F I S C A L   I M P A C T   R E P O R T

ORIGINAL DATE 2/17/19
SPONSOR Harper / Cisneros **LAST UPDATED** ___ **HB** 579

SHORT TITLE Tax Reform **SB** ___

ANALYST Clark

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY19	**FY20**	**FY21**	**FY22**	**FY23**		
$0	$44,000.0	$45,000.0	$47,000.0	$49,000.0	Recurring	General Fund – Internet Gain
$0	($25,000.0)	($27,000.0)	($28,000.0)	($29,000.0)	Recurring	General Fund – Internet Losses
$0	($22,000.0)	($44,000.0)	($45,000.0)	($46,000.0)	Recurring	General Fund – Other Out-of-State Losses
$0	($48,000.0)	($49,000.0)	($50,000.0)	($51,000.0)	Recurring	General Fund – PIT Dependent Deduction
$0	$0	$18,000.0	$18,000.0	$18,000.0	Recurring	General Fund – Repeal Muni Equiv.
$0	($5,000.0)	($5,000.0)	($5,000.0)	($5,000.0)	Recurring	General Fund – Other Provisions
$0	**($55,000.0)**	**($62,000.0)**	**($63,000.0)**	**($65,000.0)**	**Recurring**	**Total General Fund**
$0	Indeterminate but Positive, Likely Significant	Indeterminate but Positive, Likely Significant	Indeterminate but Positive, Likely Significant	Indeterminate but Positive, Likely Significant	Recurring	Local Governments

Parenthesis ( ) indicate revenue decreases

Note: the impacts shown are preliminary estimates and require additional analysis by economists at LFC and the Taxation and Revenue Department

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY19	FY20	FY21	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	Moderate to Significant	Moderate to Significant	Moderate	Moderate to Significant	Nonrecurring	TRD Operating Budget

Parenthesis ( ) indicate expenditure decreases

Conflicts with or relates to HB582, HB6, SB358, SB421, and others

SOURCES OF INFORMATION
LFC Files

Responses NOT Received From
Taxation and Revenue Department (TRD)

Responses Received From
New Mexico Attorney General's office (NMAG)
Economic Development Department (EDD)

SUMMARY

Synopsis of Bill

House Bill 579 is a tax reform bill that performs modernization and cleanup, equalizes some tax rates, levels tax burdens for in-state and out-of-state sellers, and changes distributions of revenues. It also creates a new dependent deduction intended to offset negative impacts of state personal income taxes (PIT) on people with dependents (such as children), resulting from federal tax reform.

The New Mexico Attorney General's office (NMAG) provided the following detailed breakdown of the bill's actions.

The individual sections of the bill are:

- Section 1 – Amends Section 7-1-2 to change the tax acts that the Tax Administration Act applies to, deleting reference to the Venture Capital Investment Act (7-2D-1 NMSA) and a general reference to state GRTs. Adds reference to the Oil and Gas Proceeds and Pass-Through Entity Withholding Tax Act (7-3A-1 NMSA), the Interstate Telecommunications Gross Receipts Tax Act (7-9C-1 NMSA), the Leased Vehicle Gross Receipts Tax Act (7-14A-1 NMSA), and municipal and county compensating taxes, included in later sections of the Bill.

- Section 2 – Amends the definitions in the Tax Administration Act (7-1-3 NMSA) to delete specific GRTs from the definition of "local option gross receipts tax."

- Sections 3 & 4 – Adds references to compensating taxes to Sections 7-1-6.12 and 7-1-6.13's requirements that TRD transfer to municipalities and counties local option gross receipts taxes (GRTs) it collects.

- Section 5 – Adds references to municipal and county compensating taxes to Section 7-1-6.15's provisions regarding adjustments made to distributions to counties and municipalities.

- Section 6 – Creates a new section of the Tax Administration Act providing for a distribution of net receipts from the GRT of $1.25 million to municipalities and $750,000 to counties, both distributed among municipalities and counties in proportion to prior net receipts transferred.

- Section 7 – Amends Section 7-1-11's provision regarding audits of taxpayers to provide that TRD shall only audit a marketplace provider (defined later in the bill) for sales made by a marketplace seller that are facilitated by the marketplace provider.

