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

SPONSOR Papen **DATE TYPED** 01/26/04 **HB**

SHORT TITLE Agricultural Water Conservation Tax Credit **SB** 12

ANALYST Neel

APPROPRIATION

Appropriation Contained		Estimated Additional Impact		Recurring or Non-Rec	Fund Affected
FY04	FY05	FY04	FY05		
			$40.0	Recurring	General Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

REVENUE

Estimated Revenue		Subsequent Years Impact	Recurring or Non-Rec	Fund Affected
FY05	FY06			
(1,000.0)	(3,000.0)	(4,000.0)	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

Duplicates: HB 48, Agricultural Water Conservation Tax Credit;

Relates to:

HB 60, Water Conservation Gross Receipts
SB 47, Sandia National Laboratories Water Model
SB 78, National Lab Water Treatment Tax Credit

SOURCES OF INFORMATION

LFC Files

Responses Received From
Attorney General Office (AGO)
Office of State Engineer (OSE)
New Mexico Department of Agriculture

Office of Natural Resource Trustee
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 12 provides a personal and corporate income tax credit for agricultural water conservation expenses. It provides for a credit against income tax liability equal to 75 percent of incurred expenses, not to exceed a maximum annual credit of $10,000, for eligible improvements in irrigation systems or water management methods. A credit may be claimed for the taxable year in which expenses are incurred if the taxpayer in that year: owned or leased a water right appurtenant to the land on which an eligible improvement was made; complies with a water conservation plan approved by the local soil and water conservation district in which the improvement is located; and the improvement is primarily designed to conserve water on land in New Mexico that is owned or leased by the taxpayer and used by the taxpayer or the taxpayer's lessee to produce agricultural products, harvest or grow trees, or sustain livestock.

Significant Issues

According to the State Engineer, there is little incentive at the present time for irrigators to make improvements to their irrigation systems to conserve water. A tax credit will provide an incentive for making improvements in irrigation efficiency.

As proposed in this bill, a preferable way to encourage water conservation is to provide tax incentives to those who invest in drip irrigation and other water conservation techniques.
If irrigators attempt to increase the number of acres irrigated using conserved water, or attempt to lease this water to other farmers, this will increase the total consumptive use of water which could reduce return flows and surface water supplies that are available to downstream irrigators.

The rules promulgated by the Soil and Water Conservation Commission which establish the guidelines for determining which improvements are eligible for tax credit (Section 1.F of the bill) should be written in such a way as to place certification of eligibility (methods, standards) in the hands of either the Soil and Water Conservation Commission or the New Mexico Department of Agriculture.

The State Engineer notes there should be language in the bill assuring that persons or entities cannot claim a tax credit as a person <u>and</u> as corporation but only as one or the other.

FISCAL IMPLICATIONS

TRD notes the following assumptions in determining the fiscal impact:

According to the Water Use and Conservation Bureau of the Office of the State Engineer, there are over 1 million acres of irrigated cropland in New Mexico. The USDA Economic Research Service reports that farms in New Mexico spend about $70 million per year on repair and maintenance of capital items.

The USDA reports that net farm income was approximately $500 million in 2000. The Economic Census of 1997 reports a total of 14,000 operating farms in the state. Approximately 2,000 farms had sales in excess of $100 thousand. Because of the importance of irrigation and water conservation to farm operations in New Mexico, the likelihood is that many farms will have some expenditures that qualify for the proposed credit. However, the net tax liability of most farms is relatively low, limiting the dollar amount of tax credits they could claim. The estimate assumes that about one-fifth of all farms have eligible expenses averaging $2,500 in a given year, for total eligible expenses of $7 million. 75% of this amount would yield $5 million of potential credits. Limited tax liability reduces the fiscal impacts to an estimated $3 million per year.

The FY 2005 estimate reflects adjustments to tax payments for the first six months of tax year 2005

ADMINISTRATIVE IMPLICATIONS

TRD notes the need of one additional FTE for manual processes required with passage of SB 12. The associated cost is estimated at $40 thousand.

TECHNICAL ISSUES

TRD notes the measure would probably not allow owners of S-corporations to share the credit. Owners of S-corporations are co-owners of the corporation not co-owners of the land. If the intent is for owners of S-corporation to share the credit, the term "pass-through entity" should be employed in statute. An example of this type of language would be similar to: "If a pass-through entity (S-corporation partnership or limited liability company) owns the land on which an eligible improvement in irrigation systems or water management method is made, the owners of the entity may claim a pro rata share of the credit allowed….".

OTHER SUBSTANTIVE ISSUES

The measure would, in many cases, reward taxpayers for engaging in water conservation expenditures that they would undertake in absence of the proposed credits. Moreover, without a provision actually guaranteeing reduced water use – and perhaps a resulting sale to municipalities or environmental credits for leaving the water in the river – the proposed credits may not achieve their stated purpose of water use reduction.

As noted by TRD, the proposed 75% credit rate is a very high rate of subsidy for the targeted expenditures, especially because these expenditures are already deductible for federal and state income tax purposes. If a taxpayer is in a combined federal/state income tax bracket of 25% or more, the proposed credit would mean that the government is effectively paying the full cost of the qualified expenses. To avoid excessive rates of subsidy, the proportion of eligible expenses for which a credit can be claimed should likely be no more than 25%. Combined with the deductibility of the expenses, this would still yield an effective subsidy rate of 50% for taxpayers in the 25% bracket.

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