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FISCAL IMPACT REPORT

ORIGINAL DATE 01/22/19

SPONSOR Trujillo, J. LAST UPDATED _____ HB 163

SHORT TITLE Tax Deduction For Nonresident Beneficiary SB _____

ANALYST Iglesias

REVENUE (dollars in thousands)

| Estimated Revenue | | | | | Recurring or Nonrecurring | Fund Affected |
|-------------------|-----------|-----------|-----------|-----------|------------------------------|------------------|
| FY19 | FY20 | FY21 | FY22 | FY23 | | |
| * | (\$343.0) | (\$345.0) | (\$345.0) | (\$345.0) | Recurring | General Fund |

Parenthesis () indicate revenue decreases

(*) Note, since the bill's provisions apply to TY19 income, there might be a small amount of impact in FY19. However, the bill becomes effective 90 days after adjournment and might only affect the June PIT estimated payments. If there is an impact in FY19, it would be negative to the general fund.

SOURCES OF INFORMATION

LFC Files

Responses Received From

Taxation and Revenue Department

SUMMARY

Synopsis of Bill

House Bill 163 adds a new section to the Income Tax Act. It grants a deduction for taxpayers that are estates or trusts. The deduction is for the portion of the net income of the estate or trust that is set aside for future distribution to a nonresident individual beneficiary. The deduction excludes income derived from New Mexico real property, oil and gas, and water interests as well as income that the estate or trust would allocate or apportion to New Mexico. This bill also requires the Taxation and Revenue Department (TRD) to compile an annual report on this deduction and present the report to the specified legislative committees.

There is no effective date of this bill. It is assumed that the effective date is 90 days after this session ends. This bill is applicable to taxable years on or after January 1, 2019.

FISCAL IMPLICATIONS

The fiscal impact estimates are provided by TRD using baseline data was obtained from the general fund report. TRD used New Mexico fiduciary income tax for FY14-FY18 and calculated a five-year average.

Since the majority of trusts established in New Mexico are for oil, gas, and property, TRD assumes that only 20 percent of the net income from an estate or trust will qualify for the deduction. Further, TRD assumed that only 25 percent of the fiduciary income would be distributed to nonresident beneficiaries. The five-year average for fiduciary income tax is approximately \$6.7 million. TRD estimated the baseline cost for this deduction as 5 percent of the five-year average and used personal income tax growth rates obtained from the December 2018 consensus revenue estimate to estimate the fiscal impact for the subsequent years.

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.

Estimating the cost of tax expenditures is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. The statutory criteria for a tax expenditure may be ambiguous, further complicating the initial cost estimate of the expenditure's fiscal impact. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures.

SIGNIFICANT ISSUES

The purpose of the bill is to expand the trust and estate business in New Mexico by allowing an income deduction from the net income of an estate or trust. Additional consideration to the scope of the deduction, and the types of trusts intended to benefit from it, may be warranted as to not implicate efficiency. While facts for each business will vary, professional service business that perform trustee functions typically employ minimal personnel that are devoted to the trust function and little property. The property typically held in trust is intangible and, therefore, not taxable. In short, the extent of the direct and indirect benefit of incentivizing this industry is unclear.

Additionally, the taxation of trust and trust beneficiary income depends on numerous factors, including the trust document, the type of trust, the nature of the income, trust accounting, and federal rules. Because of this, there may be leakage.

TRD provides the following additional discussion below:

“Trusts pay tax under a federal system that first looks to whether the income earned each year is distributed or retained by the trust. The trust does not pay tax on distributed income—but the beneficiary may. If the income is not distributed, the trust would then pay tax on that income (and in the future, the beneficiary would not pay tax). New Mexico follows this treatment. But states also must determine to what extent they will tax the income of trusts. Most states do so by looking to the residency of the trust. But because trusts and their

beneficiaries may be residents of different states, this may affect where state taxes are ultimately paid. Also, rules for when a trust is a resident vary from state to state.

