FISCAL IMPACT REPORT

		ORIGINAL DATE	1/24/17		191/aHAFC/aSFC/
SPONSOR	Larrañaga	**LAST UPDATED**	3/17/17	**HB**	aSFl#1/CC

SHORT TITLE Oil & Gas School Tax to Stabilization Reserve **SB**

ANALYST Iglesias/Graeser/Clark

REVENUE (dollars in thousands)

Conference Committee – Changes to Delayed Repeal of Deductions and Credits

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**	**FY20**	**FY21**		
$0.0	$0.0	$0.0	$0.0	$0.0	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

Original Bill – Tax Stabilization Reserve Impact

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**	**FY20**	**FY21**		
$0.0	$0.0	$0.0	($14,988.1)	($39,465.5)	Recurring	General Fund
$0.0	$0.0	$0.0	$14,988.1	$39,465.5	Recurring	Tax Stabilization Reserve

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY17	**FY18**	**FY19**	**3 Year Total Cost**	**Recurring or Nonrecurring**	**Fund/Agency Affected**
Total	$21.0	$0.0	$0.0	$21.0	Nonrecurring	Taxation and Revenue Department (General Fund)

Parenthesis ( ) indicate expenditure decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Office of Attorney General (OAG) – on related bill
New Mexico Tax Research Institute (NMTRI) – on related bill

SUMMARY

Synopsis of Conference Committee

The Conference Committee added language requiring the Legislature to make appropriate adjustments to the gross receipts tax rate to maintain revenue neutrality following recommendations by the Revenue Stabilization and Tax Policy Committee regarding the delayed repeal of deductions and credits. This changes the fiscal impact of this portion of the bill to zero for all years.

The committee also struck four of the deductions that would be subject to delayed repeal or "sunset" (still shown on appendix tables for reference):

- 7-9-54.3 wind and solar generation equipment deduction;
- 7-9-56.2 hosting world wide web sites deduction;
- 7-9-95 back to school deduction (tax holiday); and
- 7-9-112 solar energy systems deduction.

<u>Synopsis of Senate Floor Amendment #1</u>

The Senate Floor amendment strikes the SFC amendment but adds back all the SFC provisions along with another tax reform component by amending Section 7-9-17 NMSA 1978 to exempt from gross receipts tax (GRT) employee wages in the form of guaranteed payments to partners for personal services. Good tax policy dictates that as an issue of fairness, an individual's income should not be taxed twice simply due to the structure of the payment from the individual's employer company when another individual with a different payment structure would only be taxed once, potentially for the exact same work and same starting income. However, New Mexico currently taxes these guaranteed payments twice.

The Taxation and Revenue Department (TRD) reports it collects, on average, 40 percent of the total amounts due from guaranteed payments. One type of guaranteed payment can be viewed as an additional form of employee wages, and that is the type of payment addressed by this amendment. Proponents would note providing one employee with salary and another with salary and another type of guaranteed payment should not result in different taxation schemes for the two employees. Many people would object to also subjecting these payments to GRT, and this is likely a significant portion of the reason why 60 percent of the taxes due are not collected – anecdotal reports note the state receives little to no revenue from GRT receipts on this type of guaranteed payment.

In this case, the amendment solves an existing problem of double taxation for partners at some small businesses in the state, although the solution will require rulemaking by TRD to clarify exactly what type of guaranteed payments made for personal services should be viewed as employee wages and therefore removed from GRT taxation. Because of the tax collection issue noted above and anecdotal reports from multiple tax experts noting the state receives little to no revenue from this particular type of guaranteed payment, the amendment should have either no fiscal impact or a minimal negative general fund impact and thus does not appear in the fiscal impact tables above.

<u>Synopsis of SFC Amendment</u>

The Senate Finance Committee amendment makes two significant changes. First, it adds market-based sourcing for apportionment of income for taxation. Second, it provides delayed repeal dates or "sunsets" (in two stages) for numerous tax deductions and credits and requires the interim Revenue Stabilization and Tax Policy (RSTP) Committee to study these deductions and credits and report back to the Legislature with recommendations in December 2018 and

December 2020. It also requires RSTP to make recommendations by December 2018 to reduce the pyramiding effects of the gross receipts tax (GRT). Each of these two changes in the amendment is discussed in detail below.

