

Department of Legislative Services
 Maryland General Assembly
 2007 Special Session

FISCAL AND POLICY NOTE

House Bill 44 (Delegate Hixson)
 Ways and Means

Individual Income Tax - Rates

This bill establishes new income tax brackets and rates. The new rates would range from 3% to 6% of net taxable income. The bill also repeals the two-income subtraction modification.

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

Fiscal Summary

State Effect: General fund revenues would increase by \$24.4 million in FY 2008, which reflects the impact of about one-half a tax year, and \$51.7 million in FY 2009. Future year revenues reflect estimated taxable income. General fund expenditures would increase by \$120,000 in FY 2008 for implementation costs at the Comptroller’s Office.

(\$ in millions)	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
GF Revenue	\$24.4	\$51.7	\$53.5	\$55.1	\$56.9
GF Expenditure	.1	0	0	0	0
Net Effect	\$24.3	\$51.7	\$53.5	\$55.1	\$56.9

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

Local Effect: Local income tax revenues would increase due to the repeal of the two-income subtraction modification. Local income tax revenues would increase by \$10.2 million in FY 2008 and by \$21 million annually beginning in FY 2009. Potential minimal increase in expenditures in Montgomery County due to increased local earned income tax credit payments.

Small Business Effect: Meaningful.

Analysis

Bill Summary/Current Law: The bill establishes new income tax brackets and rates. The new rates range from 3% to 6% of net taxable income as specified by the bill. This provision takes effect January 1, 2008 and applies to tax years 2008 and beyond. The bill also repeals the two-income subtraction modification allowed to married couples filing a joint return. Under current law, the value of the subtraction modification is equal to the lesser of \$1,200 or the Maryland modified income of the spouse with the lesser Maryland modified income for the taxable year.

Exhibit 1 shows the current State income tax rates. **Exhibit 2** lists the income tax rates as proposed by the bill.

Exhibit 1 Maryland State Income Tax Rates Tax Year 2007

Maryland Taxable Income

<u>Over</u>	<u>But Not Over</u>	<u>Rate</u>
\$0	\$1,000	2% of Maryland taxable income
1,000	2,000	3% of excess over \$1,000
2,000	3,000	4% of excess over \$2,000
3,000	---	4.75% of excess over \$3,000

Exhibit 2
Maryland State Income Tax Rates
As Proposed by HB 44

Single, Dependent Filer, Married Filing Separate			Joint, Head of Household, Widower		
<u>Over</u>	<u>But Not Over</u>	<u>Rate</u>	<u>Over</u>	<u>But Not Over</u>	<u>Rate</u>
\$0	\$5,000	3% of Maryland taxable income	\$0	\$7,500	3% of Maryland taxable income
5,000	15,000	4% of excess over \$5,000	7,500	22,500	4% of excess over \$7,500
15,000	150,000	4.75% of excess over \$15,000	22,500	225,000	4.75% of excess over \$22,500
150,000	---	6% of excess over \$150,000	225,000	---	6% of excess over \$225,000

State Revenues: The new tax rates and repeal of the two-income subtraction modification would be in effect beginning tax year 2008, with general fund revenues increasing by \$50.9 million in that tax year. It is estimated that about \$24.4 million of this increase would occur in fiscal 2008, which reflects the historic correlation between tax year and fiscal year revenues, an adjustment for delays in adjusting withholding and estimated payments due to the limited time that would occur between enactment of the bill and the effective date of the bill, and because the bill does not change safe harbor provisions and withholding for wages. These timing issues do not impact the overall impact of the bill. Future years reflect the historic correlation between tax year and fiscal year revenues and forecasted income growth.

This estimate is based on projected tax year 2005 gross tax impact of the proposed rate changes on single and joint filers and fiduciaries and takes into account interaction with State income tax credits and revenues from withholdings that are never matched to a tax return. To the extent that the lack of adjustment of withholding rates increases tax delinquency, revenue increases would be less than estimated.

Tax Incidence of Proposal

Exhibit 3 lists the impact of the proposal on taxpayers, not including fiduciaries, based on different levels of net taxable income.

