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

ORIGINAL DATE 02/07/13
SPONSOR Larrañaga **LAST UPDATED** 03/06/13 **HB** 223

SHORT TITLE U.S. Dept. of Defense Energy Gross Receipts **SB**

ANALYST Walker-Moran

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY13	**FY14**	**FY15**	**FY16**	**FY17**		
	($2,400.0) - ($8,400.0)	($3,600.0) - ($8,400.0)	($3,900.0) - ($8,400.0)	($4,200.0) - ($8,400.0)	Recurring	General Fund
	($1,600.0) - ($5,600.0)	($2,400.0) - ($5,600.0)	($2,600.0) - ($5,600.0)	($2,800.0) - ($5,600.0)	Recurring	Local Funds

(Parenthesis ( ) Indicate Revenue Decreases)

Duplicate to SB 354

SOURCES OF INFORMATION
LFC Files

Responses Received From
Office of Military Base Planning (OMBPS)
Economic Development Department (EDD)
Department of Military Affairs (DMA)
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

House Bill 223 amends the gross receipts and compensating tax act to include a 10 year deduction for services and products for the Department of Defense (DOD) related to directed energy and satellites.

The purpose of the deduction is to promote new and sophisticated technology, enhance the viability of existing directed energy and satellite projects and attract new projects to New Mexico with concomitant high-technology employment opportunities.

The effective date of this bill is July 1, 2013. The sunset date of this bill is June 30, 2023.

FISCAL IMPLICATIONS

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.

This bill will further narrow the gross receipts tax base and would move New Mexico away from the tax policy goal of a gross receipts tax with a broad equitable base and a low rate.

The Taxation and Revenue Department (TRD) used confidential taxpayer information, including actual GRT paid, along with information provided by the industry and publically available was used to estimate the potential revenue impact to the state.

Current, actual GRT paid gives a good idea of the current impact, conservatively estimated at about $4 million a year. There is the potential for an increased impact, based on federal contracts that are currently in the bidding phase. If a large contract does end up in New Mexico, it could significantly increase the impact, as it increases the amount of qualifying gross receipts. In addition, passage of this legislation increases the chance of a firm doing business in New Mexico being awarded such a contract. This proposal is not estimated to have much effect in FY14, due to the length of time from bidding to awarding the contract, to actually spending any money. The impact grows slightly over time for the same reasons.

The Los Alamos National Lab and Sandia National Laboratories both have contracts that would qualify for this credit, but they estimate that tax liability to represent only a small proportion of total gross receipts from those contracts due to other credits and deductions.

As reported by the Office of Military Base Planning (OMBPS), the major assumption is that providing a Gross Receipts Tax Deduction for services provided to the DOD will result in additional activity at New Mexico military installations which would easily offset the cost to the General Fund. For many years, Air Force and Army executives have informally mentioned this as a factor in programs which might be located in New Mexico. However, they have been unwilling to back up their comments officially.

As reported by the Economic Development Department (EDD), 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% of which is currently spent out of state. Of the $245 million spent in New Mexico, approximately 70% ($171,500,000) would qualify for the deduction. Applying Albuquerque's 7.0% tax rate, the estimated fiscal impact on GRT collections is approximately $12 million, resulting in an average annual loss of $6.7 million to the general fund. Mandatory federal spending cuts will likely result in a significantly smaller impact.

By creating a more competitive environment for government contracts in directed energy and satellite technology, however, the deduction will boost employment and allow for recruiting for foreign firms in the field. This increase will have a substantial positive revenue impact, the exact amount of which the EDD is unable to accurately estimate. What is clear is that the positive revenue impact from increased employment in the absence of the deduction would have more than offset the fiscal impact of gross receipts tax revenue over the last decade. In 2004, Boeing moved its Airborne Laser Program Integration and Test activity from New Mexico to California. The activity lasted for six years and cost $1.36 billion in labor, goods, and services. Boeing made $668 million in purchases in California rather than New Mexico. In other words, the gross receipts tax revenue from Boeing’s purchases of goods for this program alone would have more than offset the revenue loss to the general fund had the deduction been in law in 2004. In addition, Boeing spent $689 million on labor for 230 jobs in the program relocated from New Mexico. Boeing moved its Advanced Tactical Laser program integration and testing facility from New Mexico to Florida in 2008. Seventeen high-technology jobs, equal to $5 million in labor costs, and $600,000 in material purchases and subcontracts were expended in Florida over a year, rather than New Mexico. In 2010, Boeing relocated its High Energy Laser Technology Demonstrator program integration and testing from New Mexico to Alabama. Eighteen high-technology jobs, equal to $5.5 million in labor costs, and $1.4 million in material purchases and subcontracts were expended in Alabama over two years, rather than New Mexico.

