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

SPONSOR	Armstrong/Duncan/Murphy/Dow/ Hernandez	**LAST UPDATED**	3/04/2025
		ORIGINAL DATE	2/13/2025
SHORT TITLE	Housing Construction Tax Credit	**BILL NUMBER**	House Bill 325
		ANALYST	Faubion

REVENUE*
(dollars in thousands)

Type	FY25	FY26	FY27	FY28	FY29	Recurring or Nonrecurring	Fund Affected
Labor Costs: GRT	$0.0	($21,600.0) to ($40,340.0)	($22,400.0) to ($41,550.0)	($22,700.0) to ($42,797.0)	($22,800.0) to ($44,081.0)	Recurring	General Fund
Labor Costs: GRT	$0.0	($23,400.0) to ($27,470.0)	($24,200.0) to ($28,300.0)	($24,600.0) to ($29,150.0)	($24,700.0) to ($30,020.0)	Recurring	Local Governments
Home Sales: GRT	$0.0	($22,700.0) to ($42,020.0)	($23,600.0) to ($43,280.0)	($23,900.0) to ($44,580.0)	($24,100.0) to ($45,920.0)	Recurring	General Fund
Home Sales: GRT	$0.0	($24,600.0) to ($28,620.0)	($25,600.0) to ($29,480.0)	($25,900.0) to ($30,360.0)	($26,100.0) to ($31,270.0)	Recurring	Local Governments
Local Hold Harmless	$0.0	($48,000.0) to ($56,090.0)	($49,800.0) to ($57,780.0)	($50,500.0) to ($59,510.0)	($50,800.0) to ($61,290.0)	Recurring	General Fund
Local Hold Harmless	$0.0	$48,000.0 to $56,090.0	$49,800.0 to $57,780.0	$50,500.0 to $59,510.0	$50,800.0 to $61,290.0	Recurring	Local Governments
TOTAL	**$0.0**	**($92,300.0) to ($138,450.0)**	**($95,800.0) to ($142,610.0)**	**($97,100.0) to ($146,887.0)**	**($97,700.0) to ($151,291.0)**	Recurring	**General Fund**
TOTAL	**$0.0**	**$0.0**	**$0.0**	**$0.0**	**$0.0**	Recurring	**Local Governments**

Parentheses ( ) indicate revenue decreases.
*Amounts reflect most recent analysis of this legislation.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT*
(dollars in thousands)

Agency/Program	FY25	FY26	FY27	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
TRD	**$161.0**	**$6.3**	**No fiscal impact**	**$167.3**	Nonrecurring	**General Fund**

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

Sources of Information

LFC Files

<u>Agency Analysis Received From</u>
Governor's Office on Housing

NM Mortgage Finance Authority (NMFA)
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of House Bill 325

House Bill 325 allows for gross receipts tax (GRT) deductions on labor costs incurred during the construction of new residential housing and for the sale of new residential housing. “Residential housing" is a single-family residence, a town house, a condominium, or an apartment building. Up to $125 thousand in gross receipts can be deducted per twelve-month period for the sale of new residential housing, and up to $75 thousand for housing intended for lease. The bill also establishes a "hold harmless" provision, ensuring that municipalities and counties receive distributions from the state to offset potential revenue losses from these deductions.

The effective date of this bill is July 1, 2025.

FISCAL IMPLICATIONS

This bill creates or expands a tax expenditure with a cost that is difficult to determine but likely significant. LFC has serious concerns about the substantial 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 action be postponed until the implications can be more fully studied.

Industry estimates suggest that labor costs typically constitute up to 40 percent of residential project expenses, while materials account for approximately 40 to 50 percent. The remaining 10 to 20 percent is attributed to permits, fees, overhead, and other related expenses. These percentages can fluctuate based on factors such as regional labor rates, material availability, and specific project requirements. To estimate the impact of this bill, LFC used the 2024 Census Permit Survey records, which reported 7,588 single family residences constructed in the state in 2024. As a conservative estimate, LFC assumes each residence receives a 40 percent labor cost deduction on $300 thousand of total constructions costs, the average cost to build a home in New Mexico. For the sale of homes, LFC assumed each permitted new build claimed the full $125 thousand deduction upon sale. LFC applied the effective GRT rate the state and for local governments to estimate both the state and local GRT revenue loss. The 2024 revenue loss estimate is grown by the consensus revenue estimating group GRT forecast growth each year. Because of the hold harmless provision, the revenue loss to locals is repaid by the state.

