Peter Franchot
Comptroller

David Roose
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February 22, 2011

Honorable Martin O'Malley
Governor of Maryland
State House
Annapolis, Maryland 21401

Honorable Thomas V. "Mike" Miller, Jr.
President, Senate of Maryland
State House
Annapolis, Maryland 21401

Honorable Michael E. Busch
Speaker, Maryland House of Delegates
State House
Annapolis, Maryland 21401

Dear Governor, President and Speaker:

Section 10-108 of the Tax-General Article of the Annotated Code of Maryland requires that the Comptroller's Office report the impact of changes in federal income tax law on State revenues. On December 17, 2010, President Obama signed into law H.R. 4853, the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* ("the Act"). The Act temporarily extends the number of federal income tax cuts enacted during the past decade, reduces the federal payroll tax rate from 6.2% to 4.2% for all taxpayers, and also extends unemployment benefits for an additional 13 months. Some of these provisions affect federal adjusted gross income (FAGI) and thus flow through to the Maryland income tax return, directly affecting State revenues. Other provisions will have an indirect impact on State revenues, as putting more money in the pockets of State residents is assumed to lead to an increase in spending in the State, and thus an increase in State sales tax receipts.

Due to the timing of the enactment of the Act, however, automatic decoupling is not required. Additionally, the December 2010 Maryland general fund revenue estimates of the Board of Revenue Estimates anticipated that Congress would enact legislation substantially similar to the Act, and the Governor's budget assumes additional revenues related to these changes. Hence, the official revenue estimates largely reflect the Maryland revenue effects of the Act.

Provisions with a direct revenue impact

The *Economic Growth and Tax Relief Act of 2001* (*EGTRRA*) repealed the phase-out of the limitation on itemized deductions for certain high-income taxpayers. Under the Act, this repeal will remain in place for tax year 2011 and later, maintaining the increased amount of itemized deductions that taxpayers can deduct. Had the provision expired and the limitation been put back in place, State revenues would have increased by $11.9 million in fiscal year 2011, and an additional $49.4 million in fiscal year 2012.

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Another provision with a direct impact on State revenues is the deduction of interest on qualified higher education loans. The maximum deduction remains at $2,500, and the higher phase-out ranges—based on FAGI and filing status—also remain in place. Had this provision expired, State revenues would have increased by $3.0 million in fiscal year 2011, and $12.1 million in fiscal year 2012.

Changes made to the calculation of the federal earned income credit (EIC) also will directly affect State revenues, as the State's nonrefundable and refundable EIC are based on the calculated federal credit amount. The *American Recovery and Reinvestment Act of 2009 (ARRA)* increased the phase-out ranges for the credit and added an additional 5% credit for taxpayers claiming three or more child dependents beginning in tax year 2009. Had this provision expired—accounting for both the State refundable and nonrefundable credits as well as the indirect impact of an increase in federal tax liability—State revenues would have increased by $1.1 million in fiscal year 2011 and an additional $4.4 million in fiscal year 2012.

The State's child and dependent care credit is also based on the federal credit of the same name; thus, this fourth provision will also directly affect State revenues. Under *EGTTRA*, the dependent care tax credit was increased from 30% to 35% of eligible expenses, which were increased from a maximum of $2,400 to $3,000 for one child and from $4,800 to $6,000 for two or more children. Also, the phase-out threshold was increased to $15,000 of FAGI; the credit is reduced by one percentage point for every $2,000 of FAGI above this amount. Had this provision expired, State revenues would have increased by less than $500,000 in fiscal year 2011 and by $1.5 million in fiscal year 2012.

Another provision with a direct impact on State revenues relates to the deduction for teacher expenses. Under the *Emergency Economic Stabilization Act of 2008,* the above-the-line federal deduction for up to $250 of classroom expenses paid for by teachers was extended for two additional years. Had this provisions expired, State revenues would have increased by less than $1.0 million annually in fiscal years 2011 and 2012.

An additional provision related to the expansion of the federal standard deduction would have a marginal impact on State revenues. As a result of the *Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)*, from 2003-2010 the federal standard deduction for married filing joint taxpayers was increased to double—rather than 167%—the standard deduction for single filers. This provision would have sunset in 2011, with the standard deduction for joint filers reverting back to 167% of that for single filers, reducing the amount from $11,400 to $9,500. While some taxpayers would switch from itemized deductions to the standard deduction as a result of this provision, had this provision been allowed to expire, State revenues would have declined by less $500,000 annually.

