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

ORIGINAL DATE 03/01/15
SPONSOR Herrell **LAST UPDATED** 03/04/15 **HB** 444

SHORT TITLE School Contributions Tax Credit **SB**

ANALYST Dorbecker

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY15	**FY16**	**FY17**	**FY18**	**FY19**		
	($33,200.0) ($37,000.0)	($33,700.0) ($39,000.0)	($34,200.0) ($39,000.0)	($34,700.0) ($41,000.0)	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY15	FY16	FY17	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total		$42.5	$12.5	$55.0	Recurring	TRD Operating

Parenthesis ( ) indicate expenditure decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Office of the State Auditor (OSA)
Attorney General's Office (AGO)
Regulation and Licensing Department (RLD)
Taxation and Revenue Department (TRD)
Department of Finance and Administration (DFA)
Public Education Department (PED)
Public School Facilities Auhtority (PSFA)

SUMMARY

Synopsis of Bill

House Bill 444 creates a new section of the Income Tax Act to create the tuition scholarship income tax credit and the extracurricular activity contribution income tax credit. The bill provides the income tax credit for contributions made to school tuition organizations (STOs) that provides scholarships to private elementary and secondary schools, would refund 100 percent of a donation that would not exceed one thousand dollars ($1,000) per taxpayer in any taxable year. Also, the bill provides the income tax credit for contributions made to support extracurricular activities at New Mexico public schools serving students from grades six through nine, refunding 100 percent of a donation that would not exceed five hundred dollars ($500) per taxpayer in any taxable year.

Both credits are non refundable and non transferable but they can be carried forward for a maximum of five years. To claim the credits, the bill states TRD would provide a format for a standardized receipt to be issued by a private school tuition organization or by an elegible public school to indicate the amounts of the contributions.

The bill includes reporting requirements. TRD is required to compile an annual report on the tax credits including the number of taxpayers approved by the department to receive the tax credits, the aggregate amount of tax credits approved and any other informationalnecessary to evaluate the effectiveness of the credits. Starting in 2017, TRD would present the annual report to RSTP and LFC with a cost/benefit analysis to determine if the credits are serving their purpose.

There is no effective date of this bill. It is assumed the new effective date is 90 days after this session ends. The provisions of this act apply to taxable years beginning on or after January 1, 2015. The bill has a sunset date of December 31, 2020.

FISCAL IMPLICATIONS

The range of the revenue impact was determined by combining analyses from TRD and DFA.

TRD used the experiences of a similar credit that has been effective in Arizona since tax year 1997. TRD notes HB 444 is very similar to Arizona's law with the exception that in Arizona, the credit is equal to the cash contribution, not to exceed $1,000 for married filing joint filers and $500 for all other filing. In this bill, the tax credit may be claimed in an amount equal to the total contributions made during the taxable year for which the tax credit is claimed but shall not exceed one thousand dollars ($1,000) in any taxable year.

TRD used Arizona's historical data on the number of reported donors against Arizona's population to establish the percentage of population making the donations. An average of 1.14 percent of Arizona's population raising an average of $36 million have historically contributed to the school tuition organization creating an average of about 20,000 scholarships since inception. TRD assumes that about 1.14 percent of New Mexico's population will contribute to the tuition scholarship and extracurricular activities. By multiplying the count by the credit amount, TRD estimated an average of $26 million for tuition scholarship, $13 million for extracurricular activities, and about $39 million for both programs assuming every credit claim is maximized. TRD then used February 2015 General Fund Consensus Revenue estimates growth rates on personal income to estimate future impacts.

DFA used Arizona's 2013-2014 Tax Expenditure Report noting 73,852 claims for the tuition credits were made in 2012 totaling $51.9 million and 253,134 claims for the extracurricular activity credit were made totaling $51.3 million. DFA's estimated impact of this bill results from applying New Mexico's share of total population relative to Arizona and then applying four year average population growth rates for the years of expected impacts, with about half of the impact coming from each credit.

