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

ORIGINAL DATE 02/28/17
SPONSOR Maestas **LAST UPDATED** **HB** 504

SHORT TITLE Income Tax Changes **SB**

ANALYST Clark

REVENUE (dollars in thousands)

Estimated Revenue*					Recurring or Nonrecurring	Fund Affected
FY17	FY18	FY19	FY20	FY21		
$0	$305,800.0	$311,500.0	$317,900.0	$328,200.0	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases
* A technical issue appears to repeal personal income taxes for tax year 2017. The estimates shown above assume this issue is corrected.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY17	FY18	FY19	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	$0	$105.0	$0	$105.0	Nonrecurring	Taxation and Revenue Department

Parenthesis ( ) indicate expenditure decreases

Conflicts with numerous bills amending personal income taxes

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

House Bill 504 makes significant changes to the Income Tax Act, primarily repealing and replacing Section 7-2-7 NMSA 1978, creating new income brackets and tax rates, effective on or after January 1, 2018. The new income brackets and tax rates are:

For married individuals filing separate returns:

If the taxable income is:	The tax is:
Not over $25,000	4% of taxable income
Over $25,000 but not over $50,000	$1,000 plus 5% of excess over $25,000*
Over $50,000	$2,250 plus 6% of excess over $50,000.

* Corrected – see Fiscal Implications and Technical Issues

For heads of household, surviving spouses, married individuals filing joint returns, single individuals and estates and trusts:

If the taxable income is:	The tax is:
Not over $50,000	4% of taxable income
Over $50,000 but not over $100,000	$2,000 plus 5% of excess over $50,000
Over $100,000	$4,500 plus 6% of excess over $100,000.

The bill also repeals many personal income tax (PIT) deductions, exemptions and credits, and amends several corresponding corporate income tax credits to remove references to the personal income tax credits.

The effective date of the provisions of this bill is January 1, 2017.

FISCAL IMPLICATIONS

The Taxation and Revenue Department (TRD) estimated the fiscal impact of this bill shown in the tables above and provided the following methodology.

TRD used GenTax system taxpayer data to estimate the total amount of new revenue generated by the new income brackets and tax rates. This estimate is exclusive of net operating losses and credits available but not repealed under this bill.

TRD referenced the 2016 Tax Expenditure Report to estimate the revenue gain by repealing the various credits, deductions, and exemptions enumerated. Due to the mechanics employed to estimate the new revenue generated by this bill, the fiscal impact includes these gains. The technical section below explains where the enumerated credits, deductions, and exemptions manifest in a New Mexico personal income tax return, and how the fiscal estimate might be altered.

The following niche tax benefits are repealed by the bill: Section 7-2-18.27 NMSA 1978, cancer treatment trial incentive; Section 7-2-5.9 NMSA 1978, exemption for unreimbursed medical expenses; Section 7-2-18.13 NMSA 1978, credit for unreimbursed medical expenses; and Section 7-2-32 NMSA 1978, deduction for education trust fund contributions. The average gains to the fiscal estimate for each program are approximately zero, $107 thousand, $5.9 million, and $1.1 million, respectively.

The venture capital investment tax credit has been unused. Its repeal does not affect the fiscal estimate.

There is a typographical error on page 13 at line 3 that applies to tax rates to income over $50,000. TRD recognizes this as an accidental conflict, and calculated the tax on income between $25,000 and $50,000 for that filing status.

SIGNIFICANT ISSUES

The increase in the tax rate from 1.7 percent to 4 percent in the lowest bracket represents a substantial increase; however, the resulting effect on lower income taxpayers would be up to ~$100 per year in additional taxes (see note on poverty guidelines below, which could offset this negative impact). The impact for individuals in the next bracket, changing from 3.2 percent to 4 percent, represents an increase of about $170 or less annually. Some taxpayers would see a reduction in tax liability – for example, individuals with more than $16 thousand but less than $50 thousand taxable income would be taxed at 4 percent instead of 4.9 percent. However, once reaching the $50 thousand taxable income mark, the excess taxable income above that amount would be taxed at 5 percent, higher than any tax rate under current law, and the tax rate reaches 6 percent above $100 thousand taxable income.

