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FISCAL IMPACT REPORT

SPONSOR <u>Harper/Cadena</u>	LAST UPDATED _____
	ORIGINAL DATE <u>2/14/23</u>
SHORT TITLE <u>Pass-Through Entity Tax Credit</u>	BILL NUMBER <u>House Bill 368</u>
	ANALYST <u>Faubion</u>

REVENUE* (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY23	FY24	FY25	FY26	FY27		
No Fiscal Impact					Recurring	General Fund

Parenthesis () indicate revenue decreases
 *Amounts reflect most recent version of this legislation.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT* (dollars in thousands)

	FY23	FY24	FY25	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
	--	\$11.1	--	\$11.1	Nonrecurring	TRD/ITD

Parentheses () indicate expenditure decreases.
 *Amounts reflect most recent version of this legislation.

Sources of Information

LFC Files

Responses Received From
 Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of House Bill 368

House Bill 368 (HB368) converts the income tax exemption on income subject to the entity-level tax to a credit for the owners of pass-through entities (PTE) that elect to pay an entity-level tax. The bill provides that the election to pay entity level tax by a pass-through entity shall be binding on all owners of the electing pass-through entity. This bill also amends the definitions of "base income" and "net income" in the income tax act.

This bill does not contain an effective date, and as a result, would go into effect June 16, 2023, (90 days after the Legislature adjourns) if signed. The provisions of this bill apply to taxable years beginning on or after January 1, 2023.

FISCAL IMPLICATIONS

This bill has no fiscal impact to the state as the current income exemption should be equal as the credit amount as proposed in this bill. The Taxation and Revenue Department (TRD) notes the proposed changes of the bill do not incur a further fiscal impact than what was previously estimated for the entity-level tax law in 2022. The new entity-level tax was enacted to address the federal Tax Cuts and Jobs Act (TCJA) \$10,000 limitation on the deduction of state and local taxes for taxpayers. The proposed changes in this bill do not alter the amount due to the state but rather who pays and reports the tax and the mechanisms for recognizing excess tax paid in a tax year.

SIGNIFICANT ISSUES

TRD notes the following:

This bill makes further changes to the Oil & Gas Proceeds and Pass-Through Entity Withholding Act, Section 7-3A-1 et seq. NMSA 1978, (the “Act”) to complement and amend changes to the Act that were made by HB102 of the 2022 regular session. HB102 allowed pass-through entities (“PTEs”) to elect to pay income taxes directly at the entity level, rather than passing through the income to their members or partners for tax purposes. HB102 was enacted to allow a “work-around” to the \$10 thousand cap placed on personal income tax deductions for state and local taxes for federal income tax purposes by the federal Tax Cuts and Jobs Act of 2017 (“TCJA”). TCJA limited the amount of state and local taxes that individuals, but not other entities, could deduct from their income for federal tax purposes; because the \$10,000 cap does not apply to entities such as PTEs, allowing the PTE to pay taxes allows deduction of the full amount of any state income tax paid with respect to the income earned by the PTE.

Like most states that have enacted a PTE direct-pay statute, New Mexico discovered that the law, as enacted by HB102, contained some unintended consequences, and did not directly address all the tax situations that might arise from having a PTE elect to pay taxes directly. This bill draws on that experience, and the experience of other states, to address those issues not addressed by HB102. In particular, the bill addresses: (i) the treatment of net operating losses of a PTE; (ii) treatment of credits and deductions; and, (iii) treatment of tiered partnerships, where a partner of a PTE is itself a PTE. The bill is necessary to give clarity and consistency to the application of the law, and to address issues raised by taxpayers in taking advantage of the direct-pay availability.

Page 15, lines 19 through 21, the bill includes in the calculation of net income of a PTE 40 percent of net capital gains. As written, 40 percent of capital gains is added to net income which already includes capital gains, essentially stacking an extra 40 percent of capital gains to income. This is unlikely the intention of the bill. More clarity is needed from TRD on whether this mechanism is accomplishing its intent in this bill. As the capital gains deduction from income tax in Section 7-2-34 NMSA 1978 may be amended by current or future legislators, LFC recommends HB368 cite the capital gains deduction in statute rather than using the current rate.

In Colorado, 2022 legislation also replaces the state PTE deduction with a refundable tax credit at the PTE-owner level for each electing owner’s distributive share of the state income tax imposed on the electing PTE.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is not met since 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 credit and other information to determine whether the credit is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

TRD will need to make information system changes and update forms, instructions and publications. Staff training to administer the credit will need to take place. These changes will be incorporated into annual tax year implementation. This bill will have a low impact on TRD's Information Technology Division (ITD), approximately 200 hours or about 1 month for an estimated staff workload cost of \$11,108.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Conflicts with HB120 which removes the 40 percent capital gains income tax deduction and caps capital gains at \$2,500. If the capital gains deduction is amended, the section of this bill that includes 40 percent of net capital gains in a PTEs income calculation should be amended to match the current deduction or, preferably, cite 7-2-34 directly so that if the capital gains deduction ever changes, this will automatically change with it.

TECHNICAL ISSUES

TRD recommends adding the words “or the Corporate Income Tax Act,” on page 16, line 24. As drafted, the bill only allows tax refunds of the credit for Personal Income Tax, and Corporate Income Tax should be included here.

TRD recommends adding language stating that for the purposes of Section 7-3A-10 only, “pass-through entity” be defined as solely a partnership or an S-Corporation.

Page 15, lines 19 through 21, the bill includes in the calculation of net income of a PTE 40 percent of net capital gains. LFC recommends this section cite the capital gains deduction in Section 7-2-34 NMSA 1978 rather than using the current rate so that it will be consistent if the capital gains deduction ever changes.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

If the bill is not enacted, TRD will be unable to address the issues left open by HB102 (2022), and taxpayers will not be able to take advantage of the relief as intended and will therefore be disadvantaged with respect to their federal income taxes.

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.

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