According to the department, the credits are expected to reach their full potential in the first year and cited a 2005 study[1] that estimated tuition tax credits could grow from an initial $11 million to about $27 million in the third year and increase, on average, by about 1.2 percent in each subsequent year of the program.

Potential general fund savings are uncertain as they are dependent on whether the activity would have occurred without current legislation – whether private donors would continue making educational scholarship donations for low-income students and whether low-income students would transfer from private schools to public schools. The provisions of this bill will likely not result in decreased annual general fund appropriations to the state equalization guarantee. The potential savings are dependent on certain reductions to school district and charter school's state equalization guarantee (SEG) distributions and reversion of those funds to offset the tax credits given to individuals and corporations for donations.

This bill may be counter to the LFC tax policy principle 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

According to TRD, under the current state of the law, there are not any significant legal issues with this bill. The department notes, however, that significant litigation ensued when Arizona adopted a similar credit. Because a significant portion of private schools are affiliated with religious institutions, some sought to have the credit declared unconstitutional under the first amendment as an improper state subsidy in support of religion. The U.S. Supreme Court rebuked this challenge in 2011, but the decision was split, highly publicized, and vigorously contested.

Additionally, TRD indicates there is some potential for abuse under the proposed bill, as currently drafted, especially as it pertains to the school tuition organization credit. For example, a private school that has tuition of $10,000 per year may set up a 501(C)(3) school tuition organization. With respect to parents whose children attend the school, the school may agree to accept $9,000 in tuition, with the parents making a $1,000 contribution to the school tuition organization that gets earmarked toward their own child. Thus, families that can afford private education for their children may wind up getting a subsidy. The prohibition against claiming the credit if the contribution is included as an itemized deduction on a federal return may mitigate some or all of this risk.

DFA believes the credit may incentivize donations to increase private school attendance and

[1] Sponsored by the Milton and Rose D. Friedman Foundation, a school vouchers advocacy group, and the Albuquerque Partnership, which is funded through New Mexico Voices for Children.

certain public school extracurricular activities. Any costs or benefits associated with either of these activities will thus be increased by these credits. DFA adds however, that it is much more likely that families will use these credits to reduce the tuition costs for their children to attend private school or engage in extracurricular activities without incentivizing any additional donation activity. As such, the state would effectively be subsidizing attendance at private schools or enrollment in extracurricular activities. Because taxpayers are eligible for both credits, they have the choice of whether to support private school tuition or public school extracurricular activities. If instead, families are using the credits to support the activities of their own children, DFA believes taxpayers will likely use both credits only if they have children in both private school and public school.

Also, DFA reports the proposed tax credits are not allowed if taken as a federal itemized deduction, which prevents the possibility of receiving a credit on amounts that were previously deducted from taxable income. According to DFA, it is not clear why only certain types of elementary and high schools are eligible under the extracurricular activities tax credit.

The AGO reports that the bill is unclear whether the Income Tax Act, Section 7-2-12.1 (limitation on claiming of credits and tax rebates) would apply, or if Sec. 7-2-12.1 would need to be amended to provide for an exception to the tuition scholarship income tax credit, and/or the extracurricular activity contribution income tax credit.

Section I, on page 7 of the bill defines "eligible school" to include middle schools, junior high schools, elementary schools that enroll students in grade six, and high schools that enroll students in grade nine. According to the AGO, this definition would seemingly exclude a school that serves students in grades K through 8 as well as a school that serves students in K through 5.

According to PED, the bill does not establish oversight responsibilities for either TRD or PED in regard to the STOs besides appearing to require TRD to verify an STO's 501(c)(3) status. In particular, PED indicates the bill does not contain language requiring verification by any department or agency that an STO has expended 100 percent of its tax-credit-eligible donations in the form of scholarships to eligible nonpublic schools.

Further, PED believes the bill does not limit the associations, membership, or leadership of a STO, implying that those individuals affiliated with a particular private school could form a STO for the express purpose of accepting donations in the amount of tuition for that school, providing scholarships matching those donation amounts to the donors and allowing donors to claim a $1,000 tax credit.

