Part B
Taxes

Property Tax

Budget Reconciliation and Financing Act

As amended by the House of Delegates, ***Senate Bill 508*** ***(passed)***, the Budget Reconciliation and Financing Act of 2004, included a variety of tax provisions that would have increased revenues by approximately $1.0 billion. The House amendments to Senate Bill 508 also provided for a reduction in the State property tax rate from 13.2 cents per $100 of assessment to 5 cents per $100 of assessment. It was estimated that the property tax reduction would have saved Maryland homeowners and businesses approximately $350 million in property tax payments annually. These amendments to Senate Bill 508 were eliminated during conference committee deliberations. The other provisions of this bill are discussed in further detail in other parts of this *90 Day Report*.

Property Tax Administration

Application for Tax Exemption

Purchasers of exempt real and personal property must apply to the State Department of Assessments and Taxation (SDAT) in order to continue receiving the tax exemption on that property. ***House Bill 159*** ***(passed)*** provides that if real property that is exempt from the property tax is transferred to another person and the use of the property continues to qualify for an exemption, the owner has until September 1 of the following taxable year to apply to SDAT for an exemption. House Bill 159 also provides that if personal property that is exempt from the property tax is transferred to another person and the use of the property continues to qualify for an exemption, the owner has to apply for an exemption within six months after the first assessment notice.

Hurricane Isabel – Damaged Property

Two bills were passed to address property tax issues arising from the extensive property damage done by Hurricane Isabel.

Generally, a property taxpayer is not eligible for a Homestead Property Tax Credit if the taxpayer does not occupy the property as the principal residence for more than six months out of the year. ***House Bill 216*** ***(passed)*** is an emergency bill in response to Hurricane Isabel to provide for the continuation of the Homestead Property Tax Credit for the current taxable year and two succeeding taxable years if a homeowner otherwise eligible for the credit does not actually reside in a dwelling for the required time period due to damage resulting from an accident or natural disaster, even if property has been removed from the assessment roll because of property damage due to an accident or natural disaster.

If a residential property is damaged or destroyed due to a natural occurrence and that property is not removed from the tax rolls, the assessment cannot increase out of the regular three-year assessment cycle if that property is replaced by an improvement of equal value. ***House Bill 435*** ***(passed)*** extends the special assessment of damaged or destroyed real property to all real property other than property used for commercial purposes. House Bill 435 expands current law to include all noncommercial properties such as farms and certain condominiums and clarifies that the bill applies to property improvements of comparable size, quality, construction, and utility.

Property Tax Credits

Agricultural Limited Liability Companies

Current law requires that property eligible for the Homestead Property Tax Credit be the principle residence of the taxpayer. As a result, Maryland farmers who have or will change the title of their property to a limited liability company (LLC) in order to protect themselves from potential legal liabilities are no longer eligible for the credit. ***House Bill 323*** ***(passed)*** extends the benefits provided to homeowners under the Homestead Property Tax Credit and semiannual property tax payment schedule to specified agricultural LLCs. An agricultural LLC is defined as an LLC that (1) owns real property that includes land receiving an agricultural use assessment and includes land used as a homesite that is part of the contiguous parcel receiving the agricultural land use assessment; (2) owns personal property used to operate the agricultural land; and (3) owns no other property. Under House Bill 323, eligible farmers would qualify for the credit as long as their principle residence is still on the property.

High Performance Buildings

House Bill 804 ***(passed)*** authorizes a county or municipal corporation to provide, by law, a property tax credit against the local property tax for specified "high performance buildings." The county or municipal corporation may provide for the amount of the credit, the duration of the credit, the criteria and qualifications necessary to receive the credit, and any other necessary provisions. A high performance building is defined as a building that achieves at least (1) a silver rating according to the U.S. Green Building Council's Leadership in Energy and Environmental Design (LEED) Green Building Rating System as adopted by the Maryland Green Building Council or (2) a comparable rating according to any other appropriate rating system. House Bill 804 also provides that, under LEED credit MR7 or a similar criterion in a comparable rating system, credit may be awarded for the use of wood-based materials derived from all credible sources, including the sustainable forest initiative program, the Canadian Standards Association, the American Tree Farm System, and other credible certified sources programs.

Local Property Taxes

Allegany County

House Bill 1010 ***(passed)*** authorizes Allegany County or a municipal corporation in Allegany County to grant a property tax credit against the property tax imposed on property that has been subdivided into five or more lots for the purpose of residential development. When a subdivision occurs under current law, the land owner is required to pay increased taxes for each of the vacant residential building sites. Under House Bill 1010, the tax credit is for 100 percent of the tax imposed on the increase in assessment immediately after the property is subdivided. The credit does not apply to a lot transferred to new owner after the subdivision.

Gilchrist Museum

Senate Bill 256 ***(passed)*** authorizes Allegany County or a municipal corporation in Allegany County to grant a property tax credit for property owned by the Cumberland Cultural Foundation and known as the Gilchrist Museum.

Anne Arundel County

House Bill 738 ***(passed)*** authorizes Anne Arundel County to grant, by law, a property tax credit for real property that is owned by the Village Commons Community Center, Incorporated, or leased by the Anne Arundel Community College at Arundel Mills.

Baltimore City

House Bill 543 ***(passed)*** is an emergency bill that provides that in Baltimore City the auctioneer's fee for property sold in an electronic tax sale may be an amount of up to $10 for each property sold. Under current law, the auctioneer's fee is limited to $3 per property for any day when four or more properties are sold. The authorization to increase the per property auctioneer's fee for an electronic tax sale will enable the city to secure a vendor for an online tax sale auction so as to reduce city administrative costs in conducting the tax sale.

