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

SPONSOR STBTC	**ORIGINAL DATE** 1/30/22 **LAST UPDATED** 2/13/22	**HB**	
SHORT TITLE Distribute Part of GRT on Svcs to Munis		**SB**	137/ec/STBTCS/aSFC
		ANALYST	Torres/Eckberg

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY22	**FY23**	**FY24**	**FY25**	**FY26**		
	$10,000.0				Nonrecurring	Municipalities

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

FY22	FY23	FY24	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Indeterminate				Recurring	DFA- General fund operating impact
$2,168.8	$322.2	$322.2	$2,813.2	Nonrecurring	TRD – General Fund Operating Impact

Parenthesis ( ) indicate expenditure decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
New Mexico Municipal League
Department of Finance and Administration (DFA)

SUMMARY

Synopsis of SFC Amendment

The Senate Finance Committee amendment strikes the appropriation. SFC amendments to HB2 provide a $10 million appropriation to the newly created "destination-based sourcing safety net fund” contingent on enactment of SB137.

The amendment also clarifies application procedures to DFA and provides a new effective date for Section 2 of October 1, 2022. Section 2 provides sourcing rules for certain GRT transactions.

Synopsis of STBTC Substitute for Bill

The Senate Tax, Business and Transportation Committee Substitute for Senate Bill 137 (SB137) creates the "destination-based sourcing safety net fund," the money of which shall be distributed every six months by the local government division of the department of finance and administration (DFA) to qualified municipalities beginning May 1, 2022 until October 2023. The distributions will be based on the amounts of revenue reduction resulting from destination-based sourcing of only services compared with the same period in 2020 beginning July 1, 2021. An appropriation of $50 million is made to this newly-created fund, and another $2.5 million is appropriated to the Taxation and Revenue Department (TRD) to implement this legislation.

The bill also removes the definition of "business location" from Section 7-1-14 NMSA 1978 of the Tax Administration Act. The bill also removes "business location" from the reporting of gross receipts from the lease of tangible property, changing it instead to location of primary use of the property. The bill also requires that sellers report their selling location for all transactions, even if receipts from that transaction is sourced to a different place. It also makes changes to the reporting of compensating tax to clarify that the reporting location is location of the first use.

The effective date of the bill is July 1, 2022 for the reporting changes and the remainder of the bill has an emergency clause and is effective immediately upon signing.

FISCAL IMPLICATIONS

The bill determines losses to a municipality based solely on the movement of services. This methodology ignores the gains to municipalities from the inclusion of goods and local compensating, including the largest gains municipalities received from the local tax base expansion from online purchases. By only focusing on services, many municipalities that have experienced a net gain in gross receipts tax revenue may qualify for funds from the state based on losses only attributable to services. This may be counter to the intent of the bill to support municipalities whose total revenues may have been harmed by the change to destination-based sourcing.

The new reporting requirements will reveal the effects of destination-based sourcing and tax payer noncompliance. By understanding the impacts of destination-based sourcing, changes to GRT sourcing could be better studied and the fiscal impacts of new changes could be clearer. TRD may be able to improve tax payer compliance by identifying noncompliant tax payers that need outreach. This is likely to be a significant addition to TRD's workload and the impact of amendments and improved compliance is unclear.

Because the Taxation and Revenue Department has only limited data since destination sourcing was implemented on July 1, 2021 – receipts from July, 2021 only having been reported by August 25, 2021, and TRD therefore only having data from July, 2021 through December, 2021 – TRD cannot estimate the clear impact on municipal revenues from that switch to destination sourcing, and therefore whether the $50 million appropriation will be sufficient. However, the bill calls for prorating distributions from the new fund if amounts in the fund are insufficient.

