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

SPONSOR Armstrong, G./Dow/Gauld/ White **ORIGINAL DATE** 1/29/2020 **LAST UPDATED** **HB** 130

SHORT TITLE Exempt Social Security Income from Income Tax **SB**

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY20	FY21	FY22	FY23	FY24		
	($128,500.0)	($147,100)	($140,500.0)	($145,800.0)	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

Duplicates HB29 and SB81; Conflicts with HB77, HB170 and SB68

SOURCES OF INFORMATION
LFC Files

Responses Received From
Aging and Long-Term Care (ALTSO)

SUMMARY

Synopsis of Bill

House Bill 130 proposes exempting federally taxable social security retirement income from state personal income tax. Individuals claiming this exemption are not permitted to simultaneously claim the Over 65 and Blind Exemption of Section 7-2-5.2 NMSA 1978.

The effective date of this bill is not stated, and assumed to be 90 days after the end of the session. The provisions of the act are applicable to taxable years beginning January 1, 2020. There is no delayed repeal date but LFC recommends adding one.

FISCAL IMPLICATIONS

The following table shows the results of the LFC model for the resident returns only component. The average tax benefit would be $716 for 147,718 claims, with 89 percent of the benefit received by households with an adjusted gross income (AGI) in excess of $50 thousand.[1]

[1] https://aspe.hhs.gov/poverty-guidelines

Resident Returns Only	Adjusted Gross Income (including up to 85% of Social Security Benefits if required)								
2020 Impact by Adjusted Gross Income Level	All returns	$10,000 under $25,000	$25,000 under $50,000	$50,000 under $75,000	$75,000 under $100,000	$100,000 under $200,000	$200,000 under $500,000	$500,000 under $1,000,000	$1,000,000 or more
Social Security Retirement beneficiaries, total	349,143	207,589	48,657	30,754	22,539	30,769	7,622	874	339
Mean Benefits paid	$17,172	$14,262	$16,127	$17,710	$23,583	$28,508	$33,248	$34,857	$37,880
Total Benefits ($ Millions)	$5,995.5	$2,960.7	$784.7	$544.7	$531.5	$877.1	$253.4	$30.5	$12.8
Social Security benefits in AGI: Number	147,718	16,164	38,657	30,754	22,539	30,769	7,622	874	339
% Social Security Returns	16.02%	7.52%	16.69%	25.90%	30.34%	29.45%	29.80%	29.55%	30.38%
Average Taxable Social Security Amount	$14,920	$1,772	$6,773	$15,054	$20,046	$24,231	$28,261	$29,628	$32,198
Total Taxable Social Security ($ Millions)	$2,204.0	$29.6	$261.8	$463.0	$451.8	$745.6	$215.4	$25.9	$10.9
Marginal tax rate	4.40%	1.75%	4.28%	4.89%	4.90%	4.90%	4.90%	5.90%	5.90%
100% Deduction ($ Millions)	$105.8	$0.5	$11.2	$22.7	$22.1	$36.5	$10.6	$1.5	$0.6
Average Tax Benefit per return	$716	$31	$290	$737	$982	$1,187	$1,386	$1,748	$1,900

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

In general, 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. In this case, the amount of taxable social security is not reported directly to TRD. If this bill passes and is implemented, the annual cost cannot be determined exactly, because the federally taxable social security amount will be reported to TRD as an exemption and not a credit. TRD will have to recalculate all returns claiming this deduction/exemption. (See Technical Issues.)

The LFC model makes the following assumptions:

1. From TY 2010 through TY2017, the annual growth rate of taxable social security was about 7.5 percent. The LFC model extrapolates this growth rate for forecast purposes, resulting in $2.1 billion of taxable social security income in TY2020, and $2.9 billion in TY2023. This is among the highest growing income sources.
2. The LFC model uses the marginal rate applicable to the current taxable income minus the value of the exemption. Additionally, the model includes a new top tax rate of 5.9 percent, which is expected to become effective in FY21. Taking both of these effects into account, the model applies a 4.4 percent marginal tax rate for residents filing non-schedule B income and 4.6 percent for Schedule B income.
3. The LFC model includes two classes of Schedule B filers: (1) first year residents in New Mexico; and (2) non-residents with wage income, investment returns attributable to New Mexico and other business income. The first class tends to be stable and may include social security recipients. The second class are primarily oil and gas royalty and dividend recipients and definitely include social security recipients. In both cases, the social security exemption proposed in this bill would affect the fiscal impact estimate in two ways. First, the gross tax imposed on both classes would *decrease* by the marginal tax rate applied to the amount of the exemption. If there is no federal taxable income from social security retirement payments, there would be no exemption. Second, the apportionment percentage of New Mexico income would *increase* because total taxable income would decrease. In order to model this relatively complicated calculation, LFC staff used the IRS/SOI data for Texas (a surrogate for all schedule B filers).

