

# ***Tax Matters***

*The Newsletter of the New Mexico Tax Research Institute*

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## **NMTRI Describes Options for Managing Oil and Gas Revenue Volatility to RSTP Meeting**

At the September meeting of the Revenue Stabilization and Tax Policy Committee (“RSTP”), NMTRI Research Director Tom Clifford presented an update of recent trends in energy markets and discussed the state’s options for managing increased revenue volatility due to high energy prices. Energy prices are unpredictable due to the factors influencing supply and demand. In crude oil markets, demand is “inelastic” – i.e. unresponsive – to price changes because it takes consumers time and money to significantly alter their driving habits. Meanwhile supply is subject to sudden and large fluctuations, due to everything from weather to political unrest. In natural gas markets it is supply that is relatively unresponsive because new reserves are brought on line slowly and limited pipeline capacity is available to bring them to market. Meanwhile demand can swing sharply in response to weather. In both markets, limited excess capacity means that prices must increase (or decrease) sharply in response to sudden changes in fundamentals in order to reduce (or increase) demand to match the available supply.

The underlying volatility of energy prices has been enhanced during the last few years by a dramatic increase in speculative activity on futures markets and in related transactions. In general, these markets help to reveal expectations about product prices. When fundamentals begin to cause major price movements however, speculators can easily misinterpret the extent of the fundamental shifts and “overshoot” the correct levels at which prices can be sustained. The results can be sudden price increases and subsequent decreases. This pattern appears to explain the sharp increase in oil and gas prices during 2008.

State revenues are highly sensitive to price changes. A \$1 change in oil prices if sustained over a year changes state General Fund revenue by \$3.5 million. A 10-cent change in natural gas prices changes General Fund revenue by \$10.8 million. In addition to these direct revenue effects, energy prices affect broad-based revenues like Gross Receipts Tax, Individual Income Tax and Corporate Income Tax through their effects on the state’s economy. Thus, the state cannot count on other revenues to offset the volatility of energy-based revenues.

In order to manage the risk associated with this volatility, Dr. Clifford suggested several strategies: (1) Explicitly adjust forecast prices downward to avoid risk. Although this strategy has been employed in the past, the lack of guidance from lawmakers has exposed forecasters to criticism. If the state wishes to adopt this strategy, the Legislature and Executive should issue a joint statement providing guidance to the revenue estimating group authorizing the approach. (2) Increase reserves. The appropriate reserve level is a function of the degree of risk in the forecast. If estimators are not going to explicitly risk adjust the forecast, the target reserve level should increase. (3) Include a range of low- and high-end values with each revenue forecast.

Appropriators could use the range to adjust appropriations if, for example, there was an increased likelihood of running a budget deficit. (4) Divide forecast oil and gas revenue into “recurring” and “nonrecurring” components. The former could be used to fund operations while the latter could be used to build reserves and/or for one-time spending or tax cuts. (5) Ask a panel of experts from outside state government to review revenue forecasts. The panel could advise the

Legislature and Executive on the risks inherent in the forecast. Such a panel should include a representative expert from the oil and gas industry.

A copy of the NMTRI presentation to the RSTP can be found [here](#).

