Department of Legislative Services
2011 Session

FISCAL AND POLICY NOTE

House Bill 7 (Delegate Davis)
Ways and Means

Income Tax - Subtraction Modification and Tax Credit - Interest on Loans to Enterprise Zone Businesses

This bill (1) exempts from the State income tax interest income received from a qualifying loan made to a business entity located in an enterprise zone; and (2) creates a nonrefundable income tax credit equal to 5% of the interest income received from a residential mortgage loan if the mortgagor is an individual with at least a 50% ownership interest in a business in an enterprise zone. A "lender" is required to reduce the principal of the qualifying residential loan for which the credit was claimed by the amount of the credit within 90 days of filing a State income tax return. The interest income deduction can only be claimed if the loan is used for business activities within the enterprise zone and neither tax benefit is allowed if the lender has an ownership interest in the business receiving the loan.

The bill takes effect July 1, 2011, and applies to tax year 2011 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by $6.7 million in FY 2012 due to subtraction modifications and credits claimed against the income tax. Revenue losses could be significantly more. Transportation Trust Fund (TTF) revenues decrease by $1.3 million in FY 2012, and Higher Education Investment Fund (HEIF) revenues decrease by $0.5 million. General fund expenditures increase by $143,600 in FY 2012 for one-time tax form changes and computer programming modifications at the Comptroller's Office.

($ in millions)	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
GF Revenue	($6.7)	($7.0)	($7.3)	($7.7)	($8.0)
SF Revenue	($1.8)	($1.9)	($2.0)	($2.1)	($2.2)
GF Expenditure	$0.1	$0	$0	$0	$0
Net Effect	($8.6)	($8.9)	($9.3)	($9.8)	($10.2)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Local income tax revenues decrease by $240,000 in FY 2012 and by $291,700 in FY 2016. Local highway user revenues decrease by $133,200 in FY 2012 and by $182,000 in FY 2016. Local expenditures are not affected.

Small Business Effect: Potential meaningful.

Analysis

Current Law: Interest income is generally subject to the State income tax. Businesses and individuals can qualify for enterprise zone tax credits as discussed below.

Background:

Maryland Enterprise Zones

Maryland's Enterprise Zone program is a joint effort between the State and local governments to provide tax incentives to businesses and property owners located in areas of the State designated as economically distressed areas. The program was created in 1982 with 2 zones and has grown to include 29 zones. Businesses located within an enterprise zone are eligible for local property tax credits and State income tax credits for a period of 10 years.

Real property tax credits are 10-year credits against local real property taxes on a portion of the qualifying real property improvements. The credit is equal to 80% of the assessment increase during the first five years; decreasing by 10% annually thereafter and equaling 30% in the tenth year. The State Department of Assessments and Taxation (SDAT) reimburses local governments for one-half of the cost of the property tax credit. In fiscal 2012, 1,027 businesses will claim property tax credits related to a total of $3.2 billion in capital investments, an average of $3.1 million of investment per business. SDAT will reimburse local governments $19.0 million in fiscal 2012.

In addition to the property tax credit, businesses located in a Maryland enterprise zone can also claim an income tax credit for wages paid to newly hired employees. The credits are based on the wages paid during the taxable year to each qualified employee. An enhanced credit is available if the business is located within a focus area in the enterprise zone or the employee is certified by the Department of Labor, Licensing, and Regulation as being economically disadvantaged. In tax year 2007, a total of $809,800 in enterprise zone income tax credits were claimed.

Enterprise Zone Interest Deduction Programs in Other States

Several states tax at a reduced rate the interest income earned from a loan to a business located within an enterprise zone; these states include California, Illinois, and Indiana. Indiana's loan interest credit provides a credit for interest income earned by a taxpayer from a loan that directly benefits a business, property values, or is used to rehabilitate, repair, or improve a residence within an enterprise zone. The nonrefundable credit is equal to 5% of the qualifying loan interest received during the year and can be claimed against the individual, corporate, financial institutions, and insurance premiums taxes. In tax year 2007, a total of $2.6 million in credits were claimed, of which nearly all were claimed against the corporate income tax. Financial institutions in Illinois are not taxed on interest income from a loan secured by property that is eligible for the Illinois Enterprise Zone Investment Credit.

