COMPTROLLER of MARYLAND
Serving the People

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Comptroller

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March 1, 2013

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

Honorable Thomas V. "Mike" 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:

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. The President signed into law H.R. 8, the *American Taxpayer Relief Act of 2012* (the Act) on January 2, 2013. The Act extended, made permanent, or altered many previously enacted federal tax reductions, while delaying mandatory government spending cuts ('sequestration') for two months. Many of these provisions will affect State tax revenues by adjusting the calculation of Federal Adjusted Gross Income (FAGI) or Federal Taxable Income (FTI) or by otherwise altering the after-tax income of Marylanders. Many provisions of the Act will either not flow through to the Maryland income tax calculation or will impact State revenues by a negligible amount. Other provisions were either fully or partially included by assumption in the Board of Revenue Estimates in the State's December revenue forecasts (Board Report).

Maryland income tax will automatically decouple in tax year 2013 from only one of the amendments to the Internal Revenue Code (IRC), the decrease in the Section 68 overall limitation on itemized deductions. As a result, this amendment will first affect State income tax revenues in tax year 2014. In the absence of the one-year decouple, the State's income tax revenue forecast would have declined by $30.0 million in fiscal year 2014 from decreased tax year 2013 final payments and tax year 2014 estimated payments. Following the one-year decoupling in tax year 2013, only tax year 2014 estimated payments will reduce fiscal year 2014 State income tax revenues, leading State revenues to be $20.0 million higher relative to revenues absent the decoupling. On the whole, it is estimated that this provision of the Act will reduce State personal income tax revenues by $10.0 million in fiscal year 2014 and $20.0 million annually thereafter, relative to the Board Report.

Provisions Affecting the Calculation of FAGI or FTI

Overall Limitation on Itemized Deductions

The decrease in the Section 68 overall limitation on itemized deductions for high-income taxpayers (Pease limitation), generally equal to 3 percent of the amount by which a taxpayer's FAGI exceeds the specified threshold, was slowly phased out from tax years 2006 through 2010, and completely removed for tax years 2010 through 2012. The Act allows the Pease limitation to return but under permanently increased applicable income thresholds, thereby lowering the number of affected taxpayers and decreasing their effective limitation. These elevated threshold amounts are $300,000 for joint or surviving spouse, $275,000 for head of household, $250,000 for single, and $150,000 for married filing separate filers. The Board Report assumed that the limitation on itemized deductions would fully sunset, and the Pease limitation would return under the prior, lower, income thresholds.

Maryland personal income tax revenues will be reduced by approximately $20.0 million per tax year, and, potentially, by $30.0 million in fiscal year 2014 because individuals are not expected to increase their withholding in fiscal year 2013. As a result, Maryland's personal income tax law will be automatically decoupled from this federal provision for one year, tax year 2013, and State income tax revenues will only be reduced by $10.0 million in fiscal year 2014 and by $20.0 million annually thereafter. Diminished federal tax liability will lead to higher sales tax revenues of $1.3 million in fiscal year 2014 and $0.9 million annually beginning in fiscal year 2015.

Increase in Section 179 Expensing for Small Businesses

The Act extends increased Section 179 expensing for small businesses to tax year 2013 and temporarily expands the definition of qualifying property to include certain property - specifically, qualified leasehold improvement property, qualified restaurant property, qualified retail improvement property, and computer software - for tax years 2012 and 2013. This provision would reduce State income tax revenues by $41.7 million in fiscal year 2014; however, Maryland income tax is permanently decoupled from modifications to the expensing limit and thresholds, so there is no impact on Maryland revenues. This decoupling does not apply to the alteration of qualifying property, thus the Act enables a maximum deduction of $25,000 against the State income tax for this type of property.

