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

		ORIGINAL DATE	03/02/21		CS/291/HTRCS/aHF1#
SPONSOR	HTRC	**LAST UPDATED**	03/18/21	**HB**	1/aSTBTC/aSFC
SHORT TITLE	Tax Changes			**SB**	
			ANALYST		Iglesias/Torres

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY21	FY22	FY23	FY24	FY25		
--	Up to ($48,800.0)	Up to ($49,900.0)	Up to ($50,900.0)	Up to ($52,000.0)	Recurring	General Fund - LICTR
--	($24,850.0)	($22,600.0)	($49,200.0)	($49,200.0)	Recurring	General Fund - WFTC
--	**($73,650.0)**	**($72,500.0)**	**($100,100.0)**	**($101,200.0)**	**Recurring**	**TOTAL GENERAL FUND**

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

FY21	FY22	FY23	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
--	$42.3	--	$42.3	Nonrecurring	General Fund – TRD ITD Staff Workload
--	--	$5.2	$5.2	Recurring	General Fund – TRD ITD Staff Workload

Parenthesis ( ) indicate expenditure decreases

Relates to HB42, SB339

SOURCES OF INFORMATION
LFC Files
Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of SFC Amendment

The Senate Finance Committee amendment to House Taxation and Revenue Committee substitute for House Bill 291 removes all provisions of the bill except the changes to the low income comprehensive tax rebate (LICTR) and the working families tax credit (WFTC). The fiscal impact table reflects the amended bill with these two provisions.

Notably, the federal American Rescue Plan Act (ARPA) passed in March 2021 expanded the federal earned income tax credit (EITC) for taxpayers with no qualifying children in tax year

2021 by increasing the maximum credit from $543 to $1,502; reducing the minimum age to claim the credit for these workings from 25 to 19 (except for full-time students), and eliminating the upper age limit on the credit; and, doubled the phase-in and phase-out percentages. Those changes increase the size of the New Mexico WFTC, eligibility for which is based on the EITC, and therefore reduce PIT revenue. Under current state and federal law including ARPA, PIT revenue will decrease by $7.5 million in FY2022 assuming taxpayers maximize their tax refund. The fiscal impact table reflects the additional fiscal impact given the proposed changes to the WFTC in the amended bill, estimated at $24.9 million. The combined total impact of the APRA changes and the WFTC changes for FY22 is $32.4 million.

Synopsis of STBTC Amendment

The Senate Tax, Business and Transportation Committee amendment to House Taxation and Revenue Committee substitute for House Bill 291 lowers the income level at which the bill's new 5.5 percent personal income tax rate would be effective to $75 thousand for married filing separate, $150 thousand for married filling joint and heads of household, and $100 thousand for single filers. The fiscal impact estimates applies the new proposed rate structure to historical data using tax year 2019 as the base and takes into account the new 5.9 percent marginal tax rate effective for tax year 2021.

The amendment also increases the working families tax credit (WFTC) to 25 percent of the federal earned income tax credit beginning tax year 2023. The Taxation and Revenue Department (TRD) estimates this change will increase the cost of this provision to $49.2 million starting in fiscal year 2024.

The amendment removes the original bill's changes to property tax provisions for homes not occupied by the owner.

Lastly, the amendment phases in a corporate income tax rate increase for businesses with taxable incomes over $500 thousand over five years – the current rate for businesses at this taxable income level is 5.9 percent and will increase to 6.2 percent in tax year 2022, 6.6 percent in TY2023, 6.9 percent in TY2024, 7.3 percent in TY2025, and 7.6 percent in TY2026 and beyond. Data from TRD indicates less than 1 percent of corporate income taxpayers have taxable income over $500 thousand.

Synopsis of HFl#1 Amendment

The House floor #1 amendment to the House Taxation and Revenue Committee substitute for House Bill 291 makes several minor changes to the definition of a "New Mexico Business" in Section 4 of the bill related to the capital gains tax deduction. Under the amendment, a sole proprietorship is a "New Mexico Business," the sale of which is eligible for a capital gains tax deduction, if 100 percent of the tangible assets of the business are located in New Mexico. For a corporation or limited liability company, its principal office and majority of its employees must be located in New Mexico. For a limited partnership, its principal place of business and 100 percent of its tangible assets must be located in New Mexico.

Synopsis of Original Bill

The House Taxation and Revenue Committee substitute for House Bill 291 (HB291) creates three new income tax brackets for each type of filer, expands the Low-Income Comprehensive

Tax Rebate (LICTR) and Working Families Tax Credit (WFTC), narrows the deduction for capital gain income, and allows for increases in property tax for nonowner occupied residential properties to be up to 10 percent.

