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

SPONSOR Heaton **DATE TYPED** 1/26/04 **HB** 75

SHORT TITLE Research and Development Gross Receipts **SB**

ANALYST Taylor

REVENUE

Estimated Revenue		Subsequent Years Impact	Recurring or Non-Rec	Fund Affected
FY04	FY05			
(100.0)	(1,200.0)	(1,300.0)	Recurring	General Fund
(60.0)	($730.0)	(760.0)	Recurring	Local Governments
(2.0)	(20.0)	(20.0)	Recurring	Small counties/cities assistance

(Parenthesis ( ) Indicate Revenue Decreases)

Duplicates:

HB 16, Small Business Research Gross Receipts
SB 31, Research and Development Gross Receipts

SOURCES OF INFORMATION

LFC Files

Response Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

House Bill 75 enacts gross receipts and compensating tax deduction for receipts of qualified research and development small businesses. The deductions 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.

The bill has no effective date and thus would take affect 90 days after adjournment

FISCAL IMPLICATIONS

TRD reports that their records and industry information indicate that about 280 payers currently in New Mexico might qualify for the proposed deduction. These businesses generated $30 in taxable gross receipts in FY03. In addition, these companies have estimated tangible personal property of about $2 million that would be eligible for the compensating tax deduction. Applying the average effective state gross receipts tax rate of 3.75 percent by these values yields a revenue loss of $1.2 million for the general fund in FY05. Also, revenue losses for local governments are estimated to be $730 thousand in FY05.

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.

OTHER SUBSTANTIVE ISSUES

TRD raises the following issues:

New and existing businesses qualify:
The provisions of this bill are 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.

"Double-dip" tax reduction opportunities:
This proposal appears to create a "double dip" with credits taken pursuant to the current Technology Jobs Tax Credit Act (Section 7-9F NMSA 1978), with which this proposal has many overlapping provisions. Credits of $1.2 million per year are claimed under the Technology Jobs Credit program. There is no provision contained in this proposal that would exclude a taxpayer from qualifying under both programs. Although this bill defines "qualified expenditure" to exclude "*…property 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 above 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 both programs. Further, payroll expenditures alone are likely to be sufficient to qualify a business for the proposed deductions. Nothing in the bill states that if a taxpayer claims credit pursuant to existing credit programs, the taxpayer is no longer eligible for the proposed deductions.

Potential for tax-motivated transactions:
This proposal would allow eligible companies an exclusion on certain purchases and also on their sales. The comprehensive "tax holiday" proposed raises the concern that companies might engage in tax-motivated transactions. For example, an eligible company could go into the middle-man business, buying equipment and re-selling it tax free to other businesses. These transactions could be profitable on the basis of tax savings alone, independent of any real economic merit. To avoid this potential problem, the proposal should include restrictions on the proposed GRT deduction so that it would not apply to the re-sale of goods or services.

Uneven treatment of in-state and out-of-state purchases:
The proposal offers a compensating tax deduction for eligible companies. It does not offer a similar exclusion for passed-on GRT, i.e. for the GRT paid by in-state companies on their sales to the eligible business. This imbalance creates an incentive for the eligible companies to make purchases from out-of-state vendors rather than in-state vendors.

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