It is estimated that the qualification of this new property will reduce State income tax revenues minimally in fiscal year 2013 and by $2.2 million in fiscal year 2014 through accelerated expensing in tax years 2012 and 2013. Annual revenues will be elevated thereafter by an annually diminishing amount, until the affected property is fully depreciated. The entire provision (the increased amount and the newly qualifying property) will affect the federal tax liability of Marylanders. As a result, sales tax revenues will be increased minimally in fiscal years 2013 and 2014, before annually diminishing reductions over the remaining years of depreciation. In total, after the full depreciation of the property, revenues will be negligibly affected and only the timing of revenues will be altered.

Increase in Bonus Depreciation

The Act also extends the bonus depreciation deduction of 50 percent to property purchased before January 1, 2014, previously not applicable to property purchased after December 31, 2012. Some transportation and longer period production property is eligible for the 50 percent bonus depreciation through the end of 2014. This amendment would have decreased State income tax revenues by $179.6 million in fiscal year 2014; however, Maryland income tax is permanently decoupled from all alterations to the bonus depreciation provisions in Section 168(k). Thus, this provision of the Act will not affect Maryland income tax revenues. Altered federal income tax liability will lead sales tax revenues higher by a minimal amount in fiscal year 2013 and by $1.9 million in fiscal year 2014; before annually diminishing reductions over the remaining years of depreciation, starting with a minimal reduction in fiscal year 2015. In total, after the full depreciation of the property, revenues will be negligibly affected and only the timing of revenues will be altered.

Conversion to Roth 401(k)

The Act allows individuals to roll over savings in an eligible retirement system into a Roth 401(k) retirement system after December 31, 2012. Under prior law, individuals generally are only able to realize or roll over savings from one retirement system to another in case of employment severance, death, or injury. Contributions to a Roth 401(k), unlike a traditional 401(k), are taxable at the point of contribution but distributions are not taxable. Engaging this newly authorized behavior will increase FAGI, and flow through to Maryland Adjusted Gross Income (MAGI), thereby initially increasing personal income tax revenues to the State by $0.5 million in fiscal year 2013 and $2.1 million in fiscal year 2014, steadily increasing annually thereafter. Ultimately, the net revenue gain to the State may be zero, as any additional amount that is taxed when rolled over to a Roth 401(k), along with earnings, will not be taxed when the benefit is realized.

Deduction for Certain Expenses of Elementary and Secondary School Teachers

For tax years 2002 through 2011 a deduction was allowed for expenses up to $250 paid by an eligible educator for items purchased for use in the classroom. This deduction reduced FAGI, flowing through to and lowering MAGI. The Act extends this deduction to tax years 2012 and 2013, lowering State income tax revenues by $1.3 million cumulatively in fiscal years 2013 and 2014.

Mortgage Insurance Premiums Treated as Qualified Residence Interest

The Act extends to tax years 2012 and 2013 the deduction of premiums paid for mortgage insurance in connection with a mortgage on a qualified personal residence. As a result, itemized deductions will increase, reducing Maryland income taxes revenues by $2.1 million per year in fiscal years 2013 and 2014.

Discharge of Indebtedness on Principle Residence

Indebtedness on a principle residence that is discharged by a lender is made exempt from FAGI, extending current law for one additional year. This provision will lower federal taxable income but will not affect MAGI as Senate Bill 580 (House Bill 600) of the 2012 Maryland General Assembly created a subtraction against the State income tax for this type of income for tax year 2013. If the subtraction were not in effect, Maryland income tax revenues would have declined by approximately $4.2 million in fiscal year 2014. Sales tax revenues will be minimally reduced in fiscal year 2014.

Parity for Exclusion from Income for Employer Provided Mass Transit and Parking Benefits

A portion of commuter benefits provided by an employer are excludable from a taxpayer's gross income per month. Through the Act, an exclusion from income of $175, increased from $100, per month for benefits received for transportation in a commuter highway vehicle or a transit pass is extended to tax years 2012 and 2013. This increase makes the allowable exclusion for the specified transportation fringe benefits temporarily equivalent to the exclusion for qualifying parking. The provision will flow through to the Maryland income tax return, and is anticipated to disproportionally affect the State relative to the majority of the nation due to a high concentration of federal employees, many of whom are provided transit passes for the Metro system. This amendment will diminish State income tax revenues by $1.8 million per year in fiscal years 2013 and 2014.

