SB 890

Department of Legislative Services

Maryland General Assembly
2018 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 890 (Senator Serafini)
Budget and Taxation

Income Tax – Subtraction Modification – Entities That Provide Paid Sick Leave

This bill exempts from the State income tax the first $20,000 of nonpassive income that is distributed to a member of a pass-through entity (PTE) who materially participates in the day-to-day operations of the trade or business. An eligible PTE must comply with the Maryland Healthy Working Families Act and employ at least one person who is not a member of the PTE and those nonmember employees must work in aggregate at least 1,200 hours within the State during the taxable year. Individuals with federal adjusted gross income (FAGI) of over $200,000 and married couples filing a joint return with FAGI of over $250,000 are ineligible for the subtraction modification. **The bill takes effect July 1, 2018, and applies to tax year 2019 and beyond.**

Fiscal Summary

State Effect: General fund revenues decrease by an estimated $63.0 million annually beginning in FY 2020 as a result of exempting specified PTE income. General fund expenditures increase by $54,000 in FY 2019 due to implementation costs at the Comptroller's Office.

($ in millions)	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
GF Revenue	$0	($63.0)	($63.0)	($63.0)	($63.0)
GF Expenditure	$0.1	$0	$0	$0	$0
Net Effect	($0.1)	($63.0)	($63.0)	($63.0)	($63.0)

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

Local Effect: Local income tax revenues decrease by an estimated $38.4 million annually beginning in FY 2020 as a result of exempting specified PTE income. Local expenditures are not affected.

Small Business Effect: Meaningful. Many small business owners that are members of PTEs may benefit from reduced State and local tax liabilities.

Analysis

Bill Summary: A PTE includes (1) a sole proprietorship; (2) an S corporation; (3) a partnership; (4) a limited liability company that is not taxed as a corporation; or (5) a business trust or statutory trust that is not taxed as a corporation.

Current Law/Background:

Taxation of PTEs

A PTE is a business structure that avoids the double taxation imposed on an ordinary corporation. A corporation's income generally is taxed at the corporate level and taxed again at the individual level when income is distributed as dividends (cash) to the owners or shareholders. Unlike for a corporation, income recorded by a PTE "flows through" and is allocated to the owners of the entity. The owners of the PTE pay income tax at the individual level on this amount. Owners may choose the type of entity to form for a variety of reasons, including the number of owners, liability protection, profit distribution, ease of formation, and tax treatment.

In order for a business to be treated as a PTE, the entity must organize under State law and make an election to do so on the entity's federal income tax return. PTEs generally fall within one of five categories: sole proprietorship; general partnership; limited partnership; limited liability company; and S corporation (a corporation that is taxed as a PTE). Each type of entity has different characteristics that make it more or less desirable depending on the type of business being established. PTEs have grown in popularity and make up the vast majority of businesses and over half of net business income nationally. In addition, PTEs account for significant portions of the private-sector workforce and payroll.

Exhibit 1 shows the State individual 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	
Rate	**Maryland Taxable Income**	**Rate**	**Maryland Taxable Income**
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.

Federal Tax Cuts and Jobs Act

Under the federal Tax Cuts and Jobs Act of 2017, noncorporate taxpayers may deduct up to 20% of domestic qualified business income from a partnership, S corporation, or sole proprietorship. A limitation based on wages paid, or on wages paid plus a capital element, is phased in for taxpayers with taxable income above a threshold amount. The deduction is not allowed for certain service trades or businesses, but this disallowance is phased in for lower income taxpayers. The deduction applies to tax years 2018 through 2025.

Maryland Healthy Working Families Act

Chapter 1 of 2018 requires an employer with 15 or more employees to have a sick and safe leave policy under which an employee earns at least 1 hour of *paid* sick and safe leave, at the same rate as the employee normally earns, for every 30 hours an employee works. An employer with 14 or fewer employees, based on the average monthly number of employees during the preceding year, must at least have a sick and safe leave policy that provides an employee with at least 1 hour of *unpaid* sick and safe leave for every 30 hours an employee works. An employer is not required to allow an employee to earn or carry over more than 40 hours of earned sick and safe leave in a year, use more than 64 hours of earned leave in a year, accrue more than 64 hours at any time, or use earned sick and safe leave during the first 106 calendar days the employee works for the employer. An employer is not required to carry over unused earned sick and safe leave if the leave is awarded at the beginning of each year.

Earned sick and safe leave begins to accrue the later of February 11, 2018, or the date that an employee begins employment with the employer.

State Revenues: The bill exempts from the State income tax the first $20,000 of nonpassive income that is distributed to a member of a PTE who meets specified conditions. As a result, the Comptroller's Office estimates that general fund revenues decrease by $140.6 million annually beginning in fiscal 2020. However, the Comptroller's estimate does not account for whether a PTE has a qualifying employee as required by the bill, so the Department of Legislative Services (DLS) estimates the revenue impact to be significantly lower. Based on an analysis of business owners by the U.S. Department of Treasury, DLS estimates that 30% of income from sole proprietorships and 80% of income from other PTEs are from PTEs with qualifying employees. As a result, DLS estimates that general fund revenues decrease by $63.0 million annually beginning in fiscal 2020.

This estimate does not take into consideration individuals altering behavior to take advantage of lower average taxes on PTE income. For example, this may provide an incentive for businesses to change their business structures to become a PTE. The degree to which these types of behavior are induced cannot be reliably estimated, but it could significantly decrease general fund revenues. In addition, 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 would incur programming expenses of $54,000 in fiscal 2019 to add the subtraction modification to its tax system. The Comptroller's Office advises that it will not be able to thoroughly verify whether a taxpayer materially participates in the day-to-day operations of the trade or business or whether the required employment hours are met.

Local Revenues: The bill exempts eligible PTE income from the local income tax. As a result, DLS estimates that local income tax revenues decrease by $38.4 million annually beginning in fiscal 2020.

Small Business Effect: PTEs that are small businesses are meaningfully impacted by their members paying lower taxes. A subtraction modification of $20,000 equates to approximately $950 in lower State taxes and $640 in lower local taxes for a qualifying PTE member.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Comptroller's Office; Department of Labor, Licensing, and Regulation; State Department of Assessments and Taxation; CCH Intelliconnect; Department of Legislative Services

Fiscal Note History: First Reader - March 6, 2018
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