MINUTES
of the
SECOND MEETING
of the
REVENUE STABILIZATION AND TAX POLICY COMMITTEE

July 25-27, 2018
State Capitol, Room 322
Santa Fe

The second meeting of the Revenue Stabilization and Tax Policy Committee (RSTP) for the 2018 interim was called to order by Representative Jim R. Trujillo, chair, on Wednesday, July 25, 2018, at 9:05 a.m. in Room 322 of the State Capitol in Santa Fe.

Present
Rep. Jim R. Trujillo, Chair
Sen. Carlos R. Cisneros, Vice Chair
Rep. Sharon Clahchischilliage (7/25, 7/26)
Rep. Roberto "Bobby" J. Gonzales
Rep. Jason C. Harper
Sen. Gay G. Kernan
Rep. Tim D. Lewis
Rep. Antonio Maestas (7/25, 7/26)
Rep. Javier Martínez
Sen. Mark Moores
Sen. George K. Munoz (7/25)
Sen. Clemente Sanchez
Sen. William E. Sharer (7/25)
Sen. John Arthur Smith
Rep. James R.J. Strickler (7/25)
Rep. Carl Trujillo (7/26, 7/27)
Sen. James P. White

Absent
Sen. Peter Wirth

Designees
Rep. Cathrynn N. Brown
Sen. William F. Burt (attending as a guest 7/25)
Sen. Pete Campos (attending as a guest 7/25)
Rep. Bill McCamley (7/25, 7/27)
Sen. Nancy Rodriguez
Sen. Bill Tallman (7/25, 7/26)

Rep. David E. Adkins
Rep. Eliseo Lee Alcon
Sen. Jacob R. Candelaria
Rep. Daymon Ely
Rep. Bealquin Bill Gomez
Rep. Rod Montoya
Rep. Debbie A. Rodella
Rep. Patricia Roybal Caballero
Rep. Angelica Rubio
Rep. Patricio Ruiloba

Rep. Tomás E. Salazar
Rep. Larry R. Scott
Rep. Nathan P. Small
Sen. Elizabeth "Liz" Stefanics
Rep. Candie G. Sweetser
Sen. Pat Woods

(Attendance dates are noted for members who did not attend the entire meeting.)

Staff
Pam Stokes, Staff Attorney, Legislative Council Service (LCS)
Erin Bond, Research Assistant, LCS
Felicia Garcia, Intern, LCS
Ric Gaudet, Researcher, LCS
Sara Wiedmaier, Research Assistant, LCS

Guests
The guest list is in the meeting file.

Handouts
Handouts and other written testimony are in the meeting file.

Wednesday, July 25

Welcome and Agenda Overview
Richard Anklam, president and executive director, New Mexico Tax Research Institute, described to the committee the intent of the three-day committee meeting, dubbed the "Tax Summit". Tax experts from around the country were scheduled to discuss various tax issues and provide insights into how New Mexico policymakers could address the changing economic and tax climate. Recent federal tax law changes will have an impact on state revenues, and the recent decision by the U.S. Supreme Court in *South Dakota v. Wayfair, Inc.* (*Wayfair*) regarding taxation of out-of-state internet sales provides a complicated but potentially lucrative opportunity for state and local governments to increase the gross receipts tax (GRT) base. Mr. Anklam provided the committee with biographies of the 16 speakers presenting at the meeting.

New Mexico Taxation Overview
Steven Keene, CPA, managing partner, Moss Adams, L.L.P., provided the committee with an overview of the taxation system in New Mexico. Recurring state revenues come from a mix of taxes and investment income. By far, the largest source of revenue is from the GRT, followed by income taxes and then energy-related taxes. Property taxes provide a minimal source of state revenue. Mr. Keene discussed New Mexico's GRT system, which has evolved to be more of a sales tax over the years. First imposed in 1935 as the "Emergency School Tax" at a rate of two percent, the tax was originally a very broad-based tax on goods and services and was

imposed on the seller, rather than on the purchaser. This allowed for the tax to be imposed indirectly on the federal government, which for decades was the largest economic driver in the state. The GRT is the state's largest source of revenue and has grown to become the largest revenue source for municipalities and counties. The state rate of 5.125 percent is partially shared with municipalities, meaning the effective rate for state purposes is about 3.9 percent. The total GRT rate varies across the state, from 5.5 percent to 9.25 percent. Since 2004, the average total GRT rate has increased by more than two percent, as local governments have struggled to keep up with increasing expenses and a smaller GRT base.

The compensating tax is the companion tax to the GRT, intended to protect in-state businesses from unfair advantage by out-of-state businesses that, generally, are not required to pay the GRT. The tax is imposed on the purchaser of products and some services. The compensating tax rate is imposed at 5.125 percent for property and five percent for services, resulting in a perverse incentive for in-state businesses to purchase from out of state because of the tax rate differential. Generally, the compensating tax has similar deductions and exemptions as the GRT.

The GRT system taxes everything that is sold by a business in New Mexico, except for property and services that have an exemption or a deduction in statute. Many transactions are excluded from the base that are already taxed elsewhere, including motor vehicles, insurance and gasoline, and other activities that are not normally included in the concept of a traditional sales tax, such as wages, dividends, interest and the sale or lease of real property. Certain sales by and to governments and charitable organizations are exempted, and many deductions are provided to reduce the effect of pyramiding in the chain of commerce. Recently, there have been many more deductions enacted for social or economic development and special industries. In 2004, the legislature removed most food purchases and a large portion of medical services from the GRT base. There are also several credits that can be taken against GRT liability, most of which are designed to encourage economic development in the state.

