

Maryland Income Tax

ADMINISTRATIVE RELEASE

Administrative Release No. 38

Subject: Decoupling from Federal Income Tax Laws.

I. Information

A. General Information

Generally, the Maryland income tax laws conform to the federal income tax laws except where the Maryland Legislature has enacted legislation otherwise.

Maryland decoupling provisions are generally found under Sections 10-210.1 and 10-310 of the Tax-General Article of the Annotated Code of Maryland (TG).

B. Specific Information

1. Federal Bonus Depreciation Allowances and Section 179 Expensing

For Maryland income tax purposes, the depreciation deduction provided by § 167(a) of the Internal Revenue Code (I.R.C.) for tangible property should be determined without regard to the additional allowance under I.R.C. § 168(k).

This means that a taxpayer taking the Section 168(k) allowance would need to maintain separate *pro forma* federal tax returns, without the Section 168(k) allowance, in order to determine the necessary modification adjustments to compute the taxpayer's Maryland income tax. The taxpayer generally would need to add back to the taxpayer's federal adjusted gross income the amount of additional deduction allowance under I.R.C. § 168(k) in the year the allowance is claimed, which amount the taxpayer will then ratably subtract from the taxpayer's federal adjusted gross income in the subsequent years in accordance to the applicable property depreciation method for the duration of the applicable recovery period.

Similarly, Maryland requires the maximum aggregate costs that a taxpayer may treat as an expense under I.R.C. § 179 be determined without regard to any changes made to that section after December 31, 2002. This means that for Maryland income tax computation, the aggregate costs that a taxpayer may elect to treat as Section 179 expense may not exceed \$25,000, subject to the phase-out threshold of \$200,000.

Maryland also requires that heavy duty SUVs be subject to the depreciation deduction limits set forth in I.R.C. § 280F, as if the heavy duty SUVs were rated at 6,000 pounds gross vehicle weight or less.

2. NOL Carryover Provisions

Maryland allows net operating loss (NOL) deduction under I.R.C. § 172 to carryback for up to two years, without regard to any special federal provision allowing an election under I.R.C. § 172(b)(1)(H) to carryback the NOL for up to 5 years. See Administration Release No. 18 for information specifically on "Net Operating Losses and Associated Maryland Addition and Subtraction Modifications."

3. Deferral of Income Arising from Certain Discharged Business Indebtedness and Original Issue Discount Deduction Allowances

Maryland recognizes income from discharge of indebtedness by the reacquisition of a debt instrument and the allowance of any deduction with respect to original issue discount in connection with the discharge of indebtedness, without regard to the income deferral and ratable inclusion schedule set forth in I.R.C. § 108(i).¹

This means that if a taxpayer has elected under I.R.C. § 108(i) to defer the recognition of income from a discharge of indebtedness of an applicable debt instrument, Maryland requires the taxpayer to add back to the taxpayer's federal adjusted gross income the deferred amount as if the taxpayer had not elected the Section 108(i) deferral. Because Maryland recognizes income from a discharge of indebtedness in the year that the indebtedness is discharged, the taxpayer will subtract from the taxpayer's federal adjusted gross income in future years the amount of income that the taxpayer will subsequently recognize for federal income tax purposes, but which Maryland has already

¹ This is a new provision that the U.S. Congress added as part of the American Recovery and Reinvestment Act of 2009 (Public Law 111-5).

recognized in the year the indebtedness was discharged.

For any original issue discount resulting from the discharge of indebtedness by the reacquisition of a debt instrument in a debt-for-debt exchange, Maryland recognizes deduction allowances that would have normally been allowed to the issuer of the new debt instrument but for the deferral provision under I.R.C. § 108(i). This means that for Maryland income tax computation, the debt instrument issuer claims the deduction and therefore reduces the issuer's federal adjusted gross income earlier than allowed for federal income tax purposes; however, this also means that in later years when the issuer begins to claim the federal deduction allowances, the issuer must add back to the issuer's Maryland taxable income any deduction that the issuer has already taken previously.

4. Section 10-306.1 Modifications on Related Party Transactions

TG § 10-306.1 is applied to restore a corporation's federal taxable income to what it should have been without income shifting from the corporation to one or more related members under certain circumstances. A Section 10-306.1 addition may decrease the amount of NOL developed in a federal loss year or increase the amount of NOL that may be used in a carryback or carryforward year. A Section 10-306.1 subtraction may increase the amount of NOL developed in a federal loss year or decrease the amount of NOL that may be used in a carryback or carryforward year.

