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

ORIGINAL DATE 2/11/2020
SPONSOR Campos **LAST UPDATED** **HB**

SHORT TITLE Social Security Income Tax Exemption **SB** 170

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY20	**FY21**	**FY22**	**FY23**	**FY24**		
	($83,000.0)	($90.000.0)	($98,000.0)	($106,000.0)	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

Duplicates, Relates to, Conflicts with HB29, HB77, HB130, HB170, SB68, SB81

SOURCES OF INFORMATION
LFC Files

Responses Received From
Aging and Long-Term Care Department (ALTSD)
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 81 proposes exempting federally taxable social security retirement income from state personal income tax. Individuals claiming this exemption are not permitted to simultaneously claim the “over 65 and blind” exemption of Section 7-2-5.2 NMSA 1978.

The effective date of this bill is not stated and assumed to be 90 days after the end of the session (May 20). The provisions of the act are applicable to taxable years beginning January 1, 2020. There is no delayed repeal date but LFC recommends adding one.

FISCAL IMPLICATIONS

The current revenue estimates reported were obtained from the Taxation and Revenue Department (TRD). The agency provides the following discussion on its analysis:

> TRD has estimated the impact shown in the chart using base year 2017 microdata for New Mexico personal income tax (PIT) taxpayers. Base year 2017 was used due to being the most complete recent tax year. Social security benefits were increased annually by the

average cost-of-living-adjustments (COLA) in the last four calendar years and by a net population rate increase given the rate of individuals reaching social security eligible age and death rates. TRD's estimate of the impact assumes all taxable social security benefits included in adjusted gross income may be exempted. Note the technical issue below, which points to another interpretation of the bill language. TRD also assumed that taxpayers would select whichever exemption, either this new exemption or the exemption pursuant to Section 7-2-5.2 NMSA 1978, that decreased their tax liability the most.

TRD's estimate based on microdata includes both resident filers and "B" filers. B filers file a PIT-B for New Mexico allocation and apportionment of income. An important note about pension, annuity and social security benefits which are reported on line 3 of the form. If the filer is a non-resident, the taxpayer is to enter zero as these benefits are prohibited from: being allocated to New Mexico per federal law.1 If the filer is a part-year resident, first-year or full-time resident, then their taxable social security benefits are apportioned as per statute 7-2-11 NMSA 1978. TRD's estimate of the impact accounts for the apportionment of income for 'B' filers.

In general, 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. In this case, the amount of taxable social security is not reported directly to TRD. If this bill passes and is implemented, the annual cost cannot be determined exactly, because the federally taxable social security amount will be reported to TRD as an exemption and not a credit. TRD will have to recalculate all returns claiming this deduction/exemption. (See "Technical Issues".)

The following chart developed by LFC staff shows the distribution of benefits at various income levels.

Resident Returns Only	Adjusted Gross Income (including up to 85% of Social Security Benefits if required)								
2020 Impact by Adjusted Gross Income Level	All returns	$10,000 under $25,000	$25,000 under $50,000	$50,000 under $75,000	$75,000 under $100,000	$100,000 under $200,000	$200,000 under $500,000	$500,000 under $1,000,000	$1,000,000 or more
Social Security Retirement beneficiaries, total	349,143	207,589	48,657	30,754	22,539	30,769	7,622	874	339
Mean Benefits paid	$17,172	$14,262	$16,127	$17,710	$23,583	$28,508	$33,248	$34,857	$37,880
Total Benefits ($ Millions)	$5,995.5	$2,960.7	$784.7	$544.7	$531.5	$877.1	$253.4	$30.5	$12.8
Social Security benefits in AGI: Number	147,718	16,164	38,657	30,754	22,539	30,769	7,622	874	339
% Social Security Returns	16.02%	7.52%	16.69%	25.90%	30.34%	29.45%	29.80%	29.55%	30.38%
Average Taxable Social Security Amount	$14,920	$1,772	$6,773	$15,054	$20,046	$24,231	$28,261	$29,628	$32,198
Total Taxable Social Security ($ Millions)	$2,204.0	$29.6	$261.8	$463.0	$451.8	$745.6	$215.4	$25.9	$10.9
Marginal tax rate	4.40%	1.75%	4.28%	4.89%	4.90%	4.90%	4.90%	5.90%	5.90%
Total, $30,000 Limit Deduction ($1,000)	$86.9	$0.5	$11.2	$22.2	$19.1	$25.5	$6.9	$1.0	$0.4
Average Tax Benefit per return	$588	$31	$290	$723	$849	$828	$909	$1,122	$1,211

[1] Line 3 instructions, Page 5 B of *Instructions for 2019 PIT-B Schedule of New Mexico Allocation and Apportionment of Income,* "Effective for retirement income received after December 31, 1995, federal law prohibit any state from imposing an income tax on certain retirement income (primarily pension income) of an individual unless that person is a resident of or domiciled in the state imposing the state." 4 U.S. Code § 114. Limitation on State income taxation of certain pension income

This bill creates a tax expenditure with a cost that is somewhat difficult to determine because the data on which the model is based are indirect. LFC has concerns about the risk to state revenues from tax expenditures and the increase in revenue volatility from erosion of the revenue base.

