Department of Legislative Services

Maryland General Assembly
2007 Special Session

FISCAL AND POLICY NOTE
Revised

House Bill 2 (The Speaker) (By Request – Administration)
Ways and Means and Appropriations

Tax Reform Act of 2007

This Administration bill overhauls the State's tax structure beginning January 1, 2008, thereby increasing State revenues (all funds) by $149.8 million in fiscal 2008 and $420.3 million beginning in fiscal 2009 as follows:

- establishes new individual income tax brackets and rates beginning January 1, 2008, with the top rate set at 5.75% as shown below;

Maryland State Income Tax Rates as Proposed in HB 2

Single, Dependent Filer, Married Filing Separate		Joint, Head of Household, Widower	
Rate	**Maryland Taxable Income**	**Rate**	**Maryland Taxable Income**
2.00%	$1 - $1,000	2.00%	$1 - $1,000
3.00%	$1,001 - $2,000	3.00%	$1,001 - $2,000
4.00%	$2,001 - $3,000	4.00%	$2,001 - $3,000
4.75%	$3,001 - $125,000	4.75%	$3,001 - $175,000
5.25%	$125,001 - $150,000	5.25%	$175,001 - $200,000
5.50%	$150,001 - $200,000	5.50%	$200,001 - $250,000
5.75%	Excess of $200,000	5.75%	Excess of $250,000

- expands the refundable earned income credit beginning January 1, 2008;

- alters the regular personal income tax exemption – the exemption increases from $2,400 to $3,200 for individuals with federal adjusted gross income (FAGI) of up to $100,000 ($150,000 for joint filers) but gradually decreases to $600 for taxpayers with higher incomes;

- increases the corporate income tax rate from 7% to 8.75% beginning January 1, 2008, and distributes the increased revenue to the general fund;

- requires affiliated corporations to compute Maryland taxable income using "combined reporting;" and

- imposes recordation and transfer taxes on the transfer of real property through the sale of a "controlling interest" in specified corporations beginning in fiscal 2009.

Fiscal Summary

State Effect: Total revenues would increase by $149.8 million in FY 2008 and by $487.4 million in FY 2012. Administrative expenditures would increase by $322,100 in FY 2008 and by $113,600 in FY 2012. **Exhibit 1** shows the net effect on State revenues and expenditures by fund type.

Local Effect: Local government revenues would decrease by $39.2 million in FY 2008 and by $28.1 million in FY 2012. **Exhibit 4** shows the impact on local revenues by tax change for a five-year period. **Exhibit 5** shows the impact on local revenues in FY 2009 by county. Montgomery County expenditures for its Earned Income Credit program could increase by an indeterminate amount.

Small Business Effect: A small business impact statement was not provided by the Administration in time for inclusion in this fiscal note. A revised fiscal note will be issued when the Administration's assessment becomes available.

Additional Information

Prior Introductions: None.

Cross File: SB 2 (The President) (By Request – Administration) – Budget and Taxation.

Information Source(s): Comptroller's Office, State Department of Assessments and Taxation, Department of Legislative Services

Fiscal Note History: First Reader - October 30, 2007
mll/hlb Revised - House Third Reader - November 14, 2007

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Exhibit 1
Net Impact on State Revenues and Expenditures
($ in Millions)

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Revenues					
GF	$149.8	$397.4	$424.0	$448.1	$462.6
SF	0.0	14.1	14.1	14.1	14.1
TTF	0.0	8.7	8.8	9.9	10.6
Total	**$149.8**	**$420.3**	**$447.0**	**$472.2**	**$487.4**
Expenditures					
GF	$0.3	$0.0	$0.0	$0.0	$0.0
SF	0.0	0.1	0.1	0.1	0.1
TTF	0.0	0.0	0.0	0.0	0.0
Total	**$0.3**	**$0.1**	**$0.1**	**$0.1**	**$0.1**
Net Effect	**$149.5**	**$420.2**	**$446.9**	**$472.1**	**$487.3**

GF = general fund; SF = special fund; TTF = Transportation Trust Fund

Exhibit 2
Impact on State Revenues by Tax Change
($ in Millions)

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Individual Income Tax					
Rate Adjustment	$155.1	$333.4	$353.9	$373.5	$393.2
Personal Exemption	-62.1	-130.4	-132.0	-133.1	-134.3
Earned Income Credit	0.0	-38.5	-40.2	-39.8	-41.9
Blind/Elderly Exemption	0.0	0.0	0.0	0.0	0.0
Refundable Tax Credit	0.0	0.0	0.0	0.0	0.0
Subtotal	**$93.0**	**$164.5**	**$181.7**	**$200.6**	**$217.0**
Corporate Income Tax					
Increase and Distribution	$56.8	$196.1	$205.1	$205.6	$201.1
Combined Reporting	0.0	45.5	46.0	51.8	55.1
Subtotal	**$56.8**	**$241.6**	**$251.1**	**$257.4**	**$256.2**
Transfer Tax	**$0.0**	**$14.1**	**$14.1**	**$14.1**	**$14.1**
Total Revenues	**$149.8**	**$420.3**	**$447.0**	**$472.2**	**$487.4**
General Funds	149.8	397.4	424.0	448.1	462.6
Special Funds	0.0	14.1	14.1	14.1	14.1
Transportation Trust Funds	0.0	8.7	8.8	9.9	10.6

Exhibit 3
Impact on State Expenditures – Tax Reform Act of 2007

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
General Fund					
Comptroller's Office	$322,100	$0	$0	$0	$0
Special Fund					
Assessment and Taxation	$0	$96,700	$102,000	$107,600	$113,600
Total Expenditures	**$322,100**	**$96,700**	**$102,000**	**$107,600**	**$113,600**

Exhibit 4
Impact on Local Revenues by Tax Change
($ in Millions)

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Local Tax Revenues					
Personal Exemption	-39.2	-82.4	-83.4	-84.1	-84.8
Controlling Interest	0.0	48.2	48.2	48.2	48.2
Subtotal	**-$39.2**	**-$34.2**	**-$35.2**	**-$35.9**	**-$36.6**
State Aid Payments					
POS – Controlling Interest	0.0	5.3	5.3	5.3	5.3
Highway User Revenues	0.0	2.6	2.6	3.0	3.2
Subtotal	**$0.0**	**$7.9**	**$8.0**	**$8.3**	**$8.5**
Total Local Effect	**-$39.2**	**-$26.3**	**-$27.2**	**-$27.6**	**-$28.1**

Exhibit 5
Impact on Local Revenues by County
Fiscal 2009

County	Controlling Interest	Personal Exemption	Highway User Revenues	Program Open Space	Total Impact	Per Capita Amount
Allegany	$166,200	-$1,144,500	$32,100	$58,700	-$887,500	-$12.19
Anne Arundel	4,633,900	-6,251,000	138,000	624,800	-854,300	-1.68
Baltimore City	4,702,800	-9,355,600	1,185,600	560,300	-2,906,900	-4.60
Baltimore	8,553,600	-12,215,200	187,600	706,800	-2,767,200	-3.51
Calvert	176,200	-1,186,700	28,300	61,900	-920,300	-10.36
Caroline	88,200	-517,200	22,200	27,500	-379,300	-11.63
Carroll	489,300	-2,700,900	62,700	140,300	-2,008,600	-11.80
Cecil	235,800	-1,549,400	34,700	72,300	-1,206,600	-12.13
Charles	542,600	-2,092,900	44,500	127,300	-1,378,500	-9.82
Dorchester	203,300	-492,300	24,600	23,500	-240,900	-7.62
Frederick	1,076,400	-3,480,700	82,400	145,100	-2,176,800	-9.76
Garrett	158,600	-451,400	27,800	28,900	-236,100	-7.91
Harford	1,349,100	-3,973,000	72,600	207,900	-2,343,400	-9.71
Howard	2,922,200	-2,935,100	69,400	368,600	425,100	1.56
Kent	104,500	-300,100	12,500	17,500	-165,600	-8.29
Montgomery	12,594,500	-11,152,200	195,700	928,300	2,566,300	2.75
Prince George’s	7,648,100	-15,298,200	170,700	798,800	-6,680,600	-7.94
Queen Anne’s	173,900	-657,200	25,600	37,400	-420,300	-9.09
St. Mary’s	564,800	-1,532,900	34,200	70,400	-863,500	-8.73
Somerset	28,500	-354,700	14,800	16,900	-294,500	-11.43
Talbot	342,300	-434,700	20,300	39,200	-32,900	-0.91
Washington	535,600	-2,348,900	53,000	110,600	-1,649,700	-11.48
Wicomico	270,200	-1,587,700	40,500	73,900	-1,203,100	-13.08
Worcester	647,800	-373,700	30,400	69,700	374,200	7.66
Total	**$48,208,400**	**-$82,386,200**	**$2,610,200**	**$5,316,600**	**-$26,251,000**	**-$4.67**

Part A-1. Individual Income Tax – Rate Adjustment

Fiscal Summary: General fund revenues would increase by $155.1 million in fiscal 2008 and by $393.2 million in fiscal 2012. **Exhibit A 1.1** shows the fiscal impact over a five-year period.

Exhibit A 1.1
Effect on State Revenues – Individual Income Tax Rate Adjustment
($ in Millions)

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
GF Revenues	$155.1	$333.4	$353.9	$373.5	$393.2
SF Revenues	0.0	0.0	0.0	0.0	0.0
Total Revenues	**$155.1**	**$333.4**	**$353.9**	**$373.5**	**$393.2**

Bill Summary/Current Law: The bill establishes new income tax brackets and rates. The new rates range from 2% to 5.75% of net taxable income as specified by the bill. This provision takes effect January 1, 2008 and applies to tax years 2008 and beyond.

