FISCAL IMPACT REPORT

LAST UPDATED ______

SPONSOR Pope **ORIGINAL DATE** 1/30/24

SHORT TITLE Armed Service Retirement Pay Tax Sunset **BILL NUMBER** Senate Bill 56

ANALYST Faubion

REVENUE*
(dollars in thousands)

Type	FY24	FY25	FY26	FY27	FY28	Recurring or Nonrecurring	Fund Affected
PIT	No fiscal impact	($990.0)	($1,000.0)	($1,010.0)	($13,120.0)	Recurring	General Fund

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

Duplicates Senate Bill 125

Sources of Information

LFC Files

Agency Analysis Received From
Taxation and Revenue Department (TRD)
Attorney General's Office (NMAG)
Veteran Services Department (VSD)
Department of Military Affairs (DMA)

SUMMARY

Synopsis of Senate Bill 56

Senate Bill 56 (SB56) amends the Income Tax Act to remove the sunset date on the armed forces retirement pay income tax exemption currently in effect through tax year 2026. With this change, this exemption would remain at $30 thousand of retirement pay per armed forces retiree starting in taxable year 2024. This bill also adds surviving spouses of armed forces retirees to this exemption.

The effective date of this bill is January 1, 2025.

FISCAL IMPLICATIONS

Taxation and Revenue Department analysis shows, by making permanent the $30 thousand military retirement exemption for an armed forces retiree that is currently scheduled to sunset after tax year 2026, the bill will reduce general fund revenue by a recurring $12.1 million starting in fiscal year 2028. The revenue decrease for FY28 is currently factored into the December 2023 Consensus Revenue Estimating Group (CREG) forecast. Therefore, while the fiscal impact notes a loss in general fund revenue above, this loss is already considered in the CREG's December 2023 projections for FY28. The December 2023 CREG forecast made adjustments to this estimate based on tax year 2022 returns reported in the 2023 *Tax Expenditure Report*.

The bill expands the population eligible to claim the exemption to surviving spouses of an armed forces retiree. The *Statistical Report on the Military Retirement System* provides an aggregate number of retirees and survivor beneficiaries by state. As of September 30, 2021, New Mexico had 20,806 reported retirees and 2,812 survivor beneficiaries. TRD assumes an additional 2,812 surviving spouses will claim the exemption beginning in tax year 2024 (See "Technical Issues"). The impact will increase 1 percent annually based on the average retirement exemption impact to tax liability.

To the extent the legislation causes more military retirees to move to New Mexico and military retiree population growth is positive versus flat or negative, the fiscal impact will be larger. The revenue impact does not consider any potential positive impact, such as gross receipts tax revenue, that may result from growth in the military retiree population.

This bill creates or expands a tax expenditure with a cost that is difficult to determine but likely significant. LFC has serious concerns about the substantial 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 action be postponed until the implications can be more fully studied.

SIGNIFICANT ISSUES

The sunset repeal will not have any effect until FY28 when the current exemption is due to expire; therefore, it may be prudent to postpone its passage until the military retirement income tax exemption currently in statute has been implemented and data from the exemption can be analyzed. After a few years of implementation, legislators can better understand its impact and have better information with which to decide to extend the sunset. Adding surviving spouses to this section makes the change more immediate.

TRD notes the following:

> Personal income tax (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 wage and salary income). Like several states, New Mexico computes its income tax based on the federal definition of taxable income and generally conforms 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.

Excluding types of retirement income from the tax base is seen as eroding horizontal equity in state income taxes. By excluding income based on retirement status and profession, taxpayers in similar economic circumstances are no longer treated equally, with older taxpayers receiving a benefit not available to younger taxpayers at the same level of income. New Mexico also provides PIT exemptions to low-income individuals that are 65 years and older or blind.

Removing the sunset date also reduces future tax burden, but with only one year of utilization, the full impact of the current exemption is unclear. TRD supports sunset dates for policymakers to review the impact of tax expenditures before extending them.

