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Testimony Of
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Before the
Maryland House of Delegates Ways and Means Committee

Hearing on H.B. 495, CARES Act Decoupling and Decoupling from Costly Retroactive Federal Tax Changes
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Chair Kaiser and Members of the Ways and Means Committee, I'm Michael Mazerov, a Senior Fellow with the State Fiscal Policy division of the Center on Budget and Policy Priorities in Washington, D.C. The Center is a non-partisan research and policy institute that pursues federal and state policies designed to reduce poverty and inequality and to restore fiscal responsibility in equitable and effective ways. We apply our expertise in budget and tax issues and in programs and policies that help low-income people to help inform debates and achieve better policy outcomes. I appreciate the opportunity to testify in support of H.B. 495.

Delegate Palakovich Carr's bill would close a loophole in Maryland's tax law that allowed several costly changes in federal tax law included in the March 2020 CARES Act to flow automatically into the state's tax law and reduce its revenues by an estimated $97.5 million in fiscal years 2020 and 2021 combined. Maryland has had a provision in its law for many years ensuring that any federal tax changes that would reduce revenue by more than $5 million annually do not take effect until the legislature affirmatively decides to recognize them. But when the provision was written, no one considered that Congress might reduce federal taxes retroactively for a tax year earlier than the one already underway. Congress took that virtually (if not completely) unprecedented step in the CARES Act, relaxing limits it had enacted less than three years earlier on the deductibility of business losses and business interest in the 2017 Tax Cuts and Jobs Act and doing so retroactively for tax years 2018 and 2019. Earlier this year, the Comptroller determined that the specific wording of the $5 million revenue loss provision did not allow it to apply to 2018 and 2019 tax years, circumventing the clear intention of the legislature in enacting the provision to begin with. The first thing H.B.495 does is to close that loophole going forward.

The other thing it does is to decouple from several of the mostly costly CARES Act tax changes to recoup the unanticipated revenue loss. Such decoupling is fully justified on the merits. I wrote a long report in December making the case for decoupling from three business loss-related provisions of the CARES Act. (See: "First, Do No Harm: States Can Preserve Revenue by Decoupling From CARES Act Tax Breaks for Business Losses," Revised January 4, 2021, https://www.cbpp.org/sites/default/files/atoms/files/12-17-20sfp.pdf .) I will briefly summarize these provisions and explain why decoupling from them is justified on the merits:

Maryland should decouple from a CARES Act provision allowing an unlimited amount of losses from ownership of "passthrough" businesses to offset non-business income. One TCJA provision limited the extent to which owners of businesses legally structured as so-called "passthroughs" — sole proprietorships, partnerships, S corporations, and limited liability companies — could use losses from those businesses to shelter unrelated investment income from taxation. Under that provision, business losses could offset no more than $500,000 of investment income of a married couple in the tax year in which they were incurred. Any losses above that amount — deemed "excess business losses" — had to be subtracted from *future* income. But the CARES Act suspended that limit, and indeed it did so retroactively for tax years 2018 and 2019 as well as for 2020.

This suspension only benefits very high-income taxpayers; the congressional Joint Committee on Taxation estimated that more than 80 percent of the forgone federal revenue would be reaped by just 43,000 taxpayers with incomes over $1 million who would have their taxes cut an average of $1.6 million. Several tax experts have identified real estate and hedge fund investors as those most likely to benefit, and in many cases the "losses" they are deducting are only on paper and attributable to overly generous deductions for building and equipment purchases and other tax breaks. Moreover, many of the losses that taxpayers will now be able to deduct fully were experienced in 2018 and 2019, before the pandemic hit. Finally, some of the losses will be those of out-of-state businesses; in other words, Maryland will be forgoing revenue to cut taxes for businesses that are not creating or preserving existing jobs for its residents. In short, this CARES Act provision represents more of an effort to shovel tax refunds to rich people than a carefully targeted strategy to assist businesses that have suffered true economic losses resulting from the recession. Maryland should decouple and retain the TCJA limit, as provided for in H.B. 495.

Maryland should decouple from a provision allowing corporate and passthrough business losses to be used to offset profits in past years. In addition to eliminating the ability of passthrough business owners to use their businesses' *current-year* losses to offset *current-year* investment income, TCJA eliminated the ability of both passthroughs and corporations to use current-year losses to offset *prior-year* profits. Prior to TCJA, such businesses had been allowed to "carry back" their "net operating losses" (NOLs) to years in which they were profitable and (by filing amended tax returns for those years) receive refunds of some of or all the taxes they had already paid on those profits. TCJA eliminated business loss carrybacks, while retaining longstanding provisions that allow current year losses to be subtracted from profits earned in future years (NOL "carryforwards"). However, the CARES Act not only reinstated NOL carrybacks, it did so retroactively for the 2018 and 2019 tax years (again, before the pandemic) and, moreover, allowed losses to be used to get refunds of taxes paid as far back as 2013. (Previously, loss carrybacks had generally been limited to the two prior years.)

Although there are serious problems with the specific way in which the CARES Act reinstated NOL carrybacks, carrybacks are justifiable in principle as an element of *tax* policy. But because states must balance their budgets even during recessions, carrybacks are ill-advised from the standpoint of *state fiscal policy*; at the very time states are losing corporate and individual income tax revenues because many businesses are less profitable or even losing money, allowing carrybacks during a recession compounds state revenue shortfalls by compelling them to refund taxes they have already collected. For this reason, a large majority of states have eliminated loss carryback deductions for their *corporate* income taxes (while retaining carryforwards). Nonetheless, Maryland conforms to federal loss carryback provisions for both corporations and passthrough businesses. Maryland should decouple from loss carryback deductions while retaining deductions for NOL carryforwards, as provided for in H.B. 495.

Maryland should decouple from a CARES Act provision lifting the cap on the use of corporate and passthrough business losses to offset profits in future years. Finally, a new provision in TCJA prevented businesses from *zeroing-out* their tax liability in years in which they are profitable by deducting losses carried forward from prior years. This provision allowed NOL carryforwards to offset no more than 80 percent of current year profits. The CARES Act, however, removed this limit, once again for the pre-pandemic tax years of 2018 and 2019 as well as for 2020. As a result, a business that experienced a loss in 2018 could deduct 100 percent of that loss against profits realized in 2019 and 2020, and a business that had a loss in 2019 will be able to deduct 100 percent of that loss when it goes to file its 2020 tax return this year. In other words, the main beneficiaries of this provision are going to be those businesses that were losing money before the pandemic but managed to be profitable in 2020 in spite of it — hardly those most in need of tax reduction. Moreover (as was the case with the excess business loss provision), some of these losses carried forward will not be true economic losses but instead will result from provisions of the tax laws that allow taxpayers to concentrate certain expenses in particular tax years rather than spread them out over the period in which they will actually generate income. Accordingly, Maryland should decouple from this CARES Act provision as well, again, as provided for in H.B. 495.

Finally, it should be point out that that decoupling from these three provisions will not deny a large majority of taxpayers any deductions to which they are legitimately entitled. All the losses affected by decoupling can be carried forward as deductions against the future profits of the business or, in the case of the excess business loss provision, the future investment income of the business owner. In other words, staying coupled to the more restrictive TCJA treatment of losses only affects when business losses can be deducted, not if they can be.

I urge the committee to favorably report H.B. 495. Going forward, it closes the loophole that resulted in the kind of large, automatic revenue losses that longstanding state policy had sought to prevent. And it recoups those revenue losses through changes in tax policy that are fully justified on the merits.

I thank the Committee for the opportunity to testify today. I may be reached at mazerov@cbpp.org if Committee members have any further questions.