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THE MARYLAND HOUSE OF DELEGATES
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Testimony in Support of HB 507
Close the Pass-Through Entity Loophole

Some companies are gaming the tax system in the way that they structure their business. By setting the business up as a pass-through entity, such as an LLC, partnership, or S-corporation—which are intended for use by small businesses, not large companies—these businesses pay a lower state tax rate than corporations.

This legislation would close the so-called 'pass-through loophole' by applying a 4% surtax on a pass-through entity's profit in excess of $1 million. It's estimated that only 2% of pass-through companies will be subject to the surtax, but it will generate millions of dollars a year for the state.

What Are Pass-Through Entities?

Pass-through entities are specific types of business structures, including LLCs, partnerships, and S-corporations. These types of entities were designed to meet the needs of small businesses. About three-quarters of all pass-through entities are sole proprietorships,[1] which are exempted from this legislation.

Pass-Through Entities Don't Pay Corporate Taxes

By definition, these types of businesses don't pay corporate income tax. Instead, the business profits flow through to the business owner(s) and are taxed as part of the owner's individual income taxes.

In Maryland, the corporate tax rate is 8.25% but the top tax tier for individual income tax—and for pass-through entities—is 5.75%. This means that a business with a profit of $5 million that is attributable to Maryland sales would pay $412,500 in income taxes if they are a corporation but only $285,323 if they are a pass-through entity.[2] That's a 31% discount just for structuring your business in a different way!

A Growing Problem

A growing share of business activity is conducted by pass-through entities.[3] Less than half of all businesses were organized as pass-through entities in 1980; by 2014, that

[1] https://taxfoundation.org/pass-through-businesses-data-and-policy/
[2] Calculations by Delegate Palakovich Carr.
[3] Tax Policy Center, https://www.taxpolicycenter.org/briefing-book/what-are-pass-through-businesses

level grew to 80%. Similarly, the share of business net income in the U.S. contributed by pass-through entities has grown from less than 20% to more than 50%.

This rise in pass-through entities is decreasing government tax revenues. According to the Congressional Budget Office, "if the C-corporation tax rules had applied to S corporations and LLCs in 2007 and if there had been no behavioral responses to that difference in tax treatment, federal revenues in that year would have been about $76 billion higher."[4]

Maryland is also losing out on tax revenues. According to the Maryland Center on Economic Policy, "the unwarranted special tax break large pass-through companies receive on their profits has driven a growing share of businesses to organize as pass-throughs, eroding the corporate tax base." The increase in corporate entities organizing as pass-through entities was also cited by DLS as a reason for the "relative decline of corporate income tax revenues."[5]

It's not just the government that loses out. The increased share of business activity from pass-through entities also "increases the extent to which businesses similar in size and in the same industry are being taxed differently," per the Congressional Budget Office.

Actions Taken by Other States

At least three states have taken action to close their pass-through loophole. Illinois, California, and Massachusetts impose a surtax on the income of some or all types of pass-through entities.

It's important to note that not all states have a pass-through loophole in their tax code. Among Maryland's neighbors, West Virginia doesn't have a loophole, as its corporate and individual tax rates are the same. Neither does Virginia, practically speaking, as the difference in the tax rate for a corporation and a pass-through entity is only 0.25%. The District of Columbia takes a different approach and taxes pass-through entities and corporations at the same rate.

What the Bill Does

This legislation reduces the special treatment of pass-through businesses in the state tax code by establishing a 4% surtax on profits over $1 million of S-corporations, LLCs, and partnerships. Sole proprietorships and employee-owned companies are exempted. The surtax would be deductible at the federal level for these businesses.

This legislation is expected to affect only 2% of pass-through companies, yet still generate millions of dollars in new revenue.

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[4] "Taxing Businesses Through the Individual Income Tax," 2012, Congressional Budget Office.

[5] "Maryland's Corporate Income Tax Overview and Issues," 2011, Department of Legislative Services.