Tax Free Distributions from IRA to Certain Charities

The Act extends for two years, through December 31, 2013, the tax free treatment of up to $100,000 in distributions from Individual Retirement Accounts, if the distribution is contributed to certain public charities by individuals of at least 70.5 years of age. This provision of the Act will reduce Maryland personal income tax revenues by $1.4 million per year in fiscal years 2013 and 2014.

15-Year Straight Line Deduction for Qualified Depreciable Property

The Act extends an accelerated 15-year depreciation schedule for any qualified leasehold improvement property, restaurant property, or retail improvement property placed in service between December 31, 2011 and January 1, 2014. Over time, this provision will be revenue neutral; however, it will increase the depreciation deduction, and decrease gross income, of taxpayers owning this type of property each year the depreciation is claimed. After the 15-year period, the gross income of these taxpayers will be higher than under the customary, longer, depreciation schedule. Maryland income tax revenues will be reduced by $1.6 million in fiscal year 2013 and $2.1 million annually over the remaining 15-year period. Revenues will be elevated, relative to the absence of this legislation, beginning in fiscal year 2028.

Deduction of State and Local General Sales Taxes Paid

The Act extends a taxpayer's ability to deduct from FTI State and local general sales taxes paid, in lieu of deducting State and local income taxes paid, through federal itemized deductions for tax years 2012 and 2013. This provision affects Maryland taxable income, as only the amount of State or local **income** taxes paid and included in federal itemized deductions is to be subtracted from Maryland allowable deductions, while this reduction does not apply to general State and local sales taxes paid and included in itemized deductions. Maryland income tax revenues will be reduced by $2.3 million in fiscal year 2013 and $2.5 million in fiscal year 2014.

Marriage Penalty Relief Standard Deduction

The Act extends permanently federal standard deduction marriage penalty relief set to expire after tax year 2012. Through this extension, joint or surviving spouse filers are eligible for a standard deduction equal to 200 percent of the dollar amount allowed for single filers; previously, these taxpayers would have been eligible for a standard deduction equal to 167 percent of this amount.

This provision will affect both Maryland income and sales tax revenues. Certain individuals will claim the standard deduction instead of the itemized deduction on their federal return as a result of the higher allowable amount. This will lead, relative to the absence of this provision, a greater proportion of standard deductions claimed against the State income tax, as filers who claim the federal standard deduction are obligated to mirror this claim on their Maryland return. Furthermore, the federal filing limit, equal to the sum of the standard deduction and the exemption allowance, will increase, increasing the number of Marylanders falling under the federal filing threshold and, therefore, excluded from the Maryland filing requirement.

Switching to a standard deduction will generally increase State income tax revenues because the Maryland standard deduction is much smaller than the federal standard deduction. Conversely, fewer individuals will be obligated to pay Maryland income tax due to the higher federal filing threshold. Overall, State income tax revenues are increased by $1.4 million in fiscal year 2014 and $1.0 million annually thereafter. Federal tax liability will be reduced by both of the aforementioned effects, increasing Maryland sales tax revenues by $2.6 million in fiscal year 2014 and $1.8 million annually in the out-years.

Deduction for Qualified Tuition and Related Expenses

The Act also extends, by two years, the deduction for qualified tuition and related expenses which expired after tax year 2011. Taxpayers will be entitled to a either a $4,000 or $2,000 deduction (depending on adjusted gross income) for qualifying expenses. This deduction reduces FAGI, however it will not affect MAGI as an addition modification permanently decouples Maryland income tax from this federal provision. In the absence of this addition modification, Maryland income tax revenues would have been reduced by $2.7 million per year in fiscal years 2013 and 2014. Maryland sales tax revenues are increased minimally in fiscal years 2013 and 2014.