The fiscal impact tables above only reflect the impact of the original bill and the delayed repeals, because the Taxation and Revenue Department (TRD) was unable to estimate the fiscal impact of the market-based sourcing changes. The delayed repeals/sunsets are scored as indeterminate, but the intent appears to be neutral due to the instructions for RSTP to simultaneously study deductions and credits and study how to reduce pyramiding. If the Legislature, with the advice of RSTP, decides to actually repeal any of these deductions and credits, the savings could be used to reduce pyramiding and achieve revenue neutrality.

Market-Based Sourcing

The bill now amends the Uniform Division of Income for Tax Purposes Act (UDITPA) to determine the sourcing of certain sales and services. Sourcing is a means of identifying which state's taxes should be applied to a transaction. This bill amends sourcing rules for sales as they are included in the sales factor for the division of income for tax purposes. Under the provisions of the bill, sales would be sourced to New Mexico if:

- sale, rental, lease or license of real property and the real property is located in New Mexico;
- rental, lease or license of tangible personal property and the tangible personal property is located in New Mexico;
- sale of a service and the service is delivered to a location in New Mexico; and
- sale, rental, lease or license of intangible property and the intangible property is used in New Mexico.

If the source state cannot be determined, sourcing must be reasonably approximated. If the taxpayer is not taxable in a state to which a sale is assigned or the state of assignment cannot be determined or approximated, that sale shall not contribute to the calculation of the sales factor, either with inclusion in the numerator or the denominator.

The amendment provides an exception to the market sourcing rule for certain communications services. At most, 50 percent of gross revenue from communications services would be sourced to New Mexico. This appears to create a tax expenditure for communications services and appears targeted to a specific company or companies because of provisions requiring at least $43 million in qualified expenditures or sales to qualify for this tax expenditure. The amendment specifies communications services do not include broadcasters and platform distribution companies.

The bill authorizes TRD to promulgate rules to carry out the purposes of the bill's provisions related to UDIPTA, and these provisions apply to taxable years beginning on or after January 1, 2018.

Two states – North Carolina and Virginia – are studying the fiscal impact of market-sourcing, but they have not published their findings. TRD anticipates that there will be some revenue loss from firms currently taxed under cost of performance and some revenue gain from firms that would be subject to taxation under market-sourcing. However, the degree to which anticipated revenue losses and gains offset each other is unknown. Revenue loss is attributed to New Mexico firms subject to taxation in market-sourcing states as well as New Mexico. Revenue gain is attributed to economic value received from New Mexico market participation but not taxed under the cost of performance standard.

LFC staff note, however, New Mexico's status as a net market state – that is, a state that tends to be a buyer of services from without rather than a seller of services from within – indicates that the change from cost-of-performance sourcing rules to market-based sourcing could have a positive impact on revenues.

Currently, sales, other than sales of tangible personal property, are considered to be in New Mexico if:

- the income-producing activity is performed in this State; or
- the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance (COP).

TRD noted an issue with this treatment, namely:

- The cost of performance is difficult to determine, and
- "All or nothing" assignment of sales based on the state with greatest cost of performance is not a reasonable treatment.
- The COP rule somewhat duplicates the function of property and payroll.

However, the amendment requires a "qualified company" providing communications services to exclude 50 percent of its sales from the New Mexico sales factor in apportioning income for the purpose of corporate income tax or personal income tax of a pass-through entity. This would create an unquantifiable loss of revenue.

Repeals of Deductions and Credits

The bill now requires RSTP to make recommendations by December 2018 to reduce the pyramiding effects of the GRT. It also provides delayed repeal dates (in two stages – July 1, 2019 and July 1, 2021) for numerous tax deductions and credits and requires RSTP to study these deductions and credits and report back to the Legislature with recommendations in December 2018 and December 2020.

See Attachment 1 for details.

Synopsis of HAFC Amendment

The House Appropriations and Finance Committee (HAFC) amendment strikes Section 3 from the original bill and replaces it with a new Section 3 that allows for a distribution to be made to the tax stabilization reserve in the amount of the excess of the five-year annual average, if the year-to-date amount plus the current net receipts exceeds the annual average amount. If there is not an excess amount, no distribution will be made.

This bill does not change how funds are appropriated from the tax stabilization reserve and does not change or diminish legislative appropriation authority. The bill still allows for fluctuation and growth in the general fund over time.