Howard County

House Bill 1376 ***(passed)*** provides that for Howard County property tax purposes, a planned development land assessment is available to qualified land for a period of no more than 20 consecutive years. Currently, there is no limitation on how long qualified land may receive a planned development land assessment. The bill takes effect July 1, 2009, and applies to tax years beginning after June 30, 2009.

Prince George's County

Chapters 326 and 786 of 1998 established a high-bid premium system to be applied to tax sales to discourage persons from bidding excessively high amounts. Under current law, for jurisdictions other than Baltimore City, the premium amount is set at 20 percent of any bid over 40 percent of the full cash value of the property. To provide additional protection for low-value/high-lien properties, Chapter 311 of 2002 provided that a high-bid premium assessed on property tax sales in Baltimore City be calculated as 20 percent of the amount that the high bid exceeds the greater of the lien amount or 40 percent of the property's full cash value. ***House Bill 683*** ***(passed)*** requires that the high-bid premium assessed on property tax sales in Prince George's County be calculated in the same manner as in Baltimore City, 20 percent of the amount that the high bid exceeds the greater of the lien amount or 40 percent of the property's full cash value.

Senate Bill 319 ***(passed)*** authorizes Prince George's County to grant a property tax credit against the county property tax or special district tax for property that is (1) owned by a nonprofit, tax exempt community development corporation qualified under Section 501(c) (3) of the Internal Revenue Code; (2) not used for a commercial purpose; and (3) located in Prince George's County on Maryland Route 202 at the intersection with St. Joseph's Drive.

St. Mary's County

House Bill 1295 ***(passed)*** authorizes the St. Mary's County Commissioners to establish an emergency services tax on all real and personal property within the county for fire companies, rescue squads, and specified support services organizations. The county commissioners may set separate emergency services tax rates in each election district in the county, subject to specified maximum real and personal property tax rates. House Bill 1295 also provides for the distribution of emergency services tax revenues to specified emergency services providers and for specified purposes.

The St. Mary's County Commissioners must report to the St. Mary's County Delegation by December 1 of 2004, 2005, and 2006 on (1) the use of proceeds from the emergency services tax; (2) whether any emergency services tax increases have been offset by a reduction in the St. Mary's County real property tax rate; and (3) whether the St. Mary's County budget fully and adequately funds all necessary operational expenses for the county's volunteer rescue squads.

Washington County

Chapter 468 of 2003 authorized Washington County, by ordinance, to impose a building excise tax on construction and a transfer tax on an instrument of writing.

House Bill 1049 ***(passed)*** alters the uses for which the revenues from the Washington County building excise tax and transfer tax may be expended to include primary, secondary, and higher education capital expenditures. House Bill 1049 also expands the use of $400,000 in transfer tax revenues that are to be used for agricultural preservation to include the purchase of easements and transferable development rights using installment purchase agreements.

Income Tax

Budget Reconciliation and Financing Act

The Budget Reconciliation and Financing Act of 2004, Senate Bill 508 includes several income tax provisions among a variety of measures to provide increased revenues needed to balance the State budget.

Imposing the Lowest County Income Tax Rate on Nonresidents with a Tax Liability

The bill imposes a tax at a rate equal to the lowest county income tax rate in Maryland (currently 1.25 percent) on individuals who are subject to the State income tax but are not subject to the county income tax. This change is applicable to tax years 2004 and beyond. Regular wage earners who work in Maryland but live in states with which Maryland has an income tax reciprocity agreement – Virginia, Pennsylvania, West Virginia, or the District of Columbia – would not be affected. However, wage earners who work in Maryland but live anywhere else would be affected by the bill, with one exception – residents of Wilmington, Delaware who work in Maryland are technically subject to the county income tax in Maryland since Wilmington imposes a similar tax on wages of Maryland residents who work there. More generally, the provision would apply to the business-related income of nonresidents. The change is estimated to increase general fund revenues by approximately $38.6 million in fiscal 2005, reflecting one and a half tax years, and $27.8 million in fiscal 2006.

Altering Provisions Related to Unclaimed Income Tax Revenue

The bill modifies the time frame for the Comptroller's Office to hold unclaimed local income tax revenue in its local income tax reserve account from three years to one year and provides for a one-time distribution of $81 million each to the State and the local jurisdictions in fiscal 2005. Currently, the State receives income tax revenue from withholding and quarterly estimated payments, which cover both the State and local income taxes. For tax year 2000, these payments totaled about $8.6 billion. Upon reconciling withheld taxes against local income tax liabilities, a certain portion of tax collections is "unclaimed" by local governments.

The unclaimed local income tax for the tax years 2001, 2002, and 2003 is estimated at $162 million for the three-year period. (The unclaimed local income tax for tax year 2000 will be distributed in June as it normally would.) Accordingly, local jurisdictions will receive one-half of that total amount in August 2004 rather than all of it over the course of several years. Under prior law, the unclaimed local income tax for these years would be distributed over the next three years (*e.g.*, tax year 2001 in June 2005, tax year 2002 in June 2006, etc.).

The revenues will be distributed to the local jurisdictions on a pro-rata basis using tax year 2002 income tax receipts from tax returns. In future years, local jurisdictions will continue to receive a distribution in June of unclaimed local income tax revenue. Rather than this distribution being based on the third prior tax year, it will be a projection of the most recent tax year (*e.g.*, tax year 2004 in June 2005). The distributions to the local jurisdictions will thus be relatively up-to-date and the State will no longer be holding three years of local income tax revenue.

"Section 179" Expensing

In calculating Maryland individual or corporate income tax liability, the bill requires an adjustment to Maryland adjusted gross income by adding or subtracting from federal adjusted gross income to reflect the determination of the maximum aggregate costs the taxpayer may treat as an expense under Section 179 of the Internal Revenue Code for any taxable year without regard to the changes made to Section 179 by the federal Jobs and Growth Tax Relief Reconciliation Act of 2003. The provision applies to all taxable years beginning after December 31, 2002.

