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FISCAL IMPACT REPORT

ORIGINAL DATE 1/23/17

SPONSOR Maestas Barnes LAST UPDATED _____ HB 48

SHORT TITLE Small Business Income Tax Deduction SB _____

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY17	FY18	FY19	FY20	FY21		
	(\$19,900.0)	(\$20,200.0)	(\$20,670.0)	(\$21,400.0)	Recurring	General Fund

Parenthesis () indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY18	FY19	FY20	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	\$104.0	\$82.0	\$82.0	\$268.0	Recurring	TRD Admin. Fund

Parenthesis () indicate expenditure decreases

HB 48, Relates to and may Conflict with, SB 50 adjusting PIT rates. HB-76, HB-117, HB-169, HB-201 also amend the personal income tax act.

SOURCES OF INFORMATION

LFC Files

Responses Received From

Taxation and Revenue Department (TRD)

Economic Development (EDD)

SUMMARY

Synopsis of Bill

House Bill 48 creates a new personal income tax deduction to reduce the PIT liability of small business owners in the state.

The bill defines “qualified small business income” as including a sole proprietorship, a partnership, a subchapter S corporation, a limited liability company (LLC) or any other entity that reports income on a federal form 1040 rather than as a regular, subchapter C corporation. This small business entity must have its principal place of business in New Mexico, a gross income for federal purposes of \$1 million or less and employ one full-time equivalent employee for each \$250,000 of federal gross income. The requirement to be considered as a full-time equivalent employee is that the employee or combination of employees work an average of 32 hours per week for a minimum of 26 weeks per year. A taxpayer claiming this new deduction must materially participate in the business and have New Mexico base income (federal AGI excluding net loss carryback) less than \$250,000 if single, \$300,000 if head of household and \$350,000 if married filing joint. The deduction may not reduce a taxpayer’s income tax liability to less than zero. An investor in a small business must actually work in the business for 100 hours a year to be considered as materially participating.

The deduction is fractional based on federal Schedule C (or Schedule E in the case of a partnership or other pass-through entity) income:

Deduction % of small business income:	For
50%	1 st \$50,000 of income
40%	2 nd \$50,000 of income
30%	3 rd \$50,000 of income
20%	4 th \$50,000 of income
10%	5 th \$50,000 of income
0%	Income that exceeds \$250,000

The bill requires the deduction to be separately stated on the PIT return and TRD is required to prepare an annual report and analysis concerning the number of taxpayers claiming this deduction, the tax cost of the deduction and the number of jobs created or retained by the deduction.

There is no effective date of this bill. It is assumed that the effective date is 90 days after this session ends (June 23, 2017). The provisions of the bill are applicable to tax years beginning on or after January 1, 2017. The sunset date of the provisions is for tax years after 2026.

FISCAL IMPLICATIONS

This bill may be counter to the LFC tax policy principles 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 this tax expenditure is difficult. While the LFC has information from the Department of Workforce Solutions on the number of firms that are covered by State and federal unemployment insurance these data do not match well to the amounts and limits expressed in the bill. Because the bill requires separate reporting and a separate annual analytical report to the legislature, tracking the impact of the provisions of this bill will be aided.

The Taxation and Revenue Department (TRD) used a combination of the latest state and federal data to come up with the estimates. Data from IRS 1040 Schedule’s C and E were 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 according to the mechanics of the bill and applied December 2016 Consensus General Fund personal income growth rates to estimate future expenditures.

SIGNIFICANT ISSUES

The purpose of this bill is not clear. It provides tax relief for any small business that employs someone else besides the sole proprietor. However, this provides substantial tax relief for existing small businesses while creating minimal incentive for that business to hire additional employees. It is not clear whether the one full-time employee per \$250,000 in net qualified small business income enhances or lessens either the fiscal impact or the incentive to create jobs. The provisions of the bill do provide a significant incentive for a one-person, sole proprietor firm to take the step of hiring employees. However, TRD may have a somewhat difficult time excluding one-person sole proprietorship firms that do not add employees from claiming the deduction. For establishments that report and pay unemployment insurance and worker's compensation insurance, there is a third party data source, if issues of DWS confidentiality can be solved. TRD does collect the worker's compensation assessment fee, so has an internal database of firms that do have employees.

