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

SPONSOR Lujan, B **DATE TYPED** 02-15-04 **HB** 625

SHORT TITLE Food and Medical Services Gross Receipts **SB**

ANALYST Taylor

REVENUE

Estimated Revenue		Subsequent Years Impact	Recurring or Non-Rec	Fund Affected
FY04	FY05			
	(500.0)*	(2,100.0)	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

* See fiscal implications narrative for details

SOURCES OF INFORMATION
LFC Files

SUMMARY

Synopsis of Bill

House Bill 625 removes the gross receipts tax from food and certain health care services. It creates new distributions to cities and counties to offset revenue losses from removing those taxes. It adjusts the county equalization formula, provides a penalty to taxpayers that incorrectly report food and health services deductions, and it repeals the municipal gross receipts tax credit. These changes are summarized section by section in the following paragraphs.

Section 1 Provides a new distribution to municipalities to offset the foregone revenue due to the food and health care tax deductions. The distribution is made monthly and is equal to the food tax deductions claimed, multiplied by the sum of the municipality's local option gross receipts rates, plus the 1.225 percent shared by the state. Revenue from this distribution is considered gross receipts tax revenue and may be used in the same manner, including payment of gross receipts tax revenue bonds.

Section 2 Provides a new distribution to counties to offset foregone revenues due to the food and health care tax deductions. The distribution is made monthly and is equal to the food tax deductions claimed by businesses in the county, but not within a municipality, multiplied by the sum of all county's local option gross receipts rates.
Revenue from this distribution is considered gross receipts tax revenue and may be used in the same

manner, including payment of gross receipts tax revenue bonds.

Section 3 Creates a penalty for incorrectly reporting food and health care practitioner services deductions. The penalty is equal to the difference between the correct tax amount owed and the amount paid multiplied by two.

Section 4 Amends the county equalization distribution. The base of the distribution is increased by adding 5 percent of the net gross receipts attributable to the food deduction and 5 percent of the net gross receipts attributable to the medical services deduction. These adjustments are made to offset the loss of these receipts from the tax base due to the new deductions.

Section 5 Provides a gross receipts tax deduction for the sale of food at retail food stores. The deduction applies to sales that are not already exempt or deductible. The food definition follows that of for food stamps. A retail food store is also defined in a manner consistent with that used by the food stamp program.

Section 6 Provides a deduction for receipts of licensed health practitioners from payments by a managed care provider for Medicare Part C services or commercial contract services. Commercial contract services are services provided through a contract with a managed care organization other than those provided to Medicare and Medicaid patients. Licensed health care practitioners include physicians, physician assistants, osteopathic physicians, chiropractic physicians, doctors of oriental medicine, podiatrists, psychologists, registered nurses, licensed practical nurses, midwives, physical therapists, optometrists, occupational therapists, respiratory care practitioners and speech pathologists or audiologists.

Section 7 Repeals the municipal gross receipts tax credit.

Section 8 Declares the effective date for the bill to be January 1, 2005.

FISCAL IMPLICATIONS

TRD's estimates the bill's impacts on the state's general fund as summarized in the table below.

General Fund Revenue Impacts	**FY 2005**	**FY 2006**		**FY 2007**
GRT food deduction	(52,700.0)	(107,000.0)		(109,000.0)
GRT health practitioners deduction	(15,700.0)	(33,500.0)		(35,700.0)
Repeal the municipal GRT credit	67,900.0	142,600.0		149,600.0
Net General Fund Impact	**(500.0)**	**2,100.0**		**4,900.0**

It is important to note the bill only affects the state general fund: gross receipts tax deductions have been designed to have no impact on local governments. Thus, the general fund impacts shown in the table include the hold harmless provisions provided for local governments. FY05 impacts are a little less than half of those in FY06, reflecting the January 1, 2005 effective, which implies only a half-year impact in the first year of the proposed changes. The small negative general fund impacts shown in FY05 and are expected to turn positive beginning in FY06. This is because of the different growth rates associated with these revenues: food tax receipts are expected to grow by about 2 percent; health practitioners' receipts by 6.7 percent; and the municipal tax credit by 4.9 percent.

Fiscal impacts on local governments are shown in the following table.