4. Finally, the model allocates tax year effects to fiscal years using an assumed fraction that differs somewhat from the bulk assignment generally used. The population receiving benefits from this proposal are older and have dealt with state and local taxes for many years. The benefits will be received in two ways: (1) lower estimated tax payments for those who pay estimated taxes; and (2) greater refunds or lower amounts of tax due for other social security recipients.

The fiscal estimate reported in the table on page 1 are based on an LFC model that includes all four of these technical elements. By FY23, the general fund cost will approach or exceed $140 million.

This bill creates a tax expenditure with a cost that is somewhat difficult to determine because the data on which the model is based are indirect. LFC has serious concerns about the significant risk to state revenues from tax expenditures and the increase in revenue volatility from erosion of the revenue base. This concept was discussed at the December meeting of the Revenue Stabilization and Tax Policy interim committee, but this more plausible revenue estimate had not been developed at that time.

SIGNIFICANT ISSUES

This bill narrows the personal income tax (PIT) base, which appears counter to the base-broadening efforts over the last few years to reform New Mexico's tax systems. This proposal would likely reduce the income elasticity of the personal income tax, negating the improvements to income elasticity embedded in PIT tax changes passes last year (Laws 2019, Chapter 270, House Bill 6). The benefit of this proposed exemption is concentrated to higher-income individuals (see tables above).

Some proponents also claim social security income tax exemptions may be used to retain or attract retirees in order to improve the state's economy. However, recent studies find state taxes have only a small effect, if any, on the residence decisions of the elderly. These studies conclude that other factors – such as weather, cost of living (particularly cost of housing), and the location of family members – are more likely to affect migration decisions for retirees. According to research published in the National Tax Journal in 2012, "state tax policies toward the elderly have changed substantially while elderly migration patterns have not" and research has failed "to reveal any consistent effect of state tax policies on elderly migration across state lines."

New Mexico began taxing social security benefits in 1990. The action in was contained in an omnibus bill enacted in response to the "Davis v. Michigan" and "Burns v. New Mexico" problems. At that time, state retiree's pensions were 100 percent exempt from personal income tax, but federal retirees only were allowed a $3,000 deduction. The US Supreme Court found that this differential treatment was in violation of federal law ensuring that state and federal workers must be treated equally and equitably. Per the Supreme Court opinion, retiree income was covered by the federal statute. In the relevant bill, New Mexico repealed both the federal and state differential deductions. In addition, other source-specific deductions were included in the fix. These included the total exemption for social security income.

Some view the state taxation of social security benefits as a "double tax." However, the federal (and state) taxes on social security benefits are not a double tax in the sense that two different taxes are imposed on the same transaction. Currently, employee and employer each contribute

6.2 percent of wages (inclusive of year-end bonuses but exclusive of options and other salary arrangements). There is a maximum earnings level subject to the combined 12.4 percent. Because of substantially lower contribution rates in the earlier years, current social security recipients recover the total amount of their contribution in under 10 years of retirement. In some cases, this recovery is only five years. The employer contribution was not taxed at the time the wages were paid. The amounts received in excess of contributions have not been taxed. The federal tax scheme is retiree-income sensitive. That is, if the taxpayer's adjusted gross income (AGI) including half of Social Security benefits totals less than $32,000 married joint or $25,000 single, none of the Social Security benefit is taxed. For AGI including half of Social Security benefits that exceeds $44,000 for married joint and $34,000 for single, then 50 percent to 85 percent of social security income is taxable. Note that 85 percent may fairly represent the portion of social security benefits not previously taxed at the time the contributions were made.

New Mexico has a tax exemption for persons over 65 and blind; however, the exemption is modest, costing the state an estimated $1.1 million in 2017, with 93,470 claims, according to the most recent TRD Tax Expenditure report. According to a model prepared by LFC staff, this may be a low estimate in cost, but an accurate estimate in terms of number of individuals assisted. The current benefit amounts and bracket levels were established in 1987 and have not been adjusted since. In that 34-year period, CPI-U inflation has increased 141 percent. Updating both the levels and the brackets by only 50 percent would cost the general fund on the order of $15 million and would target the benefits to lower-income elderly and blind individuals.

Some argue that taxing social security benefits undermines the purpose of the Social Security Act, which was designed to lift seniors out of poverty. However, this bill exempting social security income from PIT primarily benefits individuals whose income places them far above the federal poverty standard. As shown in the *Fiscal Implications* section, virtually no elderly individuals are taxed at AGI levels under twice or three-times the federal poverty standard.