Provisions with an indirect impact on State revenues

Several provisions that were extended by the Act may have a significant indirect impact on State revenues, as they may affect the State's sales and use tax receipts. Had the following provisions

not been extended, Maryland residents would have seen a significant decrease in disposable income as a result of an increase in their federal income tax liability.

One such provision is the change to the federal income tax brackets. Under *EGTTRA*, the top federal marginal rate was lowered from 39.6% to 35%, and the rates in other brackets were adjusted accordingly. Had the higher rates gone back into effect, Maryland residents would have paid nearly $2.3 billion more in federal tax. Assuming 25% of that amount would have been spent on taxable goods, sales tax receipts could have been reduced by more than $8.2 million in fiscal year 2011 and $33.2 million in fiscal year 2012. Also under *JGTTRA*, the tax rate for taxable dividends was lowered to anywhere from 0% to 20% of qualified dividends, depending on the taxpayer's income level, rather than being taxed as ordinary income. Had this provision not been extended, all dividends would have again been taxed as ordinary income beginning in tax year 2011. Accounting also for the increase in income tax rates for ordinary income, Maryland residents would have paid an additional $348.0 million in federal income tax in tax year 2011 and $358.4 million in tax year 2012, potentially reducing State sales and use tax revenues by $1.3 million in fiscal year 2011 and an additional $5.3 million in fiscal year 2012.

Similarly, under *JGTTRA*, the capital gains tax rate was lowered to 5% from 10%, or to 10% from 20%, depending on a taxpayer's income level. Had the capital gains rates been allowed to increase, Maryland residents could have paid an additional $307.6 million in federal capital gains tax in tax year 2011 and $463.9 million in tax year 2012. The tax year 2011 number is adjusted by any behavioral changes, such as taxpayers selling additional stock in 2010 ahead of the rate increase. Thus, State revenues would have fallen by an estimated $1.2 million in fiscal year 2011 and $5.2 million in fiscal year 2012.

A fourth provision relates to the child tax credit that was increased from $500 to $1,000 under *EGTTRA*. Had the provision not been extended, the maximum credit would have reverted back to $500 beginning in tax year 2011. Assuming that each individual's credit would have been reduced by half, State sales and use tax revenues would have fallen by $1.1 million in fiscal year 2011 and by $4.2 million in fiscal year 2012.

A fifth provision relates to the limitation on the federal personal exemption amount. Prior to *EGTTRA*, a taxpayer's exemption was reduced or eliminated based on certain income thresholds. Under *EGTTRA*, the limitation on the federal personal exemption was repealed. Had the *EGTTRA* provision been allowed to expire, the limitation would again be in place: the total amount of exemptions that could be claimed by a taxpayer would be reduced by two percent for each $2,500 ($1,250 for married taxpayers filing separate returns) by which the taxpayer's FAGI exceeded the applicable threshold, which is indexed annually for inflation. With the limitation on the exemption amount, federal liability for State residents would have increased by $103.2 million in tax year 2011 and $112.2 million in tax year 2012. As a result, State sales and use tax revenues would have fallen by less than $400,000 in fiscal year 2011 and by $1.6 million in fiscal year 2012.

Finally, and also from *EGTTRA*, the federal adoption credit was available for all adoptions, not just the adoption of special needs children. The maximum adoption credit and exclusion is $13,170 per eligible child, indexed annually for inflation. These amounts are phased out for

taxpayers with modified FAGI between $182,520 and $222,520, also indexed for inflation. Had the provision not been extended, the adoption credit and employer-provided adoption assistance exclusion would have been available only to special needs adoptions, the maximum credit and exclusion would be reduced to $6,000, and the phase-out range would have been reduced to income levels between $75,000 and $115,000. Using the Joint Committee on Taxation (JCT) estimates of the federal revenue impact as a starting point, not extending the provision would have reduced State sales and use tax revenues by less than $50,000 annually in fiscal years 2011 and 2012.

Several other provisions related to the individual income tax will have only a marginal, indirect effect on State revenues, including a sunset provision related to employer-provided educational assistance, an increase in the exemption amount for contributions to Coverdell education accounts and the definition of qualified expenditures from these accounts, the elimination of tax on certain federal scholarship awards and an employer-provided child care credit, an allowance for the deduction of state and local sales tax, several credits for energy efficiency measures, and a number of business tax relief provisions, including the extension of the federal research tax credit and the exclusion of 100 percent of gain on the sale of certain small business stock.

