Analysis of Recent Tax Reform Proposals

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Fiscal Impact Analysis

SENATE BILL 123 (2017)

Overview

- Comprehensive tax reform proposal revised from prior proposals by Senator Sharer
- So broad in scope, TRD and LFC were unable to estimate the fiscal impact
- The analysis needed to properly estimate the impact of this bill helped start the conversation of contracting with an independent company to perform an expert tax analysis study
- Eliminates many taxes and makes the gross receipts tax much broader, with a far lower rate

Key GRT Provisions

- Reduce state GRT rate from 5.125 percent to 1 percent
- Reduce state GGRT rate from 5 percent to 1 percent
- Reduce municipal and county GRT rates to 0.5 percent maximum
  - Remove restrictions for use of funds for individual increments, allowing local governments to use GRT revenues for any purpose
- Repeal food and medical hold harmless distributions to local governments
- Require TRD to adjust GRT rate for initial three years depending on revenue

Key GRT Provisions, Con't.

- Create a tiered GRT credit based on federal poverty guidelines
  - Ranging from a 164 percent credit for those under 100 percent of the poverty level to a 7 percent credit for those between 200 percent and 210 percent of the poverty level
  - Refundable if the credit exceeds liability
- Remove tax increment for development district (TIDD) bonding ability against state GRT increments
- Tax internet sales

Key Compensating Tax & Income Tax Provisions

- Reduce comp tax rate from 5.125 percent to 2 percent for tangible property and from 5 percent to 1 percent for services
- Repeal Corporate Income and Franchise Tax Act
- Reduce personal income tax rate to flat 2.5 percent (and only tax income above certain levels -- ranging from $141,975 to $283,950); subject wages to GRT

Other Key Provisions

- Repeal many exemptions, deductions, and credits
- Repeal motor vehicle excise tax
- Replace county obligations with state obligations for county-supported Medicaid and safety net care pool
- Shorten timeframe for claiming a credit or refund from a maximum of nearly four years to “prior to the end of the calendar year”
- Provide temporary amnesty from penalties & interest
- Provide the repeal of certain taxes shall not impair outstanding bonds or loan guarantees

Fiscal Impact Analysis

HOUSE BILL 8 (2017SS)

Key GRT Changes

- Rebrands as “sales tax”
- Broadens tax base by removing array of tax expenditures
- Creates a limited anti-pyramiding provision for select business-to-business services
- Reduces number of non-taxable transaction certificates (NTTC) & provides for alternative evidence
- Applies sales tax to internet transactions on direct sales
- Brings most nonprofits into the tax base (including hospitals); changes nonprofit exemption to first $250 thousand in gross receipts
  - Bill contained technical error of not fully repealing the nonprofit exemption

Key GRT Changes, con't.

- Sets initial state tax rate to 3.6 percent (effective Feb 2018; down from current 4.16 percent effective state tax rate)
- Attributes the 1.225 percent municipal share to the municipalities' tax rates and reduces the share to an initial 0.965 percent rate
- Requires TRD to recalculate the tax rates, effective January 2019
- Eliminates medical hold harmless payments to local governments
- Caps general fund sales tax revenues for FY18 and FY19; distributes any excess to the tax stabilization reserve

Other Key Changes

Compensating Tax

- Rebrands as “use tax”
- Aligns rate with sales tax (GRT) rate
- Allows for local sharing

