

# ***Tax Matters***

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## Budget Concerns Over Revenue Uncertainty Remain

Don't tax you. Don't tax me. Tax the guy behind the tree...

Concern about the State's revenue outlook has been growing in Santa Fe as revenue collections have fallen below forecast for the last several months. Legislative Finance Committee staff Director David Abbey has warned interim committee meetings that FY 2009 revenue is likely to end up significantly below the February consensus revenue forecast. This time the weakness is in the State's broad-based revenues – income tax, corporate income tax and gross receipts tax – rather than in the oil and gas revenues. The shortfall is likely in the neighborhood of \$300 million for FYE 09, meaning we can probably expect a similar shortage in the current year. That's enough to chew through most of the reserves. According to Director Abbey, the shortfall is sufficiently large that a special session may be needed to approve a new “solvency package” – reserve movements, capital outlay reductions and appropriation reductions. The revised consensus revenue forecast due later this month (see LFC and RSTP meeting agendas in Knick Knacks), will in part help determine whether a special session in October is necessary. The governor has some discretionary funds originating from federal stimulus money, but thus far the administration appears to be more interested in sprinkling it around for reasons other than patching holes in the current budget.

Another question that comes up if a special session is called for is that of “revenue enhancement” (i.e. increases in tax or fees for the purpose of raising additional revenue). Taxes are never politically popular, and will be even less so as we get closer to another election. Some also feel a tax increase combined with the poor state of the economy in general would add insult to injury to those individuals and businesses trying to weather the current economic storm. Another issue not driven by the current economic but potentially tax related is education reform. Advocates would still like to see taxes raised in order to significantly increase current public school funding levels. So, significant tax increases are likely to be proposed both to increase public school funding as well as to offset some of the budget cuts potentially necessitated by a negatively revised budget forecast.

It's not hard to guess what sort of tax increase proposals might be expected. Legislation tends to be predictable as some tax increase proposals have been made over and over in recent years. Restoring personal income taxes to the pre-Richardson changes, or at least closer to prior levels, is at the top of the list, along with increases in gross receipts and/or compensating taxes, and proposals intended to increase corporate income tax revenues. Motor vehicle taxes and fees, although the latter was raised in 2003, are comparably low to those imposed in neighboring states. One perennial proposal is to raise the Oil and Gas Emergency School Tax rate on oil to equal that on natural gas – the former is currently 3.15% while the latter is 4.0%. There is no logic necessitating identical rates on such different commodities and units of measure, but when you hear “equalization” in this environment, you can be sure no one is talking about reducing the tax on natural gas to 3.15%.

Another place policy makers will look to for revenue will be business tax credits and incentives. Periodic review of such credits can be a healthy activity and useful in determining effectiveness of the incentives programs. The problem there is that most credits are fairly narrow and little used, so repealing various business credits won't save very much money. Therefore, with the possible exception of the largest incentives, balancing the budget by repealing incentives won't work. As with tax bases discussed in the following paragraph, that is particularly true during an economic downturn when the sort of investment typically necessary to garner credits aren't being made to the extent they were in more robust times. The most generous and costliest credit is the film credit, however it is very politically popular, some consider it successful, and its somewhat taboo to otherwise discuss. The manufacturers' investment credit pales in cost to film but would be next on the list. Its sunset was extended in the last legislative session, and it merely functions as a band-aid, attempting to level the playing field with competing states that have a more "normal" tax treatment of manufacturing equipment. Although current data is not available, the High Wage Tax Credit and Technology Jobs Tax Credit are probably next in line in terms of cost.

If taxes are inevitably raised, another problem imposed by the sour state and national economic climate is the fact that the underlying tax bases are soft and often likely much softer than previously anticipated. That means you can't count on the positive fiscal impacts you read in old fiscal impact reports to remain constant this year or next. As an example, eliminating the capital gains deduction, would not raise nearly as much revenue today as it would have a couple of years ago. Neither would corporate income tax increases (mandatory combined filing proposals have always been a "20% of the base" guesstimate). It's also safe to assume fewer cars are being sold, rig counts and oil and gas production is already down in an environment where investment dollars are more cost sensitive than ever. So, regardless of who may get to be the "guy behind the tree", it won't be easy to raise money painlessly or invisibly in today's economic environment. Once any budget issues are resolved, we can probably look forward to relatively flat budgets for the next couple of years, as the high growth years of the past are just that... in the past.