The Taxation and Revenue Department (TRD) used the University of New Mexico’s Bureau of Business and Economic Research January 2025 forecast on total housing units authorized in New Mexico and the statewide median price of sold units through December 2024 to compute the fiscal impact of deducting receipts from selling labor to construct new residential housing. Then, TRD assumed that labor costs of residential construction are around 27.5 percent of the total cost. The analysis is based on a statewide effective GRT rate. The fiscal impact includes the effects of this deduction on the 1.225 percent distributions to municipalities pursuant to Section 7-1-6.4 NMSA 1978 as the majority of construction is assumed to be in municipalities.

TRD used BBER's forecast of total housing units authorized as a proxy for the sale of new residential housing. Since TRD cannot predict the number of new residential housing units sold that are intended for lease (see Technical Issues), TRD used an average deduction of $100 thousand taxpayers might claim under this section. The analysis is based on a statewide effective GRT rate. The fiscal impact includes the effects of this deduction on the 1.225 percent distributions to municipalities pursuant to Section 7-1-6.4 NMSA 1978 as the majority of construction is assumed to be in municipalities.

TRD will update forms, instructions, and publications. As noted under Policy Issues, the additional complexity of GRT deductions in the residential construction industry will require taxpayer outreach and education. TRD will need to have expanded staff training to ensure compliance.

SIGNIFICANT ISSUES

While the sale of real property (including homes) is generally exempt from GRT under NMSA 1978 Section 7-9-53, new construction is still subject to GRT because the law excludes improvements made by a seller in the ordinary course of their construction business from the exemption. This means that homebuilders and developers who construct new homes for sale must pay GRT on the portion of the sale price attributable to the improvements they made, such as the house itself, utilities, and other site work. While the land value is exempt, the constructed portion is taxed, effectively making new residential construction subject to GRT, even though general home sales are not.

The Governor's Office on Housing notes that in the past few years, New Mexico has experienced a precipitous rise in the cost of construction, and this coupled with dramatic increases in interest rates, mean that the hard cost to build a new housing unit has increased as much as 50 percent in some communities. This is reflected in the prices of newly built homes which, according to the National Association of Homebuilders *Priced Out* study, have increased over $115,000 (36 percent) in just five years. The current median new home in New Mexico is now estimated at $442,000, a price which is deemed unaffordable to nearly 82 percent of New Mexican households. By providing a discount on the overall hard cost to construct a housing unit, this could move some projects that are currently on the edge of financial feasibility into feasible territory.

The Governor's Office on Housing also notes that, because this would apply to all new housing, including luxury housing, the deduction could be interpreted as subsidizing housing construction, which does not need financial support from the public sector. Similarly, with no income- or price-targeting associated with the policy, there is no guarantee this will create more entry-level or affordable housing, nor that those benefits provided by the deduction will be passed on to buyers, although eventually market competition pressures could incentivize this.

The proposed GRT deduction for construction labor raises important questions regarding its effectiveness and necessity, particularly through the lens of the "but for" concept in tax policy. The "but for" test is often used to evaluate whether a tax incentive influences behavior or if the desired activity would have occurred regardless of the tax break. In this case, the key question is whether homebuilders would increase new residential construction "but for" the tax deduction on labor costs, or if these projects would proceed at the same rate without the incentive.

If the deduction truly encourages additional home construction, it could be justified as a means to boost housing supply, particularly in areas experiencing shortages. By lowering labor costs, the policy could make projects more financially feasible, leading to increased investment in new housing developments. This could be especially beneficial in markets where high construction costs serve as a barrier to entry for developers. If the deduction leads to new construction that would not have otherwise occurred, then it would be fulfilling its intended purpose.

However, if most homebuilders would have undertaken these projects regardless of the deduction, then the policy fails the "but for" test, making it an inefficient tax incentive. In this scenario, the deduction would function primarily as a windfall for developers, reducing their tax liabilities without actually influencing their decision to build. This is a common critique of tax incentives—if they do not result in additional economic activity beyond what would have happened anyway, they may serve as an unnecessary expenditure of state resources.

Additionally, there is the question of who ultimately benefits from the tax savings. While builders and contractors may see lower tax liabilities, it is unclear whether these savings will be passed down to homebuyers in the form of lower housing costs. If market conditions allow developers to retain the financial benefit rather than adjusting home prices downward, the deduction may do little to address housing affordability. In that case, the policy would serve primarily as a subsidy to the construction industry rather than as a meaningful intervention in the housing market.

