November 15, 2022

MEMORANDUM

TO: Destination-Based Sourcing Workgroup; Senator Bobby Gonzales, Senator Gay Kernan, Representative Tara Lujan, Representative Nathan Small

FROM: Ismael Torres, Chief Economist, Legislative Finance Committee, Jennifer Faubion, Economist, Legislative Finance Committee

THROUGH: David Abbey, Director, Legislative Finance Committee;

SUBJECT: **Overview, Preliminary Analysis, and Impacts of Destination-Based Sourcing**

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. This memo abbreviates the issue with an overview and preliminary insights on impacts.

Overview of Destination-Based Sourcing

Across New Mexico, the gross receipts tax varies from 5 percent to 9.3125 percent because the total rate combines rates imposed by the state, counties, and municipalities. A 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). Previously, a business paid GRT with the location code and tax rate corresponding to the location of the business (origin-based sourcing).

Under origin sourcing, an out-of-state business hired in New Mexico is taxed only an out-of-state tax rate (5.125 percent previously, the lowest possible) while local businesses pay their local rate (a weighted average rate of 7.965 percent). This inequitable and preferred treatment of out-of-state businesses in origin sourcing is required because of the U.S. Constitution's dormant commerce clause. The dormant commerce clause implicitly prohibits states from discriminating against non-residential commerce. Under destination-based sourcing all businesses, regardless of location, pay the same rate depending on the delivery of the good or service. In this way, both in-state and out-of-state businesses pay the same tax rate. This is the only way states have evened the playing field for in-state and out-of-state businesses due to the dormant commerce clause. Recognizing this, three-quarters of all states with sales taxes have moved to destination-based sourcing to guarantee in-state businesses are not disadvantaged with more states likely to follow. Of the five states with services in the tax base, all use destination-based sourcing (Hawaii, New Mexico, South Dakota, Washington, and West Virginia).

Additionally, national research on effective tax collection suggests destination-based sourcing streamlines administration through easier tax identification and tracking of transactions. The identifiable transactions make it harder to avoid taxation, especially from out-of-state businesses. The reduction in tax avoidance is expected to bolster tax revenue for municipalities, counties and the state.

Revenues and Destination-Based Sourcing

Across levels of government, 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 GRT matched receipts 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

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 (see *Appendix A)*.

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. Furthermore, Eddy and Lea counties are experiencing a substantial gain in revenue from the inclusion of out-of-state mining services reporting to the county because of the change to destination-based sourcing.

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.

Municipal Revenues Following Implementation

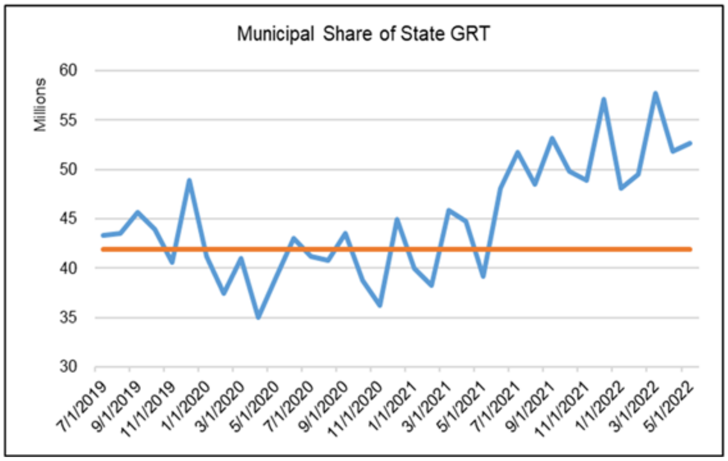
At the municipal level, nearly all local governments are experiencing gains in tax revenue when compared with 2021 (see *Appendix B*). Only eight municipalities (Elida, Causey, Dora, Vaughn, Dexter, Folsom, Grenville, and Corona) have experienced a decrease, year-over-year. The decline for all eight municipalities is unlikely attributable to destination-based sourcing, as declines follow trends from before implementation or are the result of nearby construction project fluctuations. 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 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 by the inclusion of out-of-state activity such as retail trade. LFC staff estimate at least $200 million in MTGR has been lost in each city due to destination-based sourcing.

