

Department of Legislative Services
 Maryland General Assembly
 2008 Session

FISCAL AND POLICY NOTE
 Revised

Senate Bill 46

(Senator Forehand)

Budget and Taxation

Ways and Means

Budget Financing Act

This bill repeals the sales and use tax on computer services imposed by Chapter 3 of the 2007 special session and imposes an income tax surcharge on taxpayers with net taxable income in excess of \$1 million. The bill also redistributes sales and use tax revenues from the Transportation Trust Fund to the general fund and requires the Governor to present a schedule to the Board of Public Works that reduces at least \$50 million in ongoing general fund expenditures from the fiscal 2009 State budget.

The bill takes effect July 1, 2008, except for the income tax provision which is applicable to taxable years beginning after December 31, 2007.

Fiscal Summary

State Effect: General fund revenues could increase by \$5.6 million and Transportation Trust Fund revenues could decrease by \$65.0 million in FY 2009. General fund expenditures could decrease by approximately \$49.9 million in FY 2009 assuming \$50.0 million in requested budget reductions and \$68,000 for implementation costs at the Comptroller’s Office.

(\$ in millions)	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
GF Revenue	\$5.6	(\$39.4)	(\$95.8)	(\$160.3)	(\$164.3)
SF Revenue	(65.0)	(67.7)	(70.6)	(73.5)	(76.6)
GF Expenditure	(49.9)	(49.9)	(50.0)	(50.0)	(50.0)
Net Effect	(\$9.5)	(\$57.2)	(\$116.4)	(\$183.8)	(\$190.9)

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

Local Effect: None.

Small Business Effect: Potential meaningful.

Analysis

Bill Summary: The bill repeals the State sales and use tax on computer services and provides for sales and use tax exemptions for computer services and software maintenance contracts that were in effect prior to the enactment of Chapter 3. To provide for additional general fund revenues, the bill redistributes sales and use tax revenues as follows:

<u>Fund</u>	<u>Current Law</u>	<u>FY 2009-2013</u>	<u>FY 2014 and later</u>
GF	93.5%	94.7%	93.5%
TTF	6.5%	5.3%	6.5%

The bill also increases for a three-year period, from tax years 2008 through 2010, the top income tax rate to 6.25% which would apply to taxpayers with net taxable income in excess of \$1 million. **Exhibit 1** shows the State income tax rates for single taxpayers. **Exhibit 2** shows the tax rates for joint returns. The Comptroller is required to waive any interest or penalty imposed on an individual relating to the payment of estimated income taxes for calendar 2008 to the extent that the Comptroller determines that the interest or penalty would not have incurred but for an increase in the income tax rates for calendar 2008 under the bill.

Exhibit 1 Maryland State Income Tax Rates Single, Dependent Filer, Married Filing Separate

<u>Current Law</u>		<u>As Proposed by SB 46</u>	
<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 - \$150,000	4.75%	\$3,001 - \$150,000
5.00%	\$150,001 - \$300,000	5.00%	\$150,001 - \$300,000
5.25%	\$300,001 - \$500,000	5.25%	\$300,001 - \$500,000
5.50%	Excess of \$500,000	5.50%	\$500,001 - \$1,000,000
		6.25%	Excess of \$1 million

Exhibit 2
Maryland State Income Tax Rates
Joint, Head of Household, Widower

Current Law		As Proposed by SB 46	
<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 - \$200,000	4.75%	\$3,001 - \$200,000
5.00%	\$200,001 - \$350,000	5.00%	\$200,001 - \$350,000
5.25%	\$350,001 - \$500,000	5.25%	\$350,001 - \$500,000
5.50%	Excess of \$500,000	5.50%	\$500,001 - \$1,000,000
		6.25%	Excess of \$1 million

Finally, the bill provides that it is the intent of the General Assembly that by July 1, 2008, the Governor must present a schedule to the Board of Public Works that reduces at least \$50 million in ongoing general fund expenditures from the fiscal 2009 State budget.

