HB 875

Department of Legislative Services

Maryland General Assembly
2018 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 875 (The Speaker, *et al.*) (By Request - Administration)
Ways and Means

Protecting Maryland Taxpayers Act of 2018

This emergency Administration bill specifies that certain amendments of the Internal Revenue Code (IRC) that take effect after December 20, 2017, do not affect the State income tax, unless the Comptroller determines that the impact of the amendment will result in a decrease in State income tax revenue. The bill also allows an individual to itemize deductions for State income tax purposes without regard to whether or not the individual itemizes for federal income tax purposes. **The bill applies to tax year 2018 and beyond.**

Fiscal Summary

State Effect: The bill will prevent State revenue increases of $644.3 million in FY 2019, which reflects the impact of one and one-half of a tax year. Future year revenues reflect the ongoing annual impacts of federal provisions. General fund expenditures increase by $988,200 in FY 2019 due to implementation costs at the Comptroller's Office. Future years reflect ongoing expenditures.

($ in millions)	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
GF Revenue	($614.8)	($444.7)	($464.1)	($498.4)	($566.3)
SF Revenue	($29.5)	($21.5)	($23.1)	($27.4)	($37.7)
GF Expenditure	$1.0	$0.7	$0.7	$0.7	$0.8
Net Effect	($645.3)	($466.9)	($487.9)	($526.5)	($604.8)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate increase; (-) = indeterminate decrease

Local Effect: The bill will prevent local revenue increases of $308.1 million in FY 2019 and $260.5 million in FY 2023. Local expenditures are not affected.

Small Business Effect: The Administration has determined that this bill has a meaningful impact on small business (attached). The Department of Legislative Services concurs with this assessment.

Analysis

Bill Summary: The bill applies to any amendment of IRC that affects the determination of federal adjusted gross income or federal taxable income. For any amendment that impacts this determination, the State income tax will be "decoupled" from the federal amendment, unless the Comptroller determines that the change will result in a decrease in State income tax revenue. This provision does not apply in instances in which State law expressly provides a new federal law, an amendment to existing federal law, or repeal of existing federal law does not affect State law.

Current Law:

Federal Income Tax

To determine federal taxable income, a taxpayer may reduce their federal adjusted gross income by either claiming the standard deduction or itemizing allowable deductions.

The federal standard deduction in tax year 2018 increases to $12,000 for an individual taxpayer ($24,000, if married filing jointly, and $18,000 for a head of household). These values are indexed in future years for inflation.

Beginning in tax year 2018, the maximum State and local tax deduction is limited to $10,000 – $5,000 for married taxpayers filing separately – in aggregate of income or sales taxes, real property taxes, and certain personal property taxes.

Prior to tax year 2018, Section 68 of IRC required high-income taxpayers to reduce certain itemized deductions, including the State and local tax deduction, if certain conditions were met and the taxpayer's income exceeded specified amounts – $287,650 in tax year 2017 ($313,800 for married filing jointly). This limitation is repealed beginning in tax year 2018.

State Income Tax

An individual is allowed to itemize deductions for State income tax purposes only if the individual itemizes for federal income tax purposes. An individual who itemizes for State income tax purposes is required to reduce the sum of the individual's federal itemized deductions by any amount:

- required by IRC;
- deducted under Section 170 of IRC for contributions of a preservation or conservation easement for which a State credit is claimed; and

- claimed as taxes on income paid to a State or political subdivision of the State, after subtracting a pro rata portion of the reduction to itemized deductions required under Section 68 of IRC.

The value of the standard deduction is equal to 15% of Maryland adjusted gross income subject to minimum and maximum values, depending on filing status as shown in **Exhibit 1**.

Exhibit 1
State Standard Deduction

Single, Dependent Filer, Married Filing Separately		Joint, Head of Household, Widower	
MAGI	**Deduction**	**MAGI**	**Deduction**
Under $10,000	$1,500	Under $20,000	$3,000
$10,000-13,333	15%	$20,000-26,667	15%
Over $13,333	$2,000	Over $26,667	$4,000

MAGI: Maryland adjusted gross income

Comptroller Assessment and Federal Decoupling

The Budget Reconciliation and Financing Act of 2002 (Chapter 440) included a general one-year income tax "decoupling" provision. Within 60 days after an amendment of IRC is enacted, the Comptroller must submit a report to the Governor and the General Assembly that outlines the changes in IRC, the impact on State revenues, and how different types of taxpayers will be affected.

