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

ORIGINAL DATE 2/8/18
SPONSOR House Floor **LAST UPDATED** 2/10/18 **HB** 245/HFlS/aSCORC/ec

SHORT TITLE "Construction Material" in Gross Receipts Act **SB**

ANALYST Clark

REVENUE (dollars in thousands)

Estimated Revenue*					Recurring or Nonrecurring	Fund Affected
FY18	FY19	FY20	FY21	FY22		
Negative, Likely Minimal	Negative, Likely Minimal	Negative, Likely Minimal	Negative, Likely Minimal	Negative, Likely Minimal	Recurring	General Fund, Local Governments

Parenthesis ( ) indicate revenue decreases

*Note: these minimal impacts are partly in relation to possible revenues after a recent Administrative Hearing Office decision; a significant portion of this part of the revenue impact might not have been received historically and would not be included in the latest revenue estimate

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY18	FY19	FY20	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	Minimal to Moderate Savings	Minimal to Moderate Savings	Minimal to Moderate Savings	Minimal to Moderate Savings	Recurring	State and Local Governments, Nonprofits

Parenthesis ( ) indicate expenditure decreases

Duplicates SB215/SCORCS

SOURCES OF INFORMATION
LFC Files

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

SUMMARY

Synopsis of SCORC Amendment

The Senate Corporations and Transportation Committee amendment to the House Floor Substitute for House Bill 245 strikes all language in the bill except for the emergency clause and inserts new language to duplicate the language in SB215/SCORCS. This language amends the Section 7-9-54 NMSA 1978 and 7-9-60 NMSA 1978 deductions directly instead of amending the definition of "construction material" for the entirety of the Gross Receipts and Compensating Tax Act. This appears to have less possibility of unintentional effects and makes the intent clearer.

Synopsis of Original Bill

The House Floor Substitute for House Bill 245 attempts to resolve the issue of "cost segregation" that recently became a significant issue for governmental entities and business provided industrial revenue bonds (IRBs) by local governments. It amends the definition of "construction material" in the Gross Receipts and Compensating Tax Act to clarify that it does not include tangible personal property if it "is sold or will be subsequently sold" to a nonprofit or government entity and if it is or would be classified for depreciation purposes on a three-, five-, seven-, or 10-year schedule for federal taxation purposes.

This bill contains an emergency clause and would become effective immediately upon signature by the governor.

FISCAL IMPLICATIONS

See Significant Issues for discussion of the bill that leads to the impacts shown on the tables above. The bill would result in operating budget savings for government entities and nonprofits due to expanded (compared with recent interpretation) ability to use the Section 7-9-54 NMSA 1978 deduction for sales of tangible personal property (TPP) to governments and nonprofits. As a result of the expanded use of this deduction, gross receipts tax revenues would decline, although it is unclear if there would be much, if any, reduction in revenues compared with more historical norms.

The Taxation and Revenue Department (TRD) provided the following impact analysis on similar legislation.

> Fiscal impacts are uncertain but likely negative. The treatment of TPP under present law is an issue currently being contested in the court system. TRD has argued that most such property should be treated as construction materials, which are not eligible for deduction when sold to government or non-profit entities. Taxpayers have argued TPP is deductible when included in such projects. The Administrative Hearings Office has ruled in TRD's favor on one case, and that decision has been appealed by the taxpayer.

SIGNIFICANT ISSUES

The updated definition of "construction material" in the bill largely aligns the statute with existing New Mexico building regulations. NMAC 3.2.1.11.K (2) provides a definition of "building" that excludes equipment, systems, or components classified for a three-, five-, seven-, 10-, or 15-year depreciation schedule. This updated definition would combine with the existing deduction for selling tangible personal property to nonprofits and governments to exclude such tangible personal property from taxation when sold to those entities. This would also include economic development projects receiving IRBs, because title to the property technically belongs to the local government for the life of the IRB.

According to industry, this is already a long-time established practice, but recently, industry and tax professionals began claiming TRD was more narrowly interpreting statute and the building code. When one of the TRD determinations was protested, the resulting Administrative Hearings Office decision and order severely curtailed this tax treatment.

This bill appears to be an adjustment to statute to largely return to the tax treatment industry received for many years prior to this decision and order, but it does not add tangibles subject to 15-year depreciation, providing a slightly narrower interpretation than in the building code. However, the bill seems to take a step to somewhat widen the tax treatment by removing tangibles from the "construction material" definition, because under existing law, the deduction for sales of tangibles to nonprofits and governments does not apply to construction material unless a "cost segregation" study is performed to parse out what should be excluded. This bypasses the requirement for such a study.

