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

SPONSOR	Lujan, B.	**ORIGINAL DATE** / **LAST UPDATED**	2/3/07 / 3/22/07	**HB**	436/aHTRC/aSCORC/aSFC
SHORT TITLE	Working Families Tax Credit			**SB**	
				ANALYST	Francis

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY07	**FY08**	**FY09**		
($2,950)	($50,414)	($49,550)	Recurring	General Fund
	(1,400)		Nonrecurring	General Fund
	380	493	Recurring	Local Government

(Parenthesis ( ) Indicate Revenue Decreases)

Relates to SB482, SB317, HB833, HB973

SOURCES OF INFORMATION
LFC Files
Taxation and Revenue Department (TRD)

Responses Received From
Taxation and Revenue Department (TRD)
Department of Finance and Administration (DFA)
Human Services Department (HSD)

SUMMARY

Synopsis of SFC Amendment

The Senate Finance Committee proposes to amend House Bill 436 to add the following provisions:

Disabled Street Vendor Gross Receipts: (duplicates a section of Senate Bill 317) This provision creates a gross receipts tax exemption for the receipts from sale of goods by a disabled street vendor. For the purposes of the provision, a person qualifies as disabled if they are blind, permanently disabled with medical improvement not expected pursuant to 42 USCA 421 for the purposes of the federal Social Security Act, or permanently and totally disabled pursuant to the state Workers' Compensation Act.

A street vendor is defined as a person licensed by a local government to sell tangible personal property by newly setting up a sales site daily or selling from a movable cart, blanket, or other device.

The effective date of these provisions will be July 1, 2007.

Low-income Housing Material Gross Receipts. (duplicates House Bill 833) An expansion of a gross receipts and governmental gross receipts deduction granted in Section 7-9-60 NMSA 1978 to allow receipts from selling construction material or metalliferous mineral ore to a 501(c) (3) organization organized to provide homeownership opportunities to low-income families to be deducted.

The effective date of these provisions is July 1, 2007.

Armed Services Income Tax Exemption: (duplicates a section of Senate Bill 317) The Senate Floor amendment exempts income earned from active duty service from the state personal income tax. The effective date is January 1, 2007 so would apply for tax year 2007.

Middle Income Taxpayer Exemptions. (similar to House Bill 1254) An expansion of the income thresholds for the exemption for middle-income taxpayers.

	Married/Head of		**Single**	
	Begin Phase-out	**Max Income**	**Begin Phase-out**	**Max Income**
Current Law	$ 24,000	$ 40,667	$ 16,000	$ 27,110
HB436 as Amended	**$ 30,000**	**$ 55,000**	**$ 20,000**	**$ 36,667**

The exemption, $2,500 per claimed exemption, remains the same and phases-out at a rate of 20 percent for each additional dollar for married filing separately, 15 percent for singles and 10 percent for married filing jointly and head of household filers.

The exemption would be effective for tax years 2007 and beyond.

Special Needs Adoption Tax Credit/Repeal Exemption. (Similar to House Bill 973) The proposed amendment enacts a new credit against personal income tax liability for taxpayers who adopt a special needs child up to $1,000. The credit is refundable meaning if the credit exceeds liability then the excess is refunded to the taxpayer. The credit can be claimed for each year that the taxpayer claims the special needs child as a dependent on their federal income tax return. The exemption that exists under current law is repealed for these costs.

A special needs adopted child is an individual (who may be over 18 years old) who is certified by the Children Youth and Families Department (CYFD) as meeting the definition of "difficult to place," with the caveat that if the classification is based on a physical or mental impairment or an emotional disturbance that impairment or disturbance shall be at least moderately disabling.

The effective date is January 1, 2007.

Modifying Tax Penalties and Interest. (similar to House Bill 1251) amends provisions relating to penalties and interest for incorrect and late tax payments.

