



# **Pyramiding in the New Mexico Gross Receipts Tax**

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# ***NMTRI Principles of Good Tax Policy***

*N.M. Tax Research Institute is a non-profit, non-partisan member-supported organization dedicated to advancing the following principles of good tax policy in New Mexico:*

- ***Adequacy***
  - Revenues should be sufficient to fund needed services
- ***Efficiency***
  - Interference with the private economy should be minimized
- ***Equity***
  - Taxpayers should be treated fairly
- ***Simplicity***
  - Laws, regulations, forms and procedures should be as simple as possible
- ***Comprehensiveness***
  - All taxes should be considered when evaluating the system
- ***Accountability***
  - Exceptions should be rare and should be carefully evaluated and justified

# What is pyramiding?

Pyramiding is when a general consumption or transaction tax (like a sales tax or the NM gross receipts tax) is charged on business inputs (business-to-business sales) and becomes embedded as part of the cost of the ultimate goods or services sold to the consumer.

# Pyramiding - Example

- A construction company buys engineering services on which tax is charged.
  - Part of the cost of the engineering services includes accounting services on which tax is charged.
    - Part of the cost of the accounting services includes printing services on which tax is charged.
      - Part of the costs of the printing services includes business supplies on which tax is charged.
        - » Etc.

# Pyramiding is a common problem.

Pyramiding of taxation in state transaction taxes like the GRT occurs when the tax is imposed on both the purchases and sales made by businesses. Economists have argued for years that, ideally, the GRT should be applied only to final consumption and not to business inputs. This ideal state of no taxation of business inputs is not achieved completely by any state's transaction taxes today. Intuitively it seems clear that a broad tax base, which is often a very desirable policy and which we have in New Mexico, will result in greater pyramiding of tax simply because more goods and services are subject to tax, including goods and services purchased by business.

## *Concerns Raised by Too Much Pyramiding in a State's Tax*

- Pyramiding is very rate-sensitive in that the problem is much worse with higher rates because the rate will apply to each transaction in the chain of commerce.
- Pyramiding on services is a bigger problem for small businesses because they often purchase business services rather than hiring in-house providers.
- Pyramiding places a heavier tax burden on businesses and individuals who make a lot of purchases from in-state vendors. This creates incentives to buy from out-of-state vendors.
- The likelihood is high that most of the ultimate burden of this tax is borne by in-state households, a hidden tax with regressive implications.
- In-state companies face a direct impact on their bottom line, reducing their ability to invest and add laborers, and compete with out-of-state businesses.
- The tax becomes less transparent (rather than paying 6% tax on the final purchase, a greater amount of tax is “embedded” in the price of goods and services).

## *New Mexico's Gross Receipts Tax: Statutory Provisions*

- Business privilege tax imposed on sellers:
  - “Gross receipts”: Any consideration for selling or leasing property (including intangible) or providing services
  - VERY inclusive definition, new businesses or activities are typically included unless a specific exemption or deduction is applicable
- State tax (5.125%) plus local option taxes (average 2%)
  - State shares 25% of it's revenue with municipalities
- Compensating (Use) Tax: On purchases from out-of-state sellers
  - 5.125% tax rate
  - No local options
  - Not Imposed on services
  - Estoppel on collecting from households

## *Statutes Defining the Tax Base*

- Exemptions:
  - Transactions taxed under other taxes
  - Wages and salaries
  - Sales to/by governments, non-profits (501c3's except for UBIT)
  - Financial institutions
- Deductions:
  - Sales for re-sale
  - Tangibles sold to governments
  - Manufacturer's ingredients
  - Food for home consumption
  - Medical services; Hospitals
  - Miscellany: Agriculture; Newspapers; Racetracks; Renewable energy; Sales to film producers



## *Some Implications of Broad Tax Base*

- GRT on services: Sales for resale deduction only when the next sale is taxable, primarily buyers in the same industry.
- GRT on tangibles: Narrow deductions for resale and for manufacturers' and contractors' ingredients or components. Substantial portion of tangible purchases by business remain in the tax base.
- **Pyramiding – the cascading of tax through the chain of commerce as more business inputs are taxed. (NM pyramids much more than most vanilla sales tax states because we tax more service and non-service business inputs)**
  - Example – If an engineering firm purchases legal and printing services for a project and then sells its engineering services to a construction firm that uses the engineering service in the construction of a building, the legal and printing services will be taxed when sold to the engineering firm and taxed again when the engineering services are sold. When the constructed building is sold, it will also be taxed.