There are many reasons why states may exempt some income for retirees, such as lessening the economic burdens for individuals on fixed incomes and trying to attract retirees to the state. The consideration of such exclusions and eroding horizontal equity must be placed in context of the federal and state tax structure in its entirety. This is critical when encouraging military retirees to reside in New Mexico using an armed forces retirement exemption.

Eight states currently do not tax income, including nearby Texas, Nevada, and Wyoming. 11 states partially tax military retirement. For retirees, the decision of a place of residence is not evaluated in a vacuum. For example, Texas does not tax any income. Yet the state features as one of the least tax friendly states for retirees in the country because of its high property and sales taxes. New Mexico’s property taxes are amongst the lowest in the nation. It is, therefore, necessary to take a holistic look at New Mexico’s tax code, and attempts should be made to make the tax structure more simple, broad based, and equitable, without being punitive to any segment of the population.

The Department of Military Affairs notes the following:

- Eight states—Alaska, Florida, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming—have no state income tax. New Hampshire taxes only dividends and interest income.
- Twenty-six states have state income taxes, but they don't tax military retirement benefits: Alabama, Arizona, Arkansas, Connecticut, Hawaii, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Hampshire, New Jersey, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, and Wisconsin.
- Eleven states tax military retirement benefits, but only partially. These states include Colorado, Delaware, Georgia, Idaho, Kentucky, Maryland, **New Mexico**, Oregon, South Carolina, Virginia, and West Virginia. The District of Columbia also taxes military benefits partially.
- Five states tax military retirement pay fully and offer little to no tax benefits for retirement income: California, Montana, Rhode Island, Utah, and Vermont.

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 exemption is meeting its purpose. TRD would report utilization data in its annual Tax Expenditure Report.

ADMINISTRATIVE IMPLICATIONS

The Veteran Services Department notes any additional costs would be absorbed into existing outreach and advertising budgets to support promotional materials provided to our veterans and surviving spouses to make them aware of new income tax related deduction benefit.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

This bill duplicates the effect of Senate Bill 125.

OTHER SUBSTANTIVE ISSUES

The Attorney General's Office highlights the following:

> The statute currently contains no definition of "surviving spouse." Under the Department of Defense Survivor Benefit Plan (SBP) and Dependency and Indemnity Compensation (DIC), for example, former spouses (someone the armed services retiree was divorced from prior to death) can receive lifetime benefits. Additionally, former spouses may be awarded SBP as a result of a divorce court order.
>
> A definition clarifying this potential ambiguity might be helpful to prevent future issues in applying the income tax exemption. Possible considerations for any amendment defining "surviving spouse" could include expressly stating whether this portion of the income tax exemption is intended to include 1) survivor benefits going to former spouses, 2) only those spouses who were married to the armed services retiree at the time of the retiree's death, or 3) both?

In assessing all tax legislation, LFC staff considers whether the proposal is aligned with committee-adopted tax policy principles. Those five principles:

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

In addition, staff reviews whether the bill meets principles specific to tax expenditures. Those policies and how this bill addresses those issues:

Tax Expenditure Policy Principle	Met?	Comments
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.	✓	This bill has previously been introduced and extensively debated.
Targeted: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals. Clearly stated purpose Long-term goals Measurable targets	 ✗ ✗ ✗	No stated purpose. No stated long-term goals. No measurable targets.
Transparent: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant	?	This bill does not require annual

agencies		reporting to interim legislative committees. The exemption may be included in TRD's tax expenditure report.
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. Public analysis Expiration date	 ? ✘	Because there are no stated annual targets or goals, there is nothing from which to determine progress, effectiveness, or efficiency. There is no expiration date.
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. Fulfills stated purpose Passes "but for" test	 ? ?	Because there are no stated annual targets or goals, there is nothing from which to determine effectiveness or passing of the "but for" test.
Efficient: The tax expenditure is the most cost-effective way to achieve the desired results.	✘	No desired results.
Key: ✓ Met ✘ Not Met ? Unclear		

JF/rl/ne/ss/al/hg/ss