Current Law: Chapter 3 of the 2007 special session expanded the definition of taxable service so that, beginning July 1, 2008, the State sales and use tax is imposed on specified computer services. This provision terminates June 30, 2013. Computer services are defined as • computer facilities management and operation; • custom computer programming; • computer system planning and design that integrate computer hardware, software, and communication; • technologies; • computer disaster recovery; • data processing, storage, and recovery; and • hardware or software installation, maintenance, and repair.

The definition of computer services excludes certain types of services that otherwise could be included in the definition, such as Internet access, typing or data entry, and computer training. The installation, maintenance, or repair of tangible personal property that includes computer hardware or software as a component part is also excluded, as are computer services provided in connection with other specified types of services, typically banking and financial related services, business management or other administrative services, various professional services, and telecommunications services.

Chapter 3 repealed the sales and use tax exemption for sales of custom computer software services and optional computer software maintenance contracts, but exempted computer services that are to be used by an individual in a home school program. In addition, Chapter 3 did not alter the sales and use tax exemption for the sale of a computer

program that is intended to be reproduced for resale or incorporated into another computer program for sale.

Exhibit 3 lists the types of computer services that would be taxable under the Chapter 3.

Background: The following services are subject to the State sales and use tax:

- fabrication, printing, or production of tangible personal property by special order;
- commercial cleaning or laundering of textiles for a buyer who is engaged in a business that requires the recurring service of commercial cleaning or laundering of the textiles;
- cleaning of a commercial or industrial building;
- cellular telephone or other mobile telecommunications services;
- “900,” “976,” “915,” and other “900”-type telecommunications services;
- custom calling services provided in connection with basic telephone service;
- telephone answering services;
- pay-per-view television services;
- credit reporting;
- security services, including detective, guard, or armored car services;
- security systems services;
- transportation services for transmission, distribution, or delivery of electricity or natural gas, if the sale or use of the electricity or natural gas is subject to the sales and use tax; and
- prepaid telephone calling arrangements.

Although they are not considered services under the State sales and use tax, the tax also applies generally to such items as rentals of tangible personal property, restaurant meals, hotel rooms, and utilities (although specific exemptions are allowed for residential purchases of electricity and gas).

Historically, the State sales and use tax has been imposed broadly on the sale or use of tangible personal property, but only narrowly on a few specifically enumerated taxable services. Over the past few decades, the growth in sales and use tax revenues has not kept pace with the growth in personal income, as the tax base has eroded due to several factors. One major contributing factor cited for the erosion of the sales tax base is a major shift that has occurred in the national economy from the consumption of goods, the traditional base of the tax, to the consumption of services.

About half the states that impose sales taxes limit taxation of services to utilities, rentals of property, restaurant meals, hotel rooms, and admissions and amusements. Only six states have taxes that generally apply to all services (including two that impose gross receipts taxes on businesses that are not technically sales taxes). About 10 states impose the sales tax broadly on services related to tangible personal property, such as fabrication, installation, and repair services. Several states also tax at least a few other personal services, and a few states also tax some business services.

Exhibit 3

Examples of Taxation of Computer Services

Taxable

- **Computer Facilities Management and Operation:**

Management and control of a purchaser's computer facility by a management company when the computers and peripheral equipment are not owned by the management company (if owned by the management company, would presumably be rental of tangible personal property)

Support services for computer systems or data processing facilities

- **Custom Computer Programming:**

Computer systems design and system analysis services

Writing, modifying, testing, and supporting software to meet the needs of a particular customer

- **Computer Systems Integrators:**

Designing computerized integrated systems for a specific application, including computer network systems; local area network (LAN) systems; office automation systems; computer-aided design, engineering; or manufacturing systems services

- **Computer Systems Consultants:**

Consulting services regarding computer systems design, systems analysis, program testing, debugging, or computer project advice

- **Other Computer Related Services:**

Computer disaster recovery services

Hardware or software installation, maintenance, and repair

Not Taxable

- Internet access service
 - Computer training
 - Repair of property that includes a computer as a component part
 - Any of the following that include a computer service provided as part of the service:
 - Banking or trust services, including electronic fund transfers, financial transactions, automated teller machine transactions
 - Business management, personnel, payroll, employee benefit, and other administrative services
 - Educational, legal, accounting, architectural, actuarial, medical, medical diagnostic, or other professional services
-

Among surrounding jurisdictions, New Jersey, Pennsylvania, West Virginia, and the District of Columbia tax a broad range of repair services, including automotive repairs. Pennsylvania and West Virginia tax some business services, and West Virginia also taxes some personal services. Delaware, which does not have a retail sales tax, is considered to have a broad taxation of services under its gross receipts tax, which applies to most businesses.