Insurance

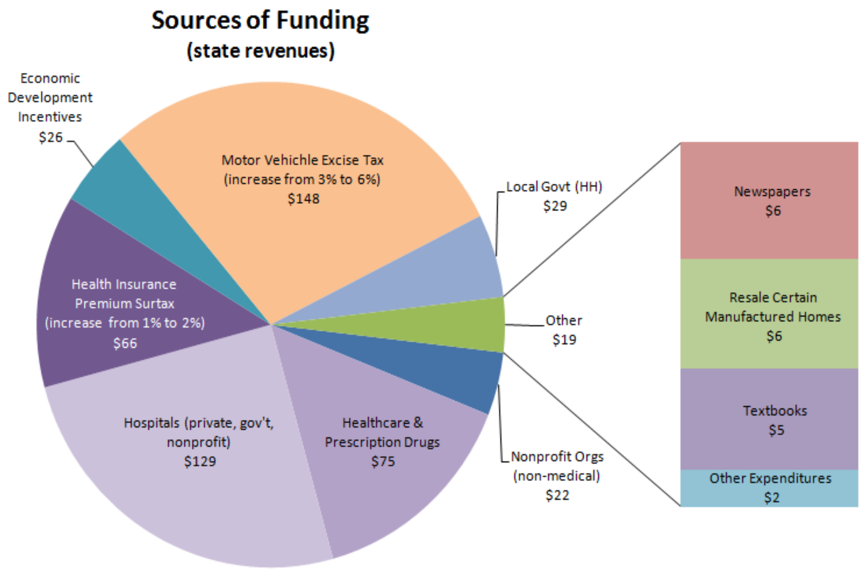
- Increases health insurance premium surtax to 2 percent, up from 1 percent
- Amends the “preemption and in lieu of provision”

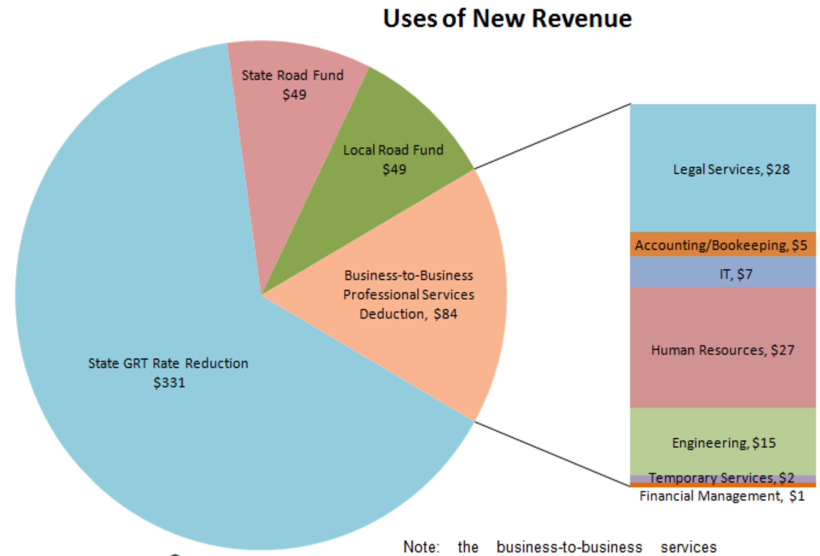
Motor Vehicle Excise Tax

- Increases tax rate to 6 percent, up from 3 percent
- Uses 1 percent to help reduce sales tax rate
- Distributes 1 percent to state road fund and 1 percent to local government road fund

Tax Reform Sources & Uses (HB8)

*(estimate of HB8, including repeal of nonprofit exemption**)*





Note: the business-to-business services deduction estimates reflect state cost only and indicate the legal incidence of the tax (responsible for remitting payment to the state). However, legal incidence is often different from economic incidence (who actually pays), as in cases where costs are passed on to the consumer of the service.

** The bill as introduced inadvertently did not repeal the nonprofit gross receipts exemption; however, the intent was to repeal the exemption for nonprofit receipts and provide a new deduction on the first $250 thousand of nonprofit receipts. The repeal of the nonprofit exemption and the new deduction is reflected in the sources chart above.

Fiscal Implications

Table 1 - Estimated Impact of HB8 on State Revenues: Bill as Introduced, Max of Anti-Pyramiding Range

