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FISCAL IMPACT REPORT

		LAST UPDATED	3/2/23
SPONSOR	Brown/Scott	**ORIGINAL DATE**	2/20/23
SHORT TITLE	Oil & Gas Production Gross Receipts	**BILL NUMBER**	House Bill 439
		ANALYST	Torres

REVENUE* (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY23	FY24	FY25	FY26	FY27		
	Less than ($40,300.0)	Less than ($41,385.0)	Less than ($42,750.0)	Less than ($43,735.0)	Recurring	General Fund[1]
	More than ($20,560.0)	More than ($21,115.0)	More than ($21,815.0)	More than ($22,315.0)	Recurring	Counties[2]
	Less than $58,700.0	Less than $60,300.0	Less than $62,310.0	Less than $63,740.0	Recurring	Municipalities[3]

Parenthesis ( ) indicate revenue decreases
*Amounts reflect most recent version of this legislation.
[1]General fund losses are likely to be smaller than shown.
[2]County losses are likely to be greater than shown.
[3]Municipal gains are likely to be smaller than shown.

Relates to Senate Bill 136 of the 2022 Regular Session.

Sources of Information
LFC Files

No Response Received
Municipal League
New Mexico Counties
Taxation and Revenue Department (TRD)
Department of Finance and Administration (DFA)

SUMMARY

Synopsis of House Bill 439

House bill 439 (HB439) provides an exception to the destination-based sourcing rules for reporting gross receipts tax (GRT) under Section 7-1-14 NMSA 1978 for oil and gas production services performed in New Mexico. This exception reverts those services to origin-based sourcing for gross receipts. In other words, the business location of the service provider will be used to determine gross receipts tax liability rather than the location of where the service is performed.

The bill also defines oil and gas production services as those services necessary for the production or severance of products, as that term is used in the Oil and Gas Emergency School

Tax Act, including services conducted in preparation for such severance, field operations, transfer of the products off a lease site, operation monitoring, operation maintenance, and workover drilling.

The effective date of this bill is July 1, 2023.

FISCAL IMPLICATIONS

In an analysis of the transition to destination-based sourcing of the gross receipts tax—an approach that bases the tax on the rates of the location where the good or service is used rather than on the rates of the location of its source—LFC staff found nearly all municipalities have seen growth in gross receipts tax revenues. However, for a few municipalities, the tax on services from companies based in the city but delivered to other locations has exceeded the gain from the sale of goods purchased remotely and delivered within the municipality, resulting in a net loss in tax revenue.

Gross receipts tax data in FY22 and the first five months of FY23 show an increase in remainder-of-county matched taxable gross receipts associated with oil and gas services. It is very difficult to disentangle how much of the increased activity in the county is a result of the change in sourcing and how much of the increase is a result of a new boom in activity unrelated but timed with the change to destination sourcing.

Furthermore, any increases in reported activity in the remainder of the county is not entirely attributable to losses in municipalities. Increases in activity in the county are largely attributable to the inclusion of out-of-state sales in the local gross receipts tax (GRT) base. For example, oil and gas matched taxable gross receipts reported as out-of-state has fallen by over a billion dollars due to destination sourcing, all of which is now incorporated in the local tax base. Returning the sourcing of these receipts to origin-based sourcing will result in at least $20.5 million of losses to county revenues as the activity returns to out-of-state taxation which is not subject to municipal or county GRT increments and remainder-of-county increments are also lost.

Additionally, municipalities who have benefited from the change to destination sourcing for oil and gas services will lose GRT revenues. Because it is less likely for oil and gas wells to be located within municipal boundaries, most oil and gas reliant municipalities will benefit from HB439. However, some municipalities with wells within municipal boundaries will see revenues reduced by the HB439. For example, Jal has experienced over 50 percent growth in its GRT from oil and gas services and, as a result of HB439, would likely lose more than $2 million a year. Additional municipalities not contemplated in this analysis may be similarly affected.

Using only those counties with a large presence of oil and gas activity (Eddy, Lea, and San Juan), the state would lose at least $40.3 million in gross receipts tax revenue as proposed in HB439.

If municipalities received all the observed remainder-of-county increases in oil and gas related services, municipalities could gain up to $63.7 million by FY27 from the 1.225 percent and a municipal increment (midpoint municipal increment for the region used for the estimate). However, a significant portion of the observed increase could be attributed to remainder-of-county and out-of-state service providers who would not be attributed back to municipalities. Furthermore, other municipalities including Jal would offset the total gain to municipalities when

those municipalities lose revenues due to HB439. It is not possible to discern how much of the increase is related to which activity.

Estimates are grown using the December 2022 Consensus Revenue Estimate for gross receipts tax revenues.

Estimating the impacts is highly difficult and unclear. More work, data, and agency analysis is needed. This bill has a cost that is difficult to determine. The committee recommends bills adhere to the LFC tax expenditure policy principles for vetting, targeting, and reporting or be held for future consideration. 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.

From prior analysis on SB136 during the 2022 Session, TRD noted:

> The transition from origin to destination based sourcing rules that went into effect July 1, 2021 has proven difficult. The Tax Information and Policy Office of TRD has experienced a high-volume of requests for clarification and assistance to understand the new law. The allowance of a further exception to the rules would add another layer of complexity to an already complicated set of reporting requirements and require further customer service resources and time.
>
> This change would require TRD to update current forms, publications, and media to work on getting the information out to the public on this additional change to destination-based sourcing. As part of forms, GRT Filers Kits are printed and mailed bi-annually to align with potential rate changes on July 1 and January 1. The Tax Information and Policy Office estimates making the required changes would take 80 hours of employee time.