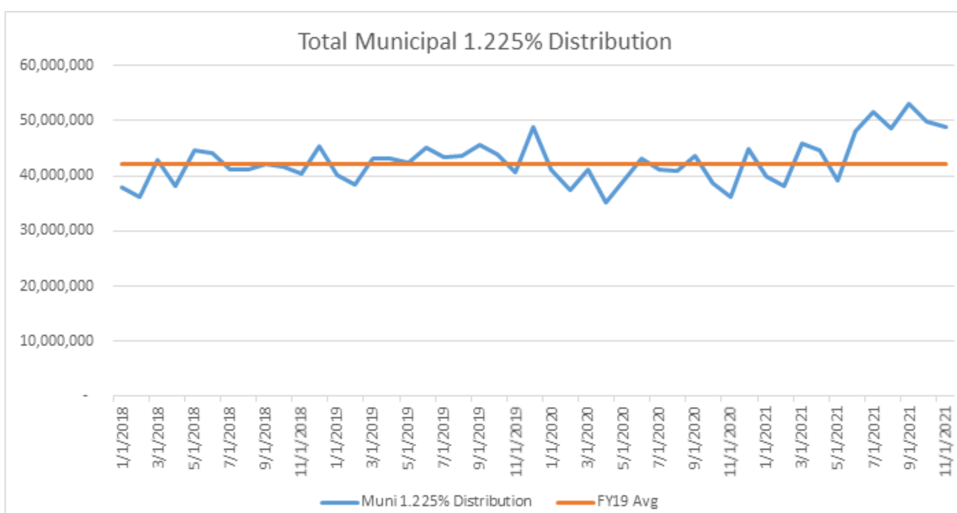
Gross receipts tax data for the first five months of destination-based sourcing show an increase in remainder-of-county matched taxable gross receipts, some portion of which is service-related change in sourcing. According to the most recent federal reserve data, 53 percent of the New

Mexico economy is service related. Fifty-three percent of the increase is likely to be closest to the service portion of the total increase and (when excluding construction and real estate) would result in an estimated cost to the state of $52 million in the first year, growing to $57 million by FY26. If even 26 percent of the total increase in remainder-of-county activity is a service-related change in sourcing excluding construction and real estate, the cost to the state and benefit to municipalities could be about $26 million. Estimating the impacts is highly difficult and unclear. More work, data, and agency analysis is needed.

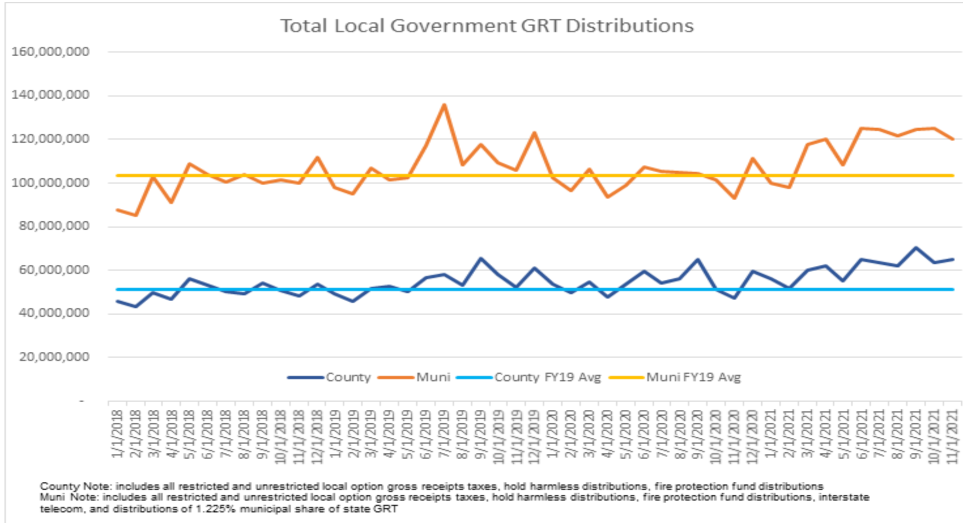
Beginning in FY22, the administration of gross receipts taxes changed from origin-based sourcing to destination-based sourcing. In general, this change requires tax to be determined by the location of the destination of the good or service rather than the previous method of determination at the location of the seller. This change allows local gross receipts taxes to be applied to out-of-state providers, leveling the playing field for New Mexico businesses. It also allows municipal and county governments to receive revenue from out-of-state sellers.

