**BILL ANALYSIS AND FISCAL IMPACT REPORT**
**Taxation and Revenue Department**

**February 4, 2024**

**Bill:** HB-280 **Sponsor:** Representatives James G. Townsend, Rod Montoya, Mark Duncan, Candy Spence Ezzell, and Alan T. Martinez

**Short Title:** Flat Income Tax Rate

**Description:** This bill amends Section 7-2-7 NMSA 1978, the personal income tax rates, to allow only one tax rate for all income levels of 1%.

**Effective Date:** Not specified; 90 days following adjournment (May 15, 2024).

**Taxation and Revenue Department Analyst:** Sara Grubbs

| Estimated Revenue Impact* | | | | | R or NR** | Fund(s) Affected |
|---|---|---|---|---|---|---|
| FY2024 | FY2025 | FY2026 | FY2027 | FY2028 | | |
| -- | ($1,730,000) | ($1,794,000) | ($1,859,000) | ($1,928,000) | R | General Fund – individual, estate and trusts PIT taxpayers |
| -- | (Unknown but likely negative) | | | | R | General Fund – Pass-through entity PIT taxpayers |

* In thousands of dollars. Parentheses ( ) indicate a revenue loss. ** Recurring (R) or Non-Recurring (NR).

**Methodology for Estimated Revenue Impact:** The impact of the proposed changes to the income tax brackets was estimated using tax years 2021-2022 tax return data for New Mexico individual taxpayers. Using the University of New Mexico's Bureau of Business and Economic Research (BBER) January 2024 forecast, the Taxation and Revenue Department (Tax & Rev) indexed the data to tax year 2024 and then grew the estimate annually by BBER's New Mexico's wage and salary growth estimate.

As discussed in "Technical Issues" below, an effective date of May 15, 2024, with applicability for taxable years beginning on January 1, 2024 will impact the administration of the personal income tax (PIT) bracket changes and fiscal impact. Typically, effective dates for PIT bracket changes allow for an adjustment of the withholding tables relied upon by employers and subsequent adjustments to employees withholding. This has a half-year fiscal year impact on the revenue as withholding is either adjusted up or down to reflect the change in the rates. Due to the timing, Tax & Rev assumes a full impact in FY2025 for the tax year 2024 decrease in the PIT rate.

The proposed changes may impact pass-through entity taxpayers' decisions to elect the entity-level tax under 7-3A-10 NMSA 1978. The entity-level tax was enacted to address the federal Tax Cuts and Jobs Act (TCJA) $10,000 limitation on the deduction of state and local taxes for taxpayers that itemize federal deductions. As discussed below under "Policy Issues", those electing the entity-level tax will pay the maximum tax rate of either the highest tax bracket for PIT or the highest tax bracket for Corporate Income Tax (CIT). Currently the rates are equal (5.9%); this bill will decrease the maximum PIT rate to 1.0% but maintain then the maximum rate of 5.9% under CIT. Pass-through entity taxpayers will weigh then the impact of their taxes on the federal side versus the impact on the state side. Tax & Rev cannot determine the aggregate impact to PIT revenue but would assume some negative impact to revenue with a portion of taxpayers no longer electing the entity-level tax at the 5.9% CIT rate and instead paying 1% income tax under PIT.

**Policy Issues:** Personal income tax (PIT) represents a consistent source of revenue for many states. For New Mexico, PIT is approximately 25% 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 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.

The last substantial amendment to the PIT brackets was passed in 2005, though the changes made by that amendment were not fully implemented until tax year 2008. In 2019, HB6 added an additional 5.9% top income bracket to each filing status, effective from tax year 2021. As New Mexico PIT brackets are not indexed to inflation, taxpayers have gradually moved into higher tax brackets, a phenomenon described as "bracket creep", despite the fact that their "real income", or the purchasing power of their income, has not changed. Over time, the effective PIT rate, which is the average tax rate paid by a taxpayer on their total gross income, has therefore increased. The federal personal income tax indexes both the standard deduction and tax brackets.

Current New Mexico PIT tax structure is progressive, progressive meaning that higher-income taxpayers are taxed at a higher rate. This reduces horizontal equity but encourages vertical equity. See table 1.

| Table 1 | | |
|---|---|---|
| **Current Tax Bracket** | **Taxable Income Range** | **Rate** |
| **Married Filing Separate** | | |
| 1 | Not over $4,000 | 1.70% |
| 2 | $4,000 -- not over $8,000 | 3.20% |
| 3 | $8,000 -- not over $12,000 | 4.70% |
| 4 | $12,000 -- not over $157,500 | 4.90% |
| 5 | Over $157,500 | 5.90% |
| **Married Filing Joint, Heads of Household** | | |
| 1 | Not over $8,000 | 1.70% |
| 2 | $8,000 -- not over $16,000 | 3.20% |
| 3 | $16,000 -- not over $24,000 | 4.70% |
| 4 | $24,000 -- not over $315,000 | 4.90% |
| 5 | Over $315,000 | 5.90% |
| **Single** | | |
| 1 | Not over $5,500 | 1.70% |
| 2 | $5,500 -- not over $11,000 | 3.20% |
| 3 | $11,000 -- not over $16,000 | 4.70% |
| 4 | $16,000 -- not over $210,000 | 4.90% |
| 5 | Over $210,000 | 5.90% |

This bill applies a flat 1% tax to all taxable income, regardless of income level. This tax structure is regressive in nature, whereby lower-income taxpayers pay a greater percentage of taxable income and reduces vertical equity but creates horizontal equity.

