required for increments above a certain level. In addition, the current distribution of the 1.225 percent portion of the state's 5.125 percent GRT rate would be converted into an equivalent municipal increment of the new sales tax.

Ideas and proposals discussed by committee members included the following.

- If local governments no longer have dedicated GRT increments, how will bonds issued to them be protected? Representative Harper said that the bill being drafted will include provisions requiring local governments to continue paying bonds from the new undedicated sales tax revenue source.
- How reliable are the anti-pyramiding estimates used in creating the proposal? Representative Harper said that estimating the fiscal impact from changing those provisions is very difficult. However, the proposal will be ready for a professional fiscal impact report by the Legislative Finance Committee and TRD soon.
- Is there enough political will to enact legislation to encourage internet sales tax collection by online retailers? Representative Harper stated there was support if it is part of a comprehensive tax package. Representative Harper also said that the state should only enact an expanded nexus bill, which has proven successful in bringing Amazon to the negotiating table, and not attempt legislation challenging the U.S. Supreme Court *Quill* decision, which established rules for when a state can tax out-of-state businesses.

Adjournment

There being no further business, the committee adjourned at 4:31 p.m.