FISCAL IMPACT REPORT

SPONSOR Burt **ORIGINAL DATE** 2/07/21
LAST UPDATED **HB**

SHORT TITLE Tax Deduction for Uniformed Retirees **SB** 259

ANALYST Graeser

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY21	FY22	FY23	FY24	FY25		
		(4,600.0)	(9,200.0)	(13,600.0)	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
Total		$5.2	--	$5.2	Nonrecurring	ITD – Staff workload***

Parenthesis ( ) indicate expenditure decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Veteran's Service Department

SUMMARY

Synopsis of Senate Bill 259

Senate Bill 259 adds a deduction for uniformed services retirees to the Income Tax Act. This deduction would be available for former members of the U.S. Army, Navy, Air Force, Marine Corps, and Coast Guard, and the commissioned officer corps of the National Oceanic and Atmospheric Administration. The deduction applies to uniformed services retirees who qualified either by years of service or disability to separate from the military service with lifetime benefits.

The deduction allowed is

- January 1, 2022, and prior to January 1, 2023: 25 percent not to exceed $6,250;
- January 1, 2023, and prior to January 1, 2024, 50 percent not to exceed $12.5 thousand;
- January 1, 2024, and prior to January 1, 2025, 75 percent not to exceed $18.75 thousand; and

- Starting January 1, 2025, 100 percent not to exceed $25 thousand.

The purpose of the deduction is to encourage uniformed services retirees to make New Mexico their state of residency. This bill calls for the deduction to be separately reported and for the Taxation and Revenue Department (TRD) to present an annual report to the Revenue Stabilization and Tax Policy Committee and the Legislative Finance Committee, so that the state can determine the efficacy of the deduction in achieving the stated goals of the legislation.

The effective date of this bill is not stated. It is assumed the effective date is 90 days after this session ends (June 18, 2021). The provisions of this act apply to taxable years beginning on or after January 1, 2022.

FISCAL IMPLICATIONS

This bill creates a tax expenditure with a cost that is difficult to determine but likely significant. LFC has serious concerns about the significant risk to state revenues from tax expenditures and the increase in revenue volatility from erosion of the revenue base. The bill's provisions adhere to the LFC tax expenditure policy principles for establishing clear goals and annual reporting on whether the tax expenditure is achieving its purpose.

TRD explains the methodology used for the estimated revenue impact:

> Two sources of data were analyzed to arrive at an estimated revenue impact. The first data source is the Department of Defense (DOD), annual *Statistical Report on the Military Retirement System* for federal fiscal year ended September 20, 2019. The second data source was a sample of New Mexico military retiree state income tax returns for tax year 2018. The analysis takes into account the new 5.9% marginal tax rate effective for Tax Year 2021.
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> The *Statistical Report on the Military Retirement System* provides an aggregate number of retirees and survivor beneficiaries by state and an aggregate amount of benefits distributed. As of September 30, 2019, New Mexico had 20,946 reported retirees and 2,770 survivor beneficiaries. Aggregate annual distribution of military retirement benefits was approximately $604 million. This analysis assumes all such retirees were qualified by years of service or disability to receive lifetime benefits.
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> The sample of military retiree returns was used to establish an average personal income tax (PIT) decrease per retiree and survivor beneficiary based on the bill's stepwise percentage deductions of 25% in Tax Year 2022, 50% in Tax Year 2023 and 75% in Tax Year 2024. (The 100% deduction falls outside of the fiscal year impact period but is estimated at $14.2 million for FY26. Maintaining the same assumptions, the impact grows annually at approximately 4%) Retiree annuities were increased by a cost-of-living adjustment, which for most retirees per the DOD report is based on the Urban Wage Earner and Clerical Worker Consumer Price Index (CPI-W). All other taxable income reported on the returns was kept flat. Subtracting the calculated deduction amount, a new taxable income was calculated and the PIT rates applied to determine the new PIT due. An average PIT decrease per each year was calculated with the sample of 15,000 returns.
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> It is assumed that the sample of approximately 15,000 military retiree returns is representative of the approximately 23,700 total reported retirees and survivors. The average

PIT decrease per year was multiplied by the 23,700 retirees. It is assumed that the net immigration and emigration of military retirees into the state per year is zero, which is supported by historical retiree numbers in the last three years from the *Statistical Report on the Military Retirement System*. The estimate also assumes that net new retirees and deceased retirees per year is zero. To the extent the legislation has its intended effect of causing more military retirees to move to New Mexico, the fiscal impact will be larger. Thus, the analysis assumes a constant 23,700 returns per year are eligible for the deduction. Finally, the analysis assumes 100% of qualifying retirees will claim the deduction in the first year of eligibility.