The provisions of this bill may be somewhat difficult to administer – see discussion later in this report.

This may be a proposal considered by LFC analysts as “buying the base” wherein each new job created by the deduction allowed in the bill may cost the general fund in excess of \$100,000 per new job.

TRD notes that “... the bill discriminates based on owner income as well as business profitability and labor requirements. On matters of vertical equity it excludes taxpayers with higher incomes. It is reasonable to cap the expenditure based on income, but there is a risk that excluding taxpayers with higher incomes from applying the deduction to the qualifying portion of their income creates legal liability for the State.”

TRD further notes that “... tax efficiency requires that taxes be levied in such a way as to minimize market distortions. As written, the bill favors established enterprises operated by a self-employed owner; there is no real incentive to employ others. The bill does create a further incentive to avoid the NM corporate income tax regime by excluding C-Corporations from eligibility.”

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. However, the bill does not establish targets or provide a clearly stated purpose.

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	✘	
Targeted		
Clearly stated purpose	✘	
Long-term goals	✘	
Measurable targets	✘	
Transparent	✔	
Accountable		
Public analysis	✔	
Expiration date	✔	
Effective		
Fulfills stated purpose	✘	
Passes “but for” test	✘	
Efficient	✘	
Key: ✔ Met ✘ Not Met ? Unclear		

ADMINISTRATIVE IMPLICATIONS

TRD reports that it will be challenged to implement this new credit. Forms, instructions, internal software systems, and Taxpayer Access Point will need to be updated at significant cost. A pre-qualification application process is strongly advised requiring the taxpayer to provide substantive evidence of eligibility. One FTE is necessary to properly administer this credit. Failure to properly fund the operational requirements exposes the State to liabilities of interest-due to taxpayers. TRD has a statutory timeframe to process taxpayer returns; if refunds are not processed within the timeframe, then the State owes taxpayers interest on the refund.

TRD has considerable concerns about the provisions of this bill:

“A broadly accepted definition of full-time-equivalent (FTE) employee is 2,080 hours, which is calculated as 8 hours per day times 5 days per week time 52 weeks per year. Under US Small Business Administration (SBA) and Internal Revenue Service (IRS) guidelines, the definition of an FTE is an employee employed on average at least 30 hours of service per week, or 130 hours of service per month, as determined by one of two methods: monthly measurement or look-back. A seasonal worker is one who works 120 days or fewer during a calendar year solely due to seasonality.”

“This bill defines an FTE as (a) one who works an average of 32 hours per week for a minimum of 26 weeks per year or a minimum of 832 hours, or (b) a combination of employees who work minimum of 832 hours. It would be difficult for TRD to verify compliance with this requirement, as the metrics could legitimately be met by employment of seasonal workers.”

“Material participation would be difficult for TRD to verify. Moreover, it would be difficult for the taxpayer to provide substantiating documentation. As written, a taxpayer is not eligible for the credit unless the enterprise has been owned and operated for at least six tax years, subject to additional participation requirements. These elements implicate the principles of accountability and simplicity. Additionally, self-employment meets the eligibility requirements; a taxpayer could take a 30 percent income deduction for simply structuring their business shrewdly. This element implicates the principle of efficiency.”

“While the definition of “qualified small business income” is overly broad, the definition requires that compensation and material participation be correlated. Additionally, the definition of “qualified small business income” is neither consistent with NM definition of allocated income nor apportioned income. The bill’s income definition includes both categories of income; this implicates the principles of equity, efficiency, and simplicity.”