Exhibit A 1.2 shows the current State income tax rates. **Exhibit A 1.3** lists the income tax rates as proposed by the bill.

Exhibit A 1.2
Maryland State Income Tax Rates
Tax Year 2007

Maryland Taxable Income		
Over	**But Not Over**	**Rate**
$0	$1,000	2% of Maryland taxable income
1,000	2,000	3% of excess over $1,000
2,000	3,000	4% of excess over $2,000
3,000	---	4.75% of excess over $3,000

Exhibit A 1.3
Maryland State Income Tax Rates
As Proposed by Tax Reform Act of 2007

Single, Dependent Filer, Married Filing Separate			Joint, Head of Household, Widower		
Over	**But Not Over**	**Rate**	**Over**	**But Not Over**	**Rate**
$0	$1,000	2% of Maryland taxable income	$0	$1,000	2% of Maryland taxable income
1,000	2,000	3% of excess over $1,000	1,000	2,000	3% of excess over $1,000
2,000	3,000	4% of excess over $2,000	2,000	3,000	4% of excess over $2,000
3,000	125,000	4.75% of excess over $3,000	3,000	175,000	4.75% of excess over $3,000
125,000	150,000	5.25% of excess over $125,000	175,000	200,000	5.25% of excess over $175,000
150,000	200,000	5.5% of excess over $150,000	200,000	250,000	5.5% of excess over $200,000
200,000	---	5.75% of excess over $200,000	250,000	---	5.75% of excess over $250,000

State Revenues: The new income tax rates and brackets would be in effect beginning tax year 2008, with general fund revenues increasing by $272.0 million in that tax year. It is estimated that $155.1 million of this increase would occur in fiscal 2008, which reflects the historic correlation between tax year and fiscal year revenues and an adjustment for delays in adjusting withholding and estimated payments due to the limited time that would occur between enactment of the bill and the effective date of the bill. Future years reflect the historic correlation between tax year and fiscal year revenues and forecasted income growth.

This estimate is based on projected tax year 2005 gross tax impact of the proposed rate changes on single and joint filers and fiduciaries and takes into account interaction with State income tax credits and revenues from withholdings that are never matched to a tax return.

Tax Incidence of Proposal

Under the new rates, single filers with net taxable income (NTI) above $125,000 and joint filers with net taxable income above $175,000 would pay additional income taxes. Based on the existing relationship between net taxable income and adjusted gross

income, on average, it can be expected that a single filer with Maryland Adjusted Gross Income (MAGI) over $142,300 would have a tax increase (in any amount) and that joint filers with MAGI over $211,000 would pay additional taxes. However, the bill also reduces the value of the regular personal exemption for individuals with federal adjusted gross income in excess of $125,000 ($175,000 for joint filers). It is likely that many taxpayers would pay additional taxes due to this reduction before any increase due to the rate increase.

Exhibit A 1.4 lists the impact of the proposal on taxpayers' State income tax liability based on different levels of net taxable income. **Exhibit A 1.5** lists changes in State and local income tax liability for different levels of net taxable income. These analyses include the proposed alteration of the regular personal exemption.

Exhibit A 1.4
Change in Gross State Taxes Paid by Net Taxable Income
Tax Year 2005

			Average State Taxes Paid			
NTI	Returns	Avg. MAGI	Current	Proposal	Change	% Change
$0-10,000	453,416	$16,159	$204	$136	($68)	-49.7%
10,000-20,000	417,295	26,244	647	577	(70)	-12.0%
20,000-30,000	303,077	37,480	1,125	1,055	(70)	-6.6%
30,000-40,000	236,202	49,020	1,598	1,525	(73)	-4.8%
40,000-50,000	176,059	61,083	2,074	1,994	(80)	-4.0%
50,000-75,000	288,110	80,985	2,859	2,768	(91)	-3.3%
75,000-100,000	152,468	109,493	4,041	3,939	(101)	-2.6%
100,000-200,000	172,898	161,395	6,300	6,417	117	1.8%
200,000-500,000	49,044	329,935	13,742	14,836	1,095	7.4%
500,000-1,000,000	10,362	743,185	32,399	37,402	5,003	13.4%
over $1 million	6,298	3,083,979	137,493	164,626	27,133	16.5%

Exhibit A 1.5
Changes in Gross State and Local Taxes Paid by Net Taxable Income

			Average State and Local Taxes Paid			
NTI	Returns	Avg. MAGI	Current	Proposal	Change	% Change
$0-10,000	453,416	$16,159	$324	$214	($110)	-34.1%
10,000-20,000	417,295	26,244	1,038	924	(113)	-12.3%
20,000-30,000	303,077	37,480	1,807	1,692	(114)	-6.8%
30,000-40,000	236,202	49,020	2,569	2,450	(119)	-4.9%
40,000-50,000	176,059	61,083	3,336	3,205	(131)	-4.1%
50,000-75,000	288,110	80,985	4,598	4,450	(148)	-3.3%
75,000-100,000	152,468	109,493	6,497	6,332	(166)	-2.6%
100,000-200,000	172,898	161,395	10,116	10,298	182	1.8%
200,000-500,000	49,044	329,935	21,919	23,080	1,162	5.0%
500,000-1,000,000	10,362	743,185	51,197	56,266	5,069	9.0%
over $1 million	6,298	3,083,979	215,314	242,513	27,199	11.2%

Exhibits A 1.4 and A 1.5 detail the statutory incidence of tax burdens resulting from the proposed rate changes. The statutory tax incidence, which refers to the individuals who actually remit the tax, can differ from the economic incidence of the tax, which refers to the individuals who in due course bear the actual cost of the tax. In some instances, part of all of an increased tax burden can be shifted to other individuals. For example, businesses that are pass-through entities (partnerships, S corporations, limited liability companies, and sole proprietorships) file under the personal income tax. The Comptroller's Office estimates that approximately 140,000 pass-through entities filed under the personal income tax in tax year 2005, or just under 6% of all personal income tax returns. Part or all of the increased income taxes paid by businesses would be borne by customers in the form of higher prices or employees through lower wages. This tax shifting will result in lower-income individuals bearing a greater portion of the ultimate tax burden than shown in Exhibits A 1.4 and A 1.5.

Another limitation of the analysis above is that it provides a "snapshot" of the incidence of the proposed changes. It is based on the annual taxes paid and annual next taxable income of taxpayers in 2005. Net taxable income in one year's time may not be an accurate depiction of an individual's economic well being because (1) it excludes factors such as wealth; (2) incomes may change over the lifetime of an individual; and (3) net taxable income may not fully capture an individual's total or comprehensive income.

Exhibit A 1.6 lists the impact of the proposed rates by county had the new tax rates been in effect in tax year 2005. **Exhibit A 1.7** shows the current amount of State income taxes paid by county and the impact of the proposed rate changes.

Exhibit A 1.8 details the percent of a taxpayer's net taxable income that is currently paid in State income taxes and how this would change due to the proposed income tax rates. The estimated tax rates are after application of credits, including the refundable earned income credit, which results in a negative tax rate for taxpayers with net taxable income less than $10,000.

