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## FISCAL IMPACT REPORT

**ORIGINAL DATE** 03/02/21  
**SPONSOR** HTRC **LAST UPDATED** 03/19/21 **HB** 278/HTRCS/aSFC  
**SHORT TITLE** Manufacturing Services Gross Receipts **SB** \_\_\_\_\_  
**ANALYST** Graeser

### REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY21	FY22	FY23	FY24	FY25		
	Indeterminate up to (3,000.0)	Indeterminate up to (3,000.0)	Indeterminate up to (3,000.0)	Indeterminate up to (3,000.0)	Recurring	General Fund (GRT) – Section 2
	Indeterminate up to (2,000.0)	Indeterminate up to (2,000.0)	Indeterminate up to (2,000.0)	Indeterminate up to (2,000.0)	Recurring	Local Governments – Section 2

Parenthesis ( ) indicate revenue decreases.

### ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY21	FY22	FY23	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
<b>Total</b>	5.2			5.2	Nonrecurring	TRD General Fund

Parenthesis ( ) indicate expenditure decreases.

~~The provisions of this bill interact with the provisions of Laws 2019, Chapter 270 (HB6).~~

### SOURCES OF INFORMATION

LFC Files

#### Responses Received From

Taxation and Revenue Department (TRD) on committee substitute bill

### SUMMARY

#### Synopsis of SFC Amendment

The Senate Finance Committee amendment to the House Taxation and Revenue Committee (HTRC) substitute for House Bill 278 deletes the proposed gross receipts tax deduction for accounting services. What remains is the deduction for the sale of tangible personal property, e.g. manufacturing equipment, to manufactures and to manufacturing services providers.

Synopsis of Original Bill

The House Taxation and Revenue Committee (HTRC) substitute for House Bill 278 proposes the following:

**Section 1:** clarifies the definition of “manufacturing” to exclude construction services, farming, electric power generation, processing of natural resources, including hydrocarbons, or the processing or preparation of meals for immediate consumption. Note that food manufacturing establishments such as bakeries or delicatessens would be considered manufacturers, but that donut shops might not be so considered. Section 1 also defines “manufacturing services.” The manufacturing service provider must perform those services on tangible property owned by a manufacturer as previously defined in Section 1.

**Section 2:** expands the manufacturing GRT deduction of Section 7-9-46 NMSA 1978 to include manufacturing services. This deduction is an anti-pyramiding deduction for sale of tangible personal property to either a manufacturer or a manufacturing services provider. This section newly requires that sellers of manufacturing consumables obtain a nontaxable transaction certificate from the buyer. There is an additional definition in this section of “manufacturing operation” that requires a manufacturer or manufacturing service provider to employ personnel to perform production tasks to produce goods in conjunction with machinery and equipment. This may be included to exclude fully automated production processes.

Section 2 also provides that receipts from selling or leasing qualified manufacturing equipment may be deducted from gross receipts if the sale is made to, or the lease is entered into with, a person engaged in the business of manufacturing or a manufacturing service provider. Qualified equipment includes computer hardware and software used directly in the manufacturing process but excludes any motor vehicle registered pursuant to the motor vehicle code.

**Section 3:** provides a 100 percent gross receipts tax deduction for the sale of inter-business accounting services. This deduction requires a new non-taxable transaction certificate to be issued by the purchaser to the seller of the services. This is to ensure that the accounting services are only deductible if sold to a registered business in this or another state. “Accounting services” carefully excludes tax preparation services for individuals and investment advice or wealth management advice for individuals. Financial management services are deductible if sold to a hedge fund, mutual fund non-captive real estate investment trust.

Neither the manufacturing services deduction nor the accounting services deduction require either separate reporting or a report to the Legislature.

The effective date of this bill is January 1, 2022. Note: the change from origin to destination sourcing in Laws 2019, Chapter 270 (HB6) with respect to in-person services is scheduled to become effective on July 1, 2021. (See *Significant Issues* for Explanation). TRD requested that the effective date of this legislation be amended to January 1, 2022 to allow time for TRD to review the implications and draft regulations as necessary to make certain that there is clarification on when the deduction for services should be used.

**FISCAL IMPLICATIONS**

This bill narrows the gross receipts tax (GRT) base. See *Significant Issues* for more information.

This bill creates a tax expenditure with a cost that is difficult to determine but likely significant. LFC has serious concerns about the significant risk to state revenues from tax expenditures and the increase in revenue volatility from erosion of the revenue base.

