

**Department of Legislative Services**  
 Maryland General Assembly  
 2014 Session

**FISCAL AND POLICY NOTE**

Senate Bill 59 (Senator Mathias)  
 Budget and Taxation

**Income Tax - Subtraction Modification - Payroll Taxes on Employee Tips**

This bill creates a subtraction modification under the State individual and corporate income tax for the amount of an employer’s federal income tax deduction that is reduced for employer Social Security and Medicare taxes under Section 45 B(C) of the Internal Revenue Code (IRC).

The bill takes effect July 1, 2014, and applies to tax year 2014 and beyond.

**Fiscal Summary**

**State Effect:** General fund revenues decrease by \$171,000 in FY 2015 due to decreases in both personal and corporate income tax revenues. Transportation Trust Fund (TTF) revenues decrease by \$31,000 and Higher Education Investment Fund (HEIF) revenues decrease by \$11,000 in FY 2015 due to decreased corporate tax revenues. General fund expenditures increase by a minimal amount due to one-time implementation costs at the Comptroller’s Office.

(in dollars)	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
GF Revenue	(\$170,839)	(\$1,713,517)	(\$1,803,307)	(\$1,857,406)	(\$1,913,128)
SF Revenue	(\$42,748)	(\$428,759)	(\$403,237)	(\$415,334)	(\$427,794)
GF Expenditure	\$66,840	\$0	\$0	\$0	\$0
Net Effect	(\$280,427)	(\$2,142,276)	(\$2,206,544)	(\$2,272,740)	(\$2,340,922)

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

**Local Effect:** Local income tax revenues and local highway user revenues decrease minimally beginning in FY 2015. Local expenditures are not affected.

**Small Business Effect:** Minimal. Small businesses that operate food or beverage establishments and pay tipped employees above an hourly wage rate of \$5.15 will benefit from the subtraction modification.

## Analysis

**Current Law:** No similar State income tax subtraction modification or credit exists.

The federal Omnibus Budget Reconciliation Act of 1993 established an income tax credit to encourage the accurate tax reporting of tips and to ensure accurate Social Security benefits for tipped employees. Under Section 45B of IRC, an employer who operates a food or beverage establishment where tipping is customary may claim a nonrefundable federal income tax credit for the share of the employer's Social Security and Medicare taxes paid with respect to employees' tip wages in excess of the 2007 federal minimum wage rate of \$5.15. The employer can claim the income tax credit whether or not the employee reports the tip wages to the employer. Under Section 45B(C), a taxpayer may not deduct any amount taken into account in determining this credit, so it prevents a double benefit to the taxpayer. This credit is a component of the federal general business credit.

**Background:** The Federal Insurance Contributions Act provides for a federal system of old-age, survivors, disability, and hospital insurance. The old-age, survivors, and disability insurance is financed by the Social Security tax and the hospital insurance is financed by the Medicare tax. The tax rate for Social Security is 6.2% each for the employer and employee (12.4% total) and the maximum wage subject to the tax is \$117,000 for tax year 2014. The 2014 tax rate for Medicare is 1.45% each for the employer and employee (2.9% total), and there is no wage limit for the Medicare tax. Additionally, there is a 0.9% additional Medicare tax on employees with wages in excess of \$200,000.

Federal law requires employees who receive cash tips of \$20 or more in a month to report every month the total amount of tips they received to their employer. An employer is responsible for paying half of employees' Social Security and Medicare taxes on both wages and reported tips. Employers also typically withhold federal, state, and local income taxes. Employees are responsible for half of their Social Security and Medicare taxes, as well as any state and federal income tax in excess of the amounts withheld by the employer. Employers may deduct the Social Security and Medicare taxes they pay employees as a business expense. However, employers that claim an income tax credit under Section 45B for Social Security and Medicare taxes may not deduct those amounts as a business expense.

**State Revenues:** **Exhibit 1** illustrates the fiscal impact of allowing a subtraction modification for excess employer withholding of Social Security and Medicare taxes. The estimated State fiscal impact is based on recent Internal Revenue Service data of the excess withholding credit claimed on individual and corporate tax returns, adjusted for Maryland's estimated share of the national economy, State tax rates, and assumptions on the timing of tax payments.

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**Exhibit 1**  
**Excess Withholdings on Tipped Employees Revenue Impact**  
**Fiscal 2015-2019**

	<u>FY 2015</u>	<u>FY 2016</u>	<u>FY 2017</u>	<u>FY 2018</u>	<u>FY 2019</u>
GF Share	(\$170,839)	(\$1,713,517)	(\$1,803,307)	(\$1,857,406)	(\$1,913,128)
HEIF Share	(11,374)	(114,082)	(117,505)	(121,30)	(124,661)
TTF Share	(31,374)	(314,677)	(285,732)	(294,304)	(303,133)
<i>MDOT</i>	(28,362)	(284,468)	(258,302)	(266,051)	(274,032)
<i>LHUR</i>	(3,012)	(30,209)	(27,430)	(28,253)	(29,101)
<b>Total</b>	<b>(\$213,587)</b>	<b>(\$2,142,275)</b>	<b>(\$2,206,543)</b>	<b>(\$2,272,740)</b>	<b>(\$2,340,922)</b>
Local Income Tax	(\$721)	(\$7,227)	(\$7,444)	(\$7,667)	(\$7,897)

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**State Expenditures:** The Comptroller’s Office reports that it will incur a one-time expenditure increase of \$66,840 in fiscal 2015 to add the subtraction modification to the individual and corporate income tax returns. This includes data processing changes to the SMART income tax return processing and imaging systems and system testing.

**Local Revenues:** Local income tax revenues decrease by about 3% of the total net State subtraction modification claimed against the personal income tax beginning in fiscal 2015, as illustrated in Exhibit 1. Subtraction modifications claimed against the corporate income tax will decrease local highway user revenues minimally beginning in fiscal 2015, as illustrated in Exhibit 1.

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**Additional Information**

**Prior Introductions:** None.

**Cross File:** None.

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

**Fiscal Note History:** First Reader - January 20, 2014  
ncs/jrb

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