COMPTROLLER of MARYLAND
Serving the People

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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 September 27, 2010, President Obama signed into law H.R. 5297, the *Small Business Jobs and Credit Act of 2010* ("the Act"). The Act makes several amendments to the Internal Revenue Code (IRC) that affect the calculation of federal adjusted gross income (FAGI) or federal taxable income (FTI) and therefore will flow through to the Maryland income tax return, affecting State revenues. Where indicated, actual tax data was used to estimate the State revenue impact. When actual tax data was not available for certain tax items, the Joint Committee on Taxation (JCT) estimate of the federal revenue impact was used to estimate the State revenue impact.

One provision of the Act increases the amount that individuals can exclude from the gains on the sale of qualified small business stock from 50% of the capital gain to 75% of the gain, provided that the stock was acquired after February 17, 2009 but before January 1, 2011. Because capital gains are included in FAGI, this provision will directly affect State revenues. The JCT estimates that in federal fiscal year 2015, federal revenues will decrease by $276 million – the revenue effect is delayed because long-term gains (gains on stock held for at least five years) are taxed at a lower percentage than regular income. Accounting for the difference between the federal and Maryland fiscal years, the federal tax rates for regular and alternative minimum tax taxpayers, and assuming that approximately 2% of the federal revenue loss will be attributable to Maryland, the State will see a marginal decrease in revenues in fiscal year 2014 (just under $300,000), and slightly larger decreases in fiscal year 2015 and 2016 ($1.5 million and $2.9 million, respectively) before declining to $1.3 million in fiscal year 2017 and less than $500,000 annually in the out-years.

A second provision of the Act expands the definition of eligible IRC Section 179 expensing to include real property and also increases the maximum amount and phaseout thresholds regarding the amount that can be expensed. Under current federal law, for tax years beginning in 2011 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service in that tax year. The $25,000 amount is reduced by the amount by which the cost of qualifying property placed in service during the tax year exceeds $200,000. The Act – for tax years 2010 and 2011 – increases the amount of qualified property that can be expensed to from $25,000 to $500,000, and also increases the phaseout threshold from $200,000 to $2,000,000. The Act also temporarily expands the definition of property qualifying for Section 179 to include certain real property – specifically, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

Maryland has permanently decoupled from the first part of this provision, as stated in Tax-General 10-210.1, which limits the annual amount of property that a business can expense under Section 179 of the IRC in Maryland to $25,000, with the phaseout beginning at $200,000. However, the inclusion of additional types of property under Section 179 will allow businesses required to file an income tax return in Maryland to claim additional expensing on their Maryland return at the $25,000/$200,000 thresholds. Assuming that approximately 30 percent of the federal effect is due to the inclusion of additional qualified property, State revenues will decline by approximately $1.5 million in fiscal year 2011, an additional $6.3 million in fiscal year 2012 and another $5.7 million in fiscal year 2013 due to the accelerated tax deductions. Beginning in fiscal year 2014, revenues increase by $1.1 million, and continue to increase by an additional $3.2 million in fiscal year 2015, $2.2 million in fiscal year 2016, $1.5 million in fiscal year 2017, and by less than $1.0 million annually in each year thereafter. The increase is a result of businesses not depreciating these assets in the out-years, as they will have already expensed them in earlier years.

A third provision of the Act increases the amount of start-up expenses deductible at the federal level from $5,000 to $10,000, and also increases the phaseout amount from $50,000 to $60,000. (The deduction is reduced by the amount by which the cumulative cost of start-up expenditures exceeds $60,000.) The increased deduction will reduce both FAGI and FTI, thus reducing Maryland taxable income. Using the JCT estimate of the federal revenue impact, again accounting for the difference between the federal and State fiscal years and also accounting for the difference in tax rates between individuals and corporations both at the federal and State levels, Maryland revenues will decline by less than $100,000 in fiscal year 2011 and approximately $500,000 in fiscal year 2012 and fiscal year 2013. Beginning in fiscal year 2014 and into the out-years, the State will see a slight increase in revenues of approximately $50,000 annually, as expenses that would have been deducted in these years have instead been deducted in the year in which the business commences.

A fourth provision of the Act allows self-employed taxpayers to reduce their earned income by the amount of their deduction for health insurance costs for purposes of calculating their old age, survivors and disability insurance (OASDI) and hospital insurance (HI) taxes. This effectively lowers the amount they must pay for these federal taxes. However, a small portion of the reduction is offset by the reduced deduction for one-half of these taxes on the federal individual income tax return. A reduced deduction will result in higher FAGI, and thus higher Maryland taxable income.

Based on tax year 2008 data, the latest federal data available, Maryland revenues will increase by $1.5 million to $2 million annually as a result of this provision.

A fifth provision of the Act allows deferred compensation retirement plans maintained by the federal government and state and local governments – 457(b) plans – to offer an "elective deferral," or Roth, option. A similar but separate provision allows businesses that currently only offer a pre-tax defined contribution plan, such as a 401(k) or a 403(b), to offer its employees a Roth option. If an organization elects to offer a Roth plan to its employees, it must allow its employees to roll over the traditional plan into the Roth plan. Employees electing a rollover must include the rollover amount in their adjusted gross income in 2010 or, as a result of a special rule for 2010, include the rollover in equal parts in 2011 and 2012. Because this will likely incentive some individuals to roll over traditional retirement plans into Roth plans – thus increasing FAGI by the amount of the rollover – the State may see an immediate acceleration of revenues, as these amounts are taxed in the year of the rollover rather than when they are distributed during an individual's retirement.

Because there is no way to know how many Maryland businesses or governments are currently offering a Roth option or how many might begin offering this option as a result of the Act, the JCT federal revenue estimate was again used to estimate the State fiscal effect of this provision. After adjusting for federal fiscal years and federal and State tax rates, and assuming that approximately 2% of the revenue effect is attributable to Maryland, the State could see a marginal acceleration of revenues in fiscal years 2011 and 2012, but a larger increase of $1 million to $2 million annually beginning in fiscal year 2013.

A final provision of the Act relates to source rules for income on guarantees and may affect FTI, thus flowing through to the Maryland corporate income tax return. Under current law, U.S. tax court ruled that fees paid by a domestic corporation to its foreign parent with respect to debt guarantees issued by the parent for the debts of the domestic corporation were analogous to interest, and thus generally not subject to the corporate income tax in the U.S. The Act overrides this ruling and subjects this income to the federal income tax. The JCT estimates an increase to federal revenues of $200 million annually. Again, accounting for the difference between State and federal fiscal years and State and federal corporate tax rates, and assuming that 2% of the federal effect is attributable to Maryland, State revenues will increase marginally in fiscal year 2011, by just under $500,000 in fiscal year 2012 and by just under $1 million annually thereafter.

Several provisions in the Act increase the amount of late penalties and other levies that can be imposed on taxpayers who are delinquent in their taxes. An additional provision requires information reporting by individuals who receive rental income, regardless of whether this income is part of a trade or business (e.g., active income). While there will not be a direct effect on State revenues, Maryland could see an increase in revenues as a result of increased compliance with federal income tax requirements that result in an increase in FAGI.

Several provisions in the Act related to bonus depreciation modifications will not have an impact on Maryland revenues, as Maryland law has automatically decoupled the State from amendments to this section of the IRC. Additional provisions affecting federal tax credits, corporate federal estimated tax payments and authorization for the U.S. Trade Representative to develop market-access opportunities for U.S. small businesses also will not directly affect State revenues. Finally, any remaining provisions will have only a minimal indirect effect on State revenues.

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