Exhibit A 1.6
Change in Taxes Paid by County
Tax Year 2005

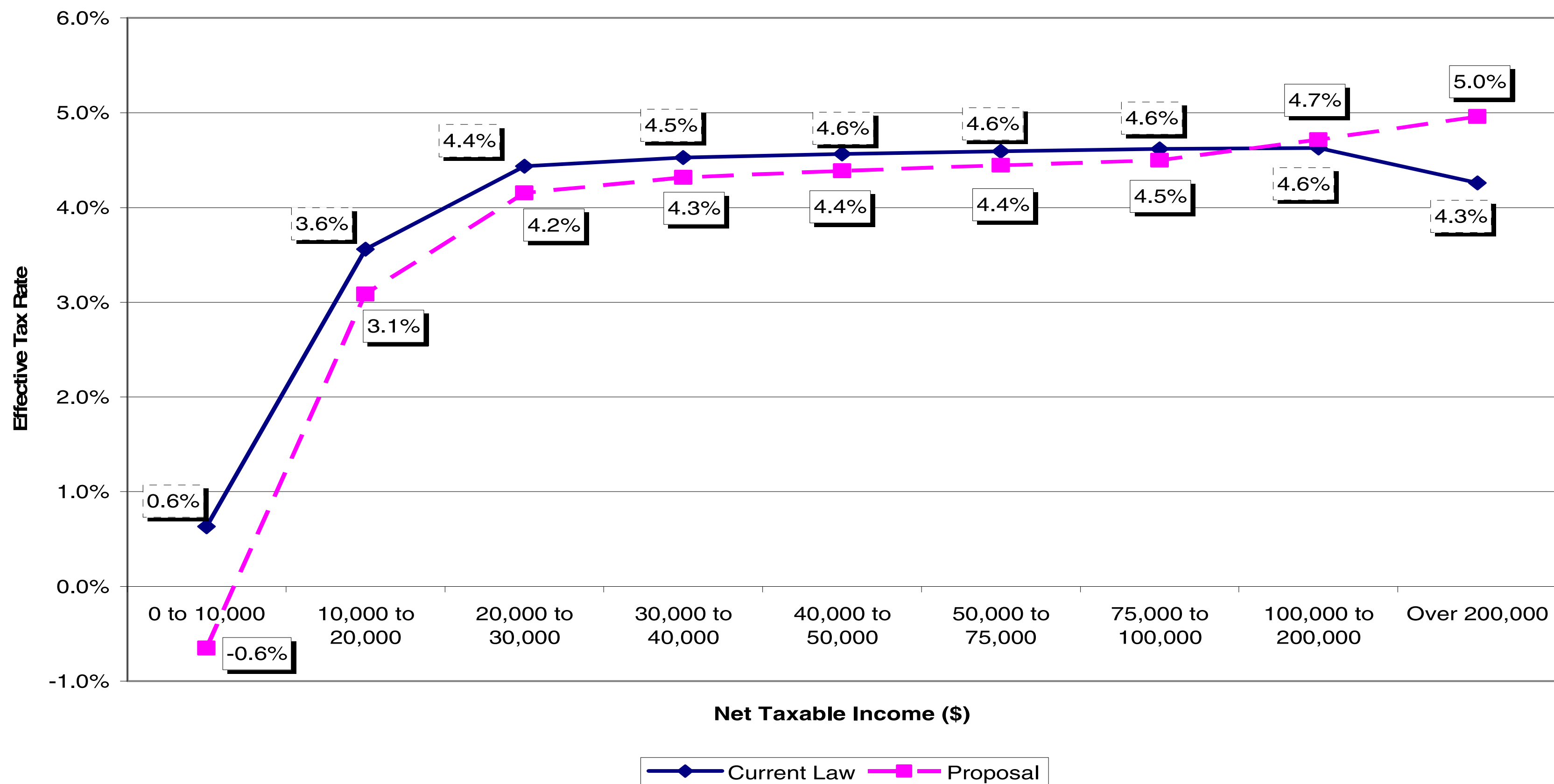
County	Change in Total Tax Liability	Percent Change	Taxpayers Paying More	Percent of County Taxpayers Paying More
Allegany	($963,471)	-2.5%	316	1.1%
Anne Arundel	11,750,372	2.0%	9,295	3.8%
Baltimore City	(2,360,344)	-0.7%	3,799	1.5%
Baltimore	25,235,098	3.0%	12,475	3.2%
Calvert	521,002	0.6%	1,025	2.6%
Caroline	(578,436)	-3.1%	136	0.9%
Carroll	(998,169)	-0.6%	1,837	2.4%
Cecil	(1,097,455)	-1.5%	629	1.5%
Charles	(1,273,369)	-1.1%	1,012	1.6%
Dorchester	(519,997)	-2.9%	188	1.3%
Frederick	982,853	0.4%	2,981	2.8%
Garrett	(350,410)	-2.0%	218	1.7%
Harford	(434,449)	-0.2%	2,556	2.3%
Howard	12,216,701	3.2%	7,886	6.3%
Kent	253,871	1.5%	283	3.1%
Montgomery	96,627,176	6.3%	33,170	7.2%
Prince George's	(17,685,508)	-3.2%	3,690	0.9%
Queen Anne's	1,342,580	2.7%	798	3.8%
St. Mary's	(1,074,978)	-1.3%	744	1.7%
Somerset	(364,356)	-3.9%	76	0.9%
Talbot	3,713,100	7.0%	974	5.4%
Washington	(1,579,548)	-1.5%	976	1.5%
Wicomico	(252,827)	-0.4%	790	1.9%
Worcester	1,367,510	2.8%	812	3.1%
Nonresident	21,630,887	10.3%	4,237	3.3%
Total	**$146,107,831**	**2.5%**	**90,903**	**3.3%**

Note: Estimate of county taxpayers paying more does not reflect phase out of exemptions.

Exhibit A 1.7
Current and Proposed State Income Taxes Paid by County
Tax Year 2005
($ in Millions)

	Current Law		Proposed	
County	**Taxes Paid**	**Percent of Total**	**Taxes Paid**	**Percent of Total**
Allegany	$38.0	0.6%	$37.0	0.6%
Anne Arundel	587.6	10.0%	599.3	10.0%
Baltimore City	321.1	5.5%	318.7	5.3%
Baltimore	852.1	14.5%	877.3	14.6%
Calvert	88.9	1.5%	89.4	1.5%
Caroline	18.6	0.3%	18.1	0.3%
Carroll	161.1	2.7%	160.1	2.7%
Cecil	73.3	1.2%	72.2	1.2%
Charles	119.8	2.0%	118.5	2.0%
Dorchester	18.0	0.3%	17.5	0.3%
Frederick	230.4	3.9%	231.4	3.8%
Garrett	17.2	0.3%	16.8	0.3%
Harford	227.5	3.9%	227.1	3.8%
Howard	384.4	6.5%	396.6	6.6%
Kent	16.7	0.3%	16.9	0.3%
Montgomery	1,542.9	26.3%	1,639.6	27.2%
Prince George's	558.5	9.5%	540.8	9.0%
Queen Anne's	50.4	0.9%	51.7	0.9%
St. Mary's	81.5	1.4%	80.4	1.3%
Somerset	9.4	0.2%	9.0	0.1%
Talbot	53.0	0.9%	56.7	0.9%
Washington	102.6	1.7%	101.0	1.7%
Wicomico	63.5	1.1%	63.3	1.1%
Worcester	48.9	0.8%	50.2	0.8%
Nonresident	209.9	3.6%	231.5	3.8%
Total	**$5,875.0**	**100.0%**	**$6,021.0**	**100.0%**

Exhibit A 1.8
Impact of Proposed Rate Changes on Tax Rates



Interaction with Federal Taxes

Additional State income taxes paid by a taxpayer, in most cases, can be taken as a federal itemized deduction and thus reduce federal tax liability. For example, 93% of Maryland federal income tax returns filed in tax year 2004 with federal adjusted gross income (FAGI) in excess of $75,000 deducted State income taxes paid. Generally, this itemization would reduce tax burdens more commonly for higher-income individuals due to the increased incidence and amount deducted by higher-income individuals. Conversely, reducing State income taxes for taxpayers who itemize can increase a taxpayer's federal tax liability by reducing the amount of taxes that may be deducted for federal tax purposes.

One important consideration is the potential limiting effect that the federal Alternative Minimum Tax (AMT) could have on the ability of a taxpayer to deduct additional State income taxes paid. Originally implemented as a way to prevent taxpayers with high incomes from paying little or no income taxes, a lack of indexing has widened the number of taxpayers potentially subject to the tax. The AMT requires some taxpayers to recalculate their tax liability under alternative tax rules to include certain income generally exempt from regular tax and disallow specific exemptions, deductions (including the deduction allowed for State and local taxes paid), and other preferences available under the Internal Revenue Code.

The significant revenue impact of providing permanent AMT relief has resulted in Congress largely enacting temporary AMT relief legislation. In the absence of permanent relief, the reach of the AMT (about 2% of returns nationwide were subject to the tax in 2004) is expected to dramatically increase over the next several years. Tax year 2005 data from the Internal Revenue Service indicate that approximately 134,200 Maryland federal income tax returns were subject to the AMT (in any amount), comprising 5% of all tax returns filed. About 80% of the returns subject to the AMT had FAGI in excess of $200,000 and would likely pay additional State income taxes under this proposal.

Part A-2. Individual Income Tax – Personal Exemption

Fiscal Summary: General fund revenues would decrease by $62.1 million in fiscal 2008 and by $134.3 million in fiscal 2012. **Exhibit A 2.1** shows the fiscal impact over a five-year period.

Exhibit A 2.1
Effect on State Revenues – Personal Exemption
($ in Millions)

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
GF Revenues	-$62.1	-$130.4	-$132.0	-$133.1	-$134.3
SF Revenues	0.0	0.0	0.0	0.0	0.0
Total Revenues	**-$62.1**	**-$130.4**	**-$132.0**	**-$133.1**	**-$134.3**

Bill Summary: The bill increases the regular personal exemption to $3,200 for individuals with federal adjusted gross income (FAGI) of $100,000 ($150,000 for joint filers), but gradually reduces the value of the exemption to $600 as shown in **Exhibit A 2.2**.

This provision goes into effect January 1, 2008 and applies to tax year 2008 and beyond.

Exhibit A 2.2
Proposed Regular Exemption Values

Single		Joint	
FAGI	**Exemption Value**	**FAGI**	**Exemption Value**
$100,000 or less	$3,200	$150,000 or less	$3,200
$100,001-$125,000	2,400	$150,001-$175,000	2,400
$125,001-$150,000	1,800	$175,001-$200,000	1,800
$150,001-$200,000	1,200	$200,001-$250,000	1,200
over $200,000	600	over $250,000	600

Current Law: Maryland conforms to federal income tax guidelines for exemptions. An individual for State income tax purposes is entitled to claim the same number of exemptions that the individual claimed on the federal income tax return. The value of the

personal exemption is $2,400. Nonresidents and part-time residents are required to prorate exemptions based on the percentage of income subject to Maryland tax.

The amount of exemptions allowed for federal income tax purposes is reduced for taxpayers whose FAGI exceeds specified threshold amounts. The amount of the reduction is equal to 2% for each $2,500 (or any fraction thereof) by which the taxpayer's FAGI exceeds the applicable threshold. **Exhibit A 2.3** lists, by filing status, the points at which the value of the taxpayer's exemptions begins to phase out and when the value of the exemption is reduced to zero.

Exhibit A 2.3
Federal Phase Out of Exemptions
Tax Year 2006

Filing Status	Phase Out Begins	Exemptions are Fully Phased Out
Joint, Surviving Spouse	$225,750	$348,250
Head of Household	188,150	310,650
Single	150,500	273,000
Married, Filing Separately	112,875	174,125

Source: Internal Revenue Code, Section 151(d)

The federal Economic Growth and Tax Relief Reconciliation Act of 2001 increased the amount of exemptions that may be claimed by these individuals by decreasing the amount by which exemptions must be reduced. However, like numerous other federal tax provisions, this specific provision enacted in 2001 is set to expire in tax year 2010 in the absence of additional federal legislation.

