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FISCAL IMPACT REPORT

ORIGINAL DATE 09/30/16
 SPONSOR Smith LAST UPDATED 10/04/16 HB _____

SHORT TITLE Tax Package SB 6/aHWMC/aHF#1

ANALYST Clark/Graeser

APPROPRIATION (dollars in thousands)

Appropriation					Recurring or Nonrecurring	Fund Affected
FY17	FY18	FY19	FY20	FY21		
\$1,500	\$0	\$0	\$0	\$0	Nonrecurring	General Fund

Parenthesis () indicate expenditure decreases

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	GF Impact from Each Bill Function
FY17	FY18	FY19	FY20	FY21		
\$1,125	\$1,500	\$1,500	\$1,500	\$1,500	Recurring	Legislative Retirement Distribution
\$4,500	\$5,900	\$6,100	\$6,300	\$6,500	Recurring	Health Care Practitioner Deduction Fix
\$4,600	\$20,000	\$20,000	\$20,000	\$20,000	Recurring	High-Wage Credit Changes
\$10,225	\$27,400	\$27,600	\$27,800	\$28,000	Recurring	Total General Fund Impact

Parenthesis () indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY17	FY18	FY19	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	Minimal	Minimal	Minimal	Minimal	Recurring	TRD Operating Budget

Parenthesis () indicate expenditure decreases

SOURCES OF INFORMATION

LFC Files

Responses Received From

Department of Finance and Administration (DFA) (provided GRT/hold harmless spreadsheet)
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of House Floor Amendment #1

The amendment strikes the \$1.5 million appropriation to the Children, Youth and Families Department to support child abuse prevention and replaces it with a nearly identical appropriation with more specific language to support home visiting services for the prevention of child abuse.

The FIR also now reflects an updated LFC estimate of \$4.6 million in savings for the high-wage jobs tax credit in FY17 after additional analysis with TRD of pending claims, claims history, denial rates, and processing times.

Synopsis of House Ways and Means Committee Amendment

The amendment removed the accelerated phase-out of hold harmless payments, leaving existing statute intact. It then changes the monthly distribution to the legislative retirement fund from \$200 thousand to \$75 thousand (or, pursuant to existing statute, one-twelfth of the amount necessary to pay out retirement benefits for the calendar year). It then removes the changes to GRT and compensating tax definitions. It then removes the cap on the high-wage jobs tax credit.

The bill appropriates \$1.5 million from the general fund to the Children, Youth and Families Department for expenditure in FY17 and subsequent fiscal years to support child abuse prevention. The appropriation is a nonrecurring expense to the general fund. Any unexpended or unencumbered balances remaining at the end of a fiscal year shall not revert to the general fund.

Finally, the bill renumbers sections and references to the sections.

Removing the cap from the high-wage jobs tax credit changes the fiscal impact for the first three years. The original bill, with the cap, would generate an estimated \$12 million in FY17, \$12 million in FY18, and \$16 million in FY19. Without the cap, all valid claims pending in FY17 must be paid without additional delay, resulting in minimal revenue in FY17, and \$20 million annually in subsequent years.

The fiscal impact for the change to the legislative retirement fund distribution was calculated by multiplying the difference between the existing and proposed monthly distribution by nine months for FY17 and 12 months for future years.

Synopsis of Original Bill

This bill has several functions as part of an effort to reform (and in some cases simplify) existing taxation and revenue laws, and each function is presented below in its own summary, fiscal impact, and significant issues sections to provide clarity regarding the impact of each function.

The functions are:

- Accelerate the food and medical hold harmless phase-out,
- Change gross receipts tax and compensating tax definitions to include certain out-of-state sellers,
- Restrict the health care practitioners deduction to health care practitioners, and
- Fix loopholes and limit eligibility requirements for the high-wage jobs tax credit and impose an annual cap.

The bill contains an emergency clause and would become effective immediately upon signature by the governor.

Accelerating Phase-Out of the Hold Harmless Distributions

The bill accelerates the phase-out of the hold harmless distribution by 1 year, with ½ year acceleration pertaining to FY 17. This will reduce hold harmless percentage from 86 percent to 76 percent for the last two quarters of FY17 and from 82 percent to 76 percent for FY18. The hold-harmless distributions first enacted in Laws 2004, Chapter 116 were phased out over a fifteen year time frame in 2013 legislation. The phase-out and this acceleration apply to both the food and the health care practitioner services deduction hold harmless distributions to counties and municipalities.

