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

SPONSOR Sanchez **ORIGINAL DATE** 2/21/19 **LAST UPDATED** 3/09/19 **HB**

SHORT TITLE Chemical & Reagent Gross Receipts **SB** 549/aSFC

ANALYST Clark

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY19	FY20	FY21	FY22	FY23		
$0	No Fiscal Impact Under Current Rulings, See Fiscal Implications				Recurring	General Fund
$0	No Fiscal Impact Under Current Rulings, See Fiscal Implications				Recurring	Local Governments

Parenthesis ( ) indicate revenue decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of SFC Amendment

The Senate Finance Committee amendment removes the changes to the chemicals and reagents deduction in the original bill and adds new language after the 18 tons provision stating the 18 tons provision only applies to a hard-rock mining or milling company for use in any combination of extracting, leaching, milling, smelting, refining, or processing ore at a mine site.

This language restricts what type of taxpayer may claim the deduction using the 18 tons provision. However, it is possible that while this language may or may not restrict the companies that may use it compared with those who are currently claiming it, the language might also be broadening the application of this provision to those companies. The Taxation and Revenue Department will need to provide analysis to determine if this amendment would create a positive, neutral, or negative fiscal impact.

Synopsis of Original Bill

Senate Bill 549 amends the chemicals and reagents gross receipts tax (GRT) deduction, 7-9-65 NMSA 1978, to strike a provision allowing receipts from selling chemicals or reagents in lots in excess of 18 tons to be deducted from GRT.

The effective date of this bill is July 1, 2019.

FISCAL IMPLICATIONS

Tax refund protests denied by the Taxation and Revenue Department (TRD) and the Administrative Hearings Office (AHO) indicate taxpayers are attempting to use this deduction in ways not previously accepted. TRD reported in its analysis, "Between December 2014 and the present time, the department received and denied approximately 30 refund claims from various taxpayers…. The department is not aware of any past use of that deduction prior to its attempted use by the taxpayers who filed refund claims in recent years."

Because all three recent AHO decisions regarding this deduction were in favor of the state, which are legally binding unless overturned by the courts, and based on this information from TRD, it appears there would likely be no fiscal impact to striking this provision. However, if the courts overturned one or more of the AHO decisions, this bill could potentially save the general fund and local governments $100 million or more annually.

TRD provided the following additional explanation.

> Because this deduction is not separately reported to the department, it is not known if the deduction has ever been used by any taxpayer at any time in the past. Although the department's position, which was supported by AHO, is that refund claims filed pursuant to Section 7-9-65 NMSA 1978 are not valid, there is a potential for a higher court to rule against the department. If higher courts uphold AHO's decision, the bill will have no fiscal impact. However, if a higher court reverses AHO's decision, this bill may help protect against very large future general fund and local revenue losses. The general fund impact as a result of revenue preserved could be as high as $150 million per year, and the potential impact to local governments could be as high as $100 million per year.

Estimating the cost of tax expenditures is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. The statutory criteria for a tax expenditure may be ambiguous, further complicating the initial cost estimate of the expenditure's fiscal impact. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures.

SIGNIFICANT ISSUES

At the September 2018 Revenue Stabilization and Tax Policy Committee hearing, TRD recognized protests related to the chemicals and reagents deduction as the "single largest risk category [of tax refund protests] from a financial perspective." The agency identified about $250 million in tax refund protests related to this deduction. This estimate might not include protest

claims for operations in FY17 or FY18, so the value of the claims could have had potential to grow by hundreds of millions of dollars.

TRD testified certain industries were claiming this deduction in a way it had never before been used. Industries attempting to exploit this provision as a tax loophole include utilities (sales of coal and natural gas for electricity) and the oil and gas industry (presumably for fracking). The agency testified that most of the protests for this deduction are not related to utilities – meaning the primary issue at stake is claims by the oil and gas industry.

AHO previously denied claims by a coal company to use the deduction against for its sale of coal to a power company and by an electric power company for its purchase of natural gas. Both decisions were appealed.

An AHO decision and order issued in February 2018 (number 19-05) related to this deduction and its attempted use for fracking found in favor of the state, at least temporarily settling the majority of the value under protest, although the taxpayers may appeal to the Court of Appeals. This decision can be found at the following link:
http://realfile.tax.newmexico.gov/19-05%20Halliburton%20Energy%20Services%20Inc.pdf
TRD provided the following summary of the AHO decision, although this covers just part of the decision. The entire document is 83 pages.

