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## FISCAL IMPACT REPORT



SPONSOR: Robinson DATE TYPED: 12/02/02 HB \_\_\_\_\_

SHORT TITLE: Net Capital Gain Income Tax Deduction SB 11/aSCORC

ANALYST: Neel

### REVENUE

Estimated Revenue		Subsequent Years Impact	Recurring or Non-Rec	Fund Affected
FY02	FY03			
	(4,581.0)		Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

### SOURCES OF INFORMATION

LFC Files  
Taxation and Revenue Department

#### Synopsis of SCORC Amendment

The amendments by SCORC clarify that ownership of a qualifying business is not restricted to natural individuals

### SUMMARY

#### Synopsis of Original Bill

This bill provides a 100 percent capital gains deduction for net capital gain income from sale of a closely held business. To qualify for the deduction a taxpayer must sell the entire interest in the business or the business must effectively sell all of its assets to an entity in which the taxpayer possesses no equity interest. Under the proposed measure, a "closely held business" is a business operated as a sole proprietorship, or by a legal entity whose equity interests are owned by 75 or fewer people. "Equity interest" is defined in the measure as equity of a legal entity, including capital stock of a corporation, interests of a general or limited partner in a partnership, or interest of a member of a limited liability company.

## **FISCAL IMPLICATIONS**

The estimate assumes New Mexico realized net capital gains will total \$1.75 billion annually, and that of this amount, 3.4 percent or \$59.5 million will result from the sale of closely held businesses. The \$59.5 million figure multiplied by an assumed tax rate of 7.7 percent results in the \$4.58 million amount shown above. Annual gains from the value of businesses tend to vary widely on an annual basis.

## **TECHNICAL ISSUES**

The measure defines a closely held business as one which is operated by a legal entity that is owned by 75 or fewer individuals. The Internal Revenue Code's definition of Chapter S corporations now allows estates, certain trusts and non-profits to be shareholders. In addition, some small businesses are not eligible for Subchapter S statute because of the amount of passive investment income they earn. Rather than set a difficult to administer standard, the measure should simply define a closely held business to be an LLC, partnership or "Chapter S corporation with 75 or fewer members corporation as that term is defined in the Internal Revenue Code. This would probably improve administration and compliance.

## **OTHER SUBSTANTIVE ISSUES**

TRD notes that the proposed legislation may be held unconstitutional since it favors in-state residents over out-of-state residents and thus may violate the Privileges and Immunities Clause of the U.S. Constitution and the Equal Protection clause of the U.S. Constitution. If the bill was amended to allow a capital gain deduction regardless of whether the gain was allocated to New Mexico or not, the bill would probably be constitutional. As the bill is written, a resident with \$75,000 of taxable income consisting of \$50,000 in wages and \$25,000 in capital gains would have net taxable income totaling \$50,000 and a tax obligation of \$2,876. A non-resident with \$50,000 in wages earned in New Mexico and \$25,000 in capital gains would pay tax of \$3,254.66 (tax of \$4,882 on \$75,000 divided by 66.66 percent).

SN/njw