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

		ORIGINAL DATE	2/6/22		
SPONSOR	Harper/Strickler	**LAST UPDATED**	2/7/22	**HB**	207
SHORT TITLE	Business-to-Business Service Gross Receipts			**SB**	
				ANALYST	Torres

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY22	FY23	FY24	FY25	FY26		
	($75,300.0-$163,300.0)	($77,700.0-$168,600.0)	($80,000.0-$173,600.0)	($82,600.0-$179,100.0)	Recurring	General Fund
	($50,200.0-$108,900.0)	($51,800.0-$112,400.0)	($53,300.0-$115,700.0)	($55,000.0-$119,300.0)	Recurring	Local Governments

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

FY22	FY23	FY24	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
$20.0			$20.0	Nonrecurring	TRD – General fund operating budget

Parenthesis ( ) indicate expenditure decreases

SOURCES OF INFORMATION

LFC Files

Responses Received From
New Mexico Attorney General (NMAG)
Economic Development Department (EDD)
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

House Bill 207 (HB207) provides deductions to the gross receipts tax (GRT) for certain business-to-business transactions.

HB207 allows for GRT deductions on accounting services, engineering services, financial management services, information technology services, human resources services, legal services, and temporary services, provided these sales are made to a sole proprietorship, a limited liability company, a partnership, or a corporation; an entity with a New Mexico tax identification number

or equivalent identification number from another state; or the purchaser presents to the seller a nontaxable transaction certificate or alternative evidence entitling a person to a deduction pursuant to Section 7-9-43 NMSA 1978. Any such deduction must be reported as required by the taxation department.

HB207 provides definitions for "accounting services," "engineering services," "financial management services," "information technology services," "human resources services," "legal services," and "temporary services."

The effective date of this bill is July 1, 2022.

FISCAL IMPLICATIONS

Estimated fiscal impacts are based on the consensus revenue estimates for gross receipts tax and compensating tax revenues. The current baseline effective state gross receipts tax rate was assumed to be 4.34 percent, which was derived from the fiscal year-to-date rate for FY22. Similarly, the FY22 statewide tax collected indicates a total weighted average rate of 7.24 percent. Therefore, a local rate of 2.89 percent was used to determine the total loss to all local governments.

The anti-pyramiding impacts in HB207 are estimated to reduce the general fund between $96 million and $190 million. Anti-pyramiding provisions are based on analysis of RP-500 and RP-80 data provided by the Taxation and Revenue Department. LFC and TRD analyzed FY19, FY20, and FY21 industry data to determine the potential size of the taxable gross receipts base affected by HB207. According to an Ernst & Young LLP study[1], New Mexico's total estimated business share of state and local sales taxes is 60 percent. The services selected in HB207 have a higher concentration of business-to-business transactions than the greater economy and could be as high as 90 percent business-to-business in transactions. For this reason, 60 percent to 90 percent of the taxable gross receipts in the relevant NAICS codes were used to develop the range. Caution is urged because NAICS codes are self-reported by taxpayers upon registration; to the extent taxpayers outside these NAICS codes legitimately claim the deduction, the fiscal impact would change.

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 HB207 is difficult and unclear. More work, data, and agency analysis is needed. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and statutory criteria for a tax expenditure may be ambiguous or imperfectly aligned with available data, 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.

[1] Phillips, Andrew and Ibaid, Muath. Ernst & Young LLP, May 2019. "The Impact of imposing sales taxes on business inputs: Prepared for the State Tax Research Institute and the Council on State Taxation"

This bill creates or expands 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. The committee recommends the bill adhere to the LFC tax expenditure policy principles for vetting, targeting, and reporting or be held for future consideration.

SIGNIFICANT ISSUES

Tax pyramiding occurs when the GRT is applied to business-to-business purchases of goods and services, creating an extra layer of taxation at each stage of production. The burden of pyramiding is then exacerbated by rising GRT rates.

New Mexico currently has anti-pyramiding provisions for many goods-based inputs, but service-based inputs are still largely taxed. Because smaller businesses are unable to incorporate many professional resources in their operations, tax pyramiding for services often disproportionately harms small businesses. HB207 could help to even the playing field for those businesses.

Though, larger businesses in New Mexico will have less of an incentive to move services in-house. By not having an incentive to hire employees, some of the enumerated services could be contracted to out-of-state or New Mexico businesses. The net employment impact is unclear from the incentive changes.