California allows a net interest deduction for the amount of interest received from loans made to a trade or business located within an enterprise zone. Net interest is defined as the full amount of interest received, less any direct expenses incurred in making the loan. In addition to initial requirements that must be met to qualify for the deduction, the borrower must in successive years continue business activities within the enterprise zone and interest payments must be received before expiration of the zone

State Revenues: Subtraction modifications and credits may be claimed beginning in tax year 2011. As a result, general fund revenues will decrease by $6.7 million in fiscal 2012. TTF revenues will decrease by $1.3 million in fiscal 2012; HEIF revenues will decrease by $484,500. Future year revenue losses increase by approximately 4.7% annually. **Exhibit 1** shows the estimated revenue loss from the subtraction modification and credit proposed by the bill and the combined revenue loss.

Legislative Services advises that data is unavailable on the number of businesses within an enterprise zone as well as the amount of business and residential interest loan payments made by these businesses. In order to estimate the fiscal impact of the subtraction modification, two methods were employed. The first method adjusted the amount claimed in Indiana for the estimated differences in capital investments and employment within each state's enterprise zones, differences in tax rates, and changes in the economy and business lending since 2007. The second method apportioned the amount of total interest reported by the FDIC for regulated Maryland financial institutions to enterprise zone businesses based on the estimated economic activity in enterprise zones relative to the entire state and the amount of business loans relative to total loans and leases. This calculation was replicated for Indiana in 2007.

Exhibit 1
HB 7 Potential State and Local Revenue Decreases
Fiscal 2012-2016

	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Subtraction Modification	$8,000,000	$8,400,000	$8,820,000	$9,261,000	$9,724,000
Tax Credit	500,000	500,000	500,000	500,000	500,000
Total State Revenue Decrease	**8,500,000**	**8,900,000**	**9,320,000**	**9,761,000**	**10,224,000**
General Fund	6,706,600	7,003,200	7,333,700	7,680,650	8,045,000
HEIF	484,500	507,300	531,200	556,400	582,800
TTF	1,308,900	1,389,500	1,455,100	1,523,900	1,596,200
MDOT	1,175,800	1,231,100	1,289,200	1,350,200	1,414,200
LHUR	133,200	158,400	165,900	173,700	182,000
Local Income Tax Revenues	240,000	252,000	264,600	277,800	291,700

LHUR = Local Highway User Revenues

The revenue loss estimated for Maryland was adjusted by the percentage difference between the estimated and actual amount of Indiana interest credit claimed in 2007. Both of these methods have their limitations; as such, actual revenue losses could be significantly different. In addition to the data limitations described above, it is not known how many enterprise zone business owners own house(s), the interest payments made on behalf of these loans, and the participation rate of lenders in the residential loan credit program. The estimated annual credit cost of $500,000 ranges from $50,000 to $1.4 million depending on different assumptions.

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of $143,600 in fiscal 2012 to add the subtraction modification and credit to the income tax returns. This includes data processing changes to the SMART income tax return processing and imaging systems and system testing.

Local Revenues: Local income tax revenues will decrease by about 3% of the total subtraction modification claimed against the personal income tax. In addition, local governments receive, as highway user revenues, a share of the TTF portion of corporate income taxes. Therefore, local highway user revenues will decrease as a result of subtraction modications and credits claimed against the corporate income tax. Exhibit 1 illustrates the estimated decrease in local revenues in fiscal 2012 through 2016. Businesses in Baltimore City and Montgomery County have made about 60% of the total capital investments qualifying under the enterprise zone property tax credit; and, by area, about 40% of Baltimore City is designated as an enterprise zone.

Small Business Impact: Reducing the after-tax cost of lending to businesses in enterprise zones will likely benefit small businesses in these zones by reducing the cost of funds and/or increasing the availability of loans. A lender who participates in the residential loan credit program proposed by the bill is required, as in loan modification programs, to reduce the principal of a qualifying residential loan by the amount of the credit. The average value of a home in Maryland in 2009 was $321,600. Although residential loan interest payments made by enterprise zone businesses owners could be significantly different than the typical Marylander, the annual reduction in principal for a typical, conventional Maryland mortgage will be about $1,000.

Conversely, any competing small business that would not qualify for the subtraction modification could be negatively impacted by the relative higher cost of funds and reduced credit availability than its competitors in enterprise zones.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Department of Business and Economic Development, Comptroller's Office, State Department of Assessments and Taxation, Federal Deposit Insurance Corporation, Indiana Legislative Services Agency, State of California Franchise Tax Board, U.S. Bureau of Labor Statistics, U.S. Census Bureau, Department of Legislative Services

Fiscal Note History: First Reader - February 9, 2011
ncs/jrb

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