5. Automatic Decoupling from Any Federal Tax Law Change that Impact Maryland Tax Revenues by \$5,000,000 or More

To allow the Maryland Legislature time to act on any federal tax law change that affects Maryland tax revenue in the year in which it is enacted, TG § 10-108 provides that when the tax revenue impact is \$5,000,000 or more, the State is automatically and temporarily decoupled from that federal law change for any taxable year that begins in the calendar year in which it is enacted.

II. Instructions

A. Federal Bonus Depreciation Allowances and Section 179 Expensing

1. General Instructions

Maryland requires that Maryland taxable or modified income be computed in accordance with federal income tax laws as if the taxpayer elected not to use the special first year additional depreciation deductions. Maryland also requires that a taxpayer be only allowed to expense up to \$25,000, reduced dollar-for-dollar by the amount over \$200,000, of the cost of depreciable tangible personal property that is purchased for use in the active conduct of a trade or business for the tax year.

The taxpayer may file an election at the federal level in order to opt out of the special depreciation allowances and expanded federal Section 179 expensing provisions. If an opt-out election is not made at the federal level, an addition or subtraction modification is required on the Maryland return to account for the difference between the amount of federal deductions claimed and the amount such deductions Maryland allows in a taxable year.

The modification will be determined using the **Maryland Form 500DM** and instructions for any year that is affected by the use of the additional federal depreciation expense. Separate federal and Maryland pro forma returns must be prepared for use in completing Form 500DM.

These instructions apply to individuals, fiduciaries, corporations and pass-through entities (collectively, "taxpayer" or "taxpayers").

2. Specific Instructions

a. Amended Return Required

If federal and Maryland returns have already been filed for the tax year and the taxpayer intends to amend the federal return to claim an additional depreciation deduction, an amended Maryland return is required even though the Maryland taxable income would be correct on the Maryland return as originally filed.

If federal and Maryland returns have already been filed for the tax year and the federal return includes an additional depreciation deduction, but no modification was entered on the Maryland return, the taxpayer must amend the Maryland return to include the appropriate modification.

Copies of all pro forma returns, forms and schedules must be clearly labeled and attached to the amended Maryland tax return along with the Maryland Form 500DM.

b. Pass-Through Entity

A pass-through entity will compute the decoupling adjustment as set forth above, but no adjustment will be made to the pass-through entity's return. The entity must allocate the required adjustment to the partners, members or beneficiaries (commonly referred to as "owner" or "owners") of the pass-through entity and report the allocable share on each owner's modified federal Schedule K-1. Each owner will use that amount to determine the modification to be included on the owner's Maryland income tax return using Maryland Form 500DM.

B. NOL Carryover Provisions

1. General Instructions

Maryland recognizes a 2-year NOL carryback period. An addition or subtraction modification may be required for Maryland purposes when a taxpayer is using the special NOL carryback period of up to 5 years for federal purposes and/or when the federal NOL, or the year to which the NOL is carried, includes the effect of the additional depreciation deductions allowed by the applicable federal act.

The modification will be determined using Maryland Form 500DM and instructions. Do not attach copies of the pro forma returns to original filings. Retain the pro forma returns with your tax records. See Administrative Release No. 18.

2. Specific Instructions

a. Amended Returns Required

A Maryland amended return must be filed for the carryback year(s) as actually **amended** for federal purposes even though there may be no net change in Maryland taxable income on those returns. An addition or subtraction modification may be required on the Maryland amended returns if any special carryback period of more than two years was used for federal purposes or if the federal loss year return or any of the carryover years include the additional depreciation deductions allowed under the provisions of the applicable federal acts.

Separate federal and Maryland pro forma returns and NOL worksheets must be prepared for use in completing Maryland Form 500DM.

Attach copies of the federal loss year return, all NOL worksheets, pro forma returns and worksheets and the completed Form 500DM to the Maryland amended return. Copies of all pro forma returns, forms and schedules must be clearly labeled.

b. Net Addition Modification (NAM)

If the addition or subtraction modification from the loss year includes a decoupling amount resulting from the use of an additional depreciation deduction and related adjustments, deduct the decoupling modification from the applicable total before calculating the net addition modification to be carried back with the NOL. See Administrative Release No. 18.

3. Section 10-306.1 Modifications on Related Party Transactions

A corporation's federal taxable income with a Section 10-306.1 modification adjustment is determined using Maryland Form 500A and instructions. This adjustment affects the corporation's preparation of the separate federal and Maryland *pro forma* returns that are used in completing Form 500DM.