In the first five months of available tax data, total gross receipts tax revenues to the state's municipalities is up 28 percent over the same period in FY21 and up about 17 percent over FY20. The increase is in large part because of the impacts of destination based sourcing.

In the destination-based sourcing clean-up bill in the regular 2020 session (HB326), the New Mexico Municipal League stated "Some of [this bill's] ideas will produce positive revenues for local governments. For example, requiring construction services and construction-related services to be reported at the construction site (regardless of their professional nature) not only relieves New Mexico architects and engineers of lower-taxed out-of-state competition—thereby perhaps shifting business to New Mexico firms—but it also ensures that out-of-state businesses who do win contracts for New Mexico projects pay local taxes." The FIR then states "LFC staff, however, note that, in general, the change from origin (business location) sourcing to destination sourcing for "in-person" services will reduce municipal revenues and increase state revenues because the municipalities would lose the 1.225 percent state share." This was deemed appropriate given the state loss of the 1.225 percent on the much larger share of out-of-state (online) retail that would be sourced to municipalities.



The compromise was intended to increase revenues to the state, municipalities, and counties. In the first months of available data, this has occurred. In total, municipalities are receiving more 1.225 percent distributions from the state than prior to destination-based sourcing and is likely to continue to rise as tax payer behavior adjusts to the change. (See Attachment A for more information).



Providing an additional 1.225 percent distribution to municipalities will further spike municipal receipts attributed to this share causing total municipal revenues to grow even more, at the expense of the state general fund. County distributions will be unaffected by the change.

The additional distributions would support municipalities that may have been adversely affected by the change to destination-based sourcing. Destination-based sourcing may have negatively affected municipalities with tax bases concentrated in service providers whose services are located outside the municipality.

The bill requires additional reporting. The Taxation and Revenue Department has indicated the additional reporting fields will require new forms and upgrades to the GenTax system which will cost approximately $4 million. The additional reporting will enhance the ability of TRD and the Legislature to estimate the impacts of bills that affect sourcing changes and to study the effects of destination based sourcing.

SIGNIFICANT ISSUES

The Taxation and Revenue Department notes:

> The amendments to Section 7-1-14 that became effective on July 1, 2021, switching to destination-based sourcing (which means that receipts were sourced to where the product was received, and not where the seller was located) increased the tax base for New Mexico, increased equity amongst local and out-of-state sellers, and increased tax revenues [in total] to local governments…
>
> The changes, which require the reporting of a seller's location on top of the correct sourcing location for the gross receipts, will require additional taxpayer reporting requirements on gross receipts tax (GRT) tax-returns, which may reduce taxpayer voluntary compliance by adding another layer of complexity. This complexity challenges the tax policy principle of simplicity. Taxpayers incur compliance burdens as they prepare, submit, and keep records about tax returns. Likewise, TRD incurs administrative costs to collect taxes, review the accuracy of tax returns and tax payments, and bring taxpayers into compliance. The changes to GRT returns and the associated complex changes to distributions to local governments further complicates the tax code for both taxpayers and TRD. The more complicated the code, the higher the cost everyone must bear to ensure compliance.

The New Mexico Municipal League notes:

> Cities provide infrastructure, services, and economic development for businesses operating within city limits, and the local distribution allows cities to provide adequate services for local businesses. The Municipal League strongly supports restoring an important source of municipal revenue.