State Calculations (in $millions)	FY17	FY18	FY19	FY20	FY21
CREG GRT Revenue Estimate	$ 1,868.6	$ 2,007.9	$ 2,103.8	$ 2,209.2	$ 2,306.2
Base 1st Half Year*	$ 24,186.0	$ 30,333.3	$ 28,425.1	$ 29,846.3	$ 31,159.5
Base 2nd Half Year*	$ 24,186.0	$ 22,602.6	$ 28,425.1	$ 29,846.3	$ 31,159.5
Effective State Rate 1st Half Year	4.16%	4.16%	3.60%	3.51%	3.51%
Effective State Rate 2nd Half Year	4.16%	3.60%	3.51%	3.51%	3.51%
GRT (Sales Tax) Revenue Generated	$ 2,012.3	$ 2,075.6	$ 2,021.0	$ 2,095.2	$ 2,187.4
Less GRT (Sales Tax) Non-Base Impacts	$ (144)	$ (155.0)	$ (155.0)	$ (155.0)	$ (155.0)
Difference (HB8 Sales Tax Revenue - CREG)	$ -	$ (87.3)	$ (237.8)	$ (269.0)	$ (273.8)
HB8 Medical Hold Harmless Repeal		$ 11.9	$ 27.9	$ 27.3	$ 27.1
HB8 MVX (1% to General Fund)		$ 20.5	$ 51.0	$ 53.0	$ 54.0
HB8 Health Ins. Premium Tax (1% to GenFund)		$ 27.5	$ 68.8	$ 71.7	$ 74.7
Comp (Use) Tax Local Sharing & Rate Red.		$ (16.0)	$ (42.6)	$ (47.7)	$ (52.5)
Total Revenue Generated	**$ 1,868.6**	**$ 1,964.4**	**$ 1,971.1**	**$ 2,044.4**	**$ 2,135.7**
Total Revenue Surplus (Deficit)	$ -	$ (43.5)	$ (132.7)	$ (164.8)	$ (170.5)
GRT (Sales Tax) GenFund Rev (capped in FY18-19)	$ 1,868.6	$ 1,875.0	$ 1,893.9	$ 1,967.5	$ 2,059.5
HB8 General Fund Impact	**$ -**	**$ (100.9)**	**$ (132.7)**	**$ (164.8)**	**$ (170.5)**
HB8 Distribution to Reserves	$ -	$ 57.4	$ -	n/a	n/a

While projected revenues grow each year, total FY18 impact to general fund is negative $100.9 million, compared to the December 2016 Consensus Revenue Estimating Group (CREG) forecast. With a projected $57.4 million going into the tax stabilization reserve, the net projected impact in FY18 was negative $43.5 million.

Projected revenues in FY19 and beyond average negative $150 million below the CREG forecast.

Key Considerations Affecting the Analysis

- Incorrect assumptions underlying the FY18 and FY19 general fund revenue caps
- February 2018 effective date limits new revenue received in FY18
- Errors in the assumed tax base underlying the new 3.6 percent sales tax rate
- Key technical error in which the nonprofit exemption is not repealed
- Large estimated range for the size of the new anti-pyramiding provision
- State historically does not receive GRT revenue equal to the base multiplied by the rate