The Act also enacts what has become an annual patch to the federal alternative minimum tax (AMT), increasing the exemption amounts to reflect inflation and allowing an individual to offset the entire regular tax liability and AMT liability by the nonrefundable personal credits for tax years 2010 and 2011. These adjustments to the AMT are estimated to increase State sales and use tax revenues by approximately $5.0 million in fiscal year 2011 and $7.5 million in fiscal year 2012.

In addition to the aforementioned direct changes to the individual income tax, the Act also lowers the payroll tax (FICA) rate by two percentage points to 4.2% for 2011, and extends unemployment insurance for an additional full year. Both of these measures are expected to lead to an immediate increase in spending, potentially increasing sales tax receipts by at least $35.8 million in fiscal year 2011 and $35.6 million in 2012. In addition, the macroeconomic impact of these changes could result in an additional 25,000 Maryland jobs in 2011 and 2012, increasing individual income tax revenues by $50 million or more than expected during these two years (as was noted in the December 2010 report of the Board of Revenue Estimates). The extension of the Work Opportunity credit for hiring certain individuals may also help to boost employment, although the effect will likely be marginal.

Several provisions will have no effect on State revenues because Maryland has decoupled from the federal law. First, under *EGTTRA*, taxpayers were permitted to claim an alternative deduction for higher education expenses instead of claiming the HOPE credit. Had the State not decoupled from this provision, State revenues would have decreased by $3.2 million in fiscal year 2011 and $12.9 million in fiscal year 2012, as taxpayers who previously had claimed the deduction would now have higher FAGI. However, because the State has decoupled from this provision, there is only a marginal indirect revenue effect, as allowing the provision to expire would have increased taxpayers' federal liability, thus reducing disposable income.

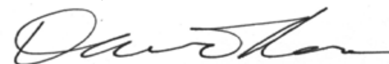
Another provision from which Maryland has decoupled relates to expensing by small business under Section 179 of the Internal Revenue Code and the allowance for bonus depreciation in the first year that an asset is placed in service. Under §179, a taxpayer investing in certain qualifying property may elect to deduct the cost of qualifying property rather than recover such costs through depreciation deductions, subject to certain limitations. For tax years beginning in 2010 and 2011, the maximum amount that a taxpayer may expense is $500,000 of the cost of qualifying property placed in service during the tax year. The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the tax year exceeds $2,000,000.

Because Maryland has permanently decoupled from this provision, on the State tax return, the taxpayer may expense only $25,000 of the cost of qualifying property, reduced by the amount by which the property exceeds $200,000. The Act also allows businesses to expense 100 percent of property placed in service between September 8, 2010 and January 1, 2012, and 50 percent of property placed in service between January 1, 2012 and December 31, 2012. Any additional amounts expensed or depreciated at the federal level must be added back to Maryland adjusted gross income. Using the JCT estimate as a starting point, had Maryland not decoupled from these provisions, State individual and corporate income tax revenues would have declined by $104.5 million in fiscal year 2011, and $185.6 million in fiscal year 2012, as expensing and depreciation are accelerated. Over time, however, the net revenue effect would essentially be zero, as expensing and bonus depreciation generally represent a shift in timing rather than a change in liability.

Finally, the Act reinstates the federal estate tax. Under *EGTRRA*, a graduated rate structure with a top rate of 55% and an effective exemption of $1 million would have applied to decedents dying after December 31, 2010. The Act raises the effective exemption to $5 million, and applies a top rate of 35%. In addition, the state death tax credit, which had been phased out by *EGTRRA* but was scheduled to return in 2011, is replaced by the Act with a deduction for certain death taxes paid to states. These provisions apply to estates of decedents dying before December 31, 2012. Because Maryland has explicitly decoupled from the federal estate tax (including an effective exemption of $1 million and a rate structure essentially identical to the pre-*EGTRRA* state estate tax) these changes will have no direct impact on Maryland revenues.

I hope this information is helpful. Please do not hesitate to contact me at (410) 260-7450 if you have any questions about this matter.

Sincerely,



David F. Roose
Director

cc: Honorable Peter Franchot