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

SPONSOR HTRC — **ORIGINAL DATE** 2/12/18 — **LAST UPDATED** 2/14/18 — **HB** CS/CS/367/HRCS/HTRCS

SHORT TITLE Income Tax Deductions — **SB**

ANALYST Graeser/Clark

REVENUE (dollars in thousands)

Estimated Revenue*					Recurring or Nonrecurring	Fund Affected
FY18	FY19	FY20	FY21	FY22		
$0.0	Approximately Revenue Neutral	Minimal	$0.0	$0.0	Nonrecurring	General Fund

Parenthesis ( ) indicate expenditure decreases

***Note: The revenue neutral scoring is in relation to the latest revenue forecast; however, if federal tax reform is believed likely to add revenue (possibly tens of millions of dollars) to the next iteration of the consensus revenue forecast in August, this bill would reduce that revenue by roughly $6 million; based on current assumptions, it would still allow the state to receive the majority of the possible revenue from federal tax reform impacts**

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY18	FY19	FY20	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	Unknown				Nonrecurring	Taxation and Revenue Department

Parenthesis ( ) indicate expenditure decreases

Conflicts with CS/SB279/SCORCS
Relates to, Conflicts with, Companion to: a number of other bills adjust personal income tax rates and brackets.

SOURCES OF INFORMATION
LFC Files
TRD Files
IRS Statistics of Income history

SUMMARY

<u>Synopsis of Bill</u>

The House Taxation and Revenue Committee Substitute for the House Rules and Order of Business Committee Substitute for House Bill 367 would give head-of-household personal income tax filers (usually single parents with dependent children) the standard deduction and personal exemption amounts for tax year 2018 (TY 2018) that they were able to take for TY 2017. At the state level, this would result in no change in the tax burden for people in this category who use the standard deduction, all else equal.

This bill targets this particular group of filers, presumably because they are thought to be the most vulnerable or most impacted by the federal tax reform changes. It essentially holds them "harmless" for the current tax year before reverting to current law. This would provide time for research, analysis, and discussions of the impacts over the interim and possible permanent changes during the next legislative session.

For tax years beginning in 2018 and beyond, federal tax reform increased the standard deduction amount for all filers and eliminated the personal exemption (creating a credit to take its place). New Mexico largely conforms to or "piggybacks" off federal personal income tax (PIT) filings, and certain federal changes would lead to automatic taxation changes at the state level.

For these two particular federal changes, the increased standard deduction creates a benefit to the taxpayers but a cost to the state; and the elimination of the personal exemption means the state can no longer piggyback off that provision, creating a cost to the taxpayers but a benefit to the state. This can result in effective tax cuts or tax increases for different groups of individuals, but the people who would be most likely to see tax increases would be those with multiple dependents (e.g. children).

Rather than using the higher standard deduction and eliminated federal personal exemption amounts for TY 2018 for state purposes, the bill would substitute the values for TY 2017 – but only for head-of-household filers. However, the rules for itemizing deductions (including the state and local income tax, or SALT, deduction) would be those for TY 2018 and impacted by the federal tax reform changes.

The table below shows the relevant changes to prior law (TY 2017) made by federal tax reform.

<table>
<tr><th></th><th>Prior Law Deduction</th><th>New Law Deduction</th><th>Current Personal Exemption</th><th>New Personal Exemption</th></tr>
<tr><td>Single</td><td>$6,350</td><td>$12,000</td><td rowspan="5">$4,150 (per exemption)</td><td rowspan="5">$0</td></tr>
<tr><td>MFJ</td><td>$12,700</td><td>$24,000</td></tr>
<tr><td>MFS</td><td></td><td></td></tr>
<tr><td>Head of Household</td><td>$9,350</td><td>$18,000</td></tr>
<tr><td>Surviving Spouse</td><td></td><td></td></tr>
</table>

There is no effective date of this bill. It is assumed that the effective date is 90 days after this session ends or May 16. The bill is self-repealing. The Taxation and Revenue Department (TRD) would implement changes to the withholding tables effective July 1, 2018. It is unknown if state wage withholding tables have been modified to accommodate the changes attributable to federal tax reform effective January 1, 2018.