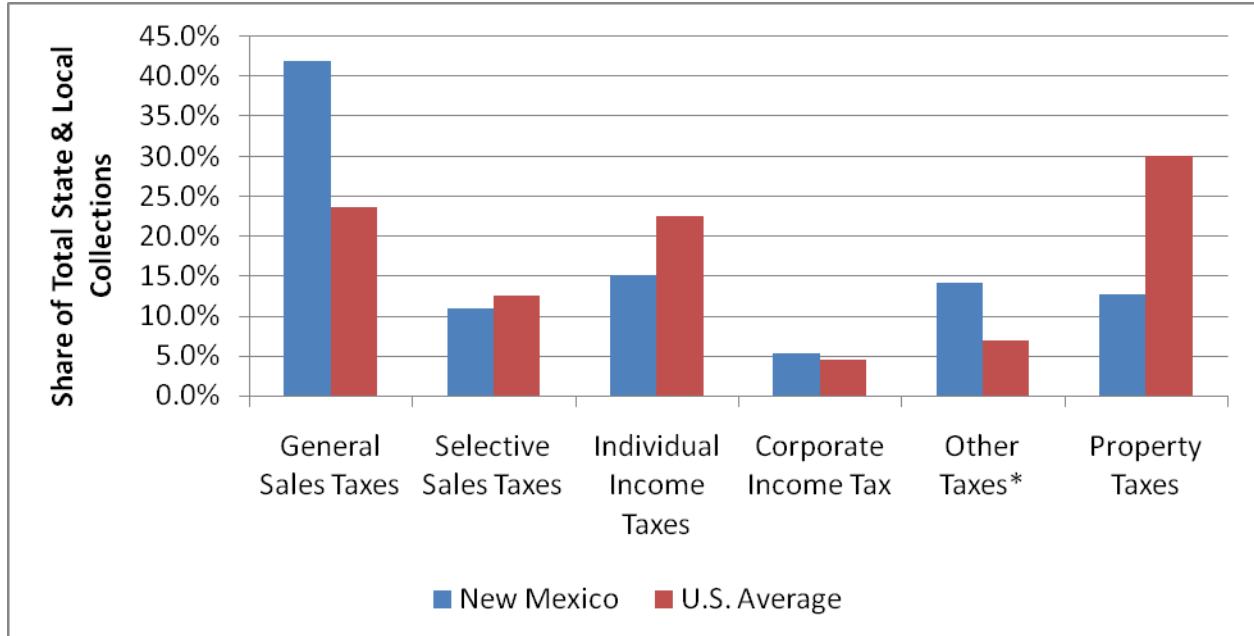


### NMTRI Presents GRT Overview to NTA Conference on Sustainability

In response to the deteriorating budget conditions of both federal and State governments, the National Tax Association (“NTA”) convened a one-day conference in Washington, DC on September 26. At the invitation of the NTA, NMTRI Research

Director Tom Clifford presented an overview of the Gross Receipts Tax (“GRT”) to the conference.

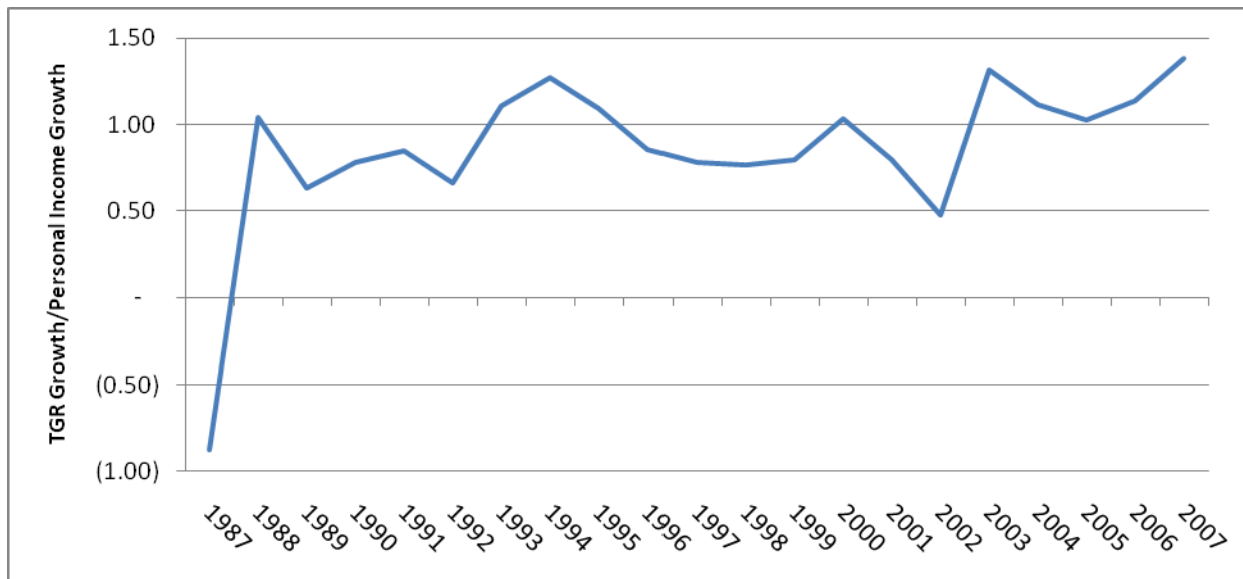
The GRT applies to far more transactions than most retail sales taxes, but is imposed at a substantially higher rate than broad-based business activity taxes in other states. The result is a hybrid, and a tax that brings in substantially more revenue than most states’ sales taxes. The GRT contributes over 40% of all state and local taxes in New Mexico, vs. less than 25% for the average state’s retail sales tax. Low reliance on the property tax offsets this heavy sales tax reliance.



