

Department of Legislative Services
2015 Session

FISCAL AND POLICY NOTE

House Bill 147 (Delegate Krebs, *et al.*)
Ways and Means

Taxpayer Protection Act - State Income Tax - Consumer Price Index
Adjustments

This bill indexes specified State income tax rate brackets based on the annual change in the Consumer Price Index (CPI).

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

Fiscal Summary

State Effect: General fund revenues decrease by \$0.5 million in FY 2017 and by \$4.5 million in FY 2020. Minimal increase in general fund expenditures beginning in FY 2017 due to computer programming expenses in the Comptroller’s Office.

| (\$ in millions) | FY 2016 | FY 2017 | FY 2018 | FY 2019 | FY 2020 |
|------------------|---------|---------|---------|---------|---------|
| GF Revenue | \$0 | (\$0.5) | (\$1.5) | (\$2.9) | (\$4.5) |
| GF Expenditure | \$0 | - | - | - | - |
| Net Effect | \$0 | (\$0.5) | (\$1.5) | (\$2.9) | (\$4.5) |

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

Local Effect: None.

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 State income tax rates under current law.

Exhibit 1
Maryland State Income Tax Rates
Current Law

| Single, Dependent Filer, Married Filing Separate | | Joint, Head of Household, Widower | |
|---|---------------------------------------|--|---------------------------------------|
| <u>Rate</u> | <u>Maryland Taxable Income</u> | <u>Rate</u> | <u>Maryland Taxable Income</u> |
| 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-\$100,000 | 4.75% | \$3,001-\$150,000 |
| 5.00% | \$100,001-\$125,000 | 5.00% | \$150,001-\$175,000 |
| 5.25% | \$125,001-\$150,000 | 5.25% | \$175,001-\$225,000 |
| 5.50% | \$150,001-\$250,000 | 5.50% | \$225,001-\$300,000 |
| 5.75% | Excess of \$250,000 | 5.75% | Excess of \$300,000 |

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 in the next 10 years.

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 Federation of Tax Administrators, 17 states, or 40% of all states that impose a broad-based income tax, provided an inflation adjustment in tax year 2014 by indexing their rate brackets, standard deductions, and/or personal exemption to a consumer price or cost-of-living measure. None of Maryland’s surrounding states or the District of Columbia provide for an explicit inflation adjustment for its income tax components.

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 is 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 bill will index the value of certain State income tax rate brackets based on the rate of inflation beginning with tax year 2015. Based on the current economic forecast and indexation specified by the bill, the values of the specified brackets will not increase until tax year 2017. It is assumed that the bill impacts withholdings and estimated payments. As a result, general fund revenues decrease by \$473,400 in fiscal 2017, which reflects the impact of one half of a taxable year. Future revenue losses increase and total \$4.5 million by fiscal 2020.

State Expenditures: General fund expenditures for the Comptroller's Office may increase minimally beginning in fiscal 2017 as a result of issuing new employer withholding tables and altering the personal income tax forms.

Additional Information

Prior Introductions: HB 557 of 2014, HB 308 of 2013, and HB 383 of 2012 received a hearing in the House Ways and Means Committee, but no further action was taken.

Cross File: None.

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

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min/jrb

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