Mr. Keene briefly discussed the personal income tax (PIT) and corporate income tax (CIT) systems with the committee. The PIT system derives from the federal tax system and takes as its starting point federal adjusted gross income. Taxable income is then calculated by adding or subtracting various additions, deductions and exemptions. The PIT program also has many credits, including several business-related credits. PIT rates vary from 1.7 percent to 4.9 percent, and top out at relatively low income levels.

The CIT is the most complex tax system in New Mexico but only accounts for a small portion of recurring General Fund revenue. Taxable income for corporations is generally derived from federal income, but that calculation quickly gets complicated for corporations with presence in more than one state. In New Mexico, most corporations are allowed to file as separate entities; that is, the income derived from each state is the basis for the state tax return. However, some corporations are required to file combined returns in which income is apportioned to the state based on several criteria.

Questions and comments from committee members included the following.

- What is the difference between a GRT and a sales tax? Mr. Keene said that the main difference is the incidence of the tax. The GRT is imposed on the seller, while sales taxes are imposed on the buyer, and the seller is required to collect it. GRTs are typically much broader based and are imposed on every transaction, except for those transactions that are specifically excluded.

- What can the legislature do to prevent abuse of the GRT deduction for chemicals and reagents? Mr. Keene said that the deduction was enacted long before hydraulic fracturing for oil and gas was developed. The new technology being applied to an old deduction could cost the state hundreds of millions of dollars.

- How will the *Wayfair* decision affect New Mexico? Mr. Keene said that New Mexico will need to make some changes to law in order to benefit from the decision, especially regarding how transactions are sourced.

- Using origination-based sourcing for services means that rural governments lose out on taxing those services, since most professionals are based in urban areas of the state. In addition, when most food ceased to be taxed in 2004, those communities lost much of their GRT base.

Federal Tax Reform Conformity, PIT Reform and GRT Reform

Michael Mazerov, senior fellow, Center on Budget and Policy Priorities, discussed with the committee how federal tax reform has affected New Mexico and also discussed previous state tax law changes. In 2003, New Mexico enacted some of the deepest PIT rate cuts in recent history, cutting rates from 8.2 percent to 4.9 percent. That same year, a capital gains deduction of 50 percent was allowed. Together, those tax cuts cost the state $500 million annually. In 2013, the legislature enacted another tax cut package, cutting CIT rates to 5.9 percent and allowing a single sales factor for manufacturers, costing an additional $145 million annually. These tax cuts coincided with an overall decrease in the state of per-pupil spending on public school and higher education students. New Mexico has one of the lowest high school graduation rates in the country, and only 27 percent of its residents have completed a bachelor's degree. In addition, New Mexico ranked last in a 2018 report in overall child well-being and it also has the nation's highest child poverty rate. Rather than creating new jobs in the state, those tax changes have only exacerbated the challenges that the state has in caring for its residents.

Mr. Mazerov discussed impacts that federal tax reform legislation will have on New Mexico's state revenues and on its residents. The federal Tax Cuts and Jobs Act of 2017 (TCJA) made major changes to how income tax is calculated, and those changes are already affecting New Mexico's PIT system. The standard deduction for most filer categories was doubled, and personal exemptions were eliminated. For state taxpayers with children, this will mean that New Mexico PIT liability will increase. Mr. Mazerov said that it is unclear whether the elimination of

personal exemptions means that New Mexico's low-income PIT exemptions have also been eliminated. Other states with similar exemption statutes have come to differing conclusions about whether those exemptions have been eliminated. Other changes made by the TCJA include limiting the amount of state and local taxes that can be deducted and the permanent adoption of a "chained consumer price index" as an index to inflation. The estimated net impact to New Mexico state revenues from the TCJA is a gain of $46 million annually, with the bulk of that revenue coming from increased tax liability of taxpayers with more than one dependent child.

Policymakers have several options in responding to changes made by the TCJA: do nothing and accept the tax increase for New Mexico taxpayers and higher state revenues; decouple the state PIT system from the federal tax code; remain coupled to some provisions of the federal tax code and decouple from others; or remain coupled to the federal tax code but create an offsetting tax cut or rebate for certain taxpayers. Any response, however, should be well informed, account for uncertainties in fiscal estimates, be designed toward meeting long-term adequacy needs and be equitable. New Mexico's tax system is already fairly regressive, and the changes made by the TCJA will benefit the highest income residents the most. Mr. Mazerov suggested that any changes made should mitigate the regressive nature of the federal tax cuts. Possible mechanisms to offset that regressivity include bolstering the low- and middle-income exemptions, increasing the earned income tax credit, creating a state child tax credit and increasing the low-income comprehensive tax rebate (LICTR), which was originally enacted to offset the regressive GRT system.

Questions and comments from committee members included the following.

- If the capital gains deduction is changed, that will mean that the sale of a business will be taxed at regular PIT rates, which does not seem fair to business owners. Mr. Mazerov said that there are many mechanisms that could provide targeted relief for small businesses to avoid being penalized by the repeal of the capital gains deduction. The current broad deduction is not good tax policy and has not created any new jobs in the state.

- A district court recently ruled that New Mexico is not adequately funding K-12 education. How could the legislature remedy this situation? Mr. Mazerov said that, from a tax policy perspective, once the state determines its expenditure needs, it will probably need to raise more revenue, but that revenue stream needs to be evaluated over the long term. Tax policy should not be based on current surpluses or deficiencies.

- If the legislature wants to make changes to the PIT system to respond to the TCJA, when does that need to happen? Mr. Mazerov said that the TCJA made changes to income tax law that are already in effect for the current tax year. If the legislature

wishes to alleviate some of the negative impacts on families with children for the current year, it will need to make changes during calendar year 2018.