In crafting such an unusual tax system, New Mexico may have been taking advantage of an unusual industry structure with a heavy reliance on federally-supported facilities and also on resource extraction industries. The seller-imposed GRT brings sales by subcontractors of each of these industries into the tax base, whereas these would not be included in most sales tax bases. Also, these are businesses that are unlikely to “pack up and leave” in response to high taxes.

These circumstances appear to be changing, however, as many businesses considering locating in the state have asked for and received exclusions from the GRT for both their inputs and their outputs.

Economists use a measure called “revenue elasticity” to track how well taxes responds to growth in the economy. Revenue elasticity is the ratio of the growth rate of revenue to that of total personal income. The GRT elasticity averages about 0.9 over time, meaning that it grows slightly less than total income. As the following chart illustrates, however, TGR growth can fluctuate widely, and it appears to be extra sensitive to “external” factors like fluctuating energy prices, the Intel plant expansion and the construction boom of the early 2000’s. TGR elasticity was less than 1.0 for most of the period between 1988 and 2003. In addition to Indian gaming, relatively slow growth in the resource extraction industry and at the national laboratories may have contributed to push the ratio down during this period. While the GRT is not immune to trends in the broader economy, it appears to be more resilient than a retail sales tax, since the latter would not capture services, the use of which has been increasing at roughly the same rate as personal income.



Dr. Clifford discussed the problem of “pyramiding” that is exacerbated by the broad base of the GRT. Pyramiding is the term given to sales taxes imposed on business inputs. Pyramiding is both unfair and inefficient because some transactions are taxed more heavily than others simply because of the way a business is structured. Economic decisions are distorted, not by considerations of efficiency, but by the uneven imposition of taxes. NMTRI has estimated that as much as 1/3 of the GRT base is derived from business-to-business transactions. A 1997 study of business taxes concluded that the GRT on business inputs more than doubles the effective tax rate on business – from less than 4% to more than 8%. New Mexico had the highest sales tax burden of any of the western states, and its sales tax burden caused the overall tax burden to be significantly above the regional average.<sup>1</sup>

<sup>1</sup> “New Mexico Business Tax Competitiveness Study,” Policy Economics Practice, Barents Group, LLC, May 1997  
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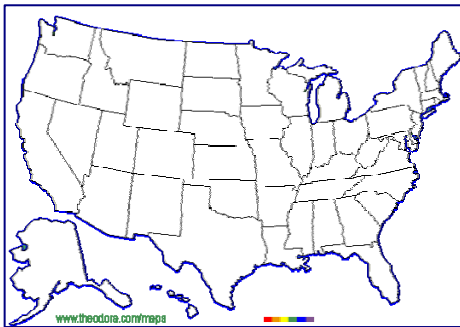
The GRT appears to be somewhat less vulnerable to tax base erosion from e-commerce sales than most sales taxes because the base includes services, a much smaller share of which are transacted through e-commerce. However, statutory exclusions for services and for household purchases in the State's Compensating Tax mean that a large portion of remote commerce transactions escape tax if the seller does not have nexus. Bringing remote transactions into the GRT base through participation in the Streamlined Sales Tax project would help to expand the base, but it would also be likely to create confusion among remote sellers because of the many unusual features of the GRT.