In tax policy, effective incentives must be targeted and designed to encourage behavior that would not otherwise occur. If the GRT deduction for construction labor fails to meaningfully increase housing production, it may not be an efficient use of tax incentives. A better approach could involve direct housing affordability initiatives, such as subsidies for first-time homebuyers, incentives for affordable housing developments, or programs that address construction labor shortages through workforce development.

The hold harmless provision ensures that municipalities and counties do not lose GRT revenue due to the newly proposed deductions for construction labor and home sales. It does so by requiring the state to reimburse local governments for the lost tax revenue based on the amount of deductions claimed within their jurisdictions. While this mechanism prevents immediate funding shortfalls for cities and counties, it shifts the fiscal burden to the state government, which must allocate funds to cover these distributions. This creates a long-term risk, as the state would bear the financial cost of a tax incentive that primarily benefits private developers and homebuilders, without a guaranteed return in the form of increased housing affordability or economic growth.

TRD notes the following:

> The residential housing system in the US, in general, and in New Mexico in particular, faces several significant challenges when it comes to cost. These challenges are interconnected and impact affordability, accessibility, and the overall stability of the housing market. One of the main drivers of high home prices is the lack of available housing supply. There are not enough homes being built to meet the demand. This is due to a combination of factors, including restrictive zoning laws, a shortage of skilled labor in construction, and rising costs of labor and materials. When supply does not keep up with demand, prices inevitably rise. High home prices are closely tied to increasing rents. Median rents in New Mexico increased by 60 percent from 2017 to 2024, much more

than the 27 percent recorded for the US overall. The average price of a New Mexico home climbed even faster during that time, increasing by 70 percent. High prices have forced individuals to live in substandard conditions or face high rental rates that drain their incomes. The limited rental supply has made it even more difficult for low-income and middle-class families to find affordable housing. The proposed deductions might help increase the number of units and revert the troubling trend of the housing system across New Mexico.

While tax incentives can support specific industries or promote desired social and economic behaviors, the growing number of such incentives complicate the tax code. Introducing more tax incentives has two main consequences: (1) it creates special treatment and exceptions within the code, leading to increased tax expenditures and a narrower tax base, which negatively impacts the general fund; and (2) it imposes a heavier compliance burden on both taxpayers and TRD. Increasing complexity and exceptions in the tax code is generally not in line with sound tax policy. As noted under technical issues, these deductions will present several more options to taxpayers in the residential housing market. Without clear language in the statute, as to any ordering of taking deductions, local governments may not see the full hold harmless payments matching overall deductions taken in the taxing district as taxpayers will determine the most advantageous deductions to apply. The complexity of deductions for residential construction will require additional outreach and education for taxpayers and more complex auditing of compliance.

Finally, legislation should seek to ensure that the benefit of this deduction be reflected in lower housing prices and not absorbed by businesses themselves. Businesses might take the deductions or see their construction labor costs reduced, but still charge a final price for a new house in line with a tight housing market with no impacts on affordability or the median home price. The final effect of this bill is not clear. The deduction does not have a defined sunset date. TRD supports sunset dates for policymakers to review the impact of tax expenditures before extending them.

This bill narrows the GRT base. Many New Mexico tax reform efforts over the last few years have 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.

PERFORMANCE IMPLICATIONS

Given the administrative impact of implementing this proposal, TRD suggests an effective date of January 1, 2026.

The LFC tax policy of accountability is met with the bill's requirement to report annually in the tax expenditure budget the data compiled from the reports from taxpayers taking the deduction.

OTHER SUBSTANTIVE ISSUES

TRD notes the following:

