

# Maryland Tax Education Foundation

Issue Note

By

CPA-Attorney Alan Zipp

July 1, 2004

## Background

In 2002, the U.S. Congress amended the Internal Revenue Code. The effect of the amendments was to reduce federal adjusted gross income for U.S. taxpayers. Rather than increasing Maryland tax rates to compensate for reduced federal taxable income, the Maryland Legislature further decoupled the Maryland gross income calculation from the federal computation, in an effort to maintain the state's level of income tax revenues. It is likely that the Legislature's objective have not been fully achieved. The new Maryland rules are so complex that many taxpayers are not following the law.

The decoupling legislation requires Maryland taxpayers to compute their state income differently from their federal income. Among the many items affected on the tax return, are Maryland itemized deductions, depreciation, gain or loss on the sale of property, depreciation recapture and passive gain or loss.

## Decoupling Effect on Maryland Taxpayers

Prior to the 2002 decoupling legislation, Maryland's income tax was essentially based on federal adjusted gross income. Certain simple changes determined Maryland taxable income. When the Legislature further decoupled the Maryland income tax from the Internal Revenue Code, it created administrative problems for both Maryland taxpayers and the Comptroller's Office. More adjustments were added to the Maryland income calculation; and, perhaps inadvertently, many Maryland taxpayers, particularly those not using computers, used their federal adjusted income as a proxy for Maryland income.

## The Example of Higher Federal Depreciation Rates that Cost Maryland

For example, the federal law increases the depreciation deduction, but the Maryland law denies this increase. When Maryland taxpayers prepare their federal tax returns, they often fail to recalculate depreciation for state tax purposes. As a result, Maryland taxable income is less than it should be and less State income taxes are collected.

If 25% of taxpayers use higher federal depreciation deductions instead of state mandated deductions, the cost to Maryland's Treasury is in the millions of dollars every year. In effect, Maryland's decoupling legislation is not revenue neutral. Rather, it costs the state tax dollars because of inadvertent calculation mistakes by taxpayers, which include businesses and individuals.

At first glance, such noncompliance appears easy to resolve through enhanced education and enforcement by the Comptroller's Office. But, the Comptroller's reporting procedures do not facilitate automated enforcement. Identifying noncompliance requires

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personal audits and examinations. This potential cost of increased enforcement also defeats the original revenue-neutral purpose of the Maryland legislation.

### *Possible Solution to Consider*

One solution to this issue is (i) to repeal the decoupling legislation; (ii) to conform Maryland tax laws to the Internal Revenue code; and (iii) to increase state tax rates to make the change revenue neutral. Because of reduced errors, Maryland income tax revenues might be enhanced and enforcement made more effective. In the future, the state Legislature can adjust state tax rates whenever changes are made to the Internal Revenue Code.

Other states have experienced similar problems and have repealed their decoupling legislation. The most recent is Arizona, which made its decoupling repeal law retroactive.

In Maryland, this response involves (1) decreasing taxable income for state filing purposes; and (2) increasing the tax rates, in order to remain revenue neutral for Maryland taxpayers. The change in tax rates is not a “tax increase” because taxable income declines at the same time as the tax rate increases.

### *Simplify Tax Administration*

Maryland’s income tax administration should be made as simple as possible. Require the use of federal income figures and make only simple adjustments for Maryland purposes. If compliance is simplified, favorable benefits may ensue: more money may flow into the State’s treasury as inadvertent mistakes are avoided by taxpayers; noncompliance with complex state tax laws may be reduced; and enforcement personnel at the Comptroller’s Office may be more available to identify and prosecute serious violations of Maryland’s income tax laws.

### *The Author*

Alan Zipp is a CPA-attorney based in Rockville, MD, with a legal practice focusing on taxation.

### *Maryland Tax Education Foundation*

The Maryland Tax Education Foundation (MTEF) is a Maryland corporation established in 1998 to help the public understand tax and expenditure policies of state and local government in Maryland. MTEF finances research, analysis and dissemination of information on taxation and spending. Contributions to MTEF are tax deductible to the extent allowed by law for 501 (c) (3) organizations.

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