Income Tax Surcharge in the 1990s

Due to the State's fiscal crisis in the early 1990s, the General Assembly approved a temporary 6% income tax bracket on taxable incomes over \$100,000 for single taxpayers and \$150,000 for joint returns. The increased rate applied for tax years 1992 through 1994 only.

State Revenues: State revenues are affected by • repealing the sales tax on computer services; • altering the distribution of sales tax revenues by requiring a higher percentage be distributed to the general fund; and • imposing an income tax surcharge on net income in excess of \$1 million. General fund revenues would increase by \$5.6 million in fiscal 2009, but decrease by \$39.4 million in fiscal 2010, and by \$164.3 million in fiscal 2013. Special fund revenues would decrease by \$65.0 million in fiscal 2009 and by \$76.6 million in fiscal 2013.

Sales Tax on Computer Services

Repealing the sales tax on computer services could decrease total sales and use tax revenues by \$214.0 million in fiscal 2009, as estimated in the Fiscal and Policy Note for Chapter 3 and the current revenue forecast. **Exhibit 4** shows the estimated revenue decrease over a five-year period. Of the total revenues attributable to the tax on computer services, 6.5% are to be distributed to TTF, per Chapter 6 of the 2007 special session.

The revenue estimate is based on data from the two most recent (1997 and 2002) *Economic Census* reports from the U.S. Census Bureau. The estimate reflects an estimated 6.0% decline in the taxable base resulting from the imposition of the sales tax on these services. The taxable base was adjusted to account for potential compliance/collection difficulties and sales made to governmental and/or nonprofit entities. For purposes of the estimate, computer services includes the “custom computer programming services;” “computer systems integrators;” “computer systems consultants (except systems integrators);” “computer facilities management services;” and “other computer related services” as referenced in the *Economic Census*.

The Fiscal and Policy Note for Chapter 3 assumed that revenues would increase by approximately 3% annually. The 6% decline in taxable sales reflects sales that no longer are subject to Maryland sales tax for two reasons: • the sale does not take place at all because the cost dissuades the purchaser; or • the sale is diverted to a neighboring state where the service is not subject to a sales tax or the tax rate is lower. To the extent that the impact on sales volume varies from what is projected, sales tax revenues would rise or decline correspondingly.

Exhibit 4 **Effect of Repealing Sales Tax on Computer Services** **(\$ in Millions)**

	<u>FY 2009</u>	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2012</u>	<u>FY 2013</u>
GF Revenues	(\$200.1)	(\$206.1)	(\$212.3)	(\$218.6)	(\$225.2)
TTF Revenues	(13.9)	(14.3)	(14.8)	(15.2)	(15.7)
Total Revenues	(\$214.0)	(\$220.4)	(\$227.0)	(\$233.8)	(\$240.9)

Impact of Fund Redistributions

The bill also alters the distribution of sales tax revenues by requiring that 5.3% be distributed to TTF for fiscal 2009 through 2013. Under current law, 6.5% of sales tax revenues are distributed to TTF. Due to this adjustment, the revenue loss from repealing

the computer services tax will reduce funding for TTF to a greater extent, whereas the overall effect on general fund revenues will be mitigated as shown in **Exhibit 5**.