Synopsis of Original Bill

The Pew Charitable Trusts, a non-partisan organization, supports HB191 and "believes this is a promising bill that contains important best practices for rainy day fund saving." Pew notes if it passed, New Mexico would join 15 states that deposit based off volatility and would become a leader at managing volatile oil and gas taxes.

The Legislative Finance Committee has endorsed this bill.

This bill distributes revenue in excess of an annual five-year average for the oil and gas emergency school tax to the tax stabilization reserve. The taxpayers dividend fund is also repealed, such that balances in the tax stabilization reserve may accumulate over time. The effective date of this bill is July 1, 2018, and there is no delayed repeal date.

FISCAL IMPLICATIONS

It is important to clarify a few things this bill does and does not do:

DOES

- ✓ Capture windfalls from the oil and gas emergency school tax
- ✓ Create a "smoothing effect" on this revenue source
- ✓ Allow general fund revenue from the oil and gas emergency school tax to fluctuate and grow over time
- ✓ Allow balances to accumulate in the tax stabilization reserve by repealing the taxpayers dividend fund

DOES NOT

- × Change how funds are appropriated from the tax stabilization reserve
- × Change or diminish legislative appropriation authority from the tax stabilization reserve
- × Give the governor appropriation authority over these funds
- × Reduce funding for schools
- × Prevent the general fund from fluctuating and/or growing over time

Distributing oil and gas emergency school tax revenues in excess of the previous five-year average would effectively capture revenue windfalls from the oil and gas industry, which has a high degree of variability, and would help to stabilize oil and gas general fund revenues over time.

Currently, the oil and gas emergency school tax is one of New Mexico's four primary severance taxes and accounts for about 90 percent of the severance tax revenue the state general fund receives and about 4 percent of total general fund recurring revenues.

While originally named the "oil and gas emergency school tax", it should be noted this revenue source flows directly to the general fund and is not tied to education funding more than any other general fund revenue.

Due to the state's high reliance on the oil and gas industry and the tendency for the state's economy and state budget to do well in periods of strong oil and gas industry growth, this bill assumes the general fund is able to absorb distributions to the tax stabilization reserve without significant negative effects on the state budget.

Table 1 below demonstrates if similar legislation had been enacted in fiscal year 2007, about $365 million would have been distributed to the tax stabilization reserve by the end of FY16 from oil and gas emergency school tax revenues in excess of the average of the five previous fiscal years. Assuming no previous withdrawals, the Legislature would have been able to utilize these funds to help address FY16 and FY17 solvency.

Table 1. Distrib. to Tax Stabilization Reserve if Previously Enacted in FY07

	School Tax (in thousands)		
FY	Revenue	Five-Year Average	Excess of Average
2007	$420,254.3	$341,317.3	$78,937.0
2008	$557,668.1	$397,718.1	$159,950.0
2009	$370,354.0	$446,151.4	$0.0
2010	$324,544.0	$437,680.7	$0.0
2011	$376,104.5	$417,315.6	$0.0
2012	$399,588.9	$408,845.1	$0.0
2013	$379,899.0	$390,490.0	$0.0
2014	$500,658.6	$374,780.8	$125,877.8
2015	$375,423.4	$406,660.1	$0.0
2016	$236,817.6	$394,226.8	$0.0
		Total to Tax Stabilization Reserve	$364,764.8

Using December 2016 consensus revenue estimates for the oil and gas emergency school tax revenues, if the Legislature were to establish this distribution effective the beginning of FY19 as proposed in the draft legislation, the fund would build a balance of $54.5 million by the end of FY21. Due to current low oil and gas prices following previous periods of significant strength in the oil and gas industries, revenues would not exceed the five-year average until FY20. This bill allows the tax stabilization reserve fund to further capture any significant future increases in the oil and gas industry in future years and would assist the state in shoring up deficits in periods of high need.

