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

Current FIRs (in HTML & Adobe PDF formats) are available on the NM Legislative Website (www.nmlegis.gov). Adobe PDF versions include all attachments, whereas HTML versions may not. Previously issued FIRs and attachments may be obtained from the LFC in Suite 101 of the State Capitol Building North.

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

SPONSOR Beffort **ORIGINAL DATE** 2/4/16 **LAST UPDATED** **HB**

SHORT TITLE Clawback Repayment Tax Credit **SB** 166

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY16	**FY17**	**FY18**	**FY19**	**FY20**		
	Minimal	Minimal	Minimal	Minimal		General Fund (PIT)

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY16	FY17	FY18	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	Minimal	Minimal	Minimal	Minimal	Recurring	TRD operating

Parenthesis ( ) indicate expenditure decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Office of the Attorney General (AGO)

SUMMARY

Senate Bill 166 creates a tax credit for a taxpayer who, in a taxable year has made a clawback repayment and who has taken a credit pursuant to Section 1341 of the Internal Revenue Code.

There is no effective date of this bill. It is assumed that the new effective date is 90 days after this session ends (May 18, 2016). The provisions of the bill are applicable for taxable years beginning on or after January 1, 2016.

FISCAL IMPLICATIONS

This bill should be considered as a technical correction. IRS Section 1341 allows taxpayers who have received income in one tax year that was clawed back in a future year the option of taking a deduction for the amount of money clawed back, or may exercise an option of recovering the tax paid as a tax credit. This bill extends the same treatment to state tax.

SIGNIFICANT ISSUES

TRD notes the following: "… Ponzi schemes are fraudulent investment schemes in which people are encouraged to invest money. Typically, before the scheme is uncovered and collapses, earlier investors earn profits from money contributed by later investors. When the scheme collapses, those earlier investors are often required to pay some or all of their earnings back to a bankruptcy trustee so that the losses can be equalized between all investors. These payments are often made several years after the year in which the early investor reported the gains as income. Under the Internal Revenue Code, the taxpayer that made the repayment is entitled to either a deduction or a credit for the tax year in which the repayment was made, depending on which results in less federal tax. If the taxpayer takes the deduction at the federal level, the taxpayer will also receive a deduction at some point in its calculation of New Mexico taxable income. However, where a credit is taken at the federal level, there is no corresponding New Mexico relief."

TRD also discusses the following: "This bill implicates horizontal equity and results from the interrelationship between federal income and state income taxation. At the federal level, clawback repayments result in either a deduction from taxable income or a credit against tax liability, depending on which method results in less taxation. When the taxpayer takes a deduction at the federal level, that deduction, at some point, is removed from the taxpayer's New Mexico tax base before determining New Mexico taxable income. However, when the taxpayer claims a credit under IRC § 1341, there is no corresponding New Mexico adjustment that provides relief.

Taxpayers are subjected to clawback repayments for a relatively narrow band of reasons. Typically, the repayment is attributed to receiving compensation later adjudicated to be an overpayment. For most taxpayers the overpayment is due to honest mistakes or miscalculations during an application for benefits. However, there are taxpayers whose clawback repayments are attributed to their malfeasance. While it is impossible to discern genuine victims from dishonest actors through this process, it is likely a slim percentage of bad actors will benefit from the passage of this bill if IRC treatment allows for a credit at the federal level."

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

The AGO notes that Senate Bills 166 and 167 are essentially identical, with a few modifications in what constitutes a "clawback repayment" under this section and the fact that Senate Bill 167 refers specifically to clawback repayments related to Ponzi schemes.

TECHNICAL ISSUES

The AGO notes the following: "Although it is clarified further on in the Bill, it might be helpful to clarify the language in the first sentence regarding "a taxable year" and explaining whether this applies to any taxable year, or the specific year during which the taxpayer is making the clawback repayment.

- It is not entirely necessary, but might be helpful to have a more specific cite to the Internal Revenue Code rather than just "Section 1341."
- It might be helpful to include more specific language regarding who is repaying whom with the various references to repaying throughout the Bill."

OTHER SUBSTANTIVE ISSUES

SB 167 proposes a new refundable clawback repayment income tax credit under the Income Tax Act. The new credit may be claimed by a taxpayer who in a taxable year has made a clawback repayment of amounts previously reported as income and who has taken a credit pursuant to Section 1341 of the Internal Revenue Code for the taxable year in which the taxpayer made the clawback repayment. The amount of the credit shall be calculated as follows:

(1) determine the amount of tax due for the taxable year in which the clawback repayment is made, without deducting the amount repaid; then
(2) determine the amount of tax due for the taxable year in which the amounts from a Ponzi scheme were reported as income, without including in income the amount repaid in the year of repayment; and then
(3) determine the amount of credit by subtracting the amount of tax in Paragraph (2) of this subsection from the amount of tax in Paragraph (1) of this subsection.

A taxpayer may claim the credit on an original or amended tax return for the taxable year in which the clawback repayment was made.

According to an Albuquerque Journal article dated May 4th, 2015 about the Vaughan case, "restitution claimants" claims totaled approximately $16.3 million. The Vaughan Company Realtors bankruptcy estate had about $3.6 million. If we assume that all claimants are reimbursed 100% of their claim, then clawback repayments from early investors would total approximately $12.7 million. Applying a 4% effective income tax rate would result in a tax expenditure of $508,000 in credits. This is a very high estimate for several reasons: (1) it is unlikely the estate will recoup funds to settle all claims at 100%; (2) it is unlikely the estate will settle claims at 100%; and (3) the methodology specified in the bill will produce a credit lower than the actual tax liability if the clawback repayment never occurred.

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

LG/al/jle