Federal tax changes in 2003 allowed for increased expensing under Section 179 of the Internal Revenue Code for small businesses for federal tax purposes which allowed for increased depreciation in the year property is purchased but lower depreciation in later years. Because the fiscal effect to the Maryland income tax was greater than $5 million in tax year 2003, State law requires an automatic decoupling from Maryland taxes for one tax year to allow the General Assembly the option to continue the decoupling.

This provision in Senate Bill 508 continues the decoupling for Maryland income tax purposes, providing for the determination of Maryland taxable income using depreciation calculated under the old Section 179 expensing provisions. The continued decoupling will result in a retention of an estimated $22.6 million in additional individual and corporate income tax revenues in fiscal 2005. Expiration of the decoupled federal provision will cause revenue increases to decrease, becoming negative in the out years. In addition, local income tax revenues are expected to increase by approximately $10.4 million in the near term, then decline in subsequent years.

Sport Utility Vehicle Depreciation

The bill decouples from the depreciation deduction allowed on the federal income tax return for specified large sport utility vehicles (SUVs) used for business purposes that are placed into service after May 31, 2004.

The bill requires an adjustment of the difference between (1) Maryland taxable income with the depreciation deduction allowed under current federal law for an SUV rated at more than 6,000 but not more than 14,000 pounds (gross vehicle weight) and (2) Maryland taxable income calculated using the depreciation deduction allowed using limitations applicable to vehicles rated at 6,000 pounds gross vehicle weight or less. The effect of this change is to subject a vehicle to the same limitation on annual depreciation expenses as is applicable to other lighter passenger vehicles under federal law. In conjunction with the general Section 179 expensing provision, State general fund revenues from this provision could increase by $13.5 million and TTF revenues could increase by $2.3 million in fiscal 2005.

House Tax Package

The Budget Reconciliation and Financing Act as passed by the House included two significant income tax changes that were rejected in conference committee. The House version would have imposed a 6 percent surcharge on higher income individuals and increased the amount of refundable earned income tax credit.

Specifically, the House plan would have established a 6 percent income tax bracket for five tax years for Maryland taxable income exceeding $150,000 for single taxpayers and $200,000 for married taxpayers filing jointly, heads of household, or qualifying widows. It was estimated that this measure would have increased general fund revenues by approximately $294.2 million in fiscal 2005, $207.3 million in fiscal 2006, $216.3 million in fiscal 2007, $225.7 million in fiscal 2008, and $115.3 million in fiscal 2009.

The House version would have also increased the amount of the refundable earned income tax credit. The amount of the credit received by a taxpayer claiming the credit would have increased from 20 to 25 percent of the federal refundable earned income tax credit earned by the taxpayer. This increase would have been phased in by 1 percent in each tax year until reaching 25 percent in tax year 2008. It was estimated that this measure would decrease general fund revenues by approximately $4.5 million in fiscal 2005, increasing to $30.2 million at full implementation in fiscal 2009.

Delaware Holding Companies

The General Assembly passed two bills relating to the use by corporations of "Delaware Holding Companies" (DHCs) to avoid the Maryland income tax. House Bill 753 from the 2003 session, passed by the General Assembly but vetoed by the Governor, had included provisions to restrict the ability of corporations operating in Maryland to shift income out of the State through the use of DHCs and related State tax avoidance techniques. In the summer of 2003, the Court of Appeals issued a decision in two long-pending cases, *Comptroller of the Treasury v. SYL, Inc.*, and *Comptroller of the Treasury v. Crown Cork & Seal Company (Delaware), Inc.*, 375 Md. 78 (2003), ruling that two corporations doing business in Maryland could not use DHCs to shelter income earned in Maryland from the Maryland income tax.

The budget plan as introduced by the Governor included an assumption that $84 million in general fund revenues would be recognized, in part from corporations paying taxes owed for past-year liabilities. ***House Bill 297*** ***(passed)*** provides prospective changes to the corporate income tax law designed to prevent tax avoidance through the use of DHCs. ***Senate Bill 187*** ***(passed)*** provides for a settlement period to be administered by the Comptroller to settle past year issues relating to the decision of the Court of Appeals last summer.

House Bill 297 includes several measures designed to prevent corporations from avoiding the Maryland corporate income tax by shifting income away from the State through the use of

DHCs and other State tax avoidance techniques. The bill takes effect July 1, 2004, and is applicable to all taxable years beginning after December 31, 2003.

Major Provisions

The bill authorizes the Comptroller to distribute, apportion, or allocate gross income, deductions, credits, or allowances between and among two or more organizations, trades, or businesses, whether or not incorporated, whether or not organized in the United States, and whether or not affiliated, if (1) the organizations, trades, or businesses are owned or controlled directly or indirectly by the same interests and (2) the Comptroller determines that the distribution, apportionment, or allocation is necessary in order to reflect an arm's length standard, within the meaning of § 1.482-1 of the regulations of the Internal Revenue Service and to clearly reflect the income of those organizations, trades, or businesses (known as "Section 482 authority"). The bill requires affiliated groups of corporations to provide a report of intermember sales and other transactions, if requested by the Comptroller.

The bill requires a corporation, for purposes of determining Maryland taxable income, to add back to its taxable income any otherwise deductible interest expense or intangible expense paid directly or indirectly to one or more related members, as defined, unless the corporation establishes that (1) the transaction did not have as a principal purpose the avoidance of tax; (2) the interest expense was paid pursuant to an arm's length rate or price; and (3) either (a) the related member paid or incurred the interest or intangible expense to an unrelated person; (b) the related member paid state taxes in the aggregate on the amount received at an effective rate of at least 4 percent; or (c) in the case of an interest expense, the related members are banks. The bill defines the manner by which the 4 percent effective rate is calculated, provides for an alternative calculation of the 4 percent effective tax rate under certain circumstances, and grants the Comptroller the authority to determine by regulation additional alternative calculations, if necessary.