In addition to these two provisions, the bill also simplifies 7-1-6.46 and 7-1-6.47 NMSA 1978 by defining a “maximum distribution amount” which takes into account the size of the county or municipality and whether the county or municipality has in effect a municipal hold harmless gross receipts tax and makes other technical changes.

The effective date of these provisions is January 1, 2017.

Change gross receipts tax and compensating tax definitions to include certain out-of-state sellers

This bill changes definitions to exclude any person without physical presence in the state and with less than \$100 thousand in average gross receipts during the prior calendar year from gross receipts tax (GRT) and compensating tax liability. By specifically excluding those with less than \$100 thousand in receipts, the bill therefore includes larger out-of-state sellers. The intent appears to be to allow for collection of taxes from internet vendors. The bill also prohibits the Taxation and Revenue Department (TRD) from enforcing the collection of GRT for a tax period prior to April 1, 2017 if the person lacked physical presence in the state and did not report taxable gross receipts for the period.

The effective date of these provisions of the bill is January 1, 2017.

Restrict Health Care Practitioners Credit to Practitioners

The bill amends the medical services gross receipts tax deduction (7-9-77.1 NMSA 1978) and the health care practitioners tax deduction (7-9-93 NMSA 1978) to address a recent hearing officer’s decision in the HealthSouth Rehabilitation Hospital dispute, where the hearing officer determined a hospital can take the health care practitioners deduction. This bill reinstates the presumed original intention of the deduction. The bill also simplifies the statute by defining in one place the meaning of the phrase, “health care practitioner.”

Finally, the relevant provisions of this bill add a penalty for incorrectly filing for the food and medical deductions that result in hold harmless distributions instead of other exemptions or deductions which must be taken first. The penalty is equal to 20 percent of the value of the hold harmless distribution resulting from the incorrect deduction.

The effective date of these provisions is the first day of the month following the date this act takes effect. If the bill passes with a supermajority in each house, this will be for receipts accrued on or after November 1, 2016. If the bill passes, but with a simple majority, this date will likely be for receipts accrued on or after February 1, 2017.

High-wage jobs tax credit changes and annual cap

This bill changes the eligibility requirements to qualify for the high-wage jobs tax credit and requires annual filing, whereas current statute allows filing for multiple qualifying periods at once, leading to dramatic swings in the amounts of credits and refunds paid out in a particular fiscal year. The bill's primary purpose is to close loopholes in existing statute that allowed the cost of the tax credit to increase by well over an order of magnitude within a few years and also allowed apparently unintended recipients to receive the credit. The bill also removes employee benefits from the calculation of the credit value. Finally, the bill adds a cap of \$24 million for approved claims in any fiscal year beginning with FY17.

The provision of the bill adding a cap to the credit becomes effective immediately, but all other provisions related to the high-wage jobs tax credit apply to credit applications filed on or after January 1, 2017.

FISCAL IMPLICATIONS

Accelerating Phase-Out of the Hold Harmless Distributions

The impact of this bill has been determined from a spreadsheet assembled by TRD and DFA economist members of the Consensus Revenue Estimating Group (CREG). A spreadsheet showing the FY 17 through FY 21 impacts by County or Municipality is appended to this FIR.

Large municipalities, including Alamogordo, Albuquerque, Artesia, Carlsbad, Clovis, Deming, Espanola, Farmington, Gallup, Hobbs, Las Cruces, Las Vegas, Los Lunas, Lovington, Portales, Rio Rancho, Roswell, Santa Fe, Silver City, and Sunland Park will contribute about \$5.9 million, or 80% of the FY 18 impact of the acceleration. The small municipalities of Corrales, Reserve and Springer will contribute \$5.1 thousand, or .07% of the FY 18 total.

The large counties Bernalillo, Chaves, Curry, Dona Ana, Eddy, Lea, McKinley, Otero, San Juan, San Miguel, Santa Fe and Valencia will contribute about \$1.42 million, or 19% of the FY 18 total.