This bill may be counter to the LFC tax policy principles of adequacy, efficiency, and equity. Due to the increasing cost of tax expenditures, revenues may be insufficient to cover growing recurring appropriations.

SIGNIFICANT ISSUES

This bill narrows the personal income tax (PIT) base, which appears counter to the base-broadening efforts over the last few years to reform New Mexico's tax systems. This proposal would likely reduce the income elasticity of the personal income tax, negating the improvements to income elasticity embedded in PIT tax changes passes last year (Chapter 270, Laws 2019, House Bill 6). About 61 percent of this proposed exemption benefits individuals with adjusted gross income under $100 thousand (see table above).

States that tax social security benefits broadly fall into four categories: (1) states that fully exempt social security benefits from their state income tax; (2) states that tax social security benefits the same way in which the federal government taxes them; (3) states that base benefit exemptions on certain factors such as age or income; and (4) states that do not tax income at all. Thirteen states tax social security benefits to some extent (see Appendix B). New Mexico is one of three states that follow the federal rules for including a portion of social security benefits as part of taxable income, and the state also provides a deduction for persons over age 65 to help offset the tax on social security benefits.

At the federal level, if the taxpayer's adjusted gross income (AGI) including half of social security benefits totals less than $32 thousand for married couples filing jointly or $25 thousand for single filers, none of the benefit amount is included in gross income. Accordingly, none of it is subject to federal income tax or state income tax. For AGI including half of social security benefits that exceeds $44 thousand for married joint and $34 thousand for single, then 50 percent to 85 percent of social security income is taxable.

New Mexico began taxing social security benefits in 1990. The action in was contained in an omnibus bill enacted in response to the *Davis v. Michigan* and *Burns v. New Mexico* problems. At that time, state retiree's pensions were 100 percent exempt from personal income tax, but federal retirees only were allowed a $3,000 deduction. The U.S. Supreme Court found that this differential treatment was in violation of federal law ensuring that state and federal workers are treated equally and equitably. Per the Supreme Court opinion, retiree income was covered by the federal statute. In the relevant bill, New Mexico repealed both the federal and state differential deductions. In addition, other source-specific deductions were included in the fix. These included the total exemption for social security income.

Reducing or eliminating income tax on social security benefits is often viewed as a mechanism for attracting or retaining retirees in the state. A 2018 publication by New Mexico State University included the following discussion:[2]

[2] *Potential Fiscal Impacts of a New Mexico Retiree Attraction Campaign*, December 2018 https://aces.nmsu.edu/pubs/_circulars/CR691.pdf

> Because New Mexico is listed as one of the "10 Least Tax Friendly" states for retirees (Kiplinger, 2017), additional research should be conducted on the impacts of reducing or eliminating taxes on retirement. However, it should be noted that while tax friendliness is often listed as a top criteria on "best places to retire" lists, other research has shown that tax policy changes have done nothing to attract retirees (Conway and Rork, 2012).

Other factors – such as weather, cost of living (particularly cost of housing), and the location of family members – also affect migration decisions for retirees. A 2001 study published in the *National Tax Journal* found, "In addition to cost-of-living and climate considerations, the elderly are attracted to states that exempt food from sales taxes and spend less on welfare. Low personal income and death taxes also encourage migration, depending on how these states taxes are measured."[3]

Some view taxing social security benefits as double taxation. To this point, an employee's social security contribution is not deductible on the employee's income tax return for the year in which the "contribution" was made – meaning the employee's "contribution" is taxed in the year it is paid. However, the employer's contribution to social security is deductible for the employer and is not required to be added to the employee's income – therefore, these contributions are not taxed in the year they are made. It could be concluded that roughly half of the social security payments has been taxed once before, up to the point where to payments to a retiree exceed contributions for that retiree. However, after that point, no part of the retiree's payments would have been previously taxed. Because of lower contribution rates in the earlier years, current social security recipients recover the total amount of their contribution in under 10 years of retirement.