LFC staff generated the following table from a combination of the 2020 RP-80 report available from TRD and the 2017 Economic Census of New Mexico businesses. While the gross amounts are representative of the aggregate gross receipts for each of the affected services, the percentages of those services sold to businesses are speculative. The economic census data represent total sales. The RP-80 reports both gross receipts and taxable gross receipts. Current deductions ratios range from a low of 5 percent for legal services to 60 percent for manufacturing services.

	2017 Economic Census	2020 RP-80				4.371%	1.107%	2.998%
	Sales Revenue (\$1,000)	Txbl GRT (\$1,000)	Best Guess Txbl GRT (\$1,000)	Estimate Business %	Deduction Amount (\$1,000)	State (\$1,000)	Counties	Municipalities
Manufacturing Services	\$35,233	\$16,196	\$16,196	25%	\$4,050	\$180	\$40	\$120

The fiscal impact report for 2019’s HB579, Section 16 indicated that the manufacturing equipment with a collateral repeal of the investment tax credit, similar to the exclusion in this bill, would be in the range of \$5 million general fund impact. However, that estimate did not include the effect of IRBs, which provide a GRT deduction for manufacturing equipment. The table on page 1 indicates that the fiscal impact could be up to (3,000.0) general fund impact for all years.

“New Manufacturing Equipment Deduction & Tax Expenditure Repeals The newly created manufacturing equipment deduction would be more expansive than the existing investment credit, which would have a delayed repeal by the bill. Several other tax expenditures are also repealed by the bill, but they are never or rarely used and would not generate significant revenue. It is impossible to estimate with any precision the fiscal impact of these provisions, but the change is likely to be a greater cost to the general fund, leading to a score of roughly \$5 million less general fund revenue.”

TRD has looked at the provisions of this bill and determined the following revenue impact:

Estimated Revenue Impact*					R or NR**	Fund(s) Affected
FY2021	FY2022	FY2023	FY2024	FY2025		
--	Indeterminate, but negative	Indeterminate, but negative	Indeterminate, but negative	Indeterminate, but negative	R	General Fund (Section 2)
--	Indeterminate, but negative	Indeterminate, but negative	Indeterminate, but negative	Indeterminate, but negative	R	Local Governments (Section 2)

thousands of dollars. Parentheses ( ) indicate a revenue loss. \*\* Recurring (R) or Non-Recurring (NR).

TRD explains the methodology for this estimated revenue impact:

[Section 2] The deduction for lease and purchase of equipment by manufacturers, and the expansion of the manufacturing consumable deduction to include manufacturing service providers, will likely reduce gross receipts revenue to the general fund and local governments. However, the taxable base is already subject to an unknown reduction for these receipts, as many large projects in New Mexico are financed with the proceeds of Industrial Revenue Bonds issued by local governments. Tangible personal property purchased with the proceeds of such bonds are already subject to a deduction, which limits the potential revenue impact of the legislation.

A reliable estimate of the impact is unavailable as there are no known data on manufacturing equipment sales and leases specific or adjustable to New Mexico characteristics. This data limitation extends to manufacturing consumables.

~~[Section 3] The fiscal impact of Section 3 relies on FY19 RP-80 data from the Taxation and Revenue Department (TRD) to determine the level of taxable gross receipts subject to business-to-business accounting services. The Consensus Revenue Estimating Group (CREG) base gross receipts forecast is used to forecast the change in the cost of the deduction over time. Historical splits between state and local Gross Receipts Tax (GRT) revenues are applied, and the effective statewide GRT rate for FY20 is assumed for the estimate. FY2022 is a half year impact due to the start date of the deduction is January 1, 2022.~~

LFC staff notes that the major impact of Section 2 is the expansion of the deduction to manufacturing equipment not the expansion of the manufacturing consumables to manufacturing service providers or the expansion of the manufacturing consumable deduction to manufacturing service providers directly. Equipment, including computer hardware and software and services such as assembly, coating, painting, engraving, etc. would become deductible. ~~In the LFC chart derived from a combination of the RP-80s and the 2017 Economic Census, a deduction is posited for manufacturing services. However, it is small in relation to the total.~~

~~Since LFC staff and TRD both used similar methodology for Section 3, the biggest uncertainty would be the proportion of the RP-80 taxable gross receipts totals for accounting services could be attributed to sales to businesses. The table on page 1 averages the two estimates then uses TRD's methodology to estimate future revenue impacts.~~

## SIGNIFICANT ISSUES

### 03/03/21 clarification:

Section 2 (C) allows a deduction to the seller or lessors of manufacturing equipment provided that the buyer deliver a nontaxable transaction certificate to the seller and that the buyer is then ineligible to claim an investment credit on that equipment. However, the bill does not interfere with the ability of industrial revenue bond (IRB) projects, which are also eligible for manufacturing equipment deductions, to also claim the investment tax credit.

