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FISCAL IMPACT REPORT

		LAST UPDATED	2/14/24
SPONSOR	Tallman	**ORIGINAL DATE**	1/30/24
SHORT TITLE	Public Employee Retirement Income Tax	**BILL NUMBER**	Senate Bill 114/aSTBTC
		ANALYST	Graeser

REVENUE*
(dollars in thousands)

Type	FY24	FY25	FY26	FY27	FY28	Recurring or Nonrecurring	Fund Affected
TRD/PIT		($10,000.0)	($9,600.0)	($9,300.0)	($9,000.0)	Recurring	General Fund

Parentheses ( ) indicate revenue decreases.
** See Substantive Issues for discussion of impact of this proposal on federal retirees.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT*
(dollars in thousands)

Agency/Program	FY24	FY25	FY26	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
TRD	$12.2			$12.2	Nonrecurring	General Fund

Parentheses ( ) indicate expenditure decreases.
*Amounts reflect most recent analysis of this legislation.

Sources of Information

LFC Files

Agency Analysis Received From
Taxation and Revenue Department (TRD)
Educational Retirement Board (ERB)
Public Employees Retirement Association (PERA)
New Mexico Attorney General (NMAG)

SUMMARY

Synopsis of STBTC amendment to Senate Bill 114

Senate Taxation, Business and Transportation Committee amendment to Senate Bill 114 adds federal retirees to the social security income tax exemption, so that all state and federal retirees who were exempt from deductions for FICA when they were working for the state or federal government are granted an income-limited 100 percent exemption for their pension income.

Synopsis of Senate Bill 114

Senate Bill 114 (SB114) would extend the state income tax exemption for social security income found in Section 7-2-5.14 NMSA 1978 to some public employee retirement income.

The exemption is related to retirement income from employment from a state, a political subdivision of state, an instrumentality of state, or political subdivision of state and was exempt, pursuant to section 3121(b)(7) for the federal Social Security Act and/or for an individual for which an agreement pursuant to Section 218 of the Social Security Act has not been entered into to extend social security benefits.

The exemption is 100 percent of the public employment pension limited by adjusted gross income. To qualify, the retiree's adjusted gross income must not exceed: $75 thousand for married individuals filing separate returns; $150 thousand for heads of household, surviving spouses, and married individuals filing joint returns; and $100 thousand for single individuals. This bill does not contain an effective date and, as a result, would go into effect 90 days after the Legislature adjourns, or May 15, 2024, if enacted. Provisions of the bill are applicable to tax years beginning January 1, 2024.

FISCAL IMPLICATIONS

TRD has estimated the impact of this exemption pursuant to the amendment which addresses the technical issue in the original bill.

> The Taxation and Revenue Department estimated the number of state and local government workers that are not covered by social security (non-covered) using data from the Congressional Research Service's analysis of social security coverage of state and local government employees[1] and estimated that 9.6 percent of New Mexico public employees are not covered by social security.
>
> The number of New Mexico taxpayers that receive public employee retirement income attributable to wages earned in another state's pension system is not available. Therefore, it is assumed that the tax base in this analysis includes taxpayers that receive public employee retirement income attributable to wages earned in New Mexico. Tax & Rev also assumes this includes all recipients of public employee retirement income attributable to wages such as child, survivor, disabled, and volunteer firefighter (VFF) recipients.
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> The Census Bureau's Annual Survey of Public Pensions reports the number of beneficiaries of public pensions by state[2]. The number of public pension beneficiaries in New Mexico from 2019 to 2022 grew by 2.7 percent.
>
> Tax & Rev used data provided by Public Employees Retirement Association (PERA) of New Mexico[3] and the New Mexico Educational Retirement Board[4] (ERB) to estimate the average public pension in New Mexico from FY2018 to FY2022. Both associations cover approximately

[1] https://crsreports.congress.gov
[2] www.census.gov/programs-surveys/
[3] www.nmpera.org/financial-overview/
[4] www.erb.nm.gov/annual-reports/

94 percent of the total number of public pension beneficiaries in New Mexico over the same time frame.

