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FISCAL IMPACT REPORT

ORIGINAL DATE 1/26/16

SPONSOR Wirth / Harper LAST UPDATED _____ HB _____

SHORT TITLE Taxation of In-State Sales of Intangibles SB 22

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY16	FY17	FY18	FY19	FY20		
***	***	***	***	***	Recurring	General Fund

Parenthesis () indicate revenue decreases

*** TRD does not have sufficient information to estimate the fiscal impact of this bill's provisions. See "Fiscal Impacts" for discussion.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY16	FY17	FY18	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	0	0	0	0	Recurring	TRD Operating

Parenthesis () indicate expenditure decreases

SOURCES OF INFORMATION

LFC Files

Responses Received From

Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 22 amends the Uniform Division of Income for Tax Purposes Act (UDITPA) for use in determining the sales factor for use in both personal income tax and corporate income tax apportionment (Section 7-4-18 NMSA 1978). The change proposed is that, for this purpose, determining sales of services and intangible property would be based on market sourcing rather than cost of performance. Specifically, the bill provides that a particular sale is "in this state" under the following circumstances:

(1) in the case of sale, rental, lease or license of real property, if and to the extent the real property is located in this state;

(2) in the case of rental, lease or license of tangible personal property, if and to the extent the tangible personal property is located in this state;

(3) in the case of sale of a service, if and to the extent the service is delivered to a location in this state; and

(4) in the case of sale, rental, lease or license of intangible property, if and to the extent the intangible property is used in this state.

The bill specifies that the Taxation and Revenue Department (TRD) may promulgate rules that are necessary to carry out the purpose of this section.

There is no effective date of this bill. It is assumed that the new effective date is 90 days after this session ends or May 18, 2016. The bill's provisions are applicable to taxable years beginning on or after January 1, 2017.

FISCAL IMPLICATIONS

Under current law, sales, other than sales of tangible personal property, are considered to be in New Mexico if:

1. The income-producing activity is performed in this State, or
2. If the income-producing activity is performed both inside and outside this State and a greater proportion of the income-producing activity in this State than in any other State, based on costs of performance (COP).

COP treatment is problematic for several reasons. First, the true cost of performance is very difficult to determine. This can lead to the second issue: "All or nothing" assignment of sales based on the state with the greatest cost of performance is not a reasonable treatment. Finally, COP treatment duplicates the function of property and payroll.

To calculate the fiscal impact, TRD requires data that is unavailable. Current CIT reporting does not provide the level of detail necessary to differentiate between various income-producing activities in a firm. Migrating to market-based sourcing does not necessarily solve this issue. Determining the effect of the bill on the sales factor used in the apportionment formula is difficult. However, an examination of market conditions and current CIT policy indicates that New Mexico state corporate taxable income is being lost because of COP treatment.

SIGNIFICANT ISSUES:

The sales factor in UDITPA is designed to reflect the character of the market for the taxpayer's goods or services. Current law, developed in the 1950's based on the localized economic realities of that time, does not easily recognize the market dynamics of the modern global economy. When markets were defined locally, cost of performance sales factors were an adequate measure of sourcing.

This bill transitions the sales factor from cost of performance to market-based sourcing. Market-based sourcing can achieve beneficial policy results because it both reflects a taxpayer's market more accurately and can incentivize companies to locate operations within a state. This bill is modeled after the Multi-State Tax Commission (MTC) model Market-Sourcing Regulations.

New Mexico is a member of the MTC. A detailed discussion of policy issues is provided below.

As of 2015, 20 states have already enacted required or elective market-based sourcing. Additionally, market-based sourcing will take effect in Tennessee in 2016.

This bill is similar to the MTC model Market-Sourcing Regulation. One potential issue is the “throw-out rule” which is on page 2, Subsection C of the bill. When this section is applied, the result is that the income will not be reflected in the sales factor or the ultimate apportionment ratio. Whether the lack of representation in the apportionment ratio raises or lowers New Mexico tax will depend on each taxpayer’s circumstances.

The sales factor in UDITPA is designed to reflect the character of the market for the taxpayer’s goods or services. Current law is based on a uniform act that was developed in the 1950s when the American economy was largely manufacturing-based, and the provision of services was much more localized. In recent years and recognizing the significant changes in the American economy, a growing number of states have shifted the focus of the sales factor from where the taxpayer incurs costs to where the taxpayer’s market is located. The MTC, of which New Mexico is a compact member, has embraced this market-based approach and adopted an amendment to the uniform law in the summer of 2014. Market-based sourcing can achieve beneficial policy results because it both better reflects a taxpayer’s market and can encourage companies to locate significant business operations within a state.

Though non-quantifiable, there may be significant revenue impacts associated with this bill. Because New Mexico is not currently a large headquarters state, the effect should be positive. Under the bill, out-of-state businesses, whose greater costs of performance are generally outside New Mexico and who would not currently source their sales to New Mexico customers to this State, would have to source their sales to New Mexico customers to this State, thereby increasing tax liabilities. However, New Mexico business that provide services or sell intangibles outside the state would source sales away from New Mexico, decreasing liability. Given the recent push to encourage businesses to locate here, such as the single sales factor for headquarters, the shift to market-based sourcing would further serve that goal, especially with respect to service-based businesses that have both headquarters and operations that generate performance costs in New Mexico.

