SB 840

Department of Legislative Services

Maryland General Assembly
2016 Session

FISCAL AND POLICY NOTE
Third Reader - Revised

Senate Bill 840 (The President)(By Request - Maryland Economic Development and Business Climate Commission)

Budget and Taxation Ways and Means

Income Tax - Rates, Personal Exemptions, and Earned Income Tax Credit

This bill (1) reduces over five tax years State income tax rates imposed on certain higher income taxpayers; (2) expands the State earned income tax credit that can be claimed by individuals without qualifying children; and (3) increases over four tax years the value of the personal exemption that can be claimed by taxpayers with federal adjusted gross income (FAGI) of $100,000 or less, or $150,000 or less if married filing jointly.

The bill takes effect July 1, 2016, and applies beginning in tax year 2016.

Fiscal Summary

State Effect: General fund revenues decrease by $98.0 million in FY 2017 due to the changes in specified income tax rates and personal exemption values and expansion of the earned income credit. Future year revenue losses reflect the phase in specified by the bill, the current economic forecast, and eligible earned income credit claimants. General fund expenditures increase by $300,000 in FY 2017 due to implementation costs at the Comptroller's Office.

($ in millions)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
GF Revenue	($98.0)	($133.0)	($168.5)	($209.1)	($236.8)
GF Expenditure	$0.3	$0	$0	$0	$0
Net Effect	($98.3)	($133.0)	($168.5)	($209.1)	($236.8)

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

Local Effect: Local income tax revenues decrease by $11.4 million in FY 2017 and by $24.2 million in FY 2021. Montgomery County expenditures for its earned income credit program may increase beginning in FY 2018.

Small Business Effect: Small businesses that are partnerships, S corporations, limited liability companies, and sole proprietorships will be meaningfully impacted by the bill. Any of these small businesses will be positively impacted through decreased income tax liabilities.

Analysis

Bill Summary/Current Law:

State Income Tax Rates

Exhibit 1 shows the State income tax rates under current law. **Exhibit 2** shows the State income tax rates proposed by the bill beginning in tax year 2020, when the rate reductions are fully phased in.

Exhibit 1
Maryland State Income Tax Rates
Current Law

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-$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

Exhibit 2
Maryland State Income Tax Rates
Proposed – Tax Year 2020

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-$100,000	4.75%	$3,001-$150,000
4.875%	$100,001-$125,000	4.875%	$150,001-$175,000
5.00%	$125,001-$150,000	5.00%	$175,001-$225,000
5.25%	$150,001-$250,000	5.25%	$225,001-$300,000
5.60%	Excess of $250,000	5.60%	Excess of $300,000

Personal Exemptions

An individual for State income tax purposes is entitled to claim the same number of personal exemptions that the individual claimed on the federal income tax return. Nonresidents and part-time residents are required to prorate exemptions based on the percentage of income subject to Maryland tax. The value of the State personal exemption depends on the FAGI and filing class of the taxpayer. Taxpayers with FAGI of $100,000 or less ($150,000 or less if married filing jointly) can currently claim an exemption of $3,200. The bill increases the value of this exemption to $3,400 in $50 increments over four tax years beginning with tax year 2016. **Exhibit 3** shows the current value of the personal exemption amounts by FAGI and filing class and the proposed values under the bill in tax year 2019, when the change is fully phased in.

Exhibit 3
Personal Exemption Values by FAGI and Filing Class

	Brackets	Current Value	Proposed Value
Single Taxpayers			
	$100,000 or less	$3,200	$3,400
	$100,001-$125,000	1,600	1,600
	$125,001-$150,000	800	800
	Over $150,000	0	$0
Joint Taxpayers			
	$150,000 or less	$3,200	$3,400
	$150,001-$175,000	1,600	1,600
	$175,001-$200,000	800	800
	Over $200,000	0	0

Earned Income Credit

Maryland offers a nonrefundable credit, which is equal to the lesser of 50% of the federal credit or the State income tax liability in the taxable year. If the nonrefundable credit reduces a taxpayer's liability to zero, the taxpayer is eligible to claim a refundable credit equal to 26% of the federal credit in tax year 2016, minus any precredit State tax liability.