To avoid potential double taxation, the bill provides, under specified circumstances, a subtraction modification to the "payee" corporation (that received payments for intangible expenses from a related member) equal to the amount received as royalties, interest, or similar income from intangibles to the extent that the payor corporation (the related member that paid the intangible expenses) is subject to the addition modification for the intangible expenses.

Fiscal Impact

The fiscal impact from closing these tax-avoidance strategies cannot be precisely estimated; however, corporate tax revenues could increase by $37 million in fiscal 2005, with additional revenues increasing to $55 million in fiscal 2007 and thereafter. Under the existing distribution of corporate income tax revenue, 76 percent of the additional revenue from this bill would be dedicated to the general fund and 24 percent to the Transportation Trust Fund (TTF). Thirty percent of any additional TTF revenues would be distributed to local governments based on the State's highway user revenue sharing.

Settlement of Existing Litigation on Corporate Tax Avoidance

In conjunction with the prospective changes related to the use of DHCs and other State tax-avoidance techniques, ***Senate Bill 187*** ***(passed)*** creates a statutory settlement period for the Comptroller to settle specified litigation, with provisions regarding penalties and interest and forgiveness of specified tax assessments.

Senate Bill 187 requires the Comptroller to administer a settlement period from July 1, 2004, through November 1, 2004, applicable to State corporate income tax that has been or may be assessed by the Comptroller on the basis of issues that were ruled on by the Maryland Court of Appeals in the decisions in *Comptroller of the Treasury v. SYL, Inc.*, and *Comptroller of the Treasury v. Crown Cork & Seal Company (Delaware), Inc.*, 375 Md. 78 (2003).

The bill allows a taxpayer to elect whether to have additional income tax calculated as though otherwise deductible payments were added back to the paying taxpayer's federal taxable income or as though the receiving taxpayer were subject to the State corporate income tax. The Maryland income tax may not be imposed more than once for the same transaction. The Comptroller is required to waive all penalties attributable to the taxes paid during the settlement period. The Comptroller is prohibited from assessing interest on taxes paid during the settlement period at a rate exceeding 6.5 percent.

If all taxes and related interest described above are paid during the settlement period for the taxpayer's taxable years beginning on or after January 1, 1995, and ending on or before December 31, 2003, then no assessment for any taxable year beginning before January 1, 1995, may be enforced.

Fiscal Estimate

The fiscal impact from the proposed settlement period on current litigation cannot be reliably estimated at this time and will depend on individual taxpayers' evaluation of the attractiveness of the Comptroller's current settlement offer versus the provisions of this bill. Under the bill, any firms that, during the settlement period, settle disputed tax liability from 1997 to the present would be absolved of any prior liability. Thus, theoretically, the full $79 million of pre-1997 liability could be lost as a result of the bill, including the $9 million already paid, which would have to be refunded.

In practice, as noted above, a significant number of taxpayers have rejected the Comptroller's settlement offer. The Comptroller will be required to pursue these taxpayers in court, and litigation could drag on for several years, with the outcome not assured. The Comptroller thus may never recoup the full $79 million but only some portion thereof. Offsetting the losses from the bill's forgiveness of pre-1997 liabilities is the possibility that additional firms may use the settlement period to settle liabilities for the period from 1997 to present. The reduced interest, and waived penalty, may cause revenues to be realized more quickly from a settlement, even if the Comptroller were to ultimately prevail in litigation with individual taxpayers.

Heritage Structure Rehabilitation Tax Credit

The Maryland Heritage Rehabilitation Tax Credit program entered its seventh year of operation in 2004 amid debate over how the program should continue. Although praised as a development tool that can revitalize communities and generate tax revenues and employment, increasing concerns have been raised in recent years over the program's mounting and uncertain impact on the State's revenues.

Established in 1996, the heritage tax credit had been modified in each legislative session through 2003. Initial modifications resulted in a significant expansion of the credit, making it the State's largest economic development program. Prior to the 2002 legislative session, significant revenue losses ($50 to $84 million annually) resulting from the credit became apparent. This revelation led to the enactment of legislation in 2002 to control the State's fiscal exposure and to provide for termination of the program on June 1, 2004. In the 2002 legislative session, additional limits were placed on the heritage tax credit.

A task force appointed by the Governor met during the 2003 interim to evaluate the tax credit and determine whether the tax credit should be continued and in what form. The task force concluded that the tax credit program had been a very successful economic and community revitalization tool that generates more in new revenues for the State and local governments than the credit and recommended that the credit be continued with no overall aggregate cap on the credit.

Senate Bill 190/***House Bill 289*** ***(both failed)***, proposed by the Administration, would have extended the heritage credit in much the same form as it currently exists, increasing the overall cap on commercial credits to $30 million per year. As originally introduced, ***House Bill 679*** ***(passed)*** would have converted the existing tax credit program into a grant program; however, the bill reestablishes the Maryland Heritage Structure Rehabilitation Tax Credit, but places the program under budgetary control, creating a competitive process, with an aggregate limit, for the awarding of commercial credits.

Major Provisions

House Bill 679 increases the existing total commercial credit cap in calendar 2004 from $15 to $25 million, of which $10 million must be awarded on a competitive basis by the Maryland Historical Trust (MHT). In order to qualify for a tax credit for tax year 2004, a commercial rehabilitation project must have received approval from MHT of its proposed rehabilitation plan by June 30, 2004. The bill creates a reserve fund to which funds are to be appropriated each of fiscal 2006 through 2008 for proposed commercial projects to be preliminarily approved in each fiscal year. The amount of commercial credits approved in each fiscal year cannot exceed the amount of money budgeted to the reserve fund for that fiscal year. There is no aggregate cap or reserve fund for tax credits for residential rehabilitations.