This bill narrows the gross receipts tax (GRT) base. Many of the efforts over the last few years to reform New Mexico's taxes focused on broadening the GRT base and lowering the rates. Narrowing the base leads to continually rising GRT rates, increasing volatility in the state's largest general fund revenue source. Higher rates compound tax pyramiding issues and force consumers and businesses to pay higher taxes on all other purchases without an exemption, deduction, or credit. On the other hand, the provisions of this bill are a novel and substantial attempt to ameliorate the undesirable pyramiding of gross receipts taxes.

Service providers subject to the gross receipts tax have concerns that service providers have no intrinsic deductions, such as the sale-for-resale deductions allowed sellers of tangible personal property in the chain of commerce. For tangible personal property, only the final sale is taxable. However, prior to the provisions of this bill, receipts from sellers of services to businesses would not be deductible and the tax would cascade or pyramid, because the price paid by the buyer would include the economic effect of the gross receipts tax paid by the seller and this tax price would add to the selling price of the subsequent goods or services. This cascading of taxes may damage the economy in unknown ways.

In addition to the accounting services rendered deductible pursuant to the provisions of this bill, other critical categories of services are highly correlated with undesirable pyramiding. These would include legal services, engineering services, human resources services, information technology services and temporary services.

There are some built-in protections in the provisions of this bill in as much as all buyers must have the right to issue non-taxable transaction certificates (NTTC) which requires the buyer to be registered with TRD as a GRT taxpayer or similar registration with another state.; ~~(2) accounting services includes bookkeeping and ordinary activities of CPAs, but excludes tax preparation when performed for an individual, even if the individual owns or participates in a business; (3) financial management services are limited to managing and directing the investments of a hedge fund, mutual fund or real estate investment trust. Receipts from tax preparation and financial management for individuals are not deductible.~~

The inclusion of manufacturing services as an addition to the deduction for sales of tangible personal property is understandable. Coatings, painting and engraving, but not the creation of prototypes would probably be covered by the deduction. Prototypes would be covered by the deduction of sale of tangible personal property to a manufacturer.

~~The provisions of this bill interact tangentially with the provisions of Laws 2019, Chapter 270 (HB6) which changed the sourcing rules for in-person services from an origin basis to a destination basis. One major exception to the in-person change was for professional services, which was loosely defined to be a service the performance of which required a professional license or advanced training. TRD has not published a detailed list of professional services that would illuminate this exemption. Most accounting services, particularly delivered by CPAs or individuals supervised by CPAs, but there are a number of tax preparation services and bookkeeping services that are not certified or licensed and would have to comply with both the exclusions and the possibility of a change in reporting location and associated tax rate.~~

TRD points out several significant features of the provisions of this bill that largely concur with the LFC staff comments.:

**[Section 2]** The deduction of manufacturing equipment sales and leases for manufacturers and manufacturing services, and the inclusion of manufacturing service providers for the manufacturing consumables deduction, may reduce tax pyramiding by eliminating the tax on business inputs. Tax pyramiding in manufacturing may result in compounded incremental increases in the cost of a finished product due to taxes on inputs. This may impair the price competitiveness of New Mexico manufacturing in export markets and may also be a barrier for the location or expansion of manufacturing businesses in New Mexico. The statute also currently excludes receipts from equipment used to create manufactured products from the scope of the deduction. The bill would make equipment used to create a manufactured product equally deductible as manufacturing inputs consumed in the creation of the manufactured products.

The deduction may improve the competitiveness of New Mexico manufacturing and make New Mexico a more desirable location for manufacturing businesses to locate and expand by reducing pyramiding in New Mexico manufacturing.

As mentioned in the methodology for revenue impact section above, some receipts from sale of manufacturing equipment are already excluded from taxation due to issuance by local governments of industrial revenue bonds. Industrial revenue bonds are more likely to benefit larger projects, suggesting that the tax relief offered by excluding manufacturing equipment may be disproportionately enjoyed by smaller projects/businesses.

~~**[Section 3]** The deduction for business to business accounting services may reduce operational costs for businesses that use these services. These lower costs may be viewed as a reduction in tax pyramiding, as well as a leveling of the playing field for small businesses that~~

are likely to be more reliant upon external business services. However, while larger businesses are more likely to have in-house accounting departments, they also have tax liabilities associated with these in-house services provided by employees in place of the GRT currently paid by businesses that use outside services, such as unemployment tax and social security withholding on employee pay, as well as overhead costs such as office space, health insurance premiums if applicable, and other employee costs. The bill may therefore encourage larger companies to shed in-house accounting staff in favor of using independent contractors to provide these services, by economically advantaging the use of outside professional service providers, who bear those costs themselves. The bill also singles out certain service providers for favorable treatment, violating principles of tax equity.