Perhaps the greatest threat to the long-term sustainability of the GRT is the increasing use of tax incentives to encourage targeted activities, some of which have little to do with tax policy. Exclusions for food and medical services eroded a large portion of the tax base, ostensibly to reduce the costs of certain necessary purchases. Since the deductions are not income contingent, however, they were not well targeted at the neediest population. Other new tax exclusions have been aimed at environmental concerns and energy conservation. In addition to reducing the fairness and sustainability of the tax, these provisions make it more expensive for the state to adopt a comprehensive remedy to the pyramiding problem.

A copy of the NTA presentation can be found on the NMTRI website [here](#). Other sustainability presentations from the same program have not yet been made available by the host, but if/when they are, we'll provide the links.

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## Multistate Tax Roundup



### *UDITPA Revision Put on Hold*

The Executive Committee of the Uniform Law Commission, which is tasked with undertaking a re-write of the Uniform Distribution of Income for Tax Purposes Act ("UDITPA"), recently decided to re-constitute the previously-appointed drafting committee as a study committee. The study committee is tasked with gathering information and comment and with preparing a report

including recommendations on whether drafting of a UDITPA re-write should be undertaken. The Executive Committee has been receiving feedback from a number of interested parties expressing concerns about the process and the purpose of the re-draft. Perhaps it is a reflection of the general "climate" in which they are operating that the study committee's next meeting is scheduled for December in Chicago.

### *Maryland Requires Pro Forma Combined Reports*

To gather information for use by the Business Tax Reform Commission in evaluating the State's business tax structure, Maryland is requiring new information reports to be filed by their corporate income tax ("CIT") payers. The new reports are required for tax years 2006 through 2010. The reports, which are required of all members of a unitary group and also of certain manufacturing companies, are to include a pro-forma water's edge combined CIT return reflecting both "Joyce" and "Finnegan" apportionment methods; dollar amounts of shipments by sellers not taxable in the state; and the amount and source of all nonoperational income of each group member with a commercial domicile in the state. Tax year 2006 reports are due by the 15<sup>th</sup> of this month, while the remaining years' reports will be due within 7 months of the original

due date for each year's CIT return. Penalties will be imposed for non-compliance with the new reporting requirements.

#### *California Budget Fix Exhausts Supply of Bailing Wire, Duct Tape*

Faced with a \$16 billion deficit in their \$103 billion General Fund budget -- despite \$7 billion of mostly temporary revenue and spending changes adopted in a February special session-- California's Executive and Legislature have agreed on a set of short-term revenue increases some of which have long-term implications. Major provisions include: Taxpayers with net business income of \$500,000 or more could offset no more than 50% of tax liability with business credits in 2008 and 2009, unused credits could be carried forward; Larger taxpayers would be prohibited from claiming individual or corporate net operating losses ("NOL's") in tax years 2008 and 2009, unclaimed losses could be carried forward, and the carryover period would be extended from 10 years to 20 years for all losses incurred after 2007; NOL carrybacks to 2 previous years would be allowed beginning in 2011; Beginning in 2010, members of a unitary group on a combined report would be able to assign corporate tax credits to other members of the group, starting with credits earned in TY 2007; A corporate and individual income tax amnesty will be conducted February 1 through March 27, 2009; Limited liability companies would be required to make an estimated payment of the LLC fee by the 15<sup>th</sup> day of the sixth month of the current tax year, a 10 percent underpayment penalty would apply; The first two estimated payments for corporate and individual income taxes would be increased to 30 percent of liability and the second two payments reduced to 20 percent, the 100 percent of prior year liability safe harbor would no longer be available to large taxpayers; a new penalty equal to 20 percent of corporate income tax underpayments will apply to underpayments of \$1 million or more, this penalty will apply to tax years 2003 and after, but could be avoided if payment is made by March 2009.

