

Department of Legislative Services
Maryland General Assembly
2016 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 341 (Senator Ready, *et al.*)
Budget and Taxation

Income Tax - Limitation Based on Federal Income Tax Liability

This bill limits the State income taxes paid by a taxpayer by specifying that the State income tax liability calculated before application of any State tax credit may not exceed the taxpayer's federal income tax liability calculated after application of federal income tax credits.

The bill takes effect July 1, 2016, and applies to tax years 2016 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease significantly beginning in FY 2017 due to the limitation specified by the bill. Based on a preliminary analysis of the bill, the Comptroller's Office estimates that revenue losses could approach \$1.0 billion annually.

Local Effect: None.

Small Business Effect: Meaningful.

Analysis

Current Law/Background: Federal adjusted gross income (FAGI) is the starting point for calculating a taxpayer's State income tax liability. Maryland adjusted gross income is equal to the taxpayer's FAGI plus any State addition modifications and minus any State subtraction modifications. A taxpayer's Maryland taxable income is then calculated after subtracting from Maryland adjusted gross income allowable deductions and exemptions. **Exhibit 1** shows the current State tax rates that are applied to a taxpayer's Maryland taxable income to determine a taxpayer's gross State tax due.

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

A taxpayer's final State tax liability is determined after application of any State tax credits. These include both refundable and nonrefundable credits that can be claimed by individuals and members of a pass-through entity (PTE). In addition, the local income tax is also calculated by applying the local income tax rate multiplied by a taxpayer's Maryland taxable income less any local income tax credit.

In tax year 2012, about 2.9 million federal income tax returns were filed by Maryland residents. These returns reported a total of \$204.4 billion in federal adjusted gross income and had a gross tax liability of \$28.0 billion before application of any tax credit. Maryland residents claimed a total of \$3.1 billion in federal income tax credits, of which about \$1.4 billion was refundable. The federal earned income tax credit, child tax credit, and education tax credits comprised a little less than 90% of all federal income tax credits claimed and almost all of the refundable credits claimed.

About 2.2 million resident State income tax returns were filed in tax year 2012 as reflected in the Comptroller's *Income Tax Summary Report* for that year. In general, the State income tax has significantly lower tax rates but lower exemption and deduction amounts and fewer tax credits. Maryland residents claimed a total of about \$550.0 million in State tax credits in tax year 2012, of which \$158.0 million was refundable. The credit for taxes paid to another state, which is a credit to prevent double taxation, and the State earned income tax credit were the largest credits. The refundable earned income tax credit comprised nearly all of the refundable tax credits. The average federal income tax liability

(including the impact of refundable credits) in tax year 2012 was \$8,705 compared to an average State income tax liability of \$2,961, as shown in **Exhibit 2**.

Exhibit 2
Federal and State Income Taxes Paid
and Income Reported
Tax Year 2012
(\$ in Billions)

	<u>Federal</u>	<u>State</u>
Taxpayers	2,860,900	2,212,000
Adjusted gross income	\$204.4	\$184.8
Net taxable income	141.4	146.2
Tax before credits	28.0	7.1
Tax credits	3.1	0.6
Tax after credits	24.9	6.5
Average liability	\$8,705	\$2,961

Note: Maryland data reflects information reported for resident returns only.

Source: Comptroller's Office; Internal Revenue Service; Department of Legislative Services

State Revenues: The bill specifies that a taxpayer's State income tax liability calculated before application of any State tax credit may not exceed the taxpayer's federal income tax liability. The taxpayer's federal income tax liability is the amount of federal income tax payable in the taxable year after application of federal income tax credits but does not include any credit for the amount of income tax withheld and estimated tax payments. As a result, general fund revenues will decrease significantly beginning in fiscal 2017.

The amount of the revenue decrease cannot be precisely determined at this time but is expected to be significant. If the bill is construed to limit, but not reduce to less than zero, a State taxpayer's income tax liability to the federal income tax liability, the Comptroller's Office estimates that general fund revenues may decrease by about \$300 million annually. If the bill results in refunds issued to State taxpayers in an amount equal to the taxpayer's federal income tax refund, the Comptroller's Office estimates that general fund revenues may decrease by up to \$1.0 billion annually.

Small Business Impact: Businesses that are PTEs would be meaningfully impacted by their members paying lower income taxes. Many of the impacted businesses would be small businesses.

Additional Information

Prior Introductions: SB 155 of 2001 received an unfavorable report from the Senate Budget and Taxation Committee.

Cross File: None.

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

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