Exclusion of Employer Provided Education Assistance

The Act permanently extends the exclusion from FAGI of up to $5,250 in employer-provided education assistance, which was set to expire after tax year 2012. Employers can deduct the same amount annually per employee. This provision will flow through to Maryland personal and corporate income taxes, reducing State revenues by approximately $1.9 million annually beginning in fiscal year 2014. Sales tax revenues will experience a minimal annual increase.

Student Loan Interest Deduction

The Act permanently extends a provision, set to expire after tax year 2012, which modified the student loan interest deduction, thereby eliminating the 60-month limitation on the $2,500 above the line student loan interest deduction, expanding the modified FAGI range for the phase-out, and removing the exclusion of voluntary interest payments from the deduction. This provision will flow through to the calculation of Maryland's income tax, reducing State income tax revenues by $3.2 million in fiscal year 2014 and rising to over $3.4 million annually by fiscal year 2018. Sales tax revenues will increase by a minimal amount annually.

Personal Exemption Phase-out

Beginning in tax year 2013, the Act reinstates the phase-out of the federal personal exemption amounts for higher income taxpayers, absent from the federal calculation since tax year 2010. However, a provision in the Act raises the applicable income thresholds above the amounts scheduled in the absence of its passage. These threshold amounts are the same as the newly amended itemized deduction thresholds: $300,000 for joint or surviving spouse, $275,000 for head of household, $250,000 for single, and $150,000 for married filing separate filers. The phase-out implemented through the Act will increase Maryland sales tax revenues by $1.0 million in fiscal year 2014 and $0.8 million annually thereafter, relative to the revival of the lower thresholds.

Provisions which Amend IRC but do not Alter FAGI or FTI Calculation

Patch and Inflation Index of the Alternative Minimum Tax

The provisions relating to the Alternative Minimum Tax (AMT) are estimated to have the greatest impact on federal tax liability. The Act permanently "patches" the AMT beginning in tax year 2012 by increasing the exemption amounts to $78,750 for joint filers and surviving spouses, $50,600 for unmarried individuals, and $39,375 for married individuals who file separately, and by allowing nonrefundable credits to be claimed against the full amount of an individual's regular tax and AMT liability. Furthermore, the Act permanently indexes the exemption amounts and thresholds for inflation beginning in tax year 2013. The Board Report generally assumed the patch would be extended, so there is no impact on revenues.

Enhanced Earned Income Credit

The Act also affects the calculation of the federal earned income credit. As Maryland's nonrefundable earned income tax credit is set at one-half the federal amount, and Maryland's refundable earned income credit is equal to the amount that one-quarter of the federal credit exceeds gross Maryland income tax liability, this amendment will directly affect Maryland income tax revenues.

The Act extends to tax years 2013 through 2017 the higher credit percentage of 45 percent allowed for taxpayers with three or more qualifying children and raises the phase-out threshold for joint filers to $5,000 above the threshold for single filers (cumulatively with the increase detailed below). Furthermore, the Act permanently extends other modifications to the earned income credit, including an increase in the phase-out threshold for joint filers (to $3,000 above the threshold for single filers) and a simplification of the definition of earned income. These provisions are expected to decrease State income tax revenues by $35.0 million per year for fiscal years 2014 through 2017. The annual revenue decrease will decline to $17.0 million beginning in fiscal year 2018, as a result of the sunset of some of the extended provisions. Sales tax revenues will increase by $2.5 million per fiscal year until fiscal year 2018 when the annual revenue increase will decline to $1.2 million.

