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## FISCAL IMPACT REPORT

ORIGINAL DATE 03/01/13

SPONSOR Smith LAST UPDATED \_\_\_\_\_ HB \_\_\_\_\_

SHORT TITLE Food & Medical Tax Hold Harmless Provisions SB 540

ANALYST Walker-Moran

### REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY13	FY14	FY15	FY16	FY17		
\$0.0	\$0.0	\$14,300.0	\$29,300.0	\$45,700.0	Recurring	General Fund
\$0.0	\$0.0	(\$12,395.0)	(\$25,350.0)	(\$38,724.0)	Recurring	Local Governments**
\$0.0	\$0.0	(\$441.0)	(\$838.0)	(\$1,195.0)	Recurring	TRD Operating Fund
\$0.0	\$0.0	<b>\$1,464.0</b>	<b>\$3,112.0</b>	<b>\$5,781.0</b>	Recurring	<b>Total</b>

(Parenthesis ( ) Indicate Revenue Decreases)

\*\*The local government impact could be offset by imposing a local option GRT on the listed deductions exempted. This behavior has not been assumed in this analysis.

### SOURCES OF INFORMATION

LFC Files

#### Responses Received From

Taxation and Revenue Department (TRD)

New Mexico Municipal League (NMML)

### SUMMARY

#### Synopsis of Bill

Senate bill 540 amends section 7-1-6.46 NMSA 1978 to phase out the hold-harmless distribution to municipalities and counties that offset the food and health care practitioner (medical) deductions. The phase out begins in FY15 at 10 percent per year over 10 years until eliminated in FY24.

The bill also amends Sections 7-19D-4 and 7-20E-4, to allow municipalities and counties to impose gross receipts tax through an ordinance, which shall not be modified for a period of two years, except to conform with the Gross Receipts and Compensating Tax Act (GRCTA). The deductions that could be taxed by a municipality or a county are listed on the last page.

The bill also adds language to these Sections to allow a municipality with a population of less than ten thousand, or a county with a population of less than 48 thousand, to elect every ten years, beginning January 1, 2014, whether to impose a gross receipts tax through an ordinance that does not provide a deduction contained in the GRCTA.

The effective date of this bill is July 1, 2013. The sunset date of this bill is July 1, 2023.

**FISCAL IMPLICATIONS**

Currently, the hold-harmless has four statutory provisions – (1) municipalities of under 10,000 population and with per capita taxable gross receipts less than the statewide average for which the municipalities receive a hold-harmless distribution for food and medical services based on their current local option rate plus 1.225 percent state share GRT. (2) municipalities of under 10,000 population and with per capita taxable gross receipts greater than the statewide average and municipalities over 10,000 population for which the municipalities receive a hold-harmless distribution for food and medical services based on their local option rate as of January 1, 2007 plus 1.225 percent state share GRT. (3) counties of under 48,000 population for which the county receive a hold-harmless distribution for food and medical services based on their current local option rate; and (4) of over 48,000 population for which the county receive a hold-harmless distribution for food and medical services based on their local option rate as of January 1, 2007.

The phase out begins in FY15 at 90 percent with 10 percent reduction each year until fully eliminated in FY24. This bill is in alignment with the LFC tax policy principles.

FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24
100%	90%	80%	70%	60%	50%	40%	30%	20%	10%	0%

This bill also allows a municipality with a population of less than ten thousand, or a county with a population of less than forty-eight thousand, to elect every ten years, beginning January 1, 2014, whether to impose a gross receipts tax through an ordinance that does not provide a deduction contained in the GRCTA.

**As estimated by the Taxation and Revenue Department (TRD):**

Hold Harmless Distribution Changes: Under the current law, the hold harmless distributions are forecasted using Global Insight economic indicators: for the food distribution the indicator used is the CPI for food, and consumer spending on health care services is used for the medical distribution. The table below lists the forecast amounts of both deductions under current law. Negative numbers indicate the impact to the general fund, which is a positive impact to local governments.

<b>Current Law Distributions</b> (in thousands of dollars)	FY13	FY14	FY15	FY16	FY17
Food Hold Harmless (GF)	(104,499)	(104,820)	(105,887)	(107,427)	(108,846)
Medical Hold Harmless (GF)	(34,805)	(36,051)	(37,450)	(38,986)	(40,374)
<b>Total</b>	<b>(139,304)</b>	<b>(140,871)</b>	<b>(143,337)</b>	<b>(146,414)</b>	<b>(149,220)</b>

Under the proposed legislation, the distributions would be phased out over ten years in 10 percent increments, beginning in FY15. The following table lists the forecast impacts to the distributions. Positive numbers reflect a positive impact to the general fund, which is a negative impact to local governments.

