Julie Palakovich Carr
Legislative District 17
Montgomery County

Ways and Means Committee

The Maryland House of Delegates
6 Bladen Street, Room 221
Annapolis, Maryland 21401
410-841-3037 · 301-858-3037
800-492-7122 *Ext.* 3037
Julie.PalakovichCarr@house.state.md.us

THE MARYLAND HOUSE OF DELEGATES
Annapolis, Maryland 21401

Testimony in Support of HB 357
Income Tax – Pass-Through Entity – Additional Tax

Some companies are gaming Maryland's tax system in the way they structure their business. By setting the business up as a pass-through entity, such as an LLC, partnership, or S-corporation, these businesses avoid paying state corporate income taxes. Pass-through entities are intended for use by small businesses, but there are no protections in place in state law to prevent large, profitable companies from avoiding the corporate income tax.

This legislation would close the so-called 'pass-through loophole' by applying a 4% tax 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 tax, but it will generate significant revenues 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 tax rate for a pass-through entity is 0%. In both cases, the owners and employees of the business are taxed on their individual income and wages; those individual taxes are the same regardless of the legal structure of the company.

[1] https://taxfoundation.org/pass-through-businesses-data-and-policy/

A Growing Problem

A growing share of business activity is conducted by pass-through entities.[2] Less than half of all businesses were organized as pass-through entities in 1980; by 2014, that 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."[3]

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."[4]

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 seven states have enacted laws to address tax fairness among different types of businesses: California, Illinois, Massachusetts, New Hampshire, Ohio, Tennessee, and Texas. Additionally, the District of Columbia and New York City also tax pass-through entities.

What the Bill Does

- Reduces the special treatment of pass-through businesses in the state tax code.
- Establishes a 4% tax on profits over $1 million of S-corporations, partnerships, and LLCs.

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[2] Tax Policy Center, https://www.taxpolicycenter.org/briefing-book/what-are-pass-through-businesses
[3] "Taxing Businesses Through the Individual Income Tax," 2012, Congressional Budget Office.
[4] "Maryland's Corporate Income Tax Overview and Issues," 2011, Department of Legislative Services.

    - Sole proprietorships and employee owned companies are exempted in the legislation.
- The taxes would be deductible at the federal level for these businesses.
    - These taxes could also be used in the SALT deduction workaround passed by the General Assembly in 2020.
- This legislation is expected to affect less than 2% of pass-through companies, yet still generate millions of dollars in new revenue.