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

SPONSOR Trujillo, J. **ORIGINAL DATE** 1/23/18 **LAST UPDATED** 2/12/18 **HB** 83/aHFl#1

SHORT TITLE Estate or Trust Distribution Tax Deduction **SB**

ANALYST Iglesias

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY18	**FY19**	**FY20**	**FY21**	**FY22**		
*	($400.0)	($400.0)	($400.0)	($400.0)	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

(*) Note: since the bill's provisions apply to TY 18 income, there might be a small amount of impact in FY18. However, the bill becomes effective 90 days after adjournment and might only affect the June PIT estimated payments. If there is an impact in FY18, it would be negative to the general fund.

SOURCES OF INFORMATION

LFC Files

Responses Received From

Taxation and Revenue Department

SUMMARY

Synopsis of HFl#1 Amendment

The House Floor amendment #1 to House Bill 83 specifies the bill's new deduction from net income of an estate or trust does not apply to business income allocated or apportioned to New Mexico.

This amendment prevents the bill from creating a planning opportunity to avoid income tax on business income if processed through a trust. See fiscal implications and technical issues sections for discussion.

Synopsis of Original Bill

House Bill 83 creates a new section of the Income Tax Act to provide a deduction from net income of an estate or trust for certain income sequestered within the overall trust or estate that is set aside for future distributions to a nonresident individual. The deduction would not include income from allocable sources of income occurring in New Mexico such as income derived from real property, mineral, oil and gas interests, and water rights, but would allow the deduction for business income that would be apportioned to the non-resident's state of residence were the income directly distributed to the beneficiary rather than flowing through the trust. The purpose of the deduction is to assist in the expansion of the trust and estate business in New Mexico.

Taxpayers allowed the deduction will be required to report the amount of the deduction separately in a manner required by the Taxation and Revenue Department (TRD). TRD will be required to compile an annual report with an analysis of the effectiveness and cost of the deduction and whether the deduction is performing the purpose for which it was created.

The effective date is not specified; therefore, it is assumed to become effective 90 days following adjournment. The provisions of the bill apply to taxable years beginning on or after January 1, 2018. The bill sunsets on December 31, 2024.

FISCAL IMPLICATIONS

This bill creates a planning opportunity to avoid income tax on business income if processed through a trust and could therefore have a large negative impact on the general fund (see technical issues section). If business income were excluded from eligibility, the bill would have only a modest negative impact, as described below.

According to the Taxation and Revenue Department (TRD), fiduciary income tax revenue has been declining since FY2012. Consequently, the baseline deduction figure is lower in 2017 than in previously proposed bills. In contrast, the personal income tax (PIT) growth rate in each subsequent year is projected to be positive. Thus, the cost of this deduction grows each year. Baseline data for TRD's analysis was obtained from the GenTax Distribution Summary. New Mexico fiduciary income tax revenues for FY09 - FY16 were used to calculate a rolling 5-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, it was 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 $7.9 million. As described above, the baseline cost for this deduction was estimated as 5 percent of the five-year average, or about $400 thousand annually.

The fiscal estimates provided represent a range, with $400 thousand at the low end (assuming the bill is amended to exclude business income from the deduction) and with 10 times that amount, or $4 million, at the high end (assuming business income remains eligible for the deduction). The high-end estimate is a ballpark number intended to demonstrate the potentially large negative revenue impact if the business income issue is not addressed.

It is not clear if the provisions of this bill create a tax expenditure. It could be argued that the provisions of the bill slightly redefine the appropriate state tax base.

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. TRD recommends giving additional consideration to the scope of the deduction and the types of trusts intended to benefit from it as to not implicate efficiency. While facts for each business will vary, professional service businesses 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, TRD states 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 analysis of previous versions of this bill (2017 House Bill 76), TRD stated, “This bill is prone to unintended consequences and tax leakage. For example, there may be instances with this deduction in which neither the trust nor the beneficiary are taxed either while the income is being held or when it is distributed. There may also be instances when the beneficiary pays tax on the income when it is finally distributed.

Efficiency incentives are most often given because the growth of a particular industry may yield additional revenue, employment, or other benefits to the state. This goal may not be served with certain types of trusts. For example, an investment fund set up as a trust typically has very little property subject to taxation, very few employees, and in certain circumstances, the trustee services may be deductible from gross receipts taxes under Section 7-9-108 NMSA 1978. There may, however, be other instances in which the growth of trust business activities may provide the sought after benefits to New Mexico.

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

This legislation may open a significant loophole in the income tax code. In section 1, part A, the bill identifies particular types of income to be excluded from this deduction; however, by not listing business income among them, it would presumably be possible for a taxpayer to send all of their business income through a trust (that has an out-of-state beneficiary) and that income would then become non-taxable under this deduction. If that is not the intent, business income should be listed as a type of income that is excluded from this proposed deduction.

In previous analyses, TRD noted critical definitions, such as “member,” are missing from the bill. Additionally, because fiduciary statutes do not provide clear guidance for estates and trusts, the bill as currently written will be hard to interpret, time consuming for taxpayers and employees to implement, and subject to the potential for fraud.

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	✘	
Measurable targets	✘	Although TRD is required to report on the effectiveness and cost of deduction, no measureable targets are given
Transparent	✓	Requires annual reporting by TRD and presentation to RSTP and LFC
Accountable		
Public analysis	?	Depends on how TRD structures the required reports
Expiration date	✓	The bill sunsets on December 31, 2023
Effective		
Fulfills stated purpose	?	Per TRD, may be subject to unintended consequences and tax leakage
Passes "but for" test	?	
Efficient	?	Per TRD, efficiency incentives may not be met in some circumstances (e.g. investment fund set up as a trust)
Key: ✓ Met ✘ Not Met ? Unclear		

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