Implementation of Destination Sourcing
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What is Sourcing?

- Concept relates to many taxes, including gross receipts taxes and compensating taxes.
- Refers to location where an economic transaction is deemed to have taken place – i.e., where does a sale of property or services occur?
- Determines which taxing entity or entities receive the benefit of taxation – who gets the revenues.
- Particularly important where multiple entities may claim a right to tax all or part of a transaction.

What are the current issues with Sourcing?

- Sourcing used to be relatively simple, because the seller and the purchaser were usually in the same place for most retail transactions.
- As economic transactions become more geographically complex and diverse, sourcing rules must change.
- The increasing amount of internet-based sales and the use of web-based marketplaces have sped up these changes, and have required legislative responses by all States.
- As sourcing rules change, tools emerge to assist taxpayers with reporting obligations

Sourcing before July 1, 2021

- New Mexico, like most states, used “origin-based” sourcing.
  - Transactions were sourced to the location of the seller.
  - This worked when most retail sales were made in person.
  - Also applied to sales of most services.
  - Certain exceptions applied.
- Pursuant to statute, sourcing rules were made by Tax & Rev through regulation.

Sourcing from July 1, 2021

- Starting July 1, 2021, New Mexico switched to "destination-based" sourcing.
  - This method of sourcing looks to where the property is delivered.
  - Also applies to many services, with major exceptions. For applicable services, this method looks to where the product of the service is delivered or initially used.
  - Other exceptions still exist.
- Sourcing rules are now set by statute, Section 7-1-14, NMSA.
  - Regulations supplement and explain, but do not change, the statutory language.

Why change the method of sourcing?

- Changes are necessary to adapt to current economic realities, and to ensure that all transactions are taxed fairly and equally.
- Changes are necessary to protect New Mexico businesses, and even the playing field with out-of-state businesses.
- Changes benefit state and local revenues on the whole by allowing taxation of internet/marketplace transactions.
- Changes are necessary to align with other states’ tax laws.

How does Destination Sourcing help New Mexico?

- Using destination sourcing ensures that New Mexico and its political subdivisions receive their fair share of revenues from transactions in interstate commerce.
- But destination sourcing is just one part of that solution.
- Adopting destination sourcing complements other changes to the law of interstate sales.
  - These complementary changes are the changes to the law of “nexus”.
  - They do not derive from state law, but from decisions of the United States Supreme Court.

A quick detour about Nexus

- The concept of nexus derives from the Interstate Commerce Clause of the United States Constitution.
- “Nexus” refers to the power of a state government to tax an individual or company, or to compel an individual or company to collect tax from its customers.
- Prior to 2018, an individual or company was required to have some physical presence in a state in order for the state to have the power to tax that individual or company, or to compel it to collect tax from its customers.

Changes to the law of Nexus

- Up until 2018, “physical presence” was required.
  - Affirmed in *Quill* decision in 1992.
  - Even then, the doctrine came in for criticism as out-dated.
- In 2018, United States Supreme Court issued the *Wayfair* decision, abandoning the “physical presence” rule, and adopting an economic test instead.
- New Mexico legislature adopted the *Wayfair* rule through change to Section 7-9-3.3, NMSA, with an effective date of July 1, 2019.
- New Mexico can now tax out-of-state sellers with no physical presence in the state.

How Destination Sourcing works with Nexus to Protect New Mexico

- After *Wayfair*, New Mexico can tax out-of-state businesses.
  - These businesses have not operated GRT-free since July 1, 2019, and therefore at an advantage over New Mexico businesses.
  - But they still had a tax advantage under origin-based sourcing from July 1, 2019 to June 30, 2021 because they did not pay local option gross receipts taxes; they paid only the basic state rate of 5.125%.
- In order for local option gross receipts taxes to apply, destination sourcing must be used.
  - Eliminates all tax advantages for out-of-state businesses.
  - Levels the playing field for New Mexico businesses.

Some examples

- Prior to *Wayfair* and change to 7-9-3.3, NMSA (prior to July 1, 2019)
  - Out-of-state seller with no physical presence sells property to a New Mexico resident over the internet, and ships the property into the state; seller pays no tax.
  - In-state seller pays state rate (5.125%) plus the local option gross receipts taxes where its business is located.
- Post-*Wayfair* but prior to adoption of destination sourcing (July 1, 2019 to July 1, 2021)
  - Out-of-state seller can be taxed, but only pays state rate of 5.125%, because its receipts are sourced out-of-state.
  - In-state seller pays state rate plus the local option gross receipts taxes where its business is located.