Section 1 creates three new income tax brackets at 5.5 percent, 6.2 percent and 6.5 percent. For married individuals filing separately, the 5.5 percent rate applies to incomes from $100 thousand to $157.5 thousand, the 6.2 percent rate applies to income from $207.5 thousand to $311 thousand, and the 6.5 percent applies to income over $311 thousand. For heads of household, surviving spouses, and married individuals filing joint returns, the 5.5 percent tax rate applies to income from $200 thousand to $315 thousand, the 6.2 percent rate applies to income from $415 thousand to $622 thousand, and the 6.5 percent to income over $622 thousand. For single individuals, estates and trusts, a 5.5 percent tax rate would apply to income from $135 thousand to $210 thousand, the 6.2 percent rate applies to income from $280 thousand to $415 thousand, and the 6.5 percent for income over $415 thousand.

Section 2 expands LICTR to apply to higher incomes, provide higher rebates, and create an automatic adjustment to LICTR amounts based on inflation. Under current law, the rebate is calculated on a sliding scale based on an individual's income up to a maximum income of $22 thousand a year. The bill would expand eligibility for the rebate to include individuals making up to $36 thousand a year and increase the maximum rebate from $450 to $730. HB291/HTRCS would link the rebate amounts to the consumer price index, increasing the rebate by the inflation rate, except in instances where the inflation rate would result in a downward revision to the rebate amount.

Section 3 expands the WFTC to increase the credit amount from 17 percent to 20 percent, allows filers to qualify without a social security number, and creates eligibility for filers ages 18-24 who previously did not qualify.

Section 4 removes the 40 percent capital gains tax deduction for any capital gains, and instead limits the 40 percent deduction to net capital gains from the sale of a New Mexico business, so long as the sale of the business did not result in net capital gains of more than $1 million, the business was the principal business of the taxpayer, and the taxpayer was involved in the operation of the small business on a regular, continuous and substantial basis. For all other taxpayers, a net capital gain income deduction of $1,000 is allowed.

Section 5 allows for an adjustment of residential property values for property tax to be up to 10 percent per year for property that is not the owner's principal place of residence, beginning in tax year 2024.

The effective date of sections 2 and 3 is January 2021, while section 4 is effective January 2022.

FISCAL IMPLICATIONS

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.

PIT Rates and Brackets. For the personal income tax (PIT) rate changes, the new proposed rate structure was applied to historical data using tax year 2019 as the base and taking into account the new 5.9 percent marginal tax rate effective for tax year 2021. The growth rates from the Consensus Revenue Estimating Group (CREG) February 2021 estimate were applied.

Low-Income Comprehensive Tax Rebate. The new proposed LICTR amounts by modified gross income (MGI) level and number of exemptions were applied to historical data using tax years 2018 and 2019. The fiscal impact includes the rebate amount increase for the current population claiming the credit, which is approximately 210 thousand taxpayers. The average rebate amount for the current population increases from $78 to $195. The fiscal impact includes the expanded population of eligible taxpayers who can now qualify under the higher threshold of $36 thousand MGI. Their average rebate amount is estimated at $68 per taxpayer. Additionally, the estimate includes a population of taxpayers who are currently eligible but have not claimed the rebate in the past.

The Covid-19-induced recession has impacted individuals working in the service industry where many jobs are low wage. Based on the website tracktherecovery.org[1], as of December 2020, New Mexico individuals with incomes less than $27 thousand have seen a 21 percent reduction in employment rates since January 2020. The $27 thousand income threshold is within the new proposed eligible threshold for LICTR. This analysis assumes this population is captured within the three sub-groups described above. Additionally, individuals with incomes between $27 thousand and $65 thousand have experienced approximately a 4 percent decrease in employment rates. A proportion of this income range may become eligible under the new proposed threshold for LICTR, but TRD states it is difficult to estimate.

The $48.8 million impact assumes taxpayers will act to maximize their benefits of tax relief and tax rebates by quickly filing their state PIT returns in spring 2022 rather than requesting extensions to file later, causing a full-year fiscal impact in FY22. Thus, the fiscal impact represents the maximum fiscal impact and assumes a full “take-up” of all sub-groups described above. This revenue impact is then grown for the following fiscal years to account for inflation adjustment provided for in the proposed legislation, using the IHS forecast for U.S inflation growth based on the consumer price index for all urban consumers published by the U.S. Bureau of Labor Statistics.