As reported on Boeing’s website “ALBUQUERQUE, N.M., Oct. 3, 2012 -- Under a follow-on contractual effort from the U.S. Army Space and Missile Defense Command (SMDC), Boeing [NYSE: BA] will continue developing a truck-mounted directed energy system that improves warfighters' ability to counter rockets, artillery, mortars and unmanned aerial threats.” There is currently such an Army procurement for directed energy capability that a New Mexico company like Boeing could bid for. Very few companies perform this type of work. As mentioned above Boeing has an Airborne Laser Program which is required per the procurement language. If Boeing were to bid for the procurement as they have in the past and maintain related activity in New Mexico this would mean an influx of funds of $76 million in FFY13, $109 million in FFY14, $122 million in FFY15, $146 million in FFY16, and $152 million in FFY17. In the past these projects have been taken to other Boeing locations outside of New Mexico. This tax credit could incentivize Boeing to perform this work in the state providing direct employment in the company at high salaries and providing indirect employment through construction of buildings to house the directed energy and satellite manufacturing work.

There are five DOD activities in New Mexico which provide Directed Energy and/or Satellite Services:

<u>Directed Energy</u>:
The Air Force Research Laboratory Directed Energy Directorate, Kirtland AFB, which has approximately 500 employees and approximately 500 contractors. Their in-state Directed Energy Budget is approximately $150 million.

The High Energy Laser Test Facility at White Sands Missile Range. For many years, this unit was assigned to the Army Space and Missile Defense Command, Huntsville, Alabama. HELSTF is now a Directorate within the White Sands Test Center, White Sands Missile Range. They have 9 federal employees and 25 contractors. Their program has been dramatically reduced over the last 10 years or so, and now current estimates are as follows: $3.0 million budget with approximately $2.0 million reimbursable from outside “customers.” The HELSTF Director has said that he believes the geographical advantages New Mexico provides, coupled with a GRT deduction, would enhance his unit's overall capability to support additional reimbursable programs—perhaps a 100% increase to $4 million annually.

<u>Satellite programs</u>:
The Operationally Responsive Space Office, Kirtland AFB: this Office was established at Kirtland shortly after the State of New Mexico passed a GRT Deduction for the ORS program during the 2007 Session. Their mission is to develop small satellites and associated support equipment which can be immediately responsive to DOD customers—which includes the various combatant command commanders. Further, they will be a customer of Spaceport America in the coming months. Their annual budget is approximately $100 million, 100% of which is directed to "satellites." Given that this program has been covered by a "NMGRT" deduction, it is not considered in the calculations.

The Air Force Space and Missile Defense Directorate, Kirtland AFB: This organization has grown significantly over the last several years—it grew from a Detachment to designation as the Space and Missile Development Test Wing, Air Force Space Command. With reorganization, they have been designated a "directorate". Their annual budget is $56 million (FY 2013), with approximately $36 million directed to satellite programs (New Mexico).

The Air Force Research Laboratory, Space Vehicles Directorate has an annual budget of approximately $345 million, with approximately $34 million directed to satellite programs (New Mexico).

SIGNIFICANT ISSUES

According to the OMBPS, one of the on-going significant issues related to providing a GRT deduction for specific technical military programs is gaining assurance from DOD commanders and senior executives that they will recognize the competitive advantage provided by New Mexico and then decide to increase their program activity in our State. However, we should review the positive impact that similar GRT deductions have had thus far: Establishing the Operationally Responsive Space Office; establishing White Sands Missile Range as the Center of Excellence for Network Integration Experiments (the transformation acquisition GRT Deduction, 2005, with sunset clause extended to 2016); and provisions of the legislation establishing the spaceport program in the 1990s, etc.

The objective is to increase the amount of activity in each of the two sectors (Directed Energy and Satellites) to offset the fiscal impact of the GRT Deduction. If New Mexico can recover 10% or so of the activity that currently goes outside the State, then the GRT Deduction can be recovered.
Additionally, there are activities in neighboring states which currently compete with New Mexico for DOD Business—removing the GRT would be a big help here as well.

ADMINISTRATION

According to the TRD, this bill requires the deduction to be separately stated from other deductions that the taxpayer may have on their CRS-1 returns so that the Department could report out on the number of taxpayers claiming the deduction. This requires the Department to have to program the GenTax system to be able to accept a new special rate code and possibly a special location. Forms will have to either be created or revised and taxpayers and Department employees will need to be educated. Also, when the taxpayer is required to report differently, they either choose not to take advantage of the deduction or they report incorrectly which in turn makes the reports inaccurate. The taxpayers also have to reprogram their systems, if they are electronic, to be able to track the deduction separate, which is an additional burden to them.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is met with the bill's requirement to report annually to the revenue stabilization and tax policy 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.

The deduction would have a substantial impact on the EDD's and the New Mexico Partnership's retention and recruiting performance.
The TRD will not be able to implement the GenTax modifications necessary to record and claim the tax deduction until at least October 1, 2013, after the effective date of the legislation.

TECHNICAL ISSUES

The TRD recommends amending Section 1, Subsection A, Paragraph 2 to require the issuance of a nontaxable transaction certificate by the contractor to the subcontractor. This would not only allow for easier administration by the Department, but it would also provide the subcontractor with evidentiary support when claiming the deduction.

The terms "related services" on page 2, line 24, and "related products and services" on page 3, line 10, are very broad and should be defined otherwise anything could be considered related services or related products.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

New Mexico military installations will not be viewed as competitive for DOD satellite and directed energy programs.

According to the EDD, New Mexico will continue to lose existing businesses and workforce in the field to other states and continue to fail to recruit businesses from other states despite an existing environment conducive to recruiting them.

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

EWM/svb:blm