HB 219

Department of Legislative Services

Maryland General Assembly
2005 Session

FISCAL AND POLICY NOTE

House Bill 219 (Chairman, Ways and Means Committee)
(