Working Families Tax Credit. For determining the impact of changes to WFTC proposed in the bill, TRD started with the population of taxpayers who claimed the credit in tax year 2019 (TY2019). To estimate the impact of raising the amount of credit from 17 percent to 20 percent of the federal EITC, TRD assumed every taxpayer eligible and claiming WFTC in TY2019 will continue to claim the credit at the higher rate. The estimated impact of this is about $15 million.

The bill also introduces two new populations who would become eligible only under the WFTC because they are currently unable to claim the EITC. This includes working childless adults ages 18 to 24 years and adults who file federal and state taxes under an individual tax identification number (ITIN) because they do not have a social security number. To be eligible for the federal EITC, a taxpayer must file with a social security number.

For working adults ages 18 to 24, TRD reviewed current personal income tax (PIT) filers who are residents, meet the age range, appear to be working given reported withholding and would

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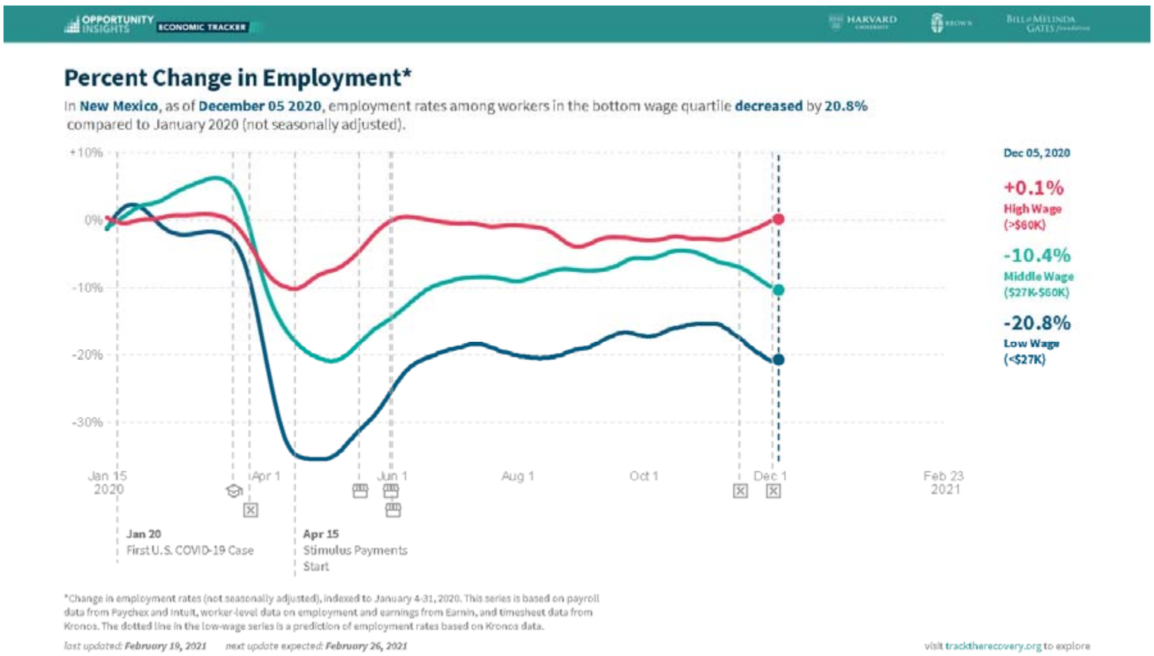
[1]

meet the income requirements given the current federal EITC tables, and are not reporting their own dependents. It was also assumed they are not a dependent of another taxpayer. (See technical notes below.) TRD arrived at a population of approximately 41,686 taxpayers. The total WFTC claimed by these taxpayers was estimated based on the average credit claimed by filers ages 25-30 years in TY2019. This average was computed based on the increased rate of 20 percent proposed in this bill. TRD's estimate of the fiscal impact of this population receiving the credit is $2.9 million.



As with working adults ages 18 to 24, TRD reviewed PIT filers who file under an ITIN. TRD again applied a filter to capture only taxpayers reporting as residents. TRD then estimated the amount of federal credit each sub-population could receive if they claim dependents or are single, head of household, or widowed based on the averages from TY2019. TRD's estimate of the fiscal impact of this population receiving the credit is about $5 million.

