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

SPONSOR HBIC **DATE TYPED** 2/11/04 **HB** 16, 75, 331 /HBICS

SHORT TITLE Small Business Research Gross Receipts **SB**

ANALYST Neel

REVENUE

Estimated Revenue		**Subsequent Years Impact**	**Recurring or Non-Rec**	**Fund Affected**
FY05	**FY06**			
High Wage Jobs Credit				
(600.0)	(900.0)	(2,250.0)	Recurring	General Fund
(70.0)	($140.0)	(250.0)	Recurring	Local Governments
R& D Small Business Tax Credit				
(4,200.0)	(4,400.0)	(4,400.0)	Recurring	General Fund
(730.0)	(760.0)	(760.0)	Recurring	Local Governments
(20.0)	(20.0)	(20.0)	Recurring	Small Cities/ Small Counties Assistance
All Provisions:				
(4,800.0)	(5,300.0)	(6,650.0)	Recurring	General Fund
(820.0)	(920.0)	(1,030.0)	Recurring	Local Gov.

(Parenthesis ( ) Indicate Revenue Decreases)

Relates: SB 31, Research and Development Gross Receipts
HB 75, Research and Development Gross Receipts

SOURCES OF INFORMATION

LFC Files

<u>Response Received From</u>
Taxation and Revenue Department (TRD)
Economic Development Department (EDD)

SUMMARY

Synopsis of Bill

High Wage Jobs Tax Credit

The bill also amends statute to create a high wage tax credit equal to 10 percent of wages and benefits of new employees in "high wage jobs". The total credit is limited to $12 thousand per eligible employee and credits must be claimed up to four years. An eligible high-wage job must:

- be created after July 1, 2004 and before July 1, 2009;
- be occupied for at least 48 weeks of the year prior to the claim for credit; and
- pay at least $40 thousand per year if located in a municipality of 40,000 or more residents, or at least $28,000 per year else where in the state.

The tax credit can be taken against the taxpayer's modified combined tax liability (gross receipts tax, compensating tax and others, excluding local GRT).

The bill stipulates that the enterprise qualifying for the tax credit must be a growing business with employment greater on the last qualifying day of the credit than the day when the new positions was created. In addition, the job must be occupied for at least 48 weeks before an employer is eligible for credits. An eligible employer must make more than 50 percent of its sales outside of New Mexico and be eligible for development training fund assistance pursuant to Section 21-19-7 NMSA 1978.

Research and Development Small Business Tax Credit

The bill also enacts gross receipts, compensating tax and withholding credit for receipts of qualified research and development small businesses. The credits may only be claimed for a total of 36 months.

Qualified research and development small businesses are defined to include corporations, general partnerships, limited partnerships, limited liability companies, sole proprietorships and similar entities that: employed less than 25 persons in the prior month, had revenues that did not exceed $10 million in any prior fiscal year, were not owned by another business as of the prior month, made qualifying research and development expenditures in the previous 12 month period that are equal to at least 20 percent of total revenues.

Qualified research expenditures are defined to mean expenditures connected with qualified research. The definition excludes research funded by another person or governmental entity, and expenditures for property owned by a municipality or county in connection with an industrial revenue bond or for which the tax payer has received any credit from the capital equipment tax Credit Act, the Investment Credit Act or the Technology Jobs Tax Credit Act.

Qualified research is defined as research that is technological in nature and intended to be useful in the development of a new or improved business component of the taxpayer.

Qualified research must be related to new or improved function, performance, reliability or quality, but not style, taste, cosmetic or seasonal design factors.

FISCAL IMPLICATIONS

TRD notes the following assumptions in determining the fiscal impact:

R&D small business tax credit:
According to department records and information provided by industry representatives, there are about 280 taxpayers currently operating in New Mexico who could potentially qualify for the R&D tax credit. In fiscal year 2003, these businesses paid $1.8 million in GRT, $3 million in withholding and $100 thousand in compensating tax.

High-wage jobs tax credit:
The fiscal impacts of the provision are limited in the first year because of the requirement that an employee hold a new job for 48 weeks before an employer is eligible for credits.

Analysis of information from the in-plant training program suggests that, in a recent year, approximately 30 employees in non-urban settings, and 90 employees in urban settings would have qualified for this credit had it been in effect. The associated cost of the credit for these employees would have been $400 thousand on an annual basis. The total population of eligible firms would be larger than the number of firms currently participating in in-plant training, so the impacts would be larger than $400 thousand per year. Although a precise estimate is not possible, the annual impact was increased to $600-$700 thousand to reflect firms not currently in the in-plant training program. The annual cost of the proposal increases over time because the credits can be claimed for up to 4 years for each eligible employee. The estimated "Subsequent Years Impact" reflects the maximum annual cost of the provision once it has been in place for three years. The proposal contains a sunset date of July 1, 2009, so the fiscal impacts would diminish gradually after that date.

