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

ORIGINAL DATE 02/25/11
SPONSOR Chavez, D. **LAST UPDATED** **HB** 448

SHORT TITLE Tax Deduction for Certain Depreciable Assets **SB**

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue				Recurring or Non-Rec	Fund Affected
FY12	FY13	FY14	FY15		
	($15,000.0)	($13,000.0)	($10,000.0)	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY11	FY12	FY13	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total		>$0.0	>$0.0	>$0.0	Recurring	General Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

TRD reports an unquantifiable operational budget impact because this bill increases the complexity of the income tax system. Auditors will have to be trained to understand and audit for this breach of federal piggybacking. For the most part, TRD can let IRS auditors verify most aspects of state PIT and CIT filings. The op bud impact, then, is in the nature of "opportunity cost", where auditors will not have a priori knowledge of whether a section 179 audit will be as productive as a GRT or CIT audit.

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

House Bill 448 would establish a state section 179 expensing provision separate from the federal Section 179 provision. While the federal section 179 treatment is designed to benefit small businesses, the state 179 provision would be somewhat more expansive. TRD describes the bill as follows:

> This bill would permit income taxpayers and corporate income taxpayers to “expense” – or deduct immediately rather than depreciating [the cost of capital assets] over time… Eligible equipment would be as defined under Section 179 of the Internal Revenue Code [and includes production equipment and tools, transportation equipment and other tangible personal property and may include oil and gas well drilling equipment]. To [partially or fully prevent taxpayers from claiming] a double-deduction for the same investment, taxpayers electing to expense their investments would be required to add back to taxable income the amount of any deduction they had claimed for the same investment on their federal tax return [filed for that year]. Any deduction resulting from the expensing election could not reduce taxable income below zero, i.e. could not by itself leave the taxpayer with a net operating loss. The new expensing election would not be available for property for which the taxpayer claims a deduction under any other section of the Internal Revenue Code. Taxpayers making the expensing election shall not be allowed to claim the business facility rehabilitation credit, the credit for electronic readers, the solar market development credit, the renewable energy production credit, the geothermal heat pump credit, the advanced energy credit, or the investment tax credit for investments in the same assets.
>
> The Taxation and Revenue Department is required to compile an annual report that includes the number of taxpayers claiming these deductions and the amount of the deductions claimed and report to the Revenue Stabilization and Tax Policy Committee prior to November 1 of each taxable year beginning in 2013.

Effective Date: January 1, 2012. Applicable to taxable years beginning on or after January 1, 2012.

The entire TRD analysis is attached to this FIR.

FISCAL IMPLICATIONS

TRD reports that the fiscal impacts are uncertain. The Joint Committee on Taxation of the U.S. Congress recently estimated that the 100 percent bonus depreciation provisions of the temporary federal tax stimulus passed in December would reduce federal revenues by $55 billion per year. The estimate in the table adjusts the Joint Committee’s estimate to reflect the size of the New Mexico economy, our lower income tax rates and an assumption that 50 percent of the equipment benefiting from the bonus depreciation provisions would qualify as Section 179 property. There are no significant revenue impacts of the provisions in FY2012 because federal law already allows for 100 percent depreciation of equipment investments. By increasing the expensing of business investments, the proposal would accelerate the timing of deductions, reducing income tax in the short run but increasing it later on. Thus, the annual fiscal impacts of the provision would eventually turn positive.

[LFC comment: the nature of the state economy means that a methodology that allocates national impacts to the state can only provide an order of magnitude impact. Despite TRD’s very competent analysis, a proposal as far-reaching as this can only be understood by peeling off layers of the onion. One creative accountant could read the law in a way that would provide a client with the means to take major advantage of the provisions. If one firm the size of a major utility or world-class manufacturer could use this provision, there would be a reasonable possibility to wipe out their entire state corporate income tax liability for the year. Thus, the potential short-term revenue exposure could be up to $100 million.]

SIGNIFICANT ISSUES

The Congressional Joint Committee on Taxation provides the following information concerning Section 179:

- Subject to certain limitations, a taxpayer that invests in certain qualifying property may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions.
- Qualified property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Temporary provisions add off-the-shelf computer software to eligible property.
- Under present law, for taxable years beginning in 2012, the maximum amount a taxpayer may expense is $125,000 of the cost of qualifying property placed in service for the taxable year. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation.
- For taxable years beginning in 2013 and thereafter, the maximum amount a taxpayer may expense is $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000.

TRD notes that, "…although the proposal gives taxpayers the option to expense Section 179 property, it does not subject the amount of expensed property to the limits that are included in federal law. Presumably this treatment is intentional and is meant to provide the benefits of expensing regardless of the amount of investment. This is a substantial change from federal law treatment, which restricts the benefits of section 179 to relatively small amounts of investment. However, federal depreciation rules have been substantially liberalized during the current recession, and 100 percent expensing of investments regardless of size is current federal law through the end of 2012."

TRD notes that, "… the provision would encourage new investment in the state. However, this goal is achieved at a substantial increase in the complexity of the tax system."