If the Comptroller determines that the federal tax change will impact State revenues by at least $5 million (positive or negative) in the fiscal year that begins during the calendar year in which the federal tax change was enacted, the federal tax change does not apply for Maryland income tax purposes for any taxable year that begins in the calendar year in which the federal tax change is enacted. Otherwise, the federal tax change applies for Maryland income tax purposes in that tax year. After this first tax year, amendments to IRC apply for Maryland income tax purposes unless otherwise explicitly provided by law.

Given the date of enactment of the federal Tax Cuts and Jobs Act of 2017, the automatic decoupling provision did not apply to the Act.

State Legislation Decoupling from Federal Provisions

State law has partially or fully decoupled from several recent federal income tax amendments. Most of these provisions primarily impacted businesses and include extended net operating losses, Section 179 expensing, bonus depreciation, and certain deferral of cancellation of debt income provisions.

Background:

Federal Tax Cuts and Jobs Act of 2017

The federal Tax Cuts and Jobs Act of 2017 (Public Law 115-97) was signed into law on December 22, 2017, and enacted significant changes to federal taxes, including the personal income tax. The U.S. Joint Committee on Taxation estimates that the Act will decrease federal revenues by $1.46 trillion in federal fiscal years 2018 through 2022. After accounting for the Act's estimated economic effects, the total loss will equal $1.07 trillion over the same time period.

The Act reduces income taxes paid by many households primarily by (1) decreasing tax rates and taxing income at lower rates by altering the tax brackets; (2) expanding the child tax credit; and (3) roughly doubling the value of the standard deduction. In addition, some high-income households will pay less taxes due to (1) a reduction in the alternative minimum tax and (2) the repeal of a limitation on itemized deductions that can be claimed by certain high-income taxpayers.

The Act also reduces or eliminates several existing income tax benefits by (1) eliminating the benefit of the federal personal exemption; (2) eliminating or reducing certain itemized deductions; and (3) using an alternative method of adjusting income tax components for inflation. Most of the personal income tax provisions are in effect for tax years 2018 through 2025.

Impact on Maryland Taxpayers

In January 2018, the Comptroller's Office issued an analysis of the impact of the federal Tax Cuts and Jobs Act of 2017 on Maryland taxpayers and State and local revenues. In its revised estimate issued in February 2018, the Comptroller's Office estimates that 71% of Maryland taxpayers will pay less in federal taxes, 13% will pay more, and the remaining 16% will not be impacted. In total, federal taxes paid by Maryland residents will decrease by $2.75 billion – reflecting a decrease of $3.54 billion paid by 2.0 million taxpayers and an increase of $782 million paid by 376,000 taxpayers.

Several provisions will impact State income taxes, including the elimination of miscellaneous deductions and a limitation on the value of the State and local taxes paid deduction. As a result of the increased value of the federal standard deduction, and that under current law only those taxpayers who itemize for federal income tax purposes can itemize on their State income tax return, the Act will also reduce the number of State taxpayers who itemize deductions.

The Comptroller's Office estimates that the federal legislation will not impact the State and local income taxes paid by 71% of all taxpayers. About 6% of taxpayers will pay less and about 23% will pay additional State and local income taxes. In total, the Comptroller's Office estimates that 9% of all taxpayers will have a net increase in federal, State, and local tax liabilities and the remaining 91% of taxpayers will have no change or a net decrease in federal, State, and local tax liabilities.

As a result, the Comptroller's initial estimate is that the direct change to the State personal income tax in fiscal 2019 will result in a net additional $572.3 million in State and local taxes paid ($361.1 million, State; and $211.2 million, local). In fiscal 2020, the increase will total $451.0 million ($284.4 million, State; and $166.6 million, local). A significant portion of the revenue gain is due to the shift in taxpayers who will now claim the standard deduction. The Comptroller's Office estimates that up to 700,000 taxpayers who would have itemized deductions will now claim the State standard deduction, due to the federal Act.

