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

ORIGINAL DATE 1/27/18
SPONSOR Ely/Rubio **LAST UPDATED** 1/30/18 **HB** 216

SHORT TITLE Working Families Tax Credit & Capital Gains **SB**

ANALYST Iglesias

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY18	FY19	FY20	FY21	FY22		
($3,120.0)	($10,400.0)	$29,500.0	$25,250.0	$15,000.0	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

FY18	FY19	FY20	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Minimal				Recurring	TRD Operating

Parenthesis ( ) indicate expenditure decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

House Bill 216 increases the working families personal income tax credit from 10 percent of the federal earned income tax credit (EITC) to the following schedule:

Taxable Years	Percentage of EITC
Prior to January 1, 2021	12
2021	14
2022 and 2023	16
2024	18
2025	20

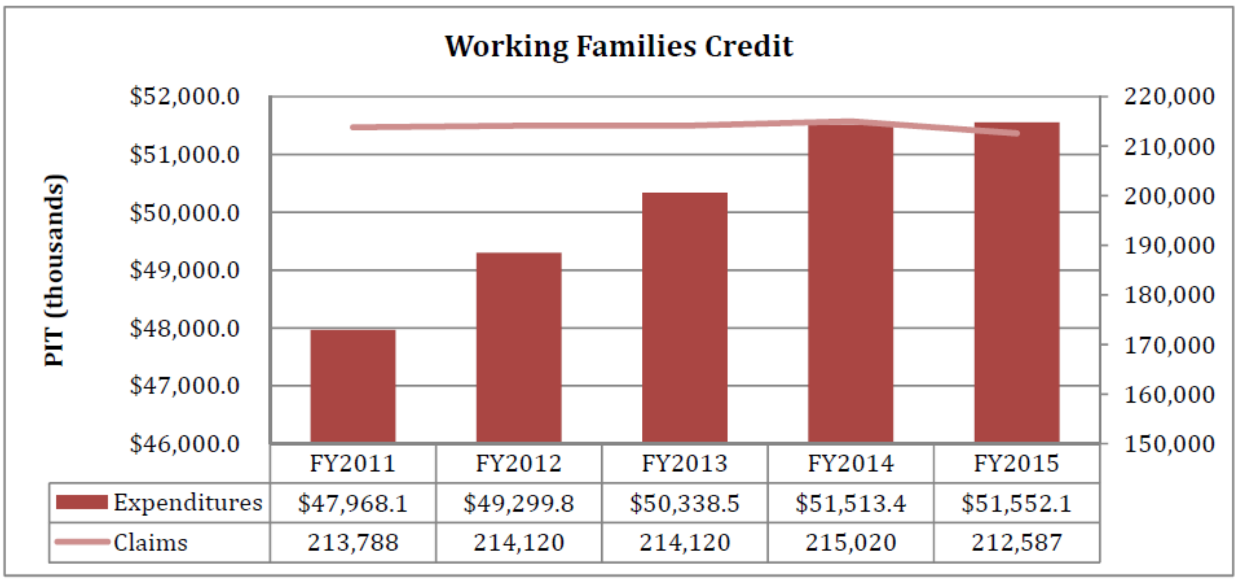
The bill also reduces the capital gains deduction against personal income taxable income from the greater of $1,000 or 50 percent of capital gains reported for federal income tax purposes to just a maximum of $1,000. This returns that deduction to the amount that was in effect prior to 2003. The reduction of the capital gains deduction is applicable to tax years beginning January 1, 2019.

There is no effective date of this bill. It is assumed that the new effective date is 90 days after this session ends.

FISCAL IMPLICATIONS

Working Families Tax Credit

The working families tax credit (WFTC) is currently 10 percent of the federal Earned Income Tax Credit (EITC). The current cost of the WFTC is provided in the Taxation and Revenue Department's (TRD) 2016 Tax Expenditure Report (TER), as illustrated below.



2016 New Mexico Tax Expenditure Report Page 190

The fiscal estimates were provided by TRD was estimated using 2016 tax expenditure report estimates. The estimated impact is based on the reported number of claimants and the Consensus Revenue Estimating Group (CREG) income tax growth rates. The result was increased proportionately to the increased credit rates authorized in the bill.

The bill gradually increases the amount that can be claimed for the WFTC, phased in from an increase of 12 percent of EITC to a maximum of 20 percent of EITC by 2025. Because the bill's first phase increases the WFTC to 12 percent for taxable years prior to January 1, 2020, LFC expects an FY18 impact; however, this appears to be a technical error (see *Technical Issues* section).