#### *Florida Property Tax Cut Stricken From Ballot*

Florida's Supreme Court held that the ballot title and summary for a proposed constitutional amendment reducing property taxes are fatally defective and that the amendment must be removed from the November 2008 general election ballot. The proposed amendment would eliminate school property taxes, and would replace the revenue by repealing certain sales and use tax exemptions and increasing the sales and use tax rate by up to 1 percent. The revenue replacement is provided for only one year, but the title and summary fail to mention the one-year limitation. The Court concluded this would mislead voters. The Court also found that the title and summary failed to clarify that the annual assessment limits in the amendment would apply to levies for purposes other than public schools.

#### *Indiana May Consider Trading Less Property Tax For More Sales Tax*

Two Indiana legislators recently stated they were considering introducing legislation that would eliminate the property tax on homeowners in exchange for a substantial expansion of the sale tax base. The proposal would apparently expand the tax to include all services with the exception of medical and legal services, which would generate sufficient revenue to replace the lost property tax revenue and reduce the rate from 7% to 5.5%. [NMTRI note: populist proposals of trading property taxes for sales tax rate increases/and or base expansions are relatively common in recent years, however meaningful discussion of pyramiding problems (see previous article) and how to address them seem to be missing from most of the conversations].

### *State Revenues Deteriorate, More to Come*

State revenues entered recessionary territory as fiscal year 2008 ended, and the outlook for 2009 is for further deterioration. These results were presented by Donald Boyd, Senior Fellow at the Rockefeller Institute of Government, to the annual meeting of the Council of State Governments/West in July. Boyd identified the following trends among revenues when aggregated among all states: sales tax collections had fallen below the prior year's level as of March, the first time in 6 years negative growth was recorded; Individual income tax collections were still rising modestly as of the 2008 filing season; corporate income taxes have been declining since last winter. One of the major factors causing individual income taxes to decline during recessions is falling capital gains realizations. [NMTRI note: *New Mexico should be insulated from this problem to some extent because 50 percent of capital gains income is excluded from tax.*] Using data from certain housing markets, Boyd noted that property taxes on residential property often continue to increase after a housing market bust. For example, when housing prices in the Austin, Texas market fell by 26 percent between 1986 and 1989, property taxes rose by over 50 percent. Even when housing values began to recover, they remained below the percentage increase in tax. Boyd attributed the delayed response to a number of factors, including the role of assessment limits. His presentation can be downloaded from our website [here](#).

### *New Mexico Revenues at Risk from Falling Oil and Gas Prices*

While New Mexico has weathered the financial storm and ensuing budgetary impacts better than many other states, the housing market continues to struggle, unemployment is up, consumer spending is down and oil and natural gas prices continue to fall. In response to Senate Finance Committee chairman John Arthur Smith's suggestion that discretionary spending be held back in anticipation of declining tax revenues, Department of Finance and Administration Secretary Katherine Miller was recently quoted as asserting the state still has an \$80 million dollar budget surplus. Subsequently, the City of Albuquerque's CFO, Anna Lamberson, indicated they were implementing cost reduction and deferment policies already. Albuquerque was only budgeting for a revenue increase of 2% relative to the prior year. The state's current budget represents an increase of a little more than 6% over the prior year. The state's revenue forecasters are revising the consensus revenue estimate, which is scheduled to be presented to the Legislative Finance Committee on October 21st. The revenue estimate will almost certainly be taken down relative to July's forecast. We would suggest that it is reasonably likely the state will see its reserves spent down before year end, and Senator Smith's suggestions should be thoughtfully considered. Erosion of the reserves, if significant, could present lawmakers with yet another unwanted and unanticipated budget priority in the next legislative session.



**WELCOME NEW MEMBERS:** The New Mexico Tax Research Institute is delighted to welcome these new members and thank them for their support of good tax policy in New Mexico.

#### ***Gap Inc.***

A very special thank you goes out to Russell Alexanderson, Scott Wade, and Mike Zientek for making the membership happen and for their individual help, support and interest in good New Mexico tax policy. To gain new members from the retail

sector at this troubled time speaks volumes as to their commitment and dedication to the community.