“Another technical issue related to “material participation” is limiting the deduction by percentage of ownership. As written, a company with 10 partners – each with a 10 percent share – are each eligible for 100 percent of the deduction. This is not a behavioral incentive for economic growth. The language should limit the value of the deduction to the equity ownership per partner. “

“Gross income for federal tax purposes” is ambiguous, and could lead the taxpayer to incorrectly interpret the term as “adjusted gross income.” “Principal place of business” is not defined and subject to various interpretations. Moreover, the bill does not require work or services to be performed in New Mexico except to the extent there must be business income for the deduction to offset. This lack of clarity creates adjudication and processing problems for the Department that would result in a further revenue loss to the general fund. “

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

A number of bills this session propose changes to the income tax act. At this point, HB-48, HB-76, HB-117, HB-169, HB-201 and SB-50 have been introduced.

TECHNICAL ISSUES

In tandem with the technical issues of “principal place of business,” the bill may raise potential Commerce Clause problems by giving a deduction based on principal place of business location.

OTHER SUBSTANTIVE ISSUES

Several data sources have been utilized to approximate the fiscal impact of this bill and to determine if the bill establishes any incentives, either to hire new employees or to pay current employees more than at present. First, the 2014 Statistics of Income (Internal Revenue Service data) have been used to approximate the number and average business income for Schedule C and Schedule E filers. The totals reported below eliminate those taxpayers with negative total income.

Singles less than \$250,000 AGI	
Number of business returns	64,348
Amount of net business income	\$503,107
Average net business income	\$7,819
H/H less than \$300,000 AGI	
Number of business returns	24,473
Amount of net business income	\$200,766
Average net business income	\$8,203
MFJ less than \$350,000	
Number of business returns	67,256
Amount of net business income	\$1,164,723
Average net business income	\$17,318

Secondly, data from DWS have been used to determine total receipts and average employees per firm for firms with 0 to 4 employees.

Approximate Averages for Firm Size 0-4	Firms	Employment	Avg Employees per firm	Annual Wages per Employee	Sales per Employee
Construction	3,760	5,090	1.35	\$31,723	\$568,145
Manufacturing	882	1,524	1.73	\$34,577	\$3,341,055
Wholesale Trade	1,960	2,811	1.43	\$62,470	\$3,496,417
Retail Trade	142	294	2.07	\$36,844	\$1,761,675
Transportation & Warehousing	899	1,302	1.45	\$35,140	\$547,089
Information	588	1,037	1.76	\$46,044	\$231,675
Finance and Insurance	1,775	3,053	1.72	\$45,101	\$364,592
Real Estate and Rental/Leasing	1,739	2,673	1.54	\$30,177	\$643,444
Professional and Technical Services	4,929	6,557	1.33	\$52,562	\$574,589

Administration and Waste Management	1,919	2,677	1.39	\$43,123	\$379,594
Educational Services	502	740	1.47	\$37,432	\$418,676
Healthcare & Social Assistance	3,354	5,228	1.56	\$34,944	\$339,596
Arts, Entertainment, Recreation	466	753	1.62	\$26,311	\$452,797
Accommodations & Food Service	1,219	2,232	1.83	\$15,627	\$217,165
Other Services (e Public Admin)	2,850	4,604	1.62	\$26,316	\$383,426
All firms excluding Agriculture, Mining and Utilities	26,984	40,575	1.50	\$38,417	\$778,201

Approximately 27,000 firms appear in the DWS data (for firms with 0 – 4 employees), while 175,000 Schedule C and Schedule E returns are noted in the IRS/SOI data.

From the DWS data, firms with 0-4 employees are 60.3 percent of all firms reporting to DWS, with 8.1 percent of the employees and 7.5 percent of the total wages paid.

The estimate for “Sales per Employee” in the chart above comes from the 2012 Economic Census. The requirement that firms have one full-time equivalent employee for each \$250,000 in net profit may be a constraint on the cost of this bill.

Further analysis may be necessary to understand the incentives established in this bill.

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