The federal EITC maximum credit amounts increase annually to keep pace with inflation. This would put an upward pressure on the estimated impact of the bill over the years. However, balancing out that upward pressure, is the downward pressure put by increased unemployment in light of the Covid-19 pandemic, which has caused the number of working adults to fall. TRD assumes that, in balance, both these effects will cancel each other out.

Capital Gains Deduction. To estimate the impact of limiting the bulk of the capital gains deduction to the sale of New Mexico businesses, TRD started with the universe of taxpayers who claimed at least $1,000 in capital gains deduction in TY2019 and used information on annual number of small business sales in the United Stated[2], after adjusting it for New Mexico using the share of New Mexico establishments in the total U.S. establishments per the *Statistics of U.S. Businesses (SUSB) of 2017 County Business Pattern*[3]. This was done because data on the number of New Mexico business sales are not currently tracked by TRD, and an approximation needed to

[2] https://www.arthurberry.com/valuation2.htm

[3] https://www.census.gov/data/tables/2017/econ/susb/2017-susb-annual.html

be made. The population of these taxpayers was further divided among those that had a deduction of $1,000 and those that claimed a deduction more than $1,000. TRD then computed this population's PIT liability under the PIT brackets proposed in Section 1 of this bill by assuming taxpayers who claim deduction for a sale of New Mexico business will have a tax liability that is the average of the tax liability of those with deductions in excess of $1,000, while the rest of the taxpayers currently claiming deduction in excess of $1,000 will have a tax liability equal to the average of those with deductions equal to $1,000, under the proposed PIT brackets. Due to uncertainty in the number of actual New Mexico business sales that will meet the $1 million net capital gain from sale, the estimated impact was then kept constant in the coming years.

Because the bill makes the changes to the capital gains deduction effective for TY2022, the revenue generated from these changes would not be realized until FY23.

Property Tax. The bill's property tax change provisions take effect in tax year 2024, so no fiscal impact is estimated for the forecast period. However, TRD estimates the provision will provide about $8 million in revenue to local governments. Using U.S. Census data on the number of New Mexico housing units and owner-occupied housing units, TRD calculated the percentage of housing units that are not owner-occupied and would be subject to the 7 percent marginal increase. TRD applied the 7 percent marginal increase to the taxable value of these housing units and applied a yield-control adjustment. This estimate establishes an aggregate impact, but the impact will vary county to county based on percentage of nonowner-occupied units, the taxable values of homes, and yield control.

SIGNIFICANT ISSUES

In Section 4, the bill does not define the "regular, continuous and substantial basis" time period a taxpayer must be involved in the operation of the business sold.

The bill creates a cliff effect by excluding any business sold for a net capital gain of greater than $1 million from the eligible capital gains tax deduction. A taxpayer who sells a New Mexico business resulting in net capital gains of $1,000,001 is ineligible to claim any capital gains tax deduction related to the sale, creating significant inequity for that taxpayer and a taxpayer who receives the deduction for a sale worth $1 less.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is <u>not</u> met with respect to the changes made to business income apportionment 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 regional operation single sales treatment and other information to determine whether the deduction is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

TRD will need to make information system changes and create new publications, forms and may need to create or revise regulations. The new rates, updates to LICTR, WFTC, the deduction from capital gain income and the updates to apportionment of business income can be implemented with annual tax year change and represent $42.3 thousand of staff workload costs.

Since the LICTR schedule is to be updated each year, this will add recurring work to each tax year beginning with tax year 2022. This will have a low impact and represents $5.2 thousand in workload costs by the Information Technology Division (ITD).

TECHNICAL ISSUES

Under Section 3, subparagraph B, to extend the WFTC to taxpayers between the ages of 18 and 24 years of age, TRD suggests adding the following on line 7, after "tax return": "and who is not a dependent of another individual." Based on the language of the bill, these individuals may be claimed as dependents for another taxpayer who also claims the WFTC. This will clarify that these are independent tax filers and they factor in only once for a determination of the WFTC.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

HB42 and SB339 also amend the Low-Income Tax Rebate. HB291 and SB339 contain similar amendments to the Working Families Tax Credit. SB339 increases the amount of the tax credit to 25 percent.

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	✘	
Targeted		
Clearly stated purpose	✘	
Long-term goals	✘	
Measurable targets	✘	
Transparent	✓	
Accountable		
Public analysis	?	
Expiration date	✘	
Effective		
Fulfills stated purpose	?	
Passes “but for” test	?	
Efficient	?	
Key: ✓ Met ✘ Not Met ? Unclear		

DI/IT/sb/rl/al/rl