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

SPONSOR Campos **ORIGINAL DATE** 02/16/21 **LAST UPDATED** **HB**

SHORT TITLE Exempt Social Security from Income Tax **SB** 162

ANALYST Iglesias

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY21	FY22	FY23	FY24	FY25		
	($77,000.0)	($81,000.0)	($84,000.0)	($88,000.0)	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

FY21	FY22	FY23	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
$10.3	-	-	$10.3	Nonrecurring	TRD – IT General Fund

Parenthesis ( ) indicate expenditure decreases

Similar to HB49, SB78, and SB208

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Aging and Long Term Services Department (ALSD)

SUMMARY

Synopsis of Bill

Senate Bill 162 creates a new section of the income tax act to allow an individual to claim an exemption in the amount of social security income not to exceed $30 thousand on net income included in adjusted gross income. An individual that claims an exemption pursuant to this section shall not claim the exemption for persons 65 and older or blind.

There is no effective date of this bill. It is assumed that the effective date is 90 days following adjournment of the Legislature.

FISCAL IMPLICATIONS

The Taxation and Revenue Department (TRD) estimated the impact with base year 2017 microdata for New Mexico Personal Income Tax (PIT) taxpayers. To scale social security benefits to tax year 2021, TRD increased the 2017 social security income by the actual cost-of-living-adjustments (COLA) in the last four calendar years, and by a net population increase given the rate of individuals reaching social security eligible age and death rates. For fiscal years 2023 through 2025, the estimate was increased by the average COLA increase over the last five years and by the U.S. Census estimated population growth of individuals aged 65 and older. TRD's estimate of the exemption impact applies the threshold level up to $30 thousand of taxable social security benefits included in adjusted gross income. TRD also assumed that taxpayers would select the exemption, either this new exemption, or the exemption pursuant to Section 7-2-5.2 NMSA 1978, which decreased their tax liability the most.

TRD's estimate based on microdata includes both resident filers and 'B' filers. 'B' filers file a PIT-B for New Mexico allocation and apportionment of income. TRD notes the following important information about pension, annuity and social security benefits which are reported on line 3 of the form; if the filer is a non-resident, the taxpayer is to enter zero, as these benefits are prohibited from being allocated to New Mexico per federal law. If the filer is a part-year resident, first-year or full-time resident, then their taxable social security benefits are apportioned as per Section 7-2-11 NMSA 1978. TRD's estimate of the impact accounts for the apportionment of income for 'B' filers.

In general, 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. In this case, the amount of taxable social security is not reported directly to TRD. If this bill passes and is implemented, the annual cost cannot be determined exactly, because the federally taxable social security amount will be reported to TRD as an exemption and not a credit. TRD will have to recalculate all returns claiming this deduction/exemption (See Technical Issues).

This bill creates a tax expenditure with a cost that is somewhat difficult to determine because the data on which the model is based are indirect. LFC has concerns about the risk to state revenues from tax expenditures and the increase in revenue volatility from erosion of the revenue base.
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.

SIGNIFICANT ISSUES

This bill narrows the personal income tax (PIT) base, which appears counter to the base-broadening efforts over the last few years to reform New Mexico's tax systems. This proposal would likely reduce the income elasticity of the personal income tax, negating the improvements to income elasticity embedded in PIT tax changes passes last year (Laws, 2019, Chapter 270, House Bill 6).

States that tax social security benefits broadly fall into four categories: (1) states that fully exempt social security benefits from their state income tax; (2) states that tax social security benefits the same way in which the federal government taxes them; (3) states that base benefit

exemptions on certain factors such as age or income; and (4) states that do not tax income at all. Thirteen states tax social security benefits to some extent (see Appendix B). New Mexico is one of three states that follow the federal rules for including a portion of social security benefits as part of taxable income, and the state also provides a deduction for persons over age 65 to help offset the tax on social security benefits.

