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

ORIGINAL DATE 01/30/17
SPONSOR Pirtle **LAST UPDATED** 02/27/17 **HB**

SHORT TITLE Payment to Partners Gross Receipts **SB** 100

ANALYST Clark

REVENUE (dollars in thousands)

Estimated Revenue*					Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**	**FY20**	**FY21**		
$0.0	Up to ($7,320.0)	Up to ($7,680.0)	Up to ($8,100.0)	Up to ($8,400.0)	Recurring	General Fund
$0.0	Up to ($4,880.0)	Up to ($5,120.0)	Up to ($5,400.0)	Up to ($5,600.0)	Recurring	Local Governments
$0.0	Up to ($12,200.0)	Up to ($12,800.0)	Up to ($13,500.0)	Up to ($14,000.0)	Recurring	Total

Parenthesis ( ) indicate revenue decreases

* TRD reports the amounts shown are the estimated totals due, but the agency historically collects about 40 percent of this amount. See Fiscal Implications for details.

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 100 amends Section 7-9-17 NMSA 1978 to exempt from gross receipts tax (GRT) employee wages in the form of guaranteed payments to partners.

The effective date of this bill is July 1, 2017.

FISCAL IMPLICATIONS

TRD reports it collects, on average, 40 percent of the total amounts due, and the total amounts due are shown on the fiscal impact table. LFC staff provided the range of $0 to these amounts to show that these are likely the maximum possible losses; however, the actual losses are likely to be 40 percent of these maximums.

The bill appears to exempt all guaranteed payments to partners from GRT, but a blanket exemption simultaneously solves one problem while creating another. Guaranteed payments can be viewed in many instances to be an additional form of employee wages, and proponents of this bill would note providing one employee with salary and another with salary and another type of guaranteed payment should not result in different taxation schemes for the two employees. Many people would object to also subjecting these payments to GRT, and this is likely a significant portion of the reason why 60 percent of the taxes due are not collected – anecdotal reports note the state receives little to no revenue from GRT receipts on this type of guaranteed payment. In this case, the bill solves an existing problem, although the solution does not require legislation – it could be done through regulation.

However, guaranteed payments can be viewed in other instances as payment for services rendered, and this probably represents a significant portion of the 40 percent of taxes due that are collected. Critics of this bill would note this type of guaranteed payment falls within the general scope of GRT, and carving it out would force the state to lose these revenues it currently receives and potentially create an incentive to structure future payments this way to avoid additional taxation. If the bill passes in its current form, it may be possible to solve this problem through regulation, although additional discussion with TRD would be necessary to be certain.

TRD used a combination of state and federal taxpayer reported information to estimate the impact of the bill. The estimated amount of GRT revenue in FY15 is the product of multiplying the total amount of guaranteed payments in that year (approximately $186 million) by the average actual GRT rate in FY15 of 6.8728 percent. The FY15 estimate was grown for FY16 and beyond using the GRT forecasted growth rates as published by the consensus revenue estimating group in December 2016. The estimated revenue impact only shows estimated revenue for fiscal years 2018 through 2021 based on the proposed effective date of the bill.

SIGNIFICANT ISSUES

TRD provided the following analysis.

According to the Journal of Accountancy[1], more and more businesses, including partnerships, are awarding equity interests to valued employees in an effort to retain them. Partnerships often are unaware that even a small equity interest can stop the new partner from continuing to be treated as an employee for tax purposes. Failure to treat these partners correctly can have numerous adverse tax effects, such as overpaying FICA tax, causing benefits paid on the partner's behalf to be taxable to the partner, and accelerating the taxation of certain bonus payments.

The proposed exemption in this bill is a response to audit efforts conducted by TRD. The agency considers the guaranteed payments to partners are payments for services rendered by the partner for the partnership. Under federal and state laws, partners cannot be considered as employees and cannot have a W-2 form issued to them. Subjecting guaranteed payments to partners to the New Mexico gross receipts tax is a recent development for TRD's Audit and Compliance Division (ACD). If the proposed legislation in the bill becomes law, guaranteed payments to partners would become an additional source of income not subject to the gross receipts tax.

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[1] http://www.journalofaccountancy.com/issues/2014/aug/20149676.html#sthash.oXzr2BuV.dpuf

About half of taxpayers are not registered with TRD to report and pay gross receipts tax for receiving guaranteed payments as defined by the Internal Revenue Service (IRS) and as reported by the taxpayer to the IRS. The industry has shown a history of unwillingness to comply with the registration process in New Mexico. These taxpayers believe they are not engaged in business and should not be required to be registered with TRD. Pursuant to Section 7-9-3.3 NMSA 1978 and Regulation 3.2.1.12 (H) NMAC, when an owner of an entity performs services to the entity, the owner is considered to be engaged in business. To prevent evasion of gross receipts taxes and to aid in its administration, it is presumed that all receipts of a person engaged in business are subject to gross receipts tax pursuant to 7-9-5 (A) NMSA 1978. In other words, these taxpayers have been out of compliance for decades and have treated approaches from TRD to come into compliance with resistance. The state of New Mexico is in arrears on this type of gross receipts tax revenue going back to the 1950s when guaranteed payments were reviewed by the IRS for taxability.

