COMPTROLLER *of* MARYLAND
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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 (Tax General §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. 133, the Consolidated Appropriations Act (CAA), on December 27, 2020. The CAA is a $2.3 trillion spending bill that combines $900 billion in stimulus relief for the COVID-19 pandemic with a $1.4 trillion omnibus spending bill for the 2021 federal fiscal year. As part of the relief package, the CAA 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, sole proprietors, and individuals.

The CAA adjusts some of the alterations made to the TCJA by the Coronavirus Aid, Relief, and Economic Security (CARES) Act and introduces new alternations to the TCJA. Some of the changes are retroactive and thus extend to past tax years. TG § 10-108 provides that when the State income tax revenue impact resulting from an amendment to the IRC is $5 million or more for the fiscal year that begins during the calendar year in which the amendment is enacted, 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. It is our belief that no provision in the CAA will meet the automatic decoupling threshold, with further explanation found below in this report. A summary of the estimated impact by fund absent any possible decoupling is shown below.

Table 1: Impact on State Revenues by Fiscal Year					
$ millions	2021	2022	2023	2024	2025
General Fund	-34.66	-47.81	-28.45	-16.93	-18.49
Transportation Trust Fund	-1.33	-3.52	-2.39	-0.13	-0.12
Higher Education Investment Fund	-0.55	-1.45	-0.98	-0.05	-0.05
Total	**-36.54**	**-52.79**	**-31.82**	**-17.10**	**-18.66**

Note: Table 1 may not equal the sum of all other tables in the report due to rounding.

As stated above, the CAA builds on the CARES Act by clarifying and adjusting various provisions in the CARES Act that altered the TCJA. Due to this, the unique revenue impact of the CAA is relatively small in comparison to the CARES Act. The following changes made under the CAA significantly impact tax revenue through their alteration of taxable income:

1) Permanent extension of medical expense deduction for expenses in excess of 7.5 percent of federal adjusted gross income under IRC §213;
2) Expanded eligibility to depreciate residential rental property under the straight-line method from 40 years to 30 years for property placed into service prior to 2018 IRC §163(j); and
3) Temporary allowance of 100% deduction for business meals under IRC *§419.*

Decoupling – The CAA Creates Decoupling Complexities

TG §10-108 authorizes the State to decouple from changes to the IRC that affect 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 CAA, which was enacted in calendar year 2020, modified provisions applicable to tax years 2020 and prior. As a result, the impact of changing the tax code for previous years will result in a gross revenue impact in excess of $5 million in fiscal year 2021. However, the revenue for such retroactive provisions will fall on multiple tax years, and thus not exceed the minimum threshold to auto-decouple any such provision in the CAA from Maryland tax law. Indeed, 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. Therefore, pursuant to TG §10-108, we would not auto-decouple from the provisions discussed in this document for tax year 2020.

That said, we believe this strict interpretation of TG §10-108 is counter to the intent of the law by failing to auto-decouple from federal tax provisions which have a significant and immediate impact on State revenue. Furthermore, in addition to reducing revenues, these changes create 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. The CAA's fiscal impact will depend largely on the course of the pandemic and its impact on businesses' and individuals' habits. Deductions will be driven by medical expenditures, employers' propensity to pay student loans or buy meals, and residential rental property owners' utilization of the revised 30-year depreciation period eligibility. The COVID-19 pandemic has introduced additional uncertainty to each of these factors. Given that at the time of writing we are less than five months from the start of fiscal year 2022, the estimated impact from tax years 2020 and prior is assumed to be realized in both fiscal 2021 and 2022. This is partly because amended returns are more complex than the typical return and therefore take longer to prepare and to process.

Permanent Extension of Medical Expense Deduction

The Medical Expense Deduction (the deduction) has been adjusted numerous times in recent years. The deduction had a historic floor of 7.5% of adjusted gross income (AGI). That is to say, if an individual spent in excess of 7.5% of their AGI on eligible medical expenses, then that amount was tax deductible. The Affordable Care Act (ACA) set a new floor at 10% for individuals under the age of 65 and was set to raise to 10% universally in 2016. The 7.5% floor was subsequently extended from 2016 through 2019. In 2020 the CARES Act once again extended the 7.5% floor through tax year 2020.

The CAA makes the 7.5% deduction floor permanent, compared to the ACA's proposed 10% floor. The larger deduction will lead to a decrease in taxable income. Table 2 exhibits the estimated revenue impact of the medical expense deduction provisions.

Table 2: Impact of Medical Expense Deduction Provisions by Fiscal Year

$ millions	2021	2022	2023	2024	2025
Personal Income Tax	-5.28	-10.83	-11.28	-11.71	-13.42

Depreciation of Certain Residential Rental Property over 30-Year Period

The TCJA allowed a real property trade or business to elect out of the business interest deduction limitations set by the TCJA provided the trade or business depreciated real property in accordance with the Alternative Depreciation System (ADS). To be eligible, the property had to be placed in service after 12/31/2017. Furthermore, the TCJA decreased the recovery period for residential rental properties from 40 years to 30 years. In effect, this allows landlords to calculate the expected depreciation of a property over 30 years, average the depreciation per tax year, and utilize the annualized expected depreciation as a tax deduction.