Chapter 389 of 2014 increased the State refundable credit value from 25% to 28% of the federal earned income tax credit, phased in over four years beginning with tax year 2015.

Maryland conforms to the federal eligibility standards – only those individuals who claim the federal earned income tax credit may claim the State credit. To be eligible in tax year 2016, a taxpayer must have earned income, investment income of $3,400 or less, and a modified federal adjusted gross income of less than:

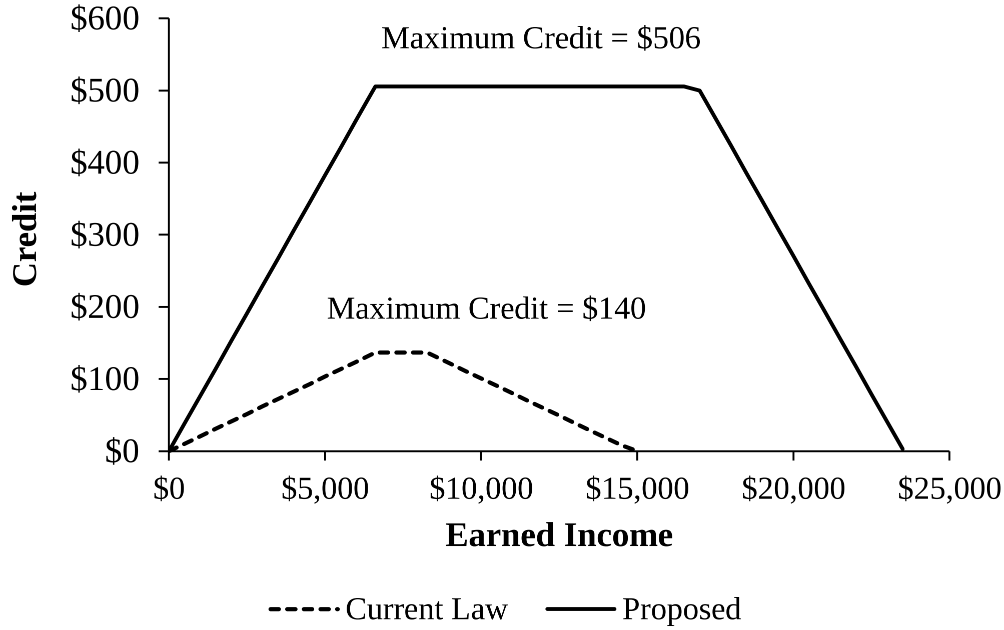
- $47,955 ($53,505 married filing jointly) with three or more qualifying children;
- $44,648 ($50,198 married filing jointly) with two qualifying children;
- $39,296 ($44,846 married filing jointly) with one qualifying child; and
- $14,880 ($20,430 married filing jointly) with no qualifying children.

In addition, eligibility for individuals without a qualifying child is limited to individuals who are between ages 25 and 64.

The bill expands eligibility for the State credit by allowing an individual without a qualifying child who is at least 18 years of age to claim the credit. The bill also increases, to 75% in tax year 2016 and 100% beginning in tax year 2017, the percentage of the federal credit, with the modified income phase outs described below, that an individual without a qualifying child can claim. A taxpayer will claim this fully refundable credit instead of the nonrefundable and refundable State earned income credits provided under current law.

The value of the earned income credit rises with an increase in an individual's earnings until the credit reaches its maximum value. The value of the credit remains at the maximum value as earnings rise but eventually earnings reach a phase-out range. From that point, the credit decreases with each additional dollar of earnings until the credit is completely phased out. Current federal law begins to phase out the credit when earnings equal about $8,300 and the credit is completely phased out at earnings of about $14,900. The bill increases to $16,900 the threshold at which the credit begins to phase out and the credit will completely phase out when earnings reach about $23,500 (about 200% of the federal poverty level for a single adult). **Exhibit 4** shows the change in the maximum refundable State earned income credit that can be claimed as a result of increasing the value and income thresholds in tax year 2017, when the increase in the percentage value of the credit is fully phased in. The actual change in an individual's tax liability may be different depending whether the individual has State tax liability or currently claims the nonrefundable credit.