- Section 8 – Replaces Section 7-1-14's definition of a "place of business" for the purpose of reporting gross receipts. The new Section 7-1-14 provides that the location of gross receipts is determined based on the source of the receipts. Gross receipts from personal property are reported based on the location of the delivery of the property, professional services based on the seller's place of business, construction based on the location of the project, real estate services based on the location of the property, other services based on the location where the service is performed, real property based on the location of the property, and transportation network company services based on the location where the customer enters a vehicle. Section 8 of the Bill also directs the Secretary of TRD to promulgate rules for unaccounted-for gross receipts and to develop a location-rate database for taxpayers.

- Section 9 – Creates a new section of the Income Tax Act to provide for a new tax deduction for taxpayers filing as "head of household" or "married filing jointly" with dependents. The deduction is $4,000 per dependent and is in effect as long as the federal deduction for dependents is $0.

- Section 10 – Removes outdated language in Section 7-4-10 regarding past apportionments of manufacturing and headquarters operations among states. Also revises the exclusions contained in the definition of "manufacturing" to exclude "construction services" rather than "construction," exempts electric power generation generally, and adds an exclusion for the processing or preparation of meals for immediate consumption.

- Section 11 – Changes Section 7-4-18's provisions regarding the location of sales for the calculation of a "sales factor" used to allocate taxes among states. The existing statute determines a sale's location based on where "income producing activity" occurred. The bill instead would categorize sales based on the type of sale: real property and personal property are sold where the property is located; services where the service is delivered; and intangible property where the property is used.

- Section 12 – Amends the definitions in the Gross Receipts and Compensating Tax Act (Section 7-9-3) to include a definition of "digital good." Also cleans up the definition of "local option gross receipts tax" (as in Section 2) and revises the definition of "manufacturing" to mirror Section 10. Adds definitions of "manufacturing service," "marketplace provider," and "marketplace seller." Refines and cleans up the definition of "property."

- Section 13 – Removes the exclusion for businesses without a physical, in-state presence from the definition of "engaging in business" in Section 7-9-3.3. Instead, such entities are considered to be "engaging in business" if they have total taxable gross receipts sourced to New Mexico of more than $100,000 per year.

- Section 14 – Amends the definition of "gross receipts" in Section 7-9-3.5 to include receipts collected by a marketplace provider from sales sourced to New Mexico and facilitated on behalf of marketplace sellers.

- Section 15 – Provides immunity to marketplace providers that incorrectly correct GRT due to reasonable reliance on erroneous information from a seller. Also bars class actions in state court by purchasers against marketplace providers "in any way related to" an overpayment of GRT or compensating tax.

- Section 16 – Adds a provision to Section 7-9-6 requiring taxpayers to separately identify taxes when billing customers.

- Section 17 – Deletes catch-all clauses regarding when a compensating tax may be imposed. Also adds compensating taxes for using a license or franchise in New Mexico. Finally, creates a uniform compensating tax for all sales and services by revising outdated references to a 5 percent tax.

- Section 18 – Removes the prohibition against enforcing compensating taxes against property used for non-business purposes. Section 18 also states that TRD shall not enforce taxes on businesses without a physical presence in the state until July 1.

- Section 19 – Revises the exemption from GRT for sales of research and development services. The current law exempts such sales except for sales between affiliated corporations, to the United States, or to for-profit national lab contractors. The Bill appears to would reverse this exemption, by exempting sales of research and development services *to* the listed entities.

- Section 20 – Excludes from GRT exemption for charitable organization non-health care facility entities with more than $75 million in receipts per year.

- Section 21 – Deletes outdated language and simplifies language for exemption for manufacturing consumables in Section 7-9-46. Also adds an exemption for selling or leasing manufacturing equipment. Revises the definition of "manufacturing consumable" and adds definitions of "manufacturing operation" and "qualified equipment."

- Section 22 – Creates a new section of the Gross Receipts and Compensating Tax Act creating a deduction for marketplace sellers where the marketplace provider is already remitting taxes on a transaction. This exemption does not apply, however, where a provider has relied upon a seller's erroneous information regarding the collection of GRT.

- <u>Section 23</u> – Creates a new section of the Gross Receipts and Compensating Tax Act authorizing the Secretary of TRD to provide information to taxpayers regarding the taxability of gross receipts and establish standards for software to determine the taxability of gross receipts.