- repeals the "double local option" penalty imposed for misreporting the food and medical services deductions and creates a tax credit for taxpayers who paid that penalty between January 1, 2005 and July 1, 2007. The amount of the credit equal to the entire amount of penalty paid. The credit must be claimed by July 1, 2010 and may be claimed against gross receipts tax, compensating tax, or withholding tax. (effective July 1, 2007)
- increases from $10 to $25 the minimum amount that a taxpayer must owe for TRD to assess.
- amend language to replace the current 15 percent interest charged when a taxpayer underpays or overpays taxes with a rate established for individuals pursuant to Section 6621 of the Internal Revenue Code. That section of federal code sets the rate of interest on underpaid taxes at the federal funds rate plus 3 percent, and sets the rate on interest on overpaid taxes as the federal funds rate plus 3 percent or 2 percent if the taxpayer is a corporation.
- allows TRD up to 120 days to process a claim for refund on severance taxes before interest would be earned by a taxpayer. Currently, TRD is allowed up to 60 days to process a refund claim before interest is earned by the taxpayer.
- increases the maximum penalty that may be assessed when a taxpayer fails to pay a tax due to negligence or disregard for TRD rules from 10 to 20 percent of the amount of tax due. The penalty will still be imposed at a rate of 2 percent per month up to the maximum.
- expands the $50 penalty for failing to file an information return on time pursuant to the gasoline tax act to include wholesalers, retailers and rack operators. Currently, that penalty applies only to "taxpayers."

The effective date of these provisions will be January 1, 2008 except as noted above.

<u>Synopsis of SCORC Amendment</u>

The Senate Corporations and Transportation Committee amended House Bill 436 clarifying that only NM residents can claim the credit. The amendment also deletes a section referring to married filing separate filers which was unnecessary as the federal earned income credit excludes this filing category.

<u>Synopsis of HTRC Amendment</u>

The House Taxation and Revenue Committee amended House Bill 436 to make the credit available even if a taxpayer has claimed a low-income comprehensive tax rebate. HTRC also amended the percentage of the federal earned income credit to 8 percent, down from the original 10 percent.

<u>Synopsis of Original Bill</u>

House Bill 436 creates a new personal income tax credit called the "Working Families Tax Credit" (WFTC) that is calculated as 10 percent of the federal Earned Income Credit (EIC). The credit is refundable, meaning if the credit exceeds the taxpayer's liability, the excess is refunded to the taxpayer. HB 436 also amends the low-income comprehensive tax rebate (LICTR) to make a taxpayer ineligible for LICTR if the taxpayer receives the WFTC. HB436 also explicitly excludes credits provided in the Income Tax Act from the calculation of modified gross income.

The effective date is January 1, 2007.

FISCAL IMPLICATIONS

Recurring Revenue Impact

	FY07	FY08	FY09		
Working Families Credit		(29,100)	(30,000)	Recurring	General Fund
Disabled Street Vendor Sales Gross Receipts		*	*	Recurring	General Fund
				Recurring	Local Government
Low-income Housing Material Gross Receipts		(400)	(420)	Recurring	General Fund
		(267)	(280)	Recurring	Local Government
Armed Forces Income Tax Exemption	(2,950)	(11,990)	(10,400)	Recurring	General Fund
Middle Income Taxpayer Exemptions		(10,100)	(10,250)	Recurring	General Fund
Special Needs Adoption Tax Credit/Repeal Exemption		(540)	(540)	Recurring	General Fund
Modifying Tax Penalties and Interest		1,716	2,055	Recurring	General Fund
		647	773	Recurring	Local Government
TOTAL GENERAL FUND	(2,950)	(50,414)	(49,555)	Recurring	General Fund
TOTAL LOCAL GOVERNMENT	0	380	493	Recurring	Local Government

Working Families Tax Credit: Enacting this credit would reduce general fund personal income tax revenue by $29.1 million per tax year based on $360 million in estimated federal EIC. Even though the credit is for tax year 2007, it is assumed that it will be claimed in the filing season in 2008 and so all of the impact is in FY08. In 2004, 199,552 New Mexican taxpayers received the federal EIC and 90 percent of the credits were in excess of liability.

Armed Services Income Tax Exemption: Exempting active duty salaries from personal income tax would result in a $10 million reduction in personal income tax revenues going to the general fund. Since the tax year straddles two fiscal years, the FY07 impact is $3 million, reflecting 30 percent of the tax year and the FY08 impact is $12 million, which include 70 percent of tax year 2007 and 50 percent of tax year 2008.

According to TRD, the fiscal impact is based on approximately 7,000 active duty military in New Mexico earning an average $45,000 per year as well as an additional 3,000 active duty National Guard and army reserve members. The average tax relief to service members would be $1,350 and $133 for National Guard and army reserve members.