Federal workers hired before 1984 were covered by the Civil Service Retirement System (CSRS) which did not contribute to social security. In 1984, federal workers began contributing to social security in the Federal Employees Retirement System (FERS)[5]. As of 2023, 98 percent of federal workers and 50 percent of federal retiree income were covered by FERS leaving 50 percent of retirees eligible for this bill. To estimate the number of federal retirement beneficiaries that do not receive social security, Tax & Rev used the Congressional Research Services' Federal Employees' Retirement System: Summary of Recent Trends from FY2016 to FY2022 to estimate the number and annual income of federal retirees in New Mexico and surviving spouses[6]. The number of federal retirees and spouses that do not receive social security has fallen 10 percent since FY2016. This is due to fewer federal retirees contributing to CSCR.

Using 2022 New Mexico resident tax returns, Tax & Rev calculated the effective tax rate and the proportion of taxpayers that fall into the income categories and filing status specified in the bill.

This bill creates or expands a tax expenditure with a cost that is difficult to determine but likely significant. LFC has serious concerns about the substantial risk to state revenues from tax expenditures and the increase in revenue volatility from erosion of the revenue base.

SIGNIFICANT ISSUES

The New Mexico Attorney General identified a possible legal pitfall of the provisions of the original bill. This legal problem was resolved with STBTC amendment by including federal retirees in the exemption. However, the NMAG's analysis is of interest and is included in the OTHER SUBSTANTIVE ISSUES section.

TRD comments on tax policy aspects of the provisions of this bill:

Personal income tax (PIT) represents a consistent source of revenue for many states. For New Mexico, PIT is approximately 25 percent of the state's recurring general fund revenue. While this revenue source is susceptible to economic downturns, it is also responsive to economic expansions. New Mexico is one of 41 states, along with the District of Columbia, which impose a broad-based PIT. Like several states, New Mexico computes its income tax based on the federal definition of taxable income and ties to other statutes in the federal tax code. This is referred to as "conformity" to the federal tax code. The PIT is an important tax policy tool with 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.

This bill is designed to ease the tax burden on low and middle-income individuals who earn non-covered public retirement income. Low and middle-income taxpayers tend to have lower taxable retirement benefits. 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.

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[5] Benefits Planner: Retirement | Social Security Benefits for Federal Workers | SSA

6 https://www.opm.gov/retirement-center/fers-information/

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. The consideration of such exclusions and eroding horizontal equity must be placed in context of the federal and state tax structure in its entirety. This is critical when encouraging retirees to reside in New Mexico using a non-covered public employee retirement income exemption.

Exempting certain public employee retirement income from taxation may not necessarily be meaningful if the goal of this exemption is to recruit to or retain retirees in New Mexico. First, the number of retirees with non-covered public employee pensions is small. This includes teachers, state and municipal police, and firefighters. Second, some states do not have an income tax or do not tax pension income. Neighboring Texas, for example, does have an income tax but is considered one of the least tax friendly states for retirees because of its high property and sales taxes[7]. 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.

The bill supports horizontal equity, as New Mexico will not tax either retirement income or Social Security income as those two incomes are described in the bill and up to a certain amount of adjusted gross income on a Federal Form 1040. If a taxpayer's reported income exceeds the limit in Section (B), none of the retirement income or Social Security income of the taxpayer may be exempted from income tax.

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 exemption and other information to determine whether the exemption is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

TRD will make information system changes and update forms, instructions, publications. These changes will be included in annual tax year modifications. This bill will have a low impact on Tax & Rev's Information Technology Department (ITD), approximately 220 hours or about 1 month for an estimated staff workload cost of $12,210.

LFC notes it may be difficult for TRD to verify qualification for the exemption. The exemption will be claimed on a subsidiary return listing deviations from federal taxable income. However, the declaration will not require proof that the pensioner was not covered by Social Security deductions for the duration of the employee's tenure as a state, local, or federal employee.

TECHNICAL ISSUES

TRD recommends specifying if all recipients of public employee retirement income attributable

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

to wages are eligible including child, survivor, those disabled, and VFF for clarification as long as the pensioner was not covered by social security.

The amendment resolved NMAG's suggestion to include pension income of qualifying federal employees in §7-2-5.14(C)(1)(a) NMSA 1978.

It will be tempting for many state and federal pension recipients to claim exemption pursuant to the provisions of this bill, whether they were covered by Social Security or not. Some exempt state, local and federal pensioners may also qualify for Social Security benefits from employment in covered employment.