General Fund Sales Tax Revenue Cap & Impact of Effective Date

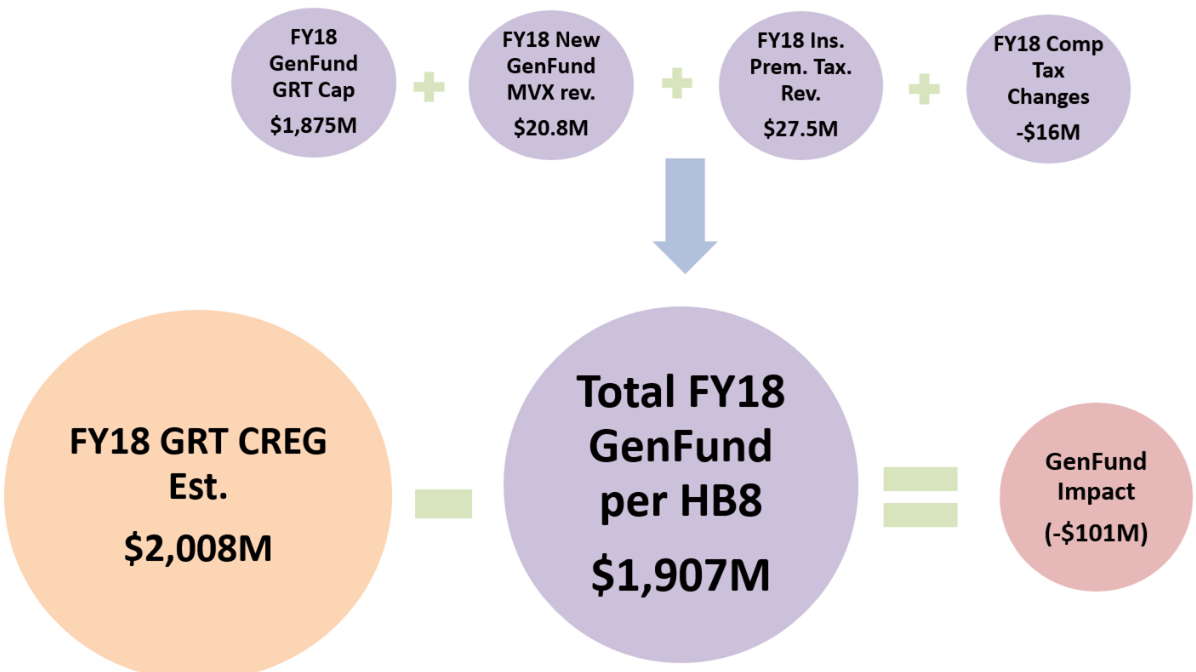
Calculating the FY18 Revenue Cap

$2,000 million Sales Tax Revenue	–	**$50 million** MVX 1%	–	**$75 million** Premium Surtax 1%	=	**$1,875 million** FY18 GenFund Sales Tax Revenue Cap

Issues with Assumptions underlying FY18 Revenue Cap

- Working from an old premium surtax estimate; annual revenue likely to be $66 million instead of $75 million
- Bill assumes a full year of revenue; however, the bill is effective February 2018, allowing only 5 months of revenue from tax increases
- Does not consider state revenue losses from local sharing of the use (comp) tax
- Does not consider changes in taxpayer behavior with knowledge of an impending tax increase

General Fund Sales Tax Revenue Cap & Impact of Effective Date



While revenue in excess of the $1,875 million cap would flow into the tax stabilization reserve, FY18 budgets were set based on the December 2016 CREG forecast, which expected $2 billion in GRT revenue to the general fund. The $101 million revenue gap could have required the Legislature to extract funds from reserves to cover appropriations.

Initial State GRT Rate

- The 3.6 percent rate set in the bill is likely too low to ensure revenue neutrality.

- Two errors in the assumptions for calculating the 3.6 percent rate:
  - Assumes the Medicare deduction is repealed (est. value ~$44 million); however, the bill does NOT repeal this deduction
  - Assumes the state benefits from the full value of repealing the nonprofit exemption; however, does not consider the new deduction on the first $250 thousand in nonprofit gross receipts

- Combined, these two assumptions overestimate the amount of revenue generated by the new sales tax base and rate.

Rate Recalculation

- Bill authorizes TRD to reset the sales tax rate, effective January 2019
  – Raises concerns regarding constitutional authority of the Legislature to set rates (delegates rate-setting to an executive agency)

- Recalculation method set by formula in the bill:

  $1,931.25 million Sales Tax Revenue Target ÷ (Feb–July 2018 Gross Receipts * 2.011)

  – Formula uses a static revenue target of $1,931.25 million; determined by growing the FY18 revenue cap by 3 percent

  – The 2.011 multiplier estimates the new expanded base for a full year

- LFC preliminary calculations result in a potential new rate ranging from 3.46 percent to 3.51 percent
  – The recalculated rate would be lower if the nonprofit exemption were repealed as intended (3.35 to 3.4 percent); however, general fund revenues would be about the same because the bill sets a static revenue target.

Rate Recalculation, Con't.

- Bill capped general fund revenue growth at 3 percent
  - December 2016 CREG forecasted GRT revenue growth of about 4.5 percent above FY18
  - Causes the revenue impact of the bill to be negative each year

- Recalculation method assumes the state receives revenue equivalent to base times rate
  - Various adjustments, such as administrative fees, credits, and distributions result in lower GRT revenue actually received in the general fund during a fiscal year. CREG considers these non-base impacts in its revenue estimates.

