COMPTROLLER of MARYLAND
Serving the People

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Comptroller

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June 12, 2020

Honorable Lawrence J. "Larry" Hogan
Governor of Maryland
State House
Annapolis, Maryland 21404

Honorable William C. Ferguson IV
President of the Senate
State House
Annapolis, Maryland 21404

Honorable Adrienne A. Jones
Speaker of the House
State House
Annapolis, Maryland 21404

Dear Governor, President, and Speaker:

As required by Tax – General §10-108 of the Annotated Code of Maryland (TG § 10-108), I am submitting this report on the impact of recent changes to the Internal Revenue Code (IRC) on Maryland tax revenues. The President signed into law H.R. 748, the Coronavirus Aid, Relief, and Economic Security Act (the Act), on March 27, 2020. The Act temporarily altered multiple tax provisions enacted under the Tax Cuts and Jobs Act (TCJA) to increase real cash flow and reduce the income tax burden on businesses, partners, and sole proprietors. Some of the changes are retroactive and thus extend to past tax years. TG § 10-108 provides that when the tax revenue impact resulting from an amendment to the IRC is $5 million or more, the State is automatically and temporarily decoupled from that amendment for any taxable year beginning in the calendar year in which the law is enacted. A summary of the impact by fund before decoupling is below.

Table 1: Impact on State Revenues by Fiscal Year

$ millions	2020	2021
General Fund	-47.0	-236.5
Transportation Trust Fund	-3.1	-14.9
Higher Education Investment Fund	-1.3	-6.1
Total	**-51.4**	**-257.5**

The following changes made under the Act significantly impact tax revenue through their alteration of taxable income:

1) temporarily and retroactively loosened the Net Operating Loss (NOL) lookback provisions for tax years 2018, 2019, and 2020 previously enacted under the TCJA in IRC 172;
2) decreased the TCJA limitation on business interest expenses subject to deduction in tax years 2019 and 2020 under IRC 163(j); and
3) eliminated loss limitations imposed on non-corporate taxpayers by the TCJA under IRC 461(l) for tax years 2018, 2019, and 2020.

Decoupling – The Act Creates Decoupling Complexities

TG § 10-108 authorizes the State to decouple from changes to the IRC that effect a tax year that begins in the calendar year that the amendment is enacted. I believe the intent of the decoupling language in TG § 10-108 is to prevent a change to the federal tax code from significantly impacting State revenues until the legislature has had the opportunity to either accept (by taking no action and allowing it to flow-through) or to deny the change (by passing legislation to decouple). However, it appears that the current statute did not contemplate the passage of federal legislation that in its year of enactment, would alter the computation of taxable income for tax periods beginning in prior calendar years. The Act, which was enacted in calendar year 2020, modified provisions applicable to tax years beginning in 2018, 2019, and 2020. The statutory language so specifically identifies the period for which the state is authorized to decouple that we could not interpret the provision to automatically decouple the State from the federal provisions that impact tax years beginning prior to 2020. We estimate that each of the key provisions would have an impact greater than $5 million for each individual tax year. Therefore, pursuant to TG § 10-108, we auto-decouple from the provisions discussed in this document for tax year 2020, but we do not decouple from any of the provisions for tax years prior to 2020. Naturally, in addition to reducing revenues, this creates complexity for taxpayers, tax professionals, and the administration of the tax code by the Comptroller's Office.

Uncertainty – Both in Economic Terms as well as in Taxpayer Impacts

Because of the impact of the Covid-19 pandemic and efforts to contain it, there is considerable uncertainty at the present time regarding the accuracy of these estimates, particularly with respect to the computation of business losses. Losses will exceed those reported in the Comptroller's 60 Day Report for the TCJA and significantly impact revenue estimates. The Act allows taxpayers to carry back losses to a time when federal tax rates, particularly the corporate income tax rate, were higher. The State is currently decoupled from some federal tax provisions that generate or increase business losses. Both facts mean that the impact on the State will be proportionately less than the impact on the federal government, after adjusting for current tax rates. Given that less than a month is left in fiscal year 2020 at the time of publication, the estimated impact from tax years 2020 and prior is assumed to be realized mostly in fiscal year 2021 rather than fiscal year 2020. Amended returns are more complex than the typical return and therefore take longer to process.

Furthermore, it is uncertain how taxpayers and the State might react to the decoupling nuances and the revenue impacts. For example, if the State were to call a Special Session of the General Assembly to decouple from all years in the Act, then perhaps it makes sense for the Comptroller's Office to not process any of the related amended filings; not processing or even just delaying the processing until a policy framework is determined, could either mute the revenue impact or at the very least shift more of the revenue impact out of fiscal year 2020 and into fiscal year 2021.