TRD provided the following analysis.

> The bill implicates the principle of tax equity by creating new income brackets, tax rates, and a new method to calculate New Mexico taxable income. The bill aligns the federal poverty income guidelines to taxable income by allowing taxpayers to deduct an amount equal to the federal poverty income level for a corresponding household size from their adjusted gross income. The result is a larger amount of income exempt from taxation. This benefits lower income taxpayers without penalizing higher income taxpayers.
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> The repeal of Section 7-2-34 NMSA 1978, the net capital gain deduction, removes an incentive for savings and investment for all taxpayers. This deduction is meant to encourage taxpayers to make investments and create wealth through those investments. While the benefit is extended to all New Mexico taxpayers, outcome of the benefit tilts toward the wealthiest taxpayers. The repeal results in a significant tax increase for approximately 96 thousand taxpayers whose incomes are spread across all income brackets. The repeal of the net capital gains deduction will return approximately $42 million to the general fund.

ADMINISTRATIVE IMPLICATIONS

There would be a moderate administrative impact to TRD. Implementation of the new tax regime will require significant updates to forms, instructions, and software systems for internal and external users.

CONFLICT

This bill conflicts with numerous bills amending personal income taxes.

TECHNICAL ISSUES

The bill becomes effective January 1, 2017; however, Section 2 of the bill repeals Section 7-2-7 NMSA 1978, which contains the PIT rates, with a replacement Section 7-2-7 only imposing rates beginning January 1, 2018. The bill needs a separate applicability date for Section 2 of January 1, 2018.

There is a typographical error on page 13 at line 3 that applies to tax rates to income over $50,000 instead of $25,000.

TRD provided the following details of another technical issue.

> The bill creates a potential constitutional concern by repealing economic credits under the PIT regime that are available to corporate income taxpayers who conduct the same activities. In such a situation, legislators would need a rational basis for that different treatment. Owners of partnership, limited liability corporation, S-corporation, or sole proprietorship are taxed under the personal income tax regime. However, due to the repeal of the PIT counterparts of the corporate income tax credits, these taxpayers are penalized for operating a business under something other than a C-corporation structure. That stated, many, but not all of these credit programs are either unused or underused. The most notable exception, however, is the renewable energy production tax credit under Section 7-2-18.18 NMSA 1978, renewable energy production tax credit (REPTC). Another significant consideration is that certain credits are transferable, which may necessitate that the credits remain in the PIT regime.
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> The following tax credits are repealed from the Income Tax Act, creating this issue: Section 7-2-18.5 NMSA 1978, welfare to work; Section 7-2-18.8 NMSA 1978, electronic reader; Section 7-2-18.18 NMSA 1978, (REPTC); Section 7-2-18.19 NMSA 1978, sustainable building; Section 7-2-18.24 NMSA 1978, geothermal heat pump; Section 7-2-18.25 NMSA 1978, advanced energy; Section 7-2-18.26 NMSA 1978, agricultural biomass; Section 7-2-18.28 NMSA 1978, veteran employment.

OTHER SUBSTANTIVE ISSUES

TRD provided the following additional analysis.

> Implementing this bill would have a high impact on the Information Technology Division, approximately 1,500 hours or about 10 months and $105,000 in employee time and effort. This bill makes significant changes to the Income Tax Act, changing the calculation of net income and changes income tax rates. It also repeals many personal income tax deductions, exemptions and credits, and amends several corresponding corporate income tax credits to remove references to the personal income tax credits. Considering the effort and estimated 10 months needed to implement, the effective date of January 1, 2017 and the time it takes for the bill to becomes law, there will not be enough time to implement all the changes by January 1, 2018 for taxable years beginning on or after January 1, 2018.

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

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.

JC/jle