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

**ORIGINAL DATE** 02/05/14
**SPONSOR** SCORC **LAST UPDATED** 02/14/14 **HB**

**SHORT TITLE** U. S. Dept. Of Defense Energy Gross Receipts **SB** 184/SCORCS

**ANALYST** Graeser/van Moorsel

## REVENUE (dollars in thousands)

| Estimated Revenue Impact* | | | | | Recurring or Nonrecurring | Fund(s) Affected |
|---|---|---|---|---|---|---|
| FY14 | FY15 | FY16 | FY17 | FY18 | | |
| | ($1,400.0) to ($7,700.0) | ($1,400.0) to ($7,700.0) | ($1,400.0) to ($7,700.0) | ($1,400.0) to ($7,700.0) | Recurring | General Fund |
| | ($620.0) to ($3,500.0) | ($620.0) to ($3,500.0) | ($620.0) to ($3,500.0) | ($620.0) to ($3,500.0) | Recurring | Bernalillo County and Albuquerque |
| See "Fiscal Impact," below | | | | | | |

(Parenthesis ( ) Indicate Revenue Decreases)

* The estimate reported here ranges from a high estimate based on AFRL budget data provided by EDD and the low estimate based on data provided by TRD.

## ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

| | FY14 | FY15 | FY16 | 3 Year Total Cost | Recurring or Nonrecurring | Fund Affected |
|---|---|---|---|---|---|---|
| **Total** | | *** | *** | *** | Recurring | General Fund |

(Parenthesis ( ) Indicate Expenditure Decreases)

*** TRD reports a high impact to administer the provisions of this bill. See below under "Administrative and Compliance Issues."

Duplicates HB45/HTRCs

**SOURCES OF INFORMATION**
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Economic Development Department (EDD)

## SUMMARY

Synopsis of Bill

Senate Corporations and Transportation Committee substitute for Senate Bill 184 adds a new deduction from the gross receipts derived from the sale of goods and services to the United States Department of Defense related to directed energy or satellites. The purpose of the deduction is to promote new and sophisticated technology, enhance the viability of existing directed energy and satellite projects, attract new projects and employers to New Mexico and increase high-technology employment opportunities. Definitions related to the new deduction are listed in the Description – Detailed Discussion section on the next page.

***Unlike the original SB 184 which provided that the amount of the deduction is equal to aggregate total of New Mexico income and property taxes paid by the taxpayer's employees whose work is related to directed energy or satellites, the SCORC substitute provides a deduction for the entire gross receipts for these activities.***

The SCORC substitute makes the deduction available for contracts entered into on or after July 1, 2014. Although the deduction would thus be limited to new contracts, nothing in the bill would preclude contractors from renegotiating contracts with the DOD after this date, thus achieving the savings equal to foregone GRT.

The taxpayer will be required to separately report this deduction pursuant to instructions of the Secretary of TRD. The separate report must also include the number of employees for whom charges were made during the reporting period. TRD is then required to report annually to the Revenue Stabilization and Tax Policy and Legislative Finance Committees the aggregate use of the deduction and other information that will facilitate the evaluation by these committees and of the benefit to the state resulting from the deduction. In FY 2021, TRD is required to analyze the data, review the efficacy of the deduction and recommend to the Legislature whether the deduction should be retained intact, modified or repealed.

## FISCAL IMPLICATIONS

The LFC and the Taxation and Revenue Department did not arrive at a consensus estimate of the fiscal impact of SB 184/SCORCs. As discussed on pages 11 and 12 Volume 1 of the LFC Budget Recommendation for FY15, the fiscal impacts of new tax expenditures has been underestimated in the past. This FIR therefore presents a range of potential impacts, calculated on two different data sources.

LFC's fiscal impact estimate of this SCORC substitute is based on AFRL's current procurement budget as reported by EDD. The estimate does not include forgone revenues on potential additional investment in New Mexico, as that activity does not currently occur in New Mexico and tax on that business activity is not currently being collected. Further, the estimate assumes contractors and the DOD renegotiate contracts quickly after the effective date, and thus the entire fiscal impact is seen in the first year (FY15).

The EDD reports the Air Force Research Laboratory (AFRL) 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. Of the $245 million spent in New Mexico, approximately 70 percent ($171.5 million) would be related to contracts for directed energy or satellite research.

The Air Force Research Laboratory confirmed this level of expenditure in New Mexico, reporting its FFY12 contract budget in New Mexico for its Space Vehicles Directorate and its Directed Energy Directorate totaled $199 million, of which $147 million comprised contracts with small businesses.