All taxpayers will see a decrease in their tax liability with most of the savings from this bill occurring for higher-income taxpayers as demonstrated in Table 2 below.

| Table 2 | | | |
|---|---|---|---|
| **Current Tax Bracket** | **Estimated No. of Taxpayers** | **Estimated Fiscal Impact for FY2026 ($ thousand)** | **Average Tax Relief Per Taxpayer** |
| 1 | 431,000 | ($2,000) | ($4.64) |
| 2 | 67,000 | ($9,000) | ($134.33) |
| 3 | 58,000 | ($19,000) | ($327.59) |
| 4 | 501,000 | ($1,202,000) | ($2,399.20) |
| 5 | 42,000 | ($563,000) | ($13,404.76) |

This bill eliminates the progressive nature of current New Mexico tax brackets and thus erodes vertical equity. The tax liability for taxpayers in the bottom tax bracket will fall on average by $4.64 per taxpayer. The tax liability for taxpayers in the top bracket will fall by an average of $13,404.76 per taxpayer.

By condensing all brackets onto one single 1% tax rate, the bill eliminates the so-called "marriage penalty". As defined by the Tax Foundation, a marriage penalty exists when a state's income brackets for married taxpayers filing jointly are less than double the bracket widths for single filers. As of tax year 2023, New Mexico is currently one of 15 states with a "marriage penalty" built into its income tax brackets[1].

This reduction in tax rate may impact the ability for taxpayers who previously had certified tax credits that are only to be applied against tax (i.e. are not refundable or transferable) to not receive the amount certified for eligibility. This may factor in the taxpayer's decision to invest in credits such as charitable incentive tax credits, energy conservation incentive tax credits, employment enhancement tax credits, or specific industry incentive tax credits.

By statute, Section 7-3A-10 NMSA 1978, those electing the entity-level tax will pay the maximum tax rate of either the highest tax bracket for PIT or the highest tax bracket for CIT. Currently the rates are equal; this bill will maintain the 5.9% maximum CIT tax rate for taxpayers electing the entity-level tax. Pass-through entity taxpayers are often thought of as corporate filers despite paying as individual owners under PIT. The lower PIT rate, which will be paid by sole proprietors, LLCs and partnerships, may be seen as a question of fairness between corporate filers filing under CIT. According to the Tax Foundation[2], these taxpayers will expend resources to calculate at the federal and state level the advantages to filing under different entities and under different state tax acts.

The impact to revenue is immense, starting at over $1.7 billion in Fiscal Year 2025, and rising to over $1.9 billion in 2028. Recurring revenue reductions of this magnitude will need to be met either with corresponding cuts to expenditures or by finding alternative sources of revenue.

**Technical Issues:** While Section 2 denotes an applicability date, it does not specify a taxable year that the change will become effective. The default effective date of May 15, 2024 for the bill would cause an administrative burden for Tax & Rev and possible confusion for the public. Withholding tables would

[1] https://taxfoundation.org/state-marriage-penalty-2022/
[2] https://taxfoundation.org/publications/state-corporate-income-tax-rates-and-brackets/

have to be changed mid tax-year. Publishing new withholding tables is normally done once a year in November prior to the upcoming tax year to allow time for employers to program and adjust their employees' withholding. Tax & Rev recommends that Section 2 be changed to "taxable years beginning on or after January 1, 2025."

**Other Issues:** When the highest rates for the Income Tax Act and the Corporate Income and Franchise Tax Act do not align there are subsequent impacts for different withholding taxes such as pass-through entity and oil and gas proceeds. The proposed rate change impacts rates for Section 7-1-13(G) NMSA 1978 Federal adjustments other than the distributive share of federal adjustments; Section 7-3-14 NMSA 1978. Composite returns; and Section 7-3A-10 NMSA 1978, Election of entity-level tax. As noted in policy issues above, the PIT rate decrease to 1.0% will place CIT above the highest tax bracket for PIT. By statute, Section 7-3A-10 (C ) NMSA 1978, those electing the entity-level tax will then pay a higher tax rate at 5.9%.

**Administrative & Compliance Impact:** This bill will have a low impact on the Information Technology Division (ITD), approximately 440 hours or about 1 month for an estimated staff workload cost of $24,420. Rate changes for Personal Income Tax and Fiduciary Tax will be included in the annual tax year changes.

This change would impact the 2024 tax year programming. Although, the programming for income taxes could be handled during the normal process. Other programs impacted such as withholding would need a longer implementation time. It would be suggested that this change take place for tax year 2025.

| Estimated Additional Operating Budget Impact* | | | | R or NR** | Fund(s) or Agency Affected |
|---|---|---|---|---|---|
| FY2024 | FY2025 | FY2026 | 3 Year Total Cost | | |
| -- | $24.4 | -- | $24.4 | NR | Tax & Rev – ITD Staffing |

* In thousands of dollars. Parentheses ( ) indicate a cost saving. ** Recurring (R) or Non-Recurring (NR).

**Related Bills:** Conflicts with HB-252 and SB-105