At the federal level, if the taxpayer's adjusted gross income (AGI) including half of social security benefits totals less than $32 thousand for married couples filing jointly or $25 thousand for single filers, none of the benefit amount is included in gross income. Accordingly, none of it is subject to federal income tax or state income tax. For AGI including half of social security benefits that exceeds $44 thousand for married joint and $34 thousand for single, then 50 percent to 85 percent of social security income is taxable.

The Aging and Long-Term Services Deparment points out that seniors with adjusted gross income level less than two to three times the poverty standard, do not pay taxes and will see no impact from this bill. However, seniors and adults with disabilities who receive social security and have additional income sources, putting them into a taxable income bracket, will be affected by this bill. In addition, those seniors and adults with disabilities who live in assisted living facilities may be potentially impacted by this bill, as approximately 67 percent of assisted living residents pay for their stay with private funds. Approximately 23 percent of assisted living residents pay for their stay from a need based income source (14 percent from Supplemental Social Security Income and 9 percent from Medicaid).[1]

See the *Other Significant Issues* section of this FIR for additional discussion.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is not met since TRD is not required in the bill to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the exemption and other information to determine whether the exemption is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

TRD will need to make information system changes and create new publications, forms and regulations. These changes will be incorporated into annual tax year implementation and represents $10,328 in workload costs.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

This bill is similar to House Bill 49, Senate Bill 78, and Senate Bill 208, which each seek to exempt social security income from personal income tax to varying degrees.

TECHNICAL ISSUES

This bill does not contain a delayed repeal date. LFC recommends adding a delayed repeal date.

[1] https://www.nmhca.org/faq-facts/

OTHER SUBSTANTIVE ISSUES

New Mexico began taxing social security benefits in 1990. The action in was contained in an omnibus bill enacted in response to the "Davis v. Michigan" and "Burns v. New Mexico" problems. At that time, state retiree's pensions were 100 percent exempt from personal income tax, but federal retirees only were allowed a $3,000 deduction. The US Supreme Court found that this differential treatment was in violation of federal law ensuring that state and federal workers must be treated equally and equitably. Per the Supreme Court opinion, retiree income was covered by the federal statute. In the relevant bill, New Mexico repealed both the federal and state differential deductions. In addition, other source-specific deductions were included in the fix. These included the total exemption for social security income.

Reducing or eliminating income tax on social security benefits is often viewed as a mechanism for attracting or retaining retirees in the state. A 2018 publication by New Mexico State University included the following discussion:[2]

> "Because New Mexico is listed as one of the "10 Least Tax Friendly" states for retirees (Kiplinger, 2017), additional research should be conducted on the impacts of reducing or eliminating taxes on retirement. However, it should be noted that while tax friendliness is often listed as a top criteria on "best places to retire" lists, other research has shown that tax policy changes have done nothing to attract retirees (Conway and Rork, 2012)."

Other factors – such as weather, cost of living (particularly cost of housing), and the location of family members – also affect migration decisions for retirees. A 2001 study published in the National Tax Journal found that, "in addition to cost-of-living and climate considerations, the elderly are attracted to state that exempt food from sales taxes and spend less on welfare. Low personal income and death taxes also encourage migration, depending on how these states taxes are measured."[3]

New Mexico has a tax exemption for persons over 65 and blind; however, the exemption is modest, costing the state an estimated $1.1 million in 2017, with 93,470 claims, according to the most recent TRD Tax Expenditure report. Analysis by LFC staff finds this may be a low estimate in cost, but an accurate estimate in terms of number of individuals assisted. The current benefit amounts and bracket levels were established in 1987 and have not been adjusted since. In that 34-year period, CPI-U inflation has increased 141 percent. Updating both the levels and the brackets by only 50 percent would cost the general fund on the order of $15 million and would target the benefits to lower-income elderly and blind individuals.

