

Department of Legislative Services
 Maryland General Assembly
 2015 Session

FISCAL AND POLICY NOTE

Senate Bill 282 (Senator Bates, *et al.*)
 Budget and Taxation

Income Tax Credit - Pass-Through Entities

This bill provides that the income distributed to a member of a pass-through entity (PTE) is taxed under the State income tax at a maximum rate of 2.875%. PTEs include (1) an S corporation; (2) a partnership; (3) a limited liability company 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 taxpayers can claim a credit against the State income tax for any tax imposed above a rate of 2.875%.

The bill takes effect July 1, 2015, and applies to tax year 2015 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by an estimated \$315.0 million annually beginning in FY 2016 as a result of taxing specified PTE income at a maximum rate of 2.875%. General fund expenditures increase by an estimated \$0.2 million in FY 2016 due to implementation costs at the Comptroller’s Office.

(\$ in millions)	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020
GF Revenue	(\$315.0)	(\$315.0)	(\$315.0)	(\$315.0)	(\$315.0)
GF Expenditure	\$0.2	\$0.1	\$0.1	\$0.1	\$0.1
Net Effect	(\$315.2)	(\$315.1)	(\$315.1)	(\$315.1)	(\$315.1)

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

Local Effect: None.

Small Business Effect: Meaningful. Many small businesses are PTEs and would benefit from lower State income 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 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 maximum 2.875% State tax rate on the income distributed to a member of a PTE beginning in tax year 2015. As a result, the Comptroller's Office estimates that general fund revenues will decrease by an estimated \$315.0 million annually beginning in fiscal 2016.

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 effective tax rate. In addition, this 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 2016 as a result of hiring one revenue specialist and incurring programming expenses. As a result, general fund expenditures increase by \$205,700 in fiscal 2016, which accounts for the bill’s July 1, 2015 effective date. It includes a salary, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Position	1
Salary and Fringe Benefits	\$56,866
Operating Expenses	4,870
Programming Expenditures	<u>144,000</u>
Total FY 2016 Expenditures	\$205,736

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

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.

Additional Information

Prior Introductions: HB 1384 of 2014 was withdrawn. Similar legislation proposing to reduce the individual income tax liabilities of PTEs was introduced in the 2013 and 2014 sessions. SB 858 of 2014, SB 590 of 2014, and SB 1 of 2013 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

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md/jrb

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