Subject to the applicable limitations, the credit allowed equals 20 percent of the qualified rehabilitation expenditures expended in the rehabilitation of a certified historic structure. The maximum credit for any project cannot exceed (1) $50,000 for noncommercial projects and

(2) the lesser of $3 million or the maximum amount stated on an initial credit certificate for commercial projects.

Taxpayers seeking the tax credit for the rehabilitation of a commercial property beginning in 2005 must submit an application to MHT between January 1 and March 31. For each approved commercial rehabilitation plan MHT must issue an initial credit certificate stating the maximum credit for which the project may qualify.

The bill creates a heritage structure rehabilitation tax credit reserve fund. The total amount of credits under initial credit certificates issued by MHT in each fiscal year cannot exceed the amount appropriated to the reserve fund in the State budget. The bill requires the Governor to appropriate to the reserve fund at least $20 million in fiscal 2006 and $30 million annually in fiscal 2007 and 2008. After the State budget had been approved by the General Assembly, the Governor may not reduce an appropriation to the reserve fund. For each fiscal year, if funds are transferred from the reserve fund for any reason other than the completion of a project for which an initial credit certificate was issued or the expiration of an initial credit certificate, the amount of total credits that can be approved by MHT is reduced by the amount of money transferred.

Not more than 50 percent of the total initial credit certificates issued in a fiscal year may be allocated for projects located in one county or Baltimore City. At least 10 percent of the total initial credit certificates issued are required to be allocated to commercial rehabilitations proposed by nonprofit organizations.

Within 15 days of each calendar quarter, MHT is required to notify the Comptroller as to the total commercial rehabilitations that were certified as being completed during the quarter. Upon this notification from MHT, the Comptroller is required to transfer from the reserve fund to the general fund the total amounts stated in initial credit certificates for each rehabilitation project completed during that quarter.

Initial credit certificates expire and the credit may not be claimed if a commercial rehabilitation is not completed by the end of the fiscal year following the fiscal year in which the certificate was issued. MHT may postpone the expiration date of a certificate indefinitely for reasonable cause. By October 1 of each year, MHT must report to the Comptroller the maximum amounts stated on the initial credit certificate for each commercial rehabilitation project for which the certificate has expired as of the prior fiscal year. Upon this notification, the Comptroller is required to transfer from the reserve fund to the general fund the amount of expired initial certificate credit amounts.

Fiscal Impact

Taking into account the increase in the commercial cap for calendar 2004 as well as the mandated appropriations to the program for fiscal 2006 through 2008, it is estimated that the bill's net effect will be a general fund decrease of approximately $7.6 million in fiscal 2005, $29.5 million in fiscal 2006, $39.3 million in fiscal 2007, and $41.0 million in fiscal 2008

Other Tax Credits

During the 2004 session, the General Assembly considered several proposals to extend the sunset dates for various tax credits that are scheduled to expire in the near future. Continued concerns about the potential impact of State tax credit expenditures on the State budget, especially in light of the State's continuing fiscal difficulties, led to greater overall scrutiny of tax credit legislation during the 2004 session.

One tax credit, the Job Creation Tax Credit, scheduled to expire after 2006, was extended by three years in ***House Bill 219*** ***(passed)***. However, the General Assembly rejected several other proposals to extend existing credits beyond their current sunset dates. These include:

- ***Senate Bill 754***/***House Bill 218*** ***(both failed)*** – Education – Tax Credit for Employer-Established Paid Work-Based Learning Programs (expired after tax year 2003);
- ***House Bill 821*** ***(failed)*** – Tax Credit – Electric and Hybrid Vehicles – Extension (applies only to vehicles titled before July 1, 2004);
- ***House Bill 987*** ***(failed)*** – Research and Development Tax Credit (expires after calendar 2004);
- ***House Bill 1496*** ***(failed)*** – Energy – Taxes – Extension and Expansion of Credit for Renewable Energy (expires at the end of 2004); and
- ***Senate Bill 485***/***House Bill 714*** ***(both passed)*** – Solar Energy Tax Credit (tax credit expires at end of 2004 – bills convert this into a grant program – see further discussion of this bill under Part K – Natural Resources, Environment, and Agriculture of this *90 Day Report*).

Tax Compliance

Senate Bill 68 ***(Ch. 22)*** exempts out-of-state nonprofit organizations and government entities that provide police, fire, rescue, and emergency services personnel during a Maryland state of emergency from State registration and income tax withholding requirements. In addition, the bill exempts the income earned during these emergencies by nonresident employees of these organizations from State income tax.

House Bill 1277 ***(passed)*** removes a requirement that the "total payment" for a sale of property be stated on every deed or on an affidavit accompanying the deed. Instead, the bill provides that for the sale of property by a nonresident for which the advance payment of income tax is required, the "total payment" for the sale must be described on a form specified by the Comptroller. The bill provides for an exemption from the requirement for property transferred pursuant to a deed or other instrument of writing that includes a required statement of consideration indicating that the consideration payable is zero. The bill also alters the definition of "net proceeds" with regards to payments on the sale of property by nonresidents. Finally, the bill defines specified terms for purposes of a requirement that specified payments be made before a deed or other instrument of writing may be recorded under specified circumstances.

Senate Bill 69 ***(Ch. 23)*** alters the due date for filing income tax withholding returns for employers who collect less than $700 per quarter in withholding taxes. The due date changes from the last day to the fifteenth day of the month that follows the calendar quarter in which the taxes were withheld. It is estimated that this measure will increase general fund revenues by approximately $86,300 annually beginning in fiscal 2005.