Reduction of Federal Personal Income Tax Rates

For tax year 2012, the federal income tax brackets had rates set at 10, 15, 25, 28, 33, and 35 percent. These rates were lowered originally through the *Economic Growth and Tax Relief Reconciliation Act of 2001* and were reduced further by the *Jobs and Growth Tax Relief Reconciliation Act of 2003* (known together as the Bush tax cuts). For tax year 2013, they were set to revert to the pre-2001 rates of 15, 28, 31, 36, and 39.6 percent. Through the Act, the decreased tax rates were extended permanently, beginning in tax year 2013, for income in the 10 through 33 percent brackets; however, the 35 percent income bracket was split into two, with income above certain thresholds now taxed at a 39.6 percent rate. These thresholds for tax year 2013 are: $450,000 for a joint or surviving spouse return, $425,000 for a head of household return, $400,000 for a non-married individual return, and $225,000 for a married filing separate return. These thresholds are adjusted for inflation in subsequent tax years.

Relative to the full reversion to pre-Bush tax cut rates, sales tax revenues will be increased by approximately $17.8 million in fiscal year 2013 and $34.2 million in fiscal year 2014. The Board Report assumed that the lower rates would be extended for income below $250,000, while the pre-Bush rates would return for income above this threshold. State sales tax revenues will be higher by $1.2 million in fiscal year 2013 and $4.7 million in fiscal 2014, as a result of the disparity between the assumed income thresholds and those instituted through the Act.

Reduction of Dividend and Capital Gains Tax Rates

Through the Bush tax cuts, long-term capital gains tax rates were reduced to a maximum of 15 percent and these preferential rates were applied to qualified dividend income, formerly taxed at the ordinary income tax rates. The Act extends permanently the maximum 15 percent rate and the preferential tax treatment of qualified dividends, both set to expire in tax year 2013, for most taxpayers, but applies a 20 percent rate to taxpayers with income above the 39.6 percent income tax threshold. These thresholds for tax year 2013 are: $450,000 for a joint or surviving spouse return, $425,000 for a head of household return, $400,000 for a non-married individual return, and $225,000 for a married filing separate return. These thresholds are adjusted for inflation in subsequent tax years. The Board Report assumed the preferential tax treatment of dividends and the decreased long-term capital gains rates would fully expire at the end of tax year 2012. These provisions of the Act will increase Maryland sales tax revenues by $3.5 million in fiscal year 2013 and $7.2 million in fiscal year 2014.

Enhanced Child Tax Credit

The Act permanently extends the $1,000 tax credit per qualifying child, set to revert to $500 per qualifying child after tax year 2012. It also extends alterations to the refundable component of the tax credit, increased to the greater of 15 percent of earned income in excess of $10,000 (indexed for inflation post tax year 2001), or social security liability to the extent it exceeds the taxpayer's earned income credit. Overall, this provision leads to sales tax revenues higher by $4.2 million in fiscal year 2013 and $8.5 million in fiscal year 2014. These extensions, and the estimates above, were assumed in the Board Report.

Enhanced Child and Dependent Care Credit

The Act permanently extends the enhancements to the tax credit for child and dependent care expenses, including a 35 percent rate, a $3,000 cap on expenses for one qualifying individual, and a $6,000 cap for two or more qualifying individuals. In the absence of this extension, these amounts would have decreased to 30 percent, $2,400, and $4,800, respectively, in tax year 2013. A percentage of the federal credit, varying by the FAGI and filing status of the taxpayer, is allowed against the Maryland income tax. Furthermore, a Maryland subtraction modification is allowed for the expenses upon which the federal credit is based. These changes will annually reduce income tax revenues, initially by $1.0 million in fiscal year 2014. As the FAGI threshold is not indexed to inflation, the annual reduction of income tax revenues will incrementally decrease each fiscal year.

American Opportunity Tax Credit

The American Opportunity tax credit is extended for five years through 2017 through the Act. This provision enhances the HOPE education tax credit, increasing the maximum allowable tax credit to 100 percent of the first $2,000 of qualified tuition and related expenses and 25 percent of the next $2,000 for a total allowable credit of $2,500 per year. It also allows the credit to be claimed for four years of post-secondary education instead of two. Furthermore this extension decreases the effect of the FAGI phase-out ratio, allows the credit against course materials, and makes a portion of the credit refundable. The tax credit will reduce federal tax liability of Maryland residents for tax years 2013 through 2017, initially increasing sales tax revenues by $4.7 million in fiscal year 2014 and $4.8 million in fiscal year 2015.

