Department of Fiscal Services

Maryland General Assembly

FISCAL NOTE
Revised

House Bill 511 (Delegate Taylor, *et al.*)
Ways and Means | Referred to Budget and Taxation

1997 Tax Reduction Act

This enrolled bill reduces the top marginal State income tax rate from 5% to 4.75% and increases the personal exemption from $1,200 to $2,400 by 2002. The bill decouples the piggyback tax from the State tax, and requires taxpayers to make two payments to the Comptroller, one reflecting State income tax liability and the other local income tax liability.

The bill also creates a credit against the sales and use tax for tangible personal property used in a production activity, and exempts such property from the sales tax beginning in fiscal 2001.

This bill is effective July 1, 1997. The income tax provisions apply to taxable years beginning after December 31, 1997.

Fiscal Summary

State Effect: General fund revenues could decline by an estimated $38.5 million in FY 1998, and expenditures could increase by an estimated $144,600. Out-year estimates reflect the effects of the tax changes in each tax year. FY 2003 would be the first fiscal year for which these changes would be fully implemented.

(in millions)	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
GF Revenues	($38.5)	($125.3)	($223.4)	($335.8)	($437.2)
GF Expenditures	0.1	0.6	0.4	0.4	0.5
Net Effect	($38.6)	($125.9)	($223.8)	($336.2)	($437.7)

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

Local Effect: None. Local income taxes would be calculated without regard to the changes to the State income tax.

Small Business Effect: Meaningful indeterminate impact on small businesses, as discussed below.

Fiscal Analysis

Bill Summary: The top marginal income tax rate is reduced from 5% to 4.75% by 2002 in annual increments of 0.05%. Personal exemptions are increased from $1,200 to $1,400 in 1998; $1,600 in 1999; $1,850 in 2000; $2,100 in 2001; and $2,400 in 2002. The two-income subtraction is adjusted to account for the change in the top income tax rate. The piggyback tax is decoupled from the State income tax by requiring that it be determined assuming that the top State tax rate is 5%, personal exemptions are $1,200 and the two-income subtraction is $1,200. Taxpayers are required to make two payments to the Comptroller, one for State income tax liability and one for local income tax liability. The payment for local income taxes is to be made payable to "Local Income Tax Fund - Comptroller."

The bill also provides for a credit against the sales and use tax and defines tangible personal property used in a manufacturing process. Tangible personal property used in a manufacturing process includes, among other items: noncapitalized machinery or equipment which would be exempt if it were capitalized; certain property not consumed within one year after it is first used in a manufacturing process; and equipment that is used to move a finished product. Providing for employee safety and quality control are added to the definition of "production activity."

The sales tax credit is one-third of the sales tax paid on tangible personal property used in a production activity for property purchased in fiscal 1999, and two-thirds of the sales tax paid on property purchased in fiscal 2000. The Comptroller shall provide for refunds of the credit if sales and use tax remittances of a manufacturer are not sufficient to use the full amount of the credit within one year. The credit expires June 30, 2000, at which time tangible personal property used in a manufacturing process is exempt from the sales tax.

State Revenues: The Maryland income tax simulation model indicates that revenues for tax year 1998 would decline by an estimated $75.4 million. Tax year 1999 revenues would decline an estimated $154.1 million; 2000 revenues would decline an estimated $247.1 million; 2001 revenues would decline an estimated $345.3 million; and 2002 revenues would decline an estimated $450.7 million.

The Office of the Comptroller has advised that withholding would be adjusted for each year of the phase-in period. Based on historical collection patterns, 51% of a tax year revenue is collected in the first fiscal year, and 49% is collected in the following fiscal year (*e.g.*, 51% of tax year 1998 revenue is collected in fiscal 1998, and 49% is collected in fiscal 1999). Thus, in fiscal 1998, general fund revenue would decline by an estimated $38.5 million. Revenues would decline by $115.5 million in fiscal 1999; $201.5 million in fiscal 2000; $297.2 million in fiscal 2001; and $399.1 million in fiscal 2002. Fiscal 2003 would be the first fiscal year in which the tax reduction is fully implemented. The revenue loss in that year would be about $460 million.

