Department of Legislative Services

Maryland General Assembly
2005 Session

FISCAL AND POLICY NOTE
Revised

House Bill 1360 (Delegates Gordon and Patterson)
Ways and Means

Income Tax - Effect of Amendment of Internal Revenue Code

This bill provides that, unless expressly provided otherwise by law, the State is permanently decoupled from any amendment to the Internal Revenue Code (IRC) enacted after January 1, 2005. In addition, the bill permanently decouples the State from the federal deduction allowed for qualified production activity income under Section 199 of the IRC. The bill also requires the Comptroller to review amendments to the IRC and submit specified information to the General Assembly and the Governor.

The bill takes effect July 1, 2005 and applies to tax year 2005 and beyond.

Fiscal Summary

State Effect: General fund and Transportation Trust Fund (TTF) revenues could increase or decrease depending on whether a federal tax act enacted after January 1, 2005 increases or decreases Maryland taxable income. The following table only includes the impact of decoupling from the federal domestic production deduction. General fund expenditures would increase by approximately $66,600 at the Comptroller's Office, which reflects the hiring of a staff attorney to monitor and analyze federal legislation.

($ in millions)	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
GF Revenue	$13.7	$12.5	$17.1	$20.7	$25.2
SF Revenue	4.3	4.0	5.4	6.5	8.0
GF Expenditure	.1	.1	.1	.1	.1
Net Effect	$18.0	$16.4	$22.4	$27.2	$33.1

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

Local Effect: Local highway user revenues as a result of decoupling from the federal domestic production deduction could increase by $1.3 million in FY 2006 and $2.4

million in FY 2010. Decoupling from the Tsunami Disaster Aid Tax Relief Act would increase local income tax revenues in FY 2005 and decrease local income tax revenues by a corresponding amount in FY 2006. Local revenues could increase or decrease depending on whether a federal tax act increases or decreases local income tax revenues or local highway user revenues distributed from the TTF.

Small Business Effect: Meaningful impact as discussed below.

Analysis

Bill Summary: The bill permanently decouples the State from any amendment to the IRC enacted after January 1, 2005 and the federal qualified production activity income under Section 199 of the IRC. Within 60 days after an amendment of the IRC the Comptroller is required to submit a report to the Governor and the General Assembly that outlines the changes in the IRC and the impact that those changes would have on State revenues and various classes and types of taxpayers if adopted by the State. By January 15 of each year, the Comptroller is required to submit to the General Assembly proposed legislation that would amend State law to adopt the IRC as it existed on December 31 in the previous year. In addition, the Comptroller is required to prepare a digest and explanation of the amended provisions of the IRC recommended for adoption as well as those that "will be limited in their operation" or are not recommended for adoption.

Current Law: Within 60 days after an amendment of the IRC is enacted, the Comptroller must submit a report to the Governor and the General Assembly that outlines the changes in the 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 the IRC apply for Maryland income tax purposes unless otherwise explicitly provided by law.

Background: The Budget Reconciliation and Financing Act of 2002 (Chapter 440) established the automatic one year decoupling provision. The provision was enacted in response to bonus depreciation and net operating loss changes enacted by the federal Job Creation and Worker Assistance Act of 2002.

The American Jobs Creation Act of 2004 (AJCA), P.L. 108-357, was signed into law on October 22, 2004. The law represented one of the most extensive revisions in corporate taxes since the 1986 Tax Reform Act. It amended nearly 600 code sections. The centerpiece of the AJCA is the repeal of the tax code's extraterritorial income (ETI) exclusion, which had been ruled as an illegal export subsidy by the World Trade Organization, and the replacement of the ETI with a 9% domestic deduction for a range of broadly defined domestic production activities.

Domestic production activity is broadly defined under the AJCA to include manufacturing, construction (including engineering and architectural services related to construction), energy production, production of computer software, film production, and processing of agricultural products. Under the Act, the deduction will be 3% of income attributable to production activities in tax year 2005, increasing by three percentage points in both 2007 and 2010, at which point the deduction will be 9% of income attributable to production activities. The Joint Committee on Taxation has estimated that this deduction will result in a loss of federal income tax revenue of $2.1 billion in federal fiscal 2005 and $3.1 billion in 2006, increasing to $10.7 billion in 2010. This deduction will flow through in the Maryland income tax calculation as it reduces federal taxable income.