## *Comparison With Similar Taxes*

	<b>New Mexico GRT</b>	<b>Washington B&amp;O</b>	<b>OHIO CAT</b>	<b>Retail Sales Tax</b>
<b>Taxable transactions</b>	<i>All except listed exemptions &amp; deductions</i>	<i>All except listed exemptions &amp; deductions</i>	<i>All except listed exemptions &amp; deductions</i>	Specifically listed transactions. Usually sales at retail for use or transfer of tangible personal property
<b>Taxation of Services</b>	<i>Most taxable</i>	<i>All taxable</i>	<i>All taxable</i>	Most not taxable. Taxed services specifically enumerated
<b>Consumer deductions</b>	<i>Health care; Food;</i>	None	None	<i>Food; Medicine; Clothing</i>
<b>Business deductions</b>	<i>Resale; Exports; Manufacturing ingredients;</i>	Wholesale	Small business	<i>Resale; Exports; Manufacturing equipment and ingredients;</i>
<b>Average Tax Rate</b>	7%	0.1% to 1.5%	0.26%	2.9% - 9.0+%

## *Summary of GRT Tax Base*

- GRT is an imperfect hybrid of a Retail Sales Tax and a Business Privilege Tax
- Tax rate and deductions for resale are similar to a retail sales tax.
- Comprehensive taxation of sales to businesses are similar to a business privilege tax.
- GRT on services sold to non-profits, government is more like BPT, broader than most RST's.
- B-to-B sales extend the GRT base well beyond consumption, but large parts of the consumption base are excluded.\*

\*Thomas F. Pogue, *"Tax Expenditure Budget: Defining the Benchmark GRT Base,"* Prepared under contract to the New Mexico Taxation and Revenue Department, April 2008.

## *Historical GRT Role in New Mexico Economy*

- Minimal role of cross-border transactions so little tax competition at retail level (changing with e-commerce).
- Large role of government facilities: Seller-imposed GRT brings government contractors into tax base.
- Large role of resource extraction industries: GRT on services brings their contractors into the base.
- Relative isolation of N.M. economy is changing. Newly-locating businesses are putting pressure on the GRT, seeking relief on inputs and outputs. Also using GRT credits to offset other liabilities like withholding. Competitiveness with out-of-state and international businesses becoming a bigger issue.

# Pyramiding Debate

To remove pyramiding from the GRT would require more tax suspension mechanisms (exemptions, deductions or credits). Pyramiding is seen as a problem not just by the economists who prefer a theoretically sound, adequate and efficient system, but also by businesses who perceive that the tax on their purchases adds to their costs, makes them less competitive and in the end causes them to lose business. In addition, taxing business inputs “hides” the tax in business costs which will ultimately be borne by the consumer.

# Pyramiding – Service Economy

Sales of services are becoming a greater portion of the economy as compared with transactions involving tangible products. This trend creates issues in the efficient administration of the GRT system. Among these issues are:

1. Jurisdictional issues: The widespread use of information and communications technologies enable many services to be provided from anywhere and it becomes increasingly difficult to determine where the sale of a service takes place.
2. Difficulties in defining the inputs: In the service economy it is increasingly difficult to determine when a service becomes an input of another subsequent service.
3. Competitiveness problems: In a service economy, states compete not only with other states, but also with nations around the world. Investment today often depends on the quality and availability of the workforce, infrastructure to support business activities and lifestyle amenities. These things may be more important than the traditional need for access to natural resources or reducing the related tax bill.