Maryland law also provides a pension exclusion subtraction for individuals who are at least 65 years old or who are totally disabled. Under this subtraction modification, up to a specified amount of taxable pension income ($22,600 in tax year 2006) may be exempt from tax. The maximum exclusion allowed is indexed to the maximum annual benefit payable under the Social Security Act and is reduced by the amount of any Social Security payments received. The pension exclusion has been a part of the Maryland income tax since 1965.

The "Social Security offset" is the reduction in the maximum pension exclusion allowed under the current law by the individual. The Social Security offset was established at the

same time as the pension exclusion. Given that Social Security benefits are exempt from Maryland income tax, the offset works to equalize the tax treatment of individuals who receive their retirement benefits from different sources by reducing the amount of allowable exclusion by the amount of Social Security benefits received.

Social Security benefits and benefits received under the federal Railroad Retirement Act are totally exempt from the Maryland income tax, even though they may be partly taxable for federal purposes. In addition, each taxpayer 65 or older can earn more income without being required to file a tax return.

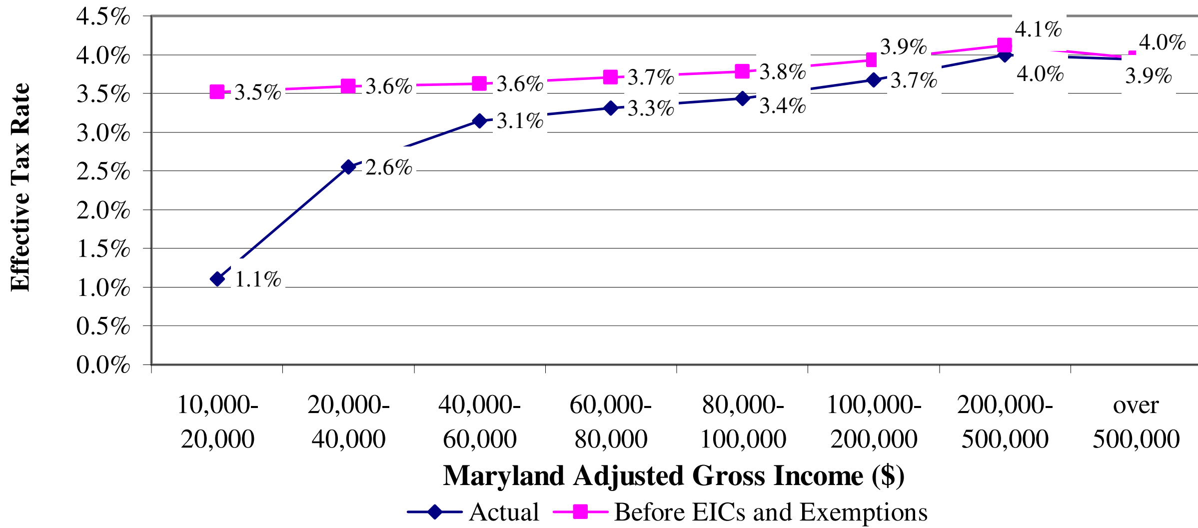
Background: The State income tax has several components designed to provide income tax relief to lower-income individuals, including the State refundable and nonrefundable earned income credits and poverty level credits. Almost one-quarter of the individuals who would meet the qualifications of the bill are currently claiming the State refundable earned income credit. In addition, lower-income individuals, like all individuals, can claim personal exemptions and the standard deduction.

In tax year 2005, taxpayers claimed a total of $91.4 million in refundable State earned income credits, $70.3 million in earned income credits, and $2.8 million in poverty level credits. In addition, 352,221 State taxpayers claimed approximately $1.2 billion in federal EIC credits.

The standard deduction decreased State income tax revenues by about $135 million in tax year 2005 – nearly 90% of the returns that claimed the standard deduction had FAGI of less than $50,000. By comparison, the regular personal exemption decreased State income tax revenues by about $512 million in tax year 2005, of which about one-half was claimed by taxpayers with FAGI of less than $50,000.

Exhibit A 2.4 lists the actual effective State income tax rates paid by Maryland Adjusted Gross Income (MAGI) and the estimated tax rate that would be paid in the absence of the State earned income credits and regular personal exemptions.

Exhibit A 2.4
Effective Tax Rates by Income Class
Tax Year 2005



EICs: State Earned Income Credits

Source: Comptroller's Office; Department of Legislative Services

Taxpayers with MAGI of between $10,000 and $20,000 pay, on average, 1.1% of their MAGI in State income taxes, as compared to 3.9% for taxpayers with the highest MAGI of over $500,000. As illustrated in Exhibit A 2.4, the State earned income credits and regular personal exemption contribute substantially to the progressivity of the State income tax by reducing tax burdens disproportionately more for lower-income individuals.

State Revenues: Increased exemptions could be claimed beginning in tax year 2008, decreasing income tax revenues by approximately $129.7 million in that year. Approximately one-half of this decrease would occur in fiscal 2008 due to decreased withholdings, resulting in a decrease of $62.1 million in fiscal 2008 and $130.4 million beginning in fiscal 2009. **Exhibit A 2.5** lists the State and local income tax revenue decreases in fiscal 2008 through 2012.

Exhibit A 2.5
Projected State and Local Revenue Decreases
Fiscal 2008-2012
($ in Millions)

Fiscal	State	Local	Total
2008	$62.1	$39.2	$101.3
2009	130.4	82.4	212.8
2010	132.0	83.4	215.4
2011	133.1	84.1	217.2
2012	134.3	84.8	219.1

Local Effect: Local government revenues would decrease by approximately 3% of the total additional State exemptions taken in each tax year. In fiscal 2008, the decrease would total approximately $39.2 million. Exhibit A 2.5 lists the local income tax revenue decreases in fiscal 2008 through 2012.

Part A-3. Individual Income Tax – Earned Income Credit

Fiscal Summary: General fund revenues would decrease by $38.5 million beginning in fiscal 2009 and by $41.9 million in fiscal 2012. **Exhibit A 3.1** shows the fiscal impact over a five-year period.

Exhibit A 3.1
Effect on State Revenues – Earned Income Credit
($ in Millions)

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
GF Revenues	$0.0	-$38.5	-$40.2	-$39.8	-$41.9
SF Revenues	0.0	0.0	0.0	0.0	0.0
Total Revenues	**$0.0**	**-$38.5**	**-$40.2**	**-$39.8**	**-$41.9**

Bill Summary: The bill expands the State refundable earned income credit by • increasing the percentage of the federal earned income credit payable by the State to a qualified individual with one or more dependents to 25% from 20%; • allowing individuals without dependents to claim the credit. The bill also increases the calculation of a county refundable EIC, if a county has one. The county refundable EIC authorized by the bill would be the amount by which five times the federal EIC multiplied by the county income tax rate exceeds the county income tax liability.

These provisions take effect January 1, 2008 and apply to tax year 2008 and beyond.

Current Law: An individual who qualifies for the federal EIC and has one or more dependents can claim a refundable State EIC equal to 20% of the federal credit, minus any pre-credit State income tax liability. The nonrefundable State EIC is currently 50% of the federal EIC, not to exceed the total pre-credit State income tax liability. To the extent provided, the county refundable EIC is the amount by which four times the federal EIC multiplied by the county income tax rate exceeds the county income tax liability.

Background: The following is a summary of the federal and State EIC programs and similar programs enacted in other states.

Federal EIC

The federal EIC began in 1975 as a temporary program to return a portion of the Social Security taxes paid by lower-income taxpayers and was made permanent in 1978. The Tax Reform Act of 1986 increased the maximum benefit of the credit and phase-out

levels and indexed the credit to inflation. The next substantive expansion of the credit occurred in the 1990s with the federal Omnibus Budget Reconciliation Acts of 1990 and 1993. Both laws again increased the value of the credit and phase-out levels. The 1990 law provided for different credit amounts for taxpayers with one or two and more children, and the 1993 law expanded the credit to childless taxpayers. The expansion of the credit in the 1990s is estimated to have tripled the cost of the credit, and the credit is now the largest anti-poverty entitlement program. The federal EIC is generally considered a successful anti-poverty program by researchers. A joint Internal Revenue Service (IRS) – Department of Treasury task force estimated that nationwide the EIC lifted 4.3 million individuals, including 2.3 million children, out of poverty in 2000. The federal Joint Committee on Taxation estimates that in federal fiscal 2008 individuals will claim approximately $46.5 billion in federal EIC.

Maryland EIC

Maryland's income tax law has provided a nonrefundable State EIC equal to 50% of the federal EIC since 1987. Chapter 5 of 1998 established a refundable EIC for taxpayers who meet the eligibility requirements of the federal credit and have at least one dependent. The value of the initial refundable credit was equal to 10% of the federal credit and increased in two steps to 15% in tax year 2001 and beyond. Chapter 493 of 1999 altered the calculation of the credit allowed against the county income tax in response to the 1997 tax law establishing flat county income tax rates. The amount of credit allowed against the county income tax is equal to the amount of federal EIC claimed multiplied by 10 times the county income tax rate, not to exceed the county income tax liability for the tax year. Chapter 510 of 2000 accelerated to tax year 2000 the 15% value of the credit and also authorized counties to provide, by law, a county refundable EIC. While no county has provided a refundable credit that can be claimed with the tax return under the formula provided under State law, Montgomery County's Earned Income Credit program acts as a grant program by matching the State EIC claimed by the taxpayer. Under the program, eligible taxpayers receive a check from the Comptroller, but the grants are paid for by Montgomery County.

