

Department of Legislative Services
 Maryland General Assembly
 2014 Session

FISCAL AND POLICY NOTE

Senate Bill 590 (Senator Brinkley)
 Budget and Taxation

Income Tax - Pass-Through Entity - Maximum Rate

This bill provides that the first \$25,000 of income distributed to a member of a pass-through entity (PTE) is taxed under the State income tax at a rate of 2.875%. In addition, the local income tax rate imposed on this income may not exceed 1.6%. PTEs include (1) an S corporation; (2) a partnership; (3) a limited liability company (LLC) that is not taxed as a corporation; or (4) a business trust or statutory trust that is not taxed as a corporation. The bill specifies that, for purposes of administering the specified tax rates, income distributed to a member of a PTE is included in the Maryland taxable income of the member and apportioned to reflect the tax rate imposed by the bill.

The bill takes effect July 1, 2014, and applies to tax year 2014 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by an estimated \$30.0 million annually beginning in FY 2015 as a result of taxing specified PTE income at a rate of 2.875%. General fund expenditures increase by an estimated \$0.2 million in FY 2015 due to implementation costs at the Comptroller’s Office.

(\$ in millions)	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
GF Revenue	(\$30.0)	(\$30.0)	(\$30.0)	(\$30.0)	(\$30.0)
GF Expenditure	\$0.2	\$0.1	\$0.1	\$0.1	\$0.1
Net Effect	(\$30.2)	(\$30.1)	(\$30.1)	(\$30.1)	(\$30.1)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Local income tax revenues decrease by an estimated \$20.0 million annually beginning in FY 2015 as a result of the limitation on the maximum local income tax rate that can be imposed on specified PTE income. Local expenditures are not affected.

Small Business Effect: Meaningful. Many small businesses are PTEs and will benefit from lower State and local tax liabilities.

Analysis

Current Law: There is no special tax treatment for income distributed to a member of a PTE. **Exhibit 1** shows the State income tax rates under current law.

Exhibit 1 Maryland State Income Tax Rates Current Law

Single, Dependent Filer, Married Filing Separate		Joint, Head of Household, Widower	
<u>Rate</u>	<u>Maryland Taxable Income</u>	<u>Rate</u>	<u>Maryland Taxable Income</u>
2.00%	\$1-\$1,000	2.00%	\$1-\$1,000
3.00%	\$1,001-\$2,000	3.00%	\$1,001-\$2,000
4.00%	\$2,001-\$3,000	4.00%	\$2,001-\$3,000
4.75%	\$3,001-\$100,000	4.75%	\$3,001-\$150,000
5.00%	\$100,001-\$125,000	5.00%	\$150,001-\$175,000
5.25%	\$125,001-\$150,000	5.25%	\$175,001-\$225,000
5.50%	\$150,001-\$250,000	5.50%	\$225,001-\$300,000
5.75%	Excess of \$250,000	5.75%	Excess of \$300,000

The counties and Baltimore City are required to levy a local income tax on their residents. The tax is assessed as a percentage of the taxpayer's Maryland taxable income. Counties are authorized to set a local income tax rate of at least 1% but not more than 3.2%. The tax rate is a flat rate, as counties are not authorized to impose the tax at different rates. Generally, each incorporated municipality shares in its county's income tax revenues by receiving a portion of the county income taxes paid by the municipality's residents. **Exhibit 2** shows the county income tax rates under current law.

Exhibit 2
County Income Tax Rates
Calendar 2014

<u>County</u>	<u>Rate</u>	<u>County</u>	<u>Rate</u>
Allegany	3.05%	Harford	3.06%
Anne Arundel	2.56%	Howard	3.20%
Baltimore City	3.20%	Kent	2.85%
Baltimore	2.83%	Montgomery	3.20%
Calvert	2.80%	Prince George's	3.20%
Caroline	2.73%	Queen Anne's	3.20%
Carroll	3.04%	St. Mary's	3.00%
Cecil	2.80%	Somerset	3.15%
Charles	3.03%	Talbot	2.40%
Dorchester	2.62%	Washington	2.80%
Frederick	2.96%	Wicomico	3.20%
Garrett	2.65%	Worcester	1.25%

The Comptroller's expenses that are necessary to administer the income tax are paid by distributions from State and local income tax revenues. These costs include the amount necessary to administer the local income tax.

State Revenues: The bill will impose a 2.875% State tax rate on the first \$25,000 in income distributed to a member of a PTE beginning in tax year 2014. As a result, general fund revenues will decrease by an estimated \$30.0 million annually beginning in fiscal 2015.

This estimate does not take into consideration individuals altering behavior to take advantage of a lower average tax rate on PTE income. A PTE that has traditionally paid out some of its income in the form of wages may shift more income to PTE business earnings to take advantage of the lower rate. In addition, the rate change may provide an incentive for businesses to change their business structures to a PTE. The degree to which these types of behavior are induced cannot be reliably estimated, but they could significantly decrease general fund revenues. PTE income is volatile, so the actual revenue impact in a tax year could be significantly different than estimated.

State Expenditures: The Comptroller's Office advises that it will incur additional costs beginning in fiscal 2015 as a result of hiring one revenue specialist and incurring programming expenses. As a result, general fund expenditures increase by \$224,500 in SB 590/ Page 3

fiscal 2015, which accounts for the bill's July 1, 2014 effective date. It includes a salary, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Position	1
Salary and Fringe Benefits	\$75,534
Operating Expenses	4,950
Employee Expenditures	\$80,484
Programming Expenditures	<u>\$144,000</u>
Total FY 2015 Expenditures	\$224,484

Future year expenditures reflect full salaries with annual increases and employee turnover as well as annual increases in ongoing operating expenses.

The above estimate assumes that the proposed rate change will be administered as a credit equal to the resulting difference in tax liabilities and does not include any additional expenses necessary to alter the corporate income tax to reflect corporate members of PTEs. The Comptroller's Office advises that expenditures may be significantly greater than estimated.

Local Revenues: The bill will impose a maximum local income tax rate of 1.6% on the first \$25,000 in income distributed to a member of a PTE. Only Worcester County currently imposes a local income tax rate of less than 1.6%. Local income tax revenues in all other counties will decrease by \$20.0 million annually beginning in fiscal 2015.

Small Business Effect: Businesses that are PTEs would be meaningfully impacted by their members paying lower taxes. Many of the impacted businesses would be small businesses. For each noncorporate member of a PTE that receives at least \$25,000 in income the bill will typically reduce State and local taxes by \$791. For example, a PTE that distributes \$100,000 in income to each of its members will reduce each member's State and local taxes from \$1,910 to \$1,119.

Additional Information

Prior Introductions: SB 1 of 2013 would have imposed a State income tax rate of 2.875% and a local income tax rate of no more than 1.6% on all of the taxable income distributed to a member of a PTE. The bill received a hearing in the Senate Budget and Taxation Committee, but no further action was taken.

Cross File: None.

Information Source(s): Comptroller's Office, Department of Legislative Services

Fiscal Note History: First Reader - February 25, 2014

ncs/jrb

Analysis by: Robert J. Rehrmann

Direct Inquiries to:

(410) 946-5510

(301) 970-5510