Despite losses in Carlsbad and Hobbs, both municipalities are among the highest in per capita GRT in the state (see *Appendix C*). In FY22 with destination-based sourcing, Carlsbad had the third highest per capita MTGR in the state for communities larger than 5 thousand, while Hobbs was the seventh highest. Each MTGR per capita is over 150 percent of the average MTGR per capita around the state. Both municipalities have gross receipts tax increments available with 1.0625 percent of GRT increment available in Hobbs and 0.4375 increment available in Carlsbad.

State Revenues Following Implementation



Prior to destination-based 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-based 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-based sourcing as more activity is sourced to municipalities, statewide 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 as a result of the change, more than two and half times the annual flat distribution provided before destination-based sourcing.

Outstanding Issues

Preliminary analysis indicates 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. This will result in larger local government revenues as local tax increments apply. Conversely, an indeterminate amount of activity is being reported in municipalities erroneously, which, as tax payer compliance improves, may result in decreasing activity and tax filing amendments that reduce local government revenues. On net, growing tax payer compliance is likely to be a positive for most local governments.

More time is also needed to determine the full impacts of destination-based sourcing. Given the significant remaining out-of-state activity and a three year ability for tax amendments, the full impacts on FY22 will likely be unknown until FY25.

Finally, the Taxation and Revenue Department is most capable in evaluating impacts in their ability to review individual taxpayer information. The department's review of destination-based sourcing is necessary to understand true impacts and determinations of greater specificity.