State Revenues: The bill specifies that certain amendments of IRC that take effect after December 20, 2017, do not affect the State income tax, unless the Comptroller determines that the impact of the amendment will result in a decrease in State income tax revenues. The bill also allows an individual to itemize deductions for State income tax purposes without regard to whether or not the individual itemizes for federal income tax purposes.

It is assumed that the intent of the legislation is to decouple the State income tax from federal amendments that increase State revenues. Federal amendments that are determined by the Comptroller to be revenue neutral or decrease State revenues are not impacted.

Appendix 1 lists the significant provisions of the federal Tax Cuts and Jobs Act that primarily impact individuals and that the Comptroller estimates will increase State revenues. Accordingly, the bill will decouple the State income tax from these provisions. **Appendix 2** lists provisions that primarily impact individuals that the State will conform to as the Comptroller estimates that the provisions will not increase State revenues. **Appendix 3** lists the significant business provisions that the State income tax will decouple from, as the Comptroller has estimated the provisions will increase State revenues. **Appendix 4** lists significant business provisions that the State will conform to as the Comptroller estimates that the provisions will not increase State revenues.

Exhibit 2 shows the projected State and local revenue loss from the bill. The fiscal impact of provisions that primarily impact individuals is detailed in **Appendix 5**. **Appendix 6** details the impact of the business provisions.

Exhibit 2
Projected State and Local Revenue Impact
($ in Millions)

	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
General Funds	($614.8)	($444.7)	($464.1)	($498.4)	($566.3)
HEIF	(8.6)	(6.3)	(6.7)	(8.0)	(11.0)
TTF	(20.9)	(15.2)	(16.4)	(19.4)	(26.7)
MDOT	*(18.9)*	*(13.8)*	*(14.8)*	*(17.5)*	*(24.2)*
Local	*(2.0)*	*(1.5)*	*(1.6)*	*(1.9)*	*(2.6)*
Total	**($644.3)**	**($466.2)**	**($487.2)**	**($525.8)**	**($604.0)**
Local Income Tax Revenues	**($306.1)**	**($222.0)**	**($230.1)**	**($241.0)**	**($257.9)**

Most of the federal Act's personal income tax provisions expire after tax year 2025. The revenue impact of the bill will be substantially less beginning in fiscal 2027.

Given the timing of the federal legislation, the estimated net revenue impact of the federal Act was not included in the Governor's proposed fiscal 2019 budget. The Board of Revenue Estimates will revise the March estimates to include the estimated net State and local revenue impact of the federal Act. The estimated impact includes additional revenue generated from the increased number of individuals who will now claim the standard deduction under current law. Accordingly, the bill will prevent revenue increases of $644.3 million in fiscal 2019. Since the bill will only decouple from the federal Act's provisions that increase State revenues, the impact of the bill is greater than the revenues that will be realized in March. Accordingly, a portion of the revenue impacts shown in Exhibit 2 reflects revenue losses relative to the revenues assumed in the proposed fiscal 2019 budget.

State Expenditures: The Comptroller's Office advises that it will incur additional costs beginning in fiscal 2019 as a result of hiring additional revenue examiners and incurring programming expenses in order to allow State taxpayers the option of itemizing. Based on a preliminary estimate, general fund expenditures increase by $988,200 in fiscal 2019, which reflects a January 1, 2019 hiring date. It includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Positions	10
Salaries and Fringe Benefits	$336,175
Operating Expenses	52,025
Programming Expenditures	600,000
Total FY 2019 Expenditures	**$988,200**

Future year expenditures reflect full salaries with annual increases and employee turnover as well as ongoing operating expenses.

Significant additional compliance costs will likely be incurred in the Comptroller's Office related to decoupling from IRC as State income tax audits will need to be conducted separately from federal Internal Revenue Service audits. These costs cannot be quantified and will depend on the number of State audits and the complexity of conducting State audit investigations independent of federal audits.

