Money Matters
Analysis by the LFC Economists
NEW MEXICO LEGISLATIVE FINANCE COMMITTEE

Update on Destination-Based Sourcing in the Gross Receipts Tax

THIS REPORT provides an overview of the current destination-based sourcing method of the gross receipts tax in New Mexico and discusses its benefits and potential limitations. This report provides preliminary research on the impact of destination sourcing.

This brief will also discuss the fiscal impact of this change and discuss potential solutions that can be leveraged to improve on existing outcomes.

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Destination-Based Sourcing in New Mexico

Increased globalization and online sales make taxation of economic transactions more geographically complex. Until July 1, 2021, New Mexico assessed the gross receipts tax using origin-based sourcing—the application of tax rates based on the location of the seller. This was the easiest form of taxation when most sales for goods and services were made in person. However, the traditional origin-based sourcing model was ill-suited to the evolving tax and emerging digital environments.

Beginning July 1, 2021, New Mexico switched to destination-based sourcing in response to the drastic increase in online sales and the competitive advantage afforded out-of-state businesses under a system that taxes the origin of the business activity and not the destination of the product. Taxing goods and services based on the delivery location of the good or service is being delivered requires out-of-state sellers to pay local GRT increments, leveling the playing field between in-state and out-of-state businesses. Under these sourcing changes to the Tax Administration Act, enacted through House Bill 6 of the 2019 legislative session, there are exceptions to destination-based sourcing for those services that may be difficult to impossible to tax based on the destination of the good or service.

Currently, of the 50 states and the District of Columbia, 35 use destination-based sourcing for sales taxes, indicating most states see it as a way to capture tax revenue more completely and ensure fairness for in-state businesses by leveling the taxation playing field. Only 11 states remain in origin-based sourcing, and five states have no sales tax.

Across New Mexico, the gross receipts tax has varied from 5.125 percent to 9.4375 percent because the total rate combines rates imposed by the state, counties, and municipalities. The business pays the total GRT to the state, which then distributes the counties' and municipalities' portions to them. To this end, businesses use location codes and tax rates corresponding to the location where their goods or services are delivered (destination-based sourcing). Under this new regulation, market competition between in-state and out-of-state businesses is equalized, mitigating competitive advantage concerns.

Revenues Since Destination-Based Sourcing

Destination-based sourcing broadens the gross receipts tax base by bringing in out-of-state activity. Best practices of tax policy maintain taxes are optimized when applied broadly to allow for the lowest possible tax rates needed to raise sufficient revenues.

Across governments, destination-based sourcing is contributing to a growing tax base. When compared with FY21, FY20, and FY19, FY22 matched taxable gross receipts (taxable gross receipts matched to tax payments) for the state, combined counties, and combined municipalities have grown significantly. Over FY21, combined counties, combined municipalities, and the state grew between 19.2 percent and 34 percent in part because of an economic recovery, but also due to destination-based sourcing. When comparing to non-pandemic years, government tax bases also grew significantly, highlighting the impact of the change in sourcing. When compared with FY20 and FY19, the FY22 tax base grew between 12.7 percent and 32 percent.