Form 500A is used for taxable years that begin in 2010 and forward.

III. Legislative History

A. The Budget Reconciliation and Financing Act of 2002 (BRFA)

The BRFA (Chapter 440, Acts of 2002) provides for a permanent decoupling from federal income tax law for Maryland purposes with regard to two components of the Job Creation and Worker Assistance Act of 2002 (JCWAA) (Public Law 107-147): the special 30% depreciation allowance, and the 5-year net operating loss carryback.

The BRFA created new TG § 10-210.1 to provide for additions to or subtractions from federal adjusted gross income to:

- Reflect the determination of the depreciation deduction provided under I.R.C. § 167(a) and the adjusted basis of property without regard to the additional allowance under I.R.C. § 168(k); and

- Determine the net operating loss deduction allowed under I.R.C. § 172 without regard to the special 5-year carryback period provided under I.R.C. § 172(b)(1)(H).

The BRFA also created new TG § 10-310 to provide that the federal taxable income of a corporation shall be adjusted as provided for an individual under TG § 10-210.1. The impact of these new sections is that the depreciation expense, depreciation recapture, gain/loss on the sale of depreciable assets, and net operating losses must be recomputed under the remaining provisions of the Internal Revenue Code.

These provisions of the BRFA are applicable to all tax periods affected by the JCWAA. See subsection B below.

The BRFA also amended § 10-108 of the Tax-General Article (formerly § 10-221), which requires that Maryland temporarily decouple from any federal tax law change that affects Maryland taxable income in the year in which it is enacted if the federal law will have an impact on Maryland tax revenues of \$5,000,000 or more. This decoupling only applies to any taxable year that begins in the calendar year in which the federal law change is enacted. Any extension would require action by the Maryland Legislature.

Section 10-108 provides that unless otherwise expressly provided by law, an amendment to the Internal Revenue Code that affects the calculation of federal taxable income or federal adjusted gross income for a tax year that begins in the calendar year in which the amendment is enacted does not affect the determination of Maryland taxable income for any tax year that begins during that calendar year. Therefore, an addition or subtraction modification is required in the calculation of Maryland taxable income. The automatic decoupling provisions of this section will apply unless it is determined by the Comptroller that the impact on State tax revenues is less than \$5,000,000. For tax years beginning in the year following the calendar year in which the amendment is enacted, Maryland taxable income determination will take into consideration the amendments to the Internal Revenue Code unless the Maryland General Assembly enacts a law that provides otherwise.

Examples:

The Comptroller has determined that Maryland is not decoupling from provisions of the Affordable Care Act of 2009 that provide a tax exclusion for loan repayment and forgiveness amounts, including amounts paid through State programs designed to increase the availability of healthcare services in underserved areas. The exclusion is retroactive for loan repayments and forgiveness received in tax year 2009. Healthcare workers who have already filed their 2009 returns will be able to claim a refund

The Comptroller has also determined that it will not decouple from provisions of federal law that allow income from the conversion of IRAs to Roth IRAs in 2010 to be deferred to tax years 2011 and 2012.

B. Job Creation and Worker Assistance Act of 2002 (JCWAA)

The JCWAA has two main provisions that affect the calculation of federal adjusted gross income or federal taxable income. The first provision is a special 30% depreciation allowance for property acquired after September 10, 2001 and before September 11, 2004, and placed-in-service after September 10, 2001 and before January 1, 2005. This additional first year depreciation is equal to 30% of the adjusted basis of the property, which is generally its cost or other basis multiplied by the percentage of business/investment use, reduced by the amount of any I.R.C. § 179 expense deduction (and adjusted to the extent provided by other provisions of the Internal Revenue Code). The adjusted basis of qualified property for which the additional first year depreciation is deductible must be reduced by the amount of the additional first year depreciation deduction before computing the amount otherwise allowable as a depreciation deduction for the year the property was placed in-service and subsequent tax years. The remaining adjusted basis of the qualified property is depreciated using the applicable depreciation provisions of the Internal Revenue Code for the property class.

The second provision provides that NOLs arising in tax years ending in 2001 and 2002 may be carried back 5 years and carried over 20 years. Prior to this change, NOLs generally could be carried back only 2 years. The entire NOL is required to be carried back to the earliest year, i.e.,

fifth preceding year, and, if not completely used to offset income in that year, is applied to succeeding taxable years until the full amount of the NOL is either used or the 20-year carryforward period has expired.

Under the new TG §§ 10-210.1 and 10-310, Maryland has decoupled from both of these JCWAA provisions.

C. Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)

The JGTRRA included the following provisions that affect the calculation of federal adjusted gross income or federal taxable income. The first provision extends and increases the depreciation provisions allowed by the JCWAA. The special depreciation allowance is increased from 30% to 50% for certain property placed in service after May 5, 2003, but before January 1, 2005. Maryland was already effectively decoupled (see subsections A and B above) from this new special depreciation allowance under TG §§ 10-210.1 and 10-310.

The second provision of the JGTRRA increases the maximum federal Section 179 expensing allowance from \$25,000 to \$100,000 and the phase-out limit from \$200,000 to \$400,000 for tax years beginning in 2003, 2004 and 2005 and includes off-the-shelf computer software placed in service during that period as qualifying property. It also provides for inflation adjustments. Maryland has decoupled from this provision under the BRFA 2004.

D. Budget Reconciliation and Financing Act of 2004 (BRFA 2004)

The BRFA 2004 (Chapter 430, Acts of 2004) amended TG § 10-210.1 to make permanent Maryland's decoupling from the maximum aggregate costs that a taxpayer may treat as an expense under I.R.C. § 179, as amended by the JGTRRA. This modification applies to all tax years beginning after December 31, 2002.

The BRFA 2004 also provides for an addition or subtraction to federal taxable income or federal adjusted gross income in the calculation of Maryland taxable income to reflect the determination of the depreciation deduction for any heavy duty SUV as if the heavy duty SUV was subject to the limitation of I.R.C. § 280F in the same manner as if the SUV was rated at 6,000

pounds gross vehicle weight or less. This limitation applies to all SUVs placed in service after May 31, 2004.²

E. Budget Reconciliation and Financing Act of 2005 (BRFA 2005), American Jobs Creation Act of 2004 (AJCA)

The BRFA 2005 (Chapter 444, Acts of 2005) made permanent Maryland's decoupling from the maximum aggregate costs that a taxpayer may treat as an expense under I.R.C. § 179, which Congress once again amended in the American Jobs Creation Act (AJCA) of 2004 (Public Law 108-357) to extend the expanded Section 179 expensing under the JGTRRA by two years to include tax years beginning in 2006 and 2007. The relevant BRFA 2005 provision is applicable to tax years beginning after December 31, 2004.

F. Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA)

Maryland House Bill 35 (Chapter 587, Acts of 2007) made permanent the State's decoupling from the maximum aggregate costs that a taxpayer may treat as an expense under I.R.C. § 179 when Congress, in the Tax Increase Prevention Reconciliation Act (TIPRA) of 2005 (Public Law 109-222), extended the higher expense thresholds allowed under the ACJA by two years, through December 31, 2009. Maryland's decoupling from TIPRA is applicable to tax years beginning after December 31, 2006.

G. Tax Reform Act of 2007 and Small Business and Work Opportunity Tax Act of 2007 (SBWOTA)

Maryland's Tax Reform Act of 2007 (Chapter 3, Acts of 2007 Special Session) amended the statutory language of TG § 10-210.1 to make permanent the Maryland decoupling provisions without regard to *any* federal law changes that might affect the I.R.C. § 179 expensing thresholds made after December 31, 2002. This provision is applicable to all taxable years beginning after December 31, 2007. Therefore, Maryland is decoupled from the change made by the Small

² The American Jobs Creation Act of 2004 has changed the federal depreciation for heavy duty SUVs placed in service after October 23, 2004. The federal changes are different from the Maryland changes, which, in most cases, will result in a decoupling modification on the Maryland return.

Business and Work Opportunity Tax Act (SBWOTA) of 2007 (Public Law 110-28) (one-year extension for the higher, expanded federal Section 179 expensing).

H. Budget Reconciliation and Financing Act of 2009 (BRFA 2009) and American Recovery and Reinvestment Act of 2009 (ARRA 2009)

The BRFA 2009 (Chapter 487, Acts of 2009) enacted Maryland's decoupling provisions in response to the federal tax law changes in the American Recovery and Reinvestment Act (ARRA) of 2009 (Public Law 111-5). The ARRA 2009 affects the bonus depreciation allowances for certain property acquired during 2009, the federal Section 179 expensing thresholds for 2008 and 2009, the 5-year carryback period for Section 172 operating losses, and allows for the deferral and ratable inclusion of income arising from business indebtedness discharged by the reacquisition of a debt instrument. Maryland has decoupled from all these federal changes, applicable to all taxable years beginning after December 31, 2008.

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