PED reports the bill limits schools eligible to accept these donations for a tax credit to those that are "a middle school or junior high school, an elementary school that enrolls students in grade six or a high school that enrolls students in grade nine". According to the department, it is unclear why elementary schools serving kindergarten through fifth grade or lower and high schools serving tenth through twelfth grades have been excluded from receiving these tax-credit-eligible donations.

From PSFA's perspective, this bill has little to do with school facilities in and of themselves. Yet, the tax incentive proposed in the bill could impact total operational funding for a district if the incentive causes a student to leave traditional K-12 schools. PSFA believes student migration from traditional K-12 schools means those district schools will see a reduction in their operating funds because state appropriations for operational expenses are based upon the State Equalization Guarantee (SEG) formula in statute which is based on enrollment.

According to PSFA[2], statewide available spaces in K-12 public schools are utilized at an average of 82 percent of their potential capacity. In other words, existing capacity of schools in New Mexico currently is greater than the number of students that currently utilize them. When schools lose enrollment, they are left with underutilized space that they have to operate and maintain. Otherwise, these schools would need to develop a strategy to deal with excess space such as disposal, re-purposing, or attendance boundary adjustment.

PSFA reports that even though the average indicates underutilization, 52 percent of schools self-report as being over capacity. PSFA notes capacities range from 89 percent underutilization to 191 percent overutilization. Further, PSFA believes schools do not currently provide maintenance adequately[3] and reduction in funding for any reason, could further negatively impact facility maintenance.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is met with the bill's requirement 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.

ADMINISTRATIVE IMPLICATIONS

Both TRD and PED have indicated administration and oversight of the new scholarship tax credit program would have an impact on their operating budgets.

<u>TRD (2015)</u>

Moderate impact (400 hours). In order to implement this, TRD will have to develop forms and procedures for implementing the credit. Additionally, the following require changes: GenTax and TAP documents and configuration changes to the Business Credit Module. Two contribution receipts and claim forms with instructions describing the process will need to be developed. A process will also need to be developed so that the contribution receipts can be distributed to the school tuition organization and to the eligible school. These forms will have to accompany the tax return in order to receive the credit. One quarter of an FTE will be needed to distribute the receipts and approve the applications. A process shall be created for collecting data for the annual report. Form PIT-1 and instructions will have to be modified to allow taxpayers to claim these credits. Time to implement these changes is limited.

<u>PED (2012)</u>

PED expects this bill would impact its budget negatively in that it would require new staff for fiscal and programmatic oversight.

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[2] PSFA tracks capacity of each school in each district based upon self-reported data in their facility master plans.
[3] As measured by PSFA's Facility Maintenance Assessment Report (FMAR), on average, school's score of 61.4 percent (poor) indicates facilities will have reduced expected life.

CONFLICT, DUPLICATION AND RELATIONSHIP

- HB 333 proposes to enact the Equal Opportunity Scholarship Act and creates income tax credits for contributions to tuition scholarship organizations. HB 333 appears to duplicate and may conflict with HB 444.

- SB 346 proposes to reform the New Mexico tax structure and proposes to eliminate certain credits. SB 346 may conflict with HB 444.

- SB 132 proposes to amend the charitable solicitations act to increase the threshold auditing requirements from income in excess of $500,000 to $1,500,000. SB 132 does not conflict with HB 444.

TECHNICAL ISSUES

If the intent of the legislation is to be applicable to K through 8 schools as well as K through 5 schools, the definition of "eligible school" should be amended to include these two types of schools.

According to TRD, consideration should be given to whether to expand this credit to the Corporate Income Tax Act.

The bill does not contain a cap on the credits. LFC staff recommend adding a cap per taxable year.

OTHER SUBSTANTIVE ISSUES

PED Analysis raised the following issues in 2012 that apply to the bill. It is not clear whether a school operated by an Indian Tribe, nation or pueblo could be considered an eligible school under the bill. The ability of the PED to deny, suspend or revoke a qualified organization's certification is not only based upon ambiguous standards and would impose unique administrative burdens on PED, but does not provide for any due process which would subject the PED to liability for "abuse of discretion".

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

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