SIGNIFICANT ISSUES

Until July 1, 2021, New Mexico assessed the gross receipts tax (GRT) using origin-based sourcing—the application of tax rates based on the location of the seller. After July 1, 2021, New Mexico switched to destination-based sourcing in response to the drastic increase in online sales, to modernize with national tax trends, to allow local business to compete equitably with out-of-state businesses, in recognition of horizontal tax equity, and to support efficient enforcement of tax compliance. Despite the benefits of destination-based sourcing, the impacts of the policy change have affected communities unequally depending on the makeup of the region's economy.

Destination sourcing allows local gross receipts taxes to be applied to out-of-state providers, leveling the playing field for New Mexico businesses. It also allows municipal and county governments to receive revenue from out-of-state sellers. In southern New Mexico, for example, oil and gas service companies compete across state lines with differing GRT rates. HB439 would place New Mexico oil and gas service businesses at a disadvantage with out-of-state businesses who would pay a lower GRT rate.

Counties

Nearly all counties have experienced growth as measured by matched taxable gross receipts (MTGR), with only four counties experiencing declines (Hidalgo, Luna, Roosevelt, and

Torrance), all of which is attributable to the completion of large-scale construction projects that had boosted MTGR in the previous fiscal year.

In part, county gains are the result of local inclusion of out-of-state activity. Online retail sales, services from out of state performed in the county, and other activity are now reported to the appropriate county, where county gross receipts tax increments apply.

Counties are not gaining, to a significant degree, on any activity shifting to the remainder of the county from the municipalities within the county because of destination-based sourcing. When activity occurs in a municipality, county increments also apply. Therefore, shifts from a municipality to a remainder of county area are not the reason for increasing total county activity. In Eddy and Lea Counties, activity has risen significantly both from rising oil and gas activity from in-state and out-of-state business.

Municipalities
For municipalities, only Carlsbad and Hobbs were found to have declines in MTGR attributable to destination sourcing, according to LFC analysis presented during the 2022 interim hearings. Where other municipalities may experience a decline of MTGR in a specific industry because of the change, the change has also resulted in a growing tax base for other industries that more than make up for the industry-specific losses. So far, this has not been the case in Carlsbad and Hobbs where the industry-specific losses in oil and gas taxable activity is so large, it has not been compensated for by the inclusion of out-of-state activity such as retail trade.

State
The state has not been the overwhelming winner because of destination sourcing. Prior to destination sourcing, the state received the full tax from out-of-state businesses minus a flat $48 million a year distribution created so municipalities could also benefit from online sales. When activity is sourced to a municipality, the state distributes an additional 1.225 percent from the state's revenues on that activity to the municipality in which the activity occurs. The switch to destination sourcing can result in the state losing revenue when out-of-state activity is sourced to municipalities. The state can gain revenue when activity in a municipality shifts to a county or to out-of-state. On net, LFC staff have determined the state is losing revenue due to the change to destination sourcing as more activity is sourced to municipalities on the whole than is shifted from municipalities to counties or out-of-state. On net, an estimated $10 million more a month ($120 million a year) is being distributed to municipalities from the state GRT share because of destination sourcing, more than two and half times the annual flat distribution provided before destination-based sourcing.

The Taxation and Revenue Department noted in other destination based sourcing legislation:

> The exclusion of [oil and gas] services from destination-based sourcing may be viewed as preferential treatment of a specific industry. The exclusion may also set precedent in the tax code for other professions with a similar reporting structure … This may cause concerns over favoritism and lead to other industries requesting a similar allowance, potentially resulting in more complex tax code as industries shift between sourcing rules….

In the 2021 Tax Expenditure Report, TRD summarizes 'Principles of Good Tax Policy.'[1] The proposed exceptions to the destination-based statutes challenge the concepts of equity and simplicity among GRT taxpayers. Regarding equity, this exception erodes horizontal equity where similarly-situated taxpayers face similar tax burdens. Regarding simplicity, taxpayers incur compliance burdens as they prepare, submit, and keep records about tax returns. Likewise, TRD incurs administrative costs to collect taxes, review the accuracy of tax returns and tax payments, and bring taxpayers into compliance. The exception to the destination-based sourcing as noted above further complicates the tax code for both taxpayers and TRD. The more complicated the code, the higher the cost everyone must bear to ensure compliance.

TECHNICAL ISSUES

On SB136 from the 2022 Regular Session, TRD noted: "On page 4, lines 10 and 11, the bill states that, the reporting location is the "location of the performer of the service or seller of the product of the service." These can be two different locations. The performer of the services may be an individual working for a company that is performing these services at the service site, but the seller of the services is the location of the company. The likely intent of this bill is to report the location at the seller of services, or in other words, wherever the business is located. The language currently does not do this (nor does the language of the current statute do this for 'professional services'). To meet the assumed intent of the exception language, TRD suggests that this language be revised to specify that the location of the services is the location where the business resides or is located."

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.

IT/rl/ne

[1] 2021 New Mexico Tax Expenditure Report, New Mexico Taxation and Revenue Department, https://www.tax.newmexico.gov/forms-publications/