Exhibit 5
Effect of Repealing Sales Tax on Computer Services and Fund Redistribution
(\$ in Millions)

	<u>FY 2009</u>	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2012</u>	<u>FY 2013</u>
GF Revenues	(\$149.0)	(\$152.7)	(\$156.4)	(\$160.3)	(\$164.3)
TTF Revenues	(65.0)	(67.7)	(70.6)	(73.5)	(76.6)
Total Revenues	(\$214.0)	(\$220.4)	(\$227.0)	(\$233.8)	(\$240.9)

Individual Income Tax – Rate Adjustment

The new top marginal tax rate would be in effect beginning tax year 2008, with general fund revenues increasing by \$102.1 million and by \$109.3 million in tax year 2009. As a result, fiscal 2009 revenues would increase by \$154.6 million, which approximately reflects the impact of tax year 2008 and half of tax year 2009. Fiscal 2010 reflects the impact of half of tax year 2009 and half of tax year 2010 and fiscal 2011 reflects half of tax year 2010. **Exhibit 6** shows the fiscal impact of the rate adjustment in fiscal 2009 through 2013.

Exhibit 6
Effect of Individual Income Tax Rate Adjustment
(\$ in Millions)

	<u>FY 2009</u>	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2012</u>	<u>FY 2013</u>
GF Revenues	\$154.6	\$113.3	\$60.6	0.0	0.0
TTF Revenues	0.0	0.0	0.0	0.0	0.0
Total Revenues	\$154.6	\$113.3	\$60.6	0.0	0.0

Tax Incidence of New Top Marginal Tax Rate

In tax year 2005, approximately 6,300 taxable returns had a net taxable income in excess of \$1 million. Of these returns, 748 were single returns, 5,394 were joint returns, and 156 were fiduciaries. This represented 0.3% of all taxable returns in 2005. Total State taxes paid by these returns would have increased from an estimated \$985.4 million under current law to \$1.076 billion. **Exhibit 7** lists the average change in gross taxes paid (before application of tax credits) and the change in the effective tax rate for the returns

impacted by the bill. These returns had an average Maryland adjusted gross income (MAGI) of \$3.1 million and an average net taxable income (NTI) of \$2.9 million.

**Exhibit 7
Change in Gross Taxes Paid**

	<u>Current</u>	<u>SB 46</u>	<u>Difference</u>	<u>% Change</u>
Average Gross Taxes Paid	\$156,600	\$170,800	\$14,200	9.1%

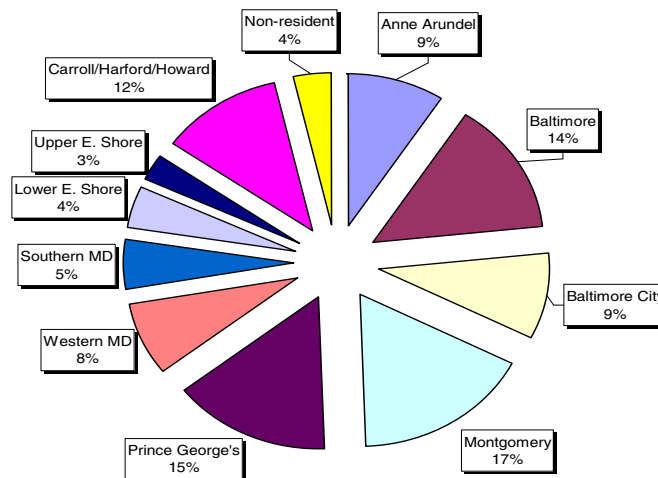
Effective Tax Rates

(Gross Taxes/ NTI)

