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

ORIGINAL DATE 3/4/19
SPONSOR Ortiz y Pino **LAST UPDATED** **HB**

SHORT TITLE Start-Up Business Gross Receipts **SB** 466

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY19	**FY20**	**FY21**	**FY22**	**FY23**		
	Unknown but significantly negative (could be in excess of ($10,000.0) annually because the definition is not sufficiently exclusive				Recurring	General Fund
	Unknown but significantly negative (could be in excess of ($5,000.0) annually because the definition is not sufficiently exclusive					Local Governments in jurisdictions that house a post-secondary institution

Parenthesis ( ) indicate revenue decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Economic Development Department (EDD)
Science and Technology Center at UNM (STC/UNM)
New Mexico Higher Education Department (NMHED)

SUMMARY

Synopsis of Bill

Senate Bill 466 provides a five-year deduction from Gross Receipts and Compensating Tax for certain start-up technology firms. A municipality is required to certify a start-up business if that business meets the specified requirements of being located within 3 miles of a public post-secondary educational institution OR is located in a research park or property owned or operated by a research park corporation. This deduction shall be separately reported and the Taxation and Revenue Department (TRD) is required to compile an annual report and present that report to the specified legislative committees. The start-up business by definition shall employee fewer than 10 full-time employees; have had less than $500 thousand in gross receipts in the previous calendar year; except for the services of scientists or researchers or similar professional services, does not include a business that provides professional services as the business's primary activity; and does not include a business that provides sales at retail as the primary business.

The effective date of this bill is July 1, 2019. There is no delayed repeal date but LFC recommends adding one. This deduction could be misused and there should be a formal review period.

FISCAL IMPLICATIONS

This bill creates a tax expenditure with a cost that is difficult to determine but likely significant, largely because of the expansive definition of a "start-up business." LFC has serious concerns about the significant risk to state revenues from tax expenditures and the increase in revenue volatility from erosion of the revenue base. The committee recommends the bill adhere to the LFC tax expenditure policy principles for vetting, targeting, and reporting or be held for future consideration.

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.

SIGNIFICANT ISSUES

TRD notes that this legislation would provide incentives for small business start-ups in certain locations in the state, and these start-up might benefit New Mexico's economy:

> The deduction may also improve the likelihood that a start-up survives past its first five years. Start-ups have a high failure rate for numerous reasons, including capital restraints, and tax relief may alleviate some of this. Examples of qualifying research parks include the Arrowhead Park affiliated with NMSU, NMT Research Park Corporation affiliated with New Mexico Tech, Sandia Science & Technology Park associated with Sandia Labs, and the Science & Technology Park affiliated with UNM.
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> The requirement that the start-up be located within 3 miles of a public post-secondary educational system or research park encourages an economic phenomenon termed "clustering". The concept behind clustering is that it in 7-9-7theory results in collaboration and a synergy between the firms locating there. Employees with similar skill sets can more easily move from one job to another and bring their knowledge with them to another firm, and firms with similar or compatible focuses can more easily collaborate due to proximity. Universities, students, and graduates may benefit from proximal high tech and research firms through internships or employment.

> While many start-ups fail, some develop into mature companies and while this deduction has an up-front cost to the state in foregone revenue, state revenues may benefit in the long run as some start-ups succeed and incur tax liability.
>
> Deductions reduce the tax base, and may result in less government services, an increase in other taxes, or both.

STC/UNM notes that start-up companies rarely have significant revenues in the first five years and that the general fund and local government costs might be minimal.

LFC staff note that the majority of start-ups qualifying for the deduction pursuant to the provisions of this bill will be located within three miles of a community college or a branch campus of the larger universities. There are smaller post-secondary institutions in San Miguel County, Santa Fe County, Taos County and a number of other communities. A full list is appended to this review.

LFC staff note that a gross receipts tax deduction usually creates a companion compensating tax deduction pursuant to 7-9-7 NMSA 1978, which imposes the compensating tax on the value of tangible property that was …" (2) acquired inside or outside of this state as the result of a transaction with a person located outside this state that would have been subject to the gross receipts tax had the tangible personal property been acquired from a person with nexus with New Mexico..." However, this deduction from compensating tax is not applicable here.

If the start-up business purchases capital equipment from an in-state vendor, then that equipment would be taxed to the vendor and the economic burden of that tax passed to the start-up business. If the start-up business purchases capital equipment from an out-of-state vendor or manufacturers that equipment, then that equipment would be taxed to the start-up business as compensating tax. Perhaps a more significant deduction for the start-up period would be to enact a companion start-up deduction from the compensating tax applicable to the start-up business.

This bill narrows the gross receipts tax (GRT) base. Many of the efforts over the last few years to reform New Mexico's taxes focused on broadening the GRT base and lowering the rates. Narrowing the base leads to continually rising GRT rates, increasing volatility in the state's largest general fund revenue source. Higher rates compound tax pyramiding issues and force consumers and businesses to pay higher taxes on all other purchases without an exemption, deduction, or credit. In this case, the proposed deduction would also affect the local governments in whose jurisdiction the start-up was located. A list of research, comprehensive, two-year and special institutions is appended to this review. The essential requirement for qualification for the deduction is that the business be located within three miles of an institution of higher education and numerous businesses would qualify.

