SB 517

Department of Legislative Services

Maryland General Assembly
2008 Session

FISCAL AND POLICY NOTE

Senate Bill 517 (Senator Stone)
Budget and Taxation

Income Tax - Personal Exemptions - Inflation Adjustment

This bill would index the value of the regular personal exemption based on the annual change in the Consumer Price Index.

The bill takes effect July 1, 2008 and applies to tax year 2011 and beyond.

Fiscal Summary

State Effect: General fund revenues could decrease by $4.8 million in FY 2011, which represents the impact of one-half a tax year. Future years reflect annualization, estimated growth in exemptions claimed, and estimated change in the CPI. Expenditures would not be affected.

($ in millions)	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
GF Revenue	$0	$0	($4.8)	($14.9)	($30.6)
Expenditure	$0	$0	$0	$0	$0
Net Effect	$0	$0	($4.8)	($14.9)	($30.6)

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

Local Effect: Local income tax revenues would decrease by $3.1 million in FY 2011, $9.7 million in FY 2012, and $20.0 million in FY 2013. Expenditures would not be affected.

Small Business Effect: Minimal.

Analysis

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. However, the value of the State personal exemption is not indexed to inflation. Nonresidents and part-time resident taxpayers are required to prorate personal exemptions based on the percentage of income subject to Maryland tax.

Chapter 3 of the 2007 special session altered the value of the regular personal exemption, which had been $2,400 for all individuals. Chapter 3 increased the regular personal exemption to $3,200 for individuals with FAGI of $100,000 or less ($150,000 or less for joint filers), but gradually reduced the value of the exemption as a taxpayer's FAGI exceeded specified thresholds. **Exhibit 1** lists the value of the exemption based on the taxpayer's FAGI.

Exhibit 1
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

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 2** lists, by filing status, the points at which the value of the taxpayer's exemptions begins to phase out.

Exhibit 2
Federal Phase Out of Exemptions
Tax Year 2007

Filing Status	Phase Out Begins
Joint, Surviving Spouse	$234,600
Head of Household	195,500
Single	156,400
Married, Filing Separately	117,300

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. The amount that taxpayers must decrease their exemptions by is decreased by one-third in tax years 2006 and 2007 and by two-thirds in tax years 2008 and 2009. 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.

Background: The CPI is the most commonly used measure of the change in prices over time (inflation). The index tracks the average change in prices paid by urban consumers for a market basket of consumer goods and services. It is used to compare the relative value of money and goods over time, given price fluctuations. Though not a perfect measure, it is also commonly used to measure the cost-of-living, and is used to increase wages in an attempt to maintain a constant standard-of-living given rising costs. The CPI has increased by an average of 2.6% annually in the last 10 years, and is expected to increase by a similar amount in the next few years.

In tax year 2007 13 states provide an inflation adjustment by indexing their income tax brackets to a consumer price or cost-of-living measure. Various states provide an adjustment implicitly by taxing income at a percentage of the taxpayer's federal tax liability. Five states index their personal exemption or standard deduction to adjust for inflation. Another eight states implicitly adjust their personal exemption or standard deduction amounts for inflation by using federal amounts to determine the state amount. **Exhibit 3** lists the states that index some component of their income tax.

Exhibit 3
States that Index Some Portion of the Income Tax

State	Tax Brackets	Standard Deduction	Personal Exemption
Arkansas	X		
California	X	X	
Idaho	X		
Iowa	X		
Maine	X		
Massachusetts			X
Michigan			X
Minnesota	X		
Montana	X		
Nebraska		X	X
North Dakota	X		
Ohio	X		X
Oregon	X		
South Carolina	X		
Vermont	X		
Wisconsin	X		

Several components of Maryland income tax system are influenced by inflation, including the State pension exclusion, State earned income credits, and poverty level credit. The maximum value of the State pension exclusion increases every year based on the maximum annual benefit payable under the Social Security Act, which is indexed to the CPI. The State earned income credits are based on a percentage of the federal credit that is adjusted in value and income eligibility annually based on the CPI. The poverty level credit is based on federal poverty standards, which are adjusted annually based on inflation. Taxpayers can claim either a standard deduction or itemized deduction for State income tax purposes. The value of the standard deduction does not change based on inflation. The value of itemized deductions are sensitive to inflation because: (1) federal income tax phase out rules based on the CPI flow through for State income tax purposes; and (2) the amount that taxpayers itemize is influenced by rising prices in the economy, particularly increases in home prices.

The lack of indexation can cause individuals to pay more taxes merely because prices increase, even if the taxpayer's economic well-being has not changed. The most salient example is the Alternative Minimum Tax, originally enacted in 1969 to ensure that high-income taxpayers were not able to avoid income taxes. The lack of indexing in the original legislation has caused it to ensnare individuals of much more limited means than originally intended, leading Congress to enact a series of temporary corrective measures in the last few years.

State Revenues: The bill would index the value of the personal exemption based on the annual change in the CPI, beginning in tax year 2011. As a result, general fund revenues would decrease by $4.8 million in fiscal 2011, which represents the impact of one-half a tax year. State revenues would decrease by $14.9 million in fiscal 2012 and $30.6 million in fiscal 2013.

Exhibit 4 lists the average State and local tax savings in tax year 2011 through 2013 based on the current law value of the exemption that a taxpayer would claim.

Exhibit 4
Estimated State and Local Income Tax Savings
Tax Year 2011-2013

		Average State and Local Tax Savings		
Current Value of Exemption Claimed	**Number of Returns**	**TY 2011**	**TY 2012**	**TY 2013**
$3,200	2,037,600	$8	$16	$31
2,400	90,200	0	9	28
1,800	52,600	0	10	20
1,200	59,200	0	0	11
600	127,900	0	0	0

The bill provides that adjustments are based on changes in the CPI, rounded down to the next $50. Current inflation forecasts would not lead to an increase for each exemption value in each year. As a result, some taxpayers would not see a benefit under the bill in tax year 2011 through 2013, but would eventually realize tax savings in tax year 2014 and beyond.

Additional Information

Prior Introductions: None.

Cross File: HB 475 (Delegate Olszewski, *et al.*) – Ways and Means.

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

Fiscal Note History: First Reader - February 18, 2008
mll/hlb

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