Local government impacts are attributable to two effects: (1) If credits are applied against the state's 5% gross receipts tax in a municipal area, 1.225% of the 5% is reduced municipal revenue sharing (Section 7-1-6.4 NMSA 1978); (2) If the credit is applied against compensating tax liability, 20% of the revenue effect will be taken against the distributions to the small cities and small counties assistance funds (Section 7-1-6.2 and 7-1-6.5). The share of credits applied against these revenue sources was modeled based on experience with the investment credit program.

ADMINISTRATIVE IMPLICATIONS

The TRD analysis reports the following administrative impact:

> The provisions in this bill would have an administrative impact on the department. The department must revise forms and instructions for claiming the deduction, and systems must be modified in order to accept and track the deduction.
>
> The definition of "qualified research" is the same definition used in the current Technology Jobs Tax Credit Act. This definition is very broad and somewhat vague. Particular problem areas

include the phrase "new or improved business component". It is not at all clear what this means, and has caused difficulties when evaluating applications for the technology jobs tax credit. The phrase "process of experimentation" has been difficult to interpret as well. Some interpretational issues can be addressed by regulation.

TECHNICAL ISSUES

TRD notes the following technical issues:

<u>*R&D small business tax credit:*</u>
The proposed R&D credit is not limited to newly formed businesses or businesses that are new to New Mexico. There are currently nearly 300 small R&D businesses already located in New Mexico. "Qualified expenditure" is defined as an expenditure by a taxpayer "in connection with" qualified research." It is not clear what is meant by "in connection with." With this definition, payroll, equipment, software, supply, travel and administrative expenses incurred by research and development firms would all qualify. According to the 1997 Economic Census, payroll expenditures alone for R&D firms average 36% of total receipts. This is almost twice the 20% criterion for determining credit eligibility. Thus the 20% criterion does little to limit eligibility.

The R&D credit proposal appears to create a "double dip" with credits taken pursuant to the current Technology Jobs Tax Credit and Investment Tax Credit. There is no provision contained in this proposal that would exclude a taxpayer from *qualifying* for credit under multiple programs.

- Although this bill defines "qualified expenditure" to exclude "*…expenditures for which the taxpayer has received any credit pursuant to the Capital Equipment Tax Credit Act, the Investment Credit Act or the Technology Jobs Tax Credit Act*," this provision simply excludes the expenditures from being counted towards the 20% of expenditures spent in connection with qualified research for the purposes determining credit eligibility. It does not preclude a taxpayer from qualifying under multiple programs. Further, payroll expenditures alone are likely to be sufficient to qualify a business for the R&D credit.

- The R&D credit proposal does contain some *limited* anti "double dip" language. If, in a particular reporting period, a taxpayer claims a technology jobs, investment or capital equipment credit against a tax liability, then the taxpayer may not claim the R&D credit for that same reporting period (Section 4, paragraph B, subparagraph 8, on page10). Similarly, Section 6, on page 11 stipulates that claiming the R&D credit renders a taxpayer ineligible to claim the credit pursuant to the aforementioned acts in the same reporting period. These limitations do prevent a taxpayer from actually applying credit amounts from multiple credit programs to a particular month's tax liability.

- However, technology jobs credits, investment credits and capital equipment credits can all be carried forward. As a hypothetical example of a potential "double dip" scenario, a taxpayer may apply and be approved for both technology jobs and R&D credits, claim the R&D credit for three years while "banking" technology jobs credits. When three years has expired on the R& D credit, the taxpayer may begin to claim their banked technology jobs credits.

- Nothing in the bill states that if a taxpayer qualifies and claims credit under the R&D credit, the taxpayer would no longer be eligible to qualify for credit under existing credit programs.

High wage jobs credit:
Refundability of credits: The provision allowing the excess of credits over liabilities to be refunded to the taxpayer could be challenged under the anti-donation provisions of the NM Constitution.

Applicability with other tax incentives: Applicants for this credit would potentially be eligible for certain other incentives including the investment credit, the rural job tax credit or the technology jobs tax credit. The lack of coordination between these statutes means that the extent of the subsidy being provided to a particular enterprise is unknown. Excessive subsidies may be provided.