Chapter 581 of 2001 phased in an additional 5% increase in the value of the credit, with a three-step increase of the credit increasing its value to 20% beginning in tax year 2004.

Earned Income Tax Credits in Other States

Including programs that will begin in 2008, 22 states and the District of Columbia offer earned income tax credits that supplement the federal credit. Most of these states follow the federal practice of making the credit refundable. **Exhibit A 3.2** summarizes the EIC in other states, expressed as a percentage of the federal credit.

Exhibit A 3.2
National Comparison of Earned Income Credit

State	Year Enacted	Percent Federal Credit	Notes
Wisconsin	1989	4-43%	4% one child, 14% two children, 43% three or more
District of Columbia	2000	35%	
Minnesota	1991	averages 33%	varies from 25 to 45%
Vermont	1988	32%	
New York	1994	30%	reverts to 20% if the state's share of TANF grants is reduced
Rhode Island	1986	25%	only a small portion is refundable
Delaware	2005	20%	nonrefundable
Virginia	2004	20%	nonrefundable
New Jersey	2000	20%	22.5% in 2008, 25% in 2009
Kansas	1998	17%	
Massachusetts	1997	15%	
Colorado	1999	10%	Credit is currently suspended
Michigan	2006	10%	Effective 2008, increases to 20% in 2009
Nebraska	2006	10%	
New Mexico	2007	8%	
Iowa	1989	7%	
Indiana	1999	6%	
Illinois	2000	5%	
Maine	2000	5%	nonrefundable
Oklahoma	2002	5%	
Oregon	1997	5%	6% in 2008, set to expire in 2011
Louisiana	2007	3.5%	Effective 2008
North Carolina	2007	3.5%	Effective 2008, set to expire in 2013

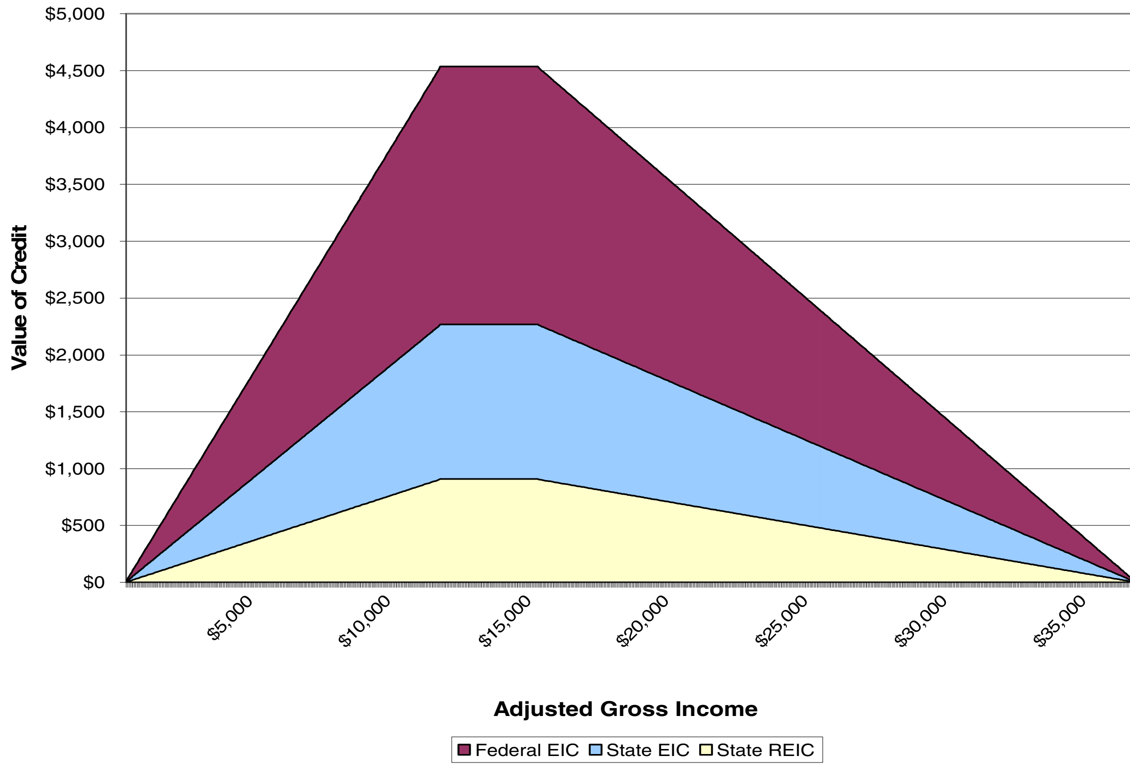
EIC Value, Requirements, and Amounts Claimed

To claim the federal EIC in tax year 2006, a taxpayer must have earned income, less than $2,800 of investment income, and a modified federal adjusted gross income of less than $12,120 with no qualifying children, $32,001 with one qualifying child, or $36,348 with two or more qualifying children. In tax years 2004 and earlier, the phase-out range is $1,000 higher for joint returns. The Economic Growth and Tax Relief Reconciliation Act of 2001 increases the phase-out range for joint returns to $2,000 for tax years 2005 through 2007 and to $3,000 for tax years 2008 and beyond. In order to claim the credit, no taxpayers can file under married filing separately, and taxpayers without qualifying children must be between 25 and 65 years old and cannot be the dependent or qualifying child of another taxpayer.

Exhibit A 3.3 illustrates the value of the federal EIC, State EIC, and State refundable earned income tax credits (REIC) in tax year 2006 for an individual taxpayer with two or more dependents.

The actual value of the State credits claimed, however, may not always equal the amount shown in the exhibit. The refundable credit is reduced by any pre-credit tax liability and the nonrefundable credit is limited by the taxpayer's total tax liability, which typically could be much less than 50% of the federal EIC. In tax year 2005, 250,830 tax returns claimed approximately $70.3 million in State EICs, and 211,141 claimed approximately $91.4 million in State refundable EICs. In tax year 2005, 352,221 State taxpayers claimed approximately $1.2 billion in federal EIC credits. **Exhibit A 3.4** provides a breakdown by county of the amount of State EIC and refundable EIC in tax year 2005.

Exhibit A 3.3
Earned Income Credits for an Individual with Two Dependents
Tax Year 2006



Source: Internal Revenue Service; Department of Legislative Services

Exhibit A 3.4
State EIC and REIC Claimed by County
Tax Year 2005

County/Region	Number of EIC Returns	EIC Amount	EIC Percent Total of Returns	Number of REIC Returns	REIC Amount	REIC Percent Total of Returns
Western Maryland						
Allegany	3,128	$916,062	10.5%	2,503	$1,028,548	8.4%
Garrett	1,407	414,610	11.2%	1,081	440,386	8.6%
Washington	5,784	1,709,192	8.9%	4,652	1,868,213	7.2%
Region Total	**10,319**	**$3,039,864**	**9.6%**	**8,236**	**$3,337,147**	**7.7%**
Central Maryland						
Anne Arundel	15,323	$4,078,997	6.3%	14,004	$6,499,056	5.8%
Baltimore City	53,677	16,284,999	21.4%	45,816	19,457,977	18.3%
Baltimore	32,596	9,415,278	8.6%	25,041	10,605,881	6.6%
Carroll	3,627	1,018,109	4.8%	2,888	1,147,521	3.8%
Frederick	6,234	1,688,325	5.9%	5,578	2,424,449	5.3%
Harford	6,554	1,872,756	5.9%	5,309	2,117,436	4.8%
Howard	6,107	1,582,164	5.0%	5,349	2,366,522	4.3%
Montgomery	30,050	7,773,251	6.7%	25,821	11,665,747	5.8%
Prince George’s	51,385	13,975,151	12.9%	44,296	20,424,983	11.1%
Region Total	**205,553**	**$57,689,030**	**9.6%**	**174,102**	**$76,709,572**	**8.2%**
Lower Eastern Shore						
Dorchester	2,222	$676,219	15.3%	1,916	$801,093	13.2%
Somerset	1,421	412,764	16.4%	1,254	517,055	14.4%
Wicomico	5,674	1,714,185	14.0%	4,703	1,952,471	11.6%
Worcester	2,272	666,181	8.9%	1,798	710,506	7.0%
Region Total	**11,589**	**$3,469,349**	**13.0%**	**9,671**	**$3,981,125**	**10.8%**
Upper Eastern Shore						
Caroline	1,944	$570,558	13.7%	1,667	$734,598	11.7%
Cecil	3,379	1,003,197	8.1%	2,733	1,095,589	6.6%
Kent	832	256,567	9.3%	646	258,759	7.2%
Talbot	1,547	442,016	8.6%	1,368	631,193	7.6%
Queen Anne’s	1,253	356,161	6.1%	1,041	432,062	5.0%
Region Total	**8,955**	**$2,628,499**	**8.7%**	**7,455**	**$3,152,201**	**7.2%**
Southern Maryland						
Calvert	2,225	$612,833	5.7%	1,888	$777,066	4.8%
Charles	4,569	1,294,684	7.3%	3,848	1,611,829	6.1%
St. Mary’s	3,148	884,394	7.4%	2,627	1,063,313	6.2%
Region Total	**9,942**	**$2,791,911**	**6.9%**	**8,363**	**$3,452,208**	**5.8%**
Nonresident	**4,472**	**$709,983**	**3.6%**	**3,314**	**$783,978**	**2.7%**
Total	**250,830**	**$70,328,636**	**9.3%**	**211,141**	**$91,416,231**	**7.8%**

Source: Income Tax Summary Report, Tax Year 2005, Office of the Comptroller

State Revenues: The provisions of the bill increasing the value of the credit are effective beginning tax year 2008. As a result, general fund revenues could decrease by $38.5 million in fiscal 2009 and by $41.9 million by fiscal 2012 as shown in **Exhibit A 3.5**. This estimate is based on existing data on the EICs, federal Joint Committee on Taxation federal EIC fiscal estimates, and current inflation forecasts. **Exhibit A 3.6** details the fiscal impact and impact on taxpayers claiming the credit by amount of federal adjusted gross income (FAGI), not including expansion to individuals without dependents. About two-thirds of the increase would occur for households with FAGI between $10,000 and $20,000.

