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Testimony Of
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Before the
Maryland House of Delegates Ways and Means Committee

Hearing on H.B. 357, A Bill to Impose an Additional Tax on the Distributed Profits of Large Passthrough Entities
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Chair Kaiser and Members of the Ways and Means Committee, I'm Michael Mazerov, a Senior Fellow with the State Fiscal Policy division of the Center on Budget and Policy Priorities in Washington, D.C. The Center is a non-partisan research and policy institute that pursues federal and state policies designed to reduce poverty and inequality and to restore fiscal responsibility in equitable and effective ways. We apply our expertise in budget and tax issues and in programs and policies that help low-income people to help inform debates and achieve better policy outcomes. I appreciate the opportunity to submit testimony in support of H.B. 357.

Delegate Palakovich Carr's bill would impose a four percent tax on the distributed profits of large pass-through entities to bring their tax treatment more in line with that of taxable corporations. The tax would not apply to sole proprietors or businesses owned by employee stock ownership plans. Passthroughs are businesses that are not subject to the corporate income tax. They are exempt either because they are not corporations, for example, they are partnerships or limited liability companies, or because they are corporations that qualify to be exempt from the corporate income tax under the conditions set in Subchapter S of the Internal Revenue Code. They are called passthroughs because their profits are passed through to the tax returns of their owners and taxed there. The owners of S corporations are almost always individuals, while the owners of partnerships and LLCs can be individuals or other businesses – including taxable corporations and other passthroughs.

Passthrough treatment, that is, exemption from the corporate income tax, was intended initially to benefit small businesses. And initially that is the kind of businesses it benefited. But many passthrough businesses now are not small. For example, many billion-dollar hedge funds are organized as passthroughs. Moreover, many passthroughs have much higher profits than many small corporations that are subject to the corporate income tax. For example, the IRS reported that in 2013 there were 490,000 taxable corporations with profits below $1 million, representing 98 percent of all taxable corporations with profits. If there are this many corporations with profits below $1 million that are subject to the normal corporate income tax, surely it is fair to expect passthroughs with profits above $1 million to pay some tax as business entities. Since many passthroughs get all or most of the non-tax benefits of taxable corporations – most importantly, their owners' liability for the debts of the business are limited to their equity investments – there is no longer any justification for completely exempting these businesses from tax at the entity level.

Accordingly, H.B. 357 proposes to impose a four percent tax on the profits over $1 million that passthroughs distribute to their owners. Profits plowed back into the business would not be subject to the tax. Even if they were distributed and subject to tax, they would still receive more favorable tax treatment than profits distributed as dividends to regular corporate shareholders. In other words, there would still be a significant tax savings in operating as a passthrough for businesses for whom that makes sense for non-tax reasons.

In making this long-overdue change, Maryland would not be alone. The District of Columbia imposes a tax on passthroughs at the full corporate tax rate, as does New York City. California, Massachusetts, and Illinois also impose taxes on the profits of some types of passthroughs. Kentucky imposes a gross receipts tax. New Hampshire, Tennessee, and Texas tax passthroughs essentially the same way they tax regular corporations.

Large passthroughs differ little from taxable corporations and should therefore be subject to some type of tax as business entities. I therefore urge the committee to favorably report H.B. 357. I thank the Committee for the opportunity to submit written testimony. I may be reached at mazerov@cbpp.org if Committee members have any questions.