The small counties of Cibola, Colfax, De Baca, Grant, Luna, Mora, Roosevelt and Sierra will contribute about \$83 thousand, or 1% of the FY 18 total.

See Appendix A for a detailed table of the impacts to counties and municipalities.

Change gross receipts tax and compensating tax definitions to include certain out-of-state sellers

The estimated fiscal impact is particularly uncertain due to a lack of data from which to develop a detailed analysis. These are highly imprecise estimates based off projections from Alabama’s recent experience with taxing internet sales and adjusted for the smaller population in New Mexico and the differential in the tax rates.

Restrict Health Care Practitioners Credit to Practitioners

The RP-500 for June 2016 indicated refunds of \$19 million to \$21 million were paid to an undetermined number of taxpayers. From the report RP-80, NAICS 622, hospitals show refunds of about \$11 million, while medical and diagnostic laboratories were paid \$9 million in refunds. This is, however, for an unknown number of tax payers over an unknown number of tax periods.

Jun 16 over Jun 15

NAICS Description	Count	Gross Receipts	Gross Tax	Food-Med Deduction	Food-Med Tax
621510 - Medical and diagnostic laboratories	89	\$13,908,511	(\$9,046,459)	\$152,145,569	\$5,092,375
622 - Hospitals (USA/CAN/MEX)	110	\$66,326,968	(\$11,803,790)	\$252,447,223	\$7,558,661

The fiscal impacts in the table are a best guess as to the ongoing impact of the enabling decision and order and represents the increase in required hold-harmless distributions. The fiscal impacts listed do not attempt to estimate the savings from the penalty provision requiring taxpayers to file deductions correctly, but the savings could be significant, so the impacts shown are likely conservative estimates.

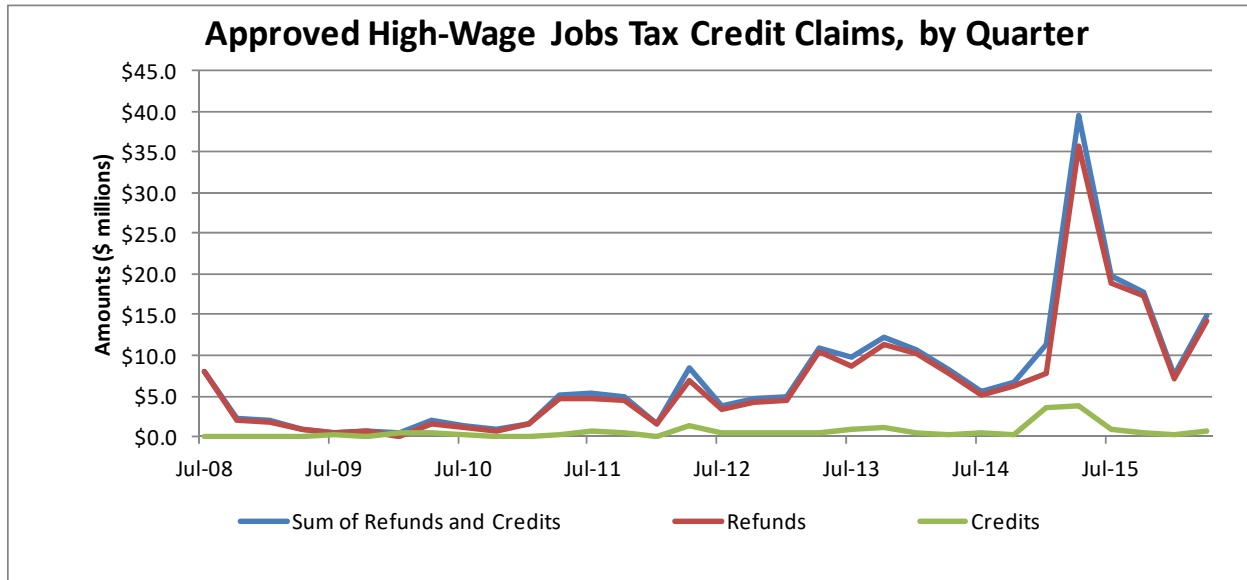
For the entire health care sector, state receipts average 53% of the total collections, while local governments average 47% of total collections.