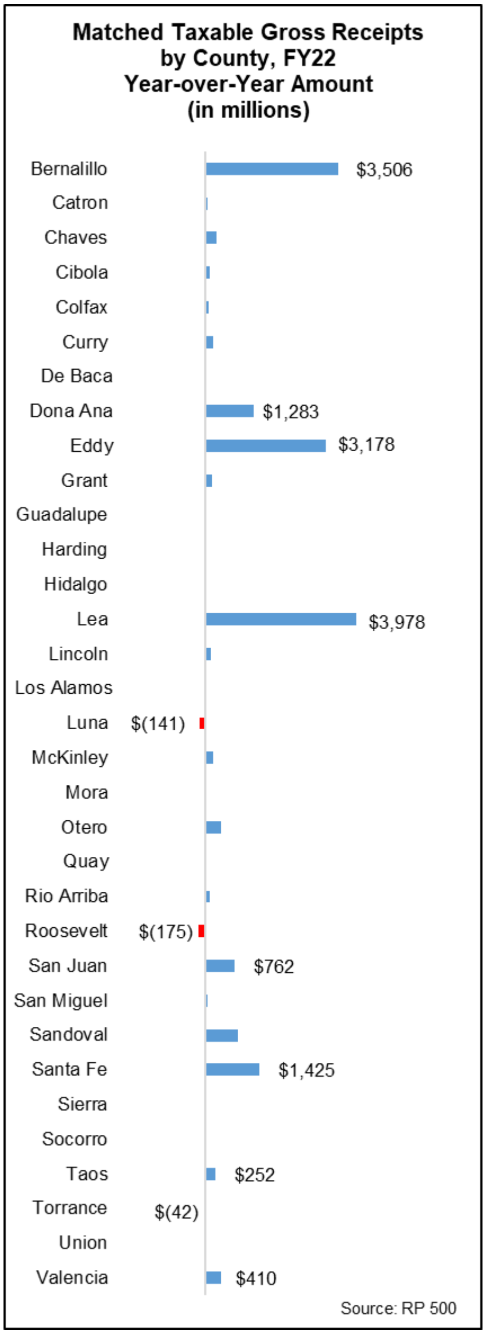
FY22 YTD MTGR Growth Over Previous Fiscal Years

	FY21	FY20	FY19
State	19.2%	12.7%	23.5%
Counties	34.0%	26.1%	32.0%
Muni.	26.7%	24.4%	24.7%

Source: RP500

County Revenues Following Implementation

For the first 11 months of destination-based sourcing, nearly all counties have experienced growth as measured by matched taxable gross receipts (MTGR), with only three counties experiencing declines (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 likely to be the reason for increasing total county activity.

Municipal Revenues Following Implementation

At the municipal level, nearly all local governments are experiencing gains in tax revenue when compared with 2021. Only eight municipalities (Elida, Causey, Dora, Vaughn, Dexter, Folsom, Grenville, and Corona) have experienced a decrease, with none experiencing a loss over $300 thousand. The decline for all eight municipalities is unlikely attributable to destination-based sourcing, as declines follow trends from before implementation. More study is needed to determine the net effects for individual municipalities as a result of the change to destination-based sourcing.

Because some municipalities are heavily dependent on a single industry, comparisons with 2021 may be difficult; the respective industry's activity may have been especially depressed during that year. When comparing FY22 MTGR with FY20, only four more municipalities (Columbus, Carlsbad, Hobbs, and Taos Ski Valley) are experiencing declines. The decline in MTGR for Columbus is attributable to the halting of the border wall construction, while Taos Ski Valley is due to pandemic declines in tourism activity, neither of which is due to destination-based sourcing.

For Carlsbad and Hobbs, the decline in MTGR is overwhelmingly attributable to the decline in oil and gas industry activity reported to each city because of destination-based sourcing. The decline in MTGR due to destination based sourcing seems to be unique in these two municipalities. Where other municipalities may experience a decline 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 activity is so large, it has not been compensated by the inclusion of out-of-state activity such as retail trade.

To quantify the losses, LFC analysis compared municipal activity for Carlsbad and Hobbs in FY22 to FY20. Because the oil and gas industry had similar drilling activity in FY20 as FY22, the decline in MTGR in those municipalities from the oil and gas industry may be the result of destination-based sourcing.