State Taxes	5.4%	5.9%	0.5%	9.1%
State and Local Taxes	8.3%	8.7%	0.5%	5.9%

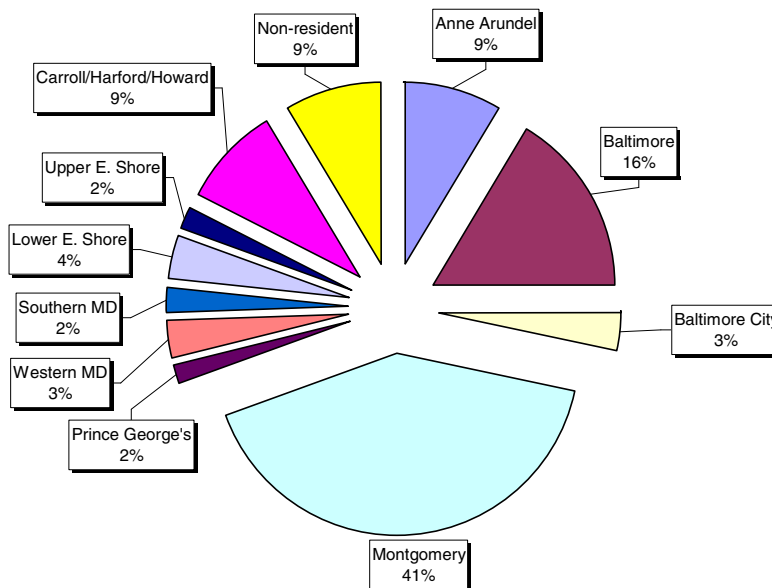
Exhibits 8 and 9 show a geographic breakdown of all taxable returns and tax returns with net taxable income in excess of \$1 million. Confidentiality requirements prevent the data from being reported for every county.

**Exhibit 8
Percent of All Taxable Returns
Tax Year 2005**



* does not include fiduciaries

Exhibit 9
Percent of Returns with Net Taxable Income Over \$1 Million
Tax Year 2005



* does not include fiduciaries

State Expenditures: General fund expenditures at the Comptroller's Office would increase by \$68,040 in fiscal 2009 and by \$71,500 in fiscal 2010 as a result of issuing new employer withholding tables. In addition, the Governor is required to present a schedule to the Board of Public Works that reduces at least \$50.0 million in ongoing general fund expenditures from the fiscal 2009 State budget. Assuming the Board of Public Works approves the budgetary reductions, net general fund expenditures would decrease by approximately \$49.9 million in fiscal 2009 which reflect \$50.0 million in general fund reductions and \$68,000 for implementation costs at the Comptroller's Office. The \$50.0 million decrease in general fund expenditures continue through fiscal 2013.

Small Business Effect: Certain small businesses would be negatively affected by the income tax rate increase while certain businesses would benefit from the repeal of the computer services tax.

Income Tax

Small businesses that are partnerships, S corporations, limited liability corporations, and sole proprietorships would be meaningfully impacted by the bill. These small businesses with higher amounts of taxable income would be negatively impacted through increased income tax liabilities.

About 5,100, or 80%, of the returns impacted by the surcharge reported either business income from Schedule C (sole proprietorships) and/or income from a partnership, LLC, or S corporation. This income represents a wide range of activities from sole proprietors owned by individuals to a partner in a large law firm. Nationwide, a little over half of partnerships, LLCs, and S corporations are in the finance and insurance or real estate/rental and leasing industrial groupings.

Although the majority of impacted returns reported some type of business income, the majority (about 75%) of income reported on these returns was non-business income and was primarily composed of salary and wage income and capital gains.

An unknown number of impacted businesses would be small businesses. Any impacted small business that was a sole proprietorship would have net profits in excess of \$1 million, after deducting wages and all other expenses, including depreciation on any real property or equipment used in the business. For small business having multiple owners or partners, the business would not be impacted unless the business had net profits high enough to distribute in excess of \$1 million to any individual or partner.

Sales Tax

To the extent that small business providing computer services would be adversely affected due to lost sales resulting from the tax imposed on these services, repealing the tax would mitigate any negative effects. As noted, the Fiscal and Policy Note for Chapter 3 assumed a 6% reduction in sales due to the imposition of the tax. As a point of reference, this would result in approximately \$60,000 in recouped sales for a business with \$1.0 million in gross sales. However, the actual effect could vary from business to business, depending on sales and proximity to other jurisdictions.

Additional Information

Prior Introductions: None.

Cross File: None designated although HB 187, HB 196, HB 253, HB 326, SB 41, and SB 138 include provisions that repeal the sales and use tax on computer services.

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

Fiscal Note History: First Reader - January 31, 2008
ncs/hlb Revised - Senate Third Reader - April 4, 2008

Analysis by: Robert Rehrmann/
Michael Sanelli

Direct Inquiries to:
(410) 946-5510
(301) 970-5510