High-wage jobs tax credit changes and annual cap

Due to the recent volatility in credit claims, it is difficult to estimate the value of claims in future years and even more difficult to estimate the savings this bill would generate. The fiscal impact uses a baseline estimate of \$36 million in approved annual claims for fiscal years 2017 and beyond absent the impact of this bill. By eliminating extractive, construction, and retail industries, the savings should be nearly half the current cost. By narrowing other rules, clarifying definitions, and removing benefits from the calculation of the credit value, the total savings should be greater than half, and potentially significantly greater. The estimated savings from all provisions of the bill except for the cap is \$20 million beginning in FY18 from the baseline of \$36 million, and this appears to be a reasonable estimate of the magnitude of the impact. The savings from these provisions in FY17 are close to zero because of the effective date of the provisions and the timeline for the Taxation and Revenue Department to review and approve claims.

However, the bill also contains a cap of \$24 million, creating a savings of \$12 million in FY17. The remaining \$12 million of claims get pushed into FY18, delaying payment to the eligible companies by one year. The cap holds down payments to \$24 million again in FY18, creating

another savings of \$12 million and pushes out \$4 million of new claims into FY19. Beginning in FY19, the savings from the other provisions of the bill presumably become more effective than the cap in reducing costs, leading to a savings of \$16 million in FY19 and \$20 million in future years. Again, the cost of this credit and any savings from adjustments are highly uncertain, so the cap creates a much greater level of certainty in total maximum cost to the state.



SIGNIFICANT ISSUES

Accelerating Phase-Out of the Hold Harmless Distributions

A number of proposals have surfaced since the phase-out was introduced in the 2013 session as a means of reducing the general fund's financial burden of funding 2004's hold-harmless distribution.

The 2013 enactment of a phase-out of the hold harmless distribution for larger municipalities (over 10,000 population) and counties (over 48,000 population) and smaller municipalities and counties which have imposed a local option hold harmless gross receipts tax (three municipalities and eight counties) was an intermediate step towards eliminating this provision. The general fund distributed an average of \$137 million to cities and counties during the FY13, FY14, and FY15 periods. While the existing statutory provision for hold harmless phase-out will reduce this amount to an estimated \$29 million in FY30, it will not eliminate the distribution.

Change gross receipts tax and compensating tax definitions to include certain out-of-state sellers

The following analysis contains historical and technical details from the New Mexico Tax Research Institute related to internet taxation issues.

In 1992, the U.S. Supreme Court in the Quill case said that some physical presence was necessary for a state to assert a sales tax collection obligation on a person selling to purchasers in a state. There was no internet retail commerce in 1992. Fast forward, and the volume of dollars at issue is huge and growing. Budget woes and fairness concerns have focused attention on overturning Quill, which was the genesis of the Streamlined Sales and Use Tax Agreement and proposed federal legislation including the Marketplace Fairness Act.

It was never entirely clear to what extent Quill’s physical presence rule applied to state taxes generally. In the early years, some states assumed it applied to all taxes, including business profits or corporate income taxes, for example. But over the years, as the limits of the case have been tested in the lower courts, there have been only a very few instances in which state courts found that it applied outside of the sales and use tax collection area. Nor has the U.S. Supreme Court ever expanded Quill’s scope. Therefore, the majority of states now hold that the case’s physical presence limit does not apply to income taxes. And Washington state, which has a broad gross receipts tax has successfully argued that it doesn’t apply to that tax. Ohio, with a similar tax, has taken a similar position, although the case is still being litigated.

States have also argued that physical presence may take different forms; for example, New York’s “Amazon” click-through nexus law (adopted by other states as well) has successfully established that internet sellers who have third-party representatives in the state promoting the sellers’ websites have physical presence. States also adopted “work-around” solutions like Colorado’s information reporting requirements which have been litigated in the Direct Marketing Association (DMA) case. In a recent opinion in that case, (which was before the U.S. Supreme Court on a procedural issue) Justice Kennedy suggested Quill’s physical presence rule is outdated.

Alabama, South Dakota and others have now enacted legislation designed to provide the basis for a challenge to Quill. Large internet sellers are responding, in many cases, by simply agreeing to begin paying tax.