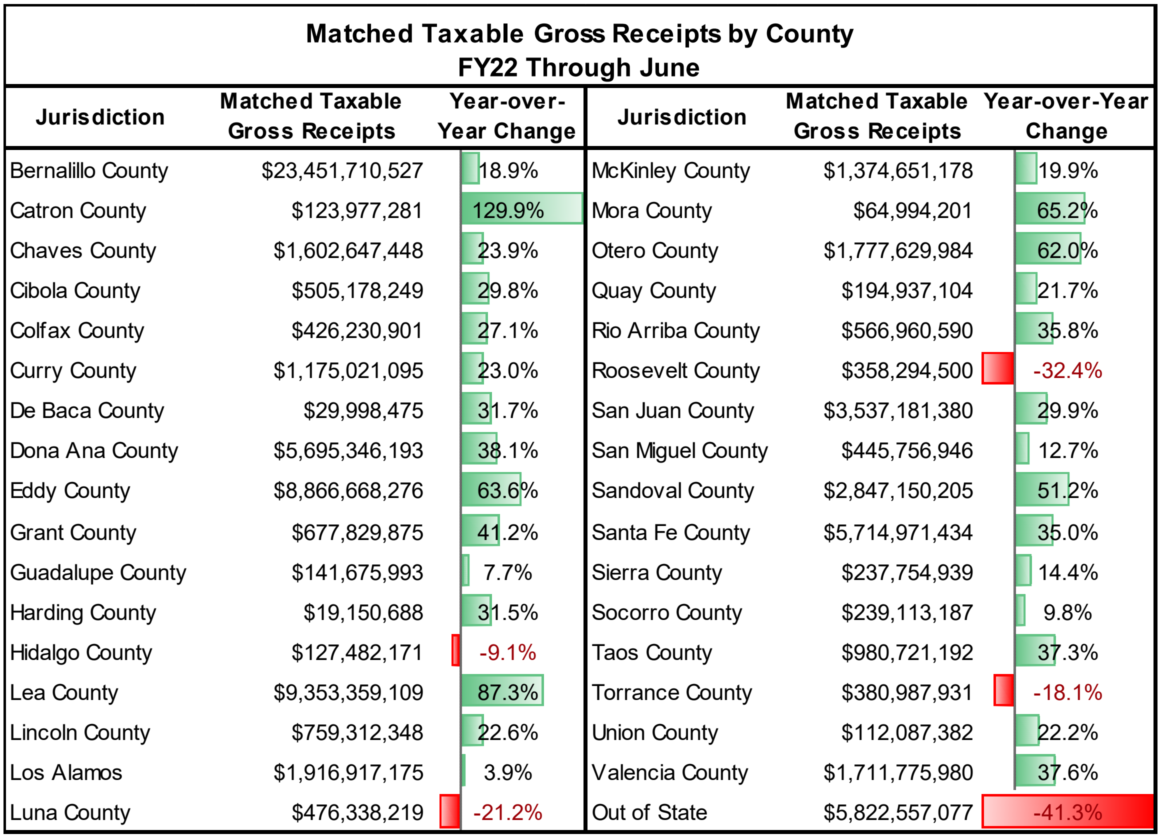
Options for Consideration

Given the incomplete understanding of destination-based sourcing impacts, more time, data, and analysis is needed. Due to vacancies, staff at the Taxation and Revenue Department have been limited in the ability to conduct such analysis and the appropriate access to taxpayer information needed for such an evaluation is not available to LFC. Waiting for the full impacts of destination-based sourcing and an evaluation of such impacts are necessary to create informed changes to recurring revenues or budgets. Moreover, the affected communities continue to collect high revenues on a per capita basis. Therefore, LFC staff recommend maintaining the status quo for the time being.

Alternatively, the solution proposed in Senate Bill 137 (SB 137) during the 2022 Legislative session could be reconsidered with a $10 million appropriation. SB 137 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 to the fund, and to the Taxation and Revenue Department (TRD) to implement the legislation.

Other alternatives include creating a stabilization fund for the affected communities, with a similarly sized appropriation, meant to offset declines in revenue that result from declines in activity from the mining industry. Finally, the state could also support revenue stability by appropriating nonrecurring funds for local roads to reduce budgetary pressures for the affected communities.

Appendix A. MTGR by County



Matched Taxable Gross Receipts by County
FY22 Through June

Jurisdiction	Matched Taxable Gross Receipts	Year-over-Year Change	Jurisdiction	Matched Taxable Gross Receipts	Year-over-Year Change
Bernalillo County	$23,451,710,527	18.9%	McKinley County	$1,374,651,178	19.9%
Catron County	$123,977,281	129.9%	Mora County	$64,994,201	65.2%
Chaves County	$1,602,647,448	23.9%	Otero County	$1,777,629,984	62.0%
Cibola County	$505,178,249	29.8%	Quay County	$194,937,104	21.7%
Colfax County	$426,230,901	27.1%	Rio Arriba County	$566,960,590	35.8%
Curry County	$1,175,021,095	23.0%	Roosevelt County	$358,294,500	-32.4%
De Baca County	$29,998,475	31.7%	San Juan County	$3,537,181,380	29.9%
Dona Ana County	$5,695,346,193	38.1%	San Miguel County	$445,756,946	12.7%
Eddy County	$8,866,668,276	63.6%	Sandoval County	$2,847,150,205	51.2%
Grant County	$677,829,875	41.2%	Santa Fe County	$5,714,971,434	35.0%
Guadalupe County	$141,675,993	7.7%	Sierra County	$237,754,939	14.4%
Harding County	$19,150,688	31.5%	Socorro County	$239,113,187	9.8%
Hidalgo County	$127,482,171	-9.1%	Taos County	$980,721,192	37.3%
Lea County	$9,353,359,109	87.3%	Torrance County	$380,987,931	-18.1%
Lincoln County	$759,312,348	22.6%	Union County	$112,087,382	22.2%
Los Alamos	$1,916,917,175	3.9%	Valencia County	$1,711,775,980	37.6%
Luna County	$476,338,219	-21.2%	Out of State	$5,822,557,077	-41.3%

