Fiscal impact reports (FIRs) are prepared by the Legislative Finance Committee (LFC) for standing finance committees of the Legislature. LFC does not assume responsibility for the accuracy of these reports if they are used for other purposes.

FISCAL IMPACT REPORT

		LAST UPDATED	3/10/23
SPONSOR	HCEDC	**ORIGINAL DATE**	3/8/23
SHORT TITLE	25% GRT Deduction For Small Businesses	**BILL NUMBER**	CS/House Bill 163/HCEDCS
		ANALYST	Graeser

REVENUE* **(dollars in thousands)**

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY23	FY24	FY25	FY26	FY27		
	($59,200.0)	($60,700.0)	($62,800.0)	($64,200.0)	Recurring**	General Fund (GRT)
	($41,300.0)	($42,500.0)	($43,900.0)	($44,900.0)	Recurring**	General Fund -- County/Muni GRT share
	($100,500.0)	($103,200.0)	($106,700.0)	($109,100.0)	Recurring**	General Fund Total
	$0	$0	$0	$0	Recurring**	Local Governments

Parenthesis ( ) indicate revenue decreases.
*Amounts reflect most recent version of this legislation.
** Although the credit expires effective July 1, 2028, for budgetary purposes, the revenue loss is considered recurring.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT*
(dollars in thousands)

	FY23	FY24	FY25	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
TRD ITD/ASD-Staff Workload Cost	$28.0	--	--	$5.5	Nonrecurring	General Fund

Parentheses ( ) indicate expenditure decreases.
*Amounts reflect most recent version of this legislation.

Sources of Information

LFC Files

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

SUMMARY

Synopsis of HCEDC Substitute for House Bill 163

House Commerce and Economic Development Committee substitute for House Bill 163 would allow small businesses in New Mexico a credit of 25 percent for the small business's tax liabilities against the state gross receipts tax due. This credit expires July 1, 2028. A small business is defined as one that:

- Employs no more than four full- or part-time employees who are employed by the business for at least 44 weeks in the 12 months prior to the month for which the deduction is claimed;
- Received no more than $1,000,000 in gross receipts in the calendar year prior to the

taxable period in which the credit is claimed.
The amount of credit shall not exceed $20 thousand per small business per calendar year. "Tax Liabilities" include local option gross receipts taxes but exclude any state or local option compensating taxes. A taxpayer that claims any other credit (such as high-wage or rural jobs credits) would be disqualified from claiming this credit.

This effectively gives an eligible small business a 25 percent decrease in the amount of gross receipts tax they would pay, but, at the same time, forces the state general fund to bear the entire fiscal burden of the credit. The deduction must be separately reported to TRD and TRD must include the utilization data in the annual Tax Expenditure Report.

This bill has an effective date of July 1, 2023. The provisions are sunset as of July 1, 2028.

FISCAL IMPLICATIONS

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.

A sample from the Quarterly Census of Employment and Wages (QCEW) for the first quarter of 2022 for New Mexico indicated that 8.6 percent of covered wages were paid by establishments with fewer than five employees. Assuming that taxable gross receipts are in the same ratio as wages paid, the deduction creates over $2 billion in creditable receipts for FY24. Single proprietors with no employees also would benefit from this deduction but may not be included in the simple estimate reported here (see Technical Issues for discussion of this point). The estimate is also understated because newly hired employees over the four maximum do not disqualify the small business until these new hires have been on board and over the four employees maximum for a 44 weeks. The impact of the $1 million annual total receipts and the $20 thousand annual credit cap per business will tend to reduce the impact. We assume that about 22 thousand small businesses will benefit from this credit with an average amount of benefit of about $4,500 each year.

