MDCEP
MARYLAND CENTER ON ECONOMIC POLICY

Maryland Must Take Proactive Steps to Counteract Harms of Federal Tax Bill

In order to protect Maryland families, the Governor and General Assembly must take proactive steps to respond to the federal tax bill Congressional Republicans passed at the end of 2017, which will cause lasting harm in our state. The new tax laws overwhelmingly benefit corporations and very wealthy individuals, while the rest of us will see little to no change in our taxes. By 2027, more than a quarter of low- and middle-income Marylanders will actually see their taxes go up.

To pay for the tax bill, which will cost $1.4 trillion over 10 years, Congressional Republicans are talking about massive cuts in programs that help thousands of Marylanders afford health care, food, housing, and other basic needs. Cuts in discretionary spending would also affect federal programs and agencies that are the backbone of Maryland's economy, such as medical research. These cuts, if they go forward, would have devastating consequences for Maryland families and our economy.

Maryland's leaders can take steps to counteract the most harmful provisions of the new tax code and ensure that the state has additional resources it needs to meet the state's current needs and respond to harmful federal cuts.

Recommended Strategies

Protect Personal Exemptions

One of the most significant provisions of the federal tax law concerns personal exemptions, or deductions filers can claim for dependent family members. Federal law now essentially eliminates personal exemptions by setting the allowable deduction to $0, while expanding the standard deduction applicable to most filers. This change cuts taxes for individuals and couples without any dependents, while hiking taxes on families caring for children, elderly adults, and some people with disabilities.

Experts disagree on how this provision affects Maryland state taxes. Maryland's tax law currently defines the *amount* tax filers can claim for each personal exemption independently, but refers to federal law to determine the *number* of exemptions a filer can claim. While some experts argue that the new federal law does not affect the number of exemptions available to each taxpayer—and therefore leaves Marylanders' state tax bills unchanged—the state comptroller could decide to interpret the law as repealing state personal exemptions altogether. This would mean large tax hikes for thousands of low- and middle-income Maryland families.

Lawmakers can put this issue to rest with a simple fix. The state should amend its tax law to define personal exemptions without any reference to federal law.

Expand the Earned Income Tax Credit

People who work in low-wage jobs were largely left out of the federal tax bill, which was overwhelmingly tilted to corporations and the wealthiest 1 percent. At least 10 percent of low-wage workers will actually see their federal taxes go up slightly by 2027. In addition, lower-income Marylanders will experience the greatest harm from the expected cuts in health coverage, food assistance, housing assistance, and many other public services. The federal tax bill also permanently erodes the federal Earned Income Tax Credit's value over time by adopting a different measure for adjusting tax brackets and certain tax provisions each year to account for inflation, which will in turn reduce credits for state EITC recipients.

The EITC is one of the most effective anti-poverty tools we have. Expanding the state EITC would provide some much-needed relief for people who work hard but aren't paid enough to afford the basics. Expanding the EITC for workers not raising children would be an important first step, as these individuals receive little to nothing from the current EITC, even though they have very low wages, which means they are essentially taxed further into poverty.

For greater impact, Maryland could also increase the refundable amount of its EITC. Starting this year, Marylanders will receive a refundable state credit equal to 28 percent of their federal credit. Increasing that percentage would put even more money back in the pockets of families to help them pay utility bills, car repairs, school supplies, and other necessities.

Reinstate the Millionaire's Tax

Maryland's millionaires are the only individual taxpayers likely to see a windfall from the federal tax bill. Those in the wealthiest 1 percent, with an average income of $1.9 million, will save an average of $50,000 on their 2019 taxes, according to analysis by the Institute for Taxation and Economic Policy.

People in this income group already don't pay their fair share for the state services we all rely on. The wealthiest 1 percent in Maryland pay about 16 percent less in state and local taxes, as a share of their incomes, than the rest of us. Reinstating an additional tax bracket that helps ensure the ultra-rich pay their fair share in state taxes, as Maryland did during the Great Recession and other states have done since then, would help the state maintain services that we all rely on.