Manufacturing industries paid an estimated $28.5 million in sales and use taxes in fiscal 1996 on machinery and equipment which would be eligible for the tax credit under this bill. Assuming growth of 5% per year, about $33 million of taxes would be paid in fiscal 1999, so a 33% credit would result in the loss of about $10.9 million. It is assumed that 90% of the credits attributable to fiscal 1999 would actually be claimed in fiscal 1999; the remainder would be claimed in fiscal 2000. Thus, the revenue loss for fiscal 1999 totals an estimated $9.8 million. The revenue loss for fiscal 2000 totals an estimated $21.9 million, which accounts for the two-thirds credit, 90% of the credits attributable to fiscal 2000, and 10% of the credits attributable to fiscal 1999. When this property becomes exempt in fiscal 2001, the revenue loss would total an estimated $38.6 million.

State Expenditures: The Office of the Comptroller will incur costs for computer programming changes in each year that changes to the tax rate are made. These costs would total $261,000 in fiscal 1999, and $130,000 for fiscal years 2000 through 2003. New withholding tables would have to be prepared for fiscal years 1998 through 2002. Costs would increase an estimated $48,000 in fiscal 1998, increasing at 2% per year. Mailing the withholding tables would cost $49,300 annually.

The requirement that taxpayers make two payments would double the number of checks which must be processed. Beginning in fiscal 1999, an additional eight temporary employees would be required each April to process payments at an hourly cost of $7.355 for the first shift and $7.855 for the second shift, resulting in an additional cost of $9,735. Verifying checks would require an additional 12 temporary employees at an hourly cost of $6.50 for the first shift and $7.00 for the second, resulting in additional costs of $12,960. These costs would increase by about 2% annually.

Lockbox costs, at 18 cents per transaction, would double resulting in increased costs of $137,000. The 3.7 cent charge for each deposit would also double, increasing costs by $48,000 annually. About 25% of the annualized cost would occur in fiscal 1998 for the processing of estimated payments. These costs would increase by about 2% in the out-years.

The Office of the Comptroller advises that an additional $745,000 would be required in fiscal 1999 to replace ten remittance processors which are old and could not handle the increased workload in a timely manner. The Department of Fiscal Services advises that these processors would have had to have been replaced shortly in any case.

Small Business Effect: Many different forms of businesses pay the individual income tax rather than the corporate income tax, including sole proprietorships, partnerships, limited liability corporations, and subchapter S corporations. Most, but not all, businesses of these types are small businesses. The total number of these types of businesses, as well as the number which are small businesses, is unknown.

In tax year 1995, 303,827 individuals owned sole proprietorships, although there were more sole proprietorships than that since some individuals owned more than one. A maximum of 160,050 individuals held ownership interests in partnerships, LLCs, and subchapter S corporations, not all of which are small businesses.

A reduction in the top income tax rate and an increase in the personal exemption will affect these small businesses as these changes would all other taxpayers. As shown below, the benefit for a taxpayer depends on income and the number of exemptions claimed.

Additional Comments: Exhibit 1 shows the savings in 1998 and 2002, when the bill is fully implemented, for single individuals earning $25,000 and $60,000 (with the standard deduction and $8,000 of itemized deductions), and for families of four earning $40,000 and $100,000 (with the standard deduction and $10,000 of itemized deductions, two-income subtraction) for tax year 2002, when the changes of this bill would be fully implemented. The table also shows the increased federal income tax liability for those who itemize deductions. Of the total reduction in State taxes paid by Maryland taxpayers, less than 15% would be paid in higher federal income taxes by those who itemize.

Exhibit 1
Examples of Tax Savings

	Single Individual		Family of Four	
Gross Income	$25,000	$60,000	$40,000	$100,000
Current State Taxes	1,030	2,480	1,440	4,140
1998 State Savings	19	34	52	79
Federal Tax Increase	0	9	0	22
Net Savings	19	24	52	57
2002 State Savings	104	177	291	426
Federal Tax Increase	0	49	0	119
Net Savings	104	127	291	307

Information Source(s): Office of the Comptroller (Revenue Administration Division, Compliance Division), Department of Fiscal Services

Fiscal Note History: First Reader - February 5, 1997
ncs Revised - House Third Reader - March 19, 1997
Revised - Enrolled Bill - May 8, 1997

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