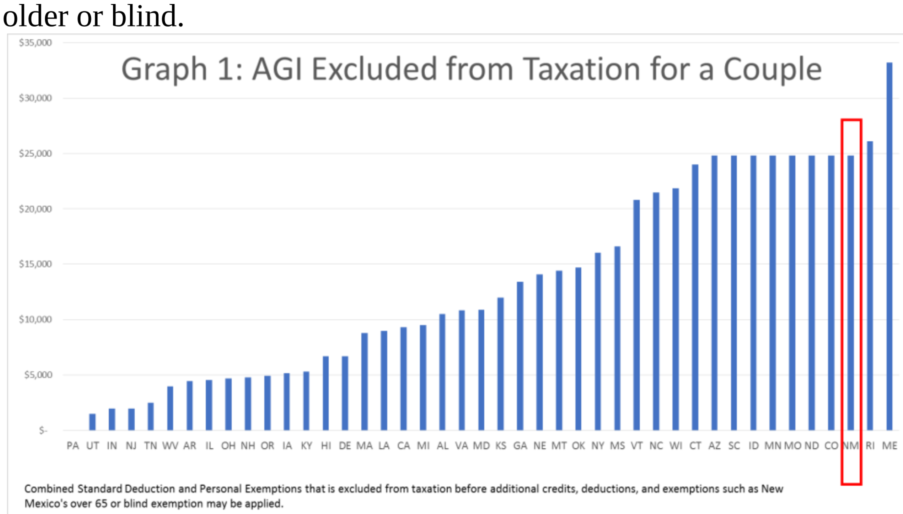
SIGNIFICANT ISSUES

TRD discusses policy issues:

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

Excluding types of income, including retirement income, from the taxable base is seen as eroding horizontal equity in state income taxes. By excluding income based on age and profession, taxpayers in similar economic circumstances are no longer treated equally, in the instant case resulting in older taxpayers receiving a benefit not available to younger taxpayers at the same level of income.

Graph 1 below compares the income level at which each state's initial income tax rate takes effect for a married couple. New Mexico, along with seven other states, has the third highest income level ($24,800 for tax year 2020) at which a couple's income may begin to be taxed. At the other end, Pennsylvania's income tax is applicable to most non-zero income. So, while New Mexico taxes retirement income, including for military retirees, the state does not begin to tax a couple's income until the $24,800 threshold for tax year 2020 and $25,100 for tax year 2021. New Mexico also provides PIT exemptions to low-income individuals that are 65 years and older or blind.



There are many reasons why states may exclude some income for retirees, such as lessening the economic burdens for individuals on fixed incomes and trying to attract retirees to the state. Military retirees, in particular, may be skilled workers who have retired from a first career in the military but seek a second career in civilian service. As Graph 1 illustrates though, the consideration of such exclusions and eroding horizontal equity must be placed in context of the federal and state tax structure, in its entirety.

In addition, exempting retirement income from income taxation may not necessarily help attract more military retirees. For example, Texas does not tax any income, social security or otherwise, 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[1]. Notably, New Mexico's property taxes are among 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.

VSD noted the following:

> There was a 2009 study conducted by NMSU Arrowhead Center that concluded that https://arrowheadcenter.nmsu.edu/wp-content/uploads/sites/40/2015/06/rmsp.pdf New Mexico is already well suited for military retirees. The proposed exemption in [SB259] of retirement pay from the personal income tax would provide one more reason for retired military service personnel (RMSP) to retire to the state. While [total taxes] do influence the decision on where to retire, taxes rates are not the only determinant. New Mexico is an attractive retirement location for RMSP and other retirees. The significant number of military installations, the level of medical services, environmental amenities and pleasant weather indicate that New Mexico will continue to attract significant numbers of RMSP.

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 will need to change information system and create new publications, forms, and regulations. These changes will be incorporated into annual tax year implementation and represents $5,164 in staff workload costs to the Information Technology Division (ITD).

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Similar to SB169, HB249 from the 2020 regular legislative session, and duplicates SB330 from the 2019 regular legislative session.

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

TECHNICAL ISSUES

This bill does not contain a delayed repeal date. Adding a delayed repeal date, perhaps in 2030. would allow evaluation of the bill and its purposed of attracting military retirees would be encouraged to retire in New Mexico and advance the economic well-being of the state by applying their skills in the economy.

TRD has two technical points that may need addressing:

> It is not clear if "uniformed services retiree" includes veterans who receive compensation and pension benefits from the Veterans Administration. Further, it is not clear if military retirement income includes non-taxable compensation due to a military related disability. The inclusion or exclusion is important; in general, disability benefits are not taxable, and thus would not be included in the tax base. Thus, some veterans would be granted an opportunity to "double dip" by reducing their taxable income by an increment that was never included in the base.
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> This bill does not outline how TRD would verify the information to determine eligibility for the deductions. TRD will have to draft regulations to outline what information will need to be submitted with the return to verify this deduction. This deduction would most likely be added to the PIT-ADJ form, which is the schedule of additions, deductions and exemptions from the federal adjusted gross income. [LFC note: VSD has indicated a willingness to certify military pensions and other eligibility criteria.]

An often-overlooked uniform service is the Indian Health Service. Not all doctors and other professionals elect the uniformed side of HIS, but many do.

OTHER SUBSTANTIVE ISSUES

TRD points out the following:

> The revenue impact is based on the current income tax rates in Section 7-2-7 NMSA 1978. Several bills in the 2021 legislative session are proposing changes to the tax rates. If the current bill to exempt uniformed services retirement benefits income and the tax rate changes go into law, the revenue impacts for each respective bill would be different and would need to be reassessed.

Military retirees' age varies considerably, with some retirees in their early 40s. It is likely then that these individuals will qualify for the proposed deduction while still earning wages in New Mexico.

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