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FISCAL IMPACT REPORT

SPONSOR: Whitaker DATE TYPED: 02/11/03 HB 148

SHORT TITLE: Capital Gains Income Tax Deduction SB _____

ANALYST: Smith

REVENUE

| Estimated Revenue | | Subsequent Years Impact | Recurring or Non-Rec | Fund Affected |
|-------------------|-----------|----------------------------|-------------------------|------------------|
| FY03 | FY04 | | | |
| | (1,190.0) | (2,380.0) | Recurring | General Fund |
| | | | | |

(Parenthesis () Indicate Revenue Decreases)

SOURCES OF INFORMATION

Responses Received From

TRD

SUMMARY

Synopsis of Bill

House Bill 148 provides a personal income tax deduction for net capital gain income from the sale of a closely held business. To qualify for the deduction, a taxpayer must sell (1) their entire interest in the business in a transaction in which substantially all of the equity interests are sold, or (2) the business must effectively sell all of its assets. "Closely held business" is defined as a business operated as a sole proprietorship or by a legal entity whose equity interests are owned by 75 or fewer people.

The deduction is limited to 50% of the eligible gains in tax year 2003, 75% in tax year 2004 and 100% thereafter. The deduction cannot be claimed if the taxpayer has taken the venture capital credit or to the extent they claim a deduction for capital gains under Section 7-2-34.

The proposal contains a "delayed repeal" provision, effectively sunseting the provisions on January 1, 2011.

FISCAL IMPLICATIONS

The estimate above assumes New Mexico realized net capital gains will total \$1 billion annually, and that of this amount, 3.4 percent or \$34 million will result from the sale of closely held businesses. The 3.4% is drawn from I.R.S. data on the share that small business interests represent in the composition of assets in estate tax returns. Multiplying by an average tax rate of 7.0 percent results in the \$2.38 million amount when fully phased in. Annual gains from the value of businesses tend to vary widely from year to year.

TECHNICAL ISSUES

TRD notes that section 7-2-36(B) prohibits a deduction (1) if the taxpayer has claimed the venture capital credit; or (2) *to the extent* a taxpayer has claimed a deduction under 7-2-34. As currently written, this language would limit the deduction allowed under the proposal because the taxpayer has claimed a deduction for some other, unrelated gains. If the intention was, rather, to limit the deductions claimed on the same small business interests, the language should be changed to make this clear.

OTHER SUBSTANTIVE ISSUES

TRD argues that New Mexico includes income from the sale of a closely held business in adjusted gross income and therefore taxes essentially 100 percent of the income. Since some neighboring states have zero state income tax rates, there may be a sizable incentive for small business owners to 1) sell their businesses and, within a short time period, 2) move to another state in which the income is not taxable, thus avoiding paying the tax. The proposed measure is intended to eliminate this incentive. However, since the fully phased-in proposal effectively gives away all of the associated tax, it could be argued that it goes too far in eliminating the disincentive effect. Since taxpayers would face real costs in moving out of state, a lesser deduction may be equally effective in reducing the incentive and retain some portion of the tax base.

SS/njw