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

SPONSOR SCORC **ORIGINAL DATE** 2/01/2020 **LAST UPDATED** 2/19/2020 **HB**

SHORT TITLE Investment Credit Act Changes **SB** CS/SB184/aSFC/aHTRC

ANALYST Torres/Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY20	FY21	FY22	FY23	FY24		
	($1,500.0)	($2,100.0)	($2,100.0)	($2,100.0)	Recurring	General Fund (ITC changes)
		Up to ($9,000.0)	Up to ($9,000.0)	Up to ($9,000.0)	Recurring	General Fund (GRT deduction)
	($1,500.0)	Up to ($11,100.0)	Up to ($11,100.0)	Up to ($11,100.0)	Recurring	Net General Fund
		Up to ($9,100.0)	Up to ($9,100.0)	Up to ($9,100.0)	Recurring	Local Governments (GRT deduction)

(Parenthesis ( ) Indicate Revenue Decreases)

Duplicates HB149

SOURCES OF INFORMATION
LFC Files

No Response Received (for Committee Substitute or Amendment)
Economic Development (EDD)
Taxation and Revenue Department (TRD)
Department of Finance and Administration (DFA)
New Mexico Association of Counties
New Mexico Municipal League

SUMMARY

Synopsis of HTRC Amendment

The House Taxation and Revenue Committee amendment to Senate Bill 184 (SB 184) strikes all amendments made by the Senate Finance Committee, adds a new manufacturer's deduction for production equipment used in a manufacturing operation, redefines "manufacturing operations," limits the proposed manufacturing deduction to qualified individuals, creates a new sunset for the investment tax credit, and limits new applicants for the investment tax credit to those with an industrial revenue bond approved before FY26.

In creating the new deduction, the amendment phases out and makes substantive changes to the investment tax credit. First, it delays the expiration of the investment tax credit by allowing for new claims of the credit to be made until July 1, 2025 for those projects that are approved by a sponsoring government for industrial revenue bond status. Second, the amendment changes the number of required jobs for a given level of investment.

Finally, the amendment changed the effective dates so that the manufacturer's equipment deduction is effective January 1, 2021 and changes to the investment tax credit are effective July 1, 2020.

Synopsis of SFC Amendment

The Senate Finance Committee amendment to the Senate Corporations and Transportation Committee substitute for Senate Bill 184 adds that the credit may be claimed against a taxpayer's local GRT and compensating tax liabilities in addition to the already allowed state GRT and compensating tax liability. The amendment also states that the credit must first be claimed against GRT and compensating tax liability before being claimed against the taxpayer's withholding tax liability. Finally, the amendment defines tax liability to include liabilities against withholding, state and local GRT, and state and local compensating tax.

Synopsis of Original Bill

The Senate Corporations and Transportation Committee substitute for Senate Bill 184 amends the investment credit for manufacturers to allow a credit equal to the effective gross receipts tax (GRT) rate starting July 1, 2021, up from current statute allowing a credit equal to the compensating tax rate on qualified equipment purchased or brought into the state. SB184 also expands the eligibility requirements for the credit to one new FTE per $750 thousand of equipment instead of the current $500 thousand, up to $30 million.

SB184 also delays by 10 years, provisions that would otherwise take effect beginning July 1, 2020 to sunset the investment credit. SB184 also eliminates a backup investment credit that otherwise takes effect when the original sunset is reached. The removed section that otherwise takes effect if the sunset is met included an annual cap per taxpayer claiming the credit of $2 million and more restrictive employment requirements of one new FTE per $100 thousand in value of qualified equipment. With those provisions removed from statute, the bill now allows for the investment credit to fully sunset on July 1, 2030, with no credit in place if the sunset is met.