EDD notes that this deduction might assist in the Department's recruiting efforts.

> The Economic Development Department (NMEDD) could use this additional tax incentive as a tool to assist businesses to launch within the science and technology sector. NMEDD has been attempting to create additional tools to assist the technology businesses. SB466 would provide for additional job creation, which is one of NMEDD's metrics.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is met with the bill's requirement of separate reporting and annual reporting 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. Determining costs is relatively easy. Determining jobs created and economic activity is less easy. To the extent that start-up firms are recruited by EDD, TRD can obtain some indication of benefits when

TECHNICAL ISSUES

While the stated purpose of this deduction is to promote the start-up and growth of science-, technology- and manufacturing-related small businesses located in the near proximity to post-secondary educational institutions, nothing in the definition of a start-up business adequately reinforces this goal. A start-up business may not engage in selling professional services, except the personal services of scientists or researchers. Similarly, the business's primary business activity may not be retail. A short list of start-up businesses that would qualify for this deduction (as long as the business was located within three-miles of a public post-secondary institution) might include: real estate brokers, trash haulers, transportation companies, auto and truck repair shops, wholesale businesses, construction companies, etc. The scope of this proposal should be narrowed so that the stated goal would have a reasonable chance of being accomplished.

The bill allows a five-year tax holiday measured from the month in which the start-up business registers as a taxpayer with the department. If the business anticipates minimal sales and no withholding obligation, it might be in the best interest of the business to delay registration until sales occur. This strategy would maximize the benefits of the deduction.

There is some confusion with the provisions of the bill. Although Section 1 provides for a five-year tax holiday, the definition of a "start-up business" requires the business to be located within 3 miles of a public post-secondary educational institution or within a research park and have fewer than ten employees and have gross receipts for the year preceding the application for the deduction less than $500 thousand. Does this mean that once qualified, a business could take the full five years of deductions even if it grew out of the qualifications? Or would the deductions cease if and when the business ceased to be a "start-up business?"

It also seems cumbersome that the five-year period begins when the business registers with the taxation and revenue department. This might exclude existing business developing a new line of business. Also cumbersome is the requirement for a municipality to certify location and line of business. Location would be possible, but how would the municipal have the information to certify that a start-up business conformed to the other requirements?

This bill does not contain a delayed repeal date. LFC recommends adding a delayed repeal date.

ALTERNATIVES

Consider deleting the questionable gross receipts tax deduction in favor of a compensating tax deduction, which would probably be of more use to true start-up technology businesses.

Consider refining the definition to be more specific to apply to start-up technology businesses.

OTHER SUBSTANTIVE ISSUES

Sandia and Los Alamos National Laboratories, through New Mexico Small Business Assistance ("NMSBA"), file an annual report with the appropriate legislative committee, documenting various program metrics. NMSBA reports that since inception, the program has assisted 2,495 small businesses with 4,863 jobs created and retained.

Public Post-Secondary Educational Institutions

Research
- New Mexico Institute of Mining and Technology
- New Mexico State University – Main Campus
- University of New Mexico – Main Campus

Comprehensive
- Eastern New Mexico University – Main Campus
- New Mexico Highlands University
- Northern New Mexico College
- Western New Mexico University

Two – Year Public Postsecondary Institutions
Branch Community Colleges
- Eastern New Mexico University – Roswell
- Eastern New Mexico University – Ruidoso
- New Mexico State University – Alamogordo
- New Mexico State University – Carlsbad
- New Mexico State University – Dona Ana
- New Mexico State University – Grants
- University of New Mexico – Gallup
- University of New Mexico – Los Alamos
- University of New Mexico – Taos
- University of New Mexico – Valencia

Independent Community Colleges
- Central New Mexico Community College
- Clovis Community College
- Mesalands Community College
- New Mexico Junior College
- San Juan College
- Santa Fe Community College
- Luna Community College

Special Schools
- New Mexico School for the Deaf
- New Mexico School for the Blind and Visually Impaired
- New Mexico Military Institute

Does the bill meet the Legislative Finance Committee tax expenditure policy principles?

1. **Vetted**: The proposed new or expanded tax expenditure was vetted through interim legislative committees, such as LFC and the Revenue Stabilization and Tax Policy Committee, to review fiscal, legal, and general policy parameters.
2. **Targeted**: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.
3. **Transparent**: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies.
4. **Accountable**: The required reporting allows for analysis by members of the public to determine progress toward annual targets and determination of effectiveness and efficiency. The tax expenditure is set to expire unless legislative action is taken to review the tax expenditure and extend the expiration date.
5. **Effective**: The tax expenditure fulfills the stated purpose. If the tax expenditure is designed to alter behavior – for example, economic development incentives intended to increase economic growth – there are indicators the recipients would not have performed the desired actions "but for" the existence of the tax expenditure.
6. **Efficient:** The tax expenditure is the most cost-effective way to achieve the desired results.

LG/sb