Disabled Street Vendor Gross Receipts: LFC and TRD believe the fiscal impact of this provision will be small due to the limited number of disabled street vendors operating in New Mexico.

Low-Income Housing Materials Gross Receipts. Based on information from federal tax returns filed by New Mexico non-profit entities TRD estimates that 20 to 30 non-profit entities operate in New Mexico each year to provide low-income homeownership opportunities. Total income of these entities is about $30 million per year TRD assumes that $10 million of that income is spent on construction materials and would be eligible for the proposed deduction. Taxed at a statewide rate of 6.6 percent, the proposal would reduce gross receipts tax collections by about $660 thousand. About 60 percent of that revenue decrease would accrue to the general fund and the remaining 40 percent would accrue to local governments.

Middle-income Tax Exemption. Fiscal impacts were estimated using information from state income tax returns. Increased exemptions will be claimed on an estimated 208 thousand tax returns filed by New Mexico residents, claiming $10.1 million in tax savings for an average savings per return of $48. Total tax savings due to the provision should be stable from year to year because the amount of the exemption and the income thresholds are not indexed for inflation. This means that as taxpayers' incomes grow over time they will become eligible for a smaller exemption amount. This effect will offset the increase in the total population eligible for the exemptions.

Special Needs Adoption Tax Credit
TRD reports that the repeal of the exemption will have an insignificant impact. On the credit, TRD has provided this analysis:

> In tax year 2004, exemptions allowed under present law totaling approximately $1.2 million were claimed on slightly over 300 New Mexico tax returns, and thus averaged approximately $4,000 per return. Taxpayers claiming the returns were subject to a tax rate of slightly over 5 percent. Hence the resulting "tax cost" to the State of New Mexico General Fund totaled approximately $60,000 (i.e., $1,200,000 x .05). The average tax benefit was approximately $125 per child or 5% of $2,500.
>
> The recurring impact shown above assumes 350 households with 600 special needs children would get credits totaling $600 thousand per year for an average benefit of $1,700 per household. The $540,000 recurring fiscal impact above is the difference between the estimated $60,000 impact of the current program and the estimated $600,000 annual impact of the proposed statute.

Modifying Tax Penalties and Interest. TRD reports that in FY05, interest collections from taxpayers who underpaid were about $20 million, while interest payments to taxpayers who overpaid were about $3 million. Thus, lowering interest rates on under and overpayments will result in a general fund revenue reduction. TRD expects general fund interest payments to fall by $2,108 thousand in FY09 and by about $8,292 thousand in FY12, when the impact of lower interest rates is expected to level off. Local governments will also lose revenue due to the lower interest rates.

TRD reports that in FY05, penalty collections were about $8 million, 95 percent of which was due to payments at the maximum rate of 10 percent. Increasing the maximum rate to 20 percent is expected to increase penalty revenue in about 75 percent of taxpayer cases because taxpayers will have more incentive to pay on time. Additional general fund revenue due to higher penalties is expected to be about $5,454 thousand in FY09. Local governments will also gain revenue due to higher penalties.

TRD reports that total penalties for the food and medical services deductions are about $1.4 million since the penalties were first imposed in January 2005. The credit would give all of those penalties. This revenue reduction to the general fund will be nonrecurring.

SIGNIFICANT ISSUES

Working Families Tax Credit. Twenty states, including the District of Columbia, currently offer a state level EIC (Colorado's EIC is tied to their TABOR rules and so some years they do not allow the credit). The credit has proven to be a simple and efficient credit. It is also popular since it only goes to individuals and families with earned income. One of the key elements is the refundability of the credit: the taxpayer receives the full amount of the credit regardless of the tax liability. Twelve of the seventeen state EICs are refundable, according to research at the Institute on Taxation and Economic Policy. New York and Vermont have the most generous EICs allowing over 30 percent of the federal credit and making it refundable. Rhode Island has a 25 percent credit but it is not refundable which restricts its effectiveness.