Estimated Revenue (in millions)									R/NR	Fund Affected
FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25	FY26		
($3.1)	($10.4)	($10.5)	($15.8)	($27.0)	($32.3)	($32.9)	($45.4)	($58.4)	R	General Fund

Capital Gains Deduction

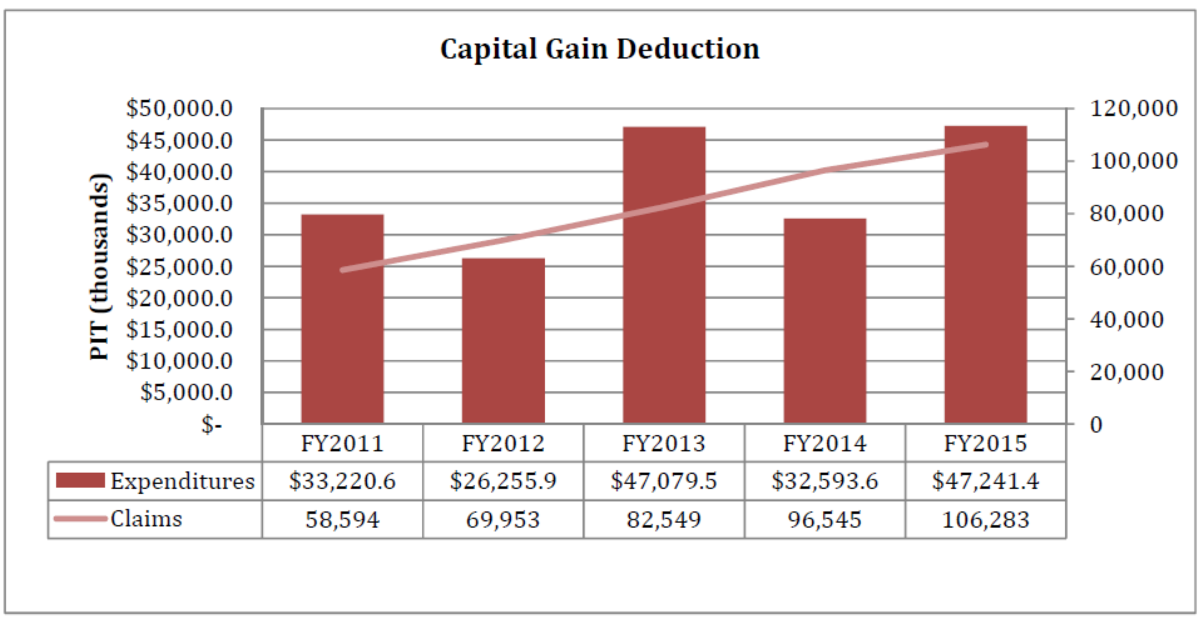
The bill reduces the capital gains deduction against personal income taxable income from the greater of $1,000 or 50 percent of capital gains reported for federal income tax purposes to just a maximum of $1,000.

Estimated Revenue (in millions)					Recurring or Nonrecurring	Fund Affected
FY18	**FY19**	**FY20**	**FY21**	**FY22**		
$0.0	$0.0*	$40.0	$41.0	$42.0	Recurring	General Fund

(*Note: the zero amount for FY19 is caused by timing, not liability. The capital gains reduction is applicable for tax year 2019 and beyond. Few higher-income taxpayers will adjust their estimated payments for the April and June 2018 payments because of the existence of the so-called "safeharbor" feature. If higher-income taxpayers pay as much in total estimated payments for TY19 as they owed for TY18, there would be no penalty. The extra amount would be paid primarily as a final settlement in April 2020. Some taxpayers adjust withholding from salaried employment to account for the additional taxes accruing to capital gains.)

TRD used tax return data to estimate the fiscal impact. The number of claimants of the capital gains deduction for the tax years 2013-2015 was multiplied by $1000 (the cap) and an average tax rate of 4.2 percent was applied. This amount was subtracted from actual claims to estimate the reduced deductions under the proposal. Future year amounts were estimated using the CREG income tax growth rates forecast.

The cost of the capital gains deduction has generally increased over time, but there are historic swings in the cost of the tax expenditure. Market volatility could cause individual years to be higher or lower than the given range.