New Mexico has a tax exemption for persons over 65 and blind; however, the exemption is modest, costing the state an estimated $1.1 million in 2017, with 93.4 thousand claims, according to the most recent TRD tax expenditure report. Analysis by LFC staff finds this may be a low estimate in cost, but an accurate estimate in terms of number of individuals assisted. The current benefit amounts and bracket levels were established in 1987 and have not been adjusted since. In that 34-year period, consumer price index for urban consumers (CPI-U) inflation has increased 141 percent. Updating both the levels and the brackets by only 50 percent would cost the general fund on the order of $15 million and would target the benefits to lower-income elderly and blind individuals.

It can be argued that taxing social security benefits undermines the purpose of the Social Security Act, which was designed to lift seniors out of poverty. However, this bill exempting social security income from PIT primarily benefits individuals with incomes well above the federal poverty standard, as shown in the "Fiscal Implications" section.

As mentioned above, this proposal will reduce the income elasticity of the personal income tax. Currently, a 10 percent increase in statewide personal income results in about a 10 percent increase in personal income tax collections. Prior to the leveling of PIT rates and brackets in 2003, the average income elasticity was about 1.34. Going back into the 1980s, the elasticity was as high as 1.46. The advantage of an income elasticity greater than 1 is that the personal income

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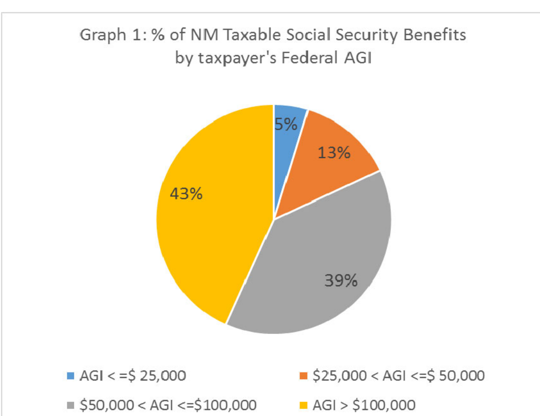
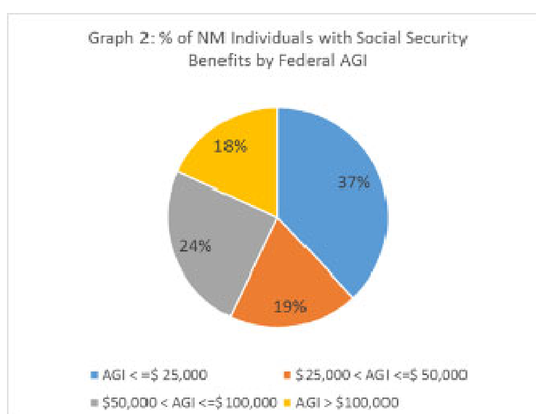
[3] Houtenville, Andrew & Conway, Karen. (2001). *Elderly Migration and State Fiscal Policy: Evidence from the 1990 Census Migration Flows*. National Tax Journal. 54. 10.17310/ntj.2001.1.05.

tax provides a progressive balance to the more regressive gross receipts tax. The $25 thousand limit reduces this decline in income elasticity.

TRD presents a similar discussion of this issue:

> PIT revenue represents a fairly consistent source of revenue for many states. PIT revenue is susceptible to economic downturns but also positively responsive to economic expansion. Social security benefits increase by cost-of-living adjustments which are tied to economic factors. The number of taxpayers with social security benefits is also increasing given the baby-boomer cohort reaching full retirement age. Social security benefits though represent a stable portion of the PIT taxable base as that is guaranteed federal retirement income. New Mexico is one of forty-two states along with the District of Columbia which impose a broad-based personal income tax. The personal income tax is seen as both horizontally equitable, the same statutes apply to all taxpayers and vertically equitable, due to the progressive design of the personal income tax. Progressive, in this context, meaning taxes where the average tax rate increase as the taxable amount increases.
>
> New Mexico statutes for state personal income tax are linked to the federal tax code. This is also termed "conformity." As federal tax code changes occur such as under the recent Tax Cuts and Jobs Act (TCJA), states see impacts to their respective revenue from PIT depending on the level of conformity. New Mexico's level of conformity is currently high given PIT starts with federal adjusted gross income (AGI), applies federal standard deductions and uses Internal Revenue Service (IRS) definitions such as for dependents. With that conformity, New Mexico treatment of social security benefits follows the federal application. For federal tax purposes, how much of social security is taxable is dependent on the total amount of social security benefits and other income. If a taxpayer's only income is from social security, their benefits may not be taxable under current law. The portion of social security benefits that are included in federal AGI is the same portion that New Mexico PIT includes. New Mexico's stable PIT taxable base as mentioned above is arrived at from higher income individuals who have both social security benefits and other sources of income. This is illustrated by Graph 1 below showing 82% of taxable social security benefits included in the state PIT base are for individuals with AGI over $50,000 but they are only 42% of taxpayers with social security benefits (Graph 2).





