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

**SPONSOR** HWMC **ORIGINAL DATE** 2/12/16 **LAST UPDATED** 2/15/16 **HB** 377/HWMCS

**SHORT TITLE** PPHSW - Gross Receipts Deduction Evidence **SB**

**ANALYST** Graeser

## REVENUE (dollars in thousands)

| Estimated Revenue | | | | | Recurring or Nonrecurring | Fund Affected |
|---|---|---|---|---|---|---|
| **FY16** | **FY17** | **FY18** | **FY19** | **FY20** | | |
| | ($840.0) | ($840.0) | ($840.0) | ($840.0) | Recurring | General Fund |
| | ($560.0) | ($560.0) | ($560.0) | ($560.0) | Recurring | Local Governments |

Parenthesis ( ) indicate revenue decreases

**SOURCES OF INFORMATION**
LFC Files

Responses Received

Taxation and Revenue Department (TRD)

## SUMMARY

Synopsis of Bill

House Ways and Means Committee Substitute for House Bill 377 allows a taxpayer to claim a gross receipts tax (GRT) deduction (except the deduction under Section 7-9-46 NMSA 1978) when they are not in possession of a nontaxable transaction certificate (NTTC) if the seller or lessor can demonstrate, by a preponderance of the evidence, the facts necessary to establish they are entitled to the deduction. A seller or lessor will only be allowed to provide this evidence if they are under audit by the Taxation and Revenue Department (TRD) or in an administrative appeal before the Hearing Office.

There is no effective date of this bill. It is assumed that the new effective date is 90 days after this session ends (May 18, 2016). Ordinarily, tax bills should have a January 1 or July 1 effective date. However, in this case, that requirement is not necessary.

## FISCAL IMPLICATIONS

TRD notes the following: "This substitute bill is largely a procedural bill that expands the forms of proof a taxpayer may provide to substantiate entitlement to a deduction. In theory, there should be no revenue impact. However, in practice, and due to the statutory requirement for the possession of NTTCs, taxpayers whose underlying transactions qualify for a deduction sometimes are disallowed deductions. Assuming that at least some taxpayers can provide alternative evidence, this procedural change will result in some additional revenue loss. That loss, however, cannot be quantified for several reasons. First, gathering accurate statistical information would require a taxpayer-by-taxpayer review of GRT audit files. Second, even if TRD could quantify the deductions disallowed for lack of NTTCs, it has no way to quantify the portion of those deductions that could be substantiated with alternative evidence."

However, LFC has access to aggregate data, as follows:

| | | FY 14 | FY 15 | FY 16 | Average |
|---|---|---|---|---|---|
| **Deposits Matched** | | | (Dollars in Millions) | | |
| Assessment Payment | $129.6 | $134.4 | $134.2 | $139.5 | $134.4 |
| Amended | $1.2 | $3.0 | $1.2 | $31.7 | $9.3 |
| Audit | $12.1 | $18.6 | $14.5 | $10.6 | $14.0 |
| Return | $4,430.9 | $4,608.6 | $4,920.3 | $4,925.6 | $4,721.3 |
| Deposit Matched Total | $4,574.4 | $4,764.7 | $5,070.5 | $5,107.4 | $4,879.2 |
| Assessment Payment % | 2.8% | 2.8% | 2.6% | 2.7% | 2.76% |
| Amended % | 0.03% | 0.06% | 0.02% | 0.62% | 0.19% |
| Audit % | 0.26% | 0.39% | 0.29% | 0.21% | 0.29% |
| Return % | 96.9% | 96.7% | 97.0% | 96.4% | 96.8% |
| | | | | | 100.00% |

Over the last few years, CRS taxes, including the Gross Receipts Tax, Local GRT, Compensating Tax, Withholding Tax, Leased Vehicle GRT and Leased Vehicle Surcharge payments have averaged $4.9 billion a year. Of this total, $14 million or .29% of the total is attributed to payments on audit assessments. If 10% of this amount is at risk from the provisions of this bill, then the amounts are as shown in the table.

This bill may be counter to the LFC tax policy principle of adequacy, efficiency and equity. Due to the increasing cost of tax expenditures revenues may be insufficient to cover growing recurring appropriations.

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

House Ways and Means Committee Substitute for House Bill 377 proposes to overturn a general gross receipts tax rule that has been in place since 1968. The New Mexico gross receipts tax equivalent of a "resale certificate" is called a "non-taxable transaction certificate." In current statute, an NTTC should be in the hands of the seller of goods or services at the time the return is due for receipts from the transaction. When a taxpayer has been selected for audit, the taxpayer has 60 days from the date of the notice to get all required NTTCs in place, otherwise the claimed deduction will be disallowed. This bill seeks to repeal the current rule and replace it with a standard that would allow, "the preponderance of evidence" that a deduction is valid. Sellers of tangible property incorporated in a manufacturing process or consumed in the process of manufacturing must have a valid NTTC available at the time of audit and preponderance of evidence would not be accepted.