> Recent changes to the gross receipts and compensating taxes, coupled with uncertain economic impacts of the pandemic, have substantially increased the volatility and uncertainty of municipal finances. The Municipal League has serious concerns about ongoing erosion of cities' tax bases and taxing authority.
>
> SB137 would also create codes to identify a seller's location, in addition to existing codes for the buyer's location, providing transparency and facilitating local economic development planning. Cities currently lack comprehensive information on business activity, such as how much in GRT comes from purchases from out-of-state internet sellers. Providing cities with detailed, transparent data on business activity and trends would allow for more accurate revenue projections and allow cities to better target economic development dollars and efforts. The Municipal League supports further tax data transparency and detail.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is met with the bill's requirement to report annually to an interim legislative committee regarding the data compiled and other.

ADMINISTRATIVE IMPLICATIONS

The administration of the "Destination-based Sourcing Safety Net Fund" adds to LGD's workload without providing for additional staff. Allowing LGD to utilize $200 thousand, which represents $100 thousand for each of the next two fiscal years, as administrative costs is reasonable based on the $50 million appropriation. The $200 thousand would give LGD the flexibility to hire temporary staff to accomplish the requirements of SB137.

There may not be sufficient GRT destination-based sourcing data available for municipalities, in conjunction with TRD, to make an assessment of revenue loss by the first allocation deadline of on or before May 1, 2022.

TRD will revise standard operation procedures, regulations and publications to clarify that the reporting location for gross receipts is the location of the seller per Section 7-1-14 NMSA 1978. Changes will need to be made to the GRT and Compensating Tax returns to allow for the reporting of the additional locations.

Section 2 of this bill would have a high impact on TRD's Information Technology Division (ITD), requiring approximately 6 months of effort and $2,168,715 ($96,670 of staff workload costs and $2,072,045 of contractual resources). This estimate assumes the following: no leased vehicle gross receipts tax account type changes are needed since there are currently no location reported for this tax; no interstate telecommunications gross receipts tax account type changes are needed since county location do not currently apply to this tax; only periods that occur after the implementation is complete are subject to the distribution and reporting updates; audit working papers will be designed the same as the returns; and current revenue distribution rules do not need to be changed. This estimate will implement the bill as written and will not change if additional needs arise during the implementation or there are other things that were missed in the analysis.

Due to the nature and complexity of the effort required to implement the proposed changes in this bill, a contract with the GenTax vendor, FAST Enterprises, LLC is required. The estimate for

FAST to implement the changes in this estimate is $1,626,563 and approximately 6 months.

In addition to the contract with FAST, a contract project manager and contract business analyst will be required at approximately $257,127. Due to the nature of such an implementation, Independent Verification and Validation (IV&V) services would also be required at a cost of approximately $188,355.

Additionally, one state development resource and one state business analyst (FTEs) would be needed for the duration of the project at an estimated $96,670 of staff workload costs. After implementation is completed, one application developer, one business analyst and one database/system administrator FTE will be necessary for ongoing operations and support.

<u>Considering the effort required to implement this bill, the effective date of July 1, 2022 is not feasible, a more feasible date is October 1, 2022.</u>

TRD notes that the changes and additional complexity may also lead to taxpayers filing more amended returns, placing additional administrative cost on TRD. It is not possible to quantify such costs.

Finally, to comply with Section 1 of the bill, TRD would need to allocate staff to work with municipalities to determine whether they have experienced revenue reductions and, if so, whether such reductions are the result of the switch to destination sourcing. It is not anticipated that the data necessary to make these determinations will be available to TRD (see Technical Issues). Disputes between a municipality and TRD could absorb additional TRD resources; this impact cannot be quantified at this time.

TECHNICAL ISSUES

The bill requires TRD to work with the municipalities to determine whether a revenue reduction to a municipality is a result of the switch to the destination sourcing with respect to services. No statutory guidance is provided as to what revenue reductions are to be deemed to be a result of the switch to destination sourcing of services. Nor is there guidance as to what evidence should be presented to the Department of Finance and Administration to demonstrate that a revenue reduction is the result of the change to sourcing rules, or what to do if a municipality and TRD fail to agree on whether a revenue reduction, or part of it, is the result of destination sourcing of services, which may lead to disputes. TRD suggests that the bill include specific guidance to prevent litigation between TRD and municipalities.