FISCAL IMPLICATIONS

The approximately revenue neutral impact of this bill is scored against the consensus revenue estimating group (CREG) mid-session update. However, if CREG were to include federal tax reform impacts in the August 2018 estimate, this bill would reduce the revenues by roughly $6 million while allowing a significant portion of the presumed positive impact to flow through into the revenue estimate. Given the recent Institute for Taxation and Economic Policy (ITEP) and TRD estimates, this bill could still allow the state to receive the majority of the tens of millions of dollars it might get absent any change in state law.

The consensus revenue estimating group did not include the impact of federal tax reform in the mid-session revenue update, because no complete, detailed analysis was available to estimate the impact on state tax revenues.

The three principal changes made by the federal tax reform that are applicable to New Mexico personal income tax revenues are to repeal the current personal exemption amounts, roughly double the standard deduction, and change the rules for itemizing deductions. It is difficult to translate these federal tax impacts into state tax impacts. Preliminary LFC modeling indicates a likely positive impact to the general fund, but it is important to note this analysis is preliminary and does not represent an official estimate of the state tax revenue impact from federal tax reform. The analysis does not capture all of the possible impacts on individual taxpayer liabilities in the state, and limitations exist on data available even to TRD regarding some impacts.

ITEP estimated a $44 million increase in New Mexico revenues. TRD statements early in the legislative session indicated the impacts could largely offset each other and the final impact may be revenue neutral, but additional analysis recently led TRD to produce estimates in the same ballpark as the ITEP projection. More analysis is needed by economists and tax professionals, and it is possible (because of the data limitations) that the impact will continue to be uncertain for some time.

SIGNIFICANT ISSUES

For the previous major federal tax reforms enacted in 1986 under President Reagan, the changes in personal exemption and standard deduction amounts were only a portion of the overall story. Many exemptions, deductions and credits were repealed. On balance, New Mexico gained far more from the repeal of deductions than it lost from the changes in personal exemption and standard deduction amounts. In what was perhaps an excess of caution, New Mexico decoupled from the feds for personal exemptions and standard deductions in favor of state-specific amounts. It was not until 1991 that the state recoupled to the federal scheme as part of the mini-tax reform occasioned by the Burns v. Michigan and Davis v. New Mexico lawsuits that forced the state to treat federal retirees equitably with state retirees. And with this fix, the state was able to recouple.

ADMINISTRATIVE IMPLICATIONS

TRD will have to change withholding tables in July whether this approach is adopted or not. The real efforts will be in designing the forms and implementing the IT changes for the changes created by the federal tax reform. Partial decoupling, as suggested in this bill, might be more difficult than continuing with existing paradigm.

OTHER SUBSTANTIVE ISSUES

There are a number of features of the federal tax reform package that may affect New Mexico's personal income tax liabilities. The following is a partial list of potential impacts:

1. SALT (not changed by this bill): taxpayers may deduct state and local taxes up to $10 thousand. May not deduct sales taxes. Homeowners who itemize their deductions can deduct the interest paid on up to $1 million of their mortgage principal.

2. Bill allows pass-through business owners to deduct a portion of their business income. This is a tax calculation, not a true deduction, so it will not affect state liabilities.

3. Taxpayers with large medical deductions currently can deduct the cost of out-of-pocket medical expenses if the total cost exceeds 10 percent of the taxpayer's AGI. The new law would lower the floor for deductible expenses to 7.5 percent of AGI, but only in 2018 and 2019. It reverts to 10 percent in 2020.

4. 50 percent AGI limit on cash contributions to public charities would be increased to 60 percent. Taxpayers cannot deduct any portion of purchase of college athletic tickets. The amount deductible for volunteer mileage would be adjusted for inflation from the current $0.14/mile.

5. Sets a limitation on charitable contributions for very high income taxpayers.

6. Sec 5002: research must have findings publicly available to remain exempt from UBIT.

7. Change in child tax credit. Currently $1,000 per child, but aggregate amount is phased out as AGI increases. The child tax credit is refundable equal to 15 percent of earned income over $3,000. Proposal to increase to $1,600 and a new $300 for non-child dependents. $300 "family flexibility" credit for individual that isn't a child or dependent. Credits will be phased out based on income thresholds, but marriage penalty eliminated. This has no effect on New Mexico liability.

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