### **RSTP Reviews Natural Resource Taxes, Capital Gains Taxation, Blue Ribbon Recommendations**

The interim Revenue Stabilization and Tax Policy Committee ("RSTP") held their July meeting in Farmington on July 13-14<sup>th</sup>. As is appropriate in energy country, energy related issues dominated the first day of presentations. The Taxation and Revenue Department's Beatrice Lucero presented a survey of energy taxes across states. DFA's Chief Economist Laird Graeser, TRD's Beatrice Lucero and LFC's Rebecca Gutierrez provided a panel discussion on the oil and gas forecasting process. After lunch, TRD Property Tax Division Director Rick Silva, Deputy Director Michael O'Melia and State Assessed Properties Bureau Chief Mitch Bonney presented on the subject of valuing oil and gas property for tax purposes. LFC's Dr. Tom Clifford continued his important work from NMTRI, presenting on Managing Volatility of Oil and Gas Revenue. The day concluded after a presentation by TRD Secretary Rick Homans and the new Motor Vehicle Division Director, Michael Sandoval, on the subject of motor vehicle code recompilation.

Ms. Lucero's survey compared effective tax rates on coal, oil, and natural gas. The apparent conclusion was that the coal industry was taxed adequately to the extent it was in the "middle of the pack". The survey implied that oil and natural gas were somewhat more favorably taxed, a perspective not welcome with industry when all conversations revolve around budget woes and revenue needs. Industry was also concerned when the presentation extended to environmental issues, which is new territory for the Taxation and Revenue Department to weigh in on. The survey used average effective tax rates and attempted to adjust the other states' tax bases to mirror New Mexico's. The survey included rents and royalties received on state lands but did not include taxes and royalties from federal lands. A copy of Ms. Lucero's extensive work can be found [here](#).

*NMTRI Note: Legislators and others should be cautious when trying to use one measure or element of a taxpayer's burden when attempting to assess the overall tax burden on a taxpayer or industry. Additionally, effective tax rate comparisons can be useful tool for understanding how much a particular industry may be burdened by certain taxes, but they are less meaningful for evaluating economic decision-making. No business concern makes a decision about investing in a specific project because a state's "effective tax rate" is high or low. They make a decision based on project-specific data. Also, an effective tax rate approach tends to imply a flat, uniform rate. The more graduated or variable a rate structure, the more apples to oranges an effective rate comparison can become. To better understand overall burden, representative firm models are particularly strong. Using specific assumptions, these models compare identical companies in various locations to determine the totality of taxes paid by the same operation in multiple jurisdictions. The weakness to this approach is cost, in that it is preferable to model activities under varied assumptions to cover the gamut of activity that might occur within a given industry. However, cost and complexity tend to limit such studies to one or a small handful of varied assumptions. Naturally, any sort of study must be well designed to be meaningful.*

*Numerous oil and gas studies, rate comparisons, and the like have been performed. To see another (Dale Craymers' presentation from the 2005 NMTRI 2<sup>nd</sup> Annual Conference), click [here](#).*

According to the panel presentation on oil and gas forecasting, and echoed in Dr. Clifford's presentation, the economic forecast of the oil & gas industry is volatile and unpredictable. The supply of oil & gas is greater than the demand, which is reflected in the budget. There is approximately a 3 month lag in reporting. Previous forecasting indicated large volumes of production, but that was done with the assumption the recession would be over and production would return to the volumes prior to the beginning of the recession. The forecast did not include forces such as an extended recession or impacts of other cost drivers like new environmental rules and regulations ("pit rules"), which industry maintains has decreased new drilling and production by increasing the cost of investment. The committee requested comparison reports for return on investment of 160 acre spacing vs. 80 acre spacing and Pit Rule: before & after impacts.