Lessons from Past Tax Reform Efforts: The Blue Ribbon Tax Reform Commission and the Professional Tax Study Committee

Robert J. Desiderio, Esq., emeritus professor of law, University of New Mexico School of Law, and Benjamin C. Roybal, partner, Betzer, Roybal and Eisenberg P.C., discussed with the committee previous attempts at reforming New Mexico's tax codes. The Professional Tax Study Committee (PTSC), which met monthly from 1994 to 1996, was composed of five experts in the areas of tax policy and practice, law and economics. At its first meeting, the legendary guru of New Mexico tax law and former secretary of taxation and revenue, Franklin Jones, discussed tax policy principles, including adequacy, equity and efficiency, and also provided detailed information on the GRT. The PTSC subsequently examined every GRT deduction, exemption and credit and ranked them on their effectiveness.

The PTSC spent much of its time studying the taxation of nonprofit entities and business-to-business pyramiding. The PTSC sent questionnaires to more than 50 nonprofit entities asking them to detail their revenue streams. The Office of the Attorney General also provided information on some nonprofit entities that were required to file information reports. The PTSC determined that allowing tax-exempt entities an exemption from paying the GRT violated the tax equity principle and recommended that the exemption be repealed. The PTSC also recommended that certain kinds of entities continue to receive the exemption, depending on the kind of services they provided and that they met a minimum threshold in receipts.

The PTSC also studied the problem of business-to-business pyramiding created by the GRT. Nearly every industry is affected by pyramiding, and taxpayers have different remedies to solve the problem. Direct pyramiding, such as the taxation of the sale of a product by both a distributor and a retailer, is usually solved by the issuance of nontaxable transaction certificates (NTTCs) and other mechanisms. Indirect pyramiding, such as the taxation of fuel used to produce electricity for subsequent sale to customers, is often more problematic to solve.

The work of the PTSC was very comprehensive, and Mr. Desiderio said that it tried to remain politically neutral while making recommendations to amend the tax codes that aligned with tax policy principles. Unfortunately, the recommendation to tax the receipts of most nonprofit organizations was met with strong opposition, and the PTSC ceased its work in late 1996. Many of the PTSC's recommendations have been enacted into law over the years, including the recent enactment of anti-pyramiding legislation.

Mr. Roybal said that the PTSC examined each exemption, deduction and credit against the tax policy principles in order to decide whether the expenditure was worthwhile. When the PTSC met, there were about 80 tax expenditures in the Gross Receipts and Compensating Tax Act; today, there are more than 100. The PTSC's goal was to expand the GRT base by eliminating some tax expenditures and ensuring that all hospitals be taxed equally. The

extensive research on pyramiding done by the PTSC might still be relevant for today's policymakers. Mr. Roybal congratulated members of the RSTP for helping to enact a law in 2018 that allows for the Taxation and Revenue Department (TRD) to be flexible in allowing for a deduction from gross receipts if the NTTC is not available, something the PTSC recommended in 1996.

Questions and comments from committee members included the following.

- What was the rationale for eliminating exemptions from the GRT for nonprofit organizations? Mr. Desiderio said that the PTSC was not interested in removing the exemption from purchases by nonprofit organizations but wanted to eliminate the exemption from the receipts of some nonprofit organizations. The PTSC recommended that nonprofit organizations should be taxed to the extent that they compete in the market sector in the same way that the governmental GRT is imposed on the receipts of certain governmental activities. This would allow for the uniform taxation of entities like hospitals, while still not taxing entities such as private schools. Mr. Roybal said that the PTSC had also recommended that an organization have a minimum amount of receipts before being subject to the GRT.

- The issue of how to ensure GRT taxation of the prime contractor at Los Alamos National Laboratory (LANL) still needs to be resolved. The simplest solution would be to set a minimum threshold of receipts after which a nonprofit organization is required to pay the tax. Mr. Desiderio said that the nonprofit exemption is based on a federal exemption from income taxes, whereas the GRT exemption is an exemption from transactional taxes. This exemption is not based on sound tax policy, he said.

- What is the best plan for New Mexico to reform its tax system? Mr. Desiderio said that the state cannot piecemeal tax reform. Policymakers need to look at the entire tax system. For example, the regressivity of the GRT was originally balanced by the LICTR in the PIT system; but over the years, the LICTR rebates have not kept pace with the increasing regressivity of the GRT. Tax expenditures are used for economic development purposes, but they often result in unintended distortions in the tax base. Mr. Roybal said that since 1996, the state has only incrementally changed the tax codes. He recommended that any tax reform examine each industry and provide occasional diversions from tax principles based on the situation of the industry.

- No other state imposes a sales tax on nonprofit entities. Why is New Mexico even considering that issue? Mr. Desiderio said that New Mexico is one of five states that tax services, which means that the taxation of nonprofit entities in most states is not much of an issue. In New Mexico, there are many industries in which for-profit businesses are competing with nonprofit businesses. This creates a large equity issue.

- Before engaging in massive tax reform, New Mexico needs to be able to expand appropriations for basic services that its residents need. The state has huge educational, health care and infrastructure needs. Mr. Desiderio said that a well-designed tax system can easily be modified to raise or decrease revenue without causing distortion. He said that out-of-state businesses are often confused by New Mexico's ever-changing tax system.

- What would be the best approach for a state to provide incentives for businesses to locate in the state? Mr. Desiderio said that tax incentives, by definition, interfere in the market, so economic tradeoffs need to be quantified. He said that it would be better to provide for expenditures to attract businesses.

