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

SPONSOR Youngblood / Papen **ORIGINAL DATE** 1/29/16 **LAST UPDATED** **HB** 169

SHORT TITLE Capital Gain Reinvestment Income Tax Credit **SB**

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY16	FY17	FY18	FY19	FY20		
($10,000.0)	($10,000.0) to ($75,000.0)	($10,000.0) to ($75,000.0)	($10,000.0) to ($75,000.0)	($10,000.0) to ($75,000.0)	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

Conflicts with HB 220 and HB 79 which seek to repeal the capital gains deduction.

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Economic Development Department (EDD)

DESCRIPTION

House Bill 169 proposes a new capital gain reinvestment income tax credit in the Income Tax Act. The new credit can be claimed against the taxpayer’s tax liability for the taxable year in which the taxpayer makes a qualified reinvestment in a New Mexico business using income from a net capital gain acquired by the taxpayer in 2015 or thereafter, as long as the reinvestment is made within 24 months after the net capital gain arises. The amount of the credit is the lesser of:

- the tax imposed by the Income Tax Act for the net capital gain and paid by the taxpayer; or
- the cost of the qualified reinvestment.

The phrase “qualified reinvestment”: (a) means a cash, stock or in-kind investment made for equity in a New Mexico business; and (b) includes a qualified reinvestment made through an entity treated as a partnership or disregarded entity for federal income tax purposes of which the taxpayer is a member, partner or other owner.

The purpose of the credit is to encourage the in-state sale and exchange of capital assets and to encourage investment in New Mexico businesses. There is no requirement in the bill to create jobs.

The credit is nontransferable and nonrefundable. The bill also includes provisions on how a taxpayer can become certified as eligible for the credit and how to claim the credit.

FISCAL IMPACT

The capital gain reinvestment tax credit is in addition to the current capital gain deduction from PIT. The current capital gain deduction is limited to the greater of $1 thousand or 50% of the qualified capital gains.

TRD notes, "…as reported in the 2015 Tax Expenditure Report (TER), the net capital gain deduction cost the General Fund over $53.8 million. Tax year 2013 federal and state tax data was used to calculate the fiscal impact. If all of the capital gains reported that year had been reinvested in qualified in-state investments, the bill would have cost the General Fund an additional $63.9 million."

However, in order to claim a reinvestment tax credit, the taxpayer must apply to the Economic Development Department for a certificate of eligibility. The vast bulk of capital gains come from financial transactions, not from the sale of productive assets. Most investors do not have access to qualified in-state investments. Hence, for both of these reasons, the likely amounts of reinvestment in the state is likely to begin at under 10% of the total capital gains received by New Mexico taxpayers.

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

TRD notes, "…this bill implicates policy principles of vertical equity and efficiency. With respect to efficiency, it is designed to stimulate investment in, and thereby growth of, New Mexico businesses. The bill defines "New Mexico business" as any form of business entity that: (1) has its principal place of business, the majority of its full time employees, and the majority of its tangible assets in New Mexico; and (2) has 100 or fewer full-time employees during the taxable year the reinvestment was made and has not had gross revenues exceeding $5 million in any fiscal year ending before the reinvestment was made. In addition to the technical problems with this definition set forth below, some consideration should be given to the universe of businesses that could fall within this definition. Portions of this definition restrict the reinvestment to relatively small businesses. However, businesses have varying degrees of contribution to New Mexico revenues and employment. A small investment partnership, for example, requires few employees and limited plant and equipment. As such, in certain circumstances, this credit could incentivize businesses that contribute little to other state revenue streams. There may also be business structuring strategies that create unintended consequences on this use of the credit. With respect to vertical equity, and based on the demographic information set forth below, the proposed bill lessens tax burdens on income that was, by necessity, already investment income and already subject to deduction."

EDD notes that the fiscal impact of this bill will be the loss of any amounts claimed as capital gains reinvestment tax credits, but should be countered, eventually, by gross receipts on the business's expenditures from the capital investment."

EDD would also like to see a job creation requirement, which would improve the effectiveness of the tax credit. The encouragement of getting new investment dollars into the New Mexico economy from a new source is very promising and could lead to positive growth.

ADMINISTRATIVE & COMPLIANCE IMPACT

Accounting for compliance and eligibility over the period can be complicated; it requires affirmation from the taxpayer that the gain was earned, and certification from EDD to validate eligibility. The EDD's input would be critical here. As part of the certification process, EDD would have to verify that the reinvestment was made in a "New Mexico business," necessitating verification of the principal place of business, annual gross revenue, and employee and asset location.

New forms and instructions will be needed; IT system will need to be updated and properly configured. These are one-time costs incurred after passage of the bill.