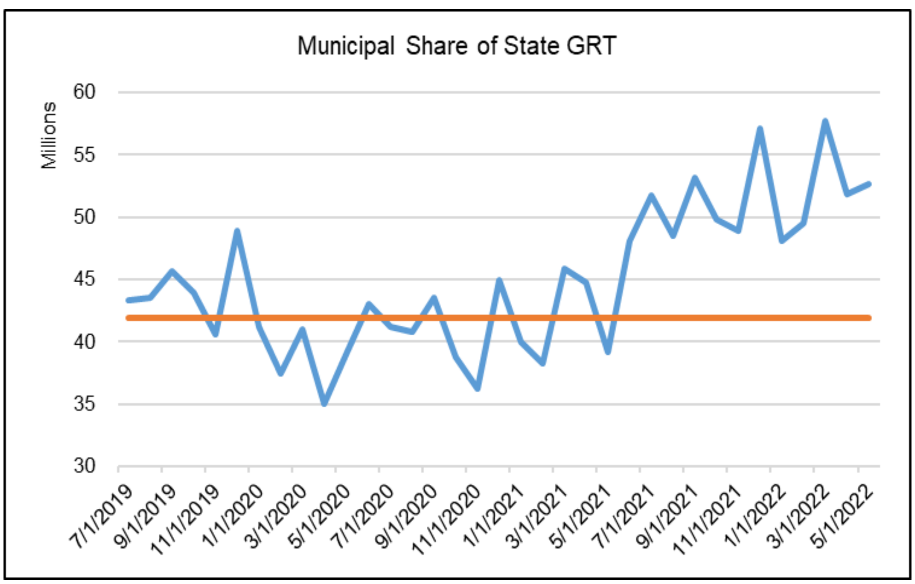
Under this assumption, Carlsbad could have lost $200.8 million in MTGR and Hobbs may have lost $226.8 million in MTGR because of the change. Given current combined tax rates of 7.6458 percent in Carlsbad and 6.8125 percent in Hobbs, the cities could have lost $7.5 million and $6.6 million in GRT revenue, respectively, from reporting specific to oil and gas industry codes, following destination-based sourcing.

In addition, other services have a direct relationship to the industry even though their activity is not reported as an oil and gas receipt. For example, oil- and gas-related services may be reported under transportation and warehousing along with non-oil and gas related transportation and warehousing, making it difficult to discern the total impact of destination-based sourcing without more granular data. Because of this, the total impact on municipalities dependent on oil and gas activity is likely much greater.

State Revenues Following Implementation

Given that the state taxed out-of-state sales in origin-based sourcing, the change to destination-based sourcing was not expected to bring substantially more activity into the state's tax base other than from increased taxpayer compliance. Research in other states has shown destination-based sourcing is easier to keep accountable, resulting in more tax revenues to the state and localities. However, the change in sourcing rules has resulted in the state distributing significantly more to local governments from the state share of GRT.

While destination-based sourcing will not bring in new taxpayers since the out-of-state taxpayers were already there, it will shift GRT revenue collected on out-of-state sales from the state to the local government where the purchases was destined. The switch in sourcing rules was expected to, and has resulted in, the state distributing significantly more to municipal governments from the state GRT. In addition to revenue from local tax increments imposed on activity occurring within a municipality, the state distributes an additional 1.225 percent of tax revenue on the activity taken from the state's gross receipts tax rate. As shown in the graph below, the municipal share of state GRT spiked following the shift to destination sourcing, resulting in an average



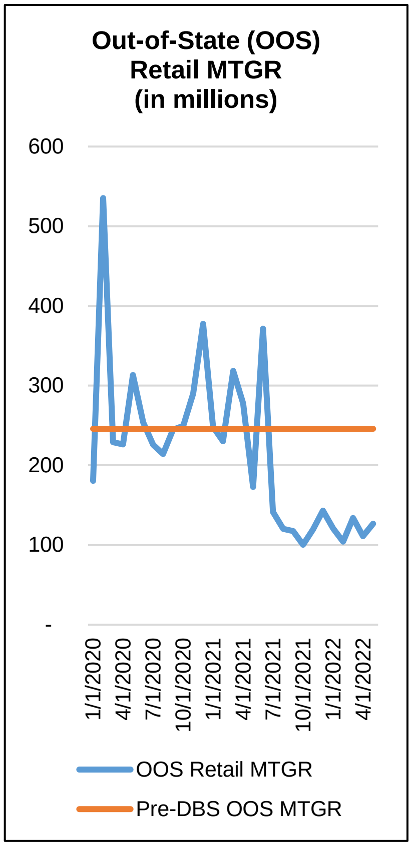
Largest 10 Municipalities by MTGR – As of May 2022