ADMINISTRATIVE IMPLICATIONS

TRD reports there would be no administrative impact on the agency.

TECHNICAL ISSUES

The bill does not include any limits on the potential window of time for which taxpayers could amend their returns to claim this exemption. Under current law, taxpayers can amend up to three years plus the current tax year.

OTHER SUBSTANTIVE ISSUES

TRD provided the following additional information.

Some taxpayers have operating agreements with a partnership(s). These agreements discuss guaranteed payments to be provided to partners regardless of profitability for the partnership and generally discuss the management of the company including qualifications, number of managers, and specific duties. The agreement states that the manager does not need to be a member (owner) of the company. These agreements provide specific duties of the manager to include acquisition of property, delegation of duties, use of company cash reserves, and check endorsements etc. These agreements also state that partners shall be paid compensation as determined by resolution of the members in return for their services. Pursuant to Section 7-9-3 (M) NMSA 1978, services mean all activities engaged in for other persons for a consideration. Therefore, guaranteed payments paid to partners from the partnerships, as well as the other entities, would be included in the classification of “all activities” and the taxpayer is liable for gross receipts on the income received from providing services provided these services are performed in New Mexico.

When it comes to income, it is common for partners to contribute capital to a partnership to receive some return on investment (distribution of capital). To this extent, the payments are dependent on profits, such as a percentage of partnership’s net income; for tax purposes, they are treated as an allocation and distribution of capital in accordance with IRC 704(b) and 731, respectively. To the extent where payments are determined without regard of income of the partnership (and are payable in all events regardless of capital), the payments are treated as guaranteed payments in accordance with IRC 707(c), provided the partner is acting in the capacity of a partner and not a third party. If the partner is acting in the capacity of a third party, the payment is in accordance with IRC 707(a).

The treatment of these payments can lead to vastly different tax consequences for the recipients. Below is a list of some notable examples:

- If a partner provides a service to the partnership and receives a guaranteed payment, according to IRC 707(c), such payment is treated in the same manner as if made to a non-partner and should be considered as income to the recipient;
- Guaranteed payments are subject to federal self-employment tax since partners cannot be employees of the partnership. Thus, guaranteed payments cannot be reported on a W-2 form and are not treated as wages for federal income tax purposes;
- Guaranteed payments are properly reported on the partner's K-1 form as guaranteed payments for services and flow to the Schedule E form and self-employment taxes are applied;
- There are 2 additional types of payments partners can receive on the K-1 form that are reported in boxes 1 and 19.
- Box 1 is the ordinary income from the partner's share of the trade or business; pursuant to Section 7-9-3.5 (A) NMSA 1978 this income does not fall under the definition for "gross receipts".
- Box 19 are distributions of capital, which are reported separately on the K-1 form and flow to different forms and schedules depending on the type of capital contributed. The distribution amounts pursuant to Section 7-9-3.5 NMSA 1978; Regulation 3.2.1.14 (S) (1) NMAC are also not gross receipts due to being characterized for federal income tax purposes as a contribution of capital.

Since partners receive payment generally in the form of either distributions (K-1 lines 1 and 19) or guaranteed payments (K-1 line 4), it is a matter of a process of elimination in reading the statutes and regulations to determine the nature of a guaranteed payment transaction for gross receipts tax purposes. Pursuant to Section 7-9.3.3 NMSA 1978; Regulation 3.2.1.12(H) NMAC when an owner of an entity performs services for the entity, the owner is engaged in business except when the transaction may be characterized for federal purposes as a "contribution of capital". Additionally, pursuant to Section 7-9-3.5 NMSA 1978; Regulation 3.2.1.14(S) NMAC if a person who owns all or part of an entity has receipts from performing services for the entity, the person's receipts are gross receipts. The only exception is when the transaction can be characterized for federal income tax purposes as a contribution of capital and the services are subject to gross receipts tax unless an exemption or deduction applies. Due to the guaranteed payments being subject to the self-employment tax and are determined without regards to the income of the partnership as well as, being considered as ordinary income, they are included in the taxpayer's gross receipts reporting and subject to gross receipts tax.

In addition, these taxpayers cannot accept a Type 5 nontaxable transaction certificate from the partnership because the services provided by the partner cannot be tied to the billing of the partnership to its customers. In other words, the partnership does not resale the services provided by the partners back to the partnership and compensate the partner in the form of guaranteed payments, as defined above. TRD believes this is probably the most important reason for the taxpayers to seek an exemption from the gross receipts tax for receiving gross receipts in the form of guaranteed payments.

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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