<b>Impacts of Proposal in SB 540</b> (in thousands of dollars)	<b>FY13</b>	<b>FY14</b>	<b>FY15</b>	<b>FY16</b>	<b>FY17</b>
Food Hold Harmless (GF)	0	0	10,600	21,500	33,700
Medical Hold Harmless (GF)	0	0	3,700	7,800	12,000
<b>Total</b>	<b>0</b>	<b>0</b>	<b>14,300</b>	<b>29,300</b>	<b>45,700</b>

Small Municipality and County GRT Changes: This part of the impact is extremely hard to estimate with any degree of certainty. It cannot be predicted how counties and municipalities will react to the change in law without making some fairly broad assumptions. The different tax rates currently enacted by localities illustrates that each county or municipality faces unique circumstances and makes choices about tax increments based on those circumstances. They will necessarily make decisions based on the particular set of circumstances faced, and so the response cannot be predicted as a group.

This analysis is based on the assumption that when given the choice, municipalities and counties will act to at least preserve the level of revenue they currently receive. So, small counties are assumed to enact the newly established tax not subject to deductions, at a level that would restore the revenues lost to them with the hold harmless removal. This would allow for retaining the current level of revenue while holding rates constant or even reducing them.

Large counties and municipalities face an altogether different situation. Unable to enact a tax that is not subject to the listed deductions, these entities may likely increase tax rates to recoup any of the lost revenues. For political subdivisions that have already enacted tax options up to the point that can be added without voter approval face the potentially tough task of convincing voters to approve higher tax rates, an uncertain prospect at best. For others, the potential exists to raise rates without voter involvement, but that could still be a politically difficult decision. For this analysis, it is assumed that large counties and municipalities will not raise rates, but will choose to weather the storm of reduced revenues, as it were. The net effect is estimated to be no impact to smaller entities, and a negative impact to large ones. The table below shows impact to large cities and counties.

	<b>FY2013</b>	<b>FY2014</b>	<b>FY2015</b>	<b>FY2016</b>	<b>FY2017</b>
Municipalities Over 10k: Food	0	0	(7,181)	(14,566)	(22,135)
Municipalities Over 10k: Medical	0	0	(2,799)	(5,844)	(9,044)
Counties Over 48k: Food	0	0	(1,744)	(3,539)	(5,377)
Counties Over 48k: Medical	0	0	(671)	(1,401)	(2,168)
<b>Total</b>	<b>0</b>	<b>0</b>	<b>(12,395)</b>	<b>(25,350)</b>	<b>(38,724)</b>

It bears restating that this is a highly uncertain estimate. Some counties and municipalities already choose to have tax rates lower than the potential maximum rate. The issue of selecting tax increments is more complex than simply maximizing revenues: it is an optimization problem constrained on several fronts, not the least of which is political will. The actual outcome, therefore, could range anywhere from a large negative to a large positive impact on local governments.

## **SIGNIFICANT ISSUES**

The New Mexico Municipal League (NMML) opposes this legislation. Assuming a local government adopted ordinances in conformance with the requirements of the Gross Receipts and Compensating Tax Act and the rules of the Department, it is unclear whether adoption of the ordinance to tax any or all of the listed deductions would be subject to positive or negative referendum or could be imposed simply through adoption of an ordinance.

## **PERFORMANCE IMPLICATIONS**

As reported by the TRD: The hold harmless provisions that offset the negative revenue impacts to political subdivisions in the 2004 enactment of the food and medical deductions, reflect significant inefficiency in implementing tax policy. Although both deductions are extremely popular with taxpayers, the dislocations and burdens imposed on the General Fund have been substantial. On this basis, and recognizing the net gain to the General Fund, there is substantial foundation in efficient and effective tax policy for implementation of the provisions provided in this bill.

Since its inception, the provisions for hold harmless distributions from the food and medical deductions have had much larger impacts than anticipated. Counties and municipalities, however, have grown to expect the additional revenues provided. To make up for this, small political subdivisions are allowed to impose a local gross receipt tax not subject to deductions contained in the GRCTA. That change, in particular, will complicate the act and greatly increase the administrative burden, as described in subsequent sections of this analysis.

## **ADMINISTRATIVE IMPLICATIONS**

As reported by the TRD: There would be a very high administrative and compliance impact resulting from this piece of legislation. The phase-out of the hold harmless distributions would create a significant loss of revenue, over \$4 million when fully phased out. (For a more detailed discussion see the TRD's FIR.)