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

FISCAL IMPLICATIONS

Fiscal Implications Related to the Investment Tax Credit

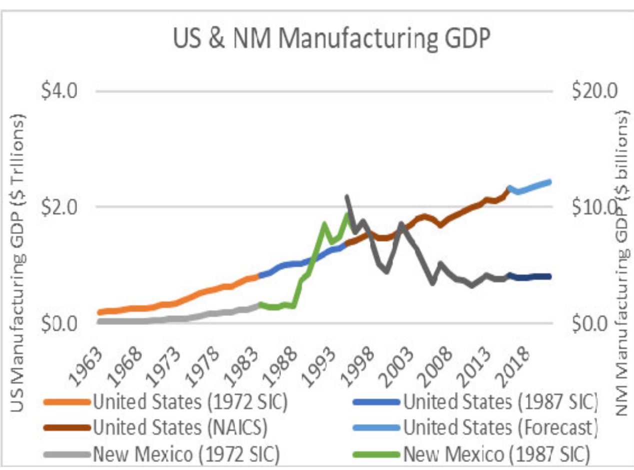
Allowing the credit rate to equal the statewide average GRT rate instead of the compensating tax rate would increase general fund costs as the GRT rate is greater than the compensating tax rate. The state would bear the entire cost of this change, with no cost to local governments, despite the local 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.

Fiscal Implications Related to the Manufacturer's Deduction

Overall, the manufacturer's deduction provisions of this bill will render New Mexico's tax treatment of manufacturing inputs much closer to the mainstream treatment in other states. As explained later, all three types of manufacturing inputs would be deductible and the deduction would create value for the claimant at the time the deduction would be claimed against liabilities.

LFC staff, in consultation with economists at the Taxation and Revenue Department (TRD), have developed a cost estimate for the creation of a manufacturer's deduction of manufacturing equipment. Using data from the U.S. Census[1] and the Bureau of Economic Analysis[2], LFC and TRD determined the potential manufacturing equipment capital stock eligible for the deduction each year, given the table below. Under this method, the creation of the deduction could cost up to the entirety of the stock's eligible deduction totaling $9 million to the general fund and $9.1 million to municipalities. This estimate assumes all deductions are claimed in a municipality and applies Albuquerque's tax rates to all state activity to determine total cost to local governments.



$1,682.9	(Billions) US Total Capital Demand
60%	The percentage of capital expenditures made up by equipment investment.
15%	The manufacturing sector's share of capital expenditures
$4,177.6	(Millions) NM manufacturing GDP
$2,790,000	(Millions) US Manufacturing GDP
0.15%	NM/US Manfacturing Ratio
$230.00	(Millions) NM manf equipment eligible for deduction

For comparison, LFC analysts then examined the average equipment purchases by manufacturers using 2012 IMPLAN model data. Manufacturing has been quite variable over the period from 2008 to 2020, but the 2012 data provides a lower bound for the purpose of this analysis. Assuming effects localized to the City of Albuquerque, the lower end cost of the deduction to the state would be about $2.2 million.

[1] https://www.census.gov/library/publications/2019/econ/2019-csr.html
[2] https://fred.stlouisfed.org/graph/?g=qaSl

This bill expands and creates 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

Currently, the investment credit excludes agricultural equipment and machinery, which is allowed a 50 percent deduction pursuant to 7-9-62 NMSA 1978. This bill may allow a deduction for agricultural equipment and machinery. The fiscal impact estimate shown in the table assumes that agricultural machinery and equipment would NOT be within the scope of the deduction, despite being unclear. If it were included in the deduction, costs could increase dramatically. See "Technical Issues" for more information.

The major purpose of the provisions of the HTRC amendments are to replace the current investment tax credit with a deduction for a specified list of manufacturing inputs. This list would include: (1) tangible personal property incorporated in the manufactured goods (current law); (2) tangible property, including electricity, consumed in manufacturing process (somewhat limited, but current law); and (3) purchase or lease of durable manufacturing equipment (proposed in this bill).