Assume	FY22	FY23	FY24	FY25	FY26	FY27
Gen Fund Revenue	$3,536,374	$3,830,800	$3,802,600	$3,905,300	$4,036,000	$4,127,600
Muni Revenue	$1,495,259	$1,654,052	$1,683,975	$1,729,456	$1,787,336	$1,827,901
County Revenue	$822,084	$955,957	$973,251	$999,536	$1,032,988	$1,056,432
Total MTGR ($1,000)	$82,265,683	$92,134,961	$93,801,764	$96,335,147	$99,559,228	$101,818,798
	7.116%	6.991%	6.866%	6.866%	6.866%	6.866%
Taxable Receipts ($1,000)			$23,450,441	$24,083,787	$24,889,807	$25,454,700
Taxable Receipts per establishment			$544,435	$559,139	$577,852	$590,966
Total Receipts per establishment (47% deductions ratio)			$1,158,000	$1,190,000	$1,229,000	$1,257,000
Total Deductions 25%			$2,031,937	$2,086,815	$2,156,655	$2,205,602
Limited Total (51%)			($100,500.0)	($103,200.0)	($106,700.0)	($109,100.0)
General Fund direct			($59,200.0)	($60,700.0)	($62,800.0)	($64,200.0)
Local Gov't share of tax of deduction			($41,300.0)	($42,500.0)	($43,900.0)	($44,900.0)

TRD reports difficulty in analyzing the multiple provisions of this bill and reports some caveats:

> … some caveats might reduce or increase the fiscal impact. First, the fact that the bill prevents a taxpayer from claiming other credits against the gross receipts tax might reduce the impact. Nonetheless, this bill will add more choices for taxpayers, introducing

more complexities and uncertainties to estimate a more precise fiscal impact (see Policy Issues). Second, individual proprietorships or non-employer establishments might be eligible for this credit since, by definition, they have fewer than four employees, and the bill has no restrictions in terms of the business structures.

SIGNIFICANT ISSUES

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.

LFC staff notes that the sponsors of this proposal assume that the credit mechanism occurs on the same tax return as that reporting the overall liability. TRD, however, points out a number of technical issues that may interfere with this assumption. It should also be noted that the purpose of the credit mechanism is to hold local governments harmless and force the general fund to bear the entire burden of the deduction.

EDD notes that: "…small businesses make up approximately two thirds of businesses within the state of New Mexico and employ about 9 percent of the state's workforce. Allowing a 25 percent deduction on receipts could help struggling small businesses stay in business or help small businesses expand and hire more employees faster. Both cases could promote additional economic activity within the state."

TRD also notes positive and negative effects from this proposal:

> Small businesses are an economically important component of the state economy and a key driver of production, employment, and growth. As such, tax policies aimed at alleviating the tax burden of small businesses may foster job growth and the production of a very dynamic sector of the economy. Even so, the bill goes against the principle of equity, which ensures that all businesses face the same tax regime. Apart from treating businesses differently, establishments that meet the bill's small business criteria might benefit differently. For instance, the bill will benefit equally a restaurant that hires unskilled workers and a tech startup that employs skilled workers. However, these two establishments might differ significantly regarding their taxable activity. It is not clear from the bill proposal what is the purpose behind this new tax incentive and TRD suggest including a purpose statement in the bill to make the goal more transparent. The bill further erodes equity by treating very similar businesses differently; a business with five (5) employees would not be able to get the credit, even though there is no significant difference between a business with four employees and one with five.
>
> The recent GRT state rate reduction to 5 percent and the additional rate drop to 4.875 percent on July 1, 2023, are aimed to benefit all taxpayers and support fewer tax incentives. While tax incentives may support particular industries or encourage specific social and economic behaviors, the proliferation of such incentives complicates the tax code. Adding more tax incentives: (1) creates special treatment and exceptions to the code, growing tax expenditures and/or narrowing the tax base, with a negative impact on the general fund; and, (2) increases the burden of compliance on both taxpayers and

TRD. Adding complexity and exceptions to the tax code does not comport generally with the best tax policy.
This bill is augmenting the tax code complexity by giving taxpayers more choices. This occurs because taxpayers are given additional credits or incentives but may only use one or a few. Any business claiming this new small business tax credit will not be eligible for any other gross receipts tax credit. It is typically believed that more options help taxpayers to make the correct decision. Nonetheless, in designing tax policy, it is not necessarily the case that more choices always offset the decision-making costs. For instance, the marginal benefit to a taxpayer of choosing between the new choice and its alternatives may be negligible compared to the costs of determining the best option. Unfortunately, the taxpayer does not know that until the cost has been undertaken. Furthermore, having more choices increases the administrative burden for TRD. Tax policy is a mechanism designed to motivate a concrete behavior in taxpayers, and in order to do so, it must reduce the number of choices given."