As mentioned above, this proposal will further degrade the income elasticity of the personal income tax. Currently, a 10 percent increase in statewide personal income results in about a 10 percent increase in personal income tax collections. Prior to the leveling of PIT rates and brackets in 2003, the average income elasticity was about 1.34. Going back into the 1980s, the elasticity was as high as 1.46. The advantage of an income elasticity greater than 1.0 is that the personal income tax provides a progressive balance to the heavily regressive gross receipts tax.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is <u>not</u> met since TRD is <u>not</u> required in the bill to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the exemption and other information to determine whether the deduction is meeting its purpose. However, it is expected that TRD would provide estimates for the cost of the exemption in its annually produced Tax Expenditure Report.

ADMINISTRATIVE IMPLICATIONS

TRD would have to change forms and instructions and otherwise inform taxpayers of these changes. Auditing would continue to rely on primary inspection by the IRS.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Bill ID	Title	Sponsor	
HB 29	SOCIAL SECURITY INCOME TAX EXEMPTION	Cathrynn N. Brown	100% Deduction
HB 77	SOCIAL SECURITY INCOME TAX EXEMPTION	Daymon Ely	Up to $24,000 per return exempt
HB 130	EXEMPT SOCIAL SECURITY INCOME FROM INCOME TAX	Gail Armstrong	100% Deduction
SB 68	SOCIAL SECURITY INCOME TAX EXEMPTION	Michael Padilla	Up to $25,000 per return exempt
SB 81	EXEMPTING SOCIAL SECURITY FROM INCOME TAX	James P. White	100% Deduction
SB 170	SOCIAL SECURITY INCOME TAX EXEMPTION	Pete Campos	Up to $25,000 per return exempt

TECHNICAL ISSUES

Related to the capped exemptions included in other bills in this series, the phrase used is, "an individual may claim an exemption in an amount not to exceed twenty-five (or twenty-four) thousand dollars…" The LFC model assumes that a married couple, each of whom is a Social Security recipient, would be entitled to the $24,000 or $25,000 exemption, even though the married couple file one joint return. Any other interpretation of the language would impose a marriage tax penalty. LFC recommends clarifying this point.

This bill does not contain a delayed repeal date. LFC recommends adding a delayed repeal date.

ALTERNATIVES

Less than 11 percent of the benefit of this proposed exemption would go to households earning less than $50 thousand in adjusted gross income. If the intent of the bill is to provide support for lower income earners with social security benefits, a more targeted approach would be to expand the existing exemptions for persons aged 65 and older (Section 7-2-5.2) or for low- and middle-income taxpayers (Section 7-2-5.8).

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	Met?	Comments
Vetted	✓	The issue was discussed at the Revenue Stabilization and Tax Policy Committee prior to the Legislative Session, but without endorsement.
Targeted Clearly stated purpose Long-term goals Measurable targets	 ✗ ✗ ✗	No purpose, targets or goals established.
Transparent	?	TRD will likely publish a cost estimate in its annual Tax Expenditure Report
Accountable Public analysis Expiration date	 ✗ ✗	 The bill contains no provisions for reporting. The bill does not include an expiration date.
Effective Fulfills stated purpose Passes "but for" test	 ? ?	Without a purpose statement or required reporting, it is not possible to determine if the exemption fulfills intended outcomes.
Efficient	✗	Without a purpose statement or required reporting, it is not possible to determine if the exemption is the most efficient means of achieving desired outcomes. However, current data and recent studies indicate this exemption would be inefficient in providing tax relief to low-income households receiving social security benefits and is unlikely to be a meaningful recruitment tool for retirees to the state.

Key:	✓ Met	✗ Not Met	? Unclear

INCOME AND BENEFITS
(IN 2018 INFLATION-ADJUSTED DOLLARS)
Total households With Social Security

Geographic Area Name	# households	Mean Social Security income (dollars)
Bernalillo County	80,557	$18,533
Catron County	874	$20,398
Chaves County	8,255	$16,853
Cibola County	3,390	$16,785
Colfax County	2,746	$17,958
Curry County	5,081	$17,416
De Baca County	345	$15,946
Dona Ana County	24,708	$17,724
Eddy County	6,830	$18,212
Grant County	5,532	$17,971
Guadalupe County	780	$15,417
Harding County	134	$17,819
Hidalgo County	778	$18,913
Lea County	5,817	$17,946
Lincoln County	3,605	$20,944
Los Alamos County	1,845	$20,940
Luna County	3,633	$16,761
McKinley County	5,928	$14,197
Mora County	842	$14,409
Otero County	8,497	$17,175
Quay County	1,647	$17,058
Rio Arriba County	4,067	$18,847
Roosevelt County	2,153	$17,295
Sandoval County	16,245	$19,833
San Juan County	13,614	$18,075
San Miguel County	4,747	$14,965
Santa Fe County	22,849	$20,133
Sierra County	3,089	$17,050
Socorro County	1,785	$17,381
Taos County	5,009	$16,518
Torrance County	2,737	$18,132
Union County	582	$17,077
Valencia County	10,693	$17,794
New Mexico	259,394	$18,197