Exhibit A 3.5
REIC General Fund Revenue Effect
Fiscal 2008-2012
($ in Millions)

FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
$0.0	($38.5)	($40.2)	($39.8)	($41.9)

Exhibit A 3.6
REIC Increases by FAGI
Tax Year 2008

FAGI	Number of Returns	Average Credit Increase	Total Increase
$0-5,000	21,535	$61	$1,320,000
$5,000-10,000	48,792	138	6,740,000
$10,000-15,000	63,322	192	12,150,000
$15,000-20,000	56,927	161	9,190,000
$20,000-25,000	34,395	129	4,430,000
$25,000-30,000	11,460	79	900,000
over $30,000	3,606	40	140,000
Total	**240,038**	**$145**	**$34,870,000**

Local Effect: No county has currently authorized a refundable county EIC as provided under current law. Montgomery County has a local EIC grant program based on the State's refundable EIC. Payments for this county EIC grant are made in the fiscal year following the fiscal year in which the returns are filed. Accordingly, Montgomery County expenditures could increase in fiscal 2008 and beyond.

Part B-1. Corporate Income Tax – Increase and Distribution

Fiscal Summary: General fund revenues would increase by $56.8 million in fiscal 2008 and by $201.1 million in fiscal 2012. Transportation Trust Fund (TTF) revenues would not be affected by this provision. **Exhibit B 1.1** shows the fiscal impact over a five-year period.

Exhibit B 1.1
Effect on State Revenues – Corporate Income Tax Rate Increase
($ in Millions)

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
GF Revenues	$56.8	$196.1	$205.1	$205.6	$201.1
TTF Revenues	0.0	0.0	0.0	0.0	0.0
Total Revenues	**$56.8**	**$196.1**	**$205.1**	**$205.6**	**$201.1**

Bill Summary: The bill increases the corporate income tax rate from 7% to 8.75% and alters the existing distribution of corporate income tax revenues beginning with fiscal 2008 as illustrated in **Exhibit B 1.2**. These provisions are effective January 1, 2008 and apply to tax year 2008 and beyond.

Exhibit B 1.2
Current and Proposed Corporate Income Tax Revenue Distributions

	Current Law	Proposal
General Fund	76.0%	80.8%
Transportation Trust Fund	24.0%	19.2%

The bill also clarifies that the State is permanently "decoupled" from any increased expensing allowed under Section 179 as a result of any federal legislation enacted after December 31, 2002.

Current Law: Every Maryland corporation and every corporation that conducts business within Maryland, including public service companies and financial institutions, are required to pay the corporate income tax. A tax rate of 7% is applied to a corporation's Maryland taxable income.

After an allowance for refunds and a distribution to an administrative cost account for the TTF share of the cost of administering the income tax on corporations, 24% of corporate income tax revenues are distributed to the Gasoline and Motor Vehicle Revenue Account in the TTF with the balance distributed to the general fund.

The State is "decoupled" from increased Section 179 expensing allowed by the federal Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the American Jobs Creation Act of 2004 (AJCA), and the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). Taxpayers are required to make an adjustment to Maryland adjusted gross income to reflect the changes made to the maximum aggregate costs of expensing enacted by the federal legislation.

Background: A comparison of corporate income tax rates in Maryland and surrounding states is provided in **Exhibit B 1.3**.

Exhibit B 1.3
Corporate Income Tax Rates
Maryland and Surrounding States
Tax Year 2007

State	Tax Rate
Pennsylvania	9.990%
District of Columbia	9.975%
New Jersey	9.000%
West Virginia	8.750%
Delaware	8.700%
Maryland	**7.000%**
North Carolina	6.900%
Virginia	6.000%

Section 179

In general, depreciable tangible personal property or certain computer software purchased for use in the active conduct of a trade or business can qualify for expensing under Section 179 of the Internal Revenue Code (IRC). In essence, expensing is the treatment for tax purposes of a cost of doing business as an ordinary and necessary expense rather than a capital expenditure. Ordinary and necessary costs are deducted in the year in which they are incurred, whereas capital costs are typically recovered over longer periods

according to depreciation methods and schedules specified in the federal tax code. Due to phase-out rules, most of the businesses able to take advantage of Section 179 expensing are likely to be relatively small. Recent federal laws have provided for increased expensing under Section 179 of the IRC that can provide tax benefits to these businesses.

Increased expensing acts to reduce the federal taxable income of a business, potentially flowing through directly to Maryland income tax computation. The Budget Reconciliation and Financing Act (BRFA) of 2002 (Chapter 440) included a general one-year "decoupling" provision. If the Comptroller determines that the impact of a federal tax change will be at least $5 million in the next fiscal year, the provision does not apply for Maryland income tax purposes for any taxable year that begins in the calendar year in which the amendment is enacted. As a result of the Comptroller's determination that increased expensing allowed under JGTRRA would decrease State revenues by at least $5 million in fiscal 2004, the State automatically decoupled from the JGTRRA provision allowing for increased expensing in tax year 2003. The 2004 BRFA (Chapter 430) provided for decoupling from JGTRRA for tax years 2003 and beyond. The 2005 BRFA (Chapter 444) and Chapter 587 of 2007 clarified that decoupling applies to the extension of Section 179 expensing enacted by AJCA and TIPRA, respectively.

State Revenues: The new corporate income tax rate is effective beginning with tax year 2008. As a result, general fund revenues would increase by approximately $56.8 million in fiscal 2008 and $196.1 million in fiscal 2009. TTF revenues would not be affected.

Section 179

State revenues would not be impacted by the bill's provision clarifying that the State is decoupled from increased Section 179 expensing with respect to any federal legislation enacted after December 31, 2002. The Board of Revenue Estimates assumes in its corporate and personal income tax revenues that it was the intent of the Maryland General Assembly in the 2004 and 2005 BRFAs to permanently decouple from increased Section 179 expensing; therefore, the provision would have no impact.

For background information on the corporate income tax, see the background section under the Combined Reporting part of this Fiscal and Policy Note (Part B-2).

Part B-2. Corporate Income Tax – Combined Reporting

Fiscal Summary: General fund revenues would increase by $36.8 million beginning in fiscal 2009 and by $44.5 million in fiscal 2012. Transportation Trust Fund (TTF) revenues would increase by $8.7 million in fiscal 2009 and by $10.6 million in fiscal 2012. **Exhibit B 2.1** shows the fiscal impact over a five-year period.

Exhibit B 2.1
Effect on State Revenues – Combined Reporting
($ in Millions)

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
GF Revenues	$0.0	$36.8	$37.2	$41.9	$44.5
TTF Revenues	0.0	8.7	8.8	9.9	10.6
Total Revenues	**$0.0**	**$45.5**	**$46.0**	**$51.8**	**$55.1**

Bill Summary: The bill requires affiliated corporations to compute Maryland taxable income using "combined reporting."

The bill requires combined groups to file "combined income tax returns," except as provided by regulations. A corporation that is a member of a combined group must compute its Maryland taxable income using the combined reporting method: • taking into account the combined income of all members of the combined group; • apportioning the combined income to Maryland using the combined factors of all members of the combined group; and • allocating the apportionment determined under item 2 among the members of the group that are subject to the Maryland income tax. The bill provides that, subject to regulations issued by the Comptroller, corporations may elect to use the "water's edge method," essentially including only "United States corporations" (corporations incorporated in the United States and specified others, generally having significant U.S. presence) in the combined group for combined filing purposes.

These provisions take effect January 1, 2008 and apply to tax year 2008 and beyond.

Current Law: In general, the Maryland corporate income tax is computed using federal provisions to determine income and deductions. Maryland is a "unitary business" state, in that a corporation is required to allocate all of its Maryland income (that portion that is "derived from or reasonably attributable to its trade or business in the State") attributable to the corporation's "unitary business." Essentially, a unitary business exists when the operations of the business in various locations or divisions or through related members of a corporate group are interrelated to and interdependent on each other to such an extent

that it is reasonable to treat the business as a single business for tax purposes and it is not practicable to accurately reflect the income of the various locations, divisions, or related members of a corporate group by separate accounting.

Under Maryland law, however, the application of the unitary business principle is limited in the case of affiliated groups of related corporations because of the requirement that each separate corporation must file a separate income tax return and determine its own taxable income on a separate basis. For a multi-corporate group, the unitary business principle is restricted to consider only the isolated income and business activities of each separate legal entity. Even though the activities of related corporations may constitute a single unitary business, the affiliated corporations that lack nexus with the State (or are protected from taxation by P.L. 86-272) are not subject to the State's income tax and neither the net income nor the apportionment factors of those affiliated corporations are taken into account on the corporate income tax return of any related corporation that is subject to the tax.

Background: The following is a brief discussion of combined reporting in other states, Maryland corporate income tax revenues, recent corporate tax compliance legislation, and the potential fiscal effects of combined reporting.