The bill uses FY20 as the base year to determine whether revenues have been reduced for the municipality. This creates several issues.

First, FY20 included the first 3.5 months of the COVID pandemic, and therefore presents a distorted baseline versus more recent years. It will make it especially difficult to determine whether a revenue reduction is both a revenue reduction from an appropriate baseline level, and whether that reduction is due to destination sourcing, or other causes such as the pandemic.

Second, it will be impossible to determine for each service providing taxpayer, whether and what part of its receipts would now be sourced differently due to the change to destination sourcing. The pool of service providers is not static; that is, merely because a service provider provided a service in one year, does not mean the service was provided by that same provider in a subsequent year. Nor does each service provider provide the same services year to year, and different services may be sourced differently. The question of whether a revenue reduction is a result of changes to sourcing may therefore be contentious, as between a municipality and TRD, and difficult or impossible to determine with any degree of accuracy.

<u>Finally, each municipality has benefitted from beginning to receive local option GRT on all remote sellers since July 1, 2021. The bill should consider all the revenues municipalities are receiving including the gain from internet sales and local compensating tax coming into the local tax base by simply striking "of services" on page 3, line 17.</u>

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.

Attachments

1. Municipality Distributions of the 1.225 percent of State GRT
2. Total GRT-Related Distributions to Municipalities

IT/al/rl

Attachment 1. Municipality Distributions of the 1.225% of State GRT

Municipality 1.225% Distribution - 2021 vs 2020	
Diff July-Nov 2021 vs July-Nov 2020	
All Muni 1.225% Distrib.	**$51,500,686**
% Overall Increase	*26%*
Excl. ABQ/C&H/LC/SF	**$18,685,603**
% Increase	*24%*
Muni's Receiving a Smaller Distrib	
Diff July-Nov 2021 vs July-Nov 2020	
Municipality	**Amount**
Carrizozo	$ (35,973)
Causey	$ (11,607)
Columbus	$ (1,874)
Dexter	$ (32,457)
Dora	$ (1,380)
Elida	$ (1,853)
Encino	$ (65,393)
Grenville	$ (1,741)
Hagerman	$ (3,147)
Los Alamos County	$ (821,040)
Maxwell	$ (651)
Vaughn	$ (19,667)
Wagon Mound	$ (826)
Sum of Declines	**$ (997,609)**

Municipality 1.225% Distribution - 2021 vs 2019	
Diff July-Nov 2021 vs July-Nov 2019	
All Muni 1.225% Distrib.	**$35,004,085**
% Overall Increase	*16%*
Excl. ABQ/C&H/LC/SF	**$17,190,264**
% Increase	*22%*
Muni's Receiving a Smaller Distrib	
Diff July-Nov 2021 vs July-Nov 2019	
Municipality	**Amount**
Bayard	$ (69,347)
Carlsbad	$ (3,072,920)
Des Moines	$ (7,036)
Dexter	$ (11,811)
Dora	$ (444)
Elida	$ (731)
Eunice	$ (20,390)
Hagerman	$ (26,730)
Hobbs	$ (3,284,384)
Hurley	$ (3,518)
Loving	$ (107,120)
Lovington	$ (72,955)
Pecos	$ (23,238)
Questa	$ (81,618)
Sum of Declines	**$ (6,782,243)**

Comparison of Jul-Nov 2021 to the Same Period in 2020

- Cumulative muni 1.225% distributions from July-November 2021 are up $51.5 million from the same period in 2020
- Excluding those with the largest differences – Albuquerque, Las Cruces, Santa Fe, Carlsbad, and Hobbs – muni 1.225% distributions from July-November 2021 are up $18.7 million from the same period in 2020
- There are 13 muni's receiving smaller 1.225% distributions in 2021 vs 2020, with a cumulative decline of less than $1 million.
  - The other 93 muni's reported by TRD received larger 1.225% distributions than in 2020.