- The largest company in the state is currently operating as a nonprofit entity and does not pay the GRT.

Update from the TRD: Discussion of Current Issues

John Monforte, Esq., acting secretary of taxation and revenue, and Thomas E. Clifford, Ph.D., economist and consultant to the TRD, provided an update to the committee on activities at the TRD. Distributions to all funds in fiscal year (FY) 2018 rose 14 percent from the previous fiscal year, with a total revenue stream of over $8 billion. This growth rate is more than double the rate forecast earlier in the year and includes increases in the oil and gas, GRT, PIT and CIT programs.

The TRD is implementing several changes in the law passed during the 2018 legislative session. House Taxation and Revenue Committee (HTRC) Substitute for House Bill 194 (Chapter 56) allowed for GRT taxpayers to provide alternative evidence to claim a deduction from gross receipts if an NTTC is not available. The TRD has updated taxpayer packets and audit manuals to implement the change.

HTRC Substitute for House Bill 223 (Chapter 57) transfers collection of the premium tax from the Office of Superintendent of Insurance to the TRD. Many issues remain outstanding for the transfer, including the need for the tax to be administered as part of the Tax Administration Act, the need for additional funding and personnel to convert and maintain the tax collection system and the need for additional stakeholder input. Secretary Monforte said that unless the TRD is allowed to audit premium tax filings, its role will be merely as a revenue-collection function.

House Business and Industry Committee Substitute for House Bill 88 (Chapter 50) allows for a streamlined process to be developed in liquidating parcels of land in large, failed subdivisions. In many cases, the value of the property to be sold is less than the total tax liability owed, and there is little incentive to buy these parcels. The bill allows for consolidated sales of the properties via an online platform.

Other recently enacted laws include provisions to provide a GRT holiday for the Saturday after Thanksgiving to certain New Mexico businesses, foster youth employment PIT and CIT credits, a GRT deduction for tangible personal property in projects that are part of an industrial revenue bond issuance, an aircraft training construction GRT deduction and a distribution of a portion of motor vehicle excise tax revenues to the State Road Fund.

The TRD completed conversion of oil and gas tax reporting from the old ONGARD system to the TRD's GenTax system. The new system allows for better enforcement across all oil and gas taxes and allows taxpayers to manage all of their account activity from a single taxpayer access point. The TRD recently created a Business Credit Bureau to manage the more than 30 business credits available in statute. Many credits are extremely complex and require staff with special expertise to administer. The bureau will also work with the Tax Policy Office in making recommendations for changes to law to ensure that the credits are not exploited in unintended ways.

The TRD is increasing the use of data analytics to detect fraud, select audits and increase collections. New software to provide for audit selection in the GRT program is expected to be functional in the first quarter of FY 2019. The department has maintained the position of taxpayer advocate since 2016, which has, so far, assisted 594 taxpayers with issues. The position is now a classified position.

Secretary Monforte said that New Mexico's tax codes may need to be modernized to address issues like remote sales, pyramiding and local distributions. Given the recent budget surplus, now may also be a good time to reform the tax codes.

Questions and comments from committee members included the following.

- The TRD's implementation of recent driver's license legislation has been a disaster, and the department is not currently following the law.

- The LICTR requires a person to have federal tax exemptions to qualify; however, federal tax law no longer has exemptions. Did the federal legislation eliminate the LICTR? Secretary Monforte said that the TRD is interpreting the changes in federal law as not affecting the LICTR.

- What does New Mexico need to do to implement the *Wayfair* decision? Dr. Clifford said that the definition of "nexus" that the court applied in the case will need to be addressed. TRD staff are currently researching how much the department can do on its own. The legislature, however, will need to address how transactions are sourced. Policymakers need to be very careful to ensure that out-of-state vendors are not treated in a different manner than in-state vendors.

- The Motor Vehicle Division (MVD) of the TRD needs a consumer advocate. Many elderly residents are being denied REAL ID driver's licenses because their original documents have been lost. Exceptions must be allowed in certain cases.

- Some residents' voter registrations are being changed by the MVD without their knowledge. The problem seems to occur when an MVD agent asks a customer if the customer wants to update the customer's voter registration. The agent then asks for the customer's political party affiliation, which many decline to state because they do not want to tell government officials which political party they belong to. This confusion causes MVD agents to change the customer's political party affiliation to "Decline to State".

- MVD employees do not inform customers of their ability to apply for a driving authorization card.

Tax Reform: City and County Perspectives

William F. Fulginiti, executive director, New Mexico Municipal League (NMML); James P. O'Neill, consultant, NMML; Katherine Miller, county manager, Santa Fe County; and Brian Moore, lobbyist, New Mexico Counties, discussed with the committee local government perspectives on potential tax reform. Mr. Fulginiti began by reminding the committee that municipalities are completely dependent on GRT revenues for their operations. Local governments need diverse tax revenue sources. Any tax reform effort that changes the GRT system needs to include participation by local governments. Changes in the GRT system affect individual municipalities differently.

Ms. Miller said that the Tax Policy Advisory Committee of New Mexico Counties works closely with the NMML. The advisory committee wants to be included in any tax reform effort. Counties would like to be able to have a set number of GRT increments that can be used for general purposes, replacing the current myriad increments that all require the revenue to be dedicated to a particular purpose. When the legislature reduced hold harmless GRT payments to local governments and allowed them to impose hold harmless GRT increments, that caused the total GRT rates in some localities to increase dramatically, which further exacerbated business-to-business pyramiding. Counties rely to some extent on property tax revenues, but the yield control statute effectively froze that revenue at 1979 levels, except for inflation and new growth. Counties today have much more responsibility to provide services to residents than they did 40 years ago, and their only option to raise revenue has been to increase GRT rates.