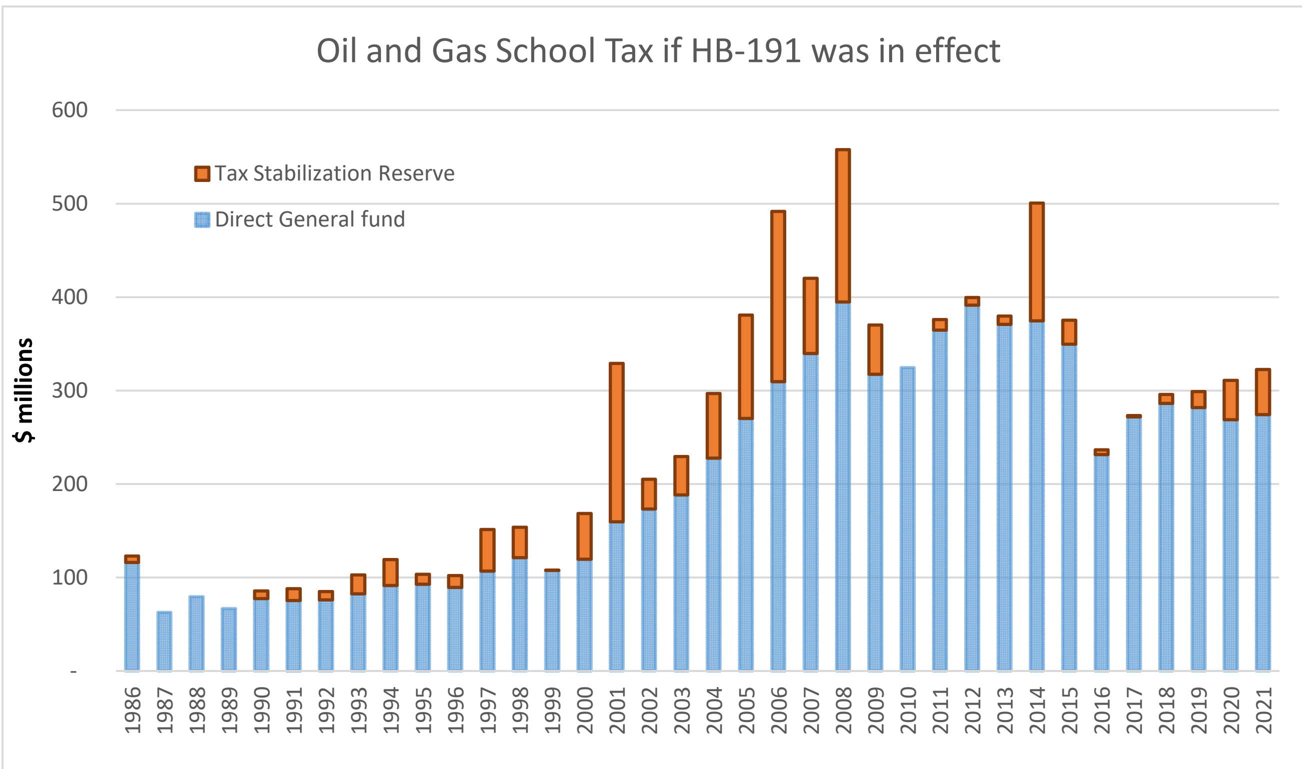
Table 2. Distrib. to Tax Stabilization Reserve if Enacted in FY19

	School Tax (in thousands)		
FY	Revenue (Dec 2016 CREG)	Five-Year Avg.	Excess of Avg.
2019	$299,100.0	$336,414.2	$0
2020	$311,100.0	$296,111.9	$14,988.1
2021	$322,700.0	$283,234.5	$39,465.5
		Total to Tax Stabilization Reserve	$54,453.6

This bill does <u>not</u> change how funds are appropriated from the tax stabilization reserve and does <u>not</u> change or diminish legislative appropriation authority. Under current law, money in the tax stabilization reserve may only be appropriated if (1) the governor declares it "necessary for the public peace, health and safety" and only with the vote of two-thirds of both the House and

Senate, or (2) if revenues are determined by the governor to be insufficient to meet authorized appropriations for the current and next fiscal year and the House and Senate approve a transfer to the general fund with a majority vote to cover the projected insufficiency for either or both fiscal years. Therefore, in FY16 and FY17 when revenues were projected to be insufficient to meet appropriations, the state would have been able to access the tax stabilization reserve for solvency measures.