Location Code	FY22 Annual Change in Dollar Value	Percent Change from FY21
Albuquerque	$3,538,658,989	**24.4%**
Santa Fe	$1,118,904,121	**37.5%**
Las Cruces	$563,256,981	**20.3%**
Farmington	$288,348,291	**18.7%**
Hobbs	$298,219,650	**19.6%**
Rio Rancho	$409,283,767	**31.4%**
Carlsbad	$367,687,302	**28.8%**
Roswell	$227,696,284	**23.2%**
Los Lunas	$261,264,868	**35.4%**
Gallup	$129,660,025	**18.4%**

of nearly $10 million more a month than the FY19 average before the pandemic. Through May, about $110 million more of the state GRT has been distributed to municipalities above pandemic and origin sourcing levels (FY19).

Given that the state did not have to share the 1.225 percent of GRT with municipalities prior to their identification as the location of the consumer, the increased municipal share of state GRT is a loss to the state's treasury.

The increased distributions also provide an insight into how activity has shifted due to destination-based sourcing. When activity moves from a county to a municipality, the amount of municipal share of state GRT increases. When activity moves from a municipality to the county area outside of a municipality, the amount of municipal share of state GRT decreases. Destination-based sourcing has resulted in shifting in both directions depending on the location of the business and the consumer. The growing municipal share of state GRT reveals the net movement of economic activity has been toward municipalities and not to remainder of county area.

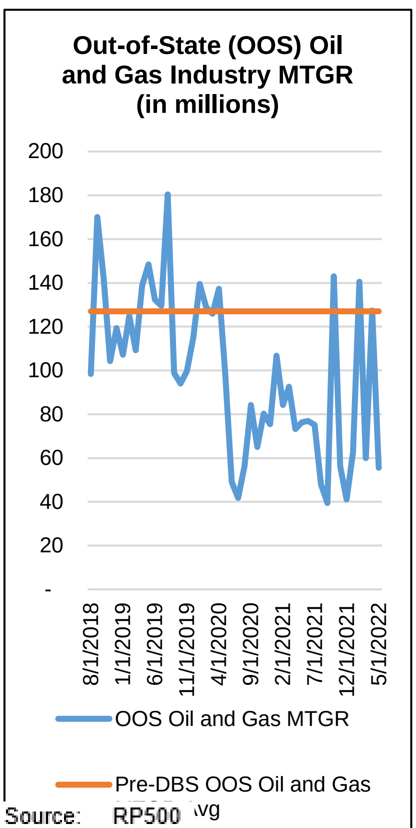


Source: RP500

Preliminary Insights on Economic Activity

Prior to destination-based sourcing, in-state purchases from out of state businesses would be subject to only the state GRT. Now, in-state purchases from out of state businesses are also subject to local tax increments. As a result, industries with a significant portion of out-of-state activity being imported to the state are paying more in local gross receipts taxes due to destination-based sourcing. Such industries include mining, oil and gas, retail trade, wholesale trade, and construction, among others.

Preliminary analysis indicates at least $1.4 million from oil and gas related activity and at least $45.2 million from retail activity has moved into the local tax base. This insight showcases the leveling of the playing field between in-state and out-of-state businesses because out-of-state businesses now pay comparable taxes on sales. Data from the Taxation and Revenue Department shows over $5.8 billion of activity was still reported as out-of-state through May of FY22, most of which will also shift into the local tax base, as taxpayers improve compliance in the years ahead.



Source: RP500

The Oil and Gas Industry and Destination-Based Sourcing

In FY22, in-state activity from the oil and gas industry increased after destination-based sourcing took effect; as the recovering energy market and inclusion of out-of-state activity grew the local tax base.

Yet, revenues in oil-patch communities have varied greatly because of sourcing changes. LFC analysis considered the difference between oil and gas GRT revenues at the county and municipal levels. All four counties with substantial oil and gas activity experienced more gains in GRT revenue from mining, oil, and gas industry activity in FY22 than in FY21 and FY20.

