FISCAL IMPACT REPORT

SPONSOR	Garcia, H/Martinez, J/Alcon/Sarinana/Lujan	**LAST UPDATED**	
		ORIGINAL DATE	2/21/23
SHORT TITLE	Armed Force Retirement Tax Sunset Date	**BILL NUMBER**	House Bill 433
		ANALYST	Faubion

REVENUE*
(dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY24	FY25	FY26	FY27	FY28		
--	--	--	--	(18,800.0)	Recurring	General Fund

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

Duplicates SB54

Sources of Information

LFC Files

<u>Responses Received From</u>
Taxation and Revenue Department (TRD)
Aging and Long-Term Services Department (ALTSD)
Veteran's Services Department (VSD)

SUMMARY

Synopsis of House Bill 433

House Bill 433 (HB433) would amend the Income Tax Act to remove the sunset date on the armed forces retirement pay exemption currently in effect through tax year 2026. With this amendment, this exemption will remain at $30 thousand of retirement pay per armed forces retiree starting in taxable year 2024 forward.

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.

FISCAL IMPLICATIONS

Taxation and Revenue Department analysis shows, by making permanent the $30 thousand military retirement exemption currently scheduled to sunset, the bill will reduce general fund revenue by a recurring $18.8 million starting in FY28. The impact will increase 1 percent annually based on the methodology performed in the 2021 legislative session for the legislation introducing Section 7-2-5.13 NMSA 1978. The TRD methodology summary is as follows:

> Two sources of data were analyzed to arrive at an estimated revenue impact. The first data source is the Department of Defense (DOD) annual Statistical Report on the Military Retirement System for the federal fiscal year that ended September 30, 2020. The second data source was a sample of New Mexico military retiree state income tax returns for tax year 2018. The analysis considers the 5.9 percent marginal tax rate effective for Tax Year 2021 and beyond.
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> The Statistical Report on the Military Retirement System provides an aggregate number of retirees and survivor beneficiaries by state, and an aggregate amount of benefits distributed. As of September 30, 2020, New Mexico had 20,806 reported retirees and 2,812 survivor beneficiaries. Aggregate annual distribution of military retirement benefits for retirees (not including survivor benefits) was approximately $568 million. This analysis assumes all retirees were qualified by years of service or disability to receive lifetime benefits.
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> The sample of military retiree returns was used to establish an average personal income tax (PIT) decrease per retiree based on the maximum $30,000 exemption of military retirement pay. Retiree annuities were increased by a cost-of-living adjustment, which for most retirees per the DOD report is based on the Urban Wage Earner and Clerical Worker Consumer Price Index (CPI-W). All other taxable income reported on the returns was kept flat. Subtracting the exemption amount, a new taxable income was calculated, and the PIT rates applied to determine the new PIT due. An average PIT decrease per year was calculated with the sample of 15,000 returns.
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> Approximately 15,000 military retiree returns is assumed to be representative of the approximately 21,000 average annual reported retirees. The average PIT decrease per year was multiplied by the 21,000 retirees. It is assumed that the net immigration and emigration of military retirees into the state per year is zero and that net new retirees and deceased retirees per year is zero. The analysis therefore assumes a constant 21,000 returns per year are eligible for the exemption. The historical retiree numbers in the last four years from the annual Statistical Report on the Military Retirement System indicate a slight annual decline of -0.5 percent. To the extent the legislation causes more military retirees to move to New Mexico and military retiree population growth is positive versus flat or negative, the fiscal impact will be larger. Finally, the analysis assumes 100 percent of qualifying retirees will claim the deduction in the first year of eligibility.

This bill will not have any effect until FY27; therefore, it may be prudent to postpone its passage until the military retirement income tax exemption currently in statute has been implemented and data from the exemption can be analyzed. After a few years of implementation, legislators can better understand its impact and have better information with which to decide to remove the sunset.

This bill creates or expands a tax expenditure with a cost that is difficult to determine but likely significant. LFC has serious concerns about the significant risk to state revenues from tax expenditures and the increase in revenue volatility from erosion of the revenue base. The committee recommends the bill adhere to the LFC tax expenditure policy principles for vetting, targeting, and reporting or action be postponed until the implications can be more fully studied. 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

TRD provided the following discussion:

> Personal income tax represents a consistent source of revenue for many states. While this revenue source is susceptible to economic downturns, it is also positively responsive to economic expansions. New Mexico is one of 42 states, along with the District of Columbia, that impose a broad-based PIT. The PIT is an important tax policy tool that has the potential to further both horizontal equity, by ensuring the same statutes apply to all taxpayers, and vertical equity, by ensuring the tax burden is based on taxpayers' ability to pay.
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> Excluding types of retirement income from the taxable base is seen as eroding horizontal equity in state income taxes. By excluding income based on retirement status and profession, taxpayers in similar economic circumstances are no longer treated equally, with older and veteran taxpayers receiving a benefit not available to younger or non-veteran taxpayers at the same level of income.
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> There are many reasons why states may exempt some income for retirees, such as lessening the economic burdens for individuals on fixed incomes and trying to attract retirees to the state. Exempting retirement income is one of many factors that could help in achieving that goal but will not necessarily have that result. For example, Texas does not tax any income, military retirement or otherwise, at all. Yet the state features as one of the least tax friendly states for retirees in the country because of its high property and sales taxes[1]. Notably, New Mexico's property taxes are amongst the lowest in the nation. Looking at New Mexico's tax code holistically, the proposed permanency of the exemption may not be necessary, at least not to achieve this policy goal, especially if the exemption is contrary to other, over-arching tax policy goals of simplicity and equity.
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> The current exemption has yet to be claimed by New Mexico taxpayers. Removing the sunset on this exemption prior to observing taxpayer behavior and the fiscal impact does not allow for policymakers to review the impact of the exemption before extending it. On the other hand, for taxpayers to plan for retirement and their financial considerations, removing the sunset insures consistent future New Mexico income tax planning.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is <u>not</u> met because TRD is <u>not</u> required in the bill to report

[1] https://www.kiplinger.com/kiplinger-tools/retirement/t055-s001-state-by-state-guide-to-taxes-on-retirees/index.php?state_id=44#

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 exemption is meeting its purpose. TRD will report utilization data in its annual *Tax Expenditure Report*. However, TRD will not have access to data to establish if the bill increases the number of veterans, particularly highly skilled officers and senior enlisted retirees, to relocate to New Mexico, which is the stated goal of this tax exemption.

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	✓	This bill has previously been introduced and extensively debated.
Targeted		
Clearly stated purpose	✗	No stated purpose.
Long-term goals	✗	No stated long-term goals.
Measurable targets	✗	No measurable targets.
Transparent	?	This bill does not require annual reporting to interim legislative committees. The exemption may be included in TRD's tax expenditure report.
Accountable		

Public analysis	?	Because there are no states annual targets or goals, there is nothing from which to determine progress, effectiveness, or efficiency.
Expiration date	✘	There is no expiration date.
Effective		
Fulfills stated purpose	?	Because there are no stated annual targets or goals, there is nothing from which to determine effectiveness or passing of the "but for" test.
Passes "but for" test	?	
Efficient	✘	No desired results.
Key: ✓ Met ✘ Not Met ? Unclear		

JF/mg/hg/al/ne