OPTIONS FOR TAX RELIEF FOR FAMILIES

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There are a number of options that address the issue of providing additional, direct tax relief for New Mexico families over and above that provided by the 2003 New Mexico income tax reduction. In general, two approaches have been advanced: 1) eliminating or reducing the gross receipts tax on food purchased for home consumption; or 2) providing additional income tax relief targeted primarily at lower or middle income taxpayers. The Family Committee looked at these two approaches as complementary. However, they could also be seen as different means to the same end. The fiscal impacts of the specific options are shown on the Fiscal Impact Table.

The issue of whether to continue to tax food under the gross receipts tax was a major focus of the Family Committee. The committee heard extensive testimony on this subject and looked, in some detail, at many of the fiscal and administrative issues involved. The options brought forward by the committee focused on tightening the definition of food (compared to earlier legislation and proposals) in order to reduce the fiscal impact, but still achieve the policy goals of providing meaningful food tax relief to families.

Because of time constraints, the Family Committee was not able to undertake a comprehensive review of the personal income tax system. The committee focused on selected areas, including ways to provide additional relief targeted primarily at lower or middle income taxpayers, the need to reduce the marriage penalty and options for restructuring and expanding the low-income comprehensive tax rebate (LICTR). The overall rate structure of the income tax and many of the other credits and special exemptions and deductions did not get a thorough review. Future study of some of these issues may be warranted.

A list of the specific options and their estimated fiscal impact are shown on the Revenue Impact Table attached.

REDUCING OR ELIMINATING THE GROSS RECEIPTS TAX ON FOOD

OPTIONS

There are three options brought forth by the Family Committee relating to reducing or eliminating the gross receipts tax on food. They differ based on the definition of food. The definition options include:

OPTION 1. Food and Food Sellers, as Defined by the Streamlined Sales Tax Agreement, Excluding Certain Specified Categories of Food.
The Streamlined Sales Tax Agreement contains definitions of selected taxable items, including "food and food ingredients" that may be subject to differential tax treatment, depending upon a state's desired tax base. "Food and food ingredients" is defined as "substances, whether in liquid, concentrated, solid, frozen, dried or dehydrated form, that are sold for ingestion or chewing by humans and are consumed for their taste or nutritional value. [It] excludes alcoholic beverages and tobacco".

Unlike the food stamp definition of food, the Streamlined Sales Tax Agreement does not limit the definition of eligible food sales to retail food stores. Thus, it includes sales of food from filling stations, sports venues, movie theaters and other outlets.

This option uses the Streamlined Sales Tax Agreement definition of food and food seller, with exclusions for the following categories of food: prepared foods, soft drinks, candy and dietary supplements.

OPTION 2. A Definition of "Staple" Food Categories, Modeled after Legislation in Texas.
The specific food categories include fruit and fruit products; vegetables and vegetable products; meat and meat products; fish and seafood products; poultry and poultry products; milk and milk products, excluding ice cream; eggs and egg products; bread, including tortillas; cereal and cereal products, including flour, flour mixes, rice, dry pasta and cornmeal; peanut butter; sugar; salt, spices and seasonings; and baby food.

The fiscal impact assumes the food seller definition under the Streamlined Sales Tax Agreement.

OPTION 3. A Narrower Definition of "Staple" Food Categories.
The specific food categories include cereal and cereal products, baby food, fresh produce, meat, poultry, fish, seafood, dried beans, seasonings and sugar.

The fiscal impact assumes the food seller definition under the Streamlined Sales Tax Agreement.

STRUCTURING THE RELIEF

For each option, there are four possible ways to structure the relief. These include the following:

1) Providing a deduction for state and local gross receipts taxes with no specific hold harmless provision.
This would result in a revenue loss for the local government. The impact of the loss could be offset, to some extent, by providing additional revenue sources to local governments.

(2) Providing a deduction for state and local gross receipts taxes with a hold harmless provision that requires vendors to report the deduction amount by locality and then distributes the equivalent of the local gross receipts taxes forgone by the deduction back to each locality.
This option would require the state to absorb the full cost of the reduction and would complicate, to some extent, the administration of the tax.

(3) Providing a gross receipts tax credit for the state portion of the tax on food.
This would reduce the tax rate within municipalities by 3.275 percent and in rest-of-counties areas by five percent. Local option rates would continue to be imposed and collected and distributed to the local governments.