The Comptroller did not provide an estimate in time for inclusion in this fiscal and policy note of the implementation costs associated with decoupling from federal amendments as required by the bill.

Local Revenues: The bill will prevent local revenue increases of $308.1 million in fiscal 2019 and $260.5 million in fiscal 2023, as shown in Exhibit 2.

Additional Information

Prior Introductions: None.

Cross File: SB 733 (The President, *et al.*) (By Request - Administration) - Budget and Taxation.

Information Source(s): Department of Legislative Services

Fiscal Note History: First Reader - February 27, 2018
md/hlb

Analysis by: Robert J. Rehrmann

Direct Inquiries to:
(410) 946-5510
(301) 970-5510

Appendix 1
Federal Tax Cuts and Jobs Act
Provisions that Increase State Revenues – Individuals

The following federal amendments enacted by the Tax Cuts and Jobs Act have been determined by the Comptroller to increase State revenues. Under the bill's requirements, the State will ***decouple*** from the following provisions that are generally in effect in tax years 2018 through 2025.

Miscellaneous Deductions: The federal Act repeals miscellaneous itemized deductions including unreimbursed employee and tax preparation expenses. Expenses were generally deductible to the extent total deductions exceeded 2% of federal adjusted gross income. The bill will allow taxpayers to continue to claim these itemized deductions.

State and Local Taxes Paid Deduction: Beginning in tax year 2018, the maximum State and local tax deduction that can be claimed for federal income tax purposes is generally limited to $10,000. The bill will allow a taxpayer who itemizes deductions for State income tax purposes to deduct the combined real estate and sales taxes in excess of $10,000 without regard to the federal limitation enacted to the deduction.

Mortgage Interest Deduction: Under prior law, a taxpayer could deduct the interest paid on up to $1 million in qualifying home acquisition debt and up to $100,000 in home equity loans. The federal Act lowers the deductibility of interest to $750,000 in the combined amount of loans used to buy, build, or substantially improve the taxpayer's main home and second home. This limitation does not apply to existing loans (as of December 15, 2017). The interest paid on a home equity loan may only be deducted if the loan is used for home improvement; any loan for other purposes such as purchasing a vehicle or paying off credit card debt is not deductible beginning with tax year 2018. The bill will continue to allow taxpayers to itemize certain home mortgage and equity interest without regard to the new limitations enacted by the Act.

Moving Expenses: Prior to tax year 2018, individuals could claim an above-the-line deduction for employment-related moving expenses. In addition, qualified employer-reimbursed moving expense reimbursements were excluded from an employee's gross income. The federal Act generally repeals these provisions, except for provisions that apply to military members. Accordingly, the bill will allow taxpayers who are not members of the military to continue to claim the benefits.

Casualty and Theft Losses Deduction: Prior federal law allowed taxpayers to claim a deduction for certain uncompensated losses that were sustained during the taxable year. The federal Act limits the deduction to losses attributable to a federally declared disaster. The bill will allow taxpayers to continue to deduct losses that are not attributable to federal disasters.

Appendix 2
Federal Tax Cuts and Jobs Act
Provisions that Decrease State Revenues – Individuals

The following federal amendments enacted by the Tax Cuts and Jobs Act have been determined by the Comptroller to increase State revenues. Under the bill's requirements, the State will ***not decouple*** from the following provisions.

Repeal of Itemized Deduction Limitation for Certain High-income Taxpayers: Prior to tax year 2018, Section 68 of the Internal Revenue Code (IRC) required high-income taxpayers to reduce certain itemized deductions, including the State and local tax deduction, if certain conditions were met and the taxpayer's income exceeded specified amounts – $287,650 in tax year 2017 ($313,800 for married filing jointly). This limitation is repealed beginning in tax year 2018. The repeal will allow taxpayers who itemize and were subject to the limitation to deduct additional expenses for federal and State income tax purposes.