Mr. O'Neill discussed how the *Wayfair* decision could be implemented in a way that local governments could benefit from the new revenue. A separate U.S. Supreme Court case in 1994 prohibited states from imposing use or compensating taxes on remote sellers at local rates. This means that implementation of the *Wayfair* decision needs to be part of the GRT system, if local governments are to benefit from the decision. The biggest obstacle to implementing the decision in New Mexico is how to source transactions. The state will probably need to switch to

destination-based sourcing, but that change will have unknown consequences on distributions of current revenue to local governments. Another idea is to apply destination-based sourcing only to tangible personal property and keep origin-based sourcing for services. However, that could overly complicate an already Byzantine set of rules that governs the GRT.

Mr. Moore said that counties want to be involved in any tax reform effort, and he wants all parties to cooperate in any reform. One legislative priority for the 2019 legislative session is to de-earmark many GRT increments and allow counties to use GRT increments for general purposes. There are currently dozens of unused and unusable increments in statute. Counties are also interested in lowering state administrative fees for processing GRT revenues.

Questions and comments from committee members included the following.

- Most small cities do not have a substantial GRT base. When food ceased being taxable, many local governments lost what little tax base they had. Gasoline tax rates and distributions have not changed in more than 25 years, but local road needs have increased. The property tax base in many counties is not sufficient to fund school construction. Local governments need another tax base. The legislature should consider including a PIT distribution to local governments.

- If the legislature de-earmarks all GRT increments, would local governments accept a lower total increment capacity? Mr. Moore said that counties are willing to give up some capacity; however, there needs to be some room for future increases in GRT rates. Mr. Fulginiti said that GRT increments that are imposed countywide and those that are imposed outside the limits of municipalities will need to be negotiated.

Recess

The committee recessed at 5:49 p.m.

<u>Thursday, July 26</u>

The committee was reconvened on Thursday, July 26, 2018 at 9:07 a.m. by Representative Jim R. Trujillo.

Federal Tax Reform and National Trends; Recreational Marijuana Taxation; and Observations on Tax Reform in New Mexico

Joseph Bishop-Henchman, Esq., executive vice president, Tax Foundation, discussed with the committee the taxation of recreational marijuana. Given time constraints, the discussion of federal and New Mexico tax reform was postponed until later. Several states have adopted laws legalizing and taxing recreational marijuana. Colorado and Washington have had legal marijuana for the longest time, and other states may wish to study their experience to provide a better regulatory environment. Marijuana tax collections in Colorado and Washington have exceeded initial estimates, and revenues continue to rise. However, it can take a significant

amount of time and money for the revenues to materialize while customers, regulators and businesses get used to the new taxation and regulatory regime. In addition, the black market for marijuana may not be reduced sufficiently if the tax rates for legal marijuana are set too high. Colorado, Washington and Oregon have recently taken steps to reduce the tax rate because of that issue.

Taxing final retail sales has proven to be the most workable form of taxation. Other forms of taxation have been proposed but have proven difficult to implement, such as taxing marijuana flowers at a certain amount, taxing the processor or producer or taxing products according to their tetrahydrocannabinol content. Some states have previously established medical marijuana programs that are often taxed at much lower rates than recreational marijuana. This can cause problems because medical marijuana patients may resist being moved to the recreational marijuana program. States that legalize recreational marijuana also need to pay attention to health, agricultural, zoning, local enforcement and criminal penalty issues.

Mr. Bishop-Henchman provided estimated tax revenue for each state at different levels of taxation of marijuana, based on estimated demand in each state. New Mexico could realize between $34 million to $57 million annually from taxing marijuana. However, he cautioned that a significant portion of that revenue could be offset by additional regulatory and criminal justice costs from marijuana legalization.

Questions and comments from committee members included the following.

- How do states use the money generated by the taxation of recreational marijuana? Mr. Bishop-Henchman said that Colorado allocates one-half of the revenue for school construction projects and the rest is spent on marijuana-related enforcement and regulatory issues.

- Is the recreational and medical marijuana industry cash only? Mr. Bishop-Henchman said that the industry is almost exclusively a cash industry. However, the industry wants to be regulated and taxed. Banks generally do not get involved with the industry for fear of running afoul of federal banking regulations.

- If recreational marijuana is legalized in New Mexico, current medical marijuana patients should not be forced into the recreational program. Many patients already struggle to pay for the marijuana, and imposing a 25 percent tax would mean that many patients could not afford it.

- If New Mexico legalizes recreational marijuana, it should not follow the state's model in regulating alcohol. The state's liquor laws are a huge mess and have essentially created a monopoly. Mr. Bishop-Henchman said that there are several models to investigate, including Utah's very centralized liquor system and Washington's regional monopolies in recreational marijuana.

Developments in State Corporate Taxes

Richard D. Pomp, Esq., professor of law, University of Connecticut School of Law, discussed with the committee developments in state corporate taxes. He discussed his time served from 1981 to 1987 on the New York Tax Study Commission, which succeeded in reforming much of that state's tax codes. Professor Pomp said that, in the past, he discussed New Mexico's GRT system as an example of good tax policy, with a large base and relatively low rate. The goal of a sound sales tax system is to exempt business inputs and tax the final consumer good or service. The regressivity of the system was offset somewhat by the LICTR and other PIT credits. However, since New Mexico stopped taxing most food purchases, the GRT base has shrunk, and local rates, in some cases, have risen to more than nine percent. This has exacerbated business-to-business pyramiding, which, he said, would be more descriptive if that term were instead called "cascading".