SIGNIFICANT ISSUES

The WFTC is based on the Federal Earned Income Tax Credit which pays recipients an amount based on their earned income and family size. This benefit is seen both as increasing the incentive to work and also as offsetting the regressive impacts of the federal payroll taxes. The capital gain deduction exists to incentivize savings and investment.

This bill attempts to balance a revenue gainer (the reduction of the capital gains deduction) with a revenue decrease attributed to the doubling of the working families tax credit. (Note: see *Technical Issues* section regarding negative fiscal impacts to FY18 and FY19.) The volatile nature of the capital gains deduction makes it difficult to determine whether the limitation of this deduction will continue to offset the cost of the increased WFTC once the maximum 20 percent deduction becomes effective for tax years 2025 and beyond. It is possible for growth in the WFTC to exceed the relative value of the capital gains deduction resulting in a net negative impact to the general fund in the long run.

This bill may be counter to the LFC tax policy principle of adequacy, efficiency, and equity. Due to the increasing cost of tax expenditures, revenues may be insufficient to cover growing recurring appropriations.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is not met since TRD is not required in the bill to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the deduction is meeting its purpose.

However, since credits are separately reported, TRD is able to easily determine the cost of the WFTC. The cost of the WFTC and the capital gains deduction are included in TRD's annual Tax Expenditure Report.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Relates to all other bills amending the personal income tax act, which currently include: HB36, HB77, HB87, HB104, HB140, HB143, HB212, SB79, and SB209.

TECHNICAL ISSUES

Section 3 of the bill does not provide applicability provisions to the WFTC. Given the structure of the phase-in of the increased percentages for WFTC, this would not necessarily be an issue; however, Section 1, part A(1), raises the WFTC to 12 percent for tax years prior to January 1, 2020. Since the bill is presumed to become effective 90 days following the session, taxpayers who had not currently filed their taxes as of the bill effective date could presumably claim the credit for tax year 2017, which could have an FY18 impact. This appears to be a technical error, in which the bill may have intended to keep the deduction at 10 percent for taxable years prior to January 1, 2020 – this change the WFTC credit provisions to have no expected fiscal impact until FY21.

TRD has a similar interpretation of the issue above. TRD states that, as written, the bill could be interpreted to modify WFTC rates for periods prior to the effective date of the bill. This could lead to numerous applications for refunds, posing an administrative burden and increasing the fiscal impacts significantly. TRD suggests the bill add an applicability date for Section 1 of "tax years beginning on or after January 1, 2018."

Section 1, part A(4) and part A(5) have identical percentages of 16 percent. This may be a technical error.

Does the bill meet the Legislative Finance Committee tax expenditure policy principles?

1. **Vetted**: The proposed new or expanded tax expenditure was vetted through interim legislative committees, such as LFC and the Revenue Stabilization and Tax Policy Committee, to review fiscal, legal, and general policy parameters.
2. **Targeted**: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.
3. **Transparent**: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies.
4. **Accountable**: The required reporting allows for analysis by members of the public to determine progress toward annual targets and determination of effectiveness and efficiency. The tax expenditure is set to expire unless legislative action is taken to review the tax expenditure and extend the expiration date.
5. **Effective**: The tax expenditure fulfills the stated purpose. If the tax expenditure is designed to alter behavior – for example, economic development incentives intended to increase economic growth – there are indicators the recipients would not have performed the desired actions "but for" the existence of the tax expenditure.
6. **Efficient:** The tax expenditure is the most cost-effective way to achieve the desired results.

LFC Tax Expenditure Policy Principle	Met?	Comments
Vetted	✘	While some fiscal implications of the bill were discussed with LFC and TRD staff prior to introduction, the bill was not vetted through an interim committee hearing.
Targeted		
Clearly stated purpose	✘	None.
Long-term goals	✘	
Measurable targets	✘	
Transparent	?	The bill includes no reporting requirements. However, credits are separately reported, which enables TRD to easily determine the cost of the WFTC. The cost of the WFTC and the capital gains deduction are included in TRD's annual Tax Expenditure Report.
Accountable		
Public analysis	✘	No interim committee hearing.
Expiration date	✘	No expiration date.
Effective		
Fulfills stated purpose	?	Difficult to determine as there is no stated purpose.
Passes "but for" test	?	
Efficient	?	Difficult to determine as there is no stated purpose.
Key: ✓ Met ✘ Not Met ? Unclear		

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