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## **KNICK KNACKS**

### **Legislative Committees Staying Busy**

The interim Revenue Stabilization and Tax Policy Committee (“RSTP”) is holding its October meeting in Albuquerque on the 16-17th in the Fine Arts building on the state fair grounds (EXPO New Mexico). Tax related agenda items include a panel presentation on options to improve residential property taxes by Taxation and Revenue’s Jim Nunns, Bernalillo County Assessor Karen Montoya, NMTRI board member Jim O’Neill and NMTRI’s Tom Clifford. Taxation and Revenue Department Secretary Rick Homans and Tax Policy Director Jim Nunns will be presenting possible legislative proposals to be forthcoming from their agency. Other presentations include Bernalillo county discussing local option taxes (county correctional and healthcare). Most recently added to the schedule (may not yet be on the linked agenda) is a discussion of extending the sunset provisions on the double-weighted sales factor election for manufacturers, as well as the Investment Tax Credit, by member Intel Corporation. The agenda can be found on the LCS website [here](#).

The Legislative Finance Committee (“LFC”) is scheduled to meet October 21-24 at the Capitol building in Santa Fe. The meeting is oriented towards reviews of certain agencies, budgets, programs, and appropriation requests. Of perhaps the greatest interest to most is the presentation of the revised consensus general fund revenue estimate and forecast for FY09 and FY10, which will be presented by Secretaries Miller and Homans. Economic uncertainty and declining revenues on every front are on the forefront of many lawmakers’ minds as we move through the year and towards the next legislative session. How much money the state can expect to have or not have this year and next are perhaps the single most important questions confronting the state at this time. The agenda can be found on the LCS website [here](#).

### **New Mexico Proposes New Tax Regulations**

Proposed regulations pertaining to the Alternative Energy Product Manufacturers Tax Credit (“AEPMTC”) and Other Tax Credit Acts are set for hearing on October 15, 2008 in TRD’s Secretary’s Conference Room of the Joseph M. Montoya building in Santa Fe at 9:30 a.m. The proposal related to the AEPMTC will apparently be controversial with the small number of potentially impacted taxpayers. The proposal specifically disqualifies equipment purchased in connection with an Industrial Revenue Bond (“IRB”) project from the credit base, which would effectively render the credit useless to otherwise qualifying taxpayers that happen to have IRBs. What makes the proposal controversial is both the fact that at least some of the intended beneficiaries of the credit were expected to have IRBs when the credit was passed into law, and there does not appear to be any statutory authority that would support such a restriction. Copies of these proposed regulations can be found on the New Mexico Register website or on the Taxation and Revenue Department’s website by clicking [here](#).

Set for public hearing on October 22, 2008 at the same time/place as the previous, TRD has proposed new regulatory changes to the Motor Vehicle Code (re: commercial driver’s licenses and Mexican national truck drivers); and interpret the Gross Receipts and Compensating Tax Act with respect to the governmental gross receipts tax, clarifying that receipts from vehicle parking spaces, tie down spaces, or docking boats, are not outside scope of the Governmental Gross

Receipts Tax. Copies of these proposed regulations can be found on the New Mexico Register website or on the Taxation and Revenue Department's website by clicking [here](#).

### **COST's 39<sup>th</sup> Annual Meeting**

The Center on State Taxation ("COST") is holding its 39<sup>th</sup> annual meeting October 22-24<sup>th</sup> in Orlando Florida. Topics under discussion are broad and diverse, including current tax and litigation issues, deteriorating state fiscal conditions, incentives best practices, sales and use taxes in an M&A environment, and state tax reform efforts (boom or bust?), to name a few. The agenda and registration information can be found on the COST website [here](#).

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### **TAX QUOTABLE:**

**"The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing."**

*~Jean-Baptiste Colbert*

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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. You may also e-mail them to [tom.clifford@nmtri.org](mailto:tom.clifford@nmtri.org) or call him at 505-228-7129. We genuinely solicit your input and thank you for your support.

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"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.

*Join NMTRI today.*