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

		ORIGINAL DATE	1/25/2020		
SPONSOR	Martinez, J.	**LAST UPDATED**	2/07/2020	**HB**	149
SHORT TITLE	Investment Credit Act Changes			**SB**	
				ANALYST	Torres

REVENUE (dollars in thousands)

Estimated Revenue					**Recurring or Nonrecurring**	**Fund Affected**
FY20	**FY21**	**FY22**	**FY23**	**FY24**		
	($760.0)	($760.0)	($760.0)	($760.0)	Recurring	Local Governments
	($1,140.0-$1,400.0)	($1,140.0-$1,400.0)	($1,140.0-$1,400.0)	($1,140.0-$1,400.0)	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY20	**FY21**	**FY22**	**3 Year Total Cost**	**Recurring or Nonrecurring**	**Fund Affected**
Total		$5.2		$5.2	Nonrecurring	General Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

Duplicates SB 184.

SOURCES OF INFORMATION
LFC Files

Response Received
Taxation and Revenue Department (TRD)
Department of Finance and Administration (DFA)
Economic Development Department (EDD)

No Response Received
New Mexico Association of Counties
New Mexico Municipal League

SUMMARY

Synopsis of Bill

House Bill 149 amends the investment credit for manufacturers to allow a credit equal to the effective gross receipts tax (GRT) rate, up from current statute allowing a credit equal to the compensating tax rate on qualified equipment purchased or brought into the state.

House bill 149 also delays by 10 years provisions that would otherwise take effect beginning July 1, 2020 to make the investment credit more restrictive in two ways. One delayed item would be the annual cap per taxpayer claiming the credit of $2 million – the bill would leave no cap until July 1, 2030. The other delayed item would be the more restrictive employment requirement of one new FTE per $100 thousand in value of qualified equipment. Until that delayed provision takes effect, the bill would require one new FTE per $750 thousand of equipment, up to $30 million, and one new FTE per $1 million of equipment over $30 million.

The effective date of this bill is July 1, 2020.

FISCAL IMPLICATIONS

Allowing the credit rate to equal the statewide average GRT rate instead of the compensating tax rate would increase general fund costs as the GRT rate is greater than the compensating tax rate. The state would bear the entire cost of this change, with no cost to local governments, despite the local tax rate inclusion in calculating the credit's value. The change is in part related to the new effects of destination based sourcing changes implemented during the 2019 Legislative Session.

To estimate the fiscal impact of the bill, LFC staff used an eight-year average of historical costs as reported in TRD's *Tax Expenditure Reports*. Costs were used to extrapolate investment values in each fiscal year against which the credit is claimed. Using the product of the extrapolated investment value and statewide average GRT rate, marginal costs in using the GRT rate over the compensating rate were calculated. Given the significant fluctuations in the expenditures, the eight-year average of the marginal costs were used. While this results in an average higher than the last three years, the inability to score the impact of delaying the $2 million cap per claimant and delaying the more restrictive employment requirements lends credence to using this slightly higher average.

TRD's analysis of HB149 uses figures for FY19, and concluded a slightly lower cost to the general fund of $1.1 million. TRD also used FY19 figures to calculate the local government revenue impacts.

TRD reports that implementing HB149 would impact the Information Technology Division (ITD) through approximately 100 hours or approximately 3 weeks of work and $5,153 in soft costs. GenTax will need to be updated so that municipal and county rates can be added to calculate the tax credit. Similarly, FYI and application changes need to be made in order to accommodate the municipal and county rates. Lastly, procedures changes need to be instituted to accommodate the municipal and county rate changes.

This bill expands a tax expenditure with a cost that is difficult to determine but likely significant. LFC has serious concerns about the risk to state revenues from tax expenditures and the increase in revenue volatility from erosion of the revenue base. The committee recommends the bill adhere to the LFC tax expenditure policy principles for vetting, targeting, and reporting or be held for future consideration.