## **PERFORMANCE IMPLICATIONS**

The LFC tax policy of accountability is not met for any of the deductions provided in the provisions of this bill. While it might be feasible for accounting firms to separately report, it would not be even-handed treatment of taxpayers.

### **TRD notes an administrative policy consideration relative to the accounting services section of the bill:**

In administering GRT, TRD works to maintain a balance between ease in reporting for taxpayers, GenTax system programming requirements, and obtaining more precise return data for cost impacts. TRD notes that the new manufacturing services deduction is required to be separately reported and therefore taxpayers claiming this deduction in the future will require an additional step on their returns. Separate reporting of deduction improves data tracking for reporting and evaluation purposes but adds a slight taxpayer burden.

## **ADMINISTRATIVE IMPLICATIONS**

TRD expects a low overall impact in administering the provisions of this bill:

TRD will require updates to publications, instructions and returns. The legislation is anticipated to increase the workload on the Audit and Compliance Division (ACD) of TRD for audit efforts (though separate reporting of the manufacturing services deduction will aide ACD's efforts). The bill has a low impact on the Information Technology Division (ITD), approximately 100 hours or approximately ½ month and \$5,164 of staff workload costs for the new separately reported deduction.

## **TECHNICAL ISSUES**

This bill does not contain a delayed repeal date. In general, LFC recommends adding a delayed repeal date for GRT deductions to ensure future review of the provision. However, since the bill does not require separate reporting of the new deductions, it would be quite difficult to accurately determine if the provisions, in reducing pyramiding, contributed to a worthwhile improvement in the state economy to justify the loss of revenue.

### **TRD points out possible Technical Issues:**

**[Section 3]** The new deduction in Section 3 of this bill may be inconsistent with Section 7-9-48 NMSA 1978, in cases where the services in question are being purchased for resale. Section 7-9-48 would permit the deduction of receipts from professional services purchased for resale, so long as the next sale is taxable. The bill would allow such services to be deductible, whether they are sold for resale, and whether the subsequent sale is taxable.

[Section 1] TRD notes that Section 7-9-75 NMSA provides a deduction for receipts from providing manufacturing services, but does not define “manufacturing service”, or use that term explicitly. It might be desirable also to amend Section 7-9-75 to include the term as defined by this bill.

## OTHER SUBSTANTIVE ISSUES

It is somewhat difficult to test the provisions of this proposal against LFC guidelines and principles for judging tax expenditures. The following two charts detail these guidelines and principles. The third chart provides a report card grade for the conformance of the provisions of this bill to the LFC guidelines and principles. However, keep in mind that the LFC guidelines do not provide guidance for this type of bill that is attempting to ameliorate some of the detrimental effects of pyramiding.

### 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

### Does the bill meet the Legislative Finance Committee tax expenditure policy principles?

1. **Vetted:** The proposed new or expanded tax expenditure was vetted through interim legislative committees, such as LFC and the Revenue Stabilization and Tax Policy Committee, to review fiscal, legal, and general policy parameters.
2. **Targeted:** The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.
3. **Transparent:** The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies.
4. **Accountable:** The required reporting allows for analysis by members of the public to determine progress toward annual targets and determination of effectiveness and efficiency. The tax expenditure is set to expire unless legislative action is taken to review the tax expenditure and extend the expiration date.
5. **Effective:** The tax expenditure fulfills the stated purpose. If the tax expenditure is designed to alter behavior – for example, economic development incentives intended to increase economic growth – there are indicators the recipients would not have performed the desired actions “but for” the existence of the tax expenditure.
6. **Efficient:** The tax expenditure is the most cost-effective way to achieve the desired results.

LFC Tax Expenditure Policy Principle	Met?	Comments
<b>Vetted</b>	?	
<b>Targeted</b>		
Clearly stated purpose	✘	None stated.
Long-term goals	✘	None stated.
Measurable targets	✘	None stated.
<b>Transparent</b>	✔	
<b>Accountable</b>		
Public analysis	✘	No separate reporting required.
Expiration date	✘	None stated.
<b>Effective</b>		
Fulfills stated purpose	✘	Will certainly reduce pyramiding, but uncertain by how much or whether that reduction measurably improves business climate or business performance.
Passes “but for” test	✘	
<b>Efficient</b>	✘	
Key:    ✔ Met    ✘ Not Met    ? Unclear		

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