Local Governments' Revenue Impacts	**FY 2005**	**FY 2006**
GRT food deduction	(23,200.0)	(47,000.0)
Health Practitioners' Deductions	(7,300.0)	(15,600.0)
Local Government Offsets (hold harmless)	30,500.0	62,600.0
Net Local Governments' Impacts	**0.0**	**0.0**

ADMINISTRATIVE IMPLICATIONS

TRD reported the following administrative issues:

- Major computer system changes will be required to accept and track the deductions and to make the appropriate adjustments to local revenue distributions. Reprogramming the system to track the deductions by location is possible. However, the effective date of January 1, 2005 should give the department enough time to incorporate the changes.
- Forms will need to be redesigned to accept and track the new deductions. Taxpayer education efforts will be greater than for normal changes. For effective administration of local distributions, taxpayers must separately calculate and report the deductions claimed for each business location. This would create an additional layer of administrative complexity, not only for the department, which must track the deductions and incorporate them into monthly local distribution calculations, but also for larger food retailers who may report gross receipts to several different locations.
- Ensuring that food retailers apply the deduction only for qualified food sales might be a problem. While most retailers are likely to claim only legitimate deductions, it will be almost impossible to identify those who don't. Typically when examining retail businesses with large sums of cash flow, auditors have only cash register tapes with no (or very cryptic) descriptions of purchases at their disposal. However, this proposal does impose an additional penalty for overstating deductions. Such a measure may be helpful to ensure compliance.
- No state administers a sales tax exemption for food without litigation, protest and controversy. The definitional problems are acute and continuing. Fortunately, New Mexico can adopt other state's regulations to better create "bright lines". The department will still face a significant regulatory effort, however.
- Provisions contained in the bill increase the complexity of the GRT for taxpayers who do not currently participate in the federal food stamp program, especially retailers who lack computer pricing and scanning technology. Therefore, the burden will be more acute on the smaller retailers.

OTHER SUBSTANTIVE ISSUES

The Blue Ribbon Tax Commission considered these tax issues. Here are some of the concerns and arguments for and against that were presented to the commission:

1. Gross receipts tax on food.
   a. Arguments for a deduction: i) food is a basic necessity and should not be subject to tax; ii) tax on food is regressive—low income families pay a higher percentage of their income on this tax than higher income families; iii) while food stamps provide help to low income families, but not all participate in the program and food stamps don't cover the

b. entire food budget for many of these.
c. Arguments against: i) while food is a necessity, there are other necessities that are taxed and removing the food on tax could set a precedent for removing the tax on other necessities, thereby narrowing the tax base; ii) a considerable share of low-income families participate in the food stamp program, and thus won't benefit from the tax relief provided by lifting the food tax; iii) higher income household will receive most of the benefit of the tax cut in terms of dollars saved; iv) it would be less expensive to target this tax relief to low and moderate income households

2. Gross receipts on medical services.
   a. General arguments for: i) eliminating the tax increases providers take home pay, making it easier to recruit and retain them; ii) providers practicing under managed care plans cannot pass the tax to consumers; iii) only New Mexico and Hawaii tax health providers' receipts under a sales or gross receipts tax which sends a bad signal as to the state's medical business climate.
   b. General arguments against: i) question as to whether the federal government's Center for Medicare and Medicaid Services might interpret the exemption provided for health care practitioners' gross receipts as being too narrowly targeted at Medicaid; ii) managed care plans may not pass on the tax savings to providers; iii) narrows the gross receipts tax base.

TRD's reported these issues (and provided the attached map):

Regressivity of State Taxes:

- A tax is said to be "regressive" if it takes a higher percentage of income from poor households than it does from richer households. The gross receipts tax ("GRT") on food is one of the regressive elements in the New Mexico tax structure. According to national survey results, the percentage of household income spent on food for home consumption decreases as household income increases. Although the state taxes many of the necessities of life in one form or another, the fact that food and healthcare are necessities enhances the perceived unfairness of the GRT.

- A couple of provisions of current law mitigate to some extent the regressive impacts of the GRT:

   1. Food purchased with food stamps is exempt from the GRT. 75,000 low-income families in New Mexico, with 195,000 persons, are food-stamp recipients. This provision excluded from tax approximately $184 million--or about 10 percent of total food spending--of food purchases in FY 2003.
   2. The Low Income Comprehensive Tax Rebate (LICTR) is intended to offset to some degree the regressive impacts of the GRT. LICTR is a refundable credit of up to $450 per year for households with income of less than $22,000.