TRD points out that PIT represents a consistent source of revenue for many states. While this revenue source is susceptible to economic downturns, it is also positively responsive to economic expansions. New Mexico is one of 42 states along with the District of Columbia, that impose a broad-based PIT. The PIT is an important tax policy tool that has the potential to further both, horizontal equity by ensuring the same statutes apply to all taxpayers, and vertical equity by

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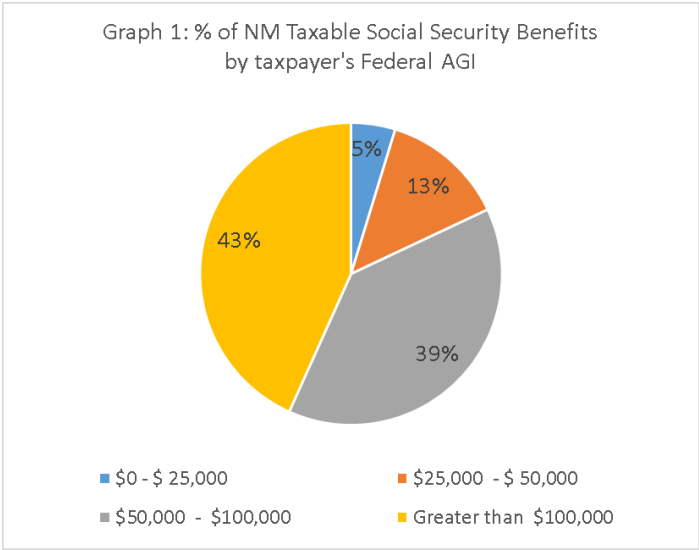
[2] *Potential Fiscal Impacts of a New Mexico Retiree Attraction Campaign*, December 2018 https://aces.nmsu.edu/pubs/_circulars/CR691.pdf

[3] Houtenville, Andrew & Conway, Karen. (2001). *Elderly Migration and State Fiscal Policy: Evidence from the 1990 Census Migration Flows*. National Tax Journal. 54. 10.17310/ntj.2001.1.05.

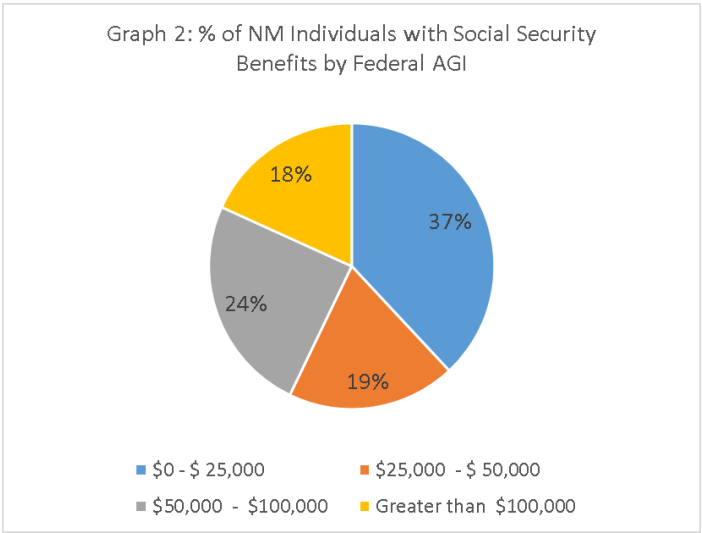
ensuring the tax burden is based on taxpayer's ability to pay.

New Mexico statutes for state personal income tax are linked to the federal tax code. This is also termed "conformity." As the federal tax code changes, such as under the 2017 Tax Cuts and Jobs Act (TCJA), states see impacts on their revenue collection from PIT, depending on their level of conformity. New Mexico's level of conformity is currently high, given that PIT starts with federal adjusted gross income (AGI), applies federal standard deductions, and uses Internal Revenue Service (IRS) definitions such as the definition for "dependents". With that conformity, New Mexico's treatment of social security benefits follows the federal application.

TRD notes that, since 1984, a portion of Social Security benefits have been subject to federal income taxes. The taxable portion is dependent on the level of the taxpayer's combined income, which includes 50 percent of the Social Security benefits, plus income from other sources, including interest on tax exempt bonds. Because the combined income thresholds for taxation of benefits have remained unchanged since they were introduced in 1984 and 1993, but wages have increased over the years, the proportion of beneficiaries paying tax on their benefits has risen over time.

