HB 129

Department of Legislative Services

Maryland General Assembly
2020 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 129 (Delegates Krimm and Cox)
Ways and Means

Taxes - Election for Pass-Through Entities

This bill authorizes a pass-through entity (PTE) to elect to be taxed at the entity level for the income tax. A PTE must pay the tax imposed on nonresident entity members as required under current law. An individual who is a PTE member may claim an income tax credit equal to the member's proportional share of the amount elected to be paid by the PTE. The credit may not exceed the individual's tax liability, calculated before application of the credit but after application of other tax credits. **The bill takes effect July 1, 2020, and applies to tax year 2020 and beyond.**

Fiscal Summary

State Effect: The bill is generally expected to be revenue neutral as discussed below. General fund expenditures increase by $226,200 in FY 2021 due to implementation costs at the Comptroller's Office. Future years reflect annualization and ongoing costs.

(in dollars)	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025
Revenues	$0	$0	$0	$0	$0
GF Expenditure	226,200	99,700	101,800	105,300	109,000
Net Effect	($226,200)	($99,700)	($101,800)	($105,300)	($109,000)

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

Local Effect: None.

Small Business Effect: Minimal.

Analysis

Bill Summary: The tax for a PTE that elects to be taxed at the entity level is the sum of the lowest county tax rate imposed and the top marginal State tax rate for individuals applied to the sum of each individual member's pro rata share of the PTE's taxable income. For entity members, the tax rate is equal to the State corporate income tax rate. The tax required to be paid by a PTE that makes the election may not exceed the sum of all of the members' and entity members' shares of the PTE's distributable cash flow.

Current Law: The PTE income tax return is generally an information return. The entity's income or loss is passed through to the separate members for taxation purposes. If a PTE is owned by a nonresident, it may be subject to the nonresident PTE income tax. A credit may be claimed on a member's income tax return for any tax paid on behalf of a nonresident member by the PTE. The PTE may elect to file a composite return on behalf of qualified nonresident individual members under which the entity would be the agent to receive any refund or to pay any tax due. Nonresident fiduciary and nonresident entity members may not participate in the filing of the composite return.

Background: 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. However, PTE income "flows through" and is allocated to the owners of the entity, who pay income tax at the individual level on this income. 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 file as a PTE 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).

Federal Tax Cuts and Jobs Act and States' Response

Under the federal Tax Cuts and Jobs Act of 2017, the maximum state and local tax deduction is limited to $10,000 – $5,000 for married taxpayers filing separately – in aggregate of income or sales taxes, real property taxes, and certain personal property taxes through tax year 2025. In response to this limitation, several states have enacted or proposed legislation subjecting PTEs to an entity-level income tax in order to allow state and local taxes to be deducted notwithstanding the limitation. Under current Internal Revenue Service (IRS) interpretations, taxes paid by entities are fully deductible and not subject to the $10,000 (or $5,000) limitation.

Connecticut, Louisiana, New Jersey, Oklahoma, Rhode Island, and Wisconsin have enacted legislation creating PTE tax plans. The IRS and the U.S. Treasury have not issued formal guidance on these newly enacted state-level PTE tax plans. However, the IRS published regulations that have disallowed workarounds related to government-created charitable funds for a variety of programs whereby a donor can receive a state tax credit in exchange for donations.

The Comptroller's Office estimates the bill will reduce federal taxes by approximately $425 million for 139,000 households (although this estimate includes Schedule C income, which is not applicable to the bill).

State Revenues: Under the bill, PTEs may elect to pay taxes on behalf of all of its members. For PTEs that do not have members that are resident corporations, the bill is expected to be revenue neutral. PTEs pay the tax on behalf of individual PTE members at the highest marginal State income tax rate (5.75%) and the lowest county tax rate imposed (equal to 2.25% in tax year 2020). This revenue is distributed to the general fund, and individual taxpayers receive credit for those amounts.

A PTE that elects to pay taxes will pay a tax of 8.25% for corporate PTE members' pro-rata share of taxable income, but the bill does not provide a tax credit for resident corporations. As a result, general fund, Transportation Trust Fund, and Higher Education Investment Fund revenues may increase beginning in fiscal 2021. However, since the tax is elective, this analysis assumes that any PTE with a member resident corporation will not elect to pay taxes on the PTE level.

State Expenditures: General fund expenditures for the Comptroller's Office increase by $226,200 in fiscal 2021, which assumes a six-month start-up delay from the bill's July 1, 2020 effective date. This estimate reflects the cost of hiring two revenue examiners to process and approve tax payments and credits. It also includes $165,000 for one-time data processing changes to the income tax return processing and imaging systems and system testing. The estimate includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Positions	2
Salaries and Fringe Benefits	$50,748
Data Processing Changes	165,000
Other Operating Expenses	10,415
Total FY 2021 State Expenditures	**$226,163**

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

Additional Information

Prior Introductions: None.

Designated Cross File: None.

Information Source(s): Comptroller's Office; Tax Analysts; Tax Notes; Internal Revenue Service; Department of Legislative Services

Fiscal Note History: First Reader - February 11, 2020
an/rjr

Analysis by: Heather N. MacDonagh

Direct Inquiries to:
(410) 946-5510
(301) 970-5510