> Excluding types of retirement income from the taxable base is seen as eroding horizontal

equity in state income taxes. By excluding income based on age, taxpayers in similar economic circumstances are no longer treated equally. Income exemptions based on age violate horizontal equity by benefiting taxpayers on the basis of age instead of the amount of income.

With the adoption of this bill, New Mexico would move closer to the majority of states who do not tax social security benefits at all. There are many reasons why states may exempt some income for those over 65, such as lessening the economic burdens for individuals on fixed incomes and trying to attract retirees to the state. With that approach, a holistic look at New Mexico's tax code should be considered including PIT tax rates in respect to other states and gross-receipts tax. In addition, healthcare services, including long-term care services in respect to quality, availability, and costs, should be considered for this population.

New Mexico's current exemption for persons sixty-five and older or blind is targeted to those with lower adjusted gross income. This new proposed exemption would have no adjusted gross income restrictions. While any taxpayer with social security benefits may apply for this exemption, most of the financial benefit of this credit will be realized by higher earning individuals as indicated in Graph 1 above. Low income taxpayers tend to have lower taxable social security benefits included in their federal adjusted gross income due to federal tax statues. At the state level, these same taxpayers are eligible for other credits and rebates such as the low-income comprehensive tax rebate (LICTR), leaving them with no tax liability or minimal tax liability under current law.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is not met because TRD is not required in the bill to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the exemption and other information to determine whether the deduction is meeting its purpose. However, it is expected that TRD would provide estimates for the cost of the exemption in its annually produced *Tax Expenditure Report*.

ADMINISTRATIVE IMPLICATIONS

TRD would have to change forms and instructions and otherwise inform taxpayers of these changes. Auditing would continue to rely on primary inspection by the IRS.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Bill ID	Title	Sponsor	
HB 29	SOCIAL SECURITY INCOME TAX EXEMPTION	Cathrynn N. Brown	100% Deduction
HB 77	SOCIAL SECURITY INCOME TAX EXEMPTION	Daymon Ely	Up to $24,000 per return exempt
HB 130	EXEMPT SOCIAL SECURITY INCOME FROM INCOME TAX	Gail Armstrong	100% Deduction
SB 68	SOCIAL SECURITY INCOME TAX EXEMPTION	Michael Padilla	Up to $25,000 per return exempt
SB 81	EXEMPTING SOCIAL SECURITY FROM INCOME TAX	James P. White	100% Deduction
SB 170	SOCIAL SECURITY INCOME TAX EXEMPTION	Pete Campos	Up to $25,000 per return exempt

TECHNICAL ISSUES

This bill does not contain a delayed repeal date. LFC recommends adding a delayed repeal date.

TRD notes the following technical issue: "The bill language may also be interpreted as follows: *This bill creates a new section of the income tax act to allow an individual to claim an exemption of social security income from the amount included in adjusted gross income. The exemption shall not exceed the individual's net income*. Net income is defined in Section 7-2-2(N) NMSA 1978. TRD suggests clarity in the language to eliminate confusion if the current definition in statute does not align with the bills intent."

ALTERNATIVES

Less than 14 percent of the benefit of this proposed exemption would go to households earning less than $50 thousand in adjusted gross income, but 61 percent of the total benefit would go to households with adjusted gross income of under $100 thousand. If the intent of the bill is to provide support for lower income earners with social security benefits, a more targeted approach would be to expand the existing exemptions for persons aged 65 and older (Section 7-2-5.2) or for low- and middle-income taxpayers (Section 7-2-5.8).