LFC believes that new technology oil and gas drilling rigs (horizontal drilling rigs) would be eligible for state section 179 treatment.

ADMINISTRATIVE IMPLICATIONS

TRD notes a substantial administrative impact with this bill:

> Taxpayers electing to utilize the proposed expensing treatment of investments would face a significant increase in the complexity of their income tax returns [and associated accounting for capital assets]. The Department's auditors will also face increased complexity, increasing costs and slowing the timing of audits.
>
> Implementing the reporting requirements under the bill will be difficult. The Department will require detailed information from taxpayers on, for example, the value of the equipment for which the deduction was claimed and any other information needed to evaluate the effectiveness of the tax benefit. Confidentiality statutes will apply to any information so collected. Since some deductions will be on assets not located in this state, in order to evaluate the effectiveness, detailed information on the location of the equipment would

> be required. Collecting this information will impose significant costs on taxpayers and the Department.

TECHNICAL ISSUES

TRD's analysis confirms LFC's. As explained by TRD:

> The anti-double deduction provisions in the bill do not appear to successfully prevent all such deductions. The provisions require a taxpayer to add back to income the amount excluded ***in the taxable year in which property is placed in service***. If property is being depreciated rather than expensed for federal tax purposes [e.g., when the cost basis of the property is limited and the excess over the limit is depreciated], there could be depreciation deductions for several years after the year the property is placed in service. Thus, although the addback appears to address the double-deduction problem in the first year property is placed in service, it does not appear to address the problem in subsequent years.

LFC notes that the bill may give TRD the ability to promulgate a rule that would forestall this potential loophole. The key is that taxpayers who elect ***state*** section 179 treatment for eligible property must permanently separate that equipment on their books and not permit the property to be entered on their books of record as a capital asset for state purposes. There may be some other rule that TRD could propose that would result in forestalling the double-deduction.

TRD also notes another discrepancy between state treatment and federal treatment of section 179 property when the expensing results in a net operating loss:

> The provision preventing an expensing deduction from reducing income below zero would deny an otherwise qualified taxpayer from generating a net operating loss to carry forward to a future tax year. This treatment is less generous than that allowed under federal tax law and would restrict to some extent the economic value of the expensing election.

OTHER SUBSTANTIVE ISSUES

TRD extensively discusses the long-term policy implications of this bill:

> **Decoupling from Federal Income Tax rules:** like most states with a broad-based income tax, New Mexico "piggybacks" on federal law definitions that determine taxable income. However, New Mexico law departs from – or "decouples" – from federal law on certain components of taxable income. For example, we have different rules for the treatment on net operating losses [and we require taxpayers to add back state income taxes deducted for federal purposes]. Among the 42 states that have a broad-based income tax, only six do not use federal taxable income as their tax base.
>
> *Pros and cons of de-coupling:*
> Pros: Federal income tax law is constantly changing. This sometimes puts the state in the position of having our revenue base erode because of federal law changes over which the state has very little direct say. A recent example was the adoption of bonus depreciation rules for corporations, which reduced state revenues by an estimated $60 million in the 2008-2009 time period. Because this provision changed only the timing of deductions, state revenues will be higher in subsequent years.

Cons: Depending on the extent of the changes from federal tax law, de-coupling can increase complexity for taxpayers. This is because they will have to maintain different records for state tax purposes than they do for federal tax purposes. When rules for depreciating investment are de-coupled, this complexity is increased because taxpayers will need to maintain separate records of their depreciation expenses for the entire life of all investments.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

The state's economy might not benefit for additional state-level stimulus that would encourage large and small firms to invest in equipment, tools and machinery. In particular, this state section 179 election might be used to retool the state's natural gas drilling services industry to invest in horizontal drilling rigs.

LG/bym

BILL ANALYSIS AND FISCAL IMPACT REPORT
Demesia Padilla, Secretary Designate, Taxation and Revenue Department

February 24, 2011

Bill: HB-448 **Sponsor:** Representative David C. Chavez

Short Title: Tax Deduction for Certain Depreciable Assets

Description: This bill would permit income taxpayers and corporate income taxpayers to "expense" – or deduct immediately rather than depreciating over time – the cost of their investments in new equipment. Eligible equipment would be as defined under Section 179 of the Internal Revenue Code. To avoid a double-deduction for the same investment, taxpayers electing to expense their investments would be required to addback to taxable income the amount of any deduction they had claimed for the same investment on their federal tax return. Any deduction resulting from the expensing election could not reduce taxable income below zero, i.e. could not by itself leave the taxpayer with a net operating loss. The new expensing election would not be available for property for which the taxpayer claims a deduction under any other section of the Internal Revenue Code. Taxpayers making the expensing election shall not be allowed to claim the business facility rehabilitation credit, the credit for electronic readers, the solar market development credit, the renewable energy production credit, the geothermal heat pump credit, the advanced energy credit, or the investment tax credit for investments in the same assets.

The Taxation and Revenue Department is required to compile an annual report that includes the number of taxpayers claiming these deductions and the amount of the deductions claimed and report to the Revenue Stabilization and Tax Policy Committee prior to November 1 of each taxable year beginning in 2013.