This bill may unintentionally hinder employment growth by creating a cliff effect. A small business that might be poised to grow to more than four employees or achieve total revenues in excess of $1,000.000 may opt not to hire because doing so will increase their effective GRT rate by 33 percent. Similarly, a business that was poised to exceed the cap in gross receipts might reduce economic activity if the loss of the credit exceeds the amount of new net receipts.

The tax code, including revenue distributions, should conform to the principle of simplicity. The proposed changes to 7-1-6.4 NMSA 1978 to tie the distribution to lost revenue from the credit adds complexity. Additionally, this increases the costs of administration associated with misinterpretations of the rule and the use of multiple and sometimes revised sources of data. Adding more complexity to the distributions for gross receipts tax are not preferred by TRD as it adds additional complexities to an already complex system.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is met with the bill's requirement for separate reporting and the 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. This reporting would be accomplished by inclusion in TRD's annual Tax Expenditure Report.

ADMINISTRATIVE IMPLICATIONS

TRD will need to make information system changes and update forms, instructions and publications. This legislation is anticipated to have a large impact on TRD's Administrative Services Division (ASD). A new credit in Gentax for the GRT tax program will need to be created. Additionally, this legislation adds a distribution to local governments based on the amount of the credit taken. Both initiatives will require defining business requirements, creating new posting documents and testing revenue and general ledger accounting and changes to reports. The Gentax effort will require one existing FTE and 120 hours split between pay-band 70 and 80 positions. Additionally, implementing this bill will have an impact on TRD's

Information Technology Division (ITD) of approximately one month and approximately $21 thousand of contractual resources.

TECHNICAL ISSUES

TRD notes extensive technical issues:

The bill defines "small business" as a business with not more than four employees, leaving open the possibility that it applies to a business with no employees other than the owner, such as sole proprietorships. It is therefore unclear whether the bill attempts to target only employer establishments, as they are directly involved in the creation of jobs, or also is supposed to cover non-employer, self-employed individuals or unincorporated businesses. TRD assumes the bill targets employer establishments in estimating the fiscal impact above but suggests the bill clarify the definition of "small-business."

The bill does not define "taxable period" and uses the term in different places to refer to potentially different periods, which creates confusion. On page 4, lines 6-9, the bill allows a small business to claim a tax credit relating to its tax liabilities "in a taxable period…" In other words, the credit is determined by the tax liabilities in a particular time frame, which will usually be monthly, assuming that "tax period" refers to the time when the gross receipts tax liability is incurred. But in the next sentence, the qualification with respect to gross receipts is determined by reference to "the taxable period in which the credit is claimed." It is not clear that the taxable period by reference to which the credit is calculated is the same as the taxable period in which the credit is claimed. Indeed, because the taxpayer must apply to TRD to be eligible for the credit, it is likely that the two taxable periods will not be the same. Using the same term to refer to different time periods may result in both taxpayer and administrative uncertainty.

In addition, in the definition of "small business", on line 14, it refers to the "deduction pursuant to this section." This should state "credit pursuant to this section."

[Section 2]: This credit on page 4, starting on line 20, does not have a set number of years to claim the credit forward. TRD would suggest a cap on the carry forward amount to four years to match the statute of limitations for claiming a refund in Section 7-1-26 NMSA 1978. This will assist TRD administratively regarding processing returns, audits, and providing data on this credit.

OTHER SIGNIFICANT ISSUES

[Section 1]: 7-1-6.4 NMSA 1978 refers to certain general fund revenues being distributed back to municipalities and has been in effect for many years. Governmental Accounting Standards Board 84 (GASB 84) changed the presentation of the accounting/financial statement for amounts paid from state-sourced taxes. With the concurrence of auditors, TRD has taken the position that amounts from legacy legislation, such as these, will not be disaggregated. Thus, it is not recommended that more amounts be diverted to local governments in this manner, creating more commingled revenues. It is suggested that the Department of Finance (DFA) analysis regarding this substitution also be reviewed.

[Section 2]: Page 4, Lines 6-9. The total gross receipts tax imposed on any business

consists of two elements, the state gross receipts tax plus any local option gross receipts taxes, (the "combined gross receipts tax" for purposes of this discussion). The credit provided may only be taken against the state gross receipts tax due, even though "tax liabilities" are defined as the combined gross receipts tax liability. This difference results in administrative complexity for TRD.

