Peter Franchot
Comptroller

January 20, 2009

Honorable Martin O'Malley
Governor of Maryland
State House
Annapolis, Maryland 21404

Honorable Thomas V. Miller, Jr.
President of the Senate
State House
Annapolis, Maryland 21404

Honorable Michael E. Busch
Speaker of the House
State House
Annapolis, Maryland 21404

Dear Governor, President and Speaker:

As required by Tax – General §10-108(b) of the Annotated Code of Maryland, I am submitting this report on the impact on Maryland revenues of recent changes made to the Internal Revenue Code by the Emergency Economic Stabilization Act of 2008 (the Act). No provision of this bill will trigger the automatic decoupling required under Tax – General §10-108. The Act has several provisions that could affect State revenues. Other provisions in this legislation will have little or no impact on Maryland revenues. The following estimates are for provisions with significant revenue impacts.

The first provision permits certain financial institutions to treat the gain or loss from the sale or exchange of preferred stock in Fannie Mae or Freddie Mac as ordinary income. The stock must have been held on September 6, 2008 or sold or exchanged on or after January 1, 2008, but before September 7, 2008. Because the banks with the largest holdings of Fannie Mae and Freddie Mac are primarily located in states with a larger financial presence (e.g., New York), it is assumed that Maryland will have a much smaller share of the provision's impact than the State's share using such measures as population or personal income. Based on estimates from the Joint Committee on Taxation of the effect on federal revenues of this provision, Maryland's revenue loss is expected to be approximately $3.3 million in fiscal year 2009.

The fiscal year 2009 revenue loss is made up not only of tax year 2008 sales, but the effect of sales incurred in tax year 2007 (since the provision is allowable for tax years ending after December 31, 2007, which would include tax years beginning as early as January 2, 2007), tax year 2008 losses carried back to prior tax years and a portion of tax year 2009 estimated payments. Revenue losses are expected to decline over time as the value of Fannie Mae and Freddie Mac stock increases, producing smaller losses; gains are expected as the proceeds begin to exceed the cost of

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the stock. Revenue losses will be lower to the extent that addition modifications would not otherwise be fully used.

Several energy conservation and efficiency provisions will also have a small effect on Maryland revenues. The extension of the energy efficient commercial buildings deduction through 2013, a 10-year applicable recovery period for qualified smart electric distribution property and a special depreciation allowance for certain reuse and recycling property may lower Maryland revenues by an estimated $400,000 in fiscal year 2009 and by about $1 million in each fiscal year thereafter.

The Act also extended a number of provisions through 2009, including a shortened (15 years) straight-line cost recovery period for qualified leasehold, restaurant and retail improvements, and new restaurants. The provision is effective for qualified leasehold and restaurants improvements placed in service after December 31, 2007, and retail improvements and new restaurants placed in service after December 31, 2008, but before January 1, 2010. Because the Act was passed in late 2008, and assuming that the expenses would be significantly higher for new restaurants rather than for improvements, much of the impact over the two years that the special depreciation period is in effect will be in tax year 2009. For this reason, the impact on fiscal year 2009 will be an estimated revenue reduction of $5.0 million, of which $1.7 million is from tax year 2008 (well below the $5 million decoupling threshold, as it relates to the "taxable year that begins in the calendar year in which the amendment is enacted"), and the balance is from tax year 2009. The estimated revenue loss will rise to $8.2 million in fiscal year 2010, then decline significantly in the out years.

Another extension, the election to use sales taxes as an itemized deduction in lieu of state and local income taxes, will reduce Maryland individual income tax revenue, but by a small amount. The estimated cost of the legislation under which the deduction was first allowed was well under $1 million. The estimated revenue loss was very low because most Maryland residents will pay substantially more in income taxes than they pay in sales tax, and therefore will include income taxes in their itemized deductions; this will be particularly true with the new higher Maryland income tax rates. Using the sales tax as a deduction in place of the income tax would generally be beneficial in the rare occurrence that an expensive taxable item is purchased during the tax year, such as a high-priced car or boat.

The two-year extension of the above-the-line deduction for up to $250 of classroom expenses paid for by teachers is expected to reduce revenues by about $600,000 per year for fiscal years 2009 and 2010. A three-year extension of the exclusion discharges of principal residence acquisition indebtedness from gross income of individuals will reduce revenues by approximately $575,000 over the life of the extension. The Act also extended the federal deduction for qualified tuition and related expenses. However, Maryland requires that taxpayers add back any amount deducted. Therefore, this provision has no impact Maryland revenues.

The extension of several provisions regarding charitable donations will have a modest effect on Maryland revenues. Under the Act, an individual aged 70 or older may make a tax-free distribution of up to $100,000 if the amount is donated to certain public charities. This provision is in effect for tax years 2008 and 2009 only and is expected to reduce revenues by about $1 million per year (in fiscal years 2009 and 2010). A basis adjustment to stock of subchapter-S corporations making charitable contributions of property will have only a nominal revenue effect of less than $200,000 in fiscal year 2009. Finally, an enhanced charitable deduction for certain donations of computers, food by farmers and ranchers, and books will result in an estimated aggregate revenue loss of approximately $1.7 million in fiscal year 2009 and about $900,000 in fiscal year 2010.

A group of provisions in the Act provide income tax benefits related to the impact of federally declared disasters. One provision allows individuals who itemize their deductions to deduct casualty losses and expenses without regard to adjusted gross income, if the loss is sustained from a federally declared disaster occurring after December 31, 2007, but before January 1, 2010. A $500 floor is applicable to all casualty losses sustained during 2009. A new "bonus depreciation" is permitted for qualified disaster property for property purchased after December 31, 2007. Because weather conditions are more moderate in the mid-Atlantic region than they are elsewhere in the U.S. and federally declared disasters are less likely in Maryland, the State's share of the revenue loss is expected to be disproportionately low. This provision, along with a number of other minor related provisions, may cause approximately $725,000 to be lost in fiscal year 2009, $940,000 in fiscal year 2010 and $600,000 in fiscal year 2011. By fiscal year 2013, the impact on revenues, if any, turns positive as the amount no longer deducted in the out years exceeds the bonus depreciation claimed for newly purchased assets.

Additional provisions will have an indirect impact on Maryland revenues. An addition to the federal standard deduction for up to $500 of property taxes paid during the tax year, first allowed under The Housing and Economic Recovery Act of 2008 for tax year 2008 only, was extended by one year. Federal standard deductions are used in the calculation of the federal filing threshold amounts. Higher federal filing thresholds, also used by Maryland, would result in fewer taxpayers required to file a return (and therefore be subject to tax). This impact is expected to be minor since only individuals near the thresholds would be affected. Many of these individuals pay no tax now due to other tax benefits (Maryland's standard deductions, exemptions, and the earned income and poverty credits).

There are a number of provisions that do not affect Maryland revenues at all, such as federal credits or provisions from which the State has decoupled (e.g., increased Section 179 expensing). Other provisions are expected to have only a negligible impact on State revenues because of Maryland's relatively small presence of certain activities (e.g., oil production and other energy production incentives). The revenue losses attributable to the remaining provisions are, in the aggregate, minimal.

I hope this information is useful to you. If you have any questions or concerns, please contact my office or David F. Roose, the Director of the Bureau of Revenue Estimates, under whose direction this analysis was prepared.

Sincerely,

Peter Franchot