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

		ORIGINAL DATE	1/27/2022		
SPONSOR	Cadena	**LAST UPDATED**	2/08/2022	**HB**	102/aHTRC
SHORT TITLE	Entity-Level Tax Income and Payment			**SB**	
				ANALYST	Faubion

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY22	**FY23**	**FY24**	**FY25**	**FY26**		
-	Indeterminate but positive	Indeterminate but positive	Indeterminate but positive	Indeterminate but positive	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

FY22	FY23	FY24	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
--	$15.5	--	$15.5	Nonrecurring	TRD/ITD - General Fund
--	$60.0	$60.0	$120.0	Recurring	TRD/RPD (FTE) – General Fund
--	$1.0	$1.0	$2.0	Recurring	TRD/RPD (Phone line) – General Fund
--	$3.0		$3.0	Nonrecurring	TRD/RPD (Equipment) – General Fund

Parenthesis ( ) indicate expenditure decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Office of the Attorney General (NMAG)
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of HTRC Amendment

The House Taxation and Revenue Committee amendment to House Bill 102 (HB102) inserts language to clarify that pass-through entities electing to pay the entity-level tax can file their tax return by the original or extended due date of their federal tax return.

Synopsis of Original Bill

House Bill 102 adds new sections to the Income Tax Act ("ITA"), the Corporate Income and Franchise Tax Act ("CIFTA"), and the Oil and Gas Proceeds and Pass-Through Entity Withholding Tax Act ("OGPPEWTA").

In Sections 1 and 2, the bill seeks to add a new section to the ITA and CIFTA that would allow the net income subject to the entity-level tax to be exempt from personal and corporate income tax.

In Section 3, the bill seeks to add new material to the OGPEWTA to allow a pass-through entity to annually elect to pay an income tax at the entity level for a taxable year and describes how entities who make this election must notify TRD, when to file the return, what income the entity-level tax is to be imposed upon and the rate, and how to calculate distributed net income of a pass-through entity.

The provisions in this bill apply to taxable years beginning on or after January 1, 2022.

FISCAL IMPLICATIONS

A major component of the 2017 Tax Cuts and Jobs Act (TCJA) was the $10 thousand limit on the amount of state and local taxes (SALT cap) an individual may deduct for regular federal income tax purposes. Currently, individual owners of pass-through entities (PTEs) report their proportionate share of business income on their individual income tax returns and are subject to the $10 thousand annual limit for state and local income taxes paid. These PTEs include S-corporations, partnerships, limited partnerships, limited liability partnerships (LLPs), and limited liability companies (LLCs).

The bill provides a way for pass-through entities to avoid the effect of the SALT cap by allowing direct taxation at the entity level under the proposed entity-level tax, instead of taxing the individual to whom the income is otherwise passed through under the Income Tax Act or the Corporate Income Tax Act. Under the proposed bill, pass-through entity taxpayers can elect to pay state income taxes at the entity-level rather than on the personal income tax returns of the individual partners and owners. They can then deduct the full amount of the entity-level tax from their federal income taxes. The state entity-level tax works because the SALT cap is applicable for only individual income tax purposes and does not apply to pass-through entities.

TRD notes that because TCJA increased the standard deduction, the number of taxpayers with pass-through entity withholdings that itemized their deductions declined. In tax years 2016 and 2017, prior to TCJA, 91 percent of taxpayers with pass-through entity withholdings itemized their deductions. However, after TCJA went into effect, tax years 2018 onwards, about only 65 percent of such taxpayers itemized their deductions. It is likely that with the passage of this bill, some of the taxpayers that moved from itemized to standard deductions will elect to pay the entity-level tax. This will allow them to decrease their federal tax liabilities while holding state tax liabilities the same or slightly higher.

Generally, the same or a slightly greater amount of income taxes are collected by the state through the entity-level tax as through personal income taxes. The entity-level tax is imposed at the higher of either the highest corporate income tax rate or the highest personal income tax rate. Currently, both of the maximum rates are set at 5.9 percent. Entities that opt in to paying the entity-level in lieu of income taxes are still required to pay estimated payments at whichever highest rate applies, currently 5.9 percent.

SIGNIFICANT ISSUES

Since the TCJA's passing, 19 states have passed a pass-through entity-level tax election to provide income tax relief for individuals. The IRS disallowed many of the state workarounds that have been proposed but approved the pass-through entity-level tax election with the release of Notice 2020-75.

TRD notes that the SALT cap mainly impacts high-income individuals, so the benefits of this legislation will mostly accrue to wealthier New Mexico taxpayers who derive a significant portion of their income from pass-through entities. Over 91 percent of taxpayers with pass-through entity withholdings between 2016-2019 belonged to the top PIT bracket. Because the top PIT bracket effective tax year 2021 has shifted from incomes over $16 thousand (singles) and $24 thousand (married or heads of households) to incomes over $210 thousand and $315 thousand, the proportion of taxpayers with pass-through entity withholdings that are in the top bracket is estimated to be around 55 percent.

TRD also notes that while this bill impacts state income taxes, the benefit will accrue from federal tax liability decreases that are significantly more than the potential state income liability increases. The federal deduction limitation is more prominent for states such as New York or California, which have very high-income tax rates and a much higher proportion of wealthier tax payers compared to New Mexico. Due to a much lower income tax rate and a very small proportion of high-income tax payers, this legislation will benefit a very small fraction of New Mexico taxpayers.

Estimating the up-take and impacts of tax elections is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. The statutory criteria for a tax election may be ambiguous, further complicating the initial cost estimate of the expenditure's fiscal impact. Once a tax election has been approved, information constraints continue to create challenges in tracking the real participation and impacts.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is <u>not</u> met since TRD is <u>not</u> required in the bill to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the election and other information to determine whether the election 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 $15,492 in workload costs for the Information Technology Department (ITD).

The Revenue and Processing Division (RPD) of TRD estimates a full-time employee (FTE) at a cost of $60 thousand will be needed to complete necessary review of reported adjustments and allocation figures for CIT and pass-through entities.

TECHNICAL ISSUES

Other states that have implemented optional or elective pass-through entity taxes in response to the TCJA limitation have also placed a limitation on the election only for tax years when the federal TCJA limitation remains in effect. TRD recommends that a similar limitation be placed on each section of this bill.

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

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.

LFC Tax Expenditure Policy Principle	**Met?**	**Comments**
Vetted	?	There was a presentation on this bill to HTRC in September 2021, but no action was taken.
Targeted		
Clearly stated purpose	✘	
Long-term goals	✘	
Measurable targets	✘	
Transparent	?	
Accountable		
Public analysis	?	
Expiration date	✘	
Effective		
Fulfills stated purpose	?	
Passes "but for" test	?	
Efficient	?	
Key: ✓ Met ✘ Not Met ? Unclear		

JF/al/acv