SB 12

Department of Legislative Services

Maryland General Assembly
2007 Special Session

FISCAL AND POLICY NOTE

Senate Bill 12 (Senators Forehand and Kasemeyer)
Budget and Taxation

Individual Income Tax - Rate

This bill increases the top marginal State income tax rate from 4.75% to 5%.

The bill takes effect January 1, 2008 and applies to tax year 2008 and beyond.

Fiscal Summary

State Effect: General fund revenues would increase by $156.0 million in FY 2008, which reflects the impact of less than half a tax year. Future year revenues reflect estimated taxable income. General fund expenditures would increase by $120,000 in FY 2008 for implementation costs at the Comptroller's Office.

($ in millions)	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
GF Revenue	$156.0	$403.7	$408.7	$435.1	$462.6
GF Expenditure	.1	0	0	0	0
Net Effect	$155.9	$403.7	$408.7	$435.1	$462.6

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

Local Effect: Potential minimal decrease in expenditures in Montgomery County due to decreased local earned income tax credit payments. Revenues would not be affected. The bill does not alter local income tax rates.

Small Business Effect: Meaningful.

Analysis

Current Law: **Exhibit 1** shows the current State income tax rates.

Exhibit 1
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

Background: The personal income tax is the State's largest source of general fund revenue accounting for $7.1 billion in fiscal 2008 and $7.5 billion in fiscal 2009.

Chapter 4 of 1997 (the 1997 Tax Reduction Act) was designed to provide a 10% reduction in State income taxes. This reduction began in tax year 1998 and was originally to be phased in over five years. Better than anticipated revenue growth enabled the General Assembly to enact Chapter 4 of 1998, which accelerated the income tax reduction for tax years 1998 and 1999. The Acts reduced the top marginal State income tax rate from 5.0 to 4.75% and increased the regular personal exemption from $1,200 to $2,400, as illustrated in **Exhibit 2**.

Exhibit 2
Phased-in Personal Income Tax Reduction
as Enacted by Chapter 4 of 1997 and Chapter 4 of 1998

	Previous Law	1998	1999	2000	2001	2002 and Beyond
Top marginal income tax rate	5.0%	4.875%	4.85%	4.85%	4.80%	4.75%
Regular personal exemption	$1,200	$1,750	$1,850	$1,850	$2,100	$2,400

Source: Department of Legislative Services

State Revenues: The top marginal tax rate of 5% would be in effect beginning tax year 2008, with general fund revenues increasing by $371.4 million in that tax year. It is estimated that about $156.0 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, and because the bill does not change safe harbor provisions. It is assumed that any delayed revenue due to these issues would be realized in fiscal 2009. 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. To the extent that the lack of adjustment of withholding rates increases tax delinquency, revenue increases would be less than estimated.

Tax Incidence of Proposal

Exhibit 3 lists the impact of the proposal on taxpayers, not including fiduciaries, based on different levels of net taxable income.

Exhibit 3
Changes in Gross Taxes Paid by Net Taxable Income

			Average State Taxes Paid			
NTI	**Average MAGI**	**Returns**	**Current**	**Proposal**	**Change**	**Percent Change**
$0-10,000	$14,802	440,819	$207	$212	$5	2.4%
10,000-20,000	25,589	414,884	647	674	27	4.1%
20,000-30,000	37,353	301,805	1,125	1,177	52	4.6%
30,000-40,000	48,882	235,422	1,598	1,675	77	4.8%
40,000-50,000	61,114	175,570	2,074	2,176	102	4.9%
50,000-75,000	80,708	287,317	2,859	3,002	143	5.0%
75,000-100,000	109,121	152,013	4,041	4,296	205	5.1%
100,000-200,000	160,937	172,168	6,299	6,623	324	5.1%
200,000-500,000	326,801	48,537	13,733	14,448	716	5.2%
500,000-1,000,000	740,522	10,157	32,386	34,083	1,697	5.2%
over $1 million	3,060,008	6,142	136,896	144,094	7,198	5.3%

Exhibit 3 details 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 Exhibit 3.

