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FISCAL IMPACT REPORT

		LAST UPDATED	
SPONSOR	Rep. Chandler/Sen. Wirth	**ORIGINAL DATE**	1/22/2024
SHORT TITLE	Limit Income Tax Capital Gains Deduction	**BILL NUMBER**	House Bill 37
		ANALYST	Faubion/Gray

REVENUE*
(dollars in thousands)

Type	FY24	FY25	FY26	FY27	FY28	Recurring or Nonrecurring	Fund Affected
PIT			$61,000.0	$63,000.0	$65,000.0	Recurring	General Fund

Parentheses ( ) indicate revenue decreases.
*Amounts reflect most recent analysis of this legislation.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT*
(dollars in thousands)

Agency/Program	FY24	FY25	FY26	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
TRD - IT		$5.6		$5.6	Nonrecurring	General Fund

Parentheses ( ) indicate expenditure decreases.
*Amounts reflect most recent analysis of this legislation.

Conflicts with Senate Bill 105

Sources of Information

LFC Files

Agency Analysis Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of House Bill 37

House Bill 37 (HB37) seeks to amend the limit of capital gains that may be deducted from personal income tax. The current limit is the greater of $1,000 or 40 percent of the taxpayer's net capital gain income. This bill changes the maximum a taxpayer may claim to $2,500. This bill allows a deduction of 40 percent of up to $1 million of capital gain income from a sale of a New Mexico business.

This bill goes into effect January 1, 2025, and applies to taxable years beginning on or after January 1, 2025.

FISCAL IMPLICATIONS

The Taxation and Revenue Department (TRD) used tax return data for taxpayers claiming the capital gain deduction from tax year 2020 to tax year 2022 to estimate the fiscal impact of the bill. The agency notes its data does not provide insight into whether the source of net capital gain income is from the sale of a business allocated or apportioned to New Mexico.

The agency assumes any taxpayer whose capital gain deduction currently equals exactly $1,000 would be eligible for the $2,500 deduction, for all eligible taxpayers with any source of net capital gain income. This marginally decreases tax liability and tax revenue. The estimate is inflated using Standard & Poor's 500 index's November 2023 forecast. TRD assumes no change in the number of taxpayers eligible for the deduction each year.

As capital gains income is volatile and subject to the behavior of markets, the fiscal impact should be considered a high-end estimate. Capital gains deductions have been as low as $41.2 million in 2019.

TRD indicates they will need to make information system changes and update forms, instructions, and publications if HB37 is implemented. Implementation will have a low impact on the Information Technology Department (ITD), approximately 100 hours or less than one month and an estimated staff workload cost of $5,550 would be required.

SIGNIFICANT ISSUES

Only nine states—Arizona, Arkansas, Hawaii, Montana, New Mexico, North Dakota, South Carolina, Vermont, and Wisconsin—tax capital gains less than ordinary income. In addition, some states, including Colorado, Idaho, Louisiana, and Oklahoma provide capital gains tax breaks only for capital gains on investments in in-state businesses, and a few states target specific industries, such as farming or manufacturing. Nationally, approximately 85 percent of capital gains are generated by the wealthiest 5 percent of taxpayers.[1]

By taxing income differently depending on the source of the income, capital gains deductions erode both horizontal and vertical equity. Horizontal equity, the principle that taxpayers with equal income should pay equal tax, is eroded as those with capital gains income are taxed less than those with earned income or wage income. Vertical equity, the principle that tax obligations should increase as incomes rise, is eroded as those with investment income are not fully taxed on that income and should be contributing more to state taxes.

TRD analysis notes:

> PIT represents a consistent source of revenue for many states. For New Mexico, PIT is approximately 25 percent of the state's recurring general fund revenue. While this revenue source is susceptible to economic downturns, it is also positively responsive to economic expansions. New Mexico is one of 41 states, along with the District of Columbia, that impose a broad-based PIT (New Hampshire and Washington do not tax

[1] Center for Budget and Policy Priorities

wage and salary income). Like several states, New Mexico computes its income tax based on the federal definition of taxable income and ties to other statues in the federal tax code. This is referred to as "conformity" to the federal tax code. The PIT is an important tax policy tool that has the potential to further both horizontal equity, by ensuring the same statutes apply to all taxpayers, and vertical equity, by ensuring the tax burden is based on taxpayers' ability to pay.

Current statute recognizes any taxpayer's capital gain during a tax year, regardless of income level. The increase in the deduction from any source of net capital gains decreases taxable income for taxpayers with lower levels of capital gains. However, higher earning individuals tend to also have higher levels of capital gains, so they receive a larger proportion of benefit from this deduction. Limiting the type of net capital gain to the sale of a qualified business and capping that income to $1 million reduces the proportion of high earning taxpayers. Out of all taxpayers that claim this capital gain deduction, approximately 3.8 percent of taxpayers claim a deduction over $1 million. The cap would not unduly harm lower-income beneficiaries with smaller capital gain. However, taxing capital gains or limiting a deduction affects savings and investment decisions over the long term. The $1 million cap could affect capital flight and cause decline in entrepreneurship in New Mexico.

JF/BG/al/ne