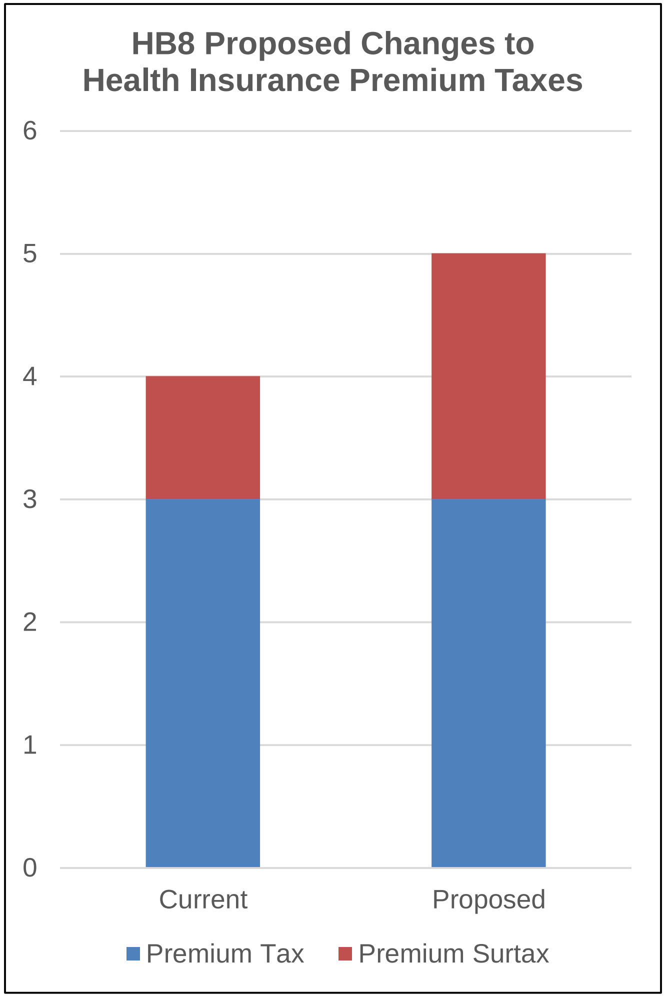
- Future changes to CREG estimates could deepen or narrow the estimated general fund impact of the bill

Local Government Fiscal Impacts

- Two parts to setting the new municipal sales tax rates:
  - Converting the 1.225 percent municipal distribution to an increment of the municipal sales tax rate; the municipal share changes to 0.965 percent
  - Fitting the existing tax rate authorizations to the new tax base
- Bill requires TRD to recalculate municipal and county sales tax rates, effective January 2019
- Average impact to municipalities is likely negative
- Average impact to counties is likely positive

Health Insurance Premium Surtax

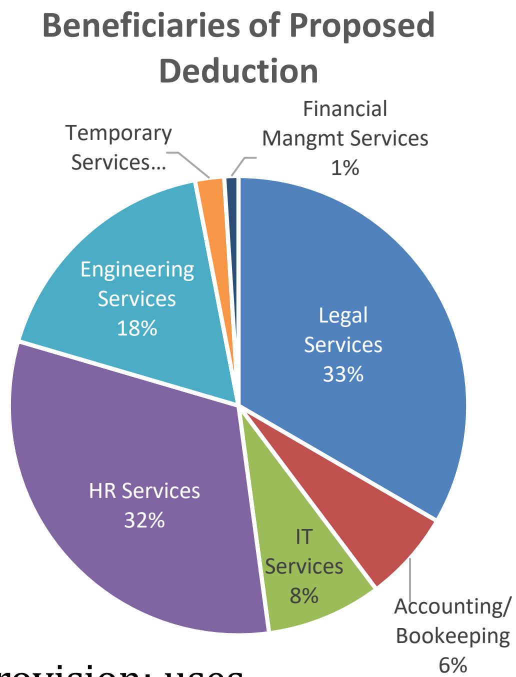
- Bill increases the premium to 2 percent, up from 1 percent
  - Combined with broader insurance premium tax of 3.003 percent, creates a combined rate of 5.003 percent
- The increase is expected to generate about $66 million annually
  - Any changes to the Affordable Care Act would substantially impact the revenue estimate.
- The state would benefit from experts reviewing the interactive effects between the surtax rate increase and the tax levied on the healthcare industry