Net Operating Loss Provisions (NOL)

Prior to the passage of the TCJA, IRC § 172 allowed taxpayers to carryback NOLs for up to two years, with an election for five years in some cases, and to carry the remaining unused losses forward for twenty years. Maryland decoupled from the five-year election, generally allowing a carryback of only two years. The TCJA repealed the provision allowing losses to be carried back and the provision limiting the loss carryforward period to twenty years. It required losses arising in tax years beginning after December 31, 2017 to be carried forward, and in each year used, the NOL could offset no more than 80% of taxable income. The NOL could be carried forward indefinitely until used up. In summary, under the TCJA, for tax years beginning after December 31, 2017, NOLs can only be carried forward and in each year are limited with respect to the extent they may be used.

The CARES Act § 2303 amended the NOL provisions enacted under the TCJA to allow a five-year carry back for NOLs, and suspend the 80% carryforward limitation for tax years beginning after December 31, 2017 and before January 1, 2021 (2018, 2019, and 2020). As a result, businesses may amend their tax year 2018 and 2019 federal income tax returns to carryback current year losses and offset taxable income for tax years as far back as 2013.

Regardless of whether the State conforms or decouples, corporations, partnerships, and individuals will file amended federal returns for prior settled years to carryback losses incurred in tax years 2018, 2019, and 2020. The carryback of these losses will result in a decrease in federal taxable income in the years to which the losses are carried back, likely as far back as tax year 2013. Because federal taxable income is the starting point for determining Maryland taxable income, a decrease in federal taxable income results in a decrease in Maryland taxable income. If Maryland decouples from these provisions, these losses will not be carried back. Taxpayers will carry their losses forward, which will offset future state income tax collections rather than be carried back and paid out as refunds. Maryland is automatically decoupled when the revenue impact of a federal law change is expected to be more than $5 million in a tax year that begins in the calendar year that the amendment is enacted. Table 2 exhibits the estimated revenue impact before decoupling of the NOL provisions.

Table 2: Impact of NOL Provisions by Fiscal Year

$ millions	2020	2021	2022	2023	2024
General Fund	-21.3	-95.8	3.7	8.9	14.5
Transportation Trust Fund	-2.4	-10.9	0.4	1.0	1.7
Higher Education Investment Fund	-1.0	-4.5	0.2	0.4	0.7
Total	**-24.7**	**-111.2**	**4.3**	**10.4**	**16.9**

Business Interest Expense Deduction

Before the enactment of the TCJA, there was no limit on the amount of business interest expense deductible. For tax years 2019 and 2020, the TCJA limited the amount deductible to the sum of (1) the taxpayer's business interest expense income, (2) 30% of the taxpayer's Adjusted Taxable

Income (ATI), and (3) the taxpayer's floor plan financing interest expense for the year. Business interest in excess of the limitation was allowed as an indefinite carryforward.

The Act increased the 30% ATI limitation to 50% for tax years 2019 and 2020 for all entities other than partnerships. Partnerships get the benefit of the 50% limitation only for tax year 2020. This increase results in a greater interest expense deduction that what was previously permitted under the TCJA. The increased deduction leads to a decrease in taxable income that may generate an NOL (or increase an existing NOL) to be carried back to previous tax years. Table 3 exhibits the estimated revenue impact before decoupling of the NOL provisions.

Table 3: Impact of Interest Deduction Provisions by Fiscal Year					
$ millions	2020	2021	2022	2023	2024
General Fund	-4.7	-25.6	-2.0	-0.9	-0.5
Transportation Trust Fund	-0.7	-3.9	-0.3	-0.1	-0.1
Higher Education Investment Fund	-0.3	-1.6	-0.1	-0.1	0.0
Total	**-5.7**	**-31.2**	**-2.4**	**-1.1**	**-0.6**

Loss limitations on Taxpayers Other Than Corporations

For tax years 2018 - 2025, the TCJA restricted the business loss deduction available to noncorporate taxpayers (individuals, trusts, and estates) from offsetting more than $250,000 ($500,000 for joint filers) of nonbusiness income with business losses in the year the loss was incurred. To the extent the loss exceeded the limitation it was deemed an excess business loss to be carried forward as an NOL. The Act retroactively delayed the effective date of the loss limitation rules enacted under the TCJA to tax years beginning after December 31, 2020, which suspends the loss limitation rules for tax years 2018, 2019, and 2020.

Under decoupling, the excess business loss rules will be in effect. As a result, taxpayers with large losses (<$250,000/<$500,000) and no taxable federal income will have taxable Maryland income. The excess business loss may be treated as an add back. Table 4 exhibits the estimated revenue impact before decoupling of the Loss Limitation provisions.

Table 4: Impact of Interest Deduction Provisions by Fiscal Year					
$ millions	2020	2021	2022	2023	2024
General Fund	**-21.0**	**-115.1**	**-3.8**	**0.7**	**0.3**

Sincerely,

Andrew M. Schaufele