To demonstrate the smoothing effect on oil and gas revenues received in state, the graph below illustrates the oil and gas school tax revenue that would have gone to the tax stabilization reserve if this bill had been enacted in 1986. As show below, general fund revenues from this tax would still have been allowed to grow; however, in periods where revenues spiked above the five-year average (e.g. period of high prices), those excess amounts would be transferred to the reserve. Thus, the general fund revenue from this tax, as indicated by the blue lines, reflect less volatility.



TRD estimates there will be a minimal information technology impact (300 hours and $21 thousand) given their understanding of the way distribution processes currently work and the planned ONGARD replacement project currently underway, where the ONGARD severance taxes and related services will be transitioning into GenTax. A further impact may need to be analyzed when the new severance tax functionality is implemented in GenTax. This upgrade is tentatively scheduled around the end of calendar year 2017 followed by a stabilization period of at least six months. Implementation requires changes to GenTax revenue processes and configuration.

SIGNIFICANT ISSUES

The December 2016 revenue forecast lowered projections by about $130 million for FY17 and FY18. Projected FY17 ending reserve balances are $95.5 million, or 1.6 percent. This bill gradually rebuilds reserves without affecting general fund balances in FY17 and FY18.

TRD points out several states have either constitutional or statute-defined economic or budget stabilization funds, otherwise known as “rainy day funds,” to provide options during serious economic downturns. Purposes for the funds vary among states but may be summarized by these categories: cover revenue shortfalls or budget deficits; finance emergency situations as defined by legislation; and, general purpose appropriations. Most states cap the size of their funds tying them to a percentage of prior years’ general fund revenues or a specified dollar amount. Authorization to make appropriations from such funds also varies by state but can require a three-fifths to two-thirds approval by the legislature. If the additional transfer of revenue to the tax stabilization reserve is intended to establish a budget stabilization fund, then further definition and purpose of this fund appears warranted.

This bill seeks to repeal the taxpayers dividend fund, which has never been used, and instead allow balances to accumulate in the tax stabilization reserve. Under current law, it is difficult to use the tax stabilization reserve as a “rainy day fund”. When the tax stabilization reserve balance reaches 6 percent of the previous fiscal year’s recurring appropriations, state law requires the transfer of the excess funds to the taxpayers dividend fund.

ADMINISTRATIVE IMPLICATIONS

TRD estimates the bill will have a minimal impact (40 hours and no additional FTEs). The Financial Distributions Bureau (FDB) will need to verify and test ONGARD system changes and GenTax system changes with planned transition of ONGARD functionalities to GenTax, completing this work by June 15, 2018. FDB will modify SHARE distribution accounts as needed and work with DFA to complete changes in distributions. A further impact may need to be analyzed when the new severance tax functionality is implemented in GenTax. This upgrade is tentatively scheduled around the end of calendar year 2017 followed by a stabilization period of at least 6 months. Implementation requires changes to GenTax revenue processes and configuration.

