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FISCAL IMPACT REPORT

ORIGINAL DATE 01/25/16
LAST UPDATED _____ **HB** 119
SPONSOR Trujillo, J
SHORT TITLE Estate Or Trust Distribution Tax Deduction **SB** _____
ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY16	FY17	FY18	FY19	FY20		
*	(395)	(411)	(430)	(454)	Recurring	General Fund

Parenthesis () indicate revenue decreases

(*) Note: since the bill's provisions apply to TY 16 income, there might be a small amount of impact in FY 16. However, the bill becomes effective 90 days after adjournment (May 18, 2016) and might only affect the June PIT estimated payments. If there is an impact in FY16, it would be negative to the general fund.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY16	FY17	FY18	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total		\$21.0		\$21.0	Nonrecurring	TRD Operating

Parenthesis () indicate expenditure decreases

SOURCES OF INFORMATION

LFC Files

Responses Received From

Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

House Bill 119 creates a new deduction from net income of an estate or trust for certain income sequestered within the overall trust or estate that is set aside for future distributions to a non-resident individual. The deduction would not include income from allocable sources of income occurring in New Mexico such as income derived from real property, mineral, oil and gas interests, and water rights, but would allow the deduction for business income that would be apportioned to the non-resident's state of residence were the income directly distributed to the beneficiary rather than flowing through the trust.

The purpose of the deduction is to assist in the expansion of the trust and estate business in New Mexico.

The bill includes reporting requirements as taxpayers claiming the deduction are required to report the amount of the deduction separately in a manner required by TRD. TRD is then required to compile an annual report on the deduction including the number of taxpayers that claimed the deduction, the aggregate amount of deductions claimed and any other information necessary to evaluate the effectiveness of the deduction. Beginning in 2018, TRD must compile and present the annual reports to the appropriate legislative committees with a cost/benefit analysis to determine if the deduction is performing to the purpose for which it was created.

The provisions of the bill apply to taxable years beginning on or after January 1, 2016. The bill sunsets on December 31, 2022.

FISCAL IMPLICATIONS

In general, the Fiduciary Income Tax has been declining since FY2009. Consequently, the baseline deduction figure is lower in 2016 than in previously proposed bills (e.g., 2015 HB 406). In contrast, the PIT growth rate in each subsequent year is projected to be positive. Thus, the cost of this deduction grows each year.

Baseline data was obtained from the General Fund Report. New Mexico Fiduciary Income Tax for FY09 – FY15 was used. Data for FY2010 and FY2011 was eliminated from the calculation; these two years were significant outliers. After this exclusion, a five-year average was calculated.

Since the majority of trusts established in New Mexico are for oil, gas, and property, TRD assumes that only 20% of the net income from an estate or trust will qualify for the deduction. Further, it was assumed that only 25% of the fiduciary income would be distributed to nonresident beneficiaries. The five-year average for fiduciary income tax is approximately \$7.6 million. As described above, the baseline cost for this deduction was estimated as 5% of the five-year average. PIT growth rates obtained from the December 2015 Consensus Revenue Estimate were used to estimate the fiscal impact for the subsequent years.

The model for the fiscal analysis of this bill's provisions is as follows:

- In the same way that income of regular Subchapter C corporations is taxed once to the corporation and a second time when it is distributed to shareholders, some income of trusts and estates is taxed to that trust or estate in addition to the income that is taxed to the individual when distributed. The purpose of the provisions of this bill is to decrease the amount of this double tax at the state level.
- Under current law and practice, most of the income of a trust or estate is distributed to beneficiaries in the year of receipt, whether the income is business income or non-business income. When the trust or estate distributes income to any beneficiary, that distribution becomes a deduction for the trust or estate in the year of distribution.
- Tax rates for estates and trusts are set up to encourage current year distributions because current year distributions are deductible to the trust or estate, whereas undistributed

income of whatever kind is taxable to the trust or estate.¹ It should be noted that the distributed income from the trust or estate to a beneficiary is taxable to that beneficiary whether it is distributed from the corpus of the trust or estate or from current income. The income is allocable or apportionable depending on its character as business income or non-business income.

- The bill's provisions focus on the corpus of the trust or estate, where a portion of the corpus characterized as undistributed income is set aside for the future benefit of a non-resident individual. The purpose of the bill is to allocate or apportion this undistributed income to a non-resident person and allow the apportionable income to escape double state tax.
- To the extent that the passage of this bill would encourage new trusts to be administered in New Mexico, the provisions of the bill would not create a revenue loss.
- However, there is a problem of "buying the base." Although perhaps not extensive, a portion of total fiduciary tax collections in New Mexico are attributed to distributions of the undistributed income of trusts or estates to non-resident individuals. The bill's provisions would reduce or eliminate the taxes at the level of the trust or estate for undistributed apportionable income set aside for non-resident individuals.

It is not clear if the provisions of this bill create a tax expenditure (although they do create a small general fund revenue loss). It may well be that the provisions of the bill slightly redefine the appropriate state tax base.

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. This bill provides explicit separate reporting to the Department and requires the Department to create and deliver a report to the interim revenue stabilization and tax policy committee. The provisions of the bill sunset after January 1, 2022.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is met with the bill's requirement to 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.

ADMINISTRATIVE IMPLICATIONS

TRD estimates there would be a moderate impact to their Information Technology (IT) division of approximately 300 hours. The bill would require changes to GenTax and Taxpayer Access Point personal income tax document rules and configurations. Additional reports would need to be developed to list the taxpayers and deduction amounts. Fiduciary forms, instructions and publications would need to be revised with minimal incremental cost with the annual renewal of the income tax forms.

¹ Federal tax for estates and trusts is progressive, with very low brackets. The tax on trust or estate income in excess of \$12,300 is \$3,179.50 + 39.6 percent of the excess over \$12,300. For personal income tax, the 39.6 percent bracket does not become effective until the taxable income (married joint) exceeds \$464,850.

TRD adds, the effective date will allow for enough time to implement the tax deduction. Audit procedures would need to be developed because the amount of the deduction allowed will be an amount not easily obtained from state and federal income tax returns alone.

OTHER SUBSTANTIVE ISSUES

TRD notes the following, “This bill raises equal protection concerns, as it treats distributions held for nonresidents differently than those held for New Mexico residents. There may be a rational basis for this treatment, but that basis is unclear to TRD.”

“Finally, this bill requires TRD to measure the effectiveness of the incentive. Criteria on which to measure effectiveness may be very difficult to develop, as information gathered by TRD would likely only reflect the utilization of the deduction.”

TECHNICAL ISSUES

TRD notes the following, “... the term “individual” is not defined. TRD assumes this term refers to a “natural person” but that should be clarified in the bill because “individual” as defined in Section 7-2-2 NMSA 1978 means a natural person, estate, trust or fiduciary. In short, the non-resident beneficiary could be another trust or estate under the current bill and may yield further unintended consequences as a result.

LG/jo