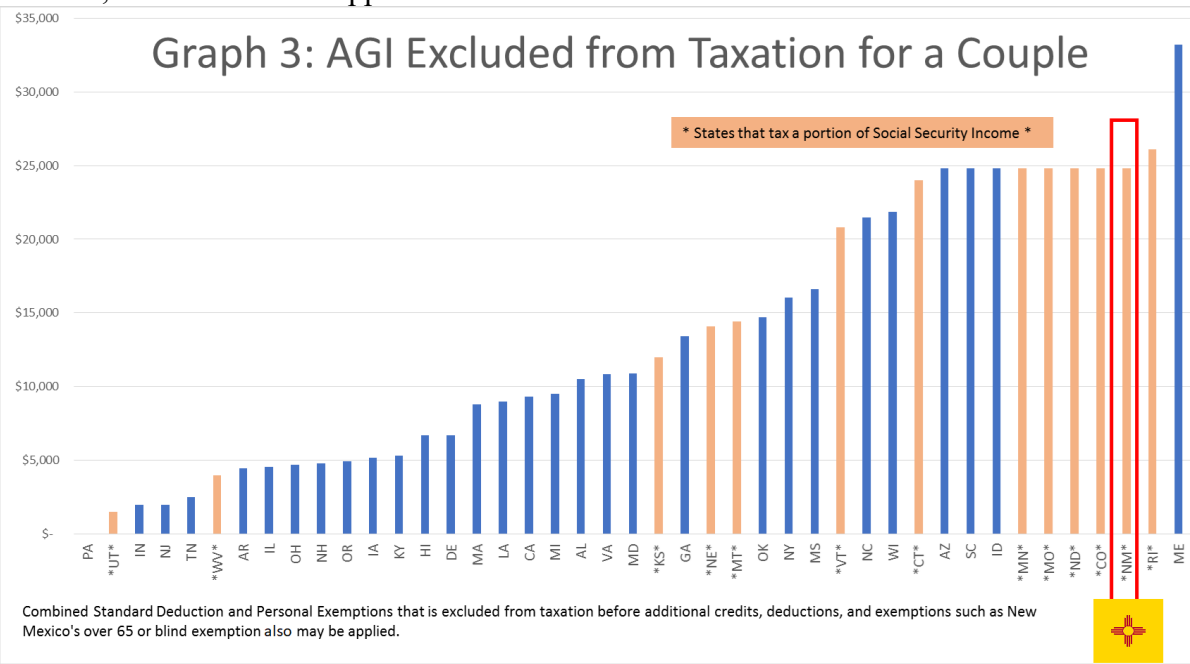


TRD further notes that New Mexico's taxable PIT base for social security benefits is reasonably stable, and a major portion of social security income is earned by relatively high-income individuals who do not depend solely on social security benefits for their income, and who have other sources of income as well. This is illustrated in Graph 1: 82 percent of taxable social security benefits are earned by individuals with AGI over $50 thousand. In contrast, Graph 2 above illustrates that taxpayers with AGI over $50 thousand represent only 42 percent of all taxpayers. While any taxpayer with social security benefits may apply for this exemption, most of the financial benefit of this credit will be realized by higher earning individuals as indicated in Graph 1 above.



Thirteen states, including New Mexico, tax some portion of social security benefit income. However, those 13 states tend to have a higher threshold at which PIT takes effect. This essentially means that low income individuals' income tax liability is generally lower in the benefits-taxing states, regardless of the source of their income. Graph 3 below compares the income level at which each state's initial income tax rate takes effect for a married couple. New Mexico, along with four other states that tax social security benefits, has the third highest income level ($24,800) at which a couple's

income may begin to be taxed. At the other end, while Pennsylvania does not tax social security benefits, its income tax is applicable to most non-zero income.



New Mexico's current PIT exemption for persons 65 and older or blind is targeted at those with lower AGI. This new proposed social security benefits PIT exemption would have no AGI restrictions, and an individual claiming exemption under this proposal will no longer be eligible to claim the current exemption for persons 65 and older or blind. TRD states low-income taxpayers tend to have lower taxable social security benefits included in their federal AGI due to federal tax statutes. At the state level, these same taxpayers are eligible for other credits and rebates such as the low-income comprehensive tax rebate (LICTR), leaving them with little or no tax liability under current law.