Appendix A

20-Jan-15

Historical Social Security Tax Rates [1]

Year	Maximum taxable earnings	OASDI tax rate [2]	HI tax rate [3]	Year	Maximum taxable earnings	OASDI tax rate [2]	HI tax rate [3]
1937	3,000	2%	-				
1938	3,000	2%	-				
1939	3,000	2%	-	1977	16,500	9.9%	1.8%
1940	3,000	2%	-	1978	17,700	10.1%	2.0%
1941	3,000	2%	-	1979	22,900	10.16%	2.1%
1942	3,000	2%	-	1980	25,900	10.16%	2.1%
1943	3,000	2%	-	1981	29,700	10.7%	2.6%
1944	3,000	2%	-	1982	32,400	10.8%	2.6%
1945	3,000	2%	-	1983	35,700	10.8%	2.6%
1946	3,000	2%	-	1984	37,800	11.4%	2.6%
1947	3,000	2%	-	1985	39,600	11.4%	2.7%
1948	3,000	2%	-	1986	42,000	11.4%	2.9%
1949	3,000	2%	-	1987	43,800	11.4%	2.9%
1950	3,000	3%	-	1988	45,000	12.12%	2.9%
1951	3,600	3%	-	1989	48,000	12.12%	2.9%
1952	3,600	3%	-	1990	51,300	12.4%	2.9%
1953	3,600	3%	-	1991	53,400	12.4%	2.9%
1954	3,600	4%	-	1992	55,500	12.4%	2.9%
1955	4,200	4%	-	1993	57,600	12.4%	2.9%
1956	4,200	4%	-	1994	60,600	12.4%	2.9%
1957	4,200	4.5%	-	1995	61,200	12.4%	2.9%
1958	4,200	4.5%	-	1996	62,700	12.4%	2.9%
1959	4,800	5%	-	1997	65,400	12.4%	2.9%
1960	4,800	6%	-	1998	68,400	12.4%	2.9%
1961	4,800	6%	-	1999	72,600	12.4%	2.9%
1962	4,800	6.25%	-	2000	76,200	12.4%	2.9%
1963	4,800	7.25%	-	2001	80,400	12.4%	2.9%
1964	4,800	7.25%	-	2002	84,900	12.4%	2.9%
1965	4,800	7.25%	-	2003	87,000	12.4%	2.9%
1966	6,600	7.7%	0.7%	2004	87,900	12.4%	2.9%
1967	6,600	7.8%	1.0%	2005	90,000	12.4%	2.9%
1968	7,800	7.6%	1.2%	2006	94,200	12.4%	2.9%
1969	7,800	8.4%	1.2%	2007	97,500	12.4%	2.9%
1970	7,800	8.4%	1.2%	2008	102,000	12.4%	2.9%
1971	7,800	9.2%	1.2%	2009	106,800	12.4%	2.9%
1972	9,000	9.2%	1.2%	2010	106,800	12.4%	2.9%
1973	10,800	9.7%	2.0%	2011 [4]	106,800	10.4%	2.9%

1974	13,200	9.9%	1.8%	2012 [4]	110,100	10.4%	2.9%
1975	14,100	9.9%	1.8%	2013	113,700	12.4%	2.9%
1976	15,300	9.9%	1.8%	2014	117,000	12.4%	2.9%

Notes:
Amounts for 1937-74 and for 1979-81 were set by statute; all other amounts were determined under automatic adjustment provisions of the Social Security Act.
Before 1989, the tax rate on self-employed persons was less than the combined tax rate on employers and employees.
For 1991, 1992 and 1993, the upper limits on earnings subject to HI taxes were $125,000, $130,200 and $135,000 respectively. The upper limit was repealed by the Omnibus Budget Reconciliation Act of 1993.
[1] The tax rate refers to the combined rate for employers and employees.
[2] OASDI refers to the "Old-Age, Survivors, and Disability Insurance" program.
[3] HI refers to Medicare's Hospital Insurance program.
[4] For 2011 and 2012, the OASDI tax rate on wages for employees and self-employed individuals is reduced from 6.2% to 4.2%. The OASDI tax rate on employers remains at 6.2%. Sources: Social Security Administration, http://www.ssa.gov/OACT/COLA/cbb.html and http://www.ssa.gov/OACT/ProgData/taxRates.html, last accessed January 20, 2015.

LG/sb