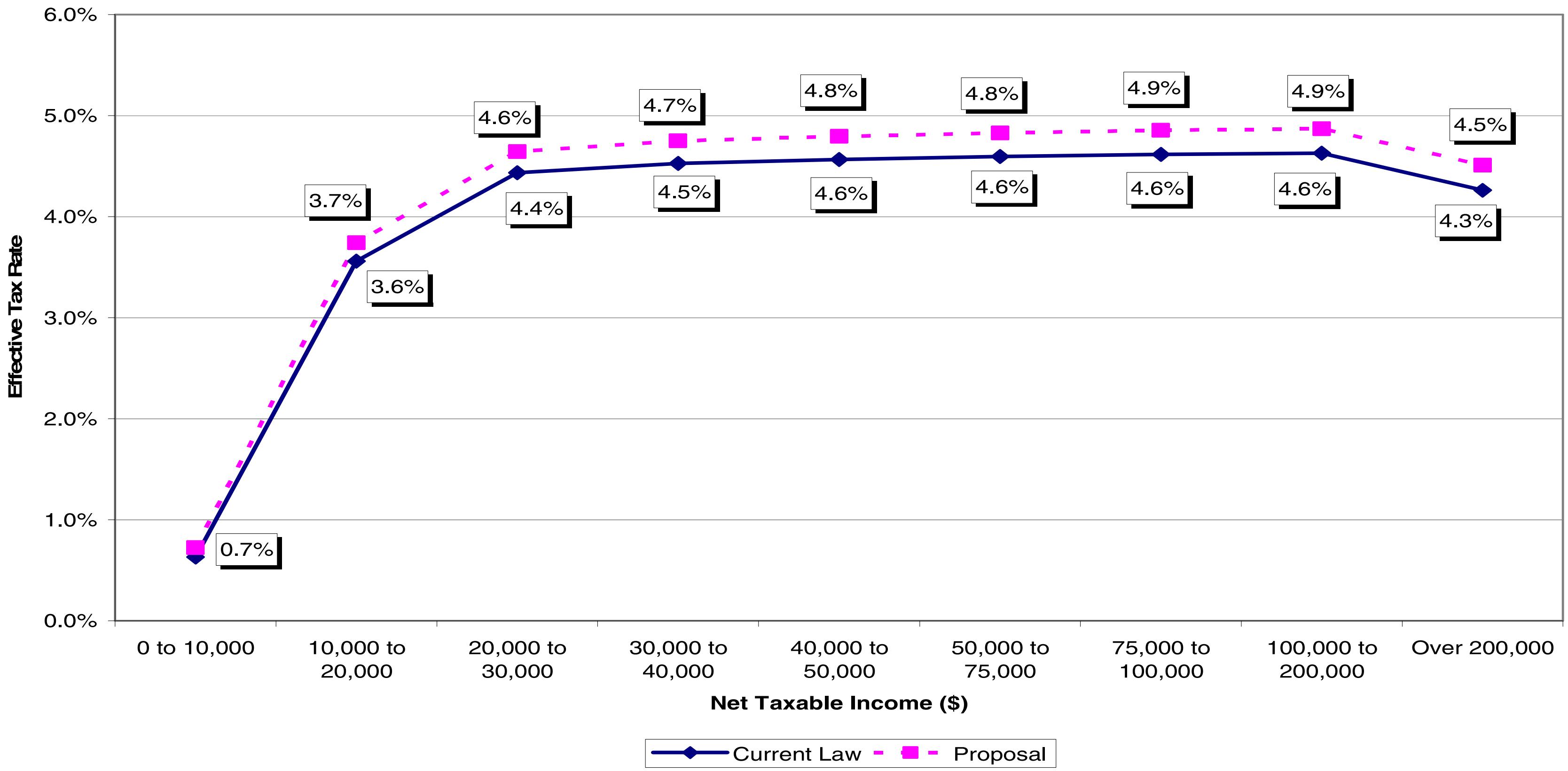
Another limitation of the analysis above is that it provides a "snapshot" of the incidence of the proposed changes. It is based on the annual taxes paid and annual next taxable income of taxpayers in 2005. Net taxable income in one year's time may not be an accurate depiction of an individual's economic 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 4 details the percentage 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 minimal tax rate for taxpayers with net taxable income less than $10,000.

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.

Exhibit 4
Impact of Proposed Rate Changes on Tax Rates



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 508,000 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.

State Expenditures: The Comptroller's Office would incur approximately $120,000 in postage, printing, and computer programming expenses in fiscal 2008 as a result of the tax rate change.

Small Business Effect: Small businesses that are partnerships, S corporations, limited liability companies, and sole proprietorships would be negatively impacted by the increased tax burden resulting from the higher top marginal rate. Exhibit 3 illustrates the magnitude of the increased burden across income levels.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Comptroller's Office, Department of Legislative Services

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mll/hlb

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