Professor Pomp discussed issues surrounding taxation of nonprofit entities and focused on the property tax. In Hartford, Connecticut, about one-half of all real property is exempt from property taxation, which has made it difficult for the city to raise sufficient operating revenue. Although Harvard University makes voluntary payments to the City of Cambridge, Massachusetts, the amount of payments it makes is a tiny fraction of what it would pay if a property tax were imposed on the university. In both examples given, the municipality bears the burden of a state tax policy. He suggested that municipalities should be able to decide whether the sale of previously taxed real property to a nonprofit entity should change the taxable status of the property. Another idea is to allow municipalities to impose "user fees" to compensate for the loss in tax revenue for entities that benefit from municipal services.

Professor Pomp also discussed the state CIT. New Mexico still allows for an election to file separately for most corporations, which makes it easier for companies to avoid paying much CIT to the state. A company can set up a subsidiary located in another state that does not impose a CIT and then "sell" most of its goods or services to that subsidiary. The company can, in this way, reduce or eliminate its New Mexico CIT liability. Most states require companies to file taxes using unitary or combined reporting, which allocates a portion of the entirety of the company's payroll, sales and property to each state.

Questions and comments from committee members included the following.

- There is a difference between yesterday's charitable institutions, which used to include hospitals and other health care providers that cared for indigent patients, and today's giant hospital corporations that are classified as nonprofit entities solely to avoid paying taxes. Professor Pomp agreed and said that approximately one-third of the nation's gross domestic product is attributable to tax-exempt, nonprofit entities.

- New Mexico has been trying to improve its business tax policy, but manufacturing jobs in the state have not increased. Professor Pomp said that tax policy is not the

most important factor in locating a business. Other factors, including workforce readiness, transportation and energy availability, are much more important. If the state does not have an educated workforce, no amount of tax incentives will serve to attract new businesses to the state. He suggested that if incentives are being considered to attract a certain business to relocate, the incentive package should be thoroughly analyzed by disinterested experts and that a strict set of clawback provisions be included.

- Businesses never move to a location merely because of tax rates. Professor Pomp agreed and added that he has often been commissioned to do tax analyses for companies considering relocation. However, those analyses are almost always done for the purpose of "checking off a box on the form" and are rarely used as the most important factor in relocation decisions.

Adoption of Minutes

The committee adopted the minutes of the June 25, 2018 meeting.

Remote Sales in the Wake of the *Wayfair* Decision

Professor Pomp discussed with the committee ramifications for the state in light of the *Wayfair* decision allowing states to tax online sales from out of state. This issue began long before the internet and was first addressed by the U.S. Supreme Court in 1967 in *National Bellas Hess v. Department of Revenue.* That case prohibited states from collecting sales tax from companies that had no physical presence in the state. In 1992, the court rejected North Dakota's claim that the Quill Corporation was required to collect a sales tax, since it had no substantial physical presence in that state. The court stated, however, in *Quill Corp. v. North Dakota* (*Quill*), that Congress could enact a law requiring just that. North Dakota had argued that, under due process provisions of the U.S. Constitution, the company had established nexus by sending its software to customers located in the state. The court did not rule on the due process issue but instead made its ruling based on the Commerce Clause of the U.S. Constitution. Congress has since been unable to enact any legislation relating to interstate sales. Following a 2015 related court ruling essentially inviting states to enact laws challenging the *Quill* case, South Dakota enacted a statute that required out-of-state vendors that had more than $100,000 in sales or more than 200 transactions annually in the state to collect tax on its sales to state residents. South Dakota specifically did not attempt to impose its sales tax retroactively, and it already was a regular member of the Streamlined Sales and Use Tax Agreement (SSUTA). The *Wayfair* decision, arising from a challenge to South Dakota's law, affirmed the state's law and overturned the *Quill* decision. The court also cited South Dakota's limits on the sales tax collection in its affirmation of the law.

Professor Pomp said that New Mexico could enact legislation requiring a minimum threshold amount for out-of-state vendors and could also join the SSUTA. However, joining the SSUTA would require that the state reform the GRT system to align with SSUTA standards. Policymakers will need to consider changing how transactions are sourced, from origin-based

sourcing to destination-based. He also recommended that the state not attempt to collect the GRT retroactively. Another related case prohibited states from treating out-of-state vendors unfairly, compared to in-state vendors. Professor Pomp said that New Mexico might not be able to collect local GRT increments for this reason, especially if current sourcing rules are maintained.

Questions and comments from committee members included the following.

- Will collecting the GRT from out-of-state vendors help bring back brick-and-mortar stores? Professor Pomp said that people do not shop online because of the lack of sales taxes. He said that collecting the GRT from out-of-state vendors will not change the economic landscape of New Mexico very much.

Medicaid and Taxes: An Overview

Brent Earnest, secretary of human services, discussed with the committee the Medicaid program administered by the Human Services Department (HSD) and the taxation structure associated with the program. The Medicaid program is a jointly financed federal-state health care program, with an average federal match of 78 percent. Federal funding is received as a reimbursement to the state for allowable expenses.