Page 4, lines 10-11 restricts the credit to businesses that have received no more than $1 million of "gross receipts" in the calendar year prior to the "taxable period" in which the credit is claimed. This phrasing raises two issues. First, the large majority of businesses pay gross receipts tax monthly, and therefore would be claiming any credit on a monthly basis. Assuming that the undefined term "taxable period" refers to the period for which the tax liability is incurred, this language will require businesses to recalculate their gross receipts each month that they claim the credit, which imposes an additional burden on both taxpayers, in determining whether they can claim the credit, and on TRD, in auditing taxpayers for compliance with the cap. Second, the use of the term "gross receipts" is potentially problematic. While "gross receipts" are defined by statute, Section 7-9-3.5 NMSA, taxpayers do not report receipts that are exempt from the gross receipts tax (although they do report deductible gross receipts, and TRD assumes that the intent of the bill is to <u>include</u> deductible gross receipts in "gross receipts" in determining the whether the $1 million cap is met or exceeded). Therefore, a small business might have total gross receipts, as defined in statute, that greatly exceed the $1 million cap, but only be required to report gross receipts that do not exceed the cap; TRD notes that there are dozens of exemptions contained in the Gross Receipts and Compensating Tax Act, some of them significant. As a result, it would be exceedingly difficult for TRD to ensure compliance with this portion of the statute. Furthermore, a taxpayer might reasonably assume that the $1 million cap did apply solely to its reported gross receipts, and claim the credit even though its gross receipts, inclusive of any exempt receipts, did exceed the cap.

Page 4, Line 21 restricts the taxpayer from claiming other incentive tax credits they may qualify for if they claim this credit. It is not clear whether, if a taxpayer carries forward any small business credit, they are also precluded from claiming any other credit in that period, or whether the exclusion applies solely to the taxable period in which the taxpayer initially claims the small business tax credit.

[Sections 2 & 3]: Although Section 3 specifies that this section applies to tax liabilities beginning on or after July 1, 2023, the first eligible tax period that the credit may be claimed is unclear on page 4, line 19. When this is not clarified for tax credit language, the taxpayers will amend tax returns already filed and request refunds of payments already made toward tax. TRD recommend that the credit is available to claim prospectively (no lookbacks or ability to amend prior year returns), from the certification date.

The bill defines "small business" as a business with not more than four employees, leaving open the possibility that it applies to a business with no employees other than the owner, such as sole proprietorships. It is therefore unclear whether the bill attempts to target only employer establishments, as they are directly involved in the creation of jobs, or is the bill supposed to cover non-employer, self-employed individuals or unincorporated businesses. TRD assumes the bill targets employer establishments in estimating the fiscal impact above but suggests the

bill clarify the definition of 'small-business.'

LFC staff note the existence of the following data source:

> The Quarterly Census of Employment and Wages (QCEW) program publishes a quarterly count of employment and wages reported by employers covering more than 95 percent of U.S. jobs available at the county, Metropolitan Statistical Area (MSA), state and national levels by detailed industry.
>
> **Employment**
>
> QCEW monthly employment data represent the number of covered workers who worked during, or received pay for, the pay period that included the 12th day of the month. Covered employees in the private-sector and in the state and local government include most corporate officials, all executives, all supervisory personnel, all professionals, all clerical workers, many farmworkers, all wage earners, all piece workers, and all part-time workers. Workers on paid sick leave, paid holiday, paid vacation, and the like are also covered.
>
> **Employment Exclusions**
>
> …QCEW excludes proprietors, the unincorporated self-employed, unpaid family members, certain farm and domestic workers from having to report employment data, and railroad workers covered by the railroad unemployment insurance system. Excluded as well are workers who earned no wages during the entire applicable pay period because of work stoppages, temporary layoffs, illness, or unpaid vacations.

POSSIBLE QUESTIONS

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.

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.

LFC Tax Expenditure Policy Principle	Met?	Comments
Vetted	✘	
Targeted		
Clearly stated purpose	✘	Not stated
Long-term goals	✘	
Measurable targets	✘	
Transparent	✓	Separate reporting
Accountable		
Public analysis	✘	
Expiration date	✘	
Effective		
Fulfills stated purpose	✘	
Passes "but for" test	✘	
Efficient	✘	
Key: ✓ Met ✘ Not Met ? Unclear		

LG/al/ne/rl