Exhibit 3
Changes in Gross Taxes Paid by Net Taxable Income

<u>NTI</u>	<u>Average MAGI</u>	<u>Returns</u>	<u>Average State Taxes Paid</u>			<u>Percent Change</u>
			<u>Current</u>	<u>Proposal</u>	<u>Change</u>	
\$0-10,000	\$14,802	440,819	\$207	\$172	(\$34)	-16.5%
10,000-20,000	25,589	414,884	647	536	(111)	-17.2%
20,000-30,000	37,353	301,805	1,125	985	(140)	-12.4%
30,000-40,000	48,882	235,422	1,598	1,467	(131)	-8.2%
40,000-50,000	61,114	175,570	2,074	1,952	(122)	-5.9%
50,000-75,000	80,708	287,317	2,859	2,712	(147)	-5.1%
75,000-100,000	109,121	152,013	4,041	3,905	(136)	-3.4%
100,000-200,000	160,937	172,168	6,299	6,136	(163)	-2.6%
200,000-500,000	326,801	48,537	13,733	14,533	800	5.8%
500,000-1,000,000	740,522	10,157	32,386	38,048	5,662	17.5%
over \$1 million	3,060,008	6,142	136,896	170,063	33,167	24.2%

Exhibit 3 details the statutory incidence of tax burdens resulting from the proposed rate changes. The statutory tax incidence, which refers to the individuals who actually remit the tax, can differ from the economic incidence of the tax, which refers to the individuals who in due course bear the actual cost of the tax. In some instances, part of all of an increased tax burden can be shifted to other individuals. For example, businesses that are pass-through entities (partnerships, S corporations, limited liability companies, and sole proprietorships) file under the personal income tax. The Comptroller's Office estimates that approximately 140,000 pass-through entities filed under the personal income tax in tax year 2005, or just under 6% of all personal income tax returns. Part or all of the increased income taxes paid by businesses would be borne by customers in the form of higher prices or employees through lower wages. This tax shifting will result in lower-income individuals bearing a greater portion of the ultimate tax burden than shown in Exhibit 3.

Another limitation of the analysis above is that it provides a "snapshot" of the incidence of the proposed changes. It is based on the annual taxes paid and annual net taxable income of taxpayers in 2005. Net taxable income in one year's time may not be an accurate depiction of an individual's economic well being because (1) it excludes factors such as wealth; (2) incomes may change over the lifetime of an individual; and (3) net taxable income may not fully capture an individual's total or comprehensive income.

Exhibit 4 details the percentage of a taxpayer's net taxable income that is currently paid in State income taxes and how this would change due to the proposed income tax rates. The estimated tax rates are after application of credits, including the refundable earned income credit, which results in a minimal tax rate for taxpayers with net taxable income less than \$10,000.

