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

ORIGINAL DATE 2/14/15
SPONSOR Maestats Barnes **LAST UPDATED** 3/2/15 **HB** 358

SHORT TITLE Small Business Income Tax Deduction **SB**

ANALYST van Moorsel

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY15	**FY16**	**FY17**	**FY18**	**FY19**		
$0.0	$0.0	($16,580.0)	($16,760.0)	($16,950.0)	Recurring	General Fund

(Parenthesis ( ) indicate revenue decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Department of Finance and Administration (DFA)
Economic Development Department (EDD)

SUMMARY

Synopsis of Bill

House Bill 358 creates a new section of the Income Tax Act that creates a deduction from Personal Income Tax (PIT) for a business with annual business income less than $350 thousand and that employs at least one full-time equivalent (FTE) employee.

Specifically, the bill permits a taxpayer who is not a dependent of another individual to claim a deduction from net income provided that the taxpayer's business income from all businesses in which the taxpayer has an interest $350 thousand or less; the taxpayer's base income is $200 thousand or less; and any one business for which the deduction is being claimed employs at least one FTE employee that is a resident of New Mexico for at least 48 weeks.

The bill provides for reporting requirements; taxpayers must report the amount of the deduction to TRD. The department is required to compile an annual report on the deduction provided by this section that shall include the number of taxpayers that claimed the deduction, the aggregate amount of deductions claimed and any other information necessary to evaluate the effectiveness of the deduction. Beginning in 2017 and every year thereafter that the deduction is in effect, the TRD must compile and present the annual reports to the Revenue Stabilization and Tax Policy committee and the LFC.

The deduction may be claimed in the amounts shown in the table below.

HB 358 Deduction Schedule

For:	Deduction:
First $50 thousand of business income	100%
Second $50 thousand	85%
Third $50 thousand	70%
Fourth $50 thousand	55%
Fifth $50 thousand	40%
Sixth $50 thousand	25%
Seventh $50 thousand	10%

The provisions of the bill apply to taxable years beginning on or after January 1, 2016.

FISCAL IMPLICATIONS

TRD used a combination of the latest state and federal data to develop its estimate for the bill's fiscal impact. TRD used data from schedules C and E, assuming that if a business either paid unemployment wages or workers compensation wages, it employed at least one full-time equivalent employee that is a New Mexico resident for at least forty-eight weeks. However, TRD could not verify whether the employment is full-time or part-time. TRD applied the deduction percentages to the first $350 thousand of income for qualifying taxpayers and used February 2015 consensus PIT growth rates to estimate out-year impacts.

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

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

DFA reports the following in its analysis of the bill:

> Small businesses with adjusted gross income (AGI) of less than $200 thousand that file as sole proprietors, partnerships or s-corporations through the personal income tax program make up approximately 18 percent of all New Mexico personal income tax filers. The positive income reported from these businesses constitutes 3.4 percent of total adjusted gross income or $1.4 billion.
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> This deduction could allow small businesses to expand operations, hire new employees,

increase wages, or otherwise invest in the New Mexico economy. According to the Small Business Administration, there are approximately 155 thousand small businesses in New Mexico, (defined as firms employing fewer than 500 employees), and those businesses employ 328 thousand New Mexicans or approximately 40 percent of total employment.

Since pass-through entities already receive a lower marginal tax rate under the personal income tax than under the corporate income tax, some may argue that an additional tax break will create an uneven playing field. Alternatively, this deduction could be viewed as another positive step towards increasing the competitiveness of New Mexico.

EDD reports the deduction is targeted to the smallest businesses in order to benefit those businesses most in need of assistance.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is met with the bill's requirement to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the deduction is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

TRD reports the bill will have a moderate administrative impact. The department would have to make changes to Gentax and Taxpayer Access Point personal income tax document rules and configurations. Additional reports need to be developed to list the taxpayers and deduction amounts. Further, TRD employees and taxpayers will need education regarding reporting and use of this deduction. The department would need to gather data for annual reports to legislature.

TECHNICAL ISSUES

This bill does not contain a sunset date. The LFC recommends adding a sunset date.

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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