TRD provided the following analysis on similar legislation.

> The deductions targeted for clarification by this bill are typically claimed in three types of construction projects: those sold to governmental entities; those sold to non-profit entities; and, those sold to an entity using IRB financing. An example in a government or non-profit project is specialized utility infrastructure to support an operating room at a hospital. An example in an IRB project is the specialized utility infrastructure to support a clean room or a data center. Each type of project presents different tax policy issues. Allowing the deduction for public construction projects reduces in some degree the cost of those projects, stretching the value of the construction budgets of various public entities including the national labs and other national facilities. Similar logic applies to non-profit projects. Allowing the deduction for IRB projects provides some additional incentive to these projects as intended by the IRB statutes. The trade-off for these policies is the reduction of state and local revenues.

ADMINISTRATIVE IMPLICATIONS

TRD reports its audit and revenue processing system will be impacted. These audits are more complicated because they involve determining the subsequent use by a buyer of equipment to determine the claim for deduction by the seller. Although they point to federal tax rules, in this case there is no federal tax return to point to for the information as the buyer is often a governmental or non-profit entity that is not required to submit a federal return.

DUPLICATION

This bill duplicates SB215/SCORCS.

TECHNICAL ISSUES

TRD noted the following technical issues.

> The bill is characterized as a "clarification" because it incorporates language currently contained in GRT Regulations 3.2.1.11(J) and 3.2.212.22(B)(1)(b) NMAC. These regulations create what might be termed an "exclusion from the denial of a deduction" for

construction projects sold to governmental entities (including those funded by an IRB) and those sold to non-profit entities. Pursuant to Sections 7-9-54 and 7-9-60 NMSA 1978, construction materials are generally <u>not</u> eligible for the deductions created in those statutes. However, the regulations cited point to federal tax definitions to identify a specific subset of TPP that should not be treated as construction material, and therefore should be deductible. The effect of the analysis is to separate construction materials into two buckets: one that is not deductible because it constitutes the "normal" types of fixtures installed in a building, and one that is deductible because it constitutes equipment with appropriate federal tax life and it supports the activities conducted in the building.

The application of these regulations has led to a number of disputes between taxpayers and TRD, in part because they appear to be contradicted by other regulations and in part because the federal tax definitions may be broader in scope than the intended purpose of the GRT deduction. For example, some of the TPP in the federal tax analysis appears to constitute normal construction material installed in a construction project.

This bill could resolve the disputes between taxpayers and TRD, but TRD has concerns about the current language. By relying exclusively on the IRS code, Section 168, the proposed language may create unintended consequences and sources of confusion. An example of the confusion is that some provisions of Section 168 *exclude* non-residential and residential real property, inclusive of its fixtures. Thus, once the equipment is installed, and affixed to the realty, Section 168 treats it as part of the real property. So the fact that an item is depreciable for purposes of federal income tax is not dispositive of the actual role, or taxability of the item, for purposes of gross receipts taxes for tangible personal property. IRS code Section 168, subsection (e)(3) (C)(v) defines seven-year property to include "any property which - (I) ***does not have a class life***, and (II) is not otherwise classified under paragraph (2) or this paragraph." (emphasis provided) In Regulation 3.2.1.11(H), a fixture such as kitchen equipment, once installed, becomes part of the realty and is taxable and not deductible as tangible personal property. However, kitchen equipment is not listed in IRS code, Section 168 in any specific class, so it would default to seven-year property and be deductible.

One issue that expands the scope of the present law regulation is the inclusion of "indirect costs" with the costs of TPP. Indirect costs are the share of a construction business's overhead that is allocated to the TPP on a project. Although their inclusion is not without rationale, these costs seem to stretch the definition of construction material beyond the traditional definition of equipment.

ALTERNATIVES

TRD suggested the following alternatives.

If the bill is intended to clarify the meaning of the above-cited federal regulations, additional definitions need to be provided that address TRD's concern that the language in the current regulations is too broad. To further limit the potential fiscal impact, the bill might exclude from the definition the indirect costs that are often added to TPP costs in a cost segregation study. In addition, the bill could direct TRD to develop new regulations to clarify the specific application of the law.

If the Legislature is concerned about the potential fiscal impacts of the legislation, the scope could be narrowed by targeting the deduction to a subset of the eligible projects. For example, if the main concern is about the impact on IRB projects, the deduction could be limited to those projects.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

The recently narrowed interpretation of statute could result in TRD audits for current and prior years that could cause state and local government entities and their building contractors to receive sudden, unexpected tax bills.

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

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