The proper GRT rate to apply to estimate the size of the proposed deduction would be some mix of Bernalillo County's 6.0625 percent rate and Albuquerque's 7.00 percent rate, depending on where the contractor was located. Thus, the LFC estimates the approximate general fund cost would be ($7,700.0) the cost to Bernalillo County, ($1,500.0) and the cost to Albuquerque ($2,000.0).

TRD, based on CRS reports, puts the cost closer to ($2,000.0) for the State, Bernalillo County and Albuquerque, or approximately ($1,400.0) for the State General Fund and ($600.0) for Albuquerque and Bernalillo County. TRD reported its data showed about $2 million in gross receipts tax is currently generated by qualifying activities. Assuming that a similar level of activity would come to New Mexico regardless of this deduction, that activity would constitute a negative revenue impact. TRD's estimated impact was based on allowing the deduction for new contracts only, and assumed contracts with lengths of five years expire at a rate of 20 percent per year. Thus, the full impact (on the general fund and local governments) would phase in over five years as follows: FY15 - $400 thousand; FY16 - $800 thousand; FY17 - $1.2 million; $FY18 - $1.6 million; and the full impact of $2.0 million would be seen in FY19.

However, assuming contractors immediately renegotiate contracts, the full impact would be seen in the first year of the deduction. This FIR uses the fully phased-in estimate as the lower range of the estimated revenue impact.

This bill creates a tax expenditure and 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.

## EFFECTIVE DATE

July 1, 2014. TRD requests a January 1, 2015 effective date to program the logically complex changes into the CRS system.

## SIGNIFICANT ISSUES

TRD notes that New Mexico represents a rather unique environment for federal contracts; these contracts are more costly than in other states because the contractor will pass on the cost of its gross receipts tax liability to the government agency. The gross receipts tax deduction provided by this bill would remove a portion of the competitive disadvantage faced by in-state firms providing directed energy and satellite services through government contracts.

EDD notes that creating a more competitive environment for government contracts in directed energy and satellite technology will boost employment and allow for recruiting for foreign firms in the field. 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 thousand 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.

EDD testifies that the bill would have a significant impact in retaining existing businesses and recruiting new ones in the field, as well as retaining the existing workforce in the field that is exiting employment with the federal government or government contractors due to spending cuts.

As used in this bill:

- "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 directed energy and satellite-related inputs" means inputs supplied to the DOD pursuant to a contract with that department entered into on or after July 1, 2014; and
- "qualified research and development services" means research and development services related to directed energy or satellites provided to the DOD pursuant to a contract with that department entered into on or after July 1, 2014;

**PERFORMANCE IMPLICATIONS**

EDD reports that the deduction would have a substantial impact on EDD's and the New Mexico Partnership's retention and recruiting performance.

The LFC tax policy of accountability is met with the bill's requirement that TRD 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. The bill further requires that TRD review the efficacy of the deduction and report to the interim revenue stabilization and tax policy committee a recommendation by December 2021.

**ADMINSTRATIVE & COMPLIANCE IMPACT**

TRD reports that the provisions of this bill create a high impact. This bill requires the deduction to be separately stated from other deductions. As TRD's CRS filing system is currently implemented, the deduction could be accounted for using special rate codes or location codes, but system performance, both in IT system and manual processing terms, is degraded as more codes are added. The added complexity also increases the likelihood of incorrect filing by taxpayers. Historically, taxpayer compliance with separately stated deductions has been low. The Department is therefore limited in its ability to report accurately on the deduction, if accurate information is not filed by the taxpayer.

Taxpayers will also incur the burden of reprogramming computer systems and changing accounting practices to separately report the deduction. Forms and instructions would need to be modified at a minimal cost. In addition, the Department would be required to compile tax information for all of the applicable employees of the taxpayer.

## DUPLICATION

Duplicates HB 45/HTRCs

## TECHNICAL ISSUES

There is no explicit sunset date for this deduction, although implicitly the legislature would probably review the efficacy of the deduction some time prior to the June 30, 2024 date mentioned in the bill. On that date, receipts are no longer deductible.

## OTHER SUBSTANTIVE ISSUES

**TRD provides an interesting historical perspective:**

> One of the original purposes for using a gross receipts tax system (a vendor sales tax) was to allow New Mexico to indirectly tax the federal government contractors who provide support to the federal installations in the state. While this has worked, it has also meant that these contracts are more costly than in other states because the contractor will pass on the cost of its gross receipts tax liability to the government agency. In instances where the federal government and their contractors have a choice about where they will locate the project work site, New Mexico often loses out because of the gross receipts tax. The gross receipts deduction provided by this bill would remove the competitive disadvantage faced by in-state firms providing directed energy and satellite services through government contracts.

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

LG:PvM/ds:svb:jl