Anti-Pyramiding

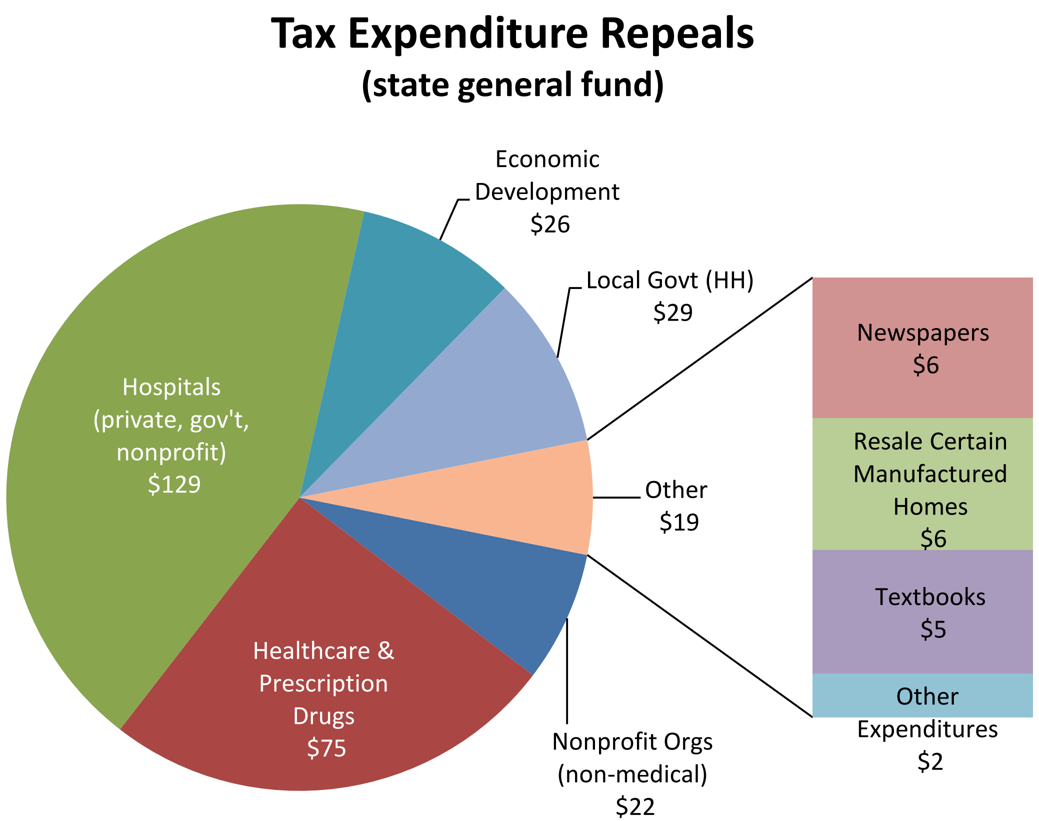
Proposed Items for Anti-Pyramiding GRT Deduction (Millions of Dollars)	Est. TGR (Base)	Est. Total Gross Tax Revenue	Est. State GRT Revenue	Min. Base Est. - 50%	Max. Base Est. - 90%
Legal Services	$756	$55	$31	$378	$680
Accounting/Bookkeeping*	$144	$10	$6	$72	$130
IT Services	$184	$12	$8	$92	$165
HR Services (Inc. Payroll)**	$717	$48	$30	$358	$645
Engineering	$394	$27	$16	$197	$355
Temporary Services***	$46	$3	$2	$23	$42
Total	**$2,241**	**$155**	**$93**	**$1,121**	**$2,017**

Source: RP-80 4, 5, and 6-Digit NAICS for FY16 and FY15
Notes: Estimated total gross tax revenue includes both state and local
* Includes payroll services
** Excludes marketing services. Includes select group of NAICS 54 and 56 categories
*** Includes only NAICS 56 category - potentially underestimated



- Deduction is narrower than the HB412 anti-pyramiding provision; uses specific inclusions and exclusions
- Analysts lack industry-specific sales data needed to better estimate the cost
- Size of the base matters for determining revenue generated by the bill and for the bill’s required rate recalculation
- Concerns regarding potential for amended returns

Base Expansion



- Estimates primarily derived from the 2016 Tax Expenditure Report and additional data by TRD
- Repeals for which the value is unknown are not included (puts upward pressure on the estimated savings)
- Potential for estimates to overlap (puts downward pressure on the estimate)
- Concerns for potential taxpayer misreporting in the first few years of implementation

