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

SPONSOR Maestas Barnes **ORIGINAL DATE** 01/27/16 **LAST UPDATED** 02/05/16 **HB** 184/aHBEC

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

ANALYST Alejandro

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY16	**FY17**	**FY18**	**FY19**	**FY20**		
	($19,670.0)	($20,574.0)	($21,706.0)	($22,748.0)	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY16	FY17	FY18	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	$111.0	$82.0	$82.0	$275.0	Recurring	TRD Operating Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION
LFC Files

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

SUMMARY

Synopsis of HBEC Amendment

The House Business and Employment Committee amendment to House Bill 184 clarifies that the deduction percentages are intended to apply to consecutive $50,000 increments of small business income. This corresponds with increasing employment thresholds for qualified small businesses at higher income levels. In addition, the amendment adds a minimum period of employment into the definition of “full-time equivalent,” and adds a delayed repeal date of December 31, 2025.

Synopsis of Bill

House Bill 184 proposes enacting a new section of the Income Tax Act to include an income tax deduction for small businesses. To qualify, an entity must have its principal place of business in New Mexico, have gross income of $1 million or less, and have a minimum of 1 to 4 full-time equivalent employees, depending on income levels.

Deductions would apply to qualified small business income under $250,000 as follows:

- 50 percent on qualified income of $50,000 or less;
- 40 percent on $50,001 - $100,000;
- 30 percent on $100,001 - $150,000;
- 20 percent on $150,001 - $200,000;
- and 10 percent on $200,001 - $250,000.

The bill also provides definitions of many terms used in the language of the new deduction, and sets income limits at which a taxpayer shall not be eligible for the deduction. For married individuals filing separately, single individuals, and estates and trusts, the taxpayer's base income may not be greater than $250,000, for heads of household, the taxpayer's base income may not be greater than $300,000, and for surviving spouses and married individuals filing jointly, the taxpayer's base income may not be greater than $350,000.

The effective date of this bill is not specified, so it is assumed 90 days following adjournment (May 18, 2016). **Applicable for tax years beginning on or after January 1, 2016.** Since this is a personal income tax deduction, there will be no change to FY 16 revenue because withholding tables will not be affected and, at most, 20% of the fiscal effect of the first year will be realized as decreased estimated tax payments.

FISCAL IMPLICATIONS

House Bill 184 is designed to provide income tax relief to small businesses in New Mexico presumably with the intention that recipients of the deduction would reinvest the money saved into their businesses. The revenue impact of this bill would be significant, however the Economic Development Department suggests that the revenue losses would be offset by the increased business activity and investment that it would create.

According to the Taxation and Revenue Department (TRD) this bill implicates the tax policy principle of efficiency. It provides income tax relief to small business owners and appears to be designed to encourage employment and small business growth through the progressive deduction and employment tiers.

The revenue estimates above were prepared by TRD using a combination of the latest state and federal data to come up with the estimates. Data from IRS 1040 Schedule's C and E was used with the assumption that if a business either paid unemployment wages or workers compensation wages then at least one full-time equivalent employee was employed who is a New Mexico resident. TRD could not verify whether the employment is full-time or part-time. TRD simulated the data as per the description of the bill and applied December 2015 Consensus General Fund personal income growth rates to estimate future expenditures.

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.

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 indicates that the bill would have a moderate administrative impact on that agency as an additional FTE would be required to properly administer this deduction. Additionally, a pre-approval process is advised. Claimants would need to provide extensive information about the taxpayer and business operations to be eligible. A pre-approval process would ensure the Department has time to review the application, thereby avoiding paying interest on any refund. Audit and compliance procedures would need to be developed.

TECHNICAL ISSUES

TRD notes two technical issues with the bill. The first involves the phased-up deduction amounts in Subsection B (p. 2). TRD assumes that the percentages are intended to apply to consecutive $50,000 increments of small business income – i.e. 50 percent for the first $50,000, 40 percent for the second $50,000, etc. This interpretation is necessary to correspond with increasing employment thresholds for qualified small businesses at higher income levels and so that the deduction increases between the income tiers. However, based strictly on the language the tiers could be read to suggest flat rate deduction amounts based on total, rather than incremental amounts of small business income.

The definition of "material participation" (line 15, page 4) could be clarified with respect to subsection "a;" (line 17, page 4). TRD assumes that each test is independent. An "or" could be placed between each test for clarity.

Finally, depending on intent, the bill may want to add a minimum period of employment during the taxable year into the definition of "full-time equivalent" (p. 8, ll. 8-14).

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

OTHER SUBSTANTIVE ISSUES

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

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

According to the Economic Development Department, small business owners will pay income tax amounts that could have been reinvested into their businesses.

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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