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

ORIGINAL DATE 1/23/17

SPONSOR Trujillo, J. **LAST UPDATED** **HB** 76

SHORT TITLE Estate or Trust Distribution Tax Deduction **SB**

ANALYST Iglesias

REVENUE (dollars in thousands)

Appropriation					Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**	**FY20**	**FY21**		
*	$(399.0)	$(407.0)	$(415.0)	$(429.0)	Recurring	General Fund

Parenthesis ( ) indicate expenditure decreases

(*)Note: since the bill's provisions apply to TY 17 income, there might be a small amount of impact in FY17. However, the bill becomes effective 90 days after adjournment (June 18, 2017) and might only affect the June PIT estimated payments. If there is an impact in FY17, it would be negative to the general fund.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY18	FY19	FY20	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	$272.0	$212.0	$212.0	$694.0	Recurring	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 76 creates a new section of the Income Tax Act to provide a 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 nonresident 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.

Taxpayers allowed the deduction will be required to report the amount of the deduction separately in a manner required by the Taxation and Revenue Department (TRD). TRD will be required to compile an annual report with an analysis of the effectiveness and cost of the deduction and whether the deduction is performing the purpose for which it was created.

The effective date is not specified, therefore it is assumed to become effective 90 days following adjournment (June 16, 2017). The provisions of the bill apply to taxable years beginning on or after January 1, 2017. The bill sunsets on December 31, 2023.

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. 2016 HB 119). In contrast, the PIT growth rate in each subsequent year is projected to be positive. Thus, the cost of this deduction grows each year. New Mexico fiduciary income tax revenues for FY09 - FY16 were used to calculate a rolling five-year average.

Since the majority of trusts established in New Mexico are for oil, gas, and property, TRD assumes that only 20 percent of the net income from an estate or trust will qualify for the deduction. Further, it was assumed that only 25 percent of the fiduciary income would be distributed to nonresident beneficiaries. The five-year average for fiduciary income tax is approximately $7.9 million. As described above, the baseline cost for this deduction was estimated as 5 percent of the five-year average. PIT growth rates obtained from the December 2016 consensus revenue estimate were used to estimate the fiscal impact for the subsequent years.

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 could be argued 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.

SIGNIFICANT ISSUES

The purpose of the bill is to expand the trust and estate business in New Mexico by allowing an income deduction from the net income of an estate or trust. The bill therefore appears to implicate efficiency and the growth of a business segment. TRD recommends giving additional consideration to the scope of the deduction and the types of trusts intended to benefit from it.

TRD further states, "Policy makers should also be concerned with the back-end benefit to the state of incentivizing this industry. While facts for each business will vary, professional service business that perform trustee functions typically employ minimal personnel that are devoted to the trust function and little property. The property typically held in trust is intangible and, therefore, not taxable. In short, the extent of the direct and indirect benefit of incentivizing this industry is unclear and should be considered in more detail."

Additionally, TRD adds, "This bill is prone to unintended consequences and tax leakage. The taxation of trust and trust beneficiary income is complicated and depends on numerous factors, including the trust document, the type of trust, the nature of the income, trust accounting, and federal rules. There may be instances with this deduction in which neither the trust nor the beneficiary are taxed either while the income is being held or when it is distributed. There may be instances when the beneficiary pays tax on the income when it is finally distributed. Because of the numerous factors that dictate how trust and beneficiary income is taxed, TRD is concerned with unintended consequences and revenue loss."

TRD further adds, "Efficiency incentives are most often given because the growth of a particular industry may yield additional revenue, employment, or other benefits to the state. This goal may not be served with certain types of trusts. For example, an investment fund set up as a trust typically has very little property subject to taxation, very few employees, and in certain circumstances, the trustee services may be deductible from gross receipts taxes under Section 7-9-108 NMSA 1978. There may, however, be other instances in which the growth of trust business activities may provide the sought after benefits to New Mexico."

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 states this bill has a high administrative and compliance impact. According to TRD, "The department does not have current personnel on staff qualified to administer this deduction." The recurring annual expense of over $200 thousand "is based upon the need for four additional FTE to support this program." TRD estimates the non-recurring impact to be equally significant, stating, "GenTax software, forms, instructions, and all other program support elements will require revisions and updates. These updates will require subject matter experts to ensure that current systems are programmed to properly adjudicate the application of this deduction."

TRD adds, "The deduction may be subject to the financial statement disclosure requirements per Government Accounting Standards Board Statement No. 77. An assessment of the deduction against the tax abatement criteria specified in GASB 77 would need to be performed to determine if the deduction meets the criteria."

It should be noted, in previous related FIRs (e.g. 2016 HB 119, 2015 HB 406), TRD estimated the bill would have only a moderate impact to their information technology (IT) division of approximately 300 hours. Previous operating budget impact estimates by TRD totaled just $21 thousand in nonrecurring costs for the implementation year only. As stated above, TRD's current estimate is over $200 thousand in recurring operating costs, which includes adding four FTE.

TECHNICAL ISSUES

TRD noted critical definitions, such as "member," are missing from the bill. Additionally, because fiduciary statutes do not provide clear guidance for estates and trusts, the bill as currently written will be hard to interpret, time consuming for taxpayers and employees to implement, and subject to the potential for fraud.

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

Does the bill meet the Legislative Finance Committee tax expenditure policy principles?

1. **Vetted**: The proposed new or expanded tax expenditure was vetted through interim legislative committees, such as LFC and the Revenue Stabilization and Tax Policy Committee (RSTP), to review fiscal, legal, and general policy parameters.
2. **Targeted**: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.
3. **Transparent**: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies.
4. **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.
5. **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.
6. **Efficient:** The tax expenditure is the most cost-effective way to achieve the desired results.

LFC Tax Expenditure Policy Principle	**Met?**	**Comments**
Vetted	✗	
Targeted		
Clearly stated purpose	✓	The purpose of the deduction is to assist in the expansion of the trust and estate business in New Mexico
Long-term goals	✗	
Measurable targets	✗	Although TRD is required to report on the effectiveness and cost of deduction, no measureable targets are given
Transparent	✓	Requires annual reporting by TRD and presentation to RSTP and LFC
Accountable		
Public analysis	?	Depends on how TRD structures the required reports
Expiration date	✓	The bill sunsets on December 31, 2023

Effective Fulfills stated purpose Passes "but for" test	 ? ?	Per TRD, may be subject to unintended consequences and tax leakage
Efficient	?	Per TRD, efficiency incentives may not be met in some circumstances (e.g. investment fund set up as a trust)
Key: ✓ Met ✘ Not Met ? Unclear		

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