For the 10 largest municipalities in these counties, this trend holds for all but Hobbs and Carlsbad. On the municipality level, those with more oil activity, such as Hobbs and Carlsbad, experienced a decrease in GRT revenue in FY22; however, cities with less activity, like Bloomfield, Artesia, Eunice and Jal, experienced small gains to their GRT revenues in FY22. Since oil and gas activity rarely occurs within city limits and only businesses tend to reside there, the gains in these small communities may suggest taxpayer behavior has yet to fully conform to changes in sourcing rules.

An examination of the out-of-state drop in oil- and gas-related receipts demonstrates the likely range of new activity being sourced in-state. Given the decline in oil and gas industry receipts reported as out-of-state from FY21, LFC analysis suggests at least $572 million of oil and gas-related activity is now taxed at local increments. This activity is estimated to have resulted in at least $1.4 million in additional revenue to oil and gas counties in the state.

Other State Experiences and Studies

Most existing literature on destination-based sourcing is at the federal level and based on the concept of domestic versus foreign goods. However, these studies also provide insight at the state level. According to the Tax Foundation, "One of the most attractive features of moving to a destination-based tax is that its base would be much easier to define."[1] It is also simpler to track one single and final transaction of a good or service under this framework. Moreover, destination-based sourcing makes it less feasible for firms to avoid taxation. This reduction in tax avoidance will help to bolster tax revenue for municipalities, counties and the state.

Additionally, in 2008, Washington changed from origin-based to destination-based taxation. After the Quill verdict in the U.S. Supreme Court, the University of Tennessee conducted a study that estimated "states have forgone more than $52 billion over the past six years in untaxed internet sales."[2] Of that amount, Washington's portion of estimated uncollected tax is $1.2 billion, including $282 million in estimated untaxed sales transactions from out-of-state retailers in 2012.[3]

According to the Taxation and Revenue Department, the change to destination-based sourcing was necessary:

- To adapt to current economic realities and ensure all transactions are taxed fairly and equally.
- To protect New Mexico businesses and even the playing field with out-of-state businesses.
- To benefit state and local revenues overall by allowing taxation of internet marketplace transactions.
- To align with other states' tax laws.

Source: November 22, 2021, hearing of the Revenue Stabilization and Tax Policy Committee

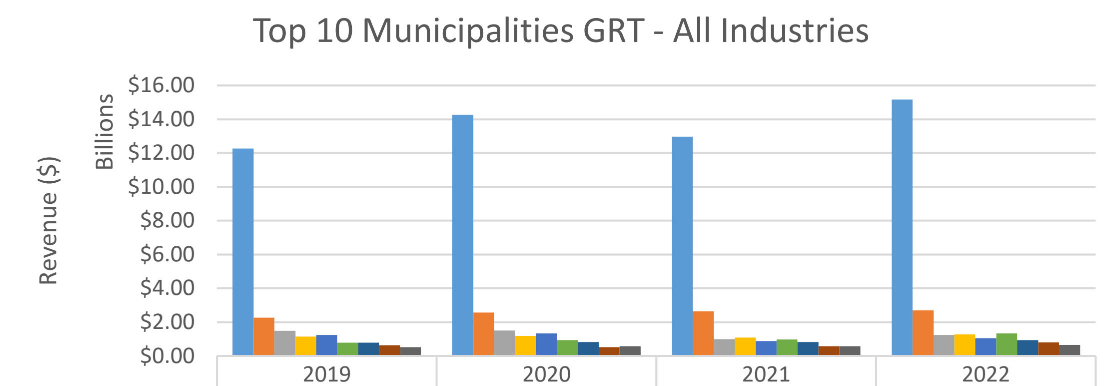
Equity Gains with Destination-Based Sourcing

The Taxation and Revenue Department reports switching to destination-based sourcing increased the tax base for New Mexico, increased equity amongst local and out-of-state sellers, and increased tax revenues to local governments.