The stated purpose of the bill is to ‘increase trust and estate business in New Mexico.’ This is presumably in recognition that, in New Mexico, a trust is a “resident” if the trustee is in the state and may, therefore, pay some tax for that reason (Section 3.3.3.7 NMAC). Some states have addressed this policy goal by adopting a different rule for when a trust is a resident—so that the presence of the trustee in the state, performing the functions of overseeing the trust, will not result in the trust being taxable. The bill [provisions] achieve the policy goal in a more limited way, by allowing a deduction from the net income of an estate or trust for the amount of non-New Mexico trust income that is irrevocably set aside for a non-resident beneficiary.

However, it must be noted that, unlike most states, New Mexico does not subject resident trusts to tax on all of their income—both New Mexico and non-New Mexico income. Trusts are included in the definition of “individuals” [in] Section 7-2-2(I) NMSA 1978. Individuals first apply the New Mexico tax rates to “net income”, which is defined to include federal taxable income, with adjustments, from whatever source, inside or outside the state. But individuals (whether residents or non-residents) are then entitled to a credit against this unapportioned tax. The credit is determined by calculating a “non-New Mexico percentage” which is based on the percentage of income derived from outside the state. See Section 7-2-11(A)(2), (B) and (C) NMSA 1978. That percentage is then multiplied by the total tax to calculate the credit. After applying this credit to the total tax, therefore, a trust, whether a resident or a nonresident, will pay tax only on its income derived from New Mexico.

The bill does not change this credit for the tax on non-New Mexico income. It would simply allow a deduction, reducing the net income on which tax is computed before the credit is applied. The credit would still be applicable and the out-of-state income used in computing that credit would not change. Nor is the deduction limited to resident trusts. This not only raises potential policy questions, but also creates technical issues.”

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is met with the bill’s requirement 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.

TECHNICAL ISSUES

According to TRD, it is not clear that the provisions of section A of the bill are entirely consistent with the provisions of Section 7-2-11 NMSA 1978. The bill refers to income derived from real property and certain property interests in the state, which may be a different approach to “sourcing” the income than would be applied under Section 7-2-11 NMSA 1978.

TRD further states the description given above assumes that in calculating the credit under Section 7-2-11 NMSA 1978, all the non-New Mexico income, as determined under that section, would be used in calculating the non-New Mexico percentage, even if that income is all or partially deductible in computing unapportioned tax. Section 7-2-11 NMSA 1978 references the Uniform Division of Income for Tax Purposes Act, and regulations and practices under that Act

often provide that when income is not included in the base, the sourcing of that income is not considered for purposes of apportionment. It would make a substantial difference in the calculation of the final New Mexico tax amount whether the non-New Mexico percentage is calculated taking into account the deductible non-New Mexico income, or not.

Lastly, TRD states it would likely raise questions of the constitutionality of the deduction to limit it to resident trusts, since, otherwise, resident and non-resident trusts are both taxed on their New Mexico income. It is less clear whether limiting the deduction to income set aside for non-resident beneficiaries would create constitutional problems.

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

1. **Adequacy:** Revenue should be adequate to fund needed government services.
2. **Efficiency:** Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity:** Different taxpayers should be treated fairly.
4. **Simplicity:** Collection should be simple and easily understood.
5. **Accountability:** Preferences should be easy to monitor and evaluate

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 | ✘ | Bill received no hearing by interim committees. |
| Targeted | | |
| Clearly stated purpose | ✔ | The purpose of the deduction is to assist in the expansion of the trust and estate business in New Mexico. |
| Long-term goals | ✘ | Although TRD is required to report on the effectiveness and cost of deduction, no long-term goals or measureable targets are given. |
| Measurable targets | ✘ | |

| | | |
|---|---|--|
| Transparent | ✓ | Requires annual reporting by TRD and presentation to RSTP and LFC. |
| Accountable | ? | Depends on how TRD structures the required reports. |
| Public analysis | ? | |
| Expiration date | ✓ | This bill sunsets on December 21, 2024. |
| Effective | | |
| Fulfills stated purpose | ? | |
| Passes “but for” test | ? | |
| Efficient | ? | |
| Key: ✓ Met ✗ Not Met ? Unclear | | |

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