> The taxpayer provides hydraulic fracturing, or "fracking," services to oil and gas companies. The primary issue to be decided in the case was whether the taxpayer was selling products to their customers when it performed fracking. The process involves pumping into the well a mixture of water and certain chemicals to make the well more productive. TRD argued that the tangible chemicals are consumed as part of the performance of the service rather than sold. The taxpayer argued that under the "predominant ingredient test," where the relative costs of the chemicals are measured against the costs of the service, the chemicals could be considered the sale of a product and would qualify for a deduction under Section 7-9-65 NMSA 1978.
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> The hearing officer, however, determined that a plain language reading of the statute showed that the Legislature intended to distinguish between the sale of chemicals and the sale of a service. The statute provides for a deduction for certain chemicals sold that will be then used in performing various processes, but this is distinct from the sale of a service that uses the chemicals as an ingredient in performing the process. The hearing officer found the test suggested by the taxpayer to determine if the sale was a service did not recognize the intent of the statute and as interpreted by the taxpayer would almost always result in every challenge to the deduction concluding that the transaction was a sale of tangibles.
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> Regulation 3.2.205.10 NMAC states that when tangible property is consumed in the performance of a service the tangible property is not sold, making the chemicals consumed in fracking not a sale of tangible property. Moreover, the hearing officer observed that fracking has been interpreted as performing services by several other states in the decisions of their state supreme courts. This having been decided, the hearing officer ordered the protest denied.

TRD provided the following analysis.

To date, refund requests denied by the department have totaled over $200 million for tax periods ranging from 12/31/2010 to 12/31/2017. Not all taxpayers have requested a refund for that entire period; it is virtually certain that some taxpayers, as ongoing businesses, continue to engage in transactions that could be argued to be deductible under this section.

In June 2016, the first decision and order on these refund claims was released by AHO (*In the Matter of the Protest of Tucson Electric Power Company*, D&O 16-29), finding that natural gas flowing through the pipeline did not constitute "lots" as required by the statute. That taxpayer appealed this matter, and the appeal is still pending in the Court of Appeals. Either party can further appeal the decision of the Court of Appeals to the New Mexico Supreme Court.

In July 2017, AHO entered its second decision and order related to Section 7-9-65 (*In the Matter of the Protest of Peabody Coal Company*, D&O 17-34), finding that coal did not constitute a "chemical" within the meaning of the statute, because when it is burned to generate energy, it is not burned to "produce a chemical reaction" as defined in the relevant regulation. This decision has likewise been appealed by the taxpayer, and that appeal is also still pending in the Court of Appeals.

Finally, in February 2019, AHO issued the third decision related to Section 7-9-65 (*In the Matter of the Protest of Halliburton Energy Services, Inc.*, D&O 19-05), again finding in the Department's favor by concluding that when a hydraulic fracturing company uses chemicals in the process of fracking, and charges the customer for these chemicals, the chemicals are not being sold – they are consumed in the performance of a service. Since no sale of chemicals occurs, Section 7-9-65 is inapplicable. Because the AHO ruled on the threshold issue of whether a separate sale of chemicals even occurred, the issue of whether fracking chemicals are sold in lots in excess of 18 tons was not given much discussion by AHO. Additionally (although this fact was not relied upon by AHO), Section 7-9-65 was passed in 1964, whereas hydraulic fracturing did not become a large-scale commercial undertaking for at least another decade – it is therefore highly unlikely that the statute was intended to be broad enough to apply to fracking. This protest was particularly notable because it involved three consolidated refunds totaling approximately $84 million.

It should be noted that all three decisions involve different issues (briefly, what is a "lot", what is a "chemical" and what is a "sale" within the meaning of this statute). It should also be noted that these are all refund cases – that is taxpayers seek to receive state and local gross receipts taxes that have already been collected and distributed. Further, as noted above, additional claims for tax periods already passed could still be filed, and the potential for a different decision from a higher court could place those revenues in jeopardy.

The department's position, which has been upheld by AHO, has been and remains that the statute was never intended to be applied as broadly as claimed by these taxpayers. However, because there is still a potential for a different decision by a higher court, the department recommends either striking the entirety of Section 7-9-65 or striking the language related to 18 ton lots as done in this bill. This will ensure that any future

decision by a higher court that allows the refund claims will not affect recurring state and local revenue in future fiscal years without raising taxes based on past usage.

ALTERNATIVES

Taxpayers are attempting to use this deduction in ways determined to be impermissible by TRD and AHO, and TRD reports it is unaware of any allowed use of the deduction prior to the denied refund claims in recent years. Therefore, as suggested by TRD, the deduction could be repealed as an alternative to striking the 18 tons provision.

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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