One important development in the Direct Marketing Association (DMA) case affects New Mexico directly. In that case, the 10th Circuit Court of Appeals (our federal circuit) held that Quill was limited to sales and use tax reporting obligations exclusively. DMA filed a petition with the Supreme Court on another issue but chose not to appeal the question of whether Quill’s physical presence limit applies to anything other than sales and use tax collection requirements. So in this circuit, at least, the issue is settled. There is no longer any reason to assume that Quill applies to our gross receipts tax—which is substantially different from a sales tax collection obligation.

The legislative intent behind our gross receipts tax “engaging in business” statute has long been much broader than the physical presence requirement of Quill. But enforcement of the tax was constrained on the assumption that Quill applied. The Legislature can now provide clarification that, given all these developments, there is no longer any reason to make that assumption.

Even if one were to take the position our tax is the equivalent of a sales tax (and it’s clearly not structured that way), we are still unlikely to see litigation challenging the position that Quill’s limit does not apply. This is because other aspects of the gross receipts tax makes it much simpler to comply with than a sales tax. Most importantly—there is a single statewide rate. And also, the tax does not have to be charged separately by the seller, so that unlike a sales tax, no purchaser can challenge the seller’s chosen method of recovering the tax—whether through separate statement or building it into the price of products sold.

Large remote seller marketplace providers and platforms are currently picking and choosing which state taxes they will comply with based on their assessment of the risks of litigation. “Squeaky wheel” states are getting the grease—more than they expected—as sellers determine it is better to simply comply than continue to fight. New Mexico is fortunate in that, if we want to

join the 14 or more states that are pushing back on Quill’s limitation, we have even more sound policy and legal reasons to do so now. And the approach for us is simpler than it is for the traditional sales and use tax states.

The approach in the proposed legislation amending the engaging in business statute could prove the fastest approach at improving voluntary compliance by remote sellers. It simply clarifies that it is now clear that Quill’s limitation does not apply to the tax and, at the same time, provides an exception for a small businesses that has limited receipts and no physical presence. It further ensures that there will be no looking backward on unsuspecting taxpayers who may have assumed that Quill applied to the gross receipts tax.

Restrict Health Care Practitioners Credit to Practitioners

According to the recent hearing officer’s decision and order, private hospitals and diagnostic laboratories, staffed with defined health care practitioners, can claim the 100% deduction for payments for these practitioner’s services made by Medicare, Medicaid, Tricare, or any third party insurance company. The presumed intent of this deduction was to provide some tax benefit to the practitioner directly as an incentive to retain these practitioners in the state. The bill makes clear that the deduction is available for receipts of the practitioner (not the employer) for provision of medical and other health services by the practitioner.

The testimony in 2003 indicated that the purpose of adding medical services deductions to the more controversial food deduction and hold harmless was to assist in retaining physicians, particularly those practicing in rural areas because a substantial portion of their receipts were paid by Medicare, Medicaid, or third party insurance carriers who paid the doctor’s bills based on regional average billing costs. The tax could not be passed forward to the patient. The bill requires the department to compile an annual report on the number and amount of deductions and other information to allow evaluation of the effectiveness of the deductions. The bill eliminates a delay until 2020 and now requires annual reports on effectiveness to be presented to the Legislature.

Changes in this bill will now require annual reports to an interim legislative committee. It is not known if that report will conclude that the health care practitioner deduction has had any substantial effect – either directly in terms of health care practitioners or indirectly in terms of average medical costs compared to the region.

High-wage jobs tax credit changes and annual cap

The loopholes in the original credit statute, and those still remaining in existing statute, combined with soaring costs far beyond original projections have led national organizations such as the Pew Charitable Trusts to use this credit as an example of a poorly drafted economic development incentive. This credit is used as a warning to other states to more carefully consider potential loopholes when designing credits.

The high-wage jobs tax credit is intended for economic-base companies, typically defined as only those manufacturing and service companies that export their goods and services outside the state, thereby bringing new dollars into the economy. Extractive and retail industries are not typically considered to be economic-base companies, but many of these companies have received credits and refunds under this statute over the last several years.

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Current statute allows companies to file for the maximum four qualifying periods (years) individually or all at once with enough leeway in the timeframe to potentially allow companies to claim four years of credits for a job created nearly six years ago. This bill requires annual filing to smooth out the general fund impact on a fiscal year basis.