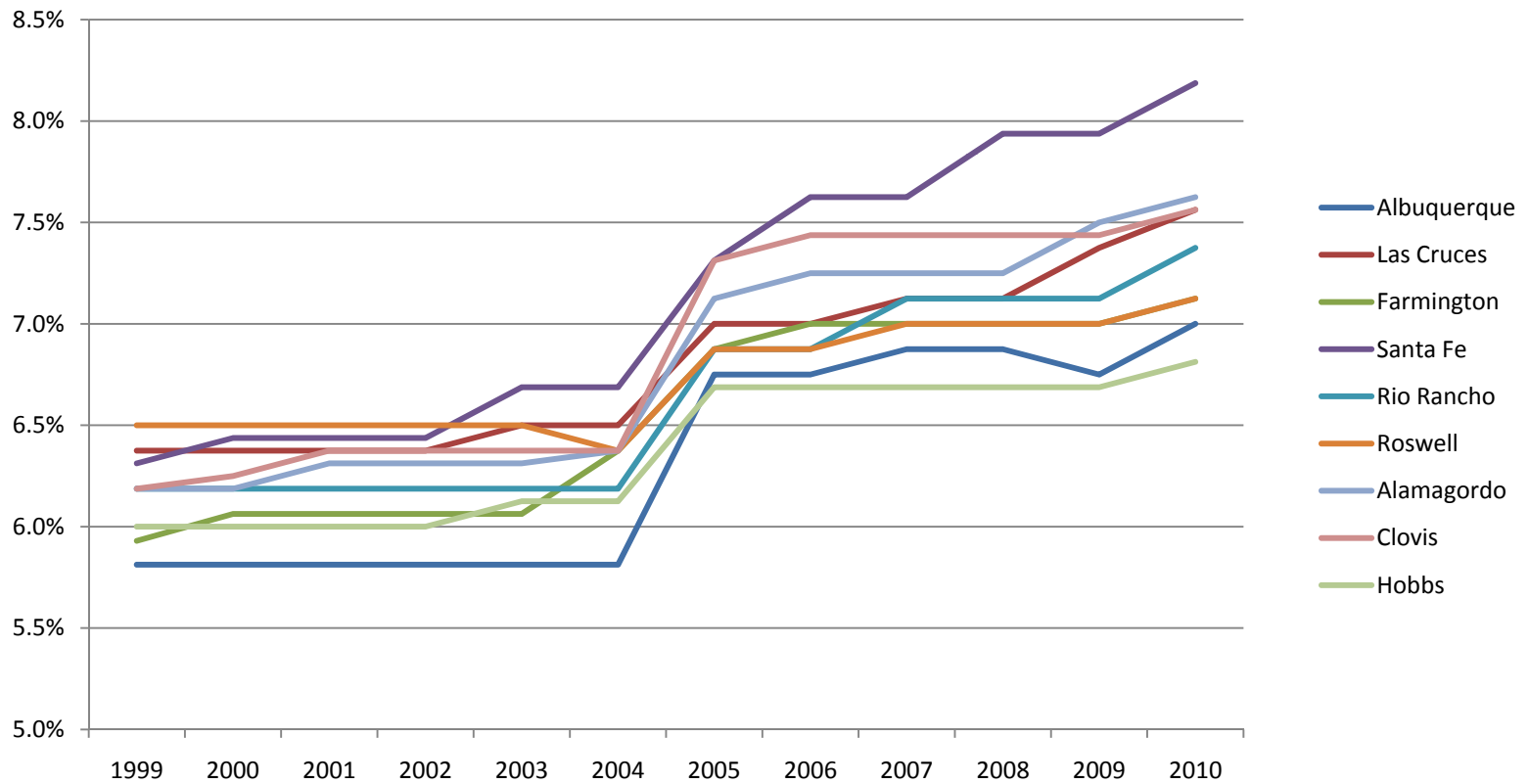
# Pyramiding of Tax

## Different Kinds of Pyramiding

- Some business inputs (services and tangibles) are always taxable under GRT because they are not directly resold
- Even services purchased for resale may sometimes be taxable when purchased
  - “Every other sale” provision of 7-9-48
  - Directly resold services not taxable with a Type 5 NTTC BUT the next sale must be subject to the GRT
  - Results in every other transaction in a series being subject to GRT. If the service is exported, deductions for sub-contracted service not allowed
  - 2003 BRTRC recommended fix – Cost \$50 million

