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

ORIGINAL DATE 2/3/17
SPONSOR Wirth/Harper **LAST UPDATED** 3/11/17 **HB**

SHORT TITLE Tax Determination of In-State Sale & Services **SB** 274/aSCORC

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**	**FY20**	**FY21**		
Indeterminate – potentially positive; however, SCORC amendment requires certain communications companies to exclude 50% of sales in determining the New Mexico apportionment factor.					Recurring	General Fund

(Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY17	FY18	FY19	3 Year Total Cost	R or NR **	Fund Affected
Total	$25.0			$25.0	NR	TRD Operating

Parenthesis ( ) indicate expenditure decreases. ** R = recurring; NR = non-recurring

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD) on original bill
Office of Attorney General (OAG)
New Mexico Tax Research Institute (NMTRI) relative to 2015's SB-281.

SUMMARY

Synopsis of Amendment

Senate Corporations and Transportation Committee amendment to Senate Bill 274 provides an exception to the market sourcing rule for certain communications services. At most, 50% of gross revenue from communications services would be sourced to New Mexico. This creates a tax expenditure for as few as one combined or consolidated company.

Synopsis of Bill

Senate Bill 274 amends the Uniform Division of Income for Tax Purposes Act (UDITPA) to determine the sourcing of certain sales and services. Sourcing is a means of identifying which state's taxes should be applied to a transaction. This bill amends sourcing rules for sales as they are included in the sales factor for the division of income for tax purposes. Under the provisions of the bill, sales would be sourced to New Mexico if:

- sale, rental, lease or license of real property and the real property is located in New Mexico;
- rental, lease or license of tangible personal property and the tangible personal property is located in New Mexico;
- sale of a service and the service is delivered to a location in New Mexico; and
- sale, rental, lease or license of intangible property and the intangible property is used in New Mexico.

If the source state cannot be determined, sourcing must be reasonably approximated. If the taxpayer is not taxable in a state to which a sale is assigned or the state of assignment cannot be determined or approximated, that sale shall not contribute to the calculation of the sales factor, either with inclusion in the numerator or the denominator.

The bill authorizes TRD to promulgate rules to carry out the purposes of the bill's provisions.

The provisions of the bill apply to taxable years beginning on or after January 1, 2018.

FISCAL IMPLICATIONS

TRD was unable to estimate the fiscal impact of this legislation. Two states – North Carolina and Virginia – are studying the fiscal impact of market-sourcing, but they have not published their findings. TRD anticipates that there will be some revenue loss from firms currently taxed under cost of performance and some revenue gain from firms that would be subject to taxation under market-sourcing. However, the degree to which anticipated revenue losses and gains offset each other is unknown. Revenue loss is attributed to New Mexico firms subject to taxation in market-sourcing states as well as New Mexico. Revenue gain is attributed to economic value received from New Mexico market participation but not taxed under the cost of performance standard.

LFC staff note, however, New Mexico's status as a net market state – that is, a state that tends to be a buyer of services from without rather than a seller of services from within – indicates that the change from cost-of-performance sourcing rules to market-based sourcing could have a positive impact on revenues.

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

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

TRD noted an issue with this treatment, namely:

- The cost of performance is difficult to determine, and
- "All or nothing" assignment of sales based on the state with greatest cost of performance is not a reasonable treatment.
- The COP rule somewhat duplicates the function of property and payroll.

However, the SCTC amendment requires a "qualified company" providing communications services to exclude 50% of its sales from the New Mexico sales factor in apportioning income for the purpose of corporate income tax or personal income tax of a pass-through entity.
The fiscal effect of the amendment is noted in the table as creating an unquantifiable loss of revenue.

SIGNIFICANT ISSUES

TRD has provided the following discussion of Policy Issues:

> New Mexico uses a uniform law, or "apportionment formula," to determine the amount of income tax a multi-state business pays to New Mexico. That formula considers the percentage of a multi-state's business property, payroll, and sales within New Mexico. The formula was developed in 1957 on the notion that a company's property (physical plant), payroll (labor force), and sales (consumer market) serve as adequate proxies for how a business generates income.
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> Under the current law, receipts from sales of services and intangibles are included in the numerator of the New Mexico sales factor based if a taxpayer incurs the majority of its costs of performing the service or developing the intangible within the state. Consequently, corporations that have a consumer market in New Mexico, but that incur the majority of their associated performance costs outside the state, end up reflecting minimal New Mexico sales in their apportionment formulas. They pay less tax despite the presence of a consumer base in the state. Conversely, multistate businesses that incur the majority of their performance costs in New Mexico, but export services and intangibles, reflect a very high portion of New Mexico sales in their sales factor, despite being economic-based business and the location of their consumer market. The proposed legislation mirrors the Multistate Tax Commission's (MTC) model regulation for market-based sourcing. New Mexico is a member of the MTC.
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> When UDITPA was originally drafted, the American economy predominantly dealt with physical goods. Services were highly local in nature and large intangible markets were relatively undeveloped. As the knowledge-economy, service sector, and intangible components of the economy have grown significantly in the last several decades, the original cost of performance test has come under significant scrutiny. The criticism is that it ends up overstating the impact of physical plant and employees and diminishes the contribution of the consumer market.
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> As of 2016, 22 states and the District of Columbia are now market-based sourcing states for services and intangibles, while five states do not impose an income-based tax. North Carolina and Virginia are studying the fiscal impact of market-based sourcing. A 2010 study by Virginia's Joint Legislative Audit & Review Commission (JLARC) indicated that cost of performance sourcing had a negative revenue impact from corporations that file a Virginia

income tax return under cost of performance. JLARC reported a positive revenue impact from corporations that do not pay Virginia income tax under cost of performance, but would pay under market-based sourcing if those corporations are fully compliant. Virginia has not published the results of the feasibility study undertaken in 2015.