Stability and adequacy of state and local revenues:

- Food expenditures historically are a very stable component of the gross receipts tax base. Gross receipts tax collections from food help dampen volatility of state tax revenue collections, and buttress

- the revenue base during cyclical downturns in the economy. Over the last ten years, gross receipts
- tax collections on food have grown at a stable 1.7% compound rate per year. This proposal would reduce projected GRT revenue by about 7.5%, and state General Fund revenue by about 2.6%.
- In addition to adding an element of stability to the gross receipts tax, receipts of health practitioners grow more quickly than general revenue. Exempting this sector reduces the "elasticity"—the rate of growth of revenue collections relative to the rate of economic growth--of the gross receipts tax. In other words, it makes it harder for the tax revenues to keep up with inflation when the higher-growth sectors are carved out of the existing tax base.
- The broad GRT base has frequently been cited as one reason New Mexico's sales tax revenue growth has been more robust than that of other states. Over the decade ending in 2002, the GRT base grew at a 5.1% compound annual growth rate, compared with personal income growth of 5.5% in the state. One explanation is that the GRT's taxation of services prevented the erosion of the base as the economy has shifted away from manufacturing to services.

Other States' Sales Tax Treatment of Food and Medical Services:

- Of the 45 states that impose a sales or gross receipts tax, 28 have exemptions for food. Of the 17 states that tax food, five do so at a reduced tax rate. Of the thirteen states that fully tax food sales, seven (including New Mexico) offer income tax credits or rebates to offset at least part of the tax on food (see Illustration 1, on page 6).
- According to a recent survey by the Federation of Tax Administrators (FTA), New Mexico is one of only four states to tax physicians' services.

Managed Care and Medicare Part "C":

- Some of the impetus behind proposals to provide deductions or exemptions to health care practitioners stems from the fact that some health plans are said to be refusing to pay the passed-on tax. Additionally, Medicare reimbursement rates are widely believed to be unjustly low, creating significant economic strain on the New Mexico healthcare sector.
- The 1997 Balanced Budget Act expanded the types of private health care plans that may offer Medicare benefits to include medical savings accounts, managed care plans, and private fee-for-service plans. The new Medicare Part C (also called Medicare+ Choice) programs are in addition to the fee-for-service options available under Medicare Parts A and B.

Definition of "Health Practitioner":

Although the bill contains a fairly comprehensive list of health practitioners that are eligible to claim the GRT deduction, dentists do not qualify under this proposal.

Repealing the 0.5% Municipal Credit:

- In general, taxpayers in municipal areas are subject to local option GRT taxes imposed by both the county and by the municipality. Thus, combined tax rates in municipal areas tend to be higher than those outside municipalities. Repealing the 0.5 percent credit will tend to increase the differential between the total GRT rates imposed in cities and total rates imposed in unincorporated areas. Repealing the credit may provide some incentive for taxpayers to locate businesses just outside municipal boundaries to take advantage of lower rates. Hence, the municipal