(4) Providing a deduction for state and local gross receipts taxes, but allowing local governments to re-impose their taxes on food.
This would provide local governments with the flexibility to either join the state in providing tax relief or to protect their revenue base and spending programs by re-imposing the tax.

PROS

The following are some of the arguments in favor of eliminating or reducing the gross receipts tax on food:

- Food, as one of the primary economic necessities of life, should not be subject to tax.
- The tax on food is regressive, imposing a larger relative burden on low- and middle-income taxpayers than higher-income taxpayers.
- The tax on food has a larger relative burden on large families than small families.
- While the federal food stamp program provides some tax relief to those low-income families who participate in the program, the number of families receiving food stamps is limited and the amount of food stamps does not necessarily cover the entire food budget of recipients.
- Most other states do not apply their sales taxes to food for home consumption.

CONS

The following are some of the arguments against eliminating or reducing the gross receipts tax on food:

- While food is a necessity, there are many other necessities also subject to the gross receipts tax. Removing the tax on food runs counter to the principle of maintaining a broad-based gross receipts tax and could set a precedent for further narrowing the base by removing the tax on other necessities.

- A significant number of low-income households do qualify for and participate in the federal food stamp program and purchase a significant amount of their food using food stamps. Since food purchased using federal food stamps is exempt from the gross receipts tax, these households will not benefit from removing the gross receipts tax.

- Higher- and middle-income taxpayers who can better afford to pay the tax will receive most of the actual benefits in terms of total dollars.

- The relatively high cost of removing the gross receipts tax on food could be reduced by providing a tax rebate, administered through the income tax program, targeted at low- and middle-income families.

- Household expenditures on food, like all other consumer goods, reflect different spending patterns and preferences. Removing the tax on food for home consumption favors families who spend a relatively higher amount of their income on food compared to other goods and services. A broad-based reduction in income taxes aimed at low- and middle-income families could provide the same total dollar amount of tax relief without favoring the consumption of food for home consumption over other consumer expenditures.

ISSUES

(1) Definition of food.
The options include three alternative definitions of food, each with a different fiscal impact. Another alternative, using the food stamp definition of food and food retailer, was also discussed but not included in the options brought forward, primarily because it has a higher fiscal impact.

How difficult will it be for the Taxation and Revenue Department to administer the selected definition of food? How costly will it be for food stores to initially administer the deduction and will there be ongoing compliance issues? Will taxpayers understand the taxable and non-taxable distinctions?

(2) Effect on local governments.
The issue of whether or not to remove the local gross receipts tax, as well as the state-imposed tax, is one of the more vexing issues to be decided. If the local gross receipts tax is removed, can or should the state hold local government harmless from the revenue loss?

Many local governments have issued revenue bonds backed by gross receipts taxes. If a hold harmless mechanism is favored, will it ensure the bondholders that the payment of bonds will not be jeopardized? Will the reduction in the gross receipts tax base affect the future confidence in and price of local gross receipts tax bonds?

(3) Conformity with the Streamlined Sales Tax Agreement.
Apparently, the Streamlined Sales Tax Agreement would allow the state to not tax food and the local governments to tax it. It is not clear whether or not it would allow some localities to impose a tax and some not.

PROVIDING ADDITIONAL INCOME TAX RELIEF TO FAMILIES

OPTIONS

______The 2003 New Mexico income tax relief bill was focused on reducing the top marginal income tax rate in New Mexico. It was agreed by the governor and the legislature that this would have a significant positive impact on the business climate in New Mexico and would be a cornerstone of future economic development initiatives in the state. Because of the way the bill was structured, many lower- and middle-income New Mexicans will receive little, if any, tax relief from the measure. Based on the fiscal impact report prepared by the Taxation and Revenue Department, approximately 250,000 taxpayers with positive taxable income who pay income taxes (40 percent) are in the bottom three tax brackets and receive no tax relief from the 2003 income tax cut.

In addition, the progressivity of the income tax has been significantly reduced. This will affect the growth of the tax in future years. It will also affect the profile of the total state and local tax burden on families which, according to various studies done prior to the 2003 income tax bill, was, at best, mildly progressive or neutral and, at worst, moderately regressive.

The first two options described below are specifically intended to provide some additional income tax relief to those families who will not receive significant relief from the 2003 tax cut and to restore some of the progressivity to the income tax system. These options have been evaluated relative to the fully phased-in income tax changes, using the bracket structure and rates that will be effective for the 2007 tax year. Changes could be structured to take effect prior to that date or could be phased in to become fully effective in 2007 or later.