The federal government requires states to develop actuarially sound schedules of reimbursements, including the cost of doing business. This includes various taxes and assessments imposed by the state and federal government on insurers and health care providers. The premium tax, including the health insurance premium surtax, of 4.003 percent is included in the Medicaid reimbursement schedule for managed care organizations (MCOs) that manage the state's Medicaid program. In 2017, approximately $130 million was added to MCO rates for the cost of the premium tax. Health insurers are allowed a credit against a portion of their premium tax due for the New Mexico Medical Insurance Pool (NMMIP). The NMMIP assessment accounts for approximately $63 million in reimbursement rates, and participation fees in the New Mexico Health Insurance Exchange add approximately $9 million. The GRT is also included but is not specifically identified in the rate structure. However, its estimated cost is built into the rate structure.

Several states have enacted so-called "Medicaid provider taxes", in which a tax is imposed on health care providers in order to generate more money for a larger federal match of Medicaid funding. The federal government has restricted conditions under which such a tax may be allowable for reimbursement. The tax must be broad-based and uniformly imposed and does not hold providers harmless from the tax burden. The hold harmless test is measured by requiring that the tax be less than six percent of net patient revenue or, if revenue exceeds that threshold, by requiring that more than 75 percent of taxpayers do not receive more than 75 percent of the extra revenues generated by federal matching funds realized from the imposition of the tax. Secretary Earnest said that any provider tax that does not meet the rules of the federal government may jeopardize Medicaid reimbursements. The New Mexico Legislature passed

legislation that would have imposed a provider tax for certain nursing home facilities in 2018, but the legislation was vetoed by the governor.

Questions and comments from committee members included the following.

- Do independent entities that contract with an MCO receive sufficient reimbursement to cover GRT liabilities? Secretary Earnest said that, typically, the GRT is included in Medicaid reimbursement rates.

- What is the status of proposed HSD rules to require Medicaid copayments by insureds? Secretary Earnest said that the HSD is proposing to require copayments for non-emergency use of hospital emergency rooms and for the use of brand-name prescription drugs when equivalent generic brands are available. Those rules are still being developed.

- Why is Medicaid enrollment declining in the state? Secretary Earnest said that Medicaid enrollment declines reflect increased economic activity. More people with well-paying jobs are no longer eligible for the program.

- The state paying $63 million to insure only a few thousand patients in the NMMIP seems like a very expensive insurance program. Secretary Earnest said that the NMMIP is used by people who otherwise cannot get insurance.

Taxation of Nonprofits and the Health Care Industry in New Mexico

Frank Crociata, Esq., of counsel, Gallagher & Kennedy, P.A., discussed with the committee the taxation of the health care industry, specifically the disparities between the nonprofit and for-profit sectors. A nonprofit corporation is merely a form of business organization allowed by the state. A nonprofit corporation can apply to the Internal Revenue Service for exemption from the federal income tax, which exemption has many benefits for taxation in New Mexico. Income and profits of nonprofit corporations are not distributed to members of the corporations, but they can otherwise act as regular corporations. New Mexico law confers tax benefits on many tax-exempt nonprofit corporations, including the payment of the CIT, the payment of the GRT for goods and services sold, the payment of the GRT for goods and services purchased (except for construction-related activities) and the payment of property taxes for property used for religious, educational or charitable purposes.

Mr. Crociata explored how the GRT system is applied to the health care sector. New Mexico is an outlier in that most states do not tax professional services. New Mexico, however, generally taxes all services, except for those that have been specifically exempted or made deductible. The problem is that there are numerous, often overlapping variables that determine whether the provision of health care is subject to the GRT, including:

- the form of the provider, which can be the government or a nonprofit or for-profit entity;
- the type of facility, including a hospital, long-term care facility, outpatient clinic, home health agency or assisted living facility;
- the ownership structure of the provider, including a doctor-owned partnership or a corporation;
- the payor, including Medicare, Medicaid, TRICARE, the Indian Health Service, an MCO, a health insurer, the Workers' Compensation Administration, a private payor or a copayment by the patient;
- the umbrella under which the service is provided, including a commercial contract service or Medicare part C; and
- the type of service or product being provided.

Mr. Crociata evaluated New Mexico's GRT taxation of the health care industry and determined that the system failed most tax policy principles, especially the equity and simplicity principles. It is also extremely difficult to administer and provides questionable revenue adequacy, given increased Medicaid obligations. Accountability is also difficult to discern because the system does not enable a full, transparent understanding of all deviations from the tax base.

Questions and comments from committee members included the following.

- How can New Mexico ensure that the new operator of LANL pays the GRT without affecting all nonprofit organizations? Mr. Crociata said that there is no perfect solution but that a threshold amount in receipts could be established before an entity is required to pay the GRT.
- Why does New Mexico tax health care services at all, when very few other states do not? Mr. Crociata said that health care is the fastest growing sector of the economy. States can only tax what they have. Other states are looking to New Mexico to see how they can tax certain professional services.

Recess

The committee recessed at 4:32 p.m.

Friday, July 27

The committee was reconvened on Friday, July 27, 2018 at 9:00 a.m. by Representative Jim R. Trujillo.

Sales Tax Scorecard; Sales Tax Reform; Administrative Scorecard; and State Implications of Federal Tax Changes

Douglas L. Lindholm, Esq., president and executive director, Council on State Taxation (COST), discussed with the committee the COST scorecards that rank states according to the fairness of their tax systems. He also discussed federal tax reform and how it impacts state CIT programs. The federal system that governs the United States is relatively unique in the world and sometimes makes domestic companies operate at a disadvantage. Besides the federal tax system, each state has its own unique tax system. Most states have some kind of sales tax that tends to tax business inputs. A recent COST study found that 42 percent of total sales tax revenue in the country is generated from taxing business inputs. Most of the world is, instead, imposing consumption taxes on the final sale of a product, which tends to reduce business-to-business pyramiding. Mr. Lindholm said that a tax on a business is reflected in higher consumer prices, lower employee wages or reduced profits.