# *Rate Matters*

Increased Rates Compound the Problem (literally)





# Pyramiding and Regressivity

- The GRT is a consumption tax and the tax on business purchases will be passed on to the ultimate customer (or may sometimes result in less business spending on things like wages).
  - Taking the tax off of one consumer good and raising the rate on business purchases simply results in taxes “embedded” in other products.
  - The regressive effect of a hidden or embedded tax is harder to evaluate and control.
- The only way to contain regressivity is to not raise rates.

## *Possible Solutions and Recommendations*

- Since 1/3 to 1/2 of the GRT revenue comes from pyramiding, the problem will be expensive to address.
- “First, do no harm”
  - Inefficiency (i.e. lost economic output) increases with the square of the tax rate – i.e. exponentially – holding down the GRT tax rate is essential
  - No exemptions targeted at consumer purchases if offset by rate increases since this simply shifts the tax to business purchases and results in greater pyramiding of tax (eventually paid for by consumers as a hidden tax)
  - Use of tax incentives should be strictly limited – they reduce the base and put upward pressure on tax rates (you need them less without the pyramiding).
- Sales tax reform should focus on final sales, exclude intermediate sales
  - Specific deductions for business inputs
- Expansion of the anti-pyramiding credit (an incremental solution)
  - Scalable and targeted
  - Has to be large enough to make a difference
- GRT could be split into two taxes:
  - Retail sales tax (only on consumption)
  - Business privilege tax (true gross receipts tax)

Table A

Economic Sectors	Value of Business Purchases (1)	Potential Tax from All Business Purchases (2)	Pyramiding Relief Under Current Law (3)	Tax Collected from Pyramiding (4=2-3)	Percentage of Pyramiding "Solved" by Current GRT Law (5=3/2)	Rank by Lack of Pyramiding Relief
Agriculture	\$1,118.8	\$67.1	\$45.0	\$22.1	67.0%	15
Mining	\$2,557.5	\$153.5	\$9.1	\$144.4	5.9%	4
Utilities	\$445.0	\$26.7	\$0.5	\$26.2	1.9%	2
Construction	\$1,621.8	\$97.3	\$71.6	\$25.7	73.6%	16
Manufacturing	\$5,307.0	\$318.4	\$149.2	\$169.2	46.9%	11
Wholesale	\$536.0	\$32.2	\$2.1	\$30.2	6.5%	5
Retail	\$1,303.0	\$78.2	\$1.9	\$76.2	2.4%	3
Transportation	\$990.0	\$59.4	\$11.7	\$47.7	19.7%	6
Information	\$686.7	\$41.2	\$16.9	\$24.3	41.0%	10
Finance	\$881.4	\$52.9	\$26.7	\$26.2	50.5%	12
Real Estate	\$761.0	\$45.7	\$12.6	\$33.1	27.6%	8
Professional, Mgmt, Admin	\$1,073.3	\$64.4	\$1.0	\$63.4	1.6%	1
Education	\$90.4	\$5.4	\$4.4	\$1.0	81.1%	17
Health	\$1,294.0	\$77.6	\$51.0	\$26.6	65.7%	14
Arts	\$124.0	\$7.4	\$2.0	\$5.4	26.9%	7
Accom and Hotels	\$545.0	\$32.7	\$13.0	\$19.7	39.8%	9
Other Services	\$254.0	\$15.2	\$8.0	\$7.2	52.5%	13
<b>Total</b>	<b>\$19,588.9</b>	<b>\$1,175.3</b>	<b>\$426.7</b>	<b>\$748.6</b>	<b>36.3%</b>	

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\*Pyramiding Transaction Taxes in New Mexico," M. Del Valle, N.M. Tax Research Institute, Sept.

2005. \_