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

SPONSOR Pope

ORIGINAL DATE 02/15/21
LAST UPDATED

HB

SHORT TITLE Military Retirement Pay Tax Exemption

SB 277

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY21	**FY22**	**FY23**	**FY24**	**FY25**		
	($19,400.0)	($19,600.0)	($19,800.0)	($20,400.0)	Recurring	General Fund (PIT)

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	General Fund

Parenthesis ( ) indicate expenditure decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 277 creates an exemption of $30 thousand from the Income Tax Act for armed forces retirees who have served in the armed forces of the United States who has qualified by years of service or disability to separate from military services with lifetime benefits.

There is no effective date of this bill. It is assumed that 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, 2021.

FISCAL IMPLICATIONS

TRD describes the methodology for 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 percent 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 maximum $30 thousand exemption. 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 exemption 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 thousand returns.
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> It is assumed that the sample of approximately 15 thousand military retiree returns is representative of the approximately 23.7 thousand total reported retirees and survivors. The average PIT decrease per year was multiplied by the 23.7 thousand 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 causes more military retirees to move to New Mexico, the fiscal impact will be larger. Thus, the analysis assumes a constant 23.7 thousand returns per year are eligible for the deduction. Finally, the analysis assumes 100 percent of qualifying retirees will claim the deduction in the first year of eligibility.

This bill creates a tax expenditure with a cost that is 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. 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

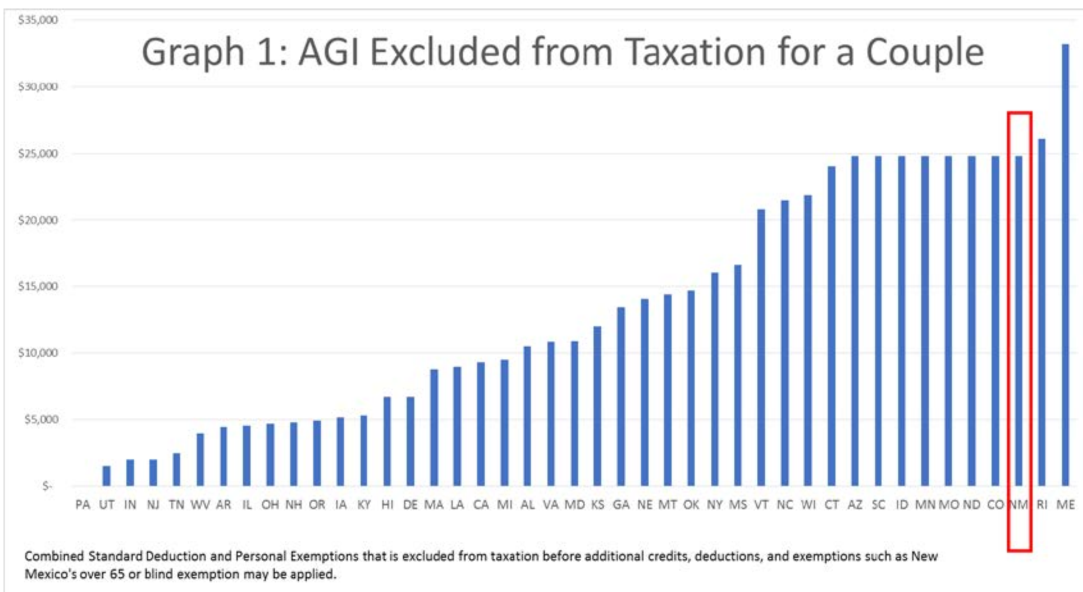
TRD describes the tax policies involved in the provision:

> 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 taxpayer's ability to pay.

Excluding types of retirement income from the taxable base is seen as eroding horizontal equity in state income taxes. By excluding income based on retirement status and profession, 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.

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 ($24.8 thousand) 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 $24.8 thousand threshold for tax year 2020. New Mexico also provides PIT exemptions to low-income individuals that are 65 years and older or blind.



Combined Standard Deduction and Personal Exemptions that is excluded from taxation before additional credits, deductions, and exemptions such as New Mexico's over 65 or blind exemption may be applied.

There are many reasons why states may exempt some income for retirees, such as lessening the economic burdens for individuals on fixed incomes and trying to attract retirees to the state. 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.

As far as attracting more retirees to the state is concerned, exempting retirement income 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[1]. 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.

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

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 deduction is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

TRD notes the following administrative issue:

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 $5,164 in workload costs.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

SB259 provides a property tax exemption for disabled military veterans and proposes a four-year ramp-up such that starting January 1, 2025, the veterans retirement pay exemption would be 100 percent not to exceed $25 thousand.
SJR16 proposes an increase in property tax exemption from $4 thousand to $10 thousand a year. HJR3 is a duplicate of SJR16.

TECHNICAL ISSUES

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

TRD notes two technical issues:

> The term armed forces might need further clarification to determine who qualifies as a military retiree. According to U.S. Code, Title 10, Chapter 1 – definitions, there is a distinction between armed forces and uniformed services. “Armed forces” means the Army, Navy, Air Force, Marine Corps, Space Force, and Coast Guard. It does not include the commissioned corps of the National Oceanic and Atmospheric Administration or the commissioned corps of the Public Health Service, both of which are part of the uniformed services.
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> This bill does not outline how TRD would verify the information to determine eligibility for the exemption. TRD may have to draft regulations to outline what information will need to be submitted with the return to verify this exemption. This exemption would most likely be added to the PIT-ADJ form, schedule of additions, deductions and exemptions.

OTHER SUBSTANTIVE ISSUES

TRD notes another substantive issue:

> 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, especially for taxpayers with higher taxable income. If the current bill to exempt armed forces retirement benefits income and the tax rate changes go into law, the revenue impacts for each respective bill would be significantly different and would need to be reassessed.

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

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

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