OTHER SUBSTANTIVE ISSUES

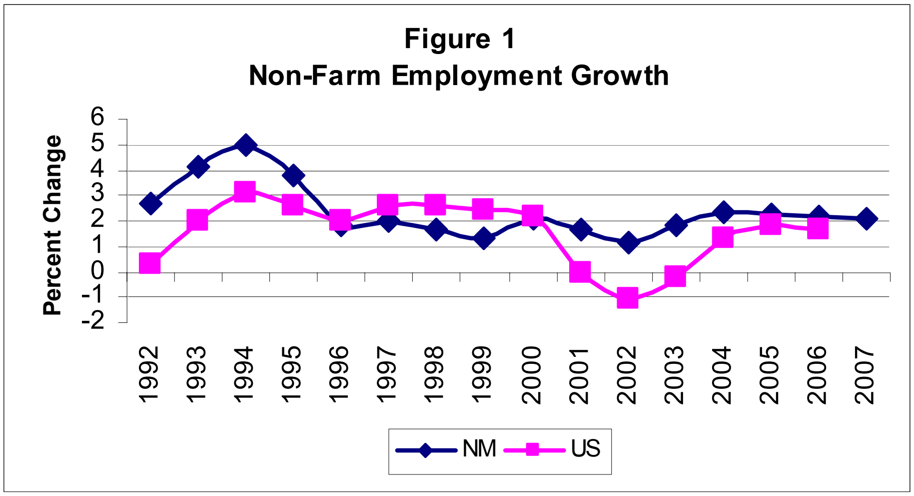
The Legislature has consistently emphasized economic development and job creation. The 2003 Legislature renewed the job mentorship tax credit that encourages businesses to hire young people to participate in career preparation education programs by providing tax credits of up to 30 percent of the gross wages paid for employing young people; the credit is limited to 320 hours per student. The Investment Tax Credit Act (Chapter 402) was amended to reduce the employment requirements to qualify for the credit; it now allows tax credits equal to 5 percent of the value of qualified equipment purchased and incorporated into certain manufacturing operations in the state.

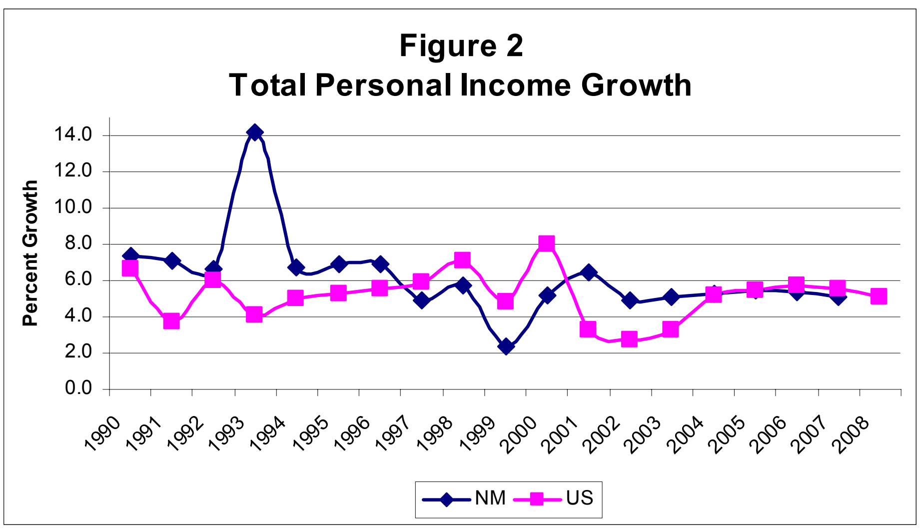
In 2002 the Legislature passed HB 40 *Software Development GRT Credit* (Laws 2002, Chapter 10) to provide a gross receipts tax deduction for receipts for software design and development and web-site design and development. The 2000 Legislature passed HB 19 *Technology Jobs Tax Credits* (Laws 2000, Chapter 22, 2nd SS) that provides a basic tax credit and an additional tax credit, both in the amount of 4 percent of the qualified expenditure made by a taxpayer conducting "qualified" research at a "qualified facility". To be eligible for the additional credit, the taxpayer must increase its payroll by $75.0 over the base payroll of the taxpayer for each $1.0 million of qualified expenditures.

New Mexico Economic Performance. Two of the most vital indicators of a state's economy are its employment and income growth. Although these indicators are often influenced by external forces, the mission of the Economic Development Department remains to provide programs and policies that help lead the state in a direction that produces an overall benefit for the citizens of New Mexico.

Figures 1 and 2 graphically depict New Mexico's need to "promote increased employment and higher wages". As illustrated in Figure 1, New Mexico lagged behind the United States in nonagricultural employment growth from 1996 to 2000. When the United States economy slipped into a recession in 2001, 2002, and 2003, New Mexico sustained a modest rate of job growth and ranked among the fastest growing states.

Similar to employment growth, New Mexico maintained a higher personal income growth from 1991 to 1996 than that of the nation. Growth, again, began to decline in 1997 and fell behind the United States. But in 2001 and 2002, New Mexico's growth surpassed the nation's, primarily due to the recession, as shown in the personal income growth graph.





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