FISCAL IMPACT REPORT

SPONSOR	Duncan/Montoya/Henry/Armstrong/ Hernandez, J.	**LAST UPDATED**	
		ORIGINAL DATE	2/25/2025
SHORT TITLE	Exempt Tips from Income Tax	**BILL NUMBER**	House Bill 484
		ANALYST	Gray

REVENUE*
(dollars in thousands)

Type	FY25	FY26	FY27	FY28	FY29	Recurring or Nonrecurring	Fund Affected
PIT	**$0**	**($21,400.0)**	**($22,100.0)**	**($22,600.0)**	**($23,400.0)**	Recurring	General Fund

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

Duplicates Senate Bill 285

Sources of Information

LFC Files

SUMMARY

Synopsis of House Bill 484

House Bill 484 (HB484) creates an exemption for tips received as compensation. Currently, for most types of employees, employers are required to withhold state income taxes in each paycheck. Income includes compensation received in the form of tips.

The provisions of this bill apply to tax years beginning 2025.

FISCAL IMPLICATIONS

HB484 is estimated to reduce recurring general fund revenue by $21.4 million in FY26. This cost was estimated using a similar methodology as resources cited in an October 2024 Congressional Research Service publication titled *Taxation of Tip Income.* Specifically, this analysis used the RP80 Gross Receipts Tax (GRT) report and retrieved taxable gross receipts by NAICS codes to identify the share of all business receipts in industries where employees routinely receive compensation in the form of tips. This is primarily made up of the full-service restaurant industry. The analysis also made adjustments to include other tipped food service establishments such as bars and coffee shops and nonfood establishments like barbershops, salons, spas, hotels, taxis, and many others, following a similar methodology used by a 2017 report by the Economic Policy Institute.[1]

In analysis of a duplicate bill (Senate Bill 285), the Taxation and Revenue Department (TRD) estimates that the bill would reduce recurring general fund revenue by between $5.6 million and $11.2 million in FY26. The agency used data from the state of Montana to estimate the average amount of tip income per taxpayer and used estimates from the Yale Budget Lab for the number of workers that regularly receive tips. The range provided by the agency was provided to recognize that some contract workers, like rideshare drivers, may be omitted in their assumptions.

Taxation and Revenue Department Revenue Impact Estimate*
(dollars in thousands)

Type	FY25	FY26	FY27	FY28	FY29	Recurring or Nonrecurring	Fund Affected
PIT	**$0**	**($5,600.0) to ($11,200)**	**($5,900.0) to ($11,800)**	**($6,200.0) to ($12,300)**	**($6,400.0) to ($12,700)**	Recurring	General Fund

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

There is a significant difference between LFC and TRD revenue estimates. This analysis presents the higher of the two agencies' analyses in recognition of the uncertainty involved in creating a major new tax expenditure and the potential behavioral effects that may be incentivized. This analysis notes that a greater share of private industry workers likely work in tipped industries in New Mexico compared with the region because of the state's weaker economy and higher poverty rates. This analysis also notes that comparing the HB484 proposal to Montana's exemption may create risks to the estimate for several reasons. First, Montana's exemption is limited only to food, beverage, and lodging establishments. This is a smaller subset of workers than that contemplated by HB484. Second, Montana's exemption was created in 1983 and taxpayers had many decades to come into compliance with the provision. By using this as a comparison, uptake may be artificially low because it assumes a compliance rate from decades after its initial implementation.

Risks. This estimate assumes taxpayers do not modify their behavior. This is a very conservative assumption that poses significant risks to the general fund. Currently, about 2.5 percent of all workers are tipped, but about 4 percent of workers earning less than $25 thousand per year. This analysis assumes the distribution of taxpayers remains constant. New, higher-wage industries may choose to adopt tips as compensation because of the significant tax incentive.

This could have a significant impact on personal income tax revenues, increasing volatility and decreasing the reliability of general fund estimates. For example, if an additional ten thousand workers were to begin primarily receiving compensation through tips, the revenue impact in this analysis could double.

SIGNIFICANT ISSUES

Policy Considerations. Excluding tip income from taxation would raise after-tax incomes for

[1] Shierholz, Cooper, Wolfe, and Zipperer (2017), Economic Policy Institute, Accessed 2/19/2025

some tipped workers, but not for nontipped workers with similar incomes. Policymakers may tolerate or approve of such a horizontal disparity if they believe there is a substantive difference between tipped and nontipped workers.

