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

SPONSOR Garcia, M.P. **ORIGINAL DATE** 03/03/11 **LAST UPDATED** **HB** 571

SHORT TITLE Capital Gains Deduction Limit **SB**

ANALYST Burrows

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY11	FY12	FY13		
$920.0	$13,040.0	$9,700.0	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION

LFC Files

Responses Received From
Economic Development Department (EDD)
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

House Bill 571 amends Section 7-2-34 NMSA 1978 of the Income Tax Act to limit the net capital gains deduction to the following percentages:

- Heads of households, surviving spouses, or married individuals filing jointly with net income up to and including $250,000 could claim 50% of net capital gains; those with net income above $250,000 could claim 25%.
- Single individuals, estates, and trusts with net income up to and including $200,000 could claim 50% of net capital gains; those with net income above $200,000 could claim 25%.

As in current law, married individuals filing separately could claim one-half of the deduction that would have been allowed if they had filed jointly.

The provisions of this bill would apply to tax years beginning on or after January 1, 2011.

FISCAL IMPLICATIONS

TRD reports:

Based on the New Mexico personal income tax data from 2005 through 2008, approximately 12 percent (or 125,000) taxpayers who filed a New Mexico income tax return reported a capital gains deduction. On average, about 62 percent, or 77,500 of these taxpayers would be affected by the reduced deduction rate in the bill because their income is above the specified levels. Their increased tax liability under this bill reflects loss of half of their current deduction, and assumes an average effective tax rate of 4.9 percent. On average, approximately $1.45 billion in capital gains income have been apportioned to New Mexico per year in the past few years. Under these values, the annual revenue impacts of the bill would be approximately $10 million. A higher amount is reflected in FY2012 because almost all of the tax year 2011 impacts and part of the tax year 2012 impacts will accrue to the state during FY2012.

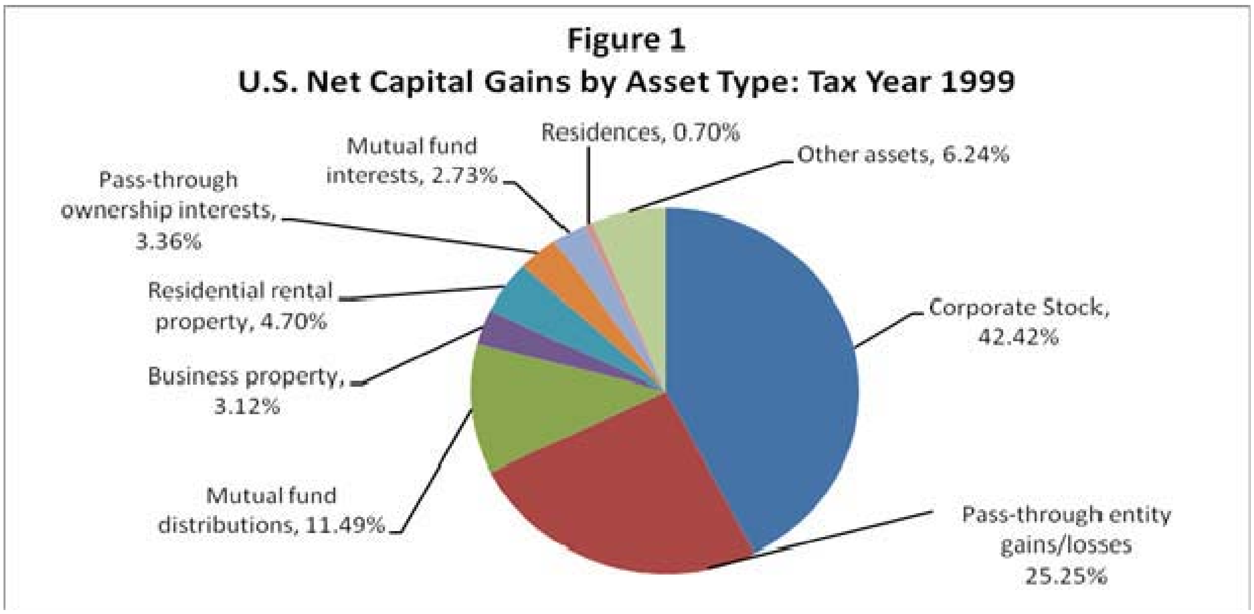
Capital gains income is highly volatile due to changes in tax laws, economic recession and recovery, etc. Fiscal impacts are expected to grow by approximately five and a half percent per year for the next few years based on the capital gains forecast published by the Congressional Budget Office. No negative "feedback" effects of the proposal on New Mexico revenues are included in the estimate because theoretical and empirical models do not provide a reliable estimate of the magnitude of these effects.

SIGNIFICANT ISSUES

Capital gains are primarily reported by higher income taxpayers, so decreasing the tax deduction on capital earned by high-income taxpayers would create a more progressive tax system.

TRD notes the 50 percent deduction for capital gains income was phased in beginning in 2003. The policy was adopted in part to encourage investment in New Mexico. However, the policy is poorly targeted to achieve this goal. According to IRS studies, most capital gains income is derived from investments in publicly-traded companies.

The following chart illustrates the distribution of net capital gains by type of asset from a study of 1999 Internal Revenue Service tax returns.



Source: IRS "Sales of Capital Assets: 1999"

According to TRD, another rationale for the deduction was to reduce the incentive for long-term New Mexico small business owners to move to states without income taxes prior to selling their business interest. This problem can be targeted for specific relief at a fraction of the cost of the across-the-board capital gains deduction.

House Bill 571 could encourage some New Mexico residents with high incomes and substantial gains to relocate out of state, and could discourage high-income non-residents from establishing New Mexico residency.

ADMINISTRATIVE IMPLICATIONS

TRD reports that House Bill 571 would require the revision of instructions and publications related to net capital gain deductions, and modifications to GenTax, PIT-Net, and federal and state applications. Additional funding would not be required.

TECHNICAL ISSUES

TRD notes that the proposal would change 2011 liabilities for which taxpayers will have made some estimated payments. A possible amendment would include an exemption from the underpayment penalty if the taxpayer's payments as of the effective date are sufficient to avoid penalty under the law as it was in effect on January 1, 2011.

OTHER SUBSTANTIVE ISSUES

Capital gains are generally taxed at a preferential rate relative to ordinary income to encourage capital investment, to fund entrepreneurial activity, and to compensate for the effects of inflation. The figure below lists those states that provide some deduction or credit for income from capital gains. This list does not account for any changes made in 2011 state legislative sessions.

Partial deduction or credit on capital gains	Arkansas, Montana, New Mexico, North Dakota, Rhode Island, South Carolina, Vermont and Wisconsin
Partial or full deduction on capital gains earned from property within the state	Colorado, Idaho, Iowa and Oklahoma
Full deduction for sale of stock of in-state companies	Colorado, Louisiana and Oklahoma
Partial or full deduction for certain types of investment	Arkansas, Maine, Missouri, Montana, Nebraska, New York and the District of Columbia
Partial or full deduction on gains earned from state and local bonds	Connecticut, Kentucky and Ohio
Full deduction on capital gains earned from eminent domain	Kentucky

21 states do not provide preferential treatment for capital gains income.

Capital gains can be earned on stocks, bonds, mutual funds, real estate, art, collectibles, or other investments. Net long-term capital gains are offset by net short-term capital losses for the purpose of determining net capital gains. Deductions for capital gains must be applied in the same tax year that they occur.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

Deductions for net capital gains from income taxes will continue to be the greater of 100 percent of net capital gains up to $1,000 or 50 percent of net capital gains.

LKB/svb

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