

Department of Legislative Services
2014 Session

FISCAL AND POLICY NOTE

House Bill 522 (Delegate Krebs, *et al.*)
Ways and Means

Income Tax - Personal Exemptions - Inflation Adjustment

This bill indexes the value of the income tax personal exemption based on the annual change in the Consumer Price Index (CPI).

The bill takes effect July 1, 2014, and applies to tax year 2015 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by \$9.7 million in FY 2015, reflecting revenues from one-half of a tax year. Future year revenue estimates reflect annualization and the projected increase in the number of personal exemptions claimed. Minimal increase in general fund expenditures beginning in FY 2015 due to computer programming expenses in the Comptroller’s Office.

(\$ in millions)	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
GF Revenue	(\$9.7)	(\$29.4)	(\$44.5)	(\$59.6)	(\$80.5)
GF Expenditure	\$0	-	-	-	-
Net Effect	(\$9.7)	(\$29.4)	(\$44.5)	(\$59.6)	(\$80.5)

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

Local Effect: Local revenues decrease by \$6.4 million in FY 2015 and by \$53.1 million in FY 2019.

Small Business Effect: Minimal.

Analysis

Current Law: Chapter 2 of the first special session of 2012 contained numerous provisions that increased State and local tax revenues, including increased State income tax rates and a reduction of the personal exemption amounts for certain higher-income

taxpayers effective beginning in tax year 2012. **Exhibit 1** shows the current value of the personal exemption by federal adjusted gross income (FAGI).

Exhibit 1
Personal Exemption Values by FAGI and Filing Class
Current Law

	<u>FAGI</u>	<u>Exemption Value</u>
Single Taxpayers		
	\$100,000 or less	\$3,200
	\$100,001-\$125,000	1,600
	\$125,001-\$150,000	800
	Over \$150,000	0
Joint Taxpayers		
	\$150,000 or less	\$3,200
	\$150,001-\$175,000	1,600
	\$175,001-\$200,000	800
	Over \$200,000	0

Background: The CPI is a measure of the average monthly change in the price for goods and services paid by consumers between any two time periods and is the most commonly utilized measure to calculate inflation and deflation. Under the current economic forecast, the CPI is expected to increase by about 2% annually through fiscal 2019.

Major components of the federal income tax are indexed for changes in inflation, including federal income tax rate brackets. The Internal Revenue Service issues revenue procedures which set the inflation adjustments for the following tax year. About 40 items are typically adjusted. Indexing tax brackets to the change in inflation prevents “bracket creep,” whereby households pay additional income taxes merely because of inflation and not because the taxpayer’s economic well-being has improved. The most salient example of bracket creep is the federal alternative minimum tax, originally enacted in 1969 to prevent high-income taxpayers from avoiding income taxes. Since the original legislation lacked indexing, it applied to households of much more limited means than originally intended, leading the U.S. Congress to enact a series of temporary corrective measures until the American Taxpayer Relief Act of 2012 provided permanent relief by indexing the tax.

According to the Tax Foundation, 14 states provided an inflation adjustment in tax year 2011 by indexing their income tax rate brackets to a consumer price or cost-of-living measure. Various states provide an implicit adjustment by taxing income at a percentage of the taxpayer's federal tax liability. In addition, some states index the value of either the standard deduction or the personal exemption.

Although the State's income tax brackets are not indexed for inflation, several components of Maryland's income tax system are influenced by inflation, including the State pension exclusion, State earned income tax credit, and poverty level tax 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 tax credit is based on a percentage of the federal earned income tax credit, of which the value of and eligibility standards for are adjusted annually based on the change in the CPI. The poverty level tax 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. While 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, when applicable, flow through for State income tax purposes and (2) the amount that taxpayers itemize is influenced by price fluctuations in the economy, particularly changes in home prices.

Income tax brackets and other important components of the income tax, such as the personal exemption and standard deduction, are not adjusted for inflation. As a result, some Maryland businesses and households pay more State income taxes over time due to inflation, even though their economic well-being may not have improved over time.

State Revenues: The new personal exemption amounts under the bill take effect beginning in tax year 2015. As a result, general fund revenues will decrease by \$9.7 million in fiscal 2015, which reflects the impact of one-half of tax year 2015. Future year estimates reflect annualization and projected increases in the number of personal exemptions claimed. **Exhibit 2** shows the estimated impact of the bill on State and local revenues.

Exhibit 2
State and Local Revenue Impacts
Fiscal 2015-2019
(\$ in Millions)

	<u>FY 2015</u>	<u>FY 2016</u>	<u>FY 2017</u>	<u>FY 2018</u>	<u>FY 2019</u>
State	(\$9.7)	(\$29.4)	(\$44.5)	(\$59.6)	(\$80.5)
Local	(6.4)	(19.4)	(29.4)	(39.4)	(53.1)
Total Revenues	(\$16.0)	(\$48.8)	(\$73.8)	(\$99.0)	(\$133.6)

State Expenditures: General fund expenditures for the Comptroller's Office may increase minimally beginning in fiscal 2015 as a result of issuing new employer withholding tables and altering the personal income tax forms.

Local Revenues: Local income tax revenues will decrease as a result of the increase in personal exemption amounts specified by the bill. Local revenues will decrease by \$6.4 million in fiscal 2015 and by \$53.1 million in fiscal 2019, as shown in Exhibit 2.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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