Option 3, which modifies the low-income comprehensive tax rebate, also addresses the progressivity issue, but more from the standpoint of the entire tax system. It could also be seen as an alternative to removing the gross receipts tax on food. Option 4, which is a hybrid of the first three options, provides more targeted tax relief by limiting it to certain income categories and is designed to roughly compensate taxpayers for the gross receipts tax on food. The remaining options are also targeted measures intended to improve the fairness of the tax.

OPTION 1. Increase the Personal Exemption Allowance for All Taxpayers.
The option reflected on the attached table would double the personal exemption amount allowed for each individual in the taxpayer's family and would cost $134 million using the 2007 rate table. The amount of the increase in the personal exemption amount is provided for purposes of illustration and it could be scaled down to meet revenue constraints. A profile of the tax relief by filing status and by taxable income brackets is attached. Tax relief would be experienced by all tax filers with positive taxable income and would be responsive to family size. Like all income tax deduction options, the actual dollar amount of tax relief per exemptions would be higher for taxpayers in higher tax rate brackets, even though the relative value of tax relief, measured as a percent of tax liability, would be higher for lower income filers.

OPTION 2. Increase the Standard Deduction Amount for Taxpayers.
The option reflected on the attached table would increase the standard deduction by 50 percent for each filing status and would cost $66 million using the 2007 rate table. The amount of the increase in the standard deduction amount is provided for purposes of illustration and it could be scaled down to meet revenue constraints. A profile of the tax relief by filing status and by taxable income brackets is attached. Tax relief would be experienced by those taxpayers with positive taxable income who currently take the standard deduction and, to a lesser extent, by those who have itemized deductions slightly in excess of the current standard deduction. Because the amount of itemized deductions is highly correlated with income, many higher-income taxpayers do not benefit from this option.

OPTION 3. Expand and Modify the Low-Income Comprehensive Tax Rebate (LICTR) in Order to Provide Additional Tax Relief to Low-Income Families.
An estimated 270,000 New Mexico families or individuals qualify for LICTR, which is administered through the personal income tax system and is intended to rebate to low-income taxpayers a portion of state and local taxes that they pay on their personal expenditures. Generally, because of the low-income eligibility requirements, these taxpayers have little or no income tax liability and therefore do not benefit from direct cuts in the income tax.

The Family Committee reviewed a number of options to provide additional tax relief to low-income families by expanding and modifying LICTR. The New Mexico Voices for Children, a private, nonprofit advocacy group, developed an option to expand and modify LICTR and rename it as FAIR (family and individual rebate). The committee recommended that the FAIR concept be considered by the full commission as a means of providing targeted income tax relief to low-income families.

OPTION 4. Increase LICTR and the Personal Exemption Amount for Certain Taxpayers to Compensate for the Gross Receipts Tax on Food.
This option, intended as an alternative to providing direct relief from the gross receipts tax on food, provides selected taxpayers with tax relief that is based on the average amount of the tax on food paid by low- and middle-income taxpayers. For low-income taxpayers who qualify for LICTR, the relief would be provided by increasing the rebate amount by an average of $40.00 per exemption. The maximum number of exemptions for LICTR has been increased from six to seven to provide additional relief for larger families. In order to address the issue of food stamp recipients, the definition of modified gross income would be changed to include the value of food stamps received. This will reduce, to some extent, the LICTR payments for these recipients. For taxpayers with income levels above the LICTR cut-off, relief would be provided by increasing the value of the personal exemption amount. This relief would be targeted to those taxpayers who do not receive a reduction from the 2003 income tax bill. For example, the exemption amount for married filing joint taxpayers with average adjusted gross income (AGI) of $17,000 or less would be increased by $3,000. This amounts to $51.00 per exemption in tax savings for taxpayers in the 1.7 percent tax bracket. The $3,000 amount would be phased out as AGI increased, up to an average level of $47,000 for married taxpayers. Similar amounts would apply to single individuals and heads of household. A profile of the tax relief by filing status and by taxable

income brackets is attached. Also attached is a chart showing the proposed LICTR payment increase.