- <u>Sections 24 & 26</u> – Removes the transportation exemption from the supplemental municipal GRT and Municipal Local Option Gross Receipts and Compensating Taxes Act.

- <u>Sections 25 & 29</u> – Amends the titles of the Municipal Local Option Gross Receipts Taxes Act and County Local Option Gross Receipts Taxes Act to include the phrase "Compensating Taxes."

- <u>Sections 27 & 30</u> – Removes language from Sections 7-19D-7 and 7-20E-7 providing for the transfer of municipal GRT and county GRT by TRD to municipalities and counties (presumably because such transfers are already directed by Sections 7-1-6.12 and 7-1-6.13).

- <u>Section 28 & 31</u> – Creates new sections of the Municipal Local Option Gross Receipts Taxes Act and County Local Option Gross Receipts Taxes Act that calculates the rate for compensating taxes in municipalities and counties. Allows a municipality or county to choose the purpose for which such tax revenues will be spent. Prohibits the repeal or amendment of compensating taxes where they would impair outstanding revenue bonds.

- <u>Section 32</u> – Deems references to the County Local Option Gross Receipts Taxes Act to the revised name of this act.

- <u>Section 33</u> – Repeals tax exemptions and credits for space vehicles, aerospace services, services sold to out-of-state buyers, licensing and leasing films and tapes, biodiesel blending equipment, sales to film production companies, contributions of inventory to charitable organizations and governments, military transformational acquisitive programs, selling services for resale, sales to the state in exchange for funds from the New Mexico Mining Act and Water Quality Act, engineering, architecture, and construction contracts for public hospitals, construction equipment and materials, equipment sales to the New Mexico Renewable Energy Transmission Authority, equipment installed in electronic transmission facilities or interconnected storage facilities, the transmission of electricity where conversion technology is used, markets for sale and trading of electricity, penalties paid for repealed Section 7-1-71.2, and construction to implement fighter aircraft training missions.

- <u>Section 34</u> – Provides for the delayed repeal of the Investment Credit Act, transportation exemptions to the Local Hospital Gross Receipts Tax Act, County Local Option Gross Receipts Taxes Act, and County Correctional Facility Gross

Receipts Tax Act, and Section 7-1-6.55, providing for a distribution of compensating tax revenue to municipalities

- Sections 35 & 36 – Lists the taxable years to which various provisions of the Bill apply and the effective dates for different parts of the Bill.

FISCAL IMPLICATIONS

Remote Sellers and Marketplace Facilitators

The estimated fiscal impact is particularly uncertain. These are highly imprecise estimates that use limited, publicly available data to represent a ballpark amount of GRT revenue lost through untaxed internet sales (note the state currently receives tax revenues from some online sellers, such as sales made directly by Amazon, otherwise the estimate would be higher). The estimate assumes nearly full compliance, and gaining revenues from the handful of largest marketplace facilitators and remote sellers would likely result in receipt of the vast majority of possible revenues.

For the first half of FY20, the state would capture all the large online sellers, but local GRT increments would not yet apply due to the time needed to switch over to destination-based sourcing, which would provide for these sales to be deemed to take place at the buyer's location instead of the "out-of-state" GRT coding. In order to provide local governments with a portion of this revenue stream during that time, $2 million per month would be sent from the general fund to local governments, apportioned on a population basis.

After this six-month delay, beginning January 1, 2020, GRT for all sales – services and tangible personal property – switches to destination-based sourcing. For example, with tangible personal property (physical purchases), all such sales would be deemed to take place at the buyer's location, and local increments would apply. Local governments should see a significant surge in revenues due to taxing the online sales the state currently taxes, taxing all the new online sales, and taxing other sales that are currently booked as out-of-state. However, out-of-state sales generate 5.125 percent revenue for the state through GRT; when booked to a specific location, most location reporting will be inside municipalities and require the state to share 1.225 percent of the revenue with the municipal governments, thus lowering state revenues.

The fiscal impact table breaks the impacts from these provisions into three categories: the gain to the state from much more broadly taxing remote sales (e-commerce), the loss to the state on e-commerce sales from the 1.225 percent distribution, and the loss to the state on existing out-of-state coded GRT sales not related to e-commerce from the 1.225 percent distribution.