Mr. Lindholm discussed the issue of mandatory combined reporting for multistate corporations. While combined reporting sounds elegant in theory, in practice it can be a nightmare, he said, because companies have to calculate sales, property and wages to allocate to each state. State tax auditors can sometimes make the problem worse by attempting to force unrelated affiliates to report in a state. This results in audits that can drag on for years. Mr. Lindholm said that requiring mandatory combined reporting makes state CIT revenue even more volatile than it already is. At a minimum, states that require combined reporting should allow corporations to file unitary returns, which makes accounting much simpler.

Mr. Lindholm also discussed the COST sales tax and tax administration scorecards. New Mexico received an "F" on the sales tax scorecard and a "B+" on the tax administration scorecard. The primary reasons for the poor rating on the sales tax scorecard were high GRT imposition on business inputs; no manufacturing equipment or inputs exemptions from the GRT; high levels of business-to-business pyramiding in the service sectors; burdensome NTTC procedures; lack of participation in the SSUTA; unclear taxation of access to software; burdensome tax liability relief procedures; no credit for payment of other states' sales taxes paid by businesses; and no ability for purchasers to obtain refunds of tax paid directly from the state.

Questions and comments from committee members included the following.

- When New Mexico cut taxes for businesses in 2012, wages did not rise. Cutting taxes leaves states with less revenue to provide vital state services.

- The TRD does not have the technical expertise to correctly manage the CIT system.

- The only way to get the GRT system to have a broad base and low rate is to eliminate most deductions and exemptions, but that approach is very problematic. Mr. Lindholm said that the state should not offer incentives for behavior that will take place regardless of the incentive. For example, wealthy people should be paying the GRT for food purchases.

- The state needs much more revenue to invest in New Mexico's workforce, solve the crisis in child well-being and increase educational funding to comply with a court order. How else, besides raising taxes, can New Mexico solve this problem? Mr. Lindholm said that policymakers should look for ways to raise revenue that do not harm interstate competitiveness.

Corporate Taxes; Uniform Division of Income for Tax Purposes Act; and How the States Are Collaborating

Helen Hecht, Esq., CPA, general counsel, Multistate Tax Commission (MTC), discussed with the committee issues affecting state taxation of businesses. All states are facing similar issues regarding how to respond to the *Wayfair* decision and to federal tax reform. Any changes that states make, however, should strive to make the tax system simpler and fairer. One legislative issue that will be ready for the 2019 session is legislation to allow New Mexico to collect the PIT from certain pass-through entities (PTEs) that have been audited by the federal government and found to owe tax. Current New Mexico law imposes the PIT on individual members of PTEs, but federal law in 2015 allowed for federal income tax to also be imposed on the PTE itself after an audit. The MTC has been working with several tax groups to develop model legislation for states to consider enacting.

Enactment of the TCJA has presented several challenges for states, including whether to conform with federal law and make corresponding changes to their tax codes. Some of the issues for New Mexico policymakers to consider include:

- should the state conform with changes made in the TCJA allowing a deduction from adjusted gross income for a portion of qualified business income? This provision is very complicated to administer, and it is unclear what the fiscal impact will be on the state;

- should the state conform with changes taxing repatriation income and a related deduction from that income?; and

- should the state comply with the global intangible low-taxed income, known as "GILTI" provisions, that source extra profit as income that would otherwise be sourced overseas for federal tax purposes? If the state does not comply, it may need to specify that the related 50 percent deduction cannot be claimed.

Ms. Hecht said that requiring companies to file using combined reporting on their CIT returns is not as complex as opponents claim it is. She said that combined returns are actually somewhat less complex to administer than separate returns. In a related CIT issue, Ms. Hecht said that changing apportionment sourcing laws for intangible property to a market-based approach would be beneficial to New Mexico businesses. Otherwise, they will end up paying more taxes in New Mexico.

The MTC is currently involved in developing standards for states to adopt in implementing the *Wayfair* decision. The MTC is encouraging the development of uniform marketplace facilitators to collect and remit sales taxes and is developing minimum threshold amounts for out-of-state vendors to be considered to have nexus. The MTC is also recommending that states not attempt to collect sales taxes on out-of-state vendors retroactively.

Mr. Lindholm and Mr. Bishop-Henchman joined Ms. Hecht in discussing various tax-related issues with the committee. Questions and comments from committee members included the following.

- Did the court in the *Wayfair* decision prohibit the retroactive collection of sales taxes from out-of-state vendors? Ms. Hecht said that the court did not prohibit it, but pointed to the fact that the South Dakota law specifically did not allow for retroactivity as being one of the factors for the ruling in its favor.

- The recent surge in state revenues makes now a good time for the legislature to consider broad tax reform. Mistakes in crafting the reform can be absorbed temporarily by the extra revenues.

Mr. Bishop-Henchman said that seven states have enacted major tax reform legislation in the past year, including addressing conformity with the TCJA. He recommended that New Mexico focus on several areas for potential reform: conformity with the TCJA; implementing the *Wayfair* decision; reforming the GRT system, including deciding what exemptions and credits should be repealed and how nonprofit organizations should be treated; deciding on combined reporting and market-based sourcing in the CIT system; and eventually deciding whether to legalize and tax recreational marijuana.

Mr. Lindholm said that the state should implement the *Wayfair* decision as soon as possible because that is essentially "free money". He cautioned the committee against making any changes to comply with or differentiate from the TCJA without fully understanding the many interrelated provisions that may also need to be modified.

Adjournment

There being no further business, the committee adjourned at 11:51 a.m.