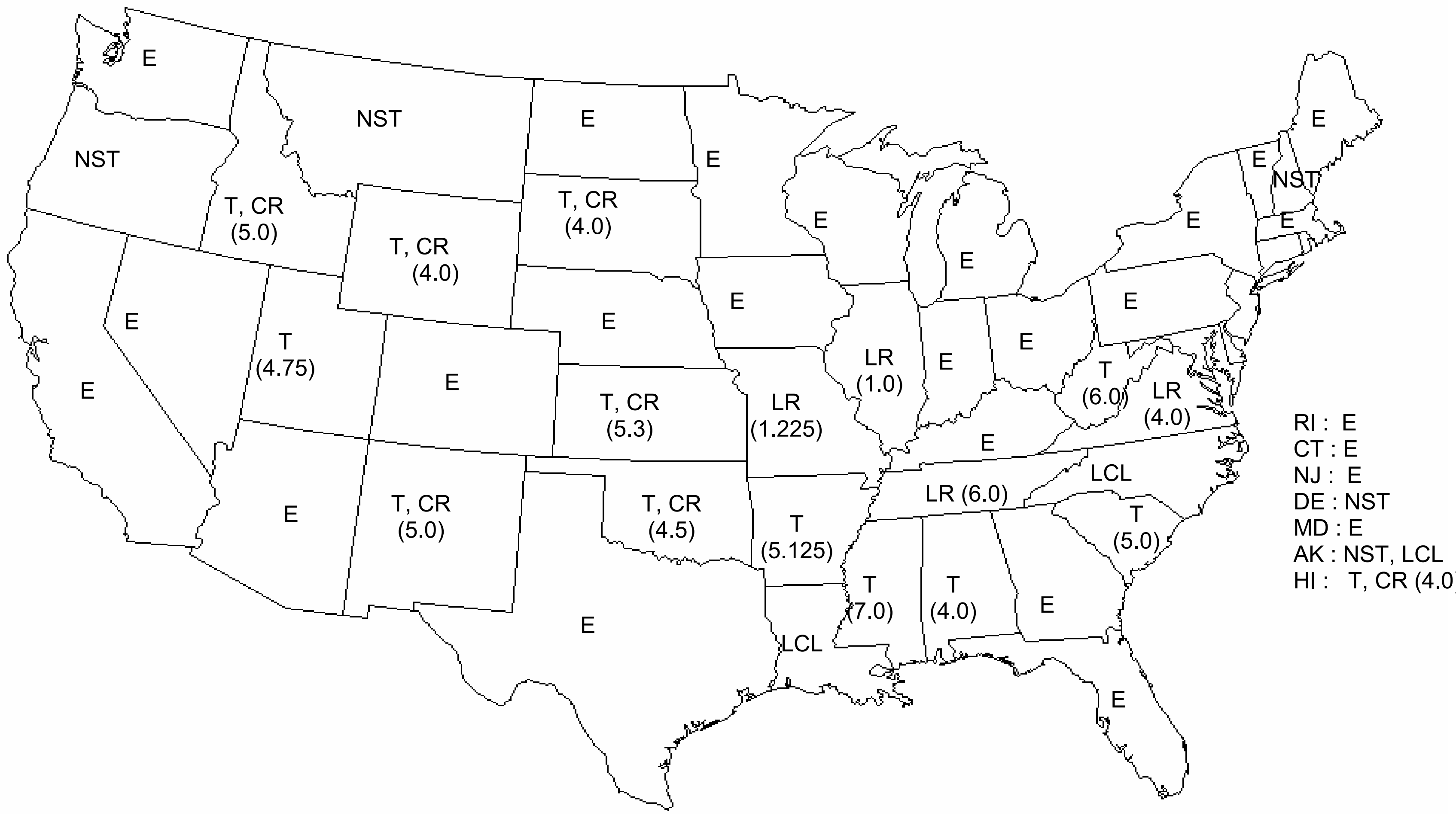
- credit may serve to limit "urban sprawl" to some degree.
- The effective .5% rate increase will lead to gross receipts tax rates in some municipalities approaching 8%. The principle on which the gross receipts tax was founded was to couple a broad base with a low rate. This proposal represents some erosion of that principle.

Hold-Harmless Provisions:

- The proposed local government hold-harmless provisions introduce a significant new layer of complication in the administration of sales taxes in the state. If these provisions were to pass, most future proposals for substantive GRT deductions can be expected to contain similar stipulations, further complicating taxpayer reporting requirements. The trend of increasing complication in the GRT program runs counter to the nationwide efforts to simplify sales tax administration as incorporated in the Streamlined Sales Tax Project.
- The local government "hold-harmless" provisions of the bill would require that the value of the deductions claimed be multiplied by the local option rates imposed at the time the deduction is claimed, and the resulting amount distributed from the general fund to the appropriate local government. Hence over time, the negative general fund impact will increase as additional local options are imposed. The additional revenue from repealing the 0.5% municipal credit may not be sufficient to support the local offset in the future.
- The state, municipal and county offsets are supported by a 0.5% GRT rate increase on municipal taxpayers. Effectively, the 75% of GRT taxpayers reporting to municipal locations would bear 100% of the additional tax burden.
- Similarly, although the majority of the GRT on food is assumed to be passed directly on to households, the department estimates that only about 40% of the increased GRT due to the 0.5% credit repeal is passed directly to households. The remainder is imposed directly on businesses and government (although it may be indirectly shifted to households). The net result of this shifting is that the GRT will be less like a retail sales tax and more like a transfer tax imposed on businesses.

BT/lg:yr

Illustration 1:
Sales Tax Treatment of Food for Home Consumption
As of January 1, 2004



T: State taxes food (state tax rate in parentheses)

CR: State offers income tax credit or rebate to offset part of tax on food

E: State exempts food from sales tax

NST: State does not levy a sales tax

LR: State taxes food at a lower rate than other goods (food tax rate in parentheses)

LCL: Food exempt from state sales tax, but subject to local sales taxes

Sources: Federation of Tax Administrators, Streamlined Sales Tax Project, and State Revenue Departments.