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

SPONSOR Stewart

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HB 270/aHTRC

SHORT TITLE Add Back Certain Tax Deductions

SB

ANALYST Clifford

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY10	FY11	FY12		
$5,300.0	$94,700.0	$64,800.0	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of HTRC amendment

House Taxation and Revenue Committee Amendment (HB270). Under present federal law, taxpayers are required to add to their gross income the amount of any refund they have received for state and local taxes that were included in their itemized deductions. This practice is needed to insure that the deduction is not overstated and is based only on actual taxes paid net of any refunds of excess payments. The amendment would require that taxpayers subtract any such refund amounts for purposes of computing New Mexico taxable income. This amendment is needed as a complement to the bill's other provisions which require the taxpayer to add back their state and local taxes itemized deductions. If the taxes were never allowed as a deduction in the first place, the taxpayer should not be required to add refunds of those taxes back to their income.

Synopsis of Original Bill

House Bill 270 amends the definition of "net income" in the Income Tax Act to subtract the amount of state and local taxes from the taxpayer's itemized deductions. The result is that state and local taxes will be added back into net income for the purposes of determining tax liability. Provisions are applicable to tax years beginning on or after January 1, 2010.

FISCAL IMPLICATIONS

According to TRD, the revenue estimate was derived using 2007 federal tax return data for New Mexico households published by the IRS Statistics of Income (SOI) Division. Taxpayers' itemized deductions were reduced by the estimated portion attributable to state and local taxes. In addition, taxpayers' gross income was reduced by estimated state and local income tax refunds. The revised values were then run through the Department's tax year simulation model and then increased to 2010 levels using the personal income growth forecast. In general, tax year liability changes were converted to fiscal year revenue estimates by applying historical payment patterns to tax year liabilities. In fiscal year 2010 the only adjustment made by taxpayers would be a partial adjustment to estimated payments.

SIGNIFICANT ISSUES

New Mexico currently allows the same itemized deductions as allowed for federal income tax purposes, including the deduction for state and local taxes. Deductible taxes include income taxes, property taxes and, under certain circumstances, sales taxes. The federal deduction can be justified as a way of cost-sharing for the cost of state and local government services. The justification for allowing the same deduction for state income tax purposes is less clear. The following table illustrates the itemized deductions claimed by New Mexico residents in tax year 2007. Roughly one-third of the total was for real estate taxes. Since these are primarily local government revenue, the cost-sharing argument would apply to this portion. In other words, by allowing this deduction, the state is effectively absorbing a portion of the costs of local government services. This rationale does not apply to the income tax portion of the deduction, however, because that revenue is exclusively state revenue. Thus, allowing the deduction merely reduces the effective rate of state income tax for taxpayers who itemize. This policy provides ease of compliance for taxpayers, but one consequence is a reduction in the effective income tax rate for households that itemize deductions relative to households that do not itemize. As the table also illustrates, in general, households are more likely to itemize deductions the higher their income level.

Individual Income and Tax Data, New Mexico Residents, Tax Year 2007
[Money amounts are in thousands of dollars]

Item	All returns	Size of adjusted gross income				
		Under $50,000	$50,000 under $75,000	$75,000 under $100,000	$100,000 under $200,000	$200,000 or more
	(1)	(2)	(3)	(4)	(5)	(6)
State and local income taxes: Number of returns	207,393	54,936	46,715	37,643	51,673	16,426
Total Dollar Amount Deducted	935,622	71,067	103,884	120,150	279,450	361,068
Share of returns	100%	8%	11%	13%	30%	39%
State and local general sales tax: Number of Returns	37,089	24,822	6,373	2,762	2,393	739
Total Dollar Amount Deducted	55,082	24,814	10,652	6,338	8,120	5,158
Share of returns	100%	45%	19%	12%	15%	9%
Real estate taxes: Number of Returns	217,740	67,239	46,666	36,950	50,762	16,123
Total Dollar Amount Deducted	396,587	89,958	67,944	61,059	111,254	66,373
Share of returns	100%	23%	17%	15%	28%	17%
Total State & Local Taxes paid: Number of Returns	249,409	83,784	53,575	40,623	54,228	17,199
Total Dollar Amount Deducted	1,415,561	193,243	187,891	191,579	404,467	438,381
Share of returns	100%	14%	13%	14%	29%	31%

Source: I.R.S. Statistics of Income Division.

Only five other states – Arizona, Hawaii, Oklahoma, Rhode Island and Vermont -- follow federal provisions that allow either state and local income taxes or state and local sales taxes to be claimed as itemized deductions. However, 11 states that do not allow deductions for state and local income taxes do permit deductions for sales taxes that were deducted for federal tax purposes – Delaware, Iowa, Kansas, Maryland, Missouri, Montana, Nebraska, New York, North Dakota, Utah, and Virginia.

ALTERNATIVES

Under current federal law, a new limitation on total itemized deductions for very high income households will take effect in 2011. In order to treat those households fairly who experience a reduction in their total itemized deductions, the proposal might be modified so that the state and local tax deduction being disallowed is reduced pro rata with the reduced total itemized deductions for federal purposes.

TECHNICAL ISSUES

Because the proposal increases tax obligations in tax year 2010, which is already under way, it does not allow a significant amount of time for taxpayers to adjust their withholding or estimated tax payments, and therefore increases the likelihood that some taxpayers will be penalized for underpayment of estimated taxes. To avoid penalizing these taxpayers, the proposal could add a temporary relaxation to the estimated tax requirements for the 2010 tax year.

DUPLICATES

Senate Bill 25 was a duplicate prior to the HTRC amendment.

TC/mew:mt

The Legislative Finance Committee has adopted the following principles to guide responsible and effective tax policy decisions:

1. ***Adequacy:*** *revenue should be adequate to fund government services.*
2. ***Efficiency:*** *tax base should be as broad as possible to minimize rates and the structure should minimize economic distortion and avoid excessive reliance on any single tax.*
3. ***Equity****: taxes should be fairly applied across similarly situated taxpayers and across taxpayers with different income levels.*
4. ***Simplicity****: taxes should be as simple as possible to encourage compliance and minimize administrative and audit costs.*
5. ***Accountability/Transparency:*** *Deductions, credits and exemptions should be easy to monitor and evaluate and be subject to periodic review.*

More information about the LFC tax policy principles will soon be available on the LFC website at www.nmlegis.gov/lcs/lfc