Compensating (Use) Tax

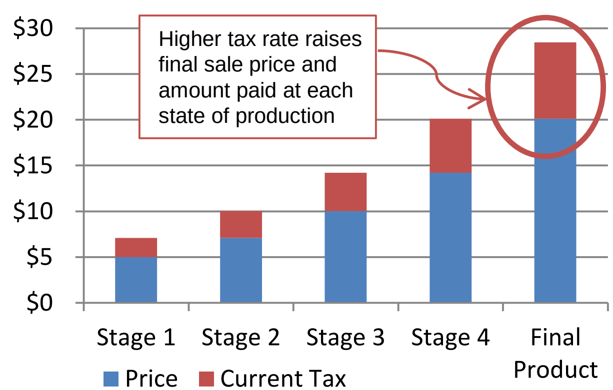
- Bill creates local government sharing of use tax revenues

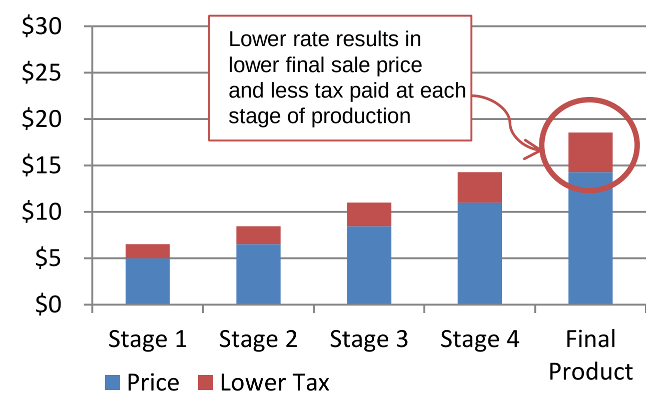
- Estimated general fund impact of negative $40 million to $50 million annually (FY19 and beyond)
  - Estimate appears high compared with CREG forecast for comp tax revenues due to differences between gross tax and net general fund tax revenues → rate changes and local sharing affects gross revenues

Tax Pyramiding, Tax Deviations, and Economic Development

Pyramiding: taxing business-to-business purchases of services, supplies, raw materials, and equipment, adding an extra layer of taxation at each stage of production

- Addressing pyramiding is one of two primary objectives for HB8
  - Reduce the burden of doing business in New Mexico
  - Potential to make New Mexico more competitive for service-based businesses
- No detailed econometric or financial analysis performed to determine if NM is better served overall by removing additional pyramiding vs. greater rate reduction





Tax Pyramiding, Tax Deviations, and Economic Development, Con't.

Considerations on Tax Expenditure Repeals

- Retains a select few economic development incentives
- Simplifies the tax code
- Initial period of uncertainty
- Food remains untaxed
- Trade-off between using savings to "buy down" the tax rate vs. implement a new anti-pyramiding deduction

Healthcare Taxation

- HB8 taxes most nonprofit healthcare organizations
- Removes the exemption for government hospitals and other government healthcare facilities
- Significant changes to the Medicare deduction:
  - Broadens the deduction to include any Medicare payments for services
  - Narrows the deduction by removing eligibility for Medicare payments for prescription drugs and other tangible personal property

Other Issues/Considerations

- Effective Date of February 1, 2018
  - Could pose difficulties for TRD to notify all new taxpayers of their tax obligations
  - Would require contract changes to reflect tax name change, new rate, the loss of certain tax expenditures, and creation of new anti-pyramiding deduction

- Technical Issues
  - Leave the nonprofit GRT exemption in place
  - New initial tax rate of 3.6 percent does not consider the new nonprofit deduction or the non-repeal of the Medicare deduction
  - FY18 revenue cap assumes a full year of revenues, which would not be the case with a February 2018 effective date
  - 2.011 adjustment factor for rate recalculation
  - Total vs. current period gross receipts
  - Liability and penalty language in the NTTC sections

Considerations for Future Tax Reform Proposals

- Anomalies in gross receipts tax data
- Automatic rate recalculation by TRD vs. recommendation to Legislature
- Opportunities for taxpayers to game the system
- Timing
  - Estimated vs. audited revenues
  - Opportunity to identify and report anomalies
  - How long before final impact is known?