This bill may be counter to the LFC tax policy principles of adequacy, efficiency, and equity. Due to the increasing cost of tax expenditures, revenues may be insufficient to cover growing recurring appropriations.

Estimating the cost of tax expenditures is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. The statutory criteria for a tax expenditure may be ambiguous, further complicating the initial cost estimate of the expenditure's fiscal impact. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures.

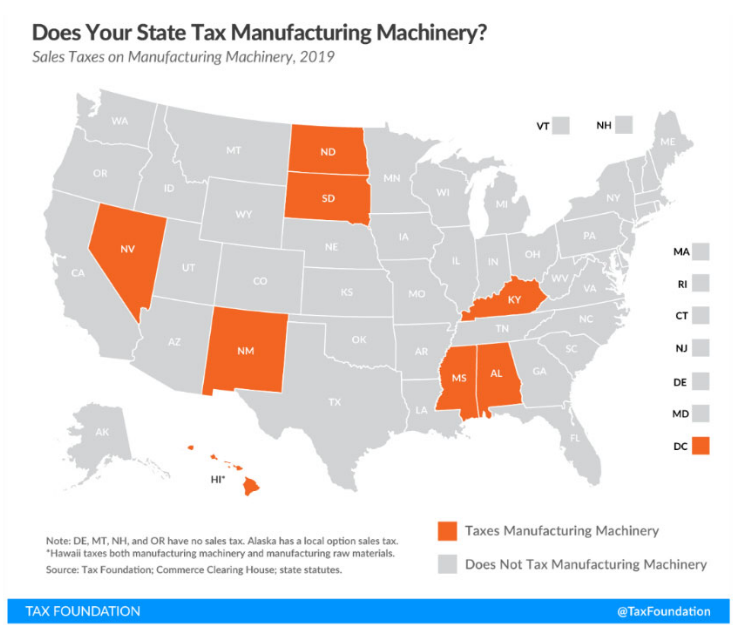
SIGNIFICANT ISSUES

It is important to note the 10-year delay proposed by this bill for two of the provisions nearly replicates the delay enacted in 2009 that set the current dates, so in effect, this is moving a sunset date forward, with the primary difference being the application of the GRT rate in certain circumstances.

The credit, and the bill, attempt to bring the state's taxation of manufacturing equipment more in line with the rest of the country. Most states do not tax manufacturing equipment, but New Mexico's broader GRT and compensating taxes would apply unless the equipment is purchased through an industrial revenue bond, in which case it is exempt.

The New Mexico Economic Development Department provides the following analysis:

> New Mexico is one of just eight states in the country that tax manufacturing equipment, although the number of states in which the tax is actually imposed is lower. For example, until New Mexico's investment tax credit essentially sunsets on July 1, 2020, it has acted over the decades to completely offset the tax in the vast majority of cases. The map below shows the states that technically tax this equipment.



The bill brings the state's taxation of manufacturing equipment more in line with the rest of the country. Most states do not tax manufacturing equipment, but New Mexico's broader GRT and compensating taxes would apply unless the equipment is purchased through an industrial revenue bond, in which case it is exempt.

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Not enacting this bill will have major implications on New Mexico's ability to retain its existing manufacturing base and recruit new and expanding companies in the manufacturing sector. Because the vast majority of other states and all of our neighboring states do not tax equipment, without this credit New Mexico will be at a 7 percent to 8 percent disadvantage. This in essence would take New Mexico off of the list for any manufacturing discussion whether it be relocation or expansion.

The Albuquerque Economic Development Department adds the following:

What is the Investment Credit for Manufacturers?
In 1979, the New Mexico Legislature created the investment credit in an attempt to offset the competitive disadvantage the taxation of manufacturing equipment placed on the state. Legislators at the time wanted to provide a more favorable tax climate for manufacturers because of the greater economic benefits they generate.

Currently, the investment credit is equal to the compensating tax rate of 5.125 percent, but it is limited to 85 percent of the taxpayer's compensating, gross receipts or withholding tax due for the reporting period. Any remaining credit may be claimed in subsequent reporting periods.