Source: RP 500

Appendix B. MTGR by Municipality Greater than $100 million

Matched Taxable Gross Receipts by Municipality for Fiscal Year 2022

Jurisdiction	Matched Taxable Gross Receipts	Year-over-Year Change
Alamogordo	$858,513,457	17.9%
Albuquerque	$19,827,240,053	23.5%
Angel Fire	$170,536,400	36.8%
Artesia	$693,320,389	29.5%
Aztec	$159,347,256	54.5%
Belen	$267,929,258	22.5%
Bernalillo	$246,205,231	14.8%
Bloomfield	$202,817,771	29.6%
Carlsbad	$1,761,283,997	21.4%
Clovis	$894,933,843	16.7%
Corrales	$141,947,967	65.6%
Deming	$369,750,178	21.0%
Edgewood	$193,396,855	29.8%
Espanola	$300,249,651	12.2%
Eunice	$178,709,484	76.5%
Farmington	$2,008,703,579	19.6%
Gallup	$915,551,593	12.8%
Grants	$264,055,866	15.6%
Hobbs	$2,000,079,711	15.9%
Jal	$649,780,308	170.6%
Las Cruces	$3,679,478,347	19.7%
Las Vegas	$326,155,889	10.8%
Los Lunas	$1,115,704,994	44.1%
Los Ranchos de Albuquerque	$164,782,018	37.9%
Loving	$183,190,749	129.8%
Lovington	$288,569,784	47.4%
Portales	$264,856,213	27.5%
Raton	$127,736,009	27.7%
Rio Rancho	$1,895,813,688	34.5%
Roswell	$1,328,189,236	22.4%
Ruidoso	$385,360,368	18.5%
Ruidoso Downs	$111,997,564	16.1%
Santa Fe, City of	$4,529,601,434	34.4%
Silver City	$376,295,142	13.8%
Socorro	$173,087,866	15.0%
Sunland Park	$198,034,173	59.5%
T or C	$143,457,178	22.3%
Taos	$431,143,950	24.0%
Tucumcari	$125,763,327	20.5%

Appendix C. MTGR per Capita by Municipality Greater than 5,000

Municipality Greater than 5,000	2020 Census Population	Per Capita MTGR	Rank
Taos	6,474	$66,596.22	1
Los Lunas	17,242	$64,708.56	2
Carlsbad	32,238	$54,633.79	3
Artesia	12,875	$53,850.13	4
Santa Fe, City of	87,505	$51,763.92	5
Ruidoso	7,679	$50,183.67	6
Hobbs	40,508	$49,374.93	7
Farmington	46,624	$43,083.04	8
Gallup	21,899	$41,807.92	9
Silver City	9,704	$38,777.32	10
Belen	7,360	$36,403.43	11
Albuquerque	564,559	$35,119.87	12
Las Cruces	111,385	$33,033.88	13
Edgewood	6,174	$31,324.40	14
Grants	9,163	$28,817.62	15
Espanola	10,526	$28,524.57	16
Los Ranchos de Albuquerque	5,874	$28,052.78	17
Alamogordo	30,898	$27,785.41	18
Roswell	48,422	$27,429.46	19
Bernalillo	8,977	$27,426.23	20
Bloomfield	7,421	$27,330.25	21
Aztec	6,201	$25,697.03	22
Deming	14,758	$25,054.22	23
Las Vegas	13,166	$24,772.59	24
Lovington	11,668	$24,731.73	25
Tucumcari	5,278	$23,827.84	26
T or C	6,052	$23,704.09	27
Clovis	38,567	$23,204.65	28
Portales	12,137	$21,822.21	29
Raton	6,041	$21,144.85	30
Socorro	8,707	$19,879.16	31
Rio Rancho	104,046	$18,220.92	32
Corrales	8,493	$16,713.52	33
Sunland Park	16,702	$11,856.91	34
Anthony	8,693	$8,396.09	35