Workers in tipped occupations who owe no or little income tax would benefit little, if at all, from excluding tips from income subject to tax. Those who face higher marginal tax rates—generally, those with higher incomes—would benefit more than those facing lower rates. Creating a significant exemption for certain types of income creates opportunities for tax avoidance.

Providing a tax advantage to compensation through tips that is not available for other forms of compensation could make tipping more desirable for workers and employers. All else equal, workers might prefer receiving their pay in the form of tax-advantaged tips rather than taxed wages or salaries. Employers, in turn, could better compete for workers by offering compensation in tips. Customer resistance to broader tipping expectations or worker preferences for stable levels of income could counteract these incentives.

Design Considerations. This bill proposes an income tax exemption for compensation received as tips. Under this bill, employers in a predominantly tipped industry would still need to withhold income taxes in each paycheck, potentially increasing the burden on taxpayers who will need to properly file their return with the exemption to receive the full benefit of HB484. Similarly, the bill makes no changes to state payroll taxes, meaning unemployment insurance taxes will still be withheld from paychecks.

The bill provides an exemption across all industries. This may induce behavioral change, incentivizing industries where tipping is not currently popular to shift to tipping. This comes with economic consequences that may be wide-ranging. Exempting tips across all industries creates more opportunities for potential tax avoidance. An alternative would be to restrict the exemption to workers in industries where tipping is already common.

The bill would allow this exemption for workers who are self-employed. According to an analysis from the Yale Budget Lab, tips earned through self-employment make up about 7 percent of all tips. Policymakers may consider whether the provisions of the bill should also apply to these workers or whether self-employed workers should be excluded to limit opportunities for tax avoidance.

Lastly, the bill exempts income tax on wages earned as tips across all income levels. An alternative could be to phase the exemption out with income above a certain threshold. Another option is a limitation on the total amount of deductible tips. A limitation based on income would alleviate potential concerns that high-income taxpayers would reclassify income to take advantage of a tax break meant for lower-income workers. However, doing so would come at the cost of complexity and higher implicit marginal rates for those in a phase-out rate range.

TECHNICAL ISSUES

TRD analysis notes several technical issues:

> This bill does not define "tip" income. As stated in the policy section, there are multiple types of tips. Commissions or bonuses could be considered "tips" because they are discretionary and often based on services. This language should be clarified to provide

taxpayers and the department sufficient guidance in implementing. Without that, TRD and taxpayers may experience a high number of protests and subsequent litigation around these issues.

The proposed bill to exempt tips from income tax presents challenges for TRD in verifying the accuracy of the exemption claims. Tips are included in the total wages reported on both the W-2 and IRS Form 1040, making it difficult to distinguish between tip income and regular wages. Since tips are not separately stated on either the W-2 form or Form 1040, it becomes challenging to accurately verify the dollar amount of tips received by taxpayers. This lack of separate reporting can lead to potential misuse of the exemption, as taxpayers who do not actually receive tips may falsely claim the exemption. The proposed exemption is therefore susceptible to tax fraud and evasion.

The absence of a clear and verifiable method to track and substantiate tip income opens the door for taxpayers to exploit the exemption. To prevent exploitation of the exemption, it is recommended to implement a certification requirement. This would involve requiring taxpayers to obtain a certification of their tip income from the employer. However, this places a burden on the taxpayer, the employer, and TRD.

OTHER SUBSTANTIVE ISSUES

In assessing all tax legislation, LFC staff considers whether the proposal is aligned with committee-adopted tax policy principles. Those five principles:

- **Adequacy**: Revenue should be adequate to fund needed government services.
- **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
- **Equity**: Different taxpayers should be treated fairly.
- **Simplicity**: Collection should be simple and easily understood.
- **Accountability**: Preferences should be easy to monitor and evaluate

In addition, staff reviews whether the bill meets principles specific to tax expenditures. Those policies and how this bill addresses those issues:

Tax Expenditure Policy Principle	Met?	Comments
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.	✗	This proposal was not vetted through an interim tax committee.
Targeted: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.		This proposal does not have these components.
Clearly stated purpose	✗	
Long-term goals	✗	
Measurable targets	✗	
Transparent: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies	?	It is unclear whether this expenditure would be included in the annual tax expenditure report.
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		The bill does not contain an expiration date.

legislative action is taken to review the tax expenditure and extend the expiration date. Public analysis Expiration date	 ✗ ✗	
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. Fulfills stated purpose Passes "but for" test	 ? ?	It is unclear whether the proposal is effective or the most cost-effective.
Efficient: The tax expenditure is the most cost-effective way to achieve the desired results.	?	
Key: ✓ Met ✗ Not Met ? Unclear		

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