Expansion of 529 Plans: The federal Act expands the permissible use of 529 plans by amending qualified higher education expenses to include expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school. An account holder can withdraw up to $10,000 in each year for expenses associated with enrollment at these schools for each qualified beneficiary, regardless of whether the funds are distributed from multiple accounts. These changes will allow an account holder to claim the State subtraction modification for qualified contributions to the Maryland College Investment Plan and qualified investment gains and distributions from these plans will not be taxable for State income tax purposes.

Alimony Payments: Prior federal law provided that a taxpayer who pays alimony may deduct the amount of alimony payments made during the year. A taxpayer who receives alimony must declare the money received as income. The Act (1) eliminates the deduction for the alimony payments made by the payor spouse and (2) repeals provisions that specify that alimony payments are included as income to the recipient. The changes are generally effective for any divorce or separation instrument executed after December 31, 2018.

Medical Expenses Deduction: Prior federal law allowed a taxpayer to deduct unreimbursed medical expenses to the extent the expenses exceeded 10% of their federal adjusted gross income. For tax years 2017 and 2018 this limitation is reduced to 7.5%; thereby allowing taxpayers to deduct additional medical expenses for federal and State income tax purposes.

Appendix 3
Federal Tax Cuts and Jobs Act
Provisions that Increase State Revenues – Businesses

Net Interest: The Act disallows the deduction of net interest expense to the extent the interest exceeds 30% of a taxpayer's adjusted taxable income. Certain businesses, including taxpayers with an average of $25 million in gross receipts over the three prior years, are exempt from the limitation. Adjusted taxable income does not include business interest or business interest income, a 20% deduction for certain pass-through entities, net operating losses (NOLs), and for tax years prior to tax year 2022, any deduction for depreciation, amortization, or depletion. Given the State has decoupled from expensing provisions for most businesses and different composition of taxpayers on the State and federal level, there is considerable uncertainty over the State-level impact.

Net Operating Losses: The Act limits the NOL deduction to 80% of federal taxable income, without regard to the deduction. The Act also repeals the 2-year carryback (except for certain farming losses) and special carryforward provisions, although unused losses can be carried forward indefinitely. For property and casualty insurance companies, a 2-year carryback and 20-year carryforward provision is allowed. These provisions apply to losses arising on or after December 31, 2017.

Meals/Expenses Deduction: The Act disallows the meal and entertainment expense deduction for entertainment; amusement or recreation activities; membership dues to clubs organized for business, pleasure, recreation or other social purposes; or a facility used in connection with any of these activities. These changes apply to amounts incurred and paid after December 31, 2017. Taxpayers may continue to deduct 50% of food and beverage expenses required for operation of the trade or business. This deduction is expanded to include food and beverages provided to employees through an eating facility that meets certain requirements, but only for amounts incurred and paid after December 31, 2017, through December 31, 2025; after December 31, 2025, these expenses will no longer be deductible.

Transportation Fringe Benefits Deduction: For costs incurred before December 31, 2017, an employer could generally deduct the cost of providing qualified transportation benefits. The Act generally disallows a deduction for expenses associated with providing any qualified transportation fringe to employees of the taxpayer, and except as necessary for ensuring the safety of an employee, any expense incurred for providing transportation (or any payment or reimbursement) for commuting between the employee's residence and place of employment.

Appendix 4
Federal Tax Cuts and Jobs Act Provisions that Decrease State Revenues – Businesses

Section 179 and Bonus Depreciation: Businesses typically depreciate property over a number of years according to depreciation methods and schedules. Since 2003, the U.S. Congress has enacted several laws that allow certain businesses to recover the costs of certain capital over a quicker period of time. Section 179 of the Internal Revenue Code allows qualifying businesses to deduct the full cost of qualifying property in the same tax year, subject to an overall limit. The benefit also phases out on a dollar-for-dollar basis once a company's total investments in the year exceed a specified amount. Section 168(k) allows companies to take additional "bonus" depreciation.

The federal Act enhances Section 179 expensing by increasing the deduction limit to $1 million and the investment phase out to $2.5 million, making at least part of the deduction available to businesses that make less than $3.5 million in annual investments. The Act also expands the types of property that qualify for the deduction; these changes apply to property placed in service after December 31, 2017.