Maryland's Corporate Income Tax

Every Maryland corporation and every corporation that conducts business within Maryland, including public service companies and financial institutions, are required to pay the corporate income tax. The tax base is the portion of federal taxable income, as determined for federal income tax purposes and adjusted for certain Maryland addition and subtraction modifications, that is allocable to Maryland. Federal taxable income for this purpose is the difference between total federal income and total federal deductions (including any special deductions). The next step is to calculate a corporation's Maryland taxable income. The Maryland taxable income of a corporation that operates wholly within the State is equal to its Maryland modified income. Corporations engaged in multistate operations are required to determine the portion of their modified income attributable to Maryland, based on the amount of their trade or business carried out in Maryland. Corporations are generally required to use either a double weighted sales factor (payroll and property being the other factors) or, in the case of a manufacturing corporation, a single sales factor. The apportionment factor is multiplied by a corporation's modified income to determine Maryland taxable income. The Maryland tax liability of a corporation equals the Maryland taxable income multiplied by the tax rate less any tax credits.

In fiscal 2007, corporate income tax revenues totaled $776 million. Consistent with a national increase in corporate profitability and statutory changes, State corporate income tax revenues have more than doubled in the last five years. However, Legislative

Services estimates that corporate income tax revenues will remain relatively flat through fiscal 2013.

Recent Tax Compliance Legislation

Corporate income tax compliance legislation enacted in 2004 and 2007 addressed two well-publicized techniques for avoiding State income tax in a "separate reporting" jurisdiction such as Maryland – Delaware Holding Companies (DHCs) and captive Real Estate Investment Trusts (REITs).

Chapter 556 of 2004 restricted the ability of corporations to use DHCs to shift income away from the State for tax purposes. Additional legislation, Chapter 557 of 2004, created a statutory settlement period for the Comptroller to settle DHC-related litigation. The Comptroller's Office estimates that Chapter 556 has increased corporate income tax revenues by $40 million annually. The settlement period netted approximately $199 million in one-time revenues, $151 million for the general fund, and $48 million for the Transportation Trust Fund.

In response to reports that some retailers and banks were employing captive REITs to avoid income taxes in several states, the General Assembly adopted legislation (Chapter 583 of 2007) that limits a company's ability to avoid the Maryland corporate income tax by shifting income away from the State through the use of a captive REIT. Typically, a corporation would form a captive REIT and pay rent to themselves in order to avoid State taxes. The Department of Legislative Services estimates that Chapter 583 will increase corporate income tax revenues by approximately $10 million annually.

The 2007 tax compliance legislation, however, does not deal with other tax avoidance strategies, including other uses of Delaware Holding Companies not addressed by the 2004 legislation, "transfer pricing" manipulation, and the use of subsidiaries to isolate profitable activities of an enterprise from nexus with the State.

Combined Reporting in Other States

Twenty-one states currently provide for a mandatory combined reporting method related to the taxation of corporations: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Texas, Utah, Vermont, and West Virginia. In addition, in several other states, under certain circumstances, combined or "consolidated" reporting either is required, allowed at the election of the taxpayer, or may be required at the discretion of the tax administrator. Several states have considered adopting mandatory combined reporting in the past few years, including Connecticut, Iowa, Massachusetts, Missouri, Pennsylvania, and Wisconsin.

Combined Reporting Revenue Effects

Over the years, there has been considerable uncertainty as to the fiscal effect of combined reporting. In the case of corporate income taxes, due to the volatility of profits over time and sensitivity to corporate structures and inter-company transactions, the accepted form of revenue estimation is to directly simulate tax accounting changes to a representative panel of sample tax returns. Due to the confidentiality of tax return data, however, the Department of Legislative Services lacks access to this data and is thus unable to perform this type of analysis. The Pennsylvania Department of Revenue recently produced an in-depth fiscal estimate of implementing combined reporting in that state using actual tax data. The Department of Revenue estimated the impact of combined reporting by matching the tax returns of corporations that filed in Pennsylvania to federal return data and data from Minnesota, which requires combined reporting.

The Department of Revenue estimated a variety of policies combined with implementing combined reporting Pennsylvania limits to $2 million the amount of net operating losses a corporation can carry forward. The department estimated that combined reporting would generate an additional $480 million in annual corporate income tax revenues with the net operating loss limitation in place. If the net operating loss provision was repealed, however, combined reporting generated an additional $190 million annually in corporate income taxes.

The Pennsylvania analysis estimated that larger corporations would bear a larger share of the increased tax burden under combined reporting. **Exhibit B 2.2** lists the expected distributional effect by the federal income of a corporation filing in Pennsylvania.

Exhibit B 2.2
Combined Reporting Tax Effect in Pennsylvania by Federal Income Size
Percentage of Additional Tax Revenues

Federal Income	Percentage of Additional Tax Revenues
Negative	-0.5%
$0	0.0%
$1 – $1 million	0.7%
$1 million – $10 million	3.2%
$10 million – $100 million	16.4%
$100 million – $1 billion	63.7%
Greater than $1 billion	16.5%

Source: Pennsylvania Department of Revenue

Unlike Maryland, Pennsylvania does not currently have statutory provisions designed to prevent tax avoidance strategies employed by utilizing DHCs. The Pennsylvania Department of Revenue, in a separate analysis, estimated that Pennsylvania loses $100 million annually from the use of DHCs. The Multistate Tax Commission (MTC) concluded in a recent study that "various corporations are increasingly taking advantages of structural weaknesses and loopholes in the state corporate tax system." The MTC estimated that in 2001, states lost $12.4 billion, or 35% of total collections, to tax avoidance techniques. Commonly employed tax avoidance strategies include the use of related entities to shield income and taking advantage of differences in state corporate tax policies to create "nowhere" income that is never taxed by any state. For Maryland, it estimated a revenue loss of $75 million to $161 million. (This estimate included all tax avoidance strategies and circumstances, not just those that would be addressed by combined reporting.

State Revenues: The provisions of the bill apply beginning with tax year 2008. The bill does not alter safe harbor provisions related to combined reporting. In addition, the Comptroller's Office may face implementation challenges, in addition to any legal challenges from corporations. Due to these factors, it is estimated that the bill would not impact revenues in fiscal 2008. **Exhibit B 2.3** details the estimated fiscal impact of the bill beginning in fiscal 2009.

Exhibit B 2.3
Combined Reporting Revenue Increase
($ in Millions)

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
General Funds	$0.0	$36.8	$37.2	$41.9	$44.5
TTF	0.0	8.7	8.8	9.9	10.6
State Share	0.0	6.1	6.2	6.9	7.4
Local Share	0.0	2.6	2.6	3.0	3.2
Total	**$0**	**$45.5**	**$46.0**	**$51.8**	**$55.1**

This estimate is based on existing research on the revenue impacts of combined reporting and increased revenue per tax year over time as implementation and legal issues are resolved. Fiscal 2009 reflects the impact of most of tax year 2008 and about one-third of tax year 2009. Future years reflect the estimated correlation between tax year and fiscal year revenue. To the extent that corporations employ alternative tax planning strategies in the future not covered by current law, revenue increases from implementing combined reporting would be greater than estimated.

These estimates also take into account the altered corporate income tax distribution and rate increase proposed in the bill and analyzed in Part B-1 of this Fiscal and Policy Note.

The bill requires companies to calculate Maryland taxable income by disregarding transactions among members of a unitary group. While this provision would go beyond the provisions enacted by Chapter 557 of 2004, the Comptroller's Office notes that combined reporting could also bring in losses by entities that are unrelated to the Maryland business and would have been excludable from Maryland income under current law. Legislative Services notes that while losses could be imported, they are more likely outweighed by the impact of bringing in additional income to the State.

Local Effect: Local governments receive a portion of TTF revenues in the form of local highway user revenues for the purpose of constructing and maintaining local roads. Local highway user revenues would increase by $2.6 million in fiscal 2009; and by $2.6 to $3.2 million in fiscal 2010 through 2012. Local expenditures would not be affected.

Part C. Recordation and Transfer Taxes – Transfer of Controlling Interest

Fiscal Summary: Special fund revenues would increase by $14.1 million annually beginning in fiscal 2009. **Exhibit C 1.1** shows the fiscal impact over a five-year period.

Exhibit C 1.1
Effect on State Revenues – Transfer Tax
($ in Millions)

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
GF Revenues	$0.0	$0.0	$0.0	$0.0	$0.0
SF Revenues	0.0	14.1	14.1	14.1	14.1
Total Revenues	**$0.0**	**$14.1**	**$14.1**	**$14.1**	**$14.1**

Bill Summary: The bill imposes recordation and transfer taxes on the transfer of real property with a value of $1.0 million or more when the transfer is achieved through the sale of a "controlling interest" in a specified corporation, partnership, limited liability company, limited liability partnership, or other form of unincorporated business. Controlling interest is defined as more than 80% of the total value of the stock or the interest in capital and profits.

Specifically, the bill • applies to transfers of controlling interests by entities that have tangible assets of which at least 80% are comprised of real property in Maryland that has an aggregate value of at least $1.0 million; • exempts certain transfers (*e.g.,* mergers and dissolutions); and • requires a report be filed with the State Department of Assessments and Taxation (SDAT) upon the transfer of a controlling interest within 30 days of the final transfer.

The tax is to be imposed on the consideration payable for the transfer of controlling interest in the real property entity reduced by the amount allocable to assets other than the real property. Consideration includes any mortgage, deed of trust, or other lien on the real property directly or beneficially owned by the real property entity and any other debt or encumbrance of the real property entity. The entity has the burden of establishing the consideration related to the real property and if it fails to do so the tax is imposed on the most recent assessed value of the property.

These provisions are effective July 1, 2008.