Protect Small Maryland Businesses Through Corporate Tax Reform

Large, multi-state corporations were among the biggest beneficiaries of the federal tax changes. These businesses already have a number of tax advantages that make it harder for smaller, Maryland-based businesses to compete with them, and the just-passed changes will make the problem worse. Maryland should take steps to create a fairer, more effective, and productive corporate tax system at the state level.

Combined reporting remains the best strategy for providing a more complete and accurate accounting of the profits corporations earn from their activities. This method of collecting corporate income taxes essentially treats a parent company and its subsidiaries as one corporation for state income tax purposes. Doing so prevents companies from reducing their taxable revenue by artificially shifting it out of state.

Main Street businesses cannot afford to spend millions developing these complicated tax avoidance structures, but their large competitors can, and in doing so gain an unfair advantage. Maryland should join the 24 states and the District of Columbia that have already adopted combined reporting. Doing so would put smaller corporations with no presence outside of Maryland on a more equal tax footing with larger companies that operate in many states.

There are other tax reform options, such as ending corporate "nowhere income" or eliminating some deductions and credits, that could also be a part of a corporate tax reform package.

Tax Pass-Through Companies as Corporations

Exempting pass-through entities from corporate income tax reflects outdated perceptions about typical pass-through companies and needlessly costs the state revenue that could be used to fund essential services. Although the exemption was originally intended to benefit small businesses, many large, profitable companies such as hedge funds are now able to claim this tax break. The state should tax large pass-through entities as corporations while continuing to exempt the small businesses the exemption was originally intended to benefit.

Several states already levy additional taxes beyond the personal income tax on certain pass-through entities:

- California and Illinois levy a 1.5 percent tax on the profits of S-corporations.
- Massachusetts levies a 1.9 percent tax on the profits of S-corporations that have $6 million to $9 million in annual total receipts and a 2.85 percent tax on those with total receipts over $9 million.
- Texas and the District of Columbia apply the full corporate income tax ("margins tax" in Texas) to S-corporations.

Maryland should pass a similar tax applying to pass-through entities that exceed a size threshold set by the state. If desired, this tax could use a progressive rate structure, applying the full corporate income tax rate to the largest companies and lower rates to smaller ones. Policymakers should consider the following policy design issues:

- Although existing state pass-through taxes apply only to S-corporations, a tax applying equally to S-corporations, LLCs, and partnerships would be more effective and introduce fewer incentives for tax avoidance. The state should continue to exempt sole proprietorships from corporate taxation.
- Thresholds used to exempt small pass-throughs and define progressive rate structures can be based on either net income (profit) or total receipts. The total receipts approach would create "cliffs" in which a small change in total receipts results in a large change in a company's tax responsibility. For this reason, thresholds based on net income are preferable to thresholds based on total receipts. In either case, the tax should apply to net income.
- While there are no hard and fast rules about the income thresholds to use in designing a pass-through tax, the $6 million and $9 million thresholds used in Massachusetts can serve as useful guides.

Maintain Maryland’s Estate Tax

The estate tax helps make sure the very wealthiest Marylanders pay their fair share and it applies to a small fraction of estates. When the General Assembly acted to exempt the families of multimillionaires from the estate tax, Maryland lost a small but important source of revenue to support schools, hospitals, safe communities, and other essential services across the state that help create jobs and build a strong economy. While Maryland used to ask the top 3 percent of estates to pay the tax, by 2019 just 0.6 percent of estates will pay the Maryland estate tax.

Allowing the state exemption to rise even further, to the new federal threshold of $11 million, would benefit just 80 very wealthy families, at further cost to public investments that benefit everyone. Policymakers should take any steps needed to ensure that Maryland’s exemption remains at its current level.

Workarounds for Cap on State and Local Tax Deductions

The new federal tax law’s cap on deductions for state and local taxes has drawn significant attention for its potential to hike federal taxes on residents of relatively high-tax states and increase political pressure for state tax cuts. Advocates and some policymakers have proposed ways to work around this cap, allowing states to protect their residents from federal tax increases without losing state revenue. **These proposals should be policymakers’ second priority at best.** The federal tax law is a massive windfall for wealthy individuals and large corporations at the expense of working families and essential state services. Policymakers should focus on protecting families who struggle to afford the basics, as well as the revenues that support investments in schools, roads, and safe communities. Only then should attention turn to preventing federal tax increases for relatively well-off individuals.