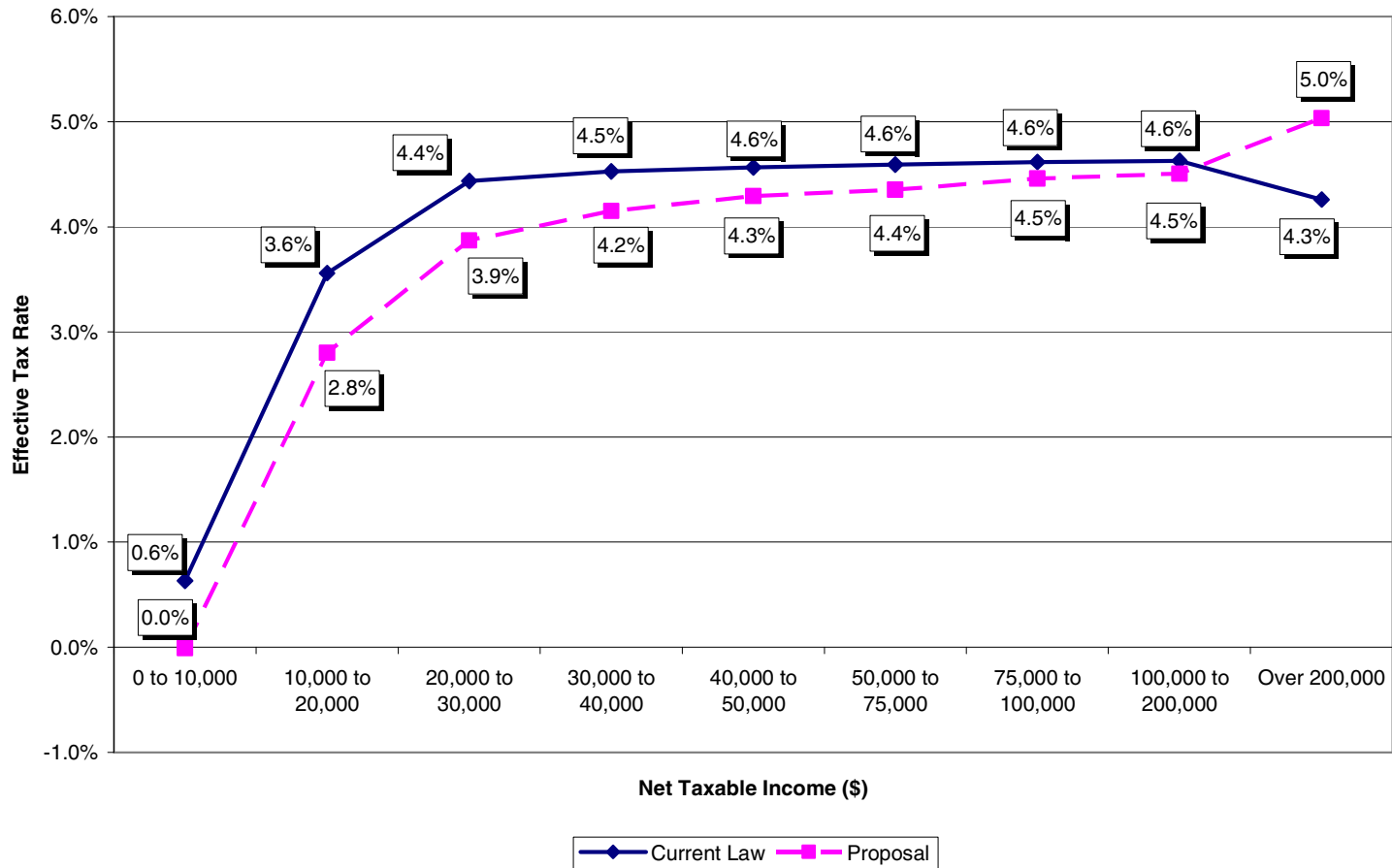
Interaction with Federal Taxes

Additional State income taxes paid by a taxpayer, in most cases, can be taken as a federal itemized deduction and thus reduce federal tax liability. For example, 93% of Maryland federal income tax returns filed in tax year 2004 with federal adjusted gross income (FAGI) in excess of \$75,000 deducted State income taxes paid. Generally, this itemization would reduce tax burdens more commonly for higher-income individuals due to the increased incidence and amount deducted by higher-income individuals. Conversely, reducing State income taxes for taxpayers who itemize can increase a taxpayer's federal tax liability by reducing the amount of taxes that may be deducted for federal tax purposes.

One important consideration is the potential limiting effect that the federal Alternative Minimum Tax (AMT) could have on the ability of a taxpayer to deduct additional State income taxes paid. Originally implemented as a way to prevent taxpayers with high incomes from paying little or no income taxes, a lack of indexing has widened the number of taxpayers potentially subject to the tax. The AMT requires some taxpayers to recalculate their tax liability under alternative tax rules to include certain income generally exempt from regular tax and disallow specific exemptions, deductions (including the deduction allowed for State and local taxes paid), and other preferences available under the Internal Revenue Code.

The significant revenue impact of providing permanent AMT relief has resulted in Congress largely enacting temporary AMT relief legislation. In the absence of permanent relief, the reach of the AMT (about 2% of returns nationwide were subject to the tax in 2004) is expected to dramatically increase over the next several years. Tax year 2005 data from the Internal Revenue Service indicate that approximately 134,000 Maryland federal income tax returns were subject to the AMT (in any amount), comprising 5% of all tax returns filed. About 80% of the returns subject to the AMT had FAGI in excess of \$200,000 and would likely pay additional State income taxes under this proposal.

Exhibit 4
Impact of Proposed Rate Changes on Tax Rates



State Expenditures: The Comptroller's Office would incur approximately \$120,000 in postage, printing, and computer programming expenses in fiscal 2008 as a result of the tax rate change.

Local Revenues: Local revenues would increase due to the repeal of the two-income earner subtraction modification. The change in local revenues would equal about 60% of the net change in State tax liability. Local revenues would increase by \$10.2 million in fiscal 2008, \$21.4 million in fiscal 2009, \$21.7 million in fiscal 2010, \$21.8 million in fiscal 2011, and \$22.0 million in fiscal 2012.

Small Business Effect: Small businesses that are partnerships, S corporations, limited liability companies, and sole proprietorships would be negatively impacted by the increased tax burden resulting from the higher top marginal rate. Exhibit 3 illustrates the magnitude of the increased burden across income levels.

Additional Information

Prior Introductions: HB 1420 of 2007, a substantially similar bill, was not reported from the House Ways and Means Committee.

Cross File: None.

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

Fiscal Note History: First Reader - November 2, 2007
ncs/hlb

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