Estate and Gift Tax Rate Reduction and Exemption Increase

The Act also permanently sets the maximum federal estate tax rate at 40 percent with an inflation adjusted $5.0 million exclusion for estates of decedents dying after December 31, 2012. For 2011 and 2012, the rate was 35 percent with an inflation adjusted $5.0 million exclusion. In the absence of the Act, the rate would have reverted to 55 percent and this exclusion reduced to $1.0 million, without an inflation adjustment. This provision will have no effect on Maryland's estate tax, but will increase State sales tax revenues annually, initially by $1.7 million in fiscal year 2013 and $3.6 million in fiscal year 2014.

Extension of Enhanced Unemployment Benefit Programs

The Act generally extends the unemployment insurance benefits instituted during the Great Recession for another year. Emergency Unemployment Compensation (EUC) is a temporary federal extension of unemployment compensation for individuals who have already collected all regular state benefits for which they are eligible. The program, originally enacted through the *Supplemental Appropriations Act, 2008*, has been expanded twice and extended nine times. The act also prolongs the termination of the Extended Benefits Program; however, the extension of the Extended Benefits Program is not anticipated to affect Maryland revenues, as Maryland's Program terminated on April 21, 2012, due to declining unemployment rates. The Board Report assumed Extended Benefits and EUC would expire. The extension of EUC will increase Maryland income tax revenues by $0.9 million in fiscal year 2013 and $1.0 million in fiscal year 2014.

Marriage Penalty Relief on 15 Percent Income Tax Bracket

The Act also includes the permanent extension of marriage penalty relief on the 15 percent tax rate set to expire after tax year 2012. Through this provision, the income tax threshold for the 15 percent bracket of married filers is increased from 167 percent to 200 percent of the income tax threshold of single filers. The indirect impact of this extension will increase Maryland sales tax revenues by $2.9 million in fiscal year 2014 and $2.0 million annually thereafter.

Other Provisions

Other provisions of the *American Taxpayer Relief Act of 2012* are anticipated to affect revenues negligibly. The modifications to sequestration laws are anticipated to significantly affect tax revenues, and the estimates included in this report, however these provisions do not amend the IRC.

Please do not hesitate to contact me at (410) 260-7450 if you have any questions regarding this report.

Sincerely,

Andrew M. Schaufele

cc Honorable Peter Franchot
Honorable T. Eloise Foster
Honorable Nancy K. Kopp
Len Foxwell
David F. Roose
Warren G. Deschenaux

American Taxpayer Relief Act of 2012: Summary of Provisions Potentially Applicable to Automatic Decoupling Provisions

Expiring Provision	FY 2014 State Income Tax Revenues ($ Millions)	First Affected Tax Year	Last Affected Tax Year
Limit on Itemized Deductions*	(30.0)	2013	Permanent
Section 179 Expensing Qualifying Property	(2.2)	2012	2013
Conversion to Roth 401 (k)	2.1	2013	Permanent
Deduction for Teacher Expenses	(0.6)	2012	2013
Mortgage Premiums as Qualified Residence Interest	(2.1)	2012	2013
Exclusion of Employer Provided Mass Transit Benefits	(1.8)	2012	2013
Tax Free Distributions from IRA to Certain Charities	(1.4)	2012	2013
15-Year Straight Line Deduction for Qualifying Property	(2.1)	2012	2013
Deduction of State and Local General Sales Taxes	(2.5)	2012	2013
Marriage Penalty Relief Standard Deduction	(1.4)	2013	Permanent
Employer Provided Education Assistance Exclusion	(1.9)	2013	Permanent
Student Loan Interest Deduction	(3.2)	2013	Permanent
Total	**(47.1)**		

* Maryland income tax will be automatically decoupled from this provision in tax year 2013. As a result, State income tax revenues will only be reduced by $10.0 million in fiscal year 2014.