Employer-Side Payroll Tax

One of the most prominent proposed workarounds would involve replacing the state personal income tax with an equivalent employer-side payroll tax. Because state business taxes are still deductible without limit at the federal level, this proposal would in theory allow the state to collect the same amount of revenue without putting anyone over the federal deduction cap. In practice, this proposal has two components:

- An employer-side payroll tax equal to the average personal income tax rate paid by Maryland wage and salary workers.
- A refundable dollar-for-dollar tax credit against the personal income tax.

This proposal would maintain the progressive structure of Maryland’s personal income tax.

- For low-income taxpayers, the payroll tax would exceed the taxpayer’s income tax responsibility. These taxpayers would receive a refund, so that the net taxes paid equal the taxpayer’s original tax responsibility.
- For high-income taxpayers, the payroll tax would be less than the taxpayer’s income tax responsibility. These taxpayers would still owe a small amount of income tax after claiming the tax credit. Again, the net taxes paid would equal the taxpayer’s original tax responsibility.

Policymakers should consider the following issues with this proposal:

- Some variations on this proposal involve repealing the personal income tax rather than offsetting the payroll tax with a refundable credit. These variations are problematic for two reasons. First, they would eliminate the personal income tax's progressive structure by replacing it with a flat tax on wages and salaries. This would represent a tax hike for low-wage workers and a tax cut for high earners. Second, repealing the personal income tax may pave the way for future harmful tax cuts.
- The effects of this approach on working Marylanders depend on the way employers respond to it. Advocates of the workaround envision the employer-side payroll tax being fully borne by workers, not employers. This would only happen if employers respond by cutting pre-tax wages and salaries. Although this cut would not reduce workers' take-home pay, it would still likely generate resistance. Alternatively, if employers decide not to cut workers' pay (or are unable to), they will bear the cost of the tax themselves. Because of this uncertainty, it is ambiguous whether the payroll tax workaround is a tax on workers or on business.
- Some low-income workers may see positive or negative changes to their disposable income because federal anti-poverty programs generally define eligibility in terms of pre-tax income. For many programs, a reduction in pre-tax income will increase the benefits workers are eligible for (e.g., a worker whose income declines from 140% to 137% of the federal poverty line would be newly eligible for Medicaid). However, this could reduce the benefits very low-income workers are eligible for through the Earned Income Tax Credit and Child Tax Credit.
- This workaround only works for **wage income of non-federal workers**. Federal workers are excluded because the state cannot constitutionally impose a payroll tax on the federal government. Non-wage income is excluded because there is no employer to tax. This includes capital income like capital gains, interest, and dividends. It also includes nonwage earnings such as those of independent contractors (true or misclassified).
- Income that cannot be taxed on the employer side remains subject to the federal SALT cap. This issue will primarily affect relatively high-income taxpayers who itemize their deductions and who pay more than $10,000 in state and local taxes.

Charitable Contribution Credit

A second proposed workaround would allow taxpayers to make voluntary contributions to the state government and create a 100 percent offsetting tax credit for these contributions. Because charitable contributions remain tax deductible without limit, this proposal would in theory allow taxpayers to deduct all their state taxes.

This workaround may cause confusion. It is not intended to allow taxpayers to choose how their taxes are spent or what level of government to contribute to. It is intended to be a simple accounting gimmick, replacing state taxes with fully offset "voluntary contributions."

Policymakers should consider two issues with this proposal:

- Some coverage of this workaround has discussed contributions to state **and local** government. While local governments could pass similar credits of their own, the state tax credit should apply **only to contributions to state government**. Allowing taxpayers to claim a state tax credit for contributions to their local governments would threaten state revenues and essential public services.

- **This workaround is untested**. It relies on the IRS cooperating by allowing taxpayers to deduct contributions to state government that are fully offset by tax credits. Some federal tax policy experts have advised that it is far from certain the IRS would allow this.