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

		ORIGINAL DATE	1/30/15		
SPONSOR	Muñoz	**LAST UPDATED**	3/11/15	**HB**	
SHORT TITLE	U.S. Dept. of Defense Energy Gross Receipts			**SB**	502
				ANALYST	van Moorsel

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY15	**FY16**	**FY17**	**FY18**	**FY19**		
$0.0	($1,700.0-$6,700.0)	($3,500.0-$7,000.0)	($5,600.0-$7,400.0)	($7,800.0)	Recurring	General Fund
$0.0	($1,300.0-$5,300.0)	($2,800.0-$5,600.0)	($4,400.0-$5,800.0)	($6,100.0)	Recurring	Local Governments

(Parenthesis ( ) indicate revenue decreases

Duplicates HB 94.

SOURCES OF INFORMATION
LFC Files

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

SUMMARY

Synopsis of Bill

Senate Bill 502 creates a new section of the Gross Receipts and Compensating Tax Act to make deductible the receipts from the sale by a qualified contractor of qualified research and development services and qualified directed energy and satellite-related inputs sold pursuant to a contract with the to the United States Department of Defense. Only receipts in the period July 1, 2015 to June 30, 2025 are deductible. The deduction would be limited to new contract entered into on or after July 1, 2015.

The purposes of the deduction are to promote new and sophisticated technology, enhance the viability of directed energy and satellite projects, attract new projects and employers to New Mexico and increase high-technology employment opportunities in New Mexico.

The bill makes the following definitions:

- "directed energy" means a system, including related services, that enables the use of the frequency spectrum, including radio waves, light and x-rays;
- "inputs" means systems, subsystems, components, prototypes and demonstrators or products and services involving optics, photonics, electronics, advanced materials, nanoelectromechanical and microelectromechanical systems, fabrication materials, test evaluation and computer control systems related to directed energy or satellites;
- "qualified contractor" means a person other than an organization designated as a national laboratory by act of congress or any operator of national laboratory facilities in New Mexico; provided that the operator may be a qualified contractor with respect to the operator's receipts not connected with operating the national laboratory;
- "qualified directed energy and satellite-related inputs" means inputs supplied to the department of defense pursuant to a contract with that department entered into on or after July 1, 2015;
- "qualified research and development services" means research and development services related to directed energy or satellites provided to the department of defense pursuant to a contract with that department entered into on or after July 1, 2015; and
- "satellite" means composite systems assembled and packaged for use in space, including launch vehicles and related products and services."

Taxpayers allowed the deduction must separately report the amount of the deduction. The bill also requires TRD to compile an annual report on the deduction provided by this section that shall include the number of taxpayers that claimed the deduction, the aggregate amount of deductions claimed and other information necessary to evaluate the deduction. Beginning in 2022 TRD and EDD must present the report to the Revenue Stabilization and Tax Policy committee and the LFC with an analysis of the effectiveness and cost of the deduction and whether the deduction is performing the purpose for which it was created.

The effective date of this bill is July 1, 2015.

The sunset date of this bill is June 30, 2025. A sunset will require legislative reconsideration before an extension of the credit, providing an opportunity for review of the effectiveness of the deduction.

FISCAL IMPLICATIONS

The Economic Development Department reports in its analysis of the bill that the Air Force Research Laboratory at Kirtland Air Force Base is the primary purchaser of directed energy and satellite research and development services with a procurement budget of approximately $700 million, approximately 65 percent of which is currently spent out of state. EDD notes that of the $245 million spent in New Mexico, approximately 70 percent ($171.5 million) would qualify for the deduction. Applying Albuquerque's 7.0 percent tax rate, the estimated fiscal impact on GRT collections totals approximately $12 million, resulting in an average annual loss of $6.7 million to the general fund. Out-year revenue impacts depend on the size of AFRL's New Mexico budget, but for the purposes of this FIR, are assumed to grow at the rate of GRT growth in December consensus revenue estimate.

The bill makes the deduction available to contracts entered into on or after July 1, 2015; however, nothing in the bill would preclude contractors from renegotiating contracts after the bill's effective date, thus achieving the savings equal to foregone GRT. It is unclear at what rate contractors would renegotiate contractors, and for this reason the FIR presents a range of revenue impacts. The low end of the range assumes 25 percent of contractors renegotiate contracts each year, whether at the expiration of existing contracts or earlier, meaning the full impact of the bill would be seen after four years. The high end assumes all contractors renegotiate immediately, meaning the full impact of the bill is realized in the first year the deduction is in law.

DFA's analysis contends not all gross receipts are currently taxable, citing TRD reports comparing total and taxable gross receipts for the scientific research and development sector show that in FY14, 42 percent of gross receipts were taxable in the sector. DFA's FIR therefore presents a lower fiscal impact, assuming 58 percent of gross receipts that this bill would make deductible are already not taxable. Further, the DFA analysis assumes that 20 percent of contracts would be renewed each year at lower costs due to the deduction, and as such the fiscal impact in the first fiscal year is 20 percent of its total estimate.

Estimated Revenue - DFA			**Recurring or Nonrecurring**	**Fund Affected**
FY15	**FY16**	**FY17**		
$0.0	($550.0)	($1,100.0)	Recurring	General Fund
$0.0	($450.0)	($900.0)	Recurring	Local Governments

TRD's analysis estimates a different, smaller fiscal impact. The department reports its data shows there is currently about $2 million in gross receipts tax currently generated by qualifying activities. TRD assumes a similar level of activity would come to New Mexico regardless of this deduction, and that activity would constitute a negative revenue impact, that would be the impact in terms of gross receipts tax revenue lost. With an assumed average length of contract of five years, twenty percent of contracts are assumed to expire annually, resulting in a gradually increasing impact. The actual value of this deduction to the taxpayer may be much higher, if more money is spent in New Mexico that would have been spent elsewhere but for this deduction. TRD's estimated revenue impact is therefore as follows:

Estimated Revenue - TRD					**Recurring or Nonrecurring**	**Fund Affected**
FY15	**FY16**	**FY17**	**FY18**	**FY19**		
$0.0	($240.0)	($480.0)	($720.0)	($960.0)	Recurring	General Fund
$0.0	($160.0)	($320.0)	($480.0)	($640.0)	Recurring	Local Governments

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 a 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 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

EDD notes in its analysis that the dynamic effects of the tax deduction will have a substantial positive revenue effect, although it does not quantify the positive effect. However, Dynamic fiscal analysis is both costly and time intensive. Further, dynamic analysis involves a high degree of uncertainty because the assumptions on which the analysis is based are subject to a wide range of interpretation. Because of these factors, LFC staff will continue to include customary analysis in fiscal impact reports. Dynamic analysis may add some value; however, it is best implemented using dedicated staff to conduct extensive study during the interim to develop base scenarios and rules of thumb that may provide better estimates of economic impacts of legislative proposals.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is met with the bill's requirement that taxpayers claiming the deduction 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.

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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