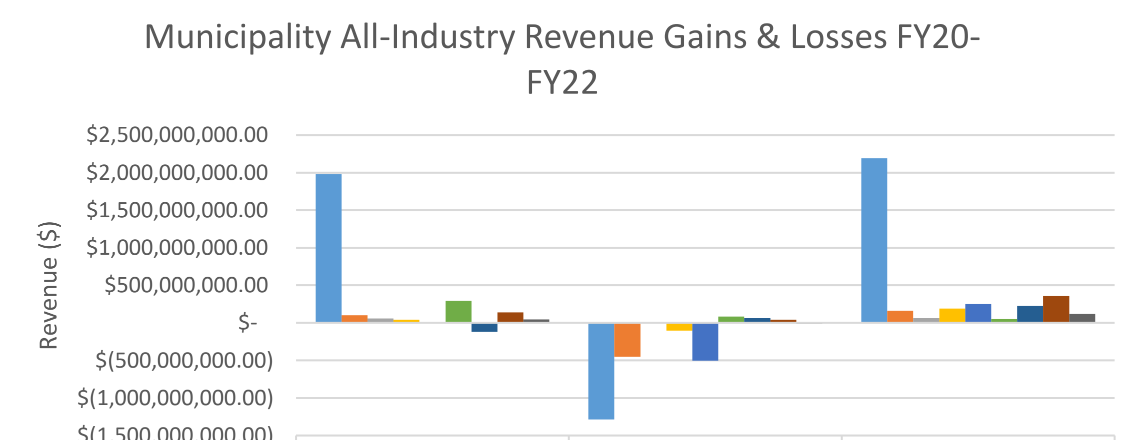
Although the exact extent of its impact is difficult to measure due to how new it is coupled with disruptions in the economy, policy and case study research have demonstrated that destination-based sourcing does result in more equitable taxation and long-term revenue growth. Where some municipalities may experience losses in activity from specific industries, the potential gains in taxing a broader base will offset these losses overtime and produce less volatile revenue sources.

[1] How a Destination-Based Tax System Reduces Tax Avoidance | Tax Foundation
[2] sales-tax.pdf (washingtonpolicy.org)
[3] sales-tax.pdf (washingtonpolicy.org)

Appendix A.



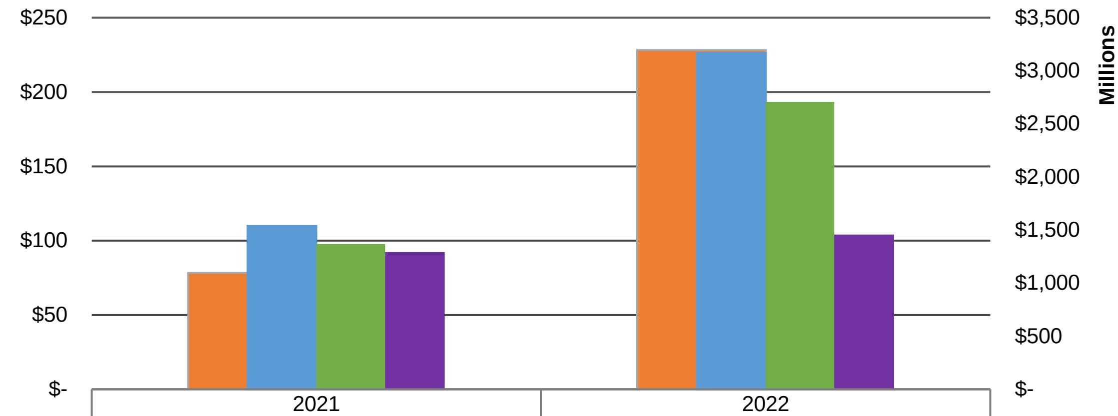
	2019	2020	2021	2022
Albuquerque	$12,276,078,043.1	$14,259,252,864.0	$12,971,413,862.9	$15,163,418,476.7
Las Cruces	$2,271,687,344.44	$2,565,555,378.51	$2,650,740,460.07	$2,699,898,704.78
Hobbs	$1,492,398,150.32	$1,498,707,837.97	$996,237,329.88	$1,246,489,141.68
Farmington	$1,146,902,250.59	$1,188,681,923.20	$1,085,827,213.66	$1,275,970,074.17
Carlsbad	$1,240,296,660.44	$1,341,987,264.59	$889,741,686.40	$1,048,678,282.47
Rio Rancho	$788,871,476.77	$928,655,167.54	$972,068,892.51	$1,326,882,118.85
Roswell	$784,064,810.57	$829,059,692.92	$816,634,229.99	$933,731,787.76
Los Lunas	$631,098,174.97	$512,791,222.67	$575,605,574.91	$800,345,967.72
Clovis	$526,025,740.14	$584,505,592.25	$583,823,998.26	$648,487,938.44