This proposal would also greatly increase the complexity of the audit process. The audit staff would need additional time to perform audits where the taxpayer has multiple locations since they will have to determine whether the local government adopted the deduction or whether the transaction in question would be deductible. The Department, along with the local governments, will have to come up with a way to educate the taxpayer's on where deductions apply and where they are taxable. This can hurt the local governments that choose tax deductions by having businesses locate to those areas where they are allowing the deduction.

Moderate IT impact (500 Hours). Distributions will need to be modified each fiscal year. The instructions and publications for the CRS tax program will need modification to explain when certain deductions do not apply within a county or municipality. There would be a need for taxpayer and department staff education.

The NMML reports that adoption of the legislation will make the administration of the Gross Receipts and Compensating Tax more complex as the Department may be required to administer up to 138 different tax bases for municipalities and counties.

## TECHNICAL ISSUES

As reported by the TRD, other legislation currently being considered may obviate the need for Section 2, 7-1-6.47(D), or may create prioritization conflicts where distributions are reduced due to this legislation. This subsection is not sufficiently clear for the Department to determine whether a local government's ability to meet debt obligations has been impaired based on the hold harmless phase-out or on economic circumstances. The solution to increase distributions to the 2013 levels would be a manual adjustment to the detriment of the General Fund, and wouldn't be something that could be automated. The amount would not be determinable in GenTax until the revenue period closed. This subsection provides neither a repayment plan nor Contingency Fund option.

## OTHER SUBSTANTIVE ISSUES

As reported by the TRD: Under the current language of Section 7-19D-4, an ordinance imposing a tax under the Municipal Local Option Gross Receipts Taxes Act must adopt the same definitions and provisions relating to exemptions and deductions as are contained in the GRCTA. Thus, there is a uniform set of deductions and exemptions available throughout the state. However, the proposed amendment appearing on page 15, lines 8-22, would allow each municipality to pick and choose which deductions under the GRCTA would be available in that municipality. This would greatly complicate administration of the GRCTA by the TRD, because determining whether a deduction was available would depend on the municipality and if that municipality had or had not provided the deduction under its local taxation ordinance. It would also lead to taxpayer confusion, as the same receipt may or may not be deductible depending on the municipality at issue.

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

**As amended in section 7-19D-4 and 7-20E-4 NMSA 1978 there are several deductions that could be taxed by a municipality or a county:**

- 7-9-46 sales to manufacturers
- 7-9-51 sale of construction material to persons engaged in the construction business
- 7-9-52 sale of construction services to persons engaged in the construction business
- 7-9-52.1 lease of construction equipment to persons engaged in the construction business
- 7-9-54.2 spaceport operations; space operations; launching, operating and recovering space vehicles or payloads; payload services; operationally responsive space program services
- 7-9-54.3 wind and solar generation equipment; sales to governments
- 7-9-54.5 test articles
- 7-9-56 intrastate transportation and services in interstate commerce
- 7-9-56.3 trade-support company in a border zone
- 7-9-57.2 sale of software development services
- 7-9-60 sales to certain organizations
- 7-9-61.2 receipts from sales to state-chartered credit unions
- 7-9-62 agricultural implements; aircraft manufacturers; vehicles that are not required to be registered
- 7-9-73 sale of prosthetic devices
- 7-9-73.2 prescription drugs; oxygen
- 7-9-77.1 certain medical and health care services
- 7-9-83 jet fuel
- 7-9-86 sales to qualified film production company
- 7-9-92 sale of food at retail food store
- 7-9-93 certain receipts for services provided by health care practitioner
- 7-9-95 sales of certain tangible personal property; limited period
- 7-9-98 biomass-related equipment; biomass materials
- 7-9-99 sale of engineering, architectural and new facility construction services used in construction of certain public health care facilities
- 7-9-100 sale of construction equipment and construction materials used in new facility construction of a sole community provider hospital that is located in a federally designated health professional shortage area
- 7-9-101 equipment for certain electric transmission or storage facilities
- 7-9-103.1 converting electricity
- 7-9-103.2 electricity exchange
- 7-9-104 nonathletic special event at post-secondary educational institution
- 7-9-106 military construction services
- 7-9-107 production or staging of professional contests
- 7-9-109 veterinary medical services, medicine or medical supplies used in medical treatment of cattle
- 7-9-111 hearing aids and vision aids and related services
- 7-9-112 solar energy systems
- 7-9-113 special fuel, dyed diesel
- 7-9-114 advanced energy deduction