Current Law: Real property can be effectively transferred without payment of transfer and recordation taxes by transferring controlling interest or ownership of the entity if the property is owned by a corporation, limited liability company, or partnership.

The counties and Baltimore City are authorized to impose locally established recordation tax rates on any business or person: (1) conveying title to real property; or (2) creating or giving notice of a security interest *(i.e.*, a lien or encumbrance) in real or personal property, by means of an instrument of writing.

The State and most counties also impose a transfer tax. The State transfer tax rate is 0.5% of the consideration payable for an instrument of writing conveying title to, or a leasehold interest in, real property (0.25% for first-time Maryland homebuyers). In some jurisdictions a local property transfer tax may be imposed on instruments transferring title to real property. A distinction is made in the local codes between instruments transferring title such as a deed and certain leaseholds and instruments securing real property such as a mortgage. Except in Prince George's County, mortgages are not subject to the tax.

Background: Several other jurisdictions in the country currently tax the transfer of the controlling interest in an entity owning real property: California, Connecticut, Delaware, Illinois, Maine, New Jersey, New York, Pennsylvania, Virginia, and Washington; and the cities of Chicago, New York, Philadelphia, and the District of Columbia.

The transfer of a controlling interest is one method of transferring commercial and industrial property and results in no recordation and transfer taxes being paid. The sale of a property through the transfer of a controlling interest is not recorded in land records, and is therefore difficult to track. The mandate that real property be assessed at its market value is jeopardized for commercial and industrial properties if these transfers are not known to the assessor. This can lead to entire classes of properties being improperly assessed, typically too low.

The State transfer tax funds several programs in the Department of Natural Resources (DNR) and the Maryland Department of Agriculture. A portion of State transfer tax revenues (3%) is earmarked to defray administrative costs within DNR, the Department of General Services, and the Maryland Department of Planning. The remainder of the revenue is dedicated to various programs including Program Open Space (POS), the Maryland Agricultural Land Preservation Fund (MALPF), Rural Legacy, and the Heritage Conservation Fund. **Exhibit C 1.2** shows the distribution of State transfer tax revenues after administrative costs are deducted.

Exhibit C 1.2
Distribution of State Transfer Tax Revenues

POS	75.15%
POS Land Acquisition	1.00%
MALPF	17.05%
Rural Legacy	5.00%
Heritage Conservation Fund	1.80%
Total	**100.0%**

Of the transfer tax revenues distributed to POS, $3 million may be transferred by an appropriation in the State budget or by budget amendment to the Maryland Heritage Areas Authority Financing Fund within the Department of Housing and Community Development. Of the remaining funds, half is allocated for State acquisition and half is allocated to local governments for acquisition and development of land for recreation and open space purposes.

State Revenues: The bill requires SDAT to collect recordation (local) and transfer (State and local) taxes when real property is transferred by means of selling a controlling interest in a business entity that owns Maryland real property.

Because this type of transaction is not currently subject to these taxes, it is difficult to estimate the exact amount of revenue that could be generated by the bill. SDAT has recently identified 220 real estate transactions in calendar 2001 through 2006 that would have resulted in the following recordation and transfer tax collections if the bill was in effect in those years, as shown in **Exhibit C 1.3**.

Exhibit C 1.3
Real Estate Transactions Identified as a Controlling Interest

Calendar Year	Number of Transactions	State Transfer Tax	County Transfer/ Recordation Tax
2001	27	$3,000,000	$9,300,000
2002	21	3,500,000	9,100,000
2003	22	2,900,000	9,200,000
2004	33	5,300,000	17,800,000
2005	49	8,500,000	33,200,000
2006	68	11,700,000	40,100,000

Out-year revenues would fluctuate depending on the real estate market and the number of transfers. Additionally, the imposition of taxes on these transactions may reduce the number of transfers that occur. The actual increase in revenues depends on the number of transfers of controlling interest in real property entities and the consideration attributable to the real property.

Assuming a commensurate growth in the value of transactions that escape recordation and transfer taxes, and based on the growth of the number of transactions that are subject to the tax and those that are not, it is estimated that the bill could generate approximately $14.1 million annually beginning in fiscal 2009.

Exhibit C 1.4 lists some recently identified properties that were transferred through the transfer of controlling interest where the sale price is $100 million or more.

Exhibit C 1.4
Properties Transferred through the Transfer of Controlling Interest with Values Over $100 Million

Property	Location	Date of Transfer
IBM Building	Baltimore City	November 1997
IBM Building	Baltimore City	May 2005
Wyndham Inner Harbor	Baltimore City	August 2005
Wyndham Inner Harbor	Baltimore City	October 2005
Marshfield Business Park	Baltimore County	June 2005
Cove Point LNG Facility	Calvert County	September 2002
Village Centers in Columbia	Howard County	February 2002
Bethesda Towers	Montgomery County	September 2005
Capital Gateway II & IV	Montgomery County	October 2004
The Chase at Bethesda	Montgomery County	January 2006
Executive Plaza North & South	Montgomery County	December 2003
Human Genome	Montgomery County	May 2006
Irvington Center	Montgomery County	April 2006
Metro Park North	Montgomery County	December 2001
Peppertree Farm Apartments	Montgomery County	January 2006
Capitol Office Park	Prince George's County	March 2006

Because the bill requires all transactions to be reported to SDAT, the Comptroller will now be able to track nonresidents involved in real property transactions. Nonresidents are required to pay income tax on the net gain from real estate transactions, but to the

extent they were done through the transfer of controlling interest, the Comptroller had no mechanism with which to track these types of transactions.

It is estimated that the income tax collected from nonresidents from these sales could be significant, due to the value of properties transferred in this manner. However, because the amount of net gain from each of these transactions cannot be reliably estimated, the exact amount of income tax generated cannot be predicted.

To the extent that nonresident corporations pay more income tax, 76% of corporate income taxes are distributed to the general fund and 24% are distributed to the Transportation Trust Fund. Revenue derived from entities paying the individual income tax is distributed to the general fund.

Local Effect: The bill could increase local recordation and transfer taxes by an estimated $48.2 million beginning in fiscal 2009. State aid under Program Open Space would increase by $5.3 million beginning in fiscal 2009.

Exhibit C 1.5
Potential Increase in Local Recordation and Transfer Taxes
Fiscal 2009

County	FY 2009	Percent of Total
Allegany	$166,177	0.3%
Anne Arundel	4,633,875	9.6%
Baltimore City	4,702,790	9.8%
Baltimore	8,553,560	17.7%
Calvert	176,230	0.4%
Caroline	88,217	0.2%
Carroll	489,286	1.0%
Cecil	235,815	0.5%
Charles	542,623	1.1%
Dorchester	203,310	0.4%
Frederick	1,076,352	2.2%
Garrett	158,556	0.3%
Harford	1,349,143	2.8%
Howard	2,922,185	6.1%
Kent	104,538	0.2%
Montgomery	12,594,522	26.1%
Prince George's	7,648,086	15.9%
Queen Anne's	173,948	0.4%
St. Mary's	564,783	1.2%
Somerset	28,462	0.1%
Talbot	342,340	0.7%
Washington	535,561	1.1%
Wicomico	270,192	0.6%
Worcester	647,848	1.3%
Total	**$48,208,400**	**100.0%**

Part D. Administrative Expenditures

Implementing the various provisions of the Tax Reform Act of 2007 would result in additional administrative expenses at the Comptroller's Office and the State Department of Assessments and Taxation (SDAT). State expenditures would increase by $322,100 in fiscal 2008 and by $113,600 in fiscal 2012. **Exhibit D 1.1** shows the increase in State expenditures for both agencies for a five-year period.

Exhibit D 1.1
Total Administrative Expenditures
Fiscal 2008-2012

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
GF Expenditures	$322,100	$0	$0	$0	$0
SF Expenditures	0	96,700	102,000	107,600	113,600
Total Expenditures	**$322,100**	**$96,700**	**$102,000**	**$107,600**	**$113,600**

Comptroller's Office

The Comptroller's Office would incur a variety of expenditure increases to administer the bill, including increased notification costs relating to mailing and postage, computer programming modifications, and employee training. As a result, general fund expenditures would increase by $322,100 in fiscal 2008. **Exhibit D 1.2** provides a summary of estimated expenditures in fiscal 2008. This estimate reflects the following facts and assumptions:

- notifying 433,000 tax account holders of the changes under the Tax Reform Act at an average cost of $0.56 per account;
- 25 employees attending a Multi-State Tax Commission training program at a cost of $1,200 per person; and
- 12 auditors attending a two-week training program at a cost of $4,200 per person.

Exhibit D 1.2
Summary of Increased Expenditures – Comptroller's Office
Fiscal 2008 and 2009

	FY 2008	FY 2009
Notification Costs	$242,100	$0
Training Costs	80,000	0
Total	**$322,100**	**$0**

State Department of Assessments and Taxation

SDAT is required to deduct the cost of administering the collection of additional revenues relating to the transfer of controlling interest. Special fund expenditures by SDAT for administering the new tax would be approximately $96,700 in fiscal 2009 and $113,600 in fiscal 2012. SDAT will have to hire one charter specialist and one office secretary to assist in the collection and administration of additional recordation and transfer taxes. Future year expenditures reflect full salaries with 4.5% annual increases and 3% employee turnover; and 1% annual increases in ongoing operating expenses. **Exhibit D 1.3** provides a summary of estimated expenditures in fiscal 2008 and 2009.

Exhibit D 1.3
Summary of Increased Expenditures – SDAT
Fiscal 2008 and 2009

	FY 2008	FY 2009
Personnel Expenses	$0	$95,100
Operating Expenses	0	1,600
Total	**$0**	**$96,700**