TABLE 1: STATE EARNED INCOME TAX CREDITS BASED ON THE FEDERAL EITC

State	Percentage of Federal Credit (Tax Year 2006 Except as Noted)	Refundable	Workers Without Qualifying Children Eligible?
Delaware	20%	No	Yes
District of Columbia	35%	Yes	Yes
Indiana[a]	6%	Yes	Yes
Illinois	5%	Yes	Yes
Iowa	6.5%	No	Yes
Kansas	15%	Yes	Yes
Maine	5%	No	Yes
Maryland[b]	20%	Yes	No
Massachusetts	15%	Yes	Yes
Michigan	10% (effective in 2008; to 20% in 2009)	Yes	Yes
Minnesota[c]	Average 33%	Yes	Yes
Nebraska	8%	Yes	Yes
New Jersey[d]	20%	Yes	No
New York[e, f]	30%	Yes	Yes
Oklahoma	5%	Yes	Yes
Oregon	5% (to 6% in 2008)	Yes	Yes
Rhode Island	25%	Partially[g]	Yes
Vermont	32%	Yes	Yes
Virginia	20%	No	Yes
Wisconsin	4% - one child 14% - two children 43% - three children	4% - one child 14% - two children 43% - three children	No

TABLE 1: STATE EARNED INCOME TAX CREDITS BASED ON THE FEDERAL EITC			
State	Percentage of Federal Credit (Tax Year 2006 Except as Noted)	Refundable	Workers Without Qualifying Children Eligible?

Notes: From 1999 to 2001, Colorado offered a 10% refundable EITC financed from required rebates under the state's "TABOR" amendment. Those rebates, and hence the EITC, were suspended beginning in 2002 due to lack of funds and again in 2005 as a result of a voter-approved five-year suspension of TABOR. Under current law, the EITC is projected to resume in 2010.
a Presently scheduled to expire in TY 2011.
b Maryland also offers a non-refundable EITC set at 50 percent of the federal credit. Taxpayers in effect may claim either the refundable credit or the non-refundable credit, but not both.
c Minnesota's credit for families with children, unlike the other credits shown in this table, is not expressly structured as a percentage of the federal credit. Depending on income level, the credit for families with children may range from 25 percent to 45 percent of the federal credit; taxpayers without children may receive a 25 percent credit.
d The New Jersey credit is available only to families with incomes below $20,000.
e The New York credit would be reduced automatically to the 1999 level of 20 percent should the federal government reduce New York's share of the TANF block grant.
f Beginning in 2006, New York also allows certain non-custodial parents who are making child support payments to claim an EITC that is the greater of 20 percent of the federal EITC that they would be eligible for with one qualifying child as a custodial parent or 250 percent of the federal EITC for taxpayers without qualifying children.
g Rhode Island made a very small portion of its EITC refundable effective in TY 2003. In 2006, the refundable portion was increased from 10 percent to 15 percent of the nonrefundable credit (i.e. 3.75 percent of the federal EITC).

Source: Economic Policy Institute (www.epi.org)

For a single or married taxpayer with no children, the cut-off for benefits is very low but for taxpayers with children, the benefit goes to many more. The federal EIC can only be claimed if someone is below the income cut-offs and

- has a valid social security number
- is not filing separately
- is a US citizen or resident alien
- does not have foreign income
- does not have more than $2,800 in investment income
- has some earned income.

Table one shows the cut-off and peak amounts and the maximum credit for each class of filer. For example, a married filer with one child and adjusted gross income of between $8,000 and $16,500 would receive the maximum federal credit of $2,747 (state credit = $275). The same filer with income over $34,001 in adjusted gross income would receive no federal credit and, thus, no state credit.

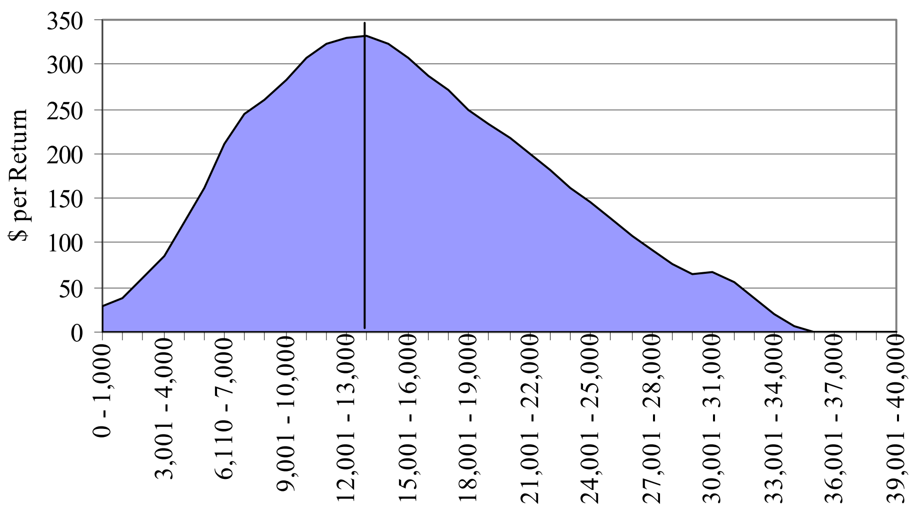
Table 1: Federal Income Cut-offs for Earned Income Credit