The Act also allows a business to claim 100% bonus depreciation on qualified property acquired and placed in service after September 27, 2017, but before January 1, 2023. The bonus depreciation is phased down by 20% in each year for property placed in service in calendar 2023 through 2026.

Most businesses will not be able to claim the benefits for State income tax purposes as the Maryland income tax is generally decoupled from the enhanced deductions under Section 179 and bonus depreciation. However, legislation enacted in 2017 allowed manufacturers to claim the enhanced benefits for property placed in service after December 31, 2019.

Small Business Accounting Reform: Taxpayers generally use either an accrual or cash method of accounting. The cash method is typically less administratively burdensome and provides flexibility in the timing of income recognition. The federal Act allows additional taxpayers to use the cash method, exempts certain businesses from the requirement to maintain inventories, and expands the exception under current law from the uniform capitalization rules.

Appendix 5
State and Local Fiscal Impact of the Bill
Individual Provisions
($ in Millions)

	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
State Revenues					
Miscellaneous Deductions	$197.1	$145.1	$149.7	$154.3	$159.3
Allow Itemizing	162.2	113.3	116.8	120.4	122.4
State and Local Tax Deduction	44.8	33.0	34.0	35.1	36.2
Personal Casualty/Loss	16.9	11.5	11.9	12.2	12.6
Mortgage Interest	11.4	8.0	8.5	8.9	9.2
Moving Expenses	6.8	5.0	5.2	5.4	5.5
Total State	**$439.3**	**$316.0**	**$326.1**	**$336.2**	**$345.3**
Local Revenues					
Miscellaneous Deductions	$128.7	$93.5	$96.5	$99.4	$102.7
Allow Itemizing	94.7	66.1	68.2	70.3	71.5
State and Local Tax Deduction	26.2	20.6	21.2	21.9	22.6
Personal Casualty/Loss	9.0	6.5	6.7	6.9	7.2
Mortgage Interest	6.1	4.6	4.8	5.0	5.2
Moving Expenses	4.6	3.4	3.5	3.6	3.7
Total Local	**$269.2**	**$194.6**	**$200.9**	**$207.1**	**$212.9**

Appendix 6
State and Local Fiscal Impact of the Bill
Business Provisions
($ in Millions)

	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
Corporate and Personal Income Tax					
Net Interest	$127.0	$87.3	$96.7	$122.4	$188.0
Net Operating Losses	36.1	36.1	36.1	36.1	36.1
Disallow Deduction/Meals	14.5	8.6	9.0	9.8	10.7
Disallow Deduction/Transportation	11.3	7.1	7.6	8.5	9.6
Other Provisions	16.1	11.1	11.8	12.8	14.4
Total	**$205.0**	**$150.2**	**$161.1**	**$189.6**	**$258.7**
Local Income Tax Revenues					
Net Interest	$20.0	$13.8	$15.2	$19.3	$29.6
Net Operating Losses	7.5	7.5	7.5	7.5	7.5
Disallow Deduction/Meals	2.5	1.5	1.6	1.7	1.9
Disallow Deduction/Transportation	2.0	1.2	1.3	1.5	1.7
Other Provisions	4.8	3.3	3.5	3.9	4.3
Total	**$36.9**	**$27.3**	**$29.2**	**$33.8**	**$45.0**

ANALYSIS OF ECONOMIC IMPACT ON SMALL BUSINESSES

TITLE OF BILL: **Protecting Maryland Taxpayers Act of 2018**

BILL NUMBER: SB0733/HB0875

PREPARED BY: Governor's Legislative Office

PART A. ECONOMIC IMPACT RATING

This agency estimates that the proposed bill:

____ WILL HAVE MINIMAL OR NO ECONOMIC IMPACT ON MARYLAND SMALL BUSINESS

OR

__X__ WILL HAVE MEANINGFUL ECONOMIC IMPACT ON MARYLAND SMALL BUSINESSES

PART B. ECONOMIC IMPACT ANALYSIS

This legislation would likely have a significant benefit to small business, through reduction in State Tax liability on pass-through entities. An exact financial benefit, however, is extremely difficult to quantify.