What is happening to the credit?
Unless action is taken in the 2020 legislative session, the investment credit will be capped at $2 million of qualified equipment after June 30, 2020. This would be a major problem, as there is currently no limit on the amount of investment a company may make and for which it can apply the credit.

That means that New Mexico would no longer be competitive for larger job creation projects from existing or new employers that could help to strengthen and diversify the state's economy. Additionally, the credit currently requires a company to hire one full-time employee for each $500 thousand of investment made, up to $30 million, and then one full-time employee for each $1 million dollars invested thereafter. Unless the credit is extended, companies will be required to hire one full-time employee for each $100 thousand of qualified equipment after June 30, 2020. In an era of ever-increasing automation, New Mexico will stand out within the region as uncompetitive as well as unresponsive to industry trends.

The Unintended Consequence of Destination-Based Sourcing
During the 2019 legislative session, New Mexico elected to adopt 'destination-based sourcing' for purposes of determining the tax rate on manufacturing equipment purchases.

Therefore, manufacturers will be required to pay the difference between the compensating tax rate (5.125 percent) and the gross receipts tax rate (7.875 percent in Albuquerque, for example), regardless of where they purchased the equipment.

Unless the investment credit is expanded to apply against gross receipts tax, New Mexico will have another barrier to overcome when trying to stimulate investment and job creation. For example, a potential employer considering Albuquerque for a $50 million investment in manufacturing equipment would be facing approximately $1,375,000 in additional taxes above the current compensating tax rate.

While this change is being phased-in beginning July 1, 2021, the tax rate on the purchase or introduction of qualified equipment will be equal to the gross receipts tax rate wherein the manufacturing operation is physically located in New Mexico.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is <u>not</u> met since TRD is <u>not</u> required in the bill to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the deduction is meeting its purpose.

ALTERNATIVES

A possible alternative is to repeal the credit and create a deduction. This would make it universally available to all taxpayers who would otherwise pay the tax, and New Mexico would no longer show up on maps and lists of states that tax manufacturing equipment.

Furthermore, this would avoid duplication and stacking of credits by manufacturers using industrial revenue bonds, which exempts them from paying the tax, who would then receive this credit despite no tax obligation.

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

Does the bill meet the Legislative Finance Committee tax expenditure policy principles?

1. **Vetted**: The proposed new or expanded tax expenditure was vetted through interim legislative committees, such as LFC and the Revenue Stabilization and Tax Policy Committee, to review fiscal, legal, and general policy parameters.
2. **Targeted**: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.
3. **Transparent**: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies.
4. **Accountable**: The required reporting allows for analysis by members of the public to determine progress toward annual targets and determination of effectiveness and efficiency. The tax expenditure is set to expire unless legislative action is taken to review the tax expenditure and extend the expiration date.
5. **Effective**: The tax expenditure fulfills the stated purpose. If the tax expenditure is designed to alter behavior – for example, economic development incentives intended to increase economic growth – there are indicators the recipients would not have performed the desired actions "but for" the existence of the tax expenditure.
6. **Efficient:** The tax expenditure is the most cost-effective way to achieve the desired results.

LFC Tax Expenditure Policy Principle	Met?	Comments
Vetted	-	Interim discussions but no vetting of bill
Targeted		
Clearly stated purpose	?	No purpose, targets or goals established.
Long-term goals	✘	
Measurable targets	✘	
Transparent	?	TRD will likely present an annual cost estimate in its tax expenditure reports.
Accountable		
Public analysis	✘	The bill does not contains provisions for reporting.
Expiration date	✓	The bill includes some expiration dates.
Effective		
Fulfills stated purpose	?	There is no purpose statement or measurable goals and targets to determine if the exemption fulfills intended outcomes.
Passes "but for" test	?	
Efficient	?	Without purpose statement, goals, or targets, it is not possible to determine if the exemption is the most efficient means of achieving a desired outcome.
Key: ✓ Met ✘ Not Met ? Unclear		

IT/rl/sb