The bill does not impact the financial distribution process, but the credit may be subject to the financial disclosure requirements per Governmental Accounting Standards Board (GASB) Statement No.77. GASB 77 disclosure statements are effective for financial statements for periods beginning after December 15, 2015. An assessment of the credit against the tax abatement criteria specified in GASB 77 will need to be performed by TRD. If the credit meets the criteria, then the disclosure is required in TRD's financial statements.

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.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

HB 220 proposes a repeal of the capital gains deduction. HB-79 proposes an increase in the working family tax credit and a simultaneous repeal of the capital gains deduction.

TECHNICAL ISSUES

This bill does not contain a delayed repeal date. LFC staff recommends the inclusion of such a date.

TRD has a number of concerns with the provisions of this bill.

First, there may be risks of US Commerce Clause challenges because the bill applies only to investments in New Mexico businesses.

Second, there are multiple technical issues in the language and mechanics of the bill, as follows:

The bill lacks applicability criteria and an effective date. Consequently, it is not clear when the credit becomes available; the default effective date if passed will be May 18, 2016.

Subsection (A)(1)(b), p. 2, ll. 1-2, which specifies that the reinvestment must be made "no later than twenty-four months after the net capital gain," raises a number of questions. First, does the period start on the date of the transaction resulting in a capital gain, or is it the tax year, or the filing of the income tax return for the tax year, in which the gain was earned?

Subsection (K)(3)(a), p. 5, ll. 17-19, uses a "fiscal year" to measure gross revenues for purposes of defining a New Mexico business. Most businesses, especially relatively small businesses, are reporting on a calendar year basis and calculating gross revenues for the taxable year. As such, the TRD recommends using taxable year to measure the gross revenue threshold.

Finally, there may be a nuanced concern regarding certain types of transactions that may, or may not, qualify for the tax credit. For example, if a small business with revenues less than the prescribed ceiling divests a portion of its business and assets to another business, which business is making the qualifying investment? What portion of the sales proceeds, if any, would be eligible for the credit, if reinvested?

OTHER SUBSTANTIVE ISSUES

TRD notes that if any taxpayer becomes eligible to claim the credit against 2015 income taxes, per page 1, line 25, the 2015 income tax forms, instructions, publications, backend systems and internet filing applications have been completed and are in production. To add a credit to the 2015 personal income taxes would have a high cost to TRD, software vendors, and taxpayers. If no one may claim the credit until 2016, the cost of implementation is absorbed with the annual review of the tax program at no cost.

TRD used state and federal income tax data drawn from federal tax returns information to calculate the fiscal impact. Net capital gains included in adjusted gross income data were examined. The stated purpose of the bill is "…to encourage the in-state sale and exchange of capital assets and to encourage investment in New Mexico businesses." Therefore, taxpayer gross incomes have a material influence on the fiscal impact.

During tax year 2013, 116,770 New Mexico taxpayers claimed net capital gain income totaling approximately $1.6 billion. The top 10.9% income earners accounted for over 66% of the net capital gain income. This group had earnings greater than $200 thousand; however the difference in net capital gain income earned between the top three earner brackets is striking. Taxpayers within the $200 thousand - $500 thousand income bracket earned an average of $31 thousand in net capital gains; within the $500 thousand - $1,000 thousand the average net capital gain was $102 thousand; and those with incomes over $1.0 million earned an average $777 thousand in net capital gains.

In contrast, the bottom 89.1% of wage earners account for less than 34% of net capital gain income; the average gain in this group is $3,000. The largest cohort of net capital gain income earners had adjusted gross incomes of $100 thousand - $200 thousand. This group represents 23.9% of the population set, and accounts for 15.6% of the total net capital gain income earned. In this group, the average net capital gain realized is $9 thousand. Anecdotally, this is the group that is most likely to use and benefit from this tax credit.

This demographic information is significant; the new bill creates a new incentive for taxpayers. The net capital gain deduction is not repealed; this new credit is an additional expense to the General Fund. During FY2013 the net capital gain deduction cost the General Fund over $53.8 million (as reported in the 2015 TER). Working backwards using an average tax rate of 4%, $53.8 million in tax deductions is derived from approximately $1.35 billion in net capital gains income. According to the available federal tax data, approximately $1.6 billion of net capital gains income was earned by New Mexico taxpayers. Because the deduction is not repealed, if this bill was in force in New Mexico during FY2013 it would have cost the General Fund an additional $63.9 million.

The absence of a cap for the net capital gain reinvestment tax credit simplifies the fiscal impact analysis. FY2013 net capital gains data is the baseline; the PIT growth rates from the January 2016 consensus forecast were applied. The credit is applied to the tax imposed by the Income Tax Act for the net capital gain income earned by the taxpayer. An average tax rate of 4% was used. The credit allows the taxpayer to reinvest all net capital gain income on a tax-free basis and use the deduction to further reduce New Mexico tax liability.

ALTERNATIVES

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

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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