	2020	2021	2022
Albuquerque	$1,983,174,820.93	$(1,287,839,001.12)	$2,192,004,613.85
Carlsbad	$101,690,604.15	$(452,245,578.19)	$158,936,596.07
Clovis	$58,479,852.11	$(681,593.99)	$64,663,940.18
Farmington	$41,779,672.61	$(102,854,709.54)	$190,142,860.51
Hobbs	$6,309,687.65	$(502,470,508.09)	$250,251,811.80
Las Cruces	$293,868,034.07	$85,185,081.56	$49,158,244.71
Los Lunas	$(118,306,952.30)	$62,814,352.24	$224,740,392.81
Rio Rancho	$139,783,690.77	$43,413,724.97	$354,813,226.34
Roswell	$44,994,882.35	$(12,425,462.93)	$117,097,557.77

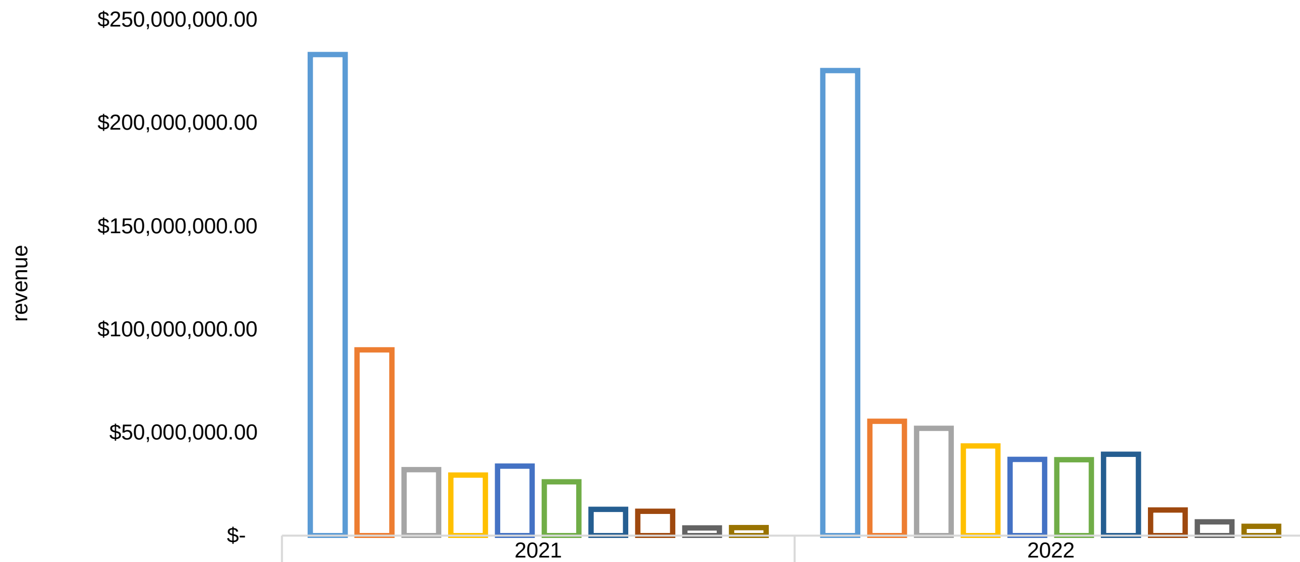
Appendix B. Oil and Gas Community MTGR Changes

Top Four County GRT Revenues: FY22 vs. FY21 Oil & Gas (through May 2022, in millions)



