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

		ORIGINAL DATE	2/03/2020		
SPONSOR	Martinez, J.	**LAST UPDATED**	2/12/2020	**HB**	148/aHTRC
SHORT TITLE	Increase Working Families Tax Credit			**SB**	
				ANALYST	Torres

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY20	**FY21**	**FY22**	**FY23**	**FY24**		
		($22,500)	($23,000)	($23,500)	Recurring	General Fund (WFTC)
		$29,000	$29,000	$29,000	Recurring	General Fund (Capital Gains)
		$6,500	$6,000	$5,500	Recurring	Net General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY20	FY21	FY22	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total		$55.5		$55.5	Nonrecurring	General fund

(Parenthesis ( ) Indicate Expenditure Decreases)

Relates to SB87

SOURCES OF INFORMATION
LFC Files

Response Received
Taxation and Revenue Department

SUMMARY

Synopsis of HTRC Amendment

The House Taxation and Revenue Committee amendment removes the provision that would allow a WFTC equal to 30 percent of the EITC for a resident who claims a qualifying child under the age of six and changes the credit allowed for all taxpayers to 20 percent of EITC. It also removes the definition of a qualifying child. It makes the provisions of the entire bill applicable to taxable years on or after January 1, 2021.

Synopsis of Orin gal Bill

House Bill 148 increases the Working Families Tax Credit (WFTC) from 17 percent to 20 percent of the corresponding federal earned income tax credit (EITC), increases the WFTC to 30 percent for taxpayers claiming a qualifying child under the age of six, ends exclusions for residents who file without a social security number, and adds eligibility for the WFTC to those age 18-24. These provisions are applicable for taxable years beginning after January 1, 2020.

HB148 also reduces the net capital gains deduction to $1,000 from the greater of $1,000 or 40 percent of the capital gain included on a federal tax return. These provisions are applicable for taxable years beginning after January 1, 2021.

There is no effective date of this bill. It is assumed that the effective date is 90 days after this session ends. There is no delayed repeal date but LFC recommends adding one.

FISCAL IMPLICATIONS

Under the amendment, all provisions of the bill are applicable to tax years beginning January 1, 2021. Revenue impacts are then starting in FY22.

Working Families Tax Credit (WFTC) Changes: LFC and TRD estimate increasing the WFTC to 20 percent would cost the state an additional $16 million a year. This is calculated based on increasing the five-year average cost by the proportional increase in the credit. Furthermore, the current Consensus Revenue Estimating Group (CREG) December 2019 forecast, includes the revenue impact of increasing the WFTC percentage from 10 percent to 17 percent, which took effect for tax year 2019 and impacts revenue starting in FY20. The additional revenue impact for FY22 over the estimated impact included in CREG estimates is $16 million.

The bill also introduces two new populations who would become eligible only under the WFTC even though they are currently unable to claim the EITC. This includes working adults aged 18 to 24 years of age who without also claiming a child are ineligible for the EITC. The other population are adults who file federal and state taxes under an individual tax identification number (ITIN) as they do not have a social security number. To be eligible for the EITC, a taxpayer must file with a social security number. TRD reviewed current Personal Income Tax (PIT) filers who are residents, meet the age range, appear to be working given reported withholding and would meet the income requirements given the current federal EITC tables and are not reporting their own dependents. TRD also assumes they are not dependents of another taxpayer. (See technical notes below.) TRD arrived at a population of approximately 17,600

taxpayers. Of the 17.6 thousand, TRD calculated the average income and the corresponding amount of EITC based on the federal tables.

For those filing with an ITIN, TRD identified residents who appear to be working given reported withholding. TRD then estimated the amount of federal credit each sub-population could receive given if they claim dependents or are single.

The annual revenue impacts for each subgroup described above total $6.5 million and are increased based on the personal income tax growth rates in the December 2019 CREG estimate. This rate is then discounted by approximately 1 percent based on average population decline for taxpayers currently receiving the credit as reported in TRD's 2018 Tax Expenditure Report[1]. The CREG growth rates are a proxy for the federal indexing.

Estimating the cost of tax expenditures is difficult. For this bill, the difficulty is both in timing and magnitude. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures.

This bill expands a tax expenditure with a cost that is difficult to determine but likely significant. 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. The committee recommends the bill adhere to the LFC tax expenditure policy principles for vetting, targeting, and reporting or be held for future consideration.

Capital Gain Deduction Changes: The savings calculated uses the highest number of claims reported in the five-year period shown in the latest *Tax Expenditure Report*, assumes tax payers would claim the $1,000 deduction, and includes changes made to the capital gains deduction in the 2019 session which are already incorporated into the CREG estimate. There are several cautions to point out with this capital gain estimate. One is the investment environment from which individuals earn capital gains such as from stocks, bonds or real estate. LFC and TRD look back historically to determine the impact but the future environment can change dramatically in either direction accruing more or less to the PIT. The other caution is taxpayer behavior that in order to avoid the tax liability, capital gains income is no longer associated with New Mexico but moved to another state with a more advantageous tax structure for the taxpayer.

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.