	Adjusted Gross Income Cut-off	Peak Start	Peak Finish	Maximum Credit
Single				
No children	12,120	5,500	6,500	412
One child	32,001	8,500	14,500	2747
More than one child	36,348	11,500	14,500	4536
Married				
No children	14,120	5,500	8,500	412
One child	34,001	8,000	16,500	2747
More than one child	38,348	11,500	16,500	4536

Source: IRS 2006 Tax Year

For filers without children, they must be age 25 to 65, not a qualifying child or dependent of another person and must have lived in the United States for more than six months. For filers with children, the children must be younger than 19, younger than 25 if a full time student, or permanently disabled. The children also have to have lived with the filer for more than six months and cannot be claimed as a qualifying child or dependent of another person.

Figure Two: Working Families Tax Credit Phase-out



Source: TRD

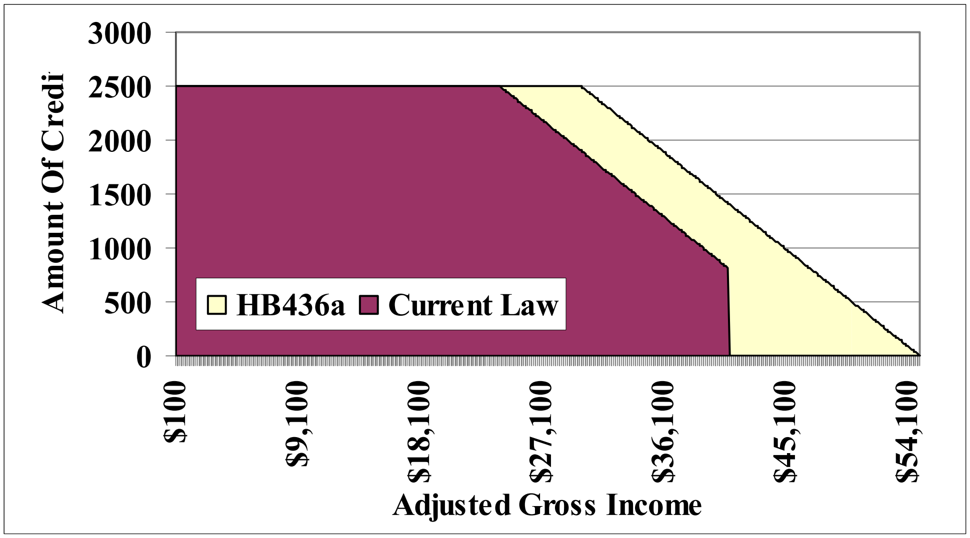
One of the features of the EIC is that it phases-out at higher incomes. Figure two, which is based on 2005 data, shows the maximum average credit of about $325, which would be $3,250 for the federal EIC, is reached at an income level of $13,000. This is an average of all tax filers, whether single or not or childless or not.

Disabled Street Vendor Gross Receipts: The Division of Vocational Rehabilitation notes that since vendors are able to pass gross receipts tax on to their customers the provision does not provide tax relief to disabled vendors. However, it will relieve disabled street vendors of the responsibility to collect and pay the gross receipts tax.