It is important to note that market-based sourcing does not affect taxpayers selling tangible personal property, as well as taxpayers already subject to special apportionment methods (many of which incorporate market-based concepts). Sales of tangible personal property are sourced on a destination basis (i.e. where the consumer is located). In many respects, market-based sourcing achieves a similar result and adds some parity between how tangible goods and how services and intangibles are sourced.
It should also be noted that the MTC finalized model market-based sourcing regulations in 2016 that could be utilized as the model that the Taxation & Revenue Department could adopt if this bill is enacted.

LFC staff note that the SCTC amendment, providing an exception for communications services, seems to have been drafted to benefit one company. Facially, this amendment seems to create a corporate income tax (or pass-through entity personal income tax) tax expenditure. A company that purchases $43 million of tangible personal property or pays $43 million in payroll or that makes over $43 million in sales subject to the gross receipts tax is required to exclude 50% of sales from the New Mexico sales factor of UDITPA.

The completed MTC regulations on market sourcing do not adopt this communication services amendment, so we cannot use MTC to explicate the meaning or impact of this amendment. This bill, prior to amendment, is identical, except for applicability date, to SB 281 of the 2015 session. The major changes in the analysis are related to the Multistate Tax Commission (MTC) having completed its draft model regulations on market sourcing, entitled, "Model General Allocation and Apportionment Regulations"

(a) Receipts, other than receipts described in Section 16, are in this State if the taxpayer's market for the sales is in this state. The taxpayer's market for sales is in this state:
(1) in the case of sale, rental, lease or license of real property, if and to the extent the 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 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 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 (a)(4)(i); and
(C) all other receipts from a sale of intangible property shall be excluded from the numerator and denominator of the receipts factor.
(b) If the state or states of assignment under subsection (a) cannot be determined, the state or states of assignment shall be reasonably approximated.
(c) If the taxpayer is not taxable in a state to which a receipt is assigned under subsection (a) or (b), or if the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (b), such receipt shall be excluded from the denominator of the receipts factor.
(d) [The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.]

In comments on the 2015 bill, the New Mexico Tax Research Institute remarks the market based sourcing proposal is consistent with a national trend in apportionment, along with greater reliance on the sales factor. Such a rule needs lots of regulations, makes sense on some levels, but also has the potential to whip-saw taxpayers in states with cost of performance rules- and certainly a few winners and losers would result. Apportionment rules affect "business income", so their implications are not limited to corporate income tax.

Because the SCTC amendment is somewhat difficult to understand, the following discussion prepared by the OAG is included:

> SB 274 was amended by Senate Corporations and Transportation Committee on March 6, 2017. The amendments added to the title of the Act, an exclusion for "Communication Services", and definitions for communication services, qualified expenditures, qualified group, and qualified member of communication services.
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> One result of this amendment is to exempt out of state internet and other telecommunication service providers from having their sales sourced to New Mexico for tax purposes if the members of the group, during the tax period: 1) incur at least forty-three million dollars ($43,000,000) in qualified expenditures in this state; or 2) make at least forty three million dollars ($43,000,000) in sales that are subject to the gross receipts tax.
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> A second result of the amendments is to set a standard for "in this state" for communications services providers of fifty percent of sales of communication services sold by a qualified group are delivered to a location in this state, and fifty percent of sales of communication services are not coming from a location in this state. Also, if the communication services provider is a partnership, a member of a qualified group that owns an interest in the entity shall be treated as providing its share of the partnership's communication services, incurring its share of the partnership's qualifying expenditures, and making its share of the partnership's sales subject to the gross receipts tax. Lastly, the amendment makes it so that a partner's share of a partnership equals the percentage of income or loss allocated to it for the taxable year.
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> The amendment would also allow for a reasonable approximation of the state of assignment for the new section B regarding communication services if the state cannot be readily determined.

ADMINISTRATIVE IMPLICATIONS

TRD reports minimal impact. Forms and systems will need to be updated as part of the annual tax year changes. Some staff training will be necessary to support taxpayer education efforts. Current regulations will need to be updated in accordance with legislative changes.

TECHNICAL ISSUES

While the bill generally follows the MTC amendment, it does not adopt it verbatim. TRD pointed out the MTC amendment was the result of a studied approach and much of the language that was stricken or changed serves specific purposes. For example, in the MTC amendment several items are sourced "if and to the extent" that the item is sold, used, or delivered in the State. The proposed bill simply uses the term "if." MTC's amendment, by using "to the extent" allows for proportional apportionment when items are used, sold, or licensed in more than one state. TRD therefore notes that the proposed bill, to some degree forces New Mexico to rely on the "reasonable approximation" provision rather than the language of the sourcing rules, which can lead to uncertainty and litigation.

TRD stated a tangential issue is that MTC proposed regulations may not adequately address the differences between the proposed bill and the MTC amendment, which would require the development of New Mexico-specific regulations. As a compact member, the Legislature may want to consider better conformity to the MTC amendment.

OTHER ISSUES

Some research materials on market-based sourcing are available at:

- http://taxexecutive.org/states-fine-tune-market-based-sourcing-rules-through-regulation/;
- https://www.tei.org/chapters/carolinas/Public%20Documents/Carolinas%20Chapter%20September%2025,%202015%20Meeting/TEI_Presentation%20State%20Apportionment%20(FINAL%209-21-2015).pdf; and
- http://www.tax.virginia.gov/sites/tax.virginia.gov/files/6.4.15FortheWG.pdf.

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