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, 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	✓	The issue was discussed at the Revenue Stabilization and Tax Policy Committee prior to the Legislative Session, but without endorsement.
Targeted		
Clearly stated purpose	✗	No purpose, targets or goals established.
Long-term goals	✗	
Measurable targets	✗	
Transparent	?	TRD will likely publish a cost estimate in its annual Tax Expenditure Report
Accountable		
Public analysis	✗	The bill contains no provisions for reporting.
Expiration date	✗	The bill does not include an expiration date.
Effective		
Fulfills stated purpose	?	Without a purpose statement or required reporting, it is not possible to determine if the exemption fulfills intended outcomes.
Passes "but for" test	?	
Efficient	✗	Without a purpose statement or required reporting, it is not possible to determine if the exemption is the most efficient means of achieving
Key: ✓ Met ✗ Not Met ? Unclear		

APPENDIX A

State Taxation of Social Security Benefits	
Colorado	For beneficiaries younger than 65, up to $20,000 of Social Security benefits can be excluded, along with other retirement income. Those 65 and older can exclude benefits and other retirement income up to $24,000. Also, Social Security income not taxed by the federal government is not added back to adjusted gross income for state income tax purposes.
Connecticut	Social Security is exempt for individual taxpayers with federal adjusted gross income of less than $75,000 and for married taxpayers filing jointly with federal AGI of less than $100,000.
Kansas	Social Security benefits are exempt from Kansas income tax for residents with a federal adjusted gross income of $75,000 or less.
Minnesota	Social Security income is taxable, but a married couple filing jointly can subtract $4,500 of their federally taxable Social Security benefits from their state income. (The break is $3,500 for single and head of household, $2,250 for married separate filers). Make more than $78,530 of income (for married filers) and the break gets phased out, and is gone for those with more than $101,030 of taxable income. Those are the 2018 limits; they're adjusted each year for inflation.
Missouri	Social Security benefits are not taxed for single taxpayers with adjusted gross income of less than $85,000 and married couples with AGI of less than $100,000. Taxpayers who exceed those income limits may qualify for a partial exemption on their benefits.
Montana	Social Security benefits are taxable. The taxable amount may be different from the federally taxable amount because Montana taxes some types of income that the federal government does not, and vice versa.
Nebraska	A taxpayer may subtract Social Security income included in federal adjusted gross income if a taxpayer's federal adjusted gross income is less than or equal to $58,000 for married couples filing jointly, or $43,000 for all other filers.
New Mexico	Benefits are taxed to the same extent as on the federal tax return. But Social Security income can be included as part of an overall retirement-income exemption of up to $8,000 per person, subject to income restrictions.
North Dakota	Benefits are taxed to the same extent as on the federal tax return.
Rhode Island	Rhode Island doesn't tax Social Security benefits for single filers with up to $83,550 in adjusted gross income and joint filers with up to $104,450 in AGI. Those are the 2018 limits; they're adjusted each year for inflation.
Utah	Social Security benefits are taxed. Benefits may qualify for a retirement-income tax credit.
Vermont	Under a law that went into effect in 2018, Social Security benefits are exempt for single filers making less than $45,000 a year ($60,000 for joint filers). This break phases out as income rises and expires for single filers making more than $55,000 ($70,000 for joint filers).
West Virginia	Social Security benefits are taxed to the extent that benefits are taxed by the federal government. Starting in the 2020 tax year, WV exempts Social Security benefits from personal income taxes in a three-year phase-out. The deduction is only allowed for a married couple filing a joint return, not over $100,000, or $50,000 for single individuals or a married individual filing a separate return.

Source: Kiplinger, 2019

INCOME AND BENEFITS
(IN 2018 INFLATION-ADJUSTED DOLLARS)
Total households With Social Security

Geographic Area Name	# households	Mean Social Security income (dollars)
Bernalillo County	80,557	$18,533
Catron County	874	$20,398
Chaves County	8,255	$16,853
Cibola County	3,390	$16,785
Colfax County	2,746	$17,958
Curry County	5,081	$17,416
De Baca County	345	$15,946
Dona Ana County	24,708	$17,724
Eddy County	6,830	$18,212
Grant County	5,532	$17,971
Guadalupe County	780	$15,417
Harding County	134	$17,819
Hidalgo County	778	$18,913
Lea County	5,817	$17,946
Lincoln County	3,605	$20,944
Los Alamos County	1,845	$20,940
Luna County	3,633	$16,761
McKinley County	5,928	$14,197
Mora County	842	$14,409
Otero County	8,497	$17,175
Quay County	1,647	$17,058
Rio Arriba County	4,067	$18,847
Roosevelt County	2,153	$17,295
Sandoval County	16,245	$19,833
San Juan County	13,614	$18,075
San Miguel County	4,747	$14,965
Santa Fe County	22,849	$20,133
Sierra County	3,089	$17,050
Socorro County	1,785	$17,381
Taos County	5,009	$16,518
Torrance County	2,737	$18,132
Union County	582	$17,077
Valencia County	10,693	$17,794
New Mexico	259,394	$18,197

LG/rl/sb