The panel discussion was a good segue into Dr. Clifford's presentation, whose bottom line was that the management of oil & gas revenue forecasting needs improvement. Options to better manage revenue forecasting included hedging, risk adjusting the revenue forecast, increasing reserves, and distinguishing recurring and nonrecurring components of the revenue stream. All

options have trade-offs and aren't easy to implement in the middle of an approaching budget crisis. As an example of the extent of risk in the State's revenue forecast, Dr. Clifford noted that reserves in excess of 15% of General Fund appropriations would have been needed to weather the latest revenue slowdown. Representative Taylor expressed concern that the State's reserves appear to be overstated because some funds are committed to more than one purpose. Senator Keller, a freshman Democrat from Albuquerque, argued that the State could significantly improve the predictability of its revenues through the use of hedging contracts. Senator Keller argued that the transactions costs associated with these contracts are manageable. In closing, Dr. Clifford raised concerns about sustainability of oil and gas revenue... a significant issue since direct and indirect oil and gas revenues accounted for an estimated one-third of the General Fund in FY 2008. Given that output is declining and the decline will accelerate if investment decreases, the State should be thinking about the long term implications of public policies affecting the industry. New Mexico taxes the oil and gas industry heavily when all taxes are considered. He suggested New Mexico should undertake a study of all taxes imposed on the industry as compared with other states, and could consider different designs for severance taxes (we agree; see NMTRI note above). Dr. Clifford also mentioned the state could commission an engineering study of the long-term production outlook for oil and gas. Speaker of the House Ben Lujan questioned Dr. Clifford on what he saw as a contradiction between his presentation and the earlier one by Ms. Lucero relative to the comparative tax burden of the oil and gas industry. Dr. Clifford explained his assertions were based on overall tax burden rather than severance taxes alone. A copy of Dr. Clifford's presentation can be found [here](#).

The following day, NMTRI's Richard Anklam provided an overview of capital gains taxation and New Mexico's policy in that regard. There are many arguments for and against preferential capital gain treatment, however the federal policy is much more significant than the states,. Since New Mexico taxes capital gains at ordinary income tax rates, the phased-in rate reductions over six years that reduced New Mexico's top marginal rate from 8.2% to 4.9%, not only made New Mexico much more comparable with surrounding states, but provided significant capital gain tax relief as well. Phasing in the capital gain deduction to 50% further reduced capital gains taxes to a much more generous extent than surrounding states. A copy of Richard's presentation can be found [here](#),

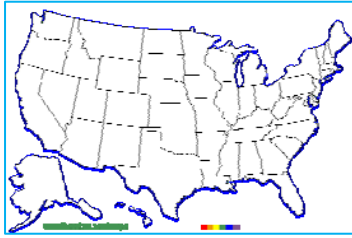
Jim O'Neill presented an overview of the result of the Blue Ribbon Tax Reform Commission ("BRTRC") in 2003, for which he was Chief of Staff. We'll be discussing this more in the future, but Chairman John Arthur Smith mentioned we'd be "looking at this stuff hard and soon" in an apparent reference to budget concerns. Recalling that the committee failed to endorse the Governor's food tax repeal efforts that resulted in the food and medical gross receipts tax deduction (Sections 7-9-93, 94), Senate President Tim Jennings mentioned that the food tax repeal was the "dumbest think he'd ever seen the legislature do".

*(NMTRI Note: although the food tax issue enjoyed populist support, it presented many legitimate policy concerns and was opposed by disparate groups such as Voices for Children and the Association of Commerce and Industry.)*

Lastly, the cable industry discussed their interest in remaining subject to local property tax assessment rather than becoming centrally assessed as the state's Property Tax Division and some competing interests would like to see.

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## Multistate Roundup



As bad as things can seem in New Mexico, one need only look to other states to feel better about ourselves. Connecticut and Massachusetts still have yet to finalize a budget even though they are now into the new fiscal year. With significant revenue shortfalls, the debate is usually one of tax increases versus spending reductions. North Carolina just recently approved a budget that included temporary (i.e. 2-3yr) increases in sales, personal and corporate income tax rates.