ADMINISTRATIVE IMPLICATIONS

There would be positive and negative administrative implications for the Taxation and Revenue Department. Some issues and processes are streamlined, but in other cases additional documentation from applicants is required or department systems and forms updates are required. The overall impact should be minimal.

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

JC & LG/jle

Appendix A: Approx. Distribution Reductions From Accelerating Hold Harmless Phase-Out (thousand \$)

	<u>FY17</u>	<u>FY18</u>	<u>FY19</u>	<u>FY20</u>	<u>FY21</u>
Bernalillo	-\$630	-\$652	-\$673	-\$811	-\$836
Chaves	-\$37	-\$39	-\$40	-\$48	-\$50
Cibola	-\$9	-\$9	-\$10	-\$12	-\$12
Colfax	-\$3	-\$3	-\$3	-\$3	-\$4
Curry	-\$30	-\$31	-\$32	-\$38	-\$39
De Baca	-\$1	-\$1	-\$1	-\$1	-\$1
Dona Ana	-\$106	-\$109	-\$113	-\$136	-\$140
Eddy	-\$17	-\$18	-\$19	-\$22	-\$23
Grant	-\$22	-\$23	-\$24	-\$29	-\$30
Lea	-\$16	-\$17	-\$17	-\$21	-\$21
Luna	-\$15	-\$15	-\$16	-\$19	-\$20
Mckinley	-\$88	-\$91	-\$94	-\$113	-\$116
Mora	-\$1	-\$1	-\$1	-\$1	-\$1
Otero	-\$23	-\$24	-\$25	-\$30	-\$31
Roosevelt	-\$20	-\$20	-\$21	-\$25	-\$26
San Juan	-\$161	-\$166	-\$171	-\$207	-\$213
San Miguel	-\$17	-\$18	-\$18	-\$22	-\$23
Santa Fe	-\$211	-\$218	-\$225	-\$271	-\$280
Sierra	-\$10	-\$10	-\$11	-\$13	-\$13
Valencia	-\$37	-\$38	-\$39	-\$48	-\$49
<u>County Total</u>	-\$1,452	-\$1,503	-\$1,551	-\$1,870	-\$1,928
Alamogordo	-\$160	-\$165	-\$170	-\$205	-\$212
Albuquerque	-\$2,356	-\$2,439	-\$2,517	-\$3,033	-\$3,127
Artesia	-\$66	-\$69	-\$71	-\$85	-\$88
Carlsbad	-\$118	-\$122	-\$126	-\$152	-\$157
Clovis	-\$156	-\$162	-\$167	-\$201	-\$207
Corrales	-\$1	-\$1	-\$1	-\$1	-\$2
Deming	-\$67	-\$70	-\$72	-\$87	-\$89
Espanola	-\$73	-\$75	-\$78	-\$94	-\$97
Farmington	-\$359	-\$372	-\$384	-\$462	-\$477
Gallup	-\$182	-\$189	-\$195	-\$235	-\$242
Hobbs	-\$119	-\$123	-\$127	-\$153	-\$158
Las Cruces	-\$553	-\$572	-\$591	-\$712	-\$734
Las Vegas	-\$71	-\$73	-\$76	-\$91	-\$94
Los Lunas	-\$113	-\$117	-\$121	-\$146	-\$150
Lovington	-\$32	-\$33	-\$34	-\$41	-\$43
Portales	-\$51	-\$53	-\$54	-\$65	-\$67
Reserve	-\$1	-\$1	-\$1	-\$2	-\$2
Rio Rancho	-\$256	-\$265	-\$274	-\$330	-\$340
Roswell	-\$190	-\$197	-\$203	-\$245	-\$253
Santa Fe	-\$683	-\$707	-\$729	-\$879	-\$906
Silver City	-\$96	-\$99	-\$102	-\$123	-\$127
Springer	-\$2	-\$3	-\$3	-\$3	-\$3
Sunland Park	-\$6	-\$7	-\$7	-\$8	-\$8
<u>Muni Total</u>	-\$5,714	-\$5,914	-\$6,103	-\$7,356	-\$7,584
<u>Local Total</u>	-\$7,167	-\$7,417	-\$7,655	-\$9,225	-\$9,511