COMPTROLLER of MARYLAND
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April 27, 2009

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:

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 American Recovery and Reinvestment Tax Act of 2009 (the Act). The Act makes a number of changes which would affect the calculation of Maryland tax and which would typically be evaluated to determine whether automatic decoupling under Tax-General §10-108(a) is necessary. During the recently completed 2009 Regular Session, however, the General Assembly enacted the Budget Reconciliation and Financing Act of 2009 (BRFA), which provides that the automatic decoupling provisions do not apply to any change included in the Act. In the absence of this provision, Maryland tax law would have been decoupled from changes to the federal earned income credit, the taxation of unemployment insurance benefits, and the deductibility of motor vehicle excise taxes for tax year 2009. The BRFA also explicitly and permanently decouples the Maryland income tax from the federal deferral of income arising from debt cancellation. Estimates of the impact of those and other provisions of the Act are discussed below.

The Act temporarily increases the federal earned income tax credit (EIC) for families with three or more children and for married individuals filing a joint return. Maryland's non-refundable EIC is up to one-half the federal EIC, while the maximum State refundable earned income credit is one-quarter of the federal EIC. As a result of the higher credit, the expected general fund revenue loss for tax year 2009 is about $7.6 million, an effect that will be felt in fiscal year 2010. For tax year 2010, the higher credit is expected to cost approximately $8.5 million, reducing revenues by that amount in fiscal year 2011. The temporary expansion sunsets at that point. In addition to the impact on State revenues, local governments will lose about $5.1 million and $5.7 million for tax years 2009 and 2010, respectively, due to the local non-refundable EIC. While local governments may adopt a refundable local EIC, none have done so, although Montgomery County has a grant that is based on the State's credit. Montgomery County revenues would decline significantly depending on the amount of the higher credit that is claimed by their residents.

The Act excludes up to $2,400 of unemployment insurance benefits from federal adjusted gross income for tax year 2009. Due to the BRFA's exclusion of automatic decoupling with respect to the Act, this change will flow through to the Maryland tax calculation and there will be a significant revenue loss to the State. The Bureau of Labor Statistics reported that there were 200,470 Marylanders unemployed as the end of February. Based on tax return data from previous years, approximately 81% of the total number of unemployed persons reported unemployment compensation on their tax returns. Thus, it is expected that more than 162,000 individuals will claim the full $2,400 exclusion. At a tax rate of 4.75%, State revenues are expected to decline by $18.5 million in fiscal year 2010. Assuming that taxpayers adjust their withholding because of this allowance, the State is expected to lose 25% of this amount ($4.6 million) in fiscal year 2009 and 75% ($13.9 million) in fiscal year 2010. To the extent that the unemployment rate continues to rise, the State would lose approximately an additional $200,000 for every percentage point increase in the unemployment rate. Local governments will lose roughly two-thirds of the State revenue loss.

The Act provides for a one-time deduction for the sales tax paid on the purchase of a new car, claimed as either as an addition to the federal standard deduction or as an itemized deduction. For taxpayers who claim the exemption as an additional federal standard deduction, the exemption will not flow through to Maryland tax. In addition, this provision will not affect taxpayers who already deduct the sales tax instead of income taxes as an itemized deduction, since the sales tax paid on a car is already including in that deduction; however, the number of taxpayers in this category is small. Finally, the provision may cause some taxpayers to switch from the standard deduction to itemized deductions in order to take advantage of a higher deduction at the State level, resulting in a larger overall reduction in tax liability. Again, however, this number is assumed to be small and therefore will not materially impact the overall revenue effect on the State.

Based on vehicle sales data from the first three months of 2009 and an assumption that the deduction will boost sales by 10%, Marylanders are expected to spend a total of approximately $6.1 billion on new cars in 2009. Using household income and expenditure data from the Bureau of Labor Statistics, the amount spent on new vehicles was allocated by income class in order to calculate the effect of the deduction's phase out provision. Actual tax return data from 2006 was used to determine the total amount deducted at each Maryland net taxable income class, and the applicable State tax rate was applied to determine the impact of the deduction for all taxpayers. The tax year 2006 data were also used to remove the revenue loss attributable to taxpayers who took the standard deduction, and whose State liability is therefore unaffected by the law change. As a result of the above facts and assumptions, general fund revenues are expected to decline by $8.0 million for tax year 2009. Because the per-person reduction in tax liability is generally small, taxpayers are not expected to adjust their withholding, therefore the entire revenue loss would occur in fiscal year 2010. Once again, the local government revenue loss is about two-thirds of the State's loss.

The Act allows income recognized from the cancellation of debt (CODI) in 2009 and 2010 to be deferred for five years, although the BRFA explicitly decouples Maryland's income tax from this change, so it will have no impact on Maryland tax revenues. Based on estimates from the Joint Committee on Taxation that approximately $150 billion of such income will be realized over this period, Maryland corporate income tax revenues could have declined by up to $116.0 million in fiscal year 2010 and $69.6 million in fiscal year 2011 without the decoupling, with a revenue increase when the CODI is ratably recognized beginning five years after tax year 2009. To the extent that such income is sheltered from Maryland's corporate income tax, the estimated revenue effect would be less

A provision of the Act that changes the ability of the banks to use certain built-in losses from an acquisition to offset tax liability will result in a revenue gain to the State. Previously, the Emergency Economic Stabilization Act of 2008 had allowed banks to recognize their total built-in losses when acquiring another bank in order to offset their existing tax liability. IRS Notice 2008-83, released following the passage of that Act, further relaxed the banks' use of these losses. The Act has now tightened the treatment of built-in losses as described in Internal Revenue Bulletin 2008-42. Using the JCT estimate of the revenue gain at the federal level, and the assumption that Maryland has a relatively small share of banking activity, 1% of any federal gains would be felt in the State. In fiscal year 2009, the State will gain $1.1 million, increasing to $4.3 million in fiscal year 2010. Another $3 million gain will occur in fiscal year 2011, with gradually smaller revenue increases in the out-years.

Finally, the modification of rules applicable to financial institutions for interest expense relating to tax-exempt income will reduce Maryland revenues by a relatively small amount beginning in fiscal year 2010. Assuming again that approximately 1% of the estimated federal revenue loss will be felt in Maryland, the State will lose $133,000 in fiscal year 2010 and $354,000 in fiscal year 2011, increasing modestly in subsequent years.

The above three provisions affect (or would have affected) the corporate income tax, and therefore would impact the general fund as well as distributions to the Transportation Trust Fund and the Higher Education Investment Fund.

One provision of the Act will have an indirect effect on Maryland revenues. The "Making Work Pay Credit," allows individuals a federal credit equal to 6.2% of earned income, up to a maximum of $400 ($800 for taxpayers filing a joint return). The credit is subject to a phaseout at higher income levels. It is estimated that Marylanders will spend about one-quarter of their credits on taxable goods, which would increase sales tax revenues by about $32.0 million in fiscal year 2009. This effect was accounted for in the Board of Revenue Estimates' March revenue revisions.

There are a number of provisions that do not affect Maryland revenues in any way, including new and modified federal tax credits and changes to the Internal Revenue Code from which the State is permanently decoupled, such as a five-year net operating loss carryback provision and allowances for bonus depreciation. Changes from all other provisions that may have a direct or indirect impact on Maryland revenues, including an increase in the alternative minimum tax exemption amount, 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

Peter Franchot

cc: Honorable Nancy K. Kopp
Secretary T. Eloise Foster