With the adoption of this bill, New Mexico would join most of the states that do not tax social security benefits at all. Excluding types of retirement income from the taxable base is seen as eroding horizontal equity in state income taxes. However, TRD states that by excluding income based on age, taxpayers in similar economic circumstances are no longer treated equally, with older taxpayers receiving a benefit not available to younger taxpayers at the same level of income.

Taxing social security benefits raises issues of double taxation because employee payroll tax contributions to social security are not deductible from the employee's income when determining their tax liability in the year the contribution is made. So, employee contributions are taxed, and it is argued that taxing social security benefits when they are paid out will entail taxing the same contribution again. However, TRD notes that social security benefits are a result of not just employee contributions, but also employer contributions. Employer contributions are deductible for the employer in the year the contribution is made. So, employer contributions are not taxed.

Because employees pay half of the payroll tax, and their payroll tax contributions were already included in taxable income for earlier years, at most 50 percent of the benefits should be excluded from future taxation. Social security benefits withdrawals for most workers, however, exceed their lifetime contribution. Goss (1993) estimated that the payroll tax contributions of

current and future workers would equal less than 15 percent of the present value of their lifetime benefits[4]. Therefore, if the ratio of lifetime contributions to benefits is less than 15 percent, then up to 85 percent of benefit income can be taxed without risk of double taxation

There are many other reasons why states may exempt some income for those over 65, such as lessening the economic burdens for individuals on fixed incomes and trying to attract retirees to the state. As Graphs 1 through 3 illustrate though, the consideration of exempting social security and eroding horizontal equity must be placed in context of the federal and state tax structure, in its entirety.

As far as attracting more retirees to the state is concerned, TRD states exempting social security from income taxation may not necessarily help in achieving that goal. For example, Texas does not tax any income, social security or otherwise, at all. Yet, the state features as one of the least tax friendly states for retirees in the country because of its high property and sales taxes[5]. Notably, New Mexico's property taxes are amongst the lowest in the nation. It is, therefore, necessary to take a holistic look at New Mexico's tax code, and attempts should be made to make the tax structure more simple, broad based, and equitable, without being punitive to any segment of the population.

ALTERNATIVES

If the intent of the bill is to provide support for lower income earners with social security benefits, a more targeted approach may be to expand the existing exemptions for persons aged 65 and older (Section 7-2-5.2) or for low- and middle-income taxpayers (Section 7-2-5.8).

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

[4] Goss, Stephen C. 1993. "Current Approach and Basis for Considering a Change to 85-Percent Taxation of Monthly OASDI Benefits." Letter to Harry C. Ballantyne, Chief Actuary, Social Security Administration.

[5] https://www.kiplinger.com/kiplinger-tools/retirement/t055-s001-state-by-state-guide-to-taxes-on-retirees/index.php?state_id=44#

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	✓	The issue was discussed in 2019 at the Revenue Stabilization and Tax Policy Committee prior to the 2020 Legislative Session, but without endorsement.
Targeted Clearly stated purpose Long-term goals Measurable targets	 ✗ ✗ ✗	No purpose, targets or goals established.
Transparent	?	TRD will likely publish a cost estimate in its annual Tax Expenditure Report; however, no specific reporting on this exemption to interim committees is required.
Accountable Public analysis Expiration date	 ✗ ✗	 The bill contains no provisions for reporting. The bill does not include an expiration date.
Effective Fulfills stated purpose Passes "but for" test	 ? ?	Without a purpose statement or required reporting, it is not possible to determine if the exemption fulfills intended outcomes.
Efficient	✗	Without a purpose statement or required reporting, it is not possible to determine if the exemption is the most efficient means of achieving desired outcomes. However, current data and recent studies indicate this exemption would be inefficient in providing tax relief to low-income households receiving social security benefits and may not be a meaningful recruitment tool for retirees to the state.
Key: ✓ Met ✗ Not Met ? Unclear		

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