HB 357

Department of Legislative Services

Maryland General Assembly
2021 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 357 (Delegate Palakovich Carr)
Ways and Means

Income Tax - Pass-Through Entity - Additional Tax

This bill imposes an additional 4% tax on the distributive share or pro-rata share of income distributed to a member of a pass-through entity (PTE) from the PTE's taxable income that exceeds $1.0 million. The bill does not apply to a sole proprietorship or a PTE that has implemented an employee stock ownership plan (ESOP). **The bill takes effect July 1, 2021, and applies to tax year 2021 and beyond.**

Fiscal Summary

State Effect: General fund revenues increase by $432.6 million in FY 2022 from imposing a 4% tax on PTEs, reflecting the impact of one and one-half tax years. Future years reflect annualization and the projected growth in PTE income. General fund expenditures increase by $66,500 in FY 2022 due to implementation costs at the Comptroller's Office. Future years reflect annualization and ongoing costs.

($ in millions)	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026
GF Revenue	$432.6	$320.7	$341.3	$354.1	$360.7
GF Expenditure	$0.1	$0.1	$0.1	$0.1	$0.1
Net Effect	$432.5	$320.6	$341.2	$354.0	$360.6

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

Local Effect: None.

Small Business Effect: Meaningful.

Analysis

Current Law: 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).

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 PTE. 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.

Under the federal Tax Cuts and Jobs Act of 2017, the deduction for state and local taxes paid 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.

Chapter 641 of 2020 authorizes a 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 or corporation that is a member of a PTE may claim a tax credit against the State income tax equal to the tax paid by PTE on the member's share of the PTE's taxable income.

State Revenues: Beginning in tax year 2021, the bill imposes a 4% tax on the distributive or pro-rata share of a PTE member's income distributed from the PTE's taxable income that exceeds $1.0 million. Resident PTE income totaled $12.9 billion in tax year 2016, the last year of available data. The Comptroller's Office reports it does not have data on how much of this income is from PTEs with over $1.0 million of taxable income or from PTEs that have ESOPs. Assuming half of the income is subject to the tax, general fund revenues increase by $432.6 million in fiscal 2022, which reflects the impact of tax year 2021 and about one-half of tax year 2022. **Exhibit 1** shows the impact of the tax in fiscal 2022 through 2026.

Exhibit 1
State Revenue Impacts
Fiscal 2022-2026
($ in Millions)

	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026
General Fund	$432.6	$320.7	$341.3	$354.1	$360.7

State Expenditures: General fund expenditures for the Comptroller's Office increase by $66,500 in fiscal 2022, which assumes a six-month start-up delay from the bill's July 1, 2021 effective date. This estimate reflects the cost of hiring two revenue examiners to process and approve tax payments. The estimate includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Positions	2
Salaries and Fringe Benefits	$55,622
Other Operating Expenses	10,835
Total FY 2022 State Expenditures	**$66,457**

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

Small Business Effect: Generally, PTEs that distribute over $1.0 million of taxable income must pay a 4% tax on the income over $1.0 million. It is unknown how many small businesses are PTEs with distributive taxable income of over $1.0 million and will have higher tax liabilities.

Additional Information

Prior Introductions: HB 507 of 2020, a similar bill, received a hearing in the House Ways and Means Committee, but no further action was taken.

Designated Cross File: None.

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

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