The Taxation and Revenue Department adds:

> The deduction for qualified business services may reduce operational costs for businesses that use these services. These lower costs represent 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 than larger businesses. However, while larger businesses are more likely to have employees provide accounting, legal, etc. departments, they also have costs and tax liabilities associated with these employees in place of the GRT, such as unemployment tax, social security withholding, office space, health insurance premiums if applicable, and other employee costs. The bill may therefore encourage larger companies to reduce employment in favor of independent contractors to provide professional 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.
>
> The bill also goes much further than just preventing pyramiding. For example, the bill allows a deduction for “legal services” when those services are sold to the appropriate purchaser. “Legal services” include “legal representation before courts”; therefore, any receipts for litigation services sold to any qualifying purchaser may be deducted from gross receipts. But even the very largest corporations routinely hire outside counsel for litigation purposes; the function of in-house counsel is usually just to supervise outside counsel, especially for larger and more complex lawsuits. With respect to litigation services, large businesses are in the same position as smaller ones. So, rather than preventing pyramiding by removing from the scope of the gross receipts tax services that larger corporations might employ in-house, but which smaller businesses might have to purchase separately, and pay gross receipts tax on, the bill actually simply removes gross receipts tax on whole range of services, drastically narrowing the tax base for the gross receipts tax. This exclusion of certain services from the gross receipts tax also runs

counter to the general trend nation-wide, which is to include more services in states' sales tax base.

While tax incentives may support particular industries or encourage specific social and economic behaviors, the proliferation of such incentives complicate the tax code. Adding more tax incentives: (1) creates special treatment and exceptions to the code, growing tax expenditures and/or narrowing the tax base, with a negative impact on the general fund; and, (2) increases the burden of compliance on both taxpayers and Tax & Rev. Adding complexity and exceptions to the tax code does not comport generally with the best tax policy.

New Mexico's film production tax credit states that for direct production expenditures to be includable in the calculation of the credit, they have to be "subject to taxation by the State of New Mexico. This bill would make many business-to-business services deductible, so no longer subject to taxation, and therefore no longer eligible expenditures to receive the film production tax credit.

In administering GRT, Tax & Rev works to maintain a balance between ease in reporting for taxpayers, GenTax system programming requirements, and obtaining more precise return data for cost impacts. Tax & Rev notes that the new deduction is not required to be separately reported, nor is Tax & Rev charged with reporting on the effectiveness of the deduction. Separate reporting of deduction improves data tracking for reporting and evaluation purposes but adds a slight taxpayer burden.

The Economic Development Department notes:

HB207 attempts to level the tax environment between small and large businesses. Most small businesses must outsource the specific types of work outlined in the bill, while larger businesses often have those services in house. This deduction would reduce tax pyramiding on businesses in the state, which has become an increasing problem as GRT rates have risen over the years. The state has a large percentage of businesses (64%) that have fewer than 5 employees, and it is likely these businesses are the ones that would benefit the most from the deduction in the bill.

According to the Bureau of Labor Statistics (BLS) Quarterly Census of Employment and Wages (QCEW), the preliminary data for the first quarter of 2021 for the number of establishments or businesses in New Mexico according to size are as follows:

Size of Business by Number of Employees	Number of Businesses	% of Businesses
Fewer than 5 employees	37,798	64.36%
5-9 employees	8,656	14.74%
10-19 employees	6,115	10.41%
20-49 employees	4,220	7.19%
50-99 employees	1,109	1.89%
100-249 employees	632	1.08%
250-499 employees	157	0.27%
500-999 employees	30	0.05%
1000 or more employees	12	0.02%
Total Number of Establishments	**58,729**	

It is worthwhile to note that while small businesses are most likely to benefit from the deduction in this bill, many film production companies also contract out many of these services. This could create confusion and potential for film production companies to assume the transaction was taxable and thus eligible for the film production tax credit when those transactions would not be eligible if the deduction were applied by the seller of the services to the production company. The result would be significant accounting and auditing challenges for film production companies and TRD, bringing increased costs to ensure proper compliance. The film production companies would need to ensure they continue to pay the GRT and their contractors do not take this optional deduction.

Section 7-2F-13(B)(1)(b) NMSA 1978 of the film production tax credit states that for direct production expenditures to be includable in the calculation of the credit, they have to be "subject to taxation by the state of New Mexico." That would mean that if the expenditures are not taxable because they are deductible, then they could not be included in the film credit calculation. This is also stated in the TRD's FYI-370.

ADMINISTRATIVE IMPLICATIONS

TRD will update forms, instructions, and associated publications. These updates will be incorporated into annual tax program revisions. Implementation of revised GRT deduction will have a low impact on Tax & Rev's Information Technology Division (ITD), approximately 100 hours or about 1 month and $20,000 of contractual resources.

TECHNICAL ISSUES

The new deduction in 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. This bill would allow such services to be deductible, whether or not they are sold for resale, and whether or not the subsequent sale is taxable.

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
Vetted	?	Though the issue has been considered before, this version of the bill was not considered by interim committees.
Targeted		
Clearly stated purpose	✘	
Long-term goals	✘	
Measurable targets	✘	
Transparent	✓	
Accountable		
Public analysis	✓	
Expiration date	✘	
Effective		
Fulfills stated purpose	?	
Passes "but for" test	?	
Efficient	?	
Key: ✓ Met ✘ Not Met ? Unclear		

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