Exhibit 4
Change in Maximum Refundable Earned Income Credit
Single Taxpayer without Qualifying Children



Note: Beginning in tax year 2017 the maximum credit under the bill will be adjusted based on inflation. Accordingly, the maximum credit may be slightly greater based on inflation.

The income phase outs shown above are higher for taxpayers filing a joint return, with the phase-out amount higher by $5,550 in tax year 2016. These amounts are adjusted in future years for inflation.

Background:

Maryland Economic Development and Business Climate Commission

In March 2014, the President of the Senate and the Speaker of the House of Delegates appointed the Maryland Economic Development and Business Climate Commission to focus on the State's economic development structure and incentive programs in order to make recommendations to the Presiding Officers. The commission's 26 members come from a broad spectrum of backgrounds and have had business involvement in many states, as well as abroad.

A report containing 10 findings and 32 recommendations was submitted to the Presiding Officers in February 2015. The principal finding of the commission is that Maryland has not nearly reached its potential in growing business and creating jobs. The recommendations in the report address various short- and long-term aspects of this principal finding and related findings. As a result, five pieces of legislation were enacted into law during the 2015 session that addressed many of the commission's recommendations.

In March 2015, the Presiding Officers asked the commission to review and make recommendations on certain tax issues affecting economic development and the State's business climate. In a report issued in January 2016, the commission offered 14 recommendations to improve the State's business tax structure, 13 of which were proposed for implementation at the present time and a fourteenth, a reduction in individual income taxes, that should be implemented when other recommendations have been assimilated and the State's revenues and economy have strengthened.

The commission found that Maryland's current tax structure is a detriment to the State's competitiveness in attracting and retaining businesses as well as in creating jobs and expanding the revenue base of the government itself. The commission also found, however, that the State has many competitive advantages, particularly an educational system that has helped produce one of the most highly qualified workforces in the nation.

The January 2016 report of the commission can be found here.

Earned Income Credit

First enacted in 1975, the federal earned income tax credit is a refundable tax credit offered to low-income workers. The federal credit has expanded significantly over time and is now one of the largest federal antipoverty programs. Maryland and about half of all states and the District of Columbia offer a state earned income tax credit that supplements the federal credit. Of the states that supplement the federal credit, Maryland has one of the highest value credits. Almost every state generally determines its credit as a percentage of the total federal credit claimed by the individual, and most states conform to federal eligibility standards. The District of Columbia extends eligibility of its credit to certain noncustodial parents from age 18 to 30 who are not eligible for the federal credit. A few states limit eligibility based on the taxpayer's income or tax liability. Maryland is the only state with both a nonrefundable and refundable credit. Some taxpayers, generally those with higher tax liabilities, claim only the nonrefundable credit; others will claim both credits, while a third group will claim only the refundable credit. In addition, low-income taxpayers may also claim a State and local poverty level credit.

The fiscal impact of the Maryland credit has expanded significantly over time, with approximately $300 million in State and local earned income tax credits and refundable credits claimed in tax year 2012. Significant factors contributing to this increase include the establishment and subsequent expansion of the State refundable credit, increased poverty rates, and federal earned income tax credit enhancements. The refundable credit was established in 1998, and legislation enhancing the value of the State refundable credit was enacted in 2001, 2007, and 2014. The 2007 legislation also extended eligibility of the refundable credit to individuals without children. The Budget Reconciliation and Financing Act of 2015 limits eligibility for the State and local earned income tax credits to State residents only beginning with tax year 2015.

Recent Proposals to Expand the Federal Credit

Numerous changes to the federal earned income tax credit have been proposed by the U.S. Congress and President, think tanks, and advocates. Many of these proposals have focused on expanding the credit for childless individuals, given that research has found the credit is generally an effective tool to alleviate poverty but does not benefit all impoverished workers equally. The President's federal fiscal year 2015 budget proposed to expand the credit for individuals without children by increasing the value, increasing the age limit, and simplifying eligibility rules. The U.S. Treasury estimated that the proposals will increase federal claims by about 10% in federal fiscal years 2016 through 2018 and by about 15% beginning in fiscal 2019. A similar proposal was recently introduced in the U.S. House of Representatives.