This bill would change the way the state measures intangibles from a cost of performance basis to a market sourcing basis. Cost of performance is the current method used. Due to the difficulty in reasonably measuring cost of performance in multiple states – especially for multi-state corporations - several states have either modified the cost of performance in some way or have gone towards (a variant of) market sourcing. Based on past experience of the states, market sourcing is neither better nor worse than current methods, as there remain issues that still need to be sorted out. Nonetheless, market-sourcing will allow for a more accurate estimation of New Mexico sales in an ever-widening global economy.

ADMINISTRATIVE IMPLICATIONS

Low to moderate impact (up to 500 hours); changes to the apportionment on all income tax documents could be needed in TAP and GenTax.

Regulations will likely be needed and audit procedures will need to be developed. TRD personnel and taxpayer education will need to be developed. The income tax forms, instructions, and publications will need to be revised at no cost during the annual updates.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

None

TECHNICAL ISSUES

The provisions of the bill do not appear to conflict with current TRD policy. The provisions of the bill adhere to current regulatory provisions. The most pressing technical issue with this bill is the need for TRD to develop regulations. The bill changes sourcing from cost of performance to market-based sourcing. Terms such as “reasonable approximation” and “delivered” will need to be defined. TRD will need to propose and implement rules necessary to provide the detail for administration and compliance.

There are two overarching technical issues with this bill. First, TRD will have to adopt regulations, especially to delineate when a service is “delivered” into this state. As an MTC compact member, New Mexico generally adopts the proposed regulations developed by the MTC. The MTC has begun a working group to develop model regulations. At this juncture, the regulations have not yet been developed, and it is uncertain whether they will be completed before the January 1, 2017 effective date of the bill.

Second, while the bill generally follows the MTC amendment, it does not adopt it verbatim. The MTC amendment was the result of a studied approach and much of the language that was stricken or changed serves specific purposes. As a compact member, the Legislature may want to consider better conformity to the MTC amendment.

The phrase “delivered to a location” in Section 1(A)(3) may not be very clear in its application. For instance, it may be difficult to determine the location that an accounting service, a tax service, a research service, or a legal service is delivered. If knowing who is the ultimate consumer is an important factor, perhaps the phrase “delivery to a consumer in this state” or “the service is delivered to a person, or entity, that is the ultimate consumer and whose business or residence is in this state” would make this clearer. These issues could be clarified with the adoption of regulations.

In Section 1 of the bill, Subsection (A)(4), the phrase “and the intangible property is used in this state,” may be clearer if it is instead stated as, “and the intangible property is used or possessed in this state” in case there is intangible property that is held in this state that is arguably not used but that the statute may contemplate would be included in the sales factor (assuming that the proposed bill desires that to be included in the sales factor).

The Hearing Office Report on Proposed Recommended Amendments to Model Multistate Tax Compact Article IV [UDITPA] at the Multistate Tax Commission treats specific sale, lease, rental, and license case as eligible to be adopted or excluded from the numerator and the denominator of the sales factor based on certain criteria. The bill could adopt suggested language provided below:

“ (4) In the case of intangible property,

(i) that is rented, leased, or licensed, if and to the extent the property is used in this state, provided that intangible property utilized in marketing a good or service to a consumer is “used in this state” if that good or service is purchased by a consumer who is in this state; and

(ii) that is sold, if and to the extent the property is used in this state, provided that:

(a) a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is “used in this state” if the geographic area includes all or part of this state;

(b) Receipts from intangible property sales that are contingent on the productivity, use, or disposition of the intangible property shall be treated as receipts from the rental, lease or licensing of such intangible property under subsection (4)(i); and

(c) All other receipts from a sale of intangible property shall be excluded from the numerator and denominator of the sales factor.”

New Mexico is not the only state to recognize the limitations of COP. A number of states have begun to address these concerns – and the challenges of market-based sourcing – using a variety of methods. Some of the methods to address sales of intangible property are listed below:

- Where Benefit is Received: California, Iowa, Michigan, Ohio, Utah, and Wisconsin;
- Where Services is Delivered: Alabama;
- Where Customer is Located: Georgia, Maryland, and Oklahoma;
- Where Service is Received: Illinois, Maine, and Minnesota;
- Where Service is Performed: Connecticut, New Jersey, New York, Rhode Island, South Carolina, and Texas.

Ultimately, the bill proposes New Mexico transition from COP to market-based sourcing, providing the following benefits:

1. Market-based sourcing is a more appropriate methodology to determine sales of intangible property;
2. The language allows for reasonable approximation where necessary;
3. Each receipt is sourced predicated upon the market existing in the State, rather than an “all or nothing” approach;
4. When reasonable approximation is indeterminate, an entity is not unfairly taxed;
5. Where COP treatment applies one rule to all transaction types, market-based sourcing is more flexible:
 - a. Real Property receipts are sourced to where the property is located;
 - b. Tangible Personal Property receipts (other than sales) are sourced to where the property is located;
 - c. Service receipts are sourced to where the service is delivered; and
 - d. Intangible Property receipts are sourced to where the property is used.

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