The CAA amended the TCJA's residential rental property ADS qualifications to include residential rentals owned by a real property trade or business that were placed in service before 01/01/2018 and who did not otherwise utilize the ADS before the same date.

Landlords who can use this change fall into two groups: those residential rental owners who used the ADS prior to 2018 for their property with a 40-year recovery period and those who chose not to use ADS due to the 40-year recovery period but will now retroactively use ADS due to the shortened recovery period. In either case, those who choose to use the system will on average have larger yearly deductions that they would have otherwise. Table 3 exhibits the estimated revenue impact of the ADS deduction provisions.

Table 3: Impact for Depreciation of Certain Residential Rental Property by Fiscal Year					
$ millions	2021	2022	2023	2024	2025
Personal Income Tax	-6.25	-0.64	-0.62	-0.62	-0.64
Corporate Income Tax	-2.14	-0.23	-0.22	-0.22	-0.22
Total	**-8.39**	**-0.87**	**-0.84**	**-0.84**	**-0.86**

As noted above, although the revenue impact of this provision is distributed in such a way as to not result in auto-decoupling (over three tax years), we believe this functions counter to the intent of TG §10-108. Furthermore, the process of amending tax filings for three or more years prior to the current tax year will pose a technical challenge to filers and may result in a delayed fiscal impact for this provision.

Temporary Business Meal Deduction Expansion

The TCJA tightened the business expense deduction to no longer include entertainment expenses but it has since been clarified that meals are expendable for deduction purposes. Depending on the nature of the food and the manner in which it was consumed, meals were deductible for either 50% or 100% of their expense under the TCJA. The CAA simplifies this deduction to be a flat 100% deduction for all food and beverages provided for business purposes in calendar years 2021 and 2022. Table 4 exhibits the estimated revenue impact.

Table 4: Impact of Temporary Business Meal Deduction by Fiscal Year					
$ millions	2021	2022	2023	2024	2025
Corporate Income Tax	-6.51	-21.69	-15.18	0.00	0.00
Personal Income Tax	-0.80	-1.59	-0.80	0.00	0.00
Total	**-7.30**	**-23.28**	**-15.98**	**0.00**	**0.00**

Paycheck Protection Program Changes

The Paycheck Protection Program (PPP) was created in the CARES Act to provide forgivable loans to small and medium sized businesses (<500 employees) impacted by the COVID-19 pandemic. PPP loans were and are eligible for full forgiveness if employers meet specific standards to maintaining payroll or rehiring quickly. Before the passage of the CAA, the PPP was funded with approximately $653 billion until its expiration on 08/08/2020.

The CAA both extended the PPP, modified the program, and clarified tax provisions for the program. The CAA allows companies to apply for their first or second PPP loan through 03/31/2021. Companies that did not receive a loan under the CARES Act but qualified according to the terms set forth in the CARES Act, are eligible to apply for a first time PPP loan. The criteria for a company requesting a second draw PPP loan is different. It must have no more than 300 employees and demonstrate at least a 25% reduction in revenue in at least one quarter of 2020 compared to the same quarter of 2019. Finally, the CAA clarifies the open question created by the CARES Act as to whether expenses paid with the proceeds of forgiven PPP loans is deductible.

Prior to the passage of the CAA the Internal Revenue Service (IRS) issued notices dictating its position that expenses paid with forgiven PPP loan proceeds would not be deductible. The CAA overturned the IRS' position on the matter and determined that expenses paid with forgiven PPP loan proceeds are eligible for deduction. This allows PPP recipients to deduct spent PPP funds on eligible expenses. The United States Congressional Joint Committee on Taxation (JCT) has stated that this clarification has no revenue impact, indicating their stance to be that the original intention of the CARES Act was to incorporate PPP deductions for recipients in the outset. Our estimate also assumed that those expenses would be deductible, therefore we have also taken the same stance that the CAA's clarification on PPP loan spending has no revenue impact.

Table 5 below demonstrates the benefit of a forgiven $150,000 PPP loan before and after the CAA clarification against a business which did not receive a PPP loan.

Table 5: Impact CAA Clarification With $150,000 PPP Loan			
	Before CAA Clarification	After CAA Clarification	No PPP Loan
PPP Loan Amount	$150,000	$150,000	$0
Annual Expenses	$150,000	$150,000	$150,000
Net Cash	$0	$0	($150,000)
Income Reported	$0	$0	$0
Deduction Taken	$0	$150,000	$150,000
Impact on Taxable Income	**$0**	**($150,000)**	**($150,000)**

Extension of Look-Through Treatment for Controlled Foreign Corporations

The Controlled Foreign Corporations (CFC) Look-Through rule (the rule) was initially instituted in 2006 as a temporary three-year measure following the 2005 Tax Increase Prevention and Reconciliation Act. The rule provides that dividends, interest, rent, and royalties received or accrued by a CFC will not be treated as foreign personal holding company income. The Look-Through rule has been extended continuously since 2006 and was extended through 2025 by the CAA.

