

Department of Legislative Services
 Maryland General Assembly
 2015 Session

FISCAL AND POLICY NOTE

House Bill 445 (Delegate B. Robinson, *et al.*)
 Ways and Means

Opportunity Bracket for Small Business

This bill creates a subtraction modification against the State income tax for 50% of business income received by the owner of a small business that is attributable to the business. A small business is defined as having gross receipts of \$2 million or less during the taxable year and includes (1) a sole proprietorship; (2) an S corporation; (3) a partnership; or (4) a limited liability company that is not taxed as a corporation. The subtraction modification may be allocated among the owners of the small business in any manner agreed upon in writing, but the subtraction claimed by all owners of a small business may not exceed \$50,000 for each small business.

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 \$145.4 million annually beginning in FY 2016 as a result of exempting specified small business income. 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	(\$145.4)	(\$145.4)	(\$145.4)	(\$145.4)	(\$145.4)
GF Expenditure	\$0.2	\$0.1	\$0.1	\$0.1	\$0.1
Net Effect	(\$145.6)	(\$145.5)	(\$145.5)	(\$145.5)	(\$145.5)

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

Local Effect: Local income tax revenues decrease by an estimated \$87.1 million annually beginning in FY 2016 as a result of exempting specified small business income. Local expenditures are not affected.

Small Business Effect: Meaningful. Many small business owners would benefit from lower State and local tax liabilities.

Analysis

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

Exhibit 1 Maryland State Income Tax Rates Current Law

<u>Rate</u>	<u>Maryland Taxable Income</u>	<u>Rate</u>	<u>Maryland Taxable Income</u>
	Single, Dependent Filer, Married Filing Separate		Joint, Head of Household, Widower
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
Tax Year 2015

<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	3.03%	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 exempts from the State income tax 50% of business income received by the owner of a small business that is attributable to the business. As a result, the Comptroller's Office estimates that general fund revenues decrease by an estimated \$145.4 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 small business income. For example, this may provide an incentive for businesses to change their business structures to a pass-through entity (PTE). The degree to which these types of behavior are induced cannot be reliably estimated, but they could significantly decrease general fund revenue. 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 full-time revenue specialist to manually inspect tax return forms and two contractual revenue specialists to assist with the peak tax filing season. Additionally, the Comptroller's Office would incur programming expenses to add the subtraction modification to its tax system. As a result, general fund expenditures

increase by \$193,224 in fiscal 2016, which accounts for the bill's July 1, 2015 effective date. It includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Regular Position	1
Contractual Positions	2
Salary and Fringe Benefits	\$130,614
Operating Expenses	14,610
Employee Expenditures	\$145,224
Programming Expenditures	<u>48,000</u>
Total FY 2016 Expenditures	\$193,224

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

This estimate does not include any health insurance costs that could be incurred for specified contractual employees under the State's implementation of the federal Patient Protection and Affordable Care Act.

Local Revenues: The bill exempts from the local income tax eligible small business income. As a result, the Comptroller's Office estimates local income tax revenues decrease by \$87.1 million annually beginning in fiscal 2016.

Small Business Effect: Small businesses that are PTEs are meaningfully impacted by their owners paying lower taxes.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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