Miscellaneous Income Tax Bills

House Bill 1000 ***(passed)*** establishes a Cancer Research Fund checkoff on the individual income tax return form. After the Comptroller deducts administrative expenses, the contributions are credited to the fund and distributed by the Department of Health and Mental Hygiene through the annual budget process to eligible entities for cancer research.

House Bill 1125 ***(passed)*** creates a Task Force on the Exemption of Law Enforcement Officers' Pensions from Taxation. The task force is charged with studying the issue of exempting members of the State Police Retirement System, the Law Enforcement Officers' Pension System, the Local Fire and Police System, any local pension or retirement system for law enforcement officers, and parole and probation officers who are members of the Employees' Retirement System or the Employees' Pension System from State income taxes on their pensions.

Sales Tax

Budget Reconciliation and Financing Act of 2004

Sales Tax Vendor Credit

To offset the expense of collecting and paying the State sales and use tax, vendors are allowed to retain a portion of the sales tax collected if they file their returns on a timely basis. This credit was temporarily halved for fiscal 2003 and 2004 by the Budget Reconciliation and Financing Act of 2002 so that vendors received 0.6 percent for the first $6,000 collected and 0.45 percent for any amount above that. Absent action by the General Assembly, in fiscal 2005, the credit would resume at 1.2 percent for the first $6,000 collected and 0.9 percent for any amount above that.

Senate Bill 508, the Budget Reconciliation and Financing Act of 2004, continues the vendor credit reduction for fiscal 2005 and 2006. General fund revenues are expected to increase by approximately $15.4 million in fiscal 2005 and $16.0 million in fiscal 2006. As the vendor credit applies to the sales tax on short-term vehicle rentals, additional revenues of about $130,000 each year would also accrue to the Transportation Trust Fund. The other revenue enhancements included in Senate Bill 508 are discussed in further detail in other parts of this *90 Day Report*.

Failed Amendments to the Budget Reconciliation and Financing Act of 2004

There were several other provisions that were added to Senate Bill 508 by either the Senate or the House that ultimately did not pass. As passed by the Senate, Senate Bill 508 included a provision that would have imposed the 5 percent sales and use tax on snack foods, including potato chips, tortilla chips, corn chips, cheese puffs, pretzels, nuts, popcorn, pork rinds, and seeds. It was estimated that taxing snack foods would have increased general fund revenues by approximately $16 million annually.

As part of its net $670 million budget balancing and revenue raising package, the House of Delegates included amendments to Senate Bill 508 that would have increased the sales and use tax rate from 5 to 6 percent and would have broadened the sales tax base by taxing some services, including real estate property management, tanning salons, massage services, and physical fitness facility memberships. It was estimated that raising the sales tax rate by 1 percent would increase general fund revenues by approximately $550 million annually and taxing the services listed (at a 6 percent rate) would have increased revenues by over $60 million annually.

Streamlined Sales and Use Tax Agreement

The Streamlined Sales Tax Project was organized in March 2000 as an effort of state governments, with assistance from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. Simplifying state sales tax structures would ease the burden of collecting these taxes by remote sellers (such as Internet and catalog retailers) and perhaps ultimately eliminate the constitutional and practical obstacles to these remote sellers collecting and remitting sales tax on purchases by Marylanders. The main motivators of the effort were the National Conference of State Legislatures, the National Governor's Association, the Federation of Tax Administrators, and the Multistate Tax Commission. The stated mission of the project was to develop measures to design, test, and implement a sales and use tax system that radically simplified sales and use taxes. The goal of the project was to provide states with a system of which the key features included (1) uniform definitions; (2) rate simplification; (3) state level administration; (4) uniform sourcing rules; (5) simplified exemption administration; (6) uniform audit procedures; and (7) state funding for the system.

Senate Bill 400*/*House Bill 694* *(both passed) adopt the Streamlined Sales and Use Tax Agreement as adopted by the Streamlined Sales and Use Tax Project on November 12, 2002, contingent on the enactment of both specified trigger legislation by the U.S. Congress and conforming legislation by the General Assembly. Senate Bill 400/House Bill 694 also require the Comptroller to prepare and submit proposed regulations and draft legislation to identify and implement changes that need to be made to the State's laws, regulations, or policies in order to bring the State into compliance with the agreement and other changes recommended by the Comptroller.

Sales Tax Rate Increase

In addition to the proposed amendments to the Budget Reconciliation and Financing Act of 2004, several other bills were introduced that would have increased the sales and use tax rate. ***House Bill 102*** ***(failed)***, ***House Bill 103*** ***(failed)***, and ***House Bill 271*** ***(failed)*** would have increased the general sales and use tax rate from 5 to 6 percent to address the State's structural fiscal deficit and/or to provide funding for the State's education initiatives. Raising the sales tax by 1 percent is estimated to increase State revenues by over $550 million annually.

Taxation of Services

A major shift has occurred in the national economy from consumption of goods, the traditional base of the tax, to consumption of services. Based on personal consumption expenditure data from the U.S. Department of Commerce, expenditures on services rose from 48 percent of total personal consumption expenditures in 1980 to 59 percent in 2002, while spending on goods fell as a percentage of total consumption. Average annual growth in expenditures was 7.7 percent for services versus 5.5 percent for goods over the same period. However, the sales and use tax historically has been imposed broadly on the sale or use of tangible personal property but only narrowly on a few specifically enumerated taxable services.

House Bill 84 ***(failed)*** would have applied the sales and use tax to a broad array of "luxury" services, including boat or aircraft repair and maintenance, marina services, tanning, saunas and steam baths, home cleaning, interior design and decorating, lawn and grounds care and landscaping, and golf course membership and fees. It was estimated that imposing the sales tax on the services enumerated in House Bill 84 could increase revenues by approximately $100 million annually.

House Bill 1364 ***(failed)*** would have applied the sales and use tax to a broader array of services, including cable TV, automotive repair, barber and beauty shops, direct mail advertising, personnel and temp services, and management consulting. It was estimated that imposing the sales tax on the services listed under House Bill 1364 could increase revenues by approximately $360 million annually.