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

DI & LG & JC/jle/al/sb/jle

ATTACHMENT 1

Repeal Date	Short Description	Statute	Purpose	Est. Cost (thousands)
7/1/2019	Textbooks Exemption from GRT	7-9-13.4	Citizen Benefit	$8,700.0
7/1/2019	Fuel Used in Space Vehicles Exemption from GRT or Comp	7-9-26.1	Economic Development	Unknown
7/1/2019	Officiating at NM Activities Association-Sanctioned School Events Exemption from GRT	7-9-41.4	Citizen Benefit	$186.0
7/1/2019	Space Related Transactions GRT Deduction	7-9-54.2	Economic Development	$100.0
7/1/2019	Wind and Solar Generation Equipment GRT Deduction	7-9-54.3	Environment/ Conservation	Unknown
7/1/2019	Space-Related Test Articles Comp Tax Deduction	7-9-54.4	Economic Development	Unknown
7/1/2019	Test Articles Comp Tax Deduction	7-9-54.5	Other	Unknown
7/1/2019	Hosting World Wide Web Sites GRT Deduction	7-9-56.2	Economic Development	$350.0
7/1/2019	Border Zone Trade-Support Companies GRT Deduction	7-9-56.3	Economic Development	$453.5
7/1/2019	Certain Services to an Out-of-State Buyer GRT Deduction	7-9-57	Economic Development	Unknown
7/1/2019	Software Development Services GRT Deduction	7-9-57.2	Economic Development	$1,480.0
7/1/2019	Publication Sales GRT Deduction	7-9-63	Other	$250.0
7/1/2019	Newspapers GRT Deduction	7-9-64	Other	$11,400.0
7/1/2019	Certain Commissions GRT Deduction (commissions are taxable as personal income)	7-9-66	Avoid double taxation	Unknown
7/1/2019	Warranty Obligations GRT Deduction (cost of the warranty is part of cost of the good or service and taxes were paid on it at the time of the original purchase)	7-9-68	Define the tax base	Unknown
7/1/2019	Prescription Drugs GRT or GGRT Deduction	7-9-73.2	Healthcare	$65,000.0
7/1/2019	DME and Medical Supplies GRT or GGRT Deduction	7-9-73.3	Healthcare	Unknown
7/1/2019	Resale of Certain Manufactured Homes GRT Deduction (deduction only applies if the initial sale was subject to the GRT, the compensating tax, or the MVX.)	7-9-76.1	Avoid double taxation	Unknown
7/1/2019	Biodiesel Blending Facility Credit against GRT or Comp Tax	7-9-79.2	Environment/ Conservation	Unknown
7/1/2019	Jet Fuel GRT and Comp Tax Deduction	7-9-83; 7-9-84	Economic Development	$6,000.0
7/1/2019	Film Companies GRT and GGRT Deduction (PIT & CIT deduction retained)	7-9-86	Economic Development	Unknown
7/1/2019	Lottery Retailers GRT Deduction	7-9-87	Other	$9,600.0
7/1/2021	Contribution of Inventory to Non-Profits & Governmental Agencies Comp Tax Deduction	7-9-91	Donation Incentive	Unknown
7/1/2021	Military Acquisition Programs GRT Deduction	7-9-94	Economic Development	Unknown
7/1/2021	Back to School GRT Deduction (Tax Holiday)	7-9-95	Citizen Benefit	$3,400.0

Repeal Date	Short Description	Statute	Purpose	Est. Cost (thousands)
7/1/2021	Purchases by or on Behalf of the State GRT Deduction	7-9-97	Relieve obligation to estimate tax	Unknown
7/1/2021	Biomass-Related Equipment and Biomass Materials Comp Tax Deduction	7-9-98	Environment/ Conservation	$55.0
7/1/2021	Services Used in Construction of Certain Public Health Care Facilities (Sole Community Providers) GRT Deduction	7-9-99	Healthcare	$0.0
7/1/2021	Construction Equipment and Materials for Certain Public Health Care Facilities (Sole Community Providers) GRT Deduction	7-9-100	Healthcare	None Claimed
7/1/2021	Electric Transmission Facilities GRT and Comp Tax Deduction	7-9-101; 7-9-102	Environment/ Conservation	$0.0
7/1/2021	Services for Electric Transmission Facilities GRT Deduction	7-9-103	Environment/ Conservation	$6.0
7/1/2021	Electricity Conversion GRT Deduction	7-9-103.1	Environment/ Conservation	None Claimed
7/1/2021	Electricity Exchange GRT Deduction	7-9-103.2	Other	None Claimed
7/1/2021	Credit for penalty pursuant to 7-1-71.2	7-9-105	Other	$0.0
7/1/2021	Production or Staging of Professional Contests GRT Deduction	7-9-107	Other	$103.1
7/1/2021	Investment Advisory Services GRT Deduction	7-9-108	Economic Development	$155.0
7/1/2021	Hearing and Vision Aides GRT Deduction	7-9-111	Healthcare	Unknown
7/1/2021	Solar Energy Systems GRT Deduction	7-9-112	Environment/ Conservation	$2,100.0
7/1/2021	Advanced Energy GRT and Comp Tax Deduction	7-9-114	Environment/ Conservation	$500.0
7/1/2021	Investment Tax Credit against GRT, Comp or WH	7-9A	Economic Development	$6,506.4
7/1/2021	High-Wage Jobs Tax Credit against GRT	7-9G-1	Economic Development	$69,919.6
7/1/2021	Advanced Energy Tax Credit against Modified Combined	7-9G-2	Environment/ Conservation	$1,586.2
7/1/2021	Alternative Energy Product Manufacturers Tax Credit against GRT, Comp, WH, ITGRT, 911 and relay svc surcharges (except Local Option)	7-9J	Economic Development	$141.4