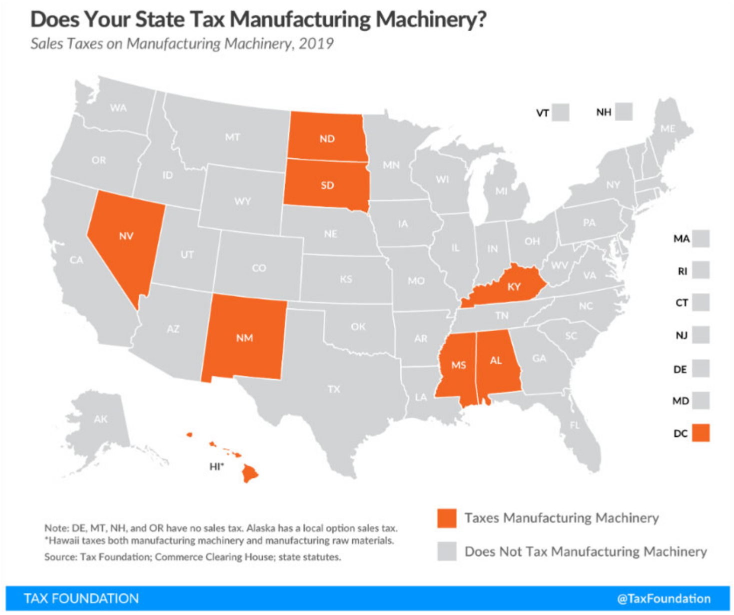
The new definition of durable equipment in the HTRC amendment includes conventional "assembly line" tools and equipment, such as lathes, milling machines, welding robots, packaging equipment or other specialized industrial equipment and the bill specifically includes computer hardware and software directly used in the manufacturing process and machinery and equipment that are used in the manufacturing operation and that are necessary to reduce, eliminate or mitigated pollution.

The bill attempts 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.

In prior statements from 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.



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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.

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.

This bill may narrow the gross receipts tax (GRT) base. Many of the efforts over the last few years to reform New Mexico's taxes focused on broadening the GRT base and lowering the rates. Narrowing the base leads to continually rising GRT rates, increasing volatility in the state's largest general fund revenue source. Higher rates compound tax pyramiding issues and force consumers and businesses to pay higher taxes on all other purchases without an exemption, deduction, or credit.

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.

While credits are reported separately and are known by TRD, deductions that are not separately reported are more difficult to analyze to determine the number of claimants and the cost to the state.

TECHNICAL ISSUES

The current investment credit excludes agricultural equipment and machinery, which is allowed a 50 percent deduction pursuant to 7-9-62 NMSA 1978. This bill may allow a deduction for agricultural equipment and machinery. This should be clarified. The fiscal impact estimate shown in the table assumes that agricultural machinery and equipment would NOT be within the scope of the deduction, despite being unclear. If it were included in the deduction, costs could increase dramatically. In Section 2 under the creation of the deduction, 7-9-46-D-2 should include "farming."

This bill does not contain a delayed repeal date. LFC recommends adding a delayed repeal date.

Notably, the seller claims the deduction and the manufacturer gains the economic benefit, which complicates any future analysis of this deduction. Adding a provision that requires taxpayers to separately report this deduction would help analysts better evaluate the costs and benefits of this deduction.

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 on certain provisions of the bill.
Targeted Clearly stated purpose Long-term goals Measurable targets	 ✘ ✘ ✘	No purpose, targets or goals established.
Transparent	?	TRD will likely present a cost estimate of the ITC in its tax expenditure reports (TER). However, the manfucturer's deduction is not separately reported, making it difficult to determine claimants and cost of the deduction. TRD may or may not include the deduction in the TER depending on classification of the expenditure as anti-pyramiding.
Accountable Public analysis Expiration date	 ✘ ✘	The bill does not contain provisions for reporting. The bill does not include expiration dates for the new deduction.
Effective Fulfills stated purpose Passes "but for" test	 ? ?	There is no purpose statement or measurable goals and targets to determine if the exemption fulfills intended outcomes.
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/al/sb/rl

ATTACHMENT 1

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.

Source: Albuquerque Economic Development