Some examples (continued)

- After July 1, 2021
  - Out-of-state seller pays state rate, plus the local option gross receipts taxes at the location where the property is delivered.
  - In-state seller pays state rate, plus the local option gross receipts taxes at the location where the property is delivered.
- By applying both new nexus rules and destination sourcing rules, out-of-state and in-state business are treated the same.
- Overall state and local revenues have increased as a result.

Related Statutory Changes

- In the first example above, although the seller would not be liable for GRT, the purchaser should be liable for compensating taxes.
  - But Tax & Rev was prohibited from seeking to collect compensating taxes from most individuals pursuant to Section 7-9-7.1, NMSA. Changed by HB6 in 2019, effective July 1, 2020.
  - However, it is still administratively difficult to collect compensating tax from individuals.
  - More transactions are subject to gross receipts tax rather than compensating tax as a result of these changes in tax law, improving collections and reducing tax avoidance.

Related Statutory Changes (continued)

- Change to Section 7-9-13.1 – receipts from performing services outside of New Mexico, the product of which is initially used in New Mexico.
  - Out-of-state service providers no longer have a tax advantage over New Mexico businesses.
- New Section 7-19D-9.1, NMSA and 7-20E-9.1, NMSA - Implementation of Local Option Compensating Taxes.
  - Applies to municipalities and counties that have enacted local option gross receipts taxes.
  - A smaller advantage for out-of-state businesses, but eliminated now.

Implementation of Nexus and Sourcing

- New nexus rules:
  - Change to Section 7-9-3.3 made by HB 6 (Section 25) in the 2019 Session, with an effective date of July 1, 2019.
  - Minor regulatory changes made in July, 2021; not required for enforcement of the new nexus rule, only explanatory.
- New destination sourcing rules:
  - Changes to Section 7-1-14 made by HB 6 (Section 11) in the 2019 Session, with an effective date of July 1, 2021.
    - Delay was to allow time to implement regulations, and for businesses to adjust to new reporting requirements.

Implementation (continued)

- Destination sourcing (continued)
  - The Department contracted with New Mexico Tax Research Institute and received technical expertise from Multistate Tax Commission on regulations
  - Draft regulations published on March 23, 2021.
  - Administrative hearing held on April 29, 2021.
  - Final regulations published and effective July 7, 2021.
  - Additional draft regulations published July 2, 2021; additional regulations regarding services.
  - Administrative hearing held on August 10, 2021.
  - Final regulations published and effective October 13, 2021.

Overview of Destination Sourcing Rules

- Receipts from the sale of tangible personal property are sourced to where the property is received.
  - If the property is received at a retail establishment, there will be no change.
  - Otherwise, instructions for delivery given by the purchaser control.
- Leases of tangible personal property sourced to where the property is primarily used.
- Receipts with respect to transactions involving real property sourced to the location of the property.
- Receipts for franchises sourced to where the franchise is used.

Overview (continued)

- Sourcing of services – the most complicated part of the change.
  - Distinguishes first between “professional” and non-professional services.
  - Distinguishes between “in person” professional services and services not provided in person.
  - Professional services that are not in person are sourced to the business location of the service provider.
  - Most other services sourced to location where the product of the service is delivered.
  - Other exceptions for real estate, transportation, and construction-related services.

Taxpayer Response

- Main concern is additional complexity in billing.
  - Formerly, sellers usually only had to use one location code and rate.
  - Now, sellers have to check the location and rate for each sale where property or service is delivered.
  - We have heard primarily from home healthcare service providers with this concern. Small businesses have also raised concerns about integrating location codes and rates into their accounting systems.
  - The Taxation and Revenue Department has implemented a location and code map on its homepage, which it continues to improve.
  - Through a contract with UNM's Earth Data Analysis Center, the Department is working to deploy internet services that will enable automation and enhance identification of location codes and rates.

Taxpayer Response (continued)

- Questions regarding when a service is professional.
  - The Department has issued guidance based on the statutory language.
- Questions regarding when a service is performed “in person”.
  - The Department intends to issue clarifying regulations.

Ongoing Steps

- Implementation is substantially complete, and the law has been in effect since July 1, 2021.
- First reports using the new rules were due on August 25, 2021, for the July 1-31, 2021 reporting period.
- Tax Policy continues to analyze the data; Covid-19 impacts and related stimulus makes interpretation of the impact of changes difficult due to multiple moving parts. Additional data over time will allow for better analysis.
- The Department is identifying additional areas where regulations may be clarified and improved. Regulation is an ongoing process.