Special Needs Adoption Credit. From Special-needs.adoption.com:

> Over 100,000 children are waiting to be adopted right now out of the more than half million US children in foster care. The rest will eventually be reunited with birth families or will "age out" of the system while waiting to be reunited. Of the waiting children with special needs who are younger than school age, many are of minority race, and all of them are members of sibling groups, or have mild to severe disabilities, or are at risk of developing disabilities later due to risk factors. Some children have correctable problems. Others will "outgrow" their challenges. A few are remarkably resilient and will not develop expected problems. However, adoptive parents must be ready to face and deal with all types of outcomes, from the bleak to the near-miraculous.
>
> [Cost of adoption]
> The cost varies from place to place but the good news is that with careful planning, special needs adoption can be a low-cost or no-cost process. Most expenses involved in most of the authors' domestic special needs adoptions were reimbursed to them.
>
> State or public adoption agencies do not usually charge for any special needs adoption service. Fees at private adoption agencies for adoption services vary widely from no charge at all to several thousand dollars, or more.
>
> When a domestic special needs adoption takes place in a state offering "Purchase of Services", the state with custody of the child may pay some or all of the private adoption expenses for the adoptive parent or parents. This is how a private agency can afford to operate without charging the family a home study or placement fee. Adoptive parents should be sure and ask a private agency about "Purchase of Service adoptions."
>
> In the U.S., up to $2,000 of a family's one-time special needs adoption expenses are refundable for children who meet the requirements under the federal law. States may allow up to $2,000 per child, or less, but not more. The expenses are reimbursed after the adoption has been completed. Adoptive parents should keep receipts for all expenses from the home study to the cost of photo listing book subscriptions. They should be sure their agency participates in this refund program, and then be sure and request the necessary forms after placement has occurred but before the adoption is legally finalized. State and federal programs are also available to help parents with the cost of raising adopted children with special needs.

Middle-income Taxpayer Exemption. The beneficiaries of the expansion of the thresholds are those taxpayers who are above the current thresholds. For example, a head of household with one child and $30,000 in adjusted gross income would deduct $5,000 from adjusted gross income rather than $3,800 resulting in about $60 tax savings. As TRD points out below, the phase out fixes a cliff that was in current law: under the formula for a married filing jointly taxpayer, if the taxpayer has income of $41,000, they should receive an $800 exemption but the law limits the exemption to those with $40,667 in income and so this taxpayer would not receive a deduction. The figure below demonstrates the cliff for married filing jointly and heads of household.



Modifying Tax Penalties and Interest. Taxpayers have protested to TRD that the 15 percent interest imposed on underpayments is too high compared with current market rates. Currently, the federal funds rate is about 5 percent. The federal government responded to this problem by enacting Section 6621 of the Internal Revenue Code. That section allows interest on tax underpayments to fluctuate as market interest rates fluctuate.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

SB317 is a related bill.

Similar to HB436, SB 482 creates a State Earned Income Tax Credit of 10 percent of the federal EIC and SB482 also allows both the created credit and LICTR.

ADMINISTRATIVE ISSUES

Modifying Tax Penalties and Interest. TRD reports that changing the interest rate on underpayments and overpayments of tax from a fixed 15 percent to a rate that moves with the federal funds rate will require systems changes. TRD will change instructions and forms. If the interest and penalty are changed effective July 1, 2008, then instructions for filing personal income tax, corporate income tax, fiduciary tax and property tax returns will be incorrect for the last half of 2008. Incorrect instructions will affect late filers and extension filers.

TECHNICAL ISSUES

Armed Services Income Tax Exemption: According to the Department of Defense, “Active Duty” refers to “Full-time duty in the active service of a Uniformed Service, including fulltime training duty, annual training duty, and attendance while in the active service at a school designated as a Military Service school by law or by the Secretary concerned.” SB492 refers to “active service” which is presumed to mean “active duty” though clarification may be a necessary correction.

TRD notes that, as written, the measure could be interpreted to include an exemption for federal personal income tax obligations. It should be amended to clarify that it does not.

Disabled Street Vendor Gross Receipts: DVR believes the definition of "disabled" provided in the provision will exclude individuals earning "substantial gainful activity," as defined by the Social Security Act, which is equivalent to $900 per month for persons with disabilities and $1,500 per month for those who are blind, from receiving the proposed gross receipts tax exemption. DVR recommends amending the bill so the definition of disability matches that cited in Section 504 of the federal Rehabilitation Act.

OTHER ISSUES

Armed Services Income Tax Exemption: By reducing state tax obligations, the proposed measure would tend to increase federal tax liability because state tax obligations are deductible against federal liability. Hence the net taxpayer benefit would be less than the $1,575 per claimant mentioned above. The $1,575 in state tax savings would, for example, be reduced to $1,260 ($1,575 x .8) for a taxpayer in the 20% federal tax bracket.

NF/mt