Miscellaneous Taxes

Estate and Inheritance Taxes

Federal Decoupling

The federal Economic Growth and Tax Reconciliation Act of 2001 provided for the reduction and ultimate repeal of the credit allowed under the federal estate tax for state death taxes paid (federal credit). Maryland, like most states, had an estate tax that was linked directly to the federal credit. Without statutory changes by the General Assembly, the repeal of the federal credit under the 2001 federal tax Act would have automatically repealed the State estate tax because of the link between the State tax and the federal credit. It was estimated that the elimination of the Maryland estate tax would have reduced general fund revenues by roughly $100 million annually by 2007.

As part of the 2002 Budget Reconciliation and Financing Act (Chapter 440), the Maryland estate tax was partially decoupled from the federal estate tax, continuing the State tax notwithstanding the phase-out and repeal of the federal credit. The State estate tax is now calculated as if the federal tax Act had not phased out the federal credit; however, it is calculated using other provisions of federal estate tax law in effect on the date of the decedent's death. The "unified credit" used to calculate the State estate tax, which effectively sets the threshold for taxability of an estate, is the unified credit in effect as of the decedent's death as set forth in federal law. Under the federal Act, the amount effectively exempted under the unified credit was increased from $700,000 to $1 million in 2002, and then phased up over a period of years to $3.5 million in 2009.

Unified Credit: As discussed above, Chapter 440 of 2002 decoupled the calculation of the Maryland estate tax liability from part of the calculation of the federal estate tax liability. However, Chapter 440 did not decouple the Maryland estate tax from the gradual increases in the unified credit allowed against the federal estate tax. The Maryland estate tax is calculated as the lesser of the federal estate tax after deducting the unified credit or the State death tax credit, reduced by any inheritance tax paid. As the unified credit increases, the amount of the Maryland estate tax will decline. The Budget Reconciliation and Financing Act of 2004, Senate Bill 508, has the effect of freezing the amount of the unified credit at $345,800 so as to exclude $1 million from the federal estate taxes for purposes of the Maryland estate tax calculation. This will affect the estate tax returns filed for decedents dying after December 31, 2003.

This provision of Senate Bill 508, which was initially encompassed in a separate bill introduced in the 2004 session, will increase the number of Maryland returns subject to State estate tax, even if no federal tax return has to be filed. This will result in a general fund revenue increase of approximately $9.1 million in fiscal 2005, growing to $26 million by fiscal 2009.

Deduction for State Death Taxes: By remaining coupled to the federal estate tax base, the "decoupled" Maryland estate tax will incorporate a provision of federal law effective beginning in 2005 that will allow a deduction for State death taxes paid, in lieu of the previously allowed credit for State death taxes paid. Allowing the deduction of State death taxes for purposes of determining the State death tax base will result in a circular calculation, because the tax being calculated results in a deduction from the tax base, which then alters the calculation of the tax owed.

Senate Bill 508 requires that the Maryland estate tax be determined without regard to the deduction for State death taxes allowed for purposes of the federal estate tax. The bill effectively creates an addition modification to the federal taxable estate for Maryland estate tax purposes in the amount deducted for State death taxes paid. A similar addition modification to the federal tax base is required under the Maryland income tax for State and local income taxes for which a deduction is allowed for federal income tax purposes. This provision, which was initially introduced as a separate bill in ***House Bill 330*** ***(failed)***, simplifies the calculation of the Maryland estate tax while preventing additional loss of revenue from the Maryland estate tax. As a result of this simplification, general fund revenues are expected to increase approximately $6.3 million in fiscal 2006, growing to $10.1 million by fiscal 2009.

Inheritance Tax

The inheritance tax is applied to the receipt of property from a decedent's estate. Under current law, direct beneficiaries and siblings are exempt from the inheritance tax. Direct beneficiaries include parents, grandparents, spouses, children, other lineal descendants, stepparents, and stepchildren. Since approximately 1980, the statute was interpreted to include stepparents and stepchildren as direct beneficiaries. In January 2004, the Baltimore County Register of Wills requested advice of counsel on whether a stepchild or stepparent relationship terminates, for the purposes of the exemption from the inheritance tax, when (1) the natural parent and the stepparent divorce or (2) the natural parent dies and the stepparent remarries. The advice of counsel stated that in both instances the relationship does terminate, with the result that the stepchild exemption is unavailable. ***Senate Bill 860*** ***(passed)*** defines the terms "child" and "parent" under the inheritance tax to clarify that a former stepchild or former stepparent are to be treated as lineal beneficiaries. In addition, Senate Bill 860 extends the exemption for lineal beneficiaries to children and other lineal decedents of a stepchild or former stepchild of the decedent and to the spouses of those individuals.

Transportation Taxes

Vehicle Registration Fees

The Governor proposed ***House Bill 1467*** ***(Chapter 9)*** in response to the findings of the 2003 Transportation Task Force, which reported significant under funded capital transportation needs. Chapter 1 increases State motor vehicle registration fee and alters the requirements for the level of miscellaneous fees charged by the Motor Vehicle Administration. A more detailed discussion of the Act can be found under Part G of this *90 Day Report*.

Titling Tax

As part of its amendments to Senate Bill 508, the 2004 BRFA, the House of Delegates introduced a revenue package which included an increase in the titling tax from 5 to 6 percent. In addition, the House proposal would have dedicated all corporate income tax revenues to the general fund and dedicated all short-term vehicle rental tax revenues to the Transportation Trust Fund (TTF). These proposed transportation revenue changes were rejected in the BRFA conference committee.