	2021	2022
San Juan County	$78,361,745.69	$228,113,807.07
McKinley County	$92,255,118.08	$104,102,252.47
Lea County	$1,540,064,162.86	$3,168,863,329.28
Eddy County	$1,368,013,350.81	$2,708,034,929.92

Top 10 Municipality GRT Revenues: FY22 vs. FY21 Oil and Gas (through May 2022)



	2021	2022
Hobbs	$233,238,436.93	$225,448,465.50
Carlsbad	$90,031,701.13	$55,368,938.84
Jal	$31,991,981.79	$51,953,489.50
Eunice	$29,331,494.63	$43,451,860.51
Artesia	$33,649,757.80	$36,904,857.58
Farmington	$26,140,109.03	$36,869,044.16
Loving	$12,696,201.30	$39,382,127.00
Lovington	$11,809,268.15	$12,404,336.91
Bloomfield	$3,815,962.82	$6,753,600.57
Tatum	$3,936,522.57	$4,562,495.70

Appendix C. 2022 Related Proposed Legislation

*HB 47 EXCLUDE HOME HEALTH CARE FROM DBS SOURCING

Summary: House Bill 47 would have provided an exception to the destination-based sourcing rules for reporting gross receipts tax (GRT) under Section 7-1-14 NMSA 1978 for home health services, hospice services, and personal care services performed in New Mexico. This exception would have reverted those services to origin-based sourcing for gross receipts. In other words, the business location of the service provider would have been used to determine gross receipts tax liability rather than the location of where the service was performed. The bill defined home health services, hospice services, and personal care services. This bill contained an emergency clause and would become effective immediately on signature by the governor.

FIR Concern: It is unclear how the proposal would address medical services that are provided over the internet through telehealth. Specified health service providers are likely burdened by the reporting required of destination-based sourcing as clients may reside in different tax districts. Yet, HB47 fails to meet the LFC tax policy principle of equity, as it provides specific tax treatment to a given industry. Making industry specific exemptions in the tax code is likely to encourage additional exceptions as each industry seeks its preferred tax treatment. Furthermore, implementation of significant tax changes with an emergency clause is untenable.

*SB 136 EXCLUDE OIL & GAS SERVICES FROM DBS RULES

Summary: Senate Bill 136 (SB136) would have provided 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 would have reverted those services to origin-based sourcing for gross receipts. In other words, the business location of the service provider would have been used to determine gross receipts tax liability rather than the location of where the service is performed. The bill also defined oil and gas production services.

FIR Concern: In southern New Mexico, for example, oil and gas service companies compete across state lines with differing GRT rates. SB136 would have placed New Mexico oil and gas service businesses at a disadvantage with out-of-state businesses that would pay a lower GRT rate. It is unclear if the definition of oil and gas production services would require additional reporting by taxpayers to self-identify as a qualifying entity. The definition may encourage tax avoidance as companies avoiding the definition could reduce tax liability. Furthermore, the LFC tax policy principle of equity is not met, as it provides specific tax treatment to a given industry. Making industry specific exemptions in the tax code is likely to encourage additional exceptions as each industry or municipality seeks its preferred tax treatment.

*SB 137 DISTRIBUTE PART OF GRT ON SVCS TO MUNIS

Summary: The Senate Tax, Business and Transportation Committee Substitute for Senate Bill 137 (SB137) would have created the "destination-based sourcing safety net fund," the money of which would have been distributed every six months to qualified municipalities. The distributions would have been based on the amounts of revenue reduction resulting from destination-based sourcing. It included an appropriation of $50 million to the fund, and $2.5 million to the Taxation and Revenue Department (TRD) to implement the legislation. The bill also would have required sellers report their selling location for all transactions, even if receipts were sourced to a different place.

FIR Concern: The changes, which would have required the reporting of a seller's location on top of the correct sourcing location for the gross receipts, would have required additional taxpayer reporting requirements on gross receipts tax (GRT) returns, which may reduce taxpayer voluntary compliance by adding another layer of complexity. This complexity challenges the tax policy principle of 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 changes to GRT returns and the associated complex changes to distributions to local governments 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.