OTHER SUBSTANTIVE ISSUES

NMAG noted the following on the original bill:

> Prior to March 1, 1990, retirement benefits paid to state retirees were generally exempt from state income tax. However, retirement benefits paid to federal retirees were not tax exempt. The United States Supreme Court, in *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 109 S.Ct. 1500, 103 L.Ed.2d 891 (1989), found this disparate treatment of federal retirees violated the intergovernmental tax immunity doctrine and 4 U.S.C. § 111 (1994) (prohibiting discriminatory tax treatment of federal employees). The New Mexico legislature, addressing the violation of the intergovernmental tax immunity doctrine, passed Senate Bill 310, S 310, 39th Leg., 2d Sess., 1990 N.M.Laws, ch. 49, repealing the longstanding tax exemptions for state retirement benefits. This repeal led, in turn, to litigation from former state employees. *See Pierce v. State*, 1996-NMSC-001, ¶ 2, 121 N.M. 212, 910 P.2d 288.
>
> If this bill exempts state retirement benefits from income tax while continuing to tax the retirement benefits of federal retirees, it could be considered a violation of the intergovernmental tax immunity doctrine and 4 U.S.C. § 111 (1994). Any special treatment of state employee retirement benefits without equal treatment for federal employee retirement benefits will likely run afoul of *Davis v. Michigan*. Perhaps a broadening of the definition of "certain public employees retirement income" could help avoid this legal conflict? One option could be the inclusion of the federal government in § 7-2-5.14(C)(1)(a).

LFC staff assisted James P. O'Neill, assistant secretary for tax policy at TRD in 1990 and has provided the following reminiscence.

In the 1980s, New Mexico provided a free ride for pensions of state and local retirees and provided only a $3,000 exemption for federal retirees, including federal military pensioners. Mr. Burns, a federal retiree, sued New Mexico on the same grounds as the Davis case. In response, TRD designed a bill that eliminated all source-based exemptions then in statute: military retirement, social security, state, and federal pensions. However, state retirees resisted this change, and the result was the birth of the retiree healthcare scheme. There were three sources of funding for the RHC scheme: (1) modest employee contributions during the whole of the employees' period of employment; (2) probably a modest match by agencies; and (3) a general fund distribution to the retiree healthcare fund equal to the amount that all state retirees paid on the increased taxable income. The 1990 fix persisted until 2021, when we untaxed military pensions for a period of time and mostly untaxed Social Security.

A sidenote on exempt federal pension:

Workers in the Public Sector[8]

When the Social Security program began, local and state employees were usually already paying in to government pension plans and so they were not taxed again for Social Security.

These days, most public employees have Social Security coverage — and thus pay into the system out of their paychecks — but there are still a few exceptions. These include public workers who participate in a government pension plan comparable to Social Security.

In addition, federal workers, including members of Congress, who have been serving consistently since before 1984 are covered under another retirement plan, so they're also exempt from Social Security taxes.

In assessing all tax legislation, LFC staff considers whether the proposal is aligned with committee-adopted tax policy principles. Those five principles:

- **Adequacy**: Revenue should be adequate to fund needed government services.
- **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
- **Equity**: Different taxpayers should be treated fairly.
- **Simplicity**: Collection should be simple and easily understood.
- **Accountability**: Preferences should be easy to monitor and evaluate.

In addition, staff reviews whether the bill meets principles specific to tax expenditures. Those policies and how this bill addresses those issues:

Tax Expenditure Policy Principle	Met?	Comments
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.	✘	Not vetted; considering the potential problem with some federal retirees, should be discussed in the interim.
Targeted: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.		Implicit purpose is fairness.
Clearly stated purpose	✘	
Long-term goals	✘	
Measurable targets	✘	
Transparent: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies	✘	TRD will be incapable of accurately verifying qualification for the exemption, although will report claimed utilization.
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.		TRD will be incapable of accurately verifying qualification for the exemption. The exemption would be permanent.
Public analysis	✘	
Expiration date	✘	

[8] https://smartasset.com/retirement/exempt-from-social-security-taxes

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. Fulfills stated purpose Passes "but for" test	 ✗ ?	
Efficient: The tax expenditure is the most cost-effective way to achieve the desired results.	?	
Key: ✓ Met ✗ Not Met ? Unclear		

LG/al/ne/ss/ne