

Presentation to
Interim Revenue Stabilization and Tax Policy Committee
State Capitol
July 16, 2012

Gross Receipts Tax Its Design and Policy Principles

James P. O'Neill
O'Neill Consulting LLC

Transition from Emergency School Tax

Our beloved gross receipts tax is a successor to New Mexico's emergency school tax. The emergency school tax was enacted on a temporary basis in 1934 and made permanent in 1935. The "emergency" was the shortage of state revenues due to the Depression-induced collapse of the property tax system.

Sales tax was a newfangled idea back then and enactment of this tax was not without controversy. Perhaps because it replaced the property tax, one of the emergency school tax's principles turned out to be that everyone in business must contribute to the costs of the state's functions (primarily the public schools in those days). With everybody in, it was possible to charge a modest 2% tax rate.¹

The idea of bringing everyone into the taxpaying fold necessarily led to a New Mexico innovation.² Service providers also owed this tax, not just purveyors of goods. After all, the vast majority of attorneys and doctors were property owners.

Enactment of the Gross Receipts and Compensating Tax Act

By 1966 the emergency school tax had accumulated a number of barnacles. Fair and efficient administration (not to mention a need for more state revenues) demanded a revised tax. The result was the Gross Receipts and Compensating Tax Act.

The gross receipts tax was part of a consciously-designed revamping of the state revenue system.³ The first element was the Income Tax Act enacted the previous year. Other reform elements included the Resources Excise Tax (1966) and the

¹ There was an unsuccessful attempt to double the tax for sales of chain stores. Some battles are never really decided. Today the same struggle has been revived, with the target being "big box" stores.

² Early adopters of the sales tax, like Mississippi and Alabama in the late 1920s, tended to tax only sales of goods.

³ The reform effort was spearheaded by a small group of volunteers, primarily Franklin Jones, Jack Deason and Woody Woodcock.

Severance Tax Act (1971) and passage of several Constitutional amendments regarding property tax (1970s).

The gross receipts tax was designed following several principles. But before we get to that, we should look first at the tax's statutory style.

Design principle

There are two general approaches to creating tax acts. One (restrictive) is to list all the activities or elements that the jurisdiction wishes to tax and to state that anything not on the list is not taxable. The other (expansive) is to declare that all activities and elements are taxable and only those specifically identified by the tax act are not.

New Mexico clearly ran with the expansive approach. For example, Section 7-9-4 NMSA 1978 imposes the tax on the gross receipts any person engaging in business in New Mexico. "Engaging in business" is then defined as "carrying on or causing to be carried on any activity with the purpose of direct or indirect benefit". "Gross receipts" includes receipts from performing services in New Mexico. Clearly this combination sweeps in earnings of employees, never an intended part of this tax base. That is why several of the exemptions (e.g., for wages, dividends and interest, governments) function as critical components defining the tax base.

Gross receipts tax policy principles

There may be others, but this discussion focusses on three general policies embodied in the design of the Gross Receipts and Compensating Tax Act.

1. Employ as broad a base as possible. Inherited from the emergency school tax, this idea posits that everyone engaging in business has a stake in a successful society and so should contribute to its upkeep. It makes possible a low tax rate. The combination of broad base and low rate has the economic benefit of introducing the least amount of interference with the workings of the marketplace.

The conceptual point (never stated explicitly) at which the gross receipts tax is imposed is on the receipts from the transaction in which the good or service leaves the stream of commerce. The purpose of many of the original deductions is to help identify this point. Unfortunately, as the national and New Mexican economies developed, centering taxability on this point also created extensive pyramiding of tax, particularly on the services side.

2. Impose tax on the seller, not the buyer. This decision, more than the others, differentiates New Mexico's gross receipts tax from the sales or general excise taxes of most other states.

The typical sales tax imposes the tax on the buyer. In-state sellers have a duty to collect the tax from the buyer and remit the proceeds to the state. When the purchase is made from an out-of-state seller, the buyer stills has an obligation

to pay the same amount of tax but must report and pay it directly to the tax administrator.

When the buyer is the federal government, however, provisions of the federal constitution prohibit imposition of the tax. Neither a sales tax or its companion compensating tax can be imposed on federal agencies.

By imposing gross receipts tax on the seller's receipts from sales to the federal government, New Mexico was able to tap a major lode of revenue. Federal economic presence then and now is of major significance to New Mexico.⁴ New Mexico's right to adopt this approach has been sustained in two federal decisions:

White Sands: *United States v. New Mexico*, 581 F.2d 803 (10th Cir. 1978) 3-0;

Energy R&D Administration: *United States v. New Mexico*, 455 U.S. 720 (102 S.Ct. 1373, 71 L.Ed.2d 580) (1982) 9-0.

A side effect of taxing the seller is the need for making another person—the buyer—the taxpayer for compensating tax purposes. New Mexico generally has no jurisdiction over out-of-state sellers, so to impose tax at all on importation of goods or services, New Mexico must tax the New Mexico buyer, over whom it does have jurisdiction.

A corollary to taxing the seller is declaring receipts from construction to be entirely a service. Incorporating the value of materials into this service helps deter the federal government from importing materials tax-free from suppliers in other states.

3. Tie the local governments to the state tax. In 1966 a number of municipal and county governments had in force their own sales taxes which they administered locally. Their tax bases could differ from the new gross receipts tax base. The municipal taxes were swept away and replaced with a distribution from the state's gross receipts tax take.⁵⁶

One reason is to create a uniform system administered centrally to minimize administrative costs (both for taxpayers and tax collectors) and to ensure evenhandedness across the state.

Another was to build in resistance to pressure by special interests for carve-outs from the tax. Every time the state Legislature restricts the gross receipts tax base, it puts pressure on local government budgets, unless, as with the food and medical deductions, it absorbs those costs in its own budget. The initial form of the

⁴ Dependency on tapping these federal sources also makes the state vulnerable to downturns in federal spending, or at least spending in New Mexico (which some say is a function of the seniority of New Mexico's Congressional delegation).

⁵ The state's tax rate was set at 4% (from the emergency school tax's 3%) to accommodate this distribution.

⁶ County tax authorizations remained in place but, by the late 1970s, only three counties levied such taxes. The taxes had been conformed to the state base and were administered by Taxation and Revenue Department.

gross receipts tax was relatively pristine and its designers hoped to retard its degradation by ever-present forces of self-interest.

Conclusion

The two primary take-aways from this presentation are:

(1) the gross receipts tax not only is complex but is also subtle. Its key principles are nowhere set out explicitly but can be discerned only by reading a number of its provisions together; and

(2) the tight linkage between local government revenues and the state gross receipts tax base is in no way accidental.