> Under this proposal it is unclear as to by whom the labor is being performed, and to whom the labor is being sold. GRT is imposed on the seller, and generally passed on to the purchaser. A housing developer may purchase labor services from other companies, making the deductions available for different taxpayers. A subcontractor may be providing the labor services through a prime contractor, in which case the subcontractor could take this deduction under Section 2, while the prime contractor and seller of the completed residence could take the deduction under Section 3. It is not clear whether this is the intent of the bill. The bill also overlaps with Section 7-9-52 NMSA 1978, which already permits a person selling construction services to a person engaged in the construction industry to deduct their receipts, so long as the subsequent sale of the completed construction project is taxable (which mirrors the requirement in Section 7-9-48 NMSA 1978, which allows a seller of services sold for resale to deduct those receipts, so long as the subsequent sale is subject to gross receipts tax). If the deduction in Section 2 may be taken by subcontractors who provide labor to prime contractors constructing residential housing, then that subsequent sale of the residence should be required to be subject to gross receipts tax. Alternatively, the bill could require subcontractors to take any deduction under Section 7-9-48 rather than taking this new deduction.
>
> The deduction amount under section 3 has two amounts under subsection A. (1) and (2) on page 4, $125 thousand for the sale of a new “residential housing: and $75 thousand for the sale of new “residential housing” intended for lease. TRD notes two concerns with the proposed language. The taxpayer selling residential housing may not have knowledge or control over the intended use of the new housing whether it is for owner-occupied or for future rent. Furthermore, there is no requirement that the completed housing actually be leased, whatever the initial intent was. There is no way for TRD, or the person performing the construction, to verify intent or whether that intent was fulfilled. This is particularly the case for single-family residence, a town house or a condominium. Secondly, a home intended for lease would still qualify under the requirement in subsection A (1) as it places no restriction on the home being owner-occupied. TRD suggests one deduction amount so as to not incentivize one particular type of new residential housing and ease the administrative burden on taxpayers and TRD.

In assessing all tax legislation, LFC staff considers whether the proposal is aligned with committee-adopted tax policy principles. Those five principles:

- **Adequacy**: Revenue should be adequate to fund needed government services.
- **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
- **Equity**: Different taxpayers should be treated fairly.
- **Simplicity**: Collection should be simple and easily understood.
- **Accountability**: Preferences should be easy to monitor and evaluate

In addition, staff reviews whether the bill meets principles specific to tax expenditures. Those policies and how this bill addresses those issues:

Tax Expenditure Policy Principle	Met?	Comments
Vetted: The proposed new or expanded tax expenditure was vetted	✗	No record of an

through interim legislative committees, such as LFC and the Revenue Stabilization and Tax Policy Committee, to review fiscal, legal, and general policy parameters.		interim committee hearing can be found.
Targeted: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals. Clearly stated purpose Long-term goals Measurable targets	✗	There are no stated purposes, goals, or targets.
Transparent: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies	✓	The deduction must be reported publicly in the TER. The deduction does not have an expiration date.
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. Public analysis Expiration date	✗	
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. Fulfills stated purpose Passes "but for" test	?	There are no stated purposes, goals, or targets with which to measure effectiveness or efficiency.
Efficient: The tax expenditure is the most cost-effective way to achieve the desired results.	?	
Key: ✓ Met ✗ Not Met ? Unclear		

ALTERNATIVES

The Governor's Office on Housing noted several alternatives to this proposal that could increase affordable housing in the state:

One way to increase the effectiveness of this legislation would be to have it only apply to entry-level housing. This would provide a benefit to market actors to explicitly target the type of housing most needed: that which serves entry-level buyers and New Mexico's workforce. A simple price threshold under which the deduction applied, such as $450 thousand (roughly equivalent to the current new median home sales price), would decrease the fiscal impact to the state and incentivize the market to work in those lower price points, without providing costly financial benefits to the development of higher end housing. For instance, the median new home price in Santa Fe County now exceeds $900 thousand, reflecting the large percentage of new luxury and custom homes being developed, an activity that does not warrant any sort of public sector benefits.

There are many other opportunities for lowering the cost to develop housing in New Mexico which have not been utilized yet, and this proposed model is unproven for increasing units or decreasing the overall cost of housing for consumers. A sunset date could make any negative financial impact short-term and create time to evaluate the initiative to assess its impact on housing markets. It would also create time to enact other best practice approaches to lowering development costs in the state.

There are a large number of state and local regulatory, land use, and building code reforms that can have a significant impact on housing development costs. For instance, Santa Fe County's Affordable Housing Plan identified that it now takes between 3-4 years to win approval for a large-scale housing development. Decreasing that time to 12-18 months through expedited approval processes could save up to $80 thousand per housing unit in holding, overhead, and legal costs. A recent effort in Virginia to "right size" building codes, removing costly compliance with little impact on life safety, netted an average decrease in hard development cost of $24 thousand per unit, more than double the tax benefit proposed for a single-family home.

JF/SL2/rl/hj/SL2