California's legislature finally passed a budget on July 25<sup>th</sup>. That certainly doesn't mean all is well in the Golden State. The Governor further reduced spending through line item vetoes and other means by an additional \$550 million since the package passed by their legislature didn't balance (they could not pass all of the items negotiated in the budget compromise). Like many states, California may have problems in subsequent years if future year revenue projections don't pan out or spending isn't held to budget. In the meantime, state employee union members are threatening strikes as a result of furloughs ordered by the Governor. Ironically, strikes could save the state more money than the twists. Meanwhile, Governor Schwarzenegger has also indicated he will call a special session to take up the recommendations of their tax reform commission. Major recommendations include replacing the corporate income and state sales tax with a business net receipts tax, as well as simplifying their income tax (two tax rates only).

Finally, this quote regarding California's new film incentive program from Tom Duffield, production designer for CBS Films' *Faster*:

"I can state without a doubt this new film incentive program is the reason we're making our movie in California. Without the incentive, it would have been made in New Mexico. I'm now free to hire the best crews and use the best local vendors in the business. This couldn't come at a better time."

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## Knick Knacks

### Legislative Finance Committee Meets in Angel Fire in August

The Legislative Finance Committee will meet in Angel Fire for three days from August 12 – 14<sup>th</sup>. The agenda includes many non-tax related items such as updates on healthcare reform, the UNM Health Sciences Center, and public school funding and accountability. LFC's Tom Clifford is reviewing Blue Ribbon Tax Reform Commission recommendations from 2003, and of perhaps greatest interest, the *Preliminary FY09 General Fund Report and Update for FY2010-2012* presented by DFA's Secretary Catherine Miller, TRD's acting Deputy Secretary Marilyn Hill, and LFC's Dr. Tom Clifford. This is the presentation where adjustments to the current consensus revenue forecast, if any, will be made, shedding some light on the question of the likelihood of a special session in the Fall. The agenda for the meeting can be found on the Legislative Council Service website by clicking [here](#).

### **Interim Tax Committee Meets in August**

The Interim Revenue Stabilization and Tax Policy Committee (“RSTP”) is scheduled to meet in Raton on August 26<sup>th</sup> and 27<sup>th</sup> at the convention center. The agenda has yet to be finalized, but the interesting topics expected to be covered include the presentation of the soon to be revised revenue forecast, an update on the Raton racetrack, a road fund update, a “fair share” collection update (relating to union dues paid by non-union members), as well as a presentation on the effects of local government hold harmless mechanisms. When the agenda is finalized, it should be found on the Legislative Council Service website [here](#).

### **Tax Free Holiday Begins in NM**

The state sponsored back to school tax holiday begins today, August 7<sup>th</sup>, and runs through 10<sup>th</sup> (it always begins on the first Friday of August and ends on Sunday at midnight). Buy what you’re told, or there’s no chance you’ll benefit! The list of tax free items can be found at the Taxation and Revenue Department’s website [here](#), and the more detailed department publication on the subject [here](#). Although tax free holidays tend to be the bane of tax policy wonks and there’s no guarantee you’ll save money, they do make people feel good. The program costs government around \$4.5 million, with \$2.7 million being attributable to the general fund.

### **July CRS-1 Reports Due in August – Do You Know What Your Tax Rate Is?**

Don’t forget that New Mexico’s local gross receipts tax rate changes take effect in July and January. For monthly filers, that means the new rates will be in effect for the July return due August 25<sup>th</sup>. Not every rate changes every time, but many do (Albuquerque’s rate, for instance, is going up from 6.75% to 6.875%), and they almost never go down. The new rates can be found on the Taxation and Revenue website [here](#).

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### **TAX QUOTABLE:**

**“Tax complexity itself is a kind of tax.”**

*~Max Baucus*

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**COMMENTS:** Your suggestions and comments on this newsletter, the conferences (past or future), the Distinguished Lectures Series, our research or any aspect of NMTRI’s operation and programs are welcome. Please send them to [richard.anklam@nmtri.org](mailto:richard.anklam@nmtri.org), call 505-269-6791 or mail them to P.O. Box 91657, Albuquerque, New Mexico 87199-1657. We genuinely solicit your input and thank you for your support.



"The power to tax involves the power to destroy" - McCulloch v. Maryland, 17 U.S. 316 (1819), Chief Justice John Marshall.

"Taxes are what we pay for civilized society" Campaña General de Tabacos v. Collector, 275 U.S. 87, 100 (1927), Justice Oliver Wendell Holmes, dissenting.

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