Department of Legislative Services Evaluation

Pursuant to the Tax Credit Evaluation Act of 2012, the Department of Legislative Services (DLS) evaluated the State earned income credit and made several recommendations in a draft report issued in November 2014. Based on the information and analysis provided in the report, DLS recommended several changes to improve the tax credit. The evaluation found that while the federal and State earned income tax credits have positive effects on reducing poverty and the credits do not proportionately benefit childless workers, the potential fiscal costs associated with expanding the credit by decoupling from the federal credit may outweigh the benefits that would otherwise accrue. Accordingly, DLS recommended that the General Assembly continue to monitor actions concerning the federal earned income tax credit and that the Comptroller provide an estimate of the potential costs associated with decoupling from the federal credit.

Additional recommendations included (1) designating the Department of Human Resources to promote the credit and gather information regarding participation rates and the credit's effectiveness; (2) examining the feasibility of simplifying the administration and claiming of the State credit; (3) requiring the Comptroller to institute additional educational and outreach efforts to both taxpayers and tax preparers and to investigate improper payments and develop strategies to address those payments; (4) examining additional measures to limit the adverse effects of refund anticipation products on the effectiveness of the credit; and (5) providing additional funding for free tax preparation services in order to combat the erosion of credit funds by tax preparation costs.

The DLS evaluation of the earned income credit can be found here. For additional background information on the earned income credit, please see the fiscal and policy note for Senate Bill 294/House Bill 1047 of 2016.

State Revenues: Beginning in tax year 2016, the bill (1) reduces over five tax years State income tax rates imposed on certain higher income taxpayers; (2) expands the State earned income tax credit that can be claimed by individuals without qualifying children; and (3) increases over four tax years the value of the personal exemption that can be claimed by taxpayers with FAGI of $100,000 or less ($150,000 or less if married filing jointly). As a result, general fund revenues decrease by $98.0 million in fiscal 2017 and by $236.8 million in fiscal 2021, as shown in **Exhibit 5**.

Exhibit 5
State and Local Fiscal Impact
Fiscal 2017-2021
($ in Millions)

	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
State					
Rates	($33.8)	($46.7)	($70.4)	($103.7)	($129.1)
Exemption	(18.4)	(23.5)	(33.3)	(38.6)	(39.0)
EIC	(45.8)	(62.9)	(64.8)	(66.8)	(68.7)
Total	**($98.0)**	**($133.0)**	**($168.5)**	**($209.1)**	**($236.8)**
Local					
Exemption	($11.4)	($14.6)	($20.7)	($23.9)	($24.2)

EIC: earned income credit

The fiscal 2017 impacts of the proposed changes to the income tax rates and personal exemption values reflect all of tax year 2016 and about one-half of tax year 2017. Future year estimates reflect annualization and the current economic forecast. The estimated impact of expanding the earned income credit is based on existing data on the State credit, federal earned income credit fiscal estimates, the Comptroller's Office analysis of tax year 2014 returns, and the current economic forecast.

State Expenditures: The Comptroller's Office reports that it will incur an expenditure increase of $300,000 in fiscal 2017 resulting from the tax rate and personal exemption changes and to provide for the calculation of a separate earned income credit for individuals without qualifying children. This includes data processing changes to the SMART income tax return processing and imaging systems and system testing. Future year expenditures increase minimally to reflecting the phased-in changes for the earned income credit, exemption values, and rate reductions.

Local Revenues: Local income tax revenues will decrease as a result of additional exemption amounts claimed against the personal income tax. Local revenues will decrease by $11.4 million in fiscal 2017 and by $24.2 million in fiscal 2021, as shown in Exhibit 5.

Local Expenditures: Montgomery County has a local grant program based on the State's refundable earned income credit. Payments for this county grant are made in the fiscal year following the fiscal year in which the returns are filed. Accordingly, Montgomery County expenditures may increase in fiscal 2018 and beyond. Based on data provided by the Comptroller's Office, these expenditures will increase by an estimated $4.6 million in fiscal 2018.

Additional Information

Prior Introductions: None.

Cross File: HB 1253 (The Speaker, *et al.*) (By Request - Maryland Economic Development and Business Climate Commission) - Ways and Means.

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

Fiscal Note History: First Reader - February 29, 2016
md/jrb Revised - Senate Third Reader - March 29, 2016

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