OPTION 5. Reduce the Marriage Penalty by Increasing the Brackets for Married Filing Joint Taxpayers to Equal Twice the Bracket Amounts for Single Individuals.
A marriage penalty or marriage bonus is an inherent part of the current income tax structure because of progressive rate tables, a standard deduction based on filing status, and income-dependent exemptions, deductions and credits based on filing status. Recent federal tax changes have significantly reduced the marriage penalty for federal income tax purposes by increasing the standard deduction for married filing joint returns. New Mexico piggybacks on these changes. Reductions in the number of brackets and the marginal tax rates in the 2003 income tax bill have also reduced the marriage penalty. However, some marriage penalty still exists because of the structure of the rate tables.

The option would reduce the marriage penalty by restructuring the rate brackets for married filing joint taxpayers to be equal to twice those applicable to single individuals.

OPTION 6. Phase Out the Capital Gains Deduction for High-Income Taxpayers.
This option is intended to restore some of the progressivity of the income tax by reducing, to some extent, the tax relief for higher-income families from the capital gains deduction included in the 2003 income tax relief bill. The proposal would phase out the 50 percent deduction for capital gains income for taxpayers with adjusted gross income of $200,000 or more.

OPTION 7. Consolidate Filing Status to Two Categories: (1) Married Filing Joint and Head of Household and (2) Single Individuals and Married Filing Separate.
This option would simplify the tax system by reducing the number of filing status options from four to two. It would also provide additional tax relief to the 78,000 single-parent families who file as heads of households. These families generally have lower income than two-parent families. However, at the same taxable income level, head of household families currently pay more taxes than two-parent families. Over 70 percent of head of household tax filers have income in the bottom three tax brackets (those not affected by the 2003 income tax cut), compared to approximately 42 percent of all taxpayers.

PROS

Following are some of arguments in favor of providing additional income tax relief:

- General income tax relief would provide additional disposable income to all taxpayers receiving the relief and would not be dependent on the consumption habits of the taxpayers.

- The income tax relief options would restore some of the progressivity to the income tax system, which results in a more balanced overall tax burden on the state's residents.
- The option to increase LICTR and provide a phased-out increase in the personal exemption amount to certain taxpayers as an alternative to the removal of the gross

receipts tax on food has a lower fiscal impact on the state and no fiscal impact on municipalities and counties. It provides tax relief to low- and middle-income families who bear a disproportionate relative burden from the gross receipts tax on food. Higher-income residents and out-of-state visitors would not receive tax relief.

- The option to reduce the marriage penalty would remove some of the current disincentive for marriage. This "family-friendly" option is consistent with other policy goals aimed at strengthening the family.

- The option to include heads of households in the marriage filing joint filing status would provide some tax relief to single-parent households, which generally have lower incomes than two-parent households.

CONS

Following are some of the arguments against providing general or targeted income tax relief:

- Unless the tax reductions are substantial enough to be reflected in withholding tables, they are relatively hidden from taxpayers and may not be perceived as meaningful tax relief.

- It is difficult to structure general income tax relief to target a limited group of taxpayers. This makes it relatively costly in terms of its fiscal impact to the general fund.

- The 2003 income tax cut has already significantly reduced New Mexico reliance on the income tax as a major funding source. Further reductions will further reduce the balance of the overall tax system.

- For taxpayers who itemize their taxes for federal income tax purposes, reductions in their New Mexico income tax burden will be partially recaptured by increases in their federal income tax.

- With respect to the option to increase LICTR and provide a phased-out increase in the personal exemption amount to certain taxpayers as an alternative to the removal of the gross receipts tax on food, lower- and middle-income taxpayers, who can least afford the tax, are required to pay it when they purchase food and do not get it back until later when they file an income tax return. The amount of the rebate or tax reduction is somewhat arbitrary and does not represent what an individual family spends on food. The general public does not necessarily make the link between the tax on food and the income tax rebate or reduction. If the public favors removal of the tax on food, they will continue to be unhappy at the check-out counter when the tax is added. Not all taxpayers who are eligible for the tax rebate will apply and some taxpayers who are not eligible will fraudulently apply.

ISSUES

(1) How should the tax relief be structured and how much should it cost? Which taxpayers are being targeted?

(2) Does the tax relief option create administrative or compliance problems? How can these be minimized?

(3) Should LICTR be restructured and renamed to make it more family friendly? What is the maximum income level it should apply to? Should the number of exemptions be limited (it currently stops at "6 or more" exemptions), expanded or unlimited? Should income eligibility be tied to some indexed standard, such as poverty guidelines?