Personal Income Tax Dependent Deduction

The bill provides a $4,000 PIT deduction for dependents. The language in the bill is problematic and likely needs to be amended (*see Technical Issues*), but the impact shown is scored assuming TRD determines the language can be interpreted to reflect the sponsor's intent (this is one possible reasonable interpretation, but there could be others, which could substantially change the impact).

New Manufacturing Equipment Deduction & Tax Expenditure Repeals

The newly created manufacturing equipment deduction would be more expansive than the existing investment credit, which would have a delayed repeal by the bill. Several other tax expenditures are also repealed by the bill, but they are never or rarely used and would not generate significant revenue. It is impossible to estimate with any precision the fiscal impact of these provisions, but the change is likely to be a greater cost to the general fund, leading to a score of roughly $5 million less general fund revenue.

Other Provisions

Other provisions in the bill may have minor or significant general fund impacts, either positive or negative. LFC staff are reviewing to determine if anything is significant enough to change the scoring of the bill, and input from TRD and other tax experts would also be useful.

Local Compensating Tax Increments

This would not have a general fund impact but could generate significant revenue for a few local governments, although many would likely see a minimal impact.

SIGNIFICANT ISSUES

Remote Sellers and Marketplace Facilitators

Untaxed Internet sales are eroding New Mexico's retail sales tax base and reducing general fund revenues by tens of millions of dollars annually. Taxing local retailers but not large, online retail operations creates significant disparities and makes it very difficult for local shops to compete with remote sellers. Amazon is now paying tax on direct sales but not on sales by other parties that use Amazon as a sales platform. Recent reporting in *The Wall Street Journal* noted third-party sales represent 70 percent of all sales through Amazon, indicating New Mexico continues to lose tax revenue on the majority of Amazon sales. Further, Amazon is only paying the state portion of the GRT, not the local government portion, which creates a disparity in the total rate that favors out-of-state sellers over local businesses and means local governments are not receiving any tax revenue.

This bill levels the playing field for local businesses by requiring all remote sellers that sell more than a specified base level within New Mexico to collect and pay GRT on all sales, including third-party platform sales. Under this bill, sales will be determined to take place at the location to which the product is delivered, and after a short period of revenue sharing with local governments, local GRT rates will apply to these sales beginning January 1, 2020.

It is important to note the shift to destination-based sourcing for GRT is a significant structural change in how the tax is applied and how it must be reported. By making these provisions effective at the start of 2020, there would be no opportunity (outside of a special legislative session) to make any necessary corrections to language in the bill after enactment before the bill takes effect. Also, this may not be enough time for TRD, taxpayers, and local governments to prepare for this shift.

Personal Income Tax Dependent Deduction

The bill provides a $4,000 PIT deduction intended to remove any negative state-level tax impacts on taxpayers that resulted from the federal government setting the personal exemption amount to zero as part of the recent federal tax reform. The federal Tax Cuts and Jobs Act (TCJA) set the personal exemption amount (where taxpayers would receive a reduction in taxable income for each dependent) equal to zero. The TCJA also created a new child credit, but the state does not automatically piggyback on that new credit, whereas it piggybacks on most other existing provisions, including setting the personal exemption amount to zero. This federal change results in higher state-level tax burdens on families, which this bill offsets.

New Manufacturing Equipment Deduction Replacing Investment Credit

The existing investment credit for manufacturers allows a credit equal to the compensating tax rate on qualified equipment purchased or brought into the state but also has employment qualifications and an upcoming cap of $2 million per claimant per year as part of an effective sunset provision that may be extended. This bill brings the state's taxation of manufacturing equipment more in line with the rest of the country. Most states do not tax manufacturing equipment, but New Mexico's broader GRT and compensating taxes would apply unless the equipment is purchased through an industrial revenue bond, in which case it is exempt.

The provisions in this bill could be viewed as an improvement in tax policy, making it universally available to all taxpayers who would otherwise pay the tax. Additionally, New Mexico would no longer show up on maps and lists of states that tax manufacturing equipment, which might currently hinder the state's ability to spark interest from manufacturers to locate here. Furthermore, it avoids duplication and stacking of credits by manufacturers using industrial revenue bonds, which exempts them from paying the tax, who would then receive this credit despite no tax obligation.