On January 7, 2005, President Bush signed into law the Tsunami Disaster Aid Tax Relief Act. This Act provided that charitable cash contributions made in January 2005 for relief of victims of the December 26, 2004 Indian Ocean tsunami could be deducted for tax year 2004.

State Revenues: The bill would have two effects on State revenues. First, the bill decouples the State from the qualified production activities income deduction under Section 199 of the IRC. Second, the bill would decouple the State from any federal tax amendment enacted after January 1, 2005. The Comptroller's Office has identified one federal tax act that this provision would apply to so far: the Tsunami Disaster Aid Tax Relief Act.

Decoupling from Federal Production Activities Deduction

Exhibit 1 lists the estimated effect of decoupling the State from the federal qualified production activities income deduction.

Exhibit 1
Revenue Increases
Decoupling from Production Activities Deduction
($ in Millions)

	FY 06	FY 07	FY 08	FY 09	FY 10
General Funds	$13.7	$12.5	$17.1	$20.7	$25.2
TTF (Total)	4.3	4.0	5.4	6.5	8.0
TTF – State	3.0	2.8	3.8	4.6	5.6
TTF – Local	$1.3	$1.2	$1.6	$2.0	$2.4

The estimated State fiscal impact is based on Joint Committee on Taxation estimates for the federal tax effect of the deduction, adjusted for estimated federal tax rates, Maryland's share of the national economy, and State tax rates. Fiscal 2006 represents the impact of all of tax year 2005 and one-half of tax year 2006. Future years reflect the impact of one-half of the prior tax year and one-half of the current tax year.

Decoupling from Tsunami Disaster Aid Tax Relief Act

Decoupling from this provision would increase State revenues in fiscal 2005 and decrease State revenues by a corresponding amount in fiscal 2006. The amount of revenue change in each year depends on the amount of qualifying contributions made by Maryland taxpayers in January 2005 and cannot be reliably estimated.

Decoupling from Other Tax Acts Enacted After January 1, 2005

Under current law, the State is automatically decoupled from any federal provision that has at least a $5 million impact on State revenues in the fiscal year that begins in the calendar year in which the tax change is enacted. This bill would extend decoupling to (1) federal tax acts with less than a $5 million impact in the first fiscal year impacted by the IRC amendment; and (2) all fiscal years afterwards.

The impact of permanently decoupling from all federal amendments to the IRC enacted after January 1, 2005 depends on the tax policies adopted by the federal government and cannot be reliably estimated. General fund revenues and TTF revenues would increase if a federal tax act would have acted to decrease Maryland taxable income. General fund

revenues and TTF revenues would decrease if a federal tax act would have acted to increase Maryland taxable income.

State Expenditures: The Comptroller's Office is required to monitor and analyze amendments to federal law and draft proposed legislation that would conform State law to federal law. As a result, the general fund expenditures at the Comptroller's Office would increase by an estimated $66,202 in fiscal 2006. This estimate reflects the hiring of one attorney and the July 1, 2005 effective date of the bill. The following estimate includes a salary, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Salary and Fringe Benefits	$60,957
Furniture and Computer Equipment	4,810
Other Operating Expenses	435
Total FY 2006 State Expenditures	**$66,202**

Future year expenditures reflect: (1) full salaries with 4.6% annual increases and 3% employee turnover; and (2) 1% annual increases in ongoing operating expenses.

In addition, to the extent that a federal tax act amends the IRC in a complex manner, the Comptroller's Office could incur additional contracting costs to review and analyze the legislation in a timely manner.

Small Business Effect: Small businesses could be positively or negatively impacted by the bill. Small business impacts of federal tax changes, whether positive or negative, would not flow through to the State income tax. Decoupling from the federal domestic production deduction would negatively impact small businesses that take the federal deduction.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Comptroller's Office, Ernst & Young, Joint Committee of Taxation, Department of Legislative Services

Fiscal Note History: First Reader - March 8, 2005
mll/hlb Revised - Correction - March 22, 2005

Analysis by: Robert J. Rehrmann

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