The following issues were identified by TRD:

The federal EITC faces critiques given differential treatment for "childless workers" versus

[1] New Mexico Taxation and Revenue Department, 2018 Tax Expenditure Report, http://www.tax.newmexico.gov/forms-publications.aspx

individuals of the same age with dependent children. Adults who are not claimed as a dependent and are under the age of 25 are ineligible for the EITC if they have no children. Adults over the age of 25 can receive an EITC but the benefit is scaled to a much lower credit than those taxpayers who have dependents. The Center of Budget and Policy Priorities states that this group under the federal tax code is taxed into poverty or deeper into poverty.[2] They detail that statement by explaining that families with children are ensured no net federal tax liability if they earn poverty-level wages through the standard deduction, EITC and Child Tax Credit (CTC). Single childless adults, on the other hand, owe federal income tax starting with earnings below the poverty line with very little or no EITC. In addition, given these individuals are working they have social security and Medicare payroll taxes deducted from their paychecks. Their disposable income is significantly lessoned given income tax and payroll tax liabilities. Expanding the state's WFTC to the population 18 to 25 years age will assist a vulnerable population who despite earning income face economic challenges and a more regressive income tax structure. New Mexico would join Washington, D.C., California, Maine, Maryland and Minnesota in expanding earned income credits to this population.

Due to states basing their state earned income credits on the federal EITC, no state currently extends the credit to taxpayers who file under an ITIN. California in its last legislative session proposed an expansion of their state credit to this population but it was not enacted. ITIN taxpayers are immigrant non-citizens who pay taxes including PIT and often their children are U.S. citizens. Thus, the WFTC is not currently horizontally equitable to New Mexico taxpayers of similar income levels and incurs a wider gap for families with children.

Most of the financial benefit for the capital gains deduction is realized by high earning individuals who have income derived from investments. The change to the capital gains deduction will increase the amount of income for these individuals subject to New Mexico Personal Income Tax. This deduction is meant to encourage taxpayers to put their income to productive use through investing, and to appeal to individuals earning investment income to come to New Mexico. The proposed changes may lessen these incentives. To a lesser extent, the capital gains deduction is used by individuals who transfer family-owned businesses, for example upon retirement.

Of the 42 states along with the District of Columbia that impose a broad-based personal income tax, only nine states including New Mexico give preferential tax treatment of capital gains income versus other income. Thus, New Mexico is in the minority of personal income tax states when it comes to the treatment of capital gains income. Including more capital gains income in the personal income tax base will increase the volatility of revenue estimates as this portion of income is highly sensitive to economic changes. But as the Center on Budget and Policy Priorities highlights in their report, "State Taxes on Capital Gains", states that have a broad array of tax revenue sources and have "rainy-day" funds can lessen this volatility.[3] The annual increase in PIT revenue from capital gains income can thus support state spending.

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[2] Marr, Chuck and Huang, Yixuan "Childless Adults and Lone Group Taxed into Poverty", Updated June 10, 2019, Center on Budget and Policy Priorities; and "Chart Book: The Earned Income Tax Credit and Child Tax Credit", Updated May 24, 2016, Center on Budget and Policies Priorities

[3] McNichol, Elizabeth, "Issues Brief: How States can Tax Wealth. States Taxes on Capital Gaines", Center on Budget and Policy Priorities, December 12, 2018.

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.

ADMINISTRATIVE IMPLICATIONS

The administrative complexity of the WFTC will increase with two expanded populations who are not eligible at the federal level. This is complicated by the fact that individuals must have earned income. The state may not have a federal return at the time of state PIT return submission to assist in validating this component. These returns will require increased review at processing. Audit procedures will need to be updated to ensure proper reporting and training for auditors. The state will need to create unique state forms and publications that will mirror the federal EITC application. TRD will need to make information system changes, create these new forms and update publications and regulations. These changes will be incorporated into annual tax year implementation and represent $15,459 in Information Technology Division (ITD) workload costs. TRD assumes another $40,000 in workload costs to establish business procedures and associated publications and forms.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

HB148 relates to Senate Bill 87 which also increases the rate to 20 percent for most and allowing for 30 percent for those with a dependent under the age of 6. However, Senate Bill 87 does not create a new section to allow for younger filers and does not make changes to the capital gains deduction.

TECHNICAL ISSUES

Under Section 2, subparagraph B, to extend the WFTC to taxpayers between the ages of 18 and 24 years of age, TRD suggests adding the following on line 12, after "tax return": "and who is not a dependent of another individual." Based on the language of the bill, these individuals may be claimed as dependents for another taxpayer who also claims the WFTC. This will clarify that these are independent tax filers and they factor in only once for a determination of the WFTC.

OTHER SUBSTANTIVE ISSUES

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 deductions and other information to determine whether the deductions are meeting their purpose.

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	✓	Was presented to the Revenue Stabilization and Tax Policy Committee during the interim.
Targeted		
Clearly stated purpose	✗	No purpose, targets or goals established.
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	✗	The bill does not contain provisions for reporting.
Expiration date	✗	The bill does not include an expiration date.
Effective		
Fulfills stated purpose	?	Without a purpose statement, it is not possible to determine if the exemption fulfills intended outcomes.
Passes "but for" test	?	
Efficient	?	Difficult to determine as there is no stated purpose.
Key: ✓ Met ✗ Not Met ? Unclear		

IT/al/rl