This bill's provisions may seem innocuous, but the entire gross receipts tax system is based on the issuance of non-taxable transactions certificates. Technically, what New Mexico has is not a retail sales tax with chain of commerce resale certificates, but a subtraction method value added tax. What most people think of as a "value added tax" is the European invoice credit VAT. In that scheme, every business in the chain of commerce is a taxpayer. Every month, the business adds up its sales, multiplies by the VAT rate and subtracts the sum total of VAT paid on purchases of supplies and inventory for resale. In the New Mexico subtraction method VAT, the tax on the sale of tangible property is only paid once – on the value of the final retail price and at the time the property or service is sold to the final consumer (or when the property or service leaves the ordinary chain of commerce). This New Mexico scheme is far easier on taxpayers than the European invoice credit VAT. But because it relies on a lot of trust by TRD that everyone is playing the game correctly, it is subject to abuse. TRD audits a relatively small percentage of all businesses and transactions. So the provisions of this bill – that would allow businesses that had failed to collect required NTTCs a loophole – may undermine everyone else's compliance. A relatively low audit rate, with an "out" for failure to present NTTCs, means that probably no one would pay very much attention to the whole scheme. In recent years, TRD has improved accountability within the NTTC scheme. Issuers of NTTCs must report to whom they issued the NTTCs in order to get more.

TRD expands on these issues:

> Policy Issues:  While this bill is procedural, it implicates fairness issues and addresses one of the most common complaints about the GRT regime. New Mexico is one of the only states, if not the only state, that inserts the revenue collection agency into the exemption certificate process. At many levels, NTTCs are used by TRD as compliance tools – TRD requires purchasers to be compliant before those purchasers can issue NTTCs to vendors. However, the unyielding requirement of NTTC possession for deductions can unfairly render the deductibility of the seller's transaction (and therefore the seller's liability) dependent on the compliance of the buyer. Moreover, it may not square with the underlying policy behind the deduction. This bill allows for alternative proof.
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> The bill does not allow alternative proof with respect to the manufacturing deductions under Section 7-9-46 NMSA 1978 because, at least with respect to consumable such as electricity, the operation of that deduction shifts reporting responsibilities from vendors

to manufacturers. Thus, NTTCs are required to identify the qualifying purchasers that will be reporting the tax.

As noted below, in some situations the bill may lessen the effectiveness of the NTTC program and increase taxpayer and TRD administrative burdens. However, both taxpayers and policymakers should be aware that the preponderance of the evidence standard is the same legal standard required for typical civil litigation. In short, the easiest route for taxpayers to establish entitlement to a deduction will be to obtain an NTTC. Prudent sellers should continue to require NTTCs.

**PERFORMANCE IMPLICATIONS**

The LFC tax policy of accountability is not met since TRD is not required in the bill to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the provision is meeting its purpose. The bill does not express any purpose of the provision other than to allow non-compliant taxpayers a means of evading the consequences of failure to follow the rules.

**ADMINISTRATIVE ISSUES**

TRD notes that, "… the bill will require additional auditor training on the "preponderance of the evidence" legal standard, transaction auditing, and the types of alternative proofs that may be accepted for each deduction. From a data collection perspective, the bill may also adversely impact TRD's ability to properly account for separately stated deductions. Audits and reviews of refunds and abatements would become more difficult, adding FTE time to validate deductions."

**OTHER SUBSTANTIVE ISSUE**

A buyer issuing a NTTC to a seller is executing a promise to pay the gross receipts tax when that buyer has receipts. If the buyer does not issue the NTTC, then it can almost be assumed that the buyer is not going to pay the GRT as implicitly promised. The "preponderance of evidence" that the seller is "entitled" to the deduction should include evidence that the buyer actually paid the GRT when the goods or services were sold.

TRD also notes the following:

> By allowing other evidence, this bill may render TRD's online NTTC program less effective, as deductions may ultimately be allowed on audit or in administrative appeals where they currently would not be under statute. These risks most specifically exist where the buyer is unable to obtain an NTTC for lack of compliance. In audit situations where taxpayers do not possess NTTCs, it will increase administrative burdens on both TRD auditors and taxpayers.
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> TRD policy will need to be established to define "preponderance of evidence." The acceptance of "other evidence", and the need to analyze such evidence to determine "preponderance of evidence", which is more time consuming than reviewing executed NTTCs, will require additional time for auditors to complete audits. It will also become difficult to administer Section 7-9-48 NMSA 1978, specifically the requirement that the next sale be taxable.

## WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

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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