Local Compensating Tax Increments

The bill creates local compensating tax increments equal to the local GRT increments, bringing the combined state and local rates for the two taxes into alignment, eliminating the existing reverse incentive to buy out-of-state to pay the lower, state-only tax rate.

Market-Based Sourcing

Market-based sourcing provides an additional measure of CIT reform by amending the Uniform Division of Income for Tax Purposes Act (UDITPA) to determine the sourcing of certain sales and services; it updates the tax code to assess the tax based on sourcing services and intangibles to New Mexico if delivered to a customer in the state or used in the state. The current assessment method using "cost of performance" does not allow New Mexico to tax companies that incur the majority of costs of providing the service or intangible outside the state but which sell to customers inside the state.

ADMINISTRATIVE IMPLICATIONS

TRD might report significant administrative complications with the effective date of January 1, 2020 for switching GRT to destination-based sourcing.

TRD will likely report a moderate operating budget impact to change systems and forms.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

There are many other bills that would similarly revise parts of the tax code. These include HB 6 SB 358, and SB 421 which also would allow for the taxation of certain interstate commerce along with many other changes to the tax code; HB 18, HB 22, HB 41, HB 165, HB 372, HB 506, HB 513, HB 515, HB 526, HB 582, HB 656, SB 11, SB 16, SB 39, SB 183, SB 242, SB 268, SB 296, SB 300, SB 347, SB 352, SB 425, SB 464, SB 466, SB 487, and SB 572 which would create or amend tax credits or deductions; HB 479, which would de-earmark local option GRTs, HB 595 and SB 348, which would provide for the remittance of GRTs to agencies and political subdivisions, SB 6, which would change the process for determining if sales are in-state, and SB 584 and SB 585, which would create local option food GRTs, reduce GRT and compensating tax rates, and alter hold-harmless GRT laws.

TECHNICAL ISSUES

NMAG noted the following possible technical issues.

- The provisions in Sections 28(F) & 31(F) that preclude the municipal compensating tax from being repealed or amended so as not to impair outstanding revenue bonds may violate legislative entrenchment principles. However, as these provisions are an attempt to comply with the Contracts Clause's prohibition against the impairment of contracts (here, revenue bonds), this may be a permitted exception to the rule against legislatures binding future legislatures.

- In Sections 3 and 4, consider changing the references to "gross receipts tax and municipal compensating tax" to "gross receipts tax *or* municipal compensating tax" to account for the possibility that only one of the two types of taxes is collected.

- In Section 7(A), the new language is somewhat confusingly worded. Specifically, it is unclear what the word "exclusively" means and modifies. Does the word mean "only?" Does it modify "department" suggesting that only TRD may undertake such an audit? Or does it modify "sales, leases and licenses" suggesting that the audit's scope is limited to sales by a seller and facilitated by the provider?

- In Section 9(A)(1), it appears that "difference between the number of dependents claimed … *minus* one" should be "difference between the number of dependents claimed … *and* one." Alternatively, the phrase "difference between" could be deleted. The same issue appears in Section 9(A)(2).

- Section 11(A)(2) does not contain a reference to the *sale* of tangible personal property. It is unclear whether this is intentional.

- In Section 14(A)(2)(g), it is unclear whether receipts collected by a marketplace provider that makes sales on its own behalf—as opposed to for a marketplace seller—is encompassed within the definition.

- In Section 19, the revisions appear to reverse the scope of the exemption from existing law. The categories of research and development services *not* exempt from taxation in existing subsection (B) becomes, post-edit, the only categories of services that *are* exempt from taxation.

- Section 21's definition of "manufacturing consumable" excludes ingredients and component parts, but also includes property "incorporated into" a manufactured product. These terms seem in tension with each other and it is difficult to discern what constitutes a "manufacturing consumable."

- The definition of "marketplace provider" in Section 12 does not appear to include the sale, lease, or license of real estate or intangible personal property, such as intellectual property. Although this may be intentional, it is worth considering which internet businesses will be excluded by these omissions.

- In Section 12(N)(3), by including digital goods but excluding intellectual property, the definition may have an inherent conflict. For example, are licenses for music—which are digital goods but also copyrights—included within the definition?

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

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