Our understanding of the effect of this extension to Maryland's revenues is minimal if it exists at all because the rule would primarily impact the federal-only tax on personal holding company income and partly due to the subtraction modifications for foreign dividends. Furthermore, the sunset of the existing law regarding CFCs in 2021 was not considered through the state's annual revenue estimates. As a result, an extension of these provisions would have no impact.

Other Provisions

There are various provisions in the CAA which are not directly referenced in this report for a variety of reasons. Most provisions which were deemed to have little or no fiscal impact by the JTC were excluded from this report, as were any provisions we determined would have no fiscal impact on the State. Examples of provisions not included in this report are: provisions removing a federal deduction that is added-back to taxable income in Maryland, the modification or creation of federal credits which don't affect the state income tax return, or effectively irrelevant provisions – such as those relating to wildfire disaster relief funding.

Clarification Notes

1) The CAA expands eligibility for the Lifetime Learning Credit to individuals making no more than $90,000 annually (joint filers making $180,00 annually) and increases the maximum credit by $500 in 2021. Maryland is effectively decoupled from the federal tuition and school fee deductions and adds-back the value of the deduction to federal Adjusted Gross Income (AGI) when calculating tax liability. As a result, the CAA's repeal of the federal deduction for tuition and fees will not affect an individual's Maryland AGI and produce no fiscal impact.
2) The Temporary Lookback for the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC) are two important provisions in the CAA which are not addressed in this report because they do not affect the determination of federal adjusted gross income, federal taxable income or Maryland taxable income. These are two of the most robust income support programs that the federal government provides. Maryland piggybacks on the Federal EITC and does not offer a CTC. Due to the high number of unemployed individuals receiving unemployment insurance in 2020, one would expect the number of EITC recipients and amount of EITC credits to decrease for tax year 2020 due to the reduction in eligible "earned income" upon which the credit is based. However, the CAA avoids this result by allowing taxpayers to use their tax year 2019 earned income to determine eligibility and compute their EITC credit for tax year 2020. We can expect this to have a significant positive effect on credits awarded in Maryland.
3) Below is Table 6, which provides the estimated revenue impacts of other relevant CAA provisions that were not otherwise addressed directly in this report.

Table 6: Impact of All Other Provisions by Fiscal Year					
$ millions	2021	2022	2023	2024	2025
Educator Expense	(0.00)	(0.01)	(0.01)	(0.01)	(0.01)
Emergency Financial Aid Grants	(0.47)	-	-	-	-
Extend Exclusion of Discharge of Personal Residence Indebtedness	(0.80)	(1.75)	(1.94)	(2.00)	(1.95)
Extend Exclusion of Employer-Paid Student Loans	(1.53)	(2.70)	(2.39)	(2.52)	(1.96)
Extend Mortgage Insurance Premium as Qualified Residence Interest	(0.36)	(0.36)	-	-	-
Above-The-Line Charitable Deduction for Non-Itemizers	(5.01)	(5.01)	-	-	-
Temp Limit on Charitable Contributions	(6.54)	(5.24)	1.94	1.02	0.55
Disease-Related Use of Retirement Funds	(0.11)	(0.13)	(0.02)	(0.00)	(0.00)
Permanently Exempt Certain Payments to Emergency Responders	(0.15)	(0.22)	(0.19)	(0.26)	(0.27)
Make Energy Efficient Commercial Building Deduction Permanent	(0.08)	(0.16)	(0.15)	(0.14)	(0.14)
Personal Income	**(15.07)**	**(15.57)**	**(2.77)**	**(3.91)**	**(3.78)**
2020 Election to Terminate Transfer Period for Pension	0.42	0.35	0.28	0.22	0.17
Extend 7-Yr Expensing for Motorsports	(0.07)	(0.27)	(0.32)	(0.35)	(0.33)
Extend Special Expensing for Media	(0.44)	(1.35)	(0.92)	(0.61)	(0.34)
Permanently Exempt Certain Payments to Emergency Responders	(0.08)	(0.26)	(0.28)	(0.28)	(0.28)
Temp Limit on Charitable Contributions	(0.33)	(0.70)	0.28	0.38	0.17
Corporate Income	**(0.50)**	**(2.23)**	**(0.96)**	**(0.64)**	**(0.61)**
Total	**(15.57)**	**(17.80)**	**(3.73)**	**(4.55)**	**(4.39)**

Sincerely,

Andrew M. Schaufele