Comparison of Jul-Nov 2021 to the Same Period in 2019

- Cumulative muni 1.225% distributions from July-November 2021 are up $35 million from the same period in 2019
- Excluding those with the largest differences – Albuquerque, Las Cruces, Santa Fe, Carlsbad, and Hobbs – muni 1.225% distributions from July-November 2021 are up $17.2 million from the same period in 2019
- There are 14 muni's receiving smaller 1.225% distributions in 2021 vs 2019, with a cumulative decline from 2019 of about $6.8 million.
  - The other 92 muni's reported by TRD received larger 1.225% distributions than in 2019

Attachment 2. Total GRT-Related Distributions to Municipalities

Includes all restricted and unrestricted local option gross receipts taxes, hold harmless distributions, fire protection fund distributions, interstate telecom, and 1.225% of state share GRT

Total GRT-Related Distributions - 2021 vs 2020

Diff July-Nov 2021 vs July-Nov 2020	
All Muni GRT Distrib.	**$ 107,131,764**
% Overall Increase	*21%*
Excl. ABQ/C&H/LC/SF	**$ 41,446,678**
% Increase	*21%*
Muni's Receiving a Smaller Distrib	
Diff July-Nov 2021 vs July-Nov 2020	
Municipality	**Amount**
Carrizozo	$ (58,848)
Causey	$ (17,482)
Columbus	$ (17,145)
Dexter	$ (77,259)
Dora	$ (3,585)
Encino	$ (118,207)
Grenville	$ (3,636)
Hagerman	$ (13,754)
Maxwell	$ (3,867)
Vaughn	$ (55,313)
Wagon Mound	$ (4,920)
Sum of Declines	**$ (374,016)**

Total GRT-Related Distributions - 2021 vs 2019

Diff July-Nov 2021 vs July-Nov 2019	
All Muni GRT Distrib.	**$ 39,390,024**
% Overall Increase	*7%*
Excl. ABQ/C&H/LC/SF	**$ 23,318,764**
% Increase	*11%*
Muni's Receiving a Smaller Distrib	
Diff July-Nov 2021 vs July-Nov 2019	
Municipality	**Amount**
Anthony	$ (44,254)
Bayard	$ (207,938)
Bloomfield	$ (43,216)
Carlsbad	$ (11,823,666)
Clovis	$ (1,997,030)
Des Moines	$ (17,284)
Dexter	$ (39,905)
Dora	$ (1,492)
Elida	$ (6,884)
Eunice	$ (173,254)
Hagerman	$ (67,623)
Hobbs	$ (11,082,266)
Hurley	$ (14,642)
Las Vegas	$ (83,280)
Loving	$ (220,419)
Lovington	$ (460,229)
Pecos	$ (56,129)
Questa	$ (227,757)
Roswell	$ (1,349,749)
Ruidoso	$ (1,622,821)
Taos	$ (461,306)
Sum of Declines	**$ (30,001,145)**

Comparison of Jul-Nov 2021 to the Same Period in 2020

- Cumulative GRT distributions from July-November 2021 are up $107.1 million from the same period in 2020.
- Excluding those with the largest differences – Albuquerque, Las Cruces, Santa Fe, Carlsbad, and Hobbs – muni GRT distributions from July-November 2021 are up $41.4 million from the same period in 2020.
- There are 11 municipalities receiving smaller GRT distributions in 2021 vs 2020, with a cumulative decline of less than $400 thousand.
    - The other 95 municipalities reported by TRD received a larger total GRT distribution than in 2020.

Comparison of Jul-Nov 2021 to the Same Period in 2019

- Cumulative muni GRT distributions from July-November 2021 are up $39.4 million from the same period in 2019.
- Excluding those with the largest differences – Albuquerque, Las Cruces, Santa Fe, Carlsbad, and Hobbs – muni GRT distributions from July-November 2021 are up $23.3 million from the same period in 2019.