Senate Bill 712/***House Bill 1332*** ***(both passed)*** extend for three years the termination date for a provision of law that allows the purchase price of a motor home or travel trailer (RVs) to be lowered by the value of a trade-in for determining the vehicle excise tax. Under the bills, this provision, which has been in effect since 2001, will be extended until 2007.

Motor Fuel Tax

House Bill 228 ***(passed)*** extends to concrete pump trucks an existing motor fuel tax refund provision already available to concrete mixing motor vehicles. Mixing vehicles may claim a refund for 35 percent of motor fuel tax paid.

Vessel Excise Tax

Senate Bill 536/House Bill 848 ***(both passed)*** provide that time spent on commissioning procedures for new or used boats is not counted against the 90 days a vessel is allowed to be in the State before becoming subject to the vessel excise tax. The bill authorizes the Department of Natural Resources to adopt regulations to determine the state of principal use for the purpose of assessing the vessel excise tax. The bill also exempts from the vessel excise tax a transfer of a vessel to a licensed dealer for rental or leasing purposes, effective July 1, 2005**.**

Recordation and Transfer Taxes

Controlling Interest

Under current law, ownership of real property can be effectively transferred without payment of transfer and recordation taxes by transferring a controlling interest or ownership of an entity if the property is owned by a corporation, limited liability company, or partnership. ***House Bill 1*** ***(failed)*** would have imposed recordation and transfer taxes on the transfer of real property, with a value of $1 million or more, when the transfer is achieved through the sale of a "controlling" interest in a corporation, partnership, limited liability company, limited liability partnership, or other form of unincorporated business. House Bill 1 would have required that specified amounts of State and local recordation and transfer tax revenues be dedicated to school construction. A more detailed discussion of the proposed use of these revenues can be found in Part L of this *90 Day Report.*

Refinancing Instrument

Senate Bill 76 ***(passed)*** extends a current exemption from recordation tax for the refinancing of a mortgage or deed of trust to the trustee of a living trust as long as the property is used as the principal residence of the settlor of the trust and either the trustee or the settlor originally assumed or incurred the debt being refinanced.

Land Trusts

House Bill 820 ***(passed)*** broadens an existing exemption from recordation and transfer taxes for certain transfers made for conservation or preservation purposes, exempting the transfer of conservation easements and fee simple interests if the transfer is to a land trust and the land is used (1) to preserve a natural area; (2) for environmental education of the public; (3) for agricultural preservation; (4) for conservation; or (5) for maintenance of a natural area for public use or wildlife sanctuary. In addition, the bill expands existing authority for local governments to grant property tax credits for conservation land, to include property used to conserve agricultural land and to promote agricultural use of the land.

Miscellaneous Taxes – Local

Hotel Rental Taxes

Several bills passed to authorize a county to impose a hotel rental tax or make changes to existing hotel rental taxes. ***House Bill 380*** ***(passed)*** increases the maximum hotel rental tax rate from 3 to 5 percent in Somerset County. ***Senate Bill 441***/***House Bill 471*** ***(both passed)*** authorize Frederick County to impose a hotel rental tax rate at a rate of up to 5 percent. ***House Bill 897*** ***(passed)*** allows Talbot County to increase its current 3 percent hotel rental tax rate to 4 percent for calendar 2005 and 2006 only. The rate would then return to 3 percent in 2007. ***House Bill 539*** ***(passed)*** allows Garrett County to treat unpaid hotel rental tax as a lien against the real and personal property of the person owing the tax, as with property taxes.

Hotel Surcharge – Dorchester County

House Bill 1547 ***(passed)*** imposes a hotel surcharge of 2.5 percent in Dorchester County on room rentals at facilities with at least 380 rooms. House Bill 1547 also establishes the Dorchester County Economic Development Fund within the Maryland Economic Development Corporation (MEDCO). Proceeds from the surcharge will be collected and remitted by the Comptroller on behalf of MEDCO and will be used to pay claims and bonds associated with the Chesapeake Bay Conference Center, also known as the Hyatt Regency Cambridge. Once MEDCO certifies to the Comptroller that all bonds regarding the conference center have been paid off, the surcharge will no longer be imposed.

Building Excise Taxes or Development Impact Taxes

Harford County: ***House Bill 965*** ***(passed)***, the Harford County School Construction Financing Act of 2004, authorizes the Harford County Council, by ordinance, to impose a development impact fee not to exceed $10,000 on new construction or development. The revenues may be used only for school construction and renovation.

Dorchester County: ***Senate Bill 836***/***House Bill 1161*** ***(both passed)*** authorize Dorchester County to impose a building excise tax on construction within the county. The revenues from the tax must be used to finance the capital costs of additional or expanded public works, improvements, and facilities required to accommodate new construction or development. The bills require that the tax rates must relate to the development or growth related infrastructure needs of the county and may not exceed $1 per square foot for nonresidential property, not to exceed $5,000 per lot or parcel. For residential property, the maximum tax rate is $5,000 per unit.

Code Home Rule Counties: ***House Bill 1162*** ***(passed)*** increases from $2,000 to $5,000 the maximum development excise tax that may be imposed to finance public school facilities or improvements in code home rule counties on the Eastern Shore.

Frederick County – Solid Waste Disposal Fee or Tax

Currently, tipping fees collected at the Frederick County landfill are the sole source of revenue for its solid waste program. The county's solid waste program, which already has significant debt, is facing disposal capacity issues that will have significant implications for the county's Solid Waste Enterprise Fund. ***House Bill 876***/***Senate Bill 606*** ***(both passed)*** allow Frederick County to assess a tax for collecting and disposing of solid waste. It is expected that the county will set the tax at the level that, along with tipping fees, covers the operating and capital costs for collecting and disposing of solid waste, assumed to be around $23.50 per equivalent residential unit. Revenue could increase by $1.4 million in fiscal 2005, increasing to up to $2.9 million by fiscal 2008 and 2009.