Effective Date: January 1, 2012. Applicable to taxable years beginning on or after January 1, 2012.

Estimated Revenue Impact*					R or NR**	Fund(s) Affected
FY2011	FY2012	FY2013	FY2014	FY2015		
--	--	(15,000)	(13,000)	(10,000)	R	General Fund

* In thousands of dollars. Parentheses ( ) indicate a revenue loss. ** Recurring (R) or Non-Recurring (NR).

Fiscal impacts are uncertain. The Joint Committee on Taxation of the U.S. Congress recently estimated that the 100 percent bonus depreciation provisions of the temporary federal tax stimulus passed in December would reduce federal revenues by $55 billion per year. The estimate above adjusts the Joint Committee's estimate to reflect the size of the New Mexico economy, our lower income tax rates and an assumption that 50 percent of the equipment benefiting from the bonus depreciation provisions would qualify as Section 179 property. There are no significant revenue impacts of the provisions in FY2012 because federal law already allows for 100 percent depreciation of equipment investments. By increasing the expensing of business investments, the proposal would accelerate the timing of deductions, reducing income tax in the short run but increasing it later on. Thus, the annual fiscal impacts of the provision would eventually turn positive.

Policy Issues: The provision would encourage new investment in the state. However, this goal is achieved at a substantial increase in the complexity of the tax system. See the discussion of "de-coupling" under "Other Issues."

Technical Issues: Although the proposal gives taxpayers the option to expense Section 179 property, it does not subject the amount of expensed property to the limits that are included in federal law. (See discussion below under "**Other Issues – Detailed Discussion"** on page 3.) Presumably this treatment is intentional and is meant to provide the benefits of expensing regardless of the amount of investment. This is a substantial change from federal law treatment, which restricts the benefits of section 179 to relatively small amounts of investment. However, federal depreciation rules have been substantially liberalized during the current recession, and 100 percent expensing of investments regardless of size is current federal law through the end of 2012.

The anti-double deduction provisions in the bill do not appear to successfully prevent all such deductions. The provisions require a taxpayer to addback to income the amount excluded in the taxable year in which property is placed in service. If property is being depreciated rather than expensed for federal tax purposes, there could be depreciation deductions for several years after the year the property is placed in service. Thus, although the addback appears to address the double-deduction problem in the first year property is placed in service, it does not appear to address the problem in subsequent years.

The provision preventing an expensing deduction from reducing income below zero would deny an otherwise qualified taxpayer from generating a net operating loss to carry forward to a future tax year. This treatment is less generous than that allowed under federal tax law and would restrict to some extent the economic value of the expensing election.

Other Issues: The Congressional Joint Committee on Taxation provides the following information concerning Section 179:

- Subject to certain limitations, a taxpayer that invests in certain qualifying property may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions.
- Qualified property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Temporary provisions add off-the-shelf computer software to eligible property.
- Under present law, for taxable years beginning in 2012, the maximum amount a taxpayer may expense is $125,000 of the cost of qualifying property placed in service for the taxable year. The $125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $500,000. The $125,000 and $500,000 amounts are indexed for inflation.
- For taxable years beginning in 2013 and thereafter, the maximum amount a taxpayer may expense is $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000.

Administrative & Compliance Impact: Taxpayers electing to utilize the proposed expensing treatment of investments would face a significant increase in the complexity of their income tax returns. The Department's auditors will also face increased complexity, increasing costs and slowing the timing of audits.

Implementing the reporting requirements under the bill will be difficult. The Department will require detailed information from taxpayers on, for example, the value of the equipment for which the deduction was claimed and any other information needed to evaluate the effectiveness of the tax benefit. Confidentiality statutes will apply to any information so collected. Since some deductions will be on assets not located in this state, in order to evaluate the effectiveness, detailed information on the location of the equipment would be required. Collecting this information will impose significant costs on taxpayers and the Department.

Related Bills: None.

Other Issues – Detailed Discussion: Decoupling from Federal Income Tax rules**:**

Like most states with a broad-based income tax, New Mexico "piggybacks" on federal law definitions that determine taxable income. However, New Mexico law departs from – or "decouples" – from federal law on certain components of taxable income. For example, we have different rules for the treatment on net operating losses. Among the 42 states that have a broad-based income tax, only 6 do not use federal taxable income as their tax base.

Pros and cons of de-coupling:

Pros: Federal income tax law is constantly changing. This sometimes puts the state in the position of having our revenue base erode because of federal law changes over which the state has very little direct say. A recent example was the adoption of bonus depreciation rules for corporations, which reduced state revenues by an estimated $60 million in the 2008-2009 time period. Because this provision changed only the timing of deductions, state revenues will be higher in subsequent years.

Cons: Depending on the extent of the changes from federal tax law, de-coupling can increase complexity for taxpayers. This is because they will have to maintain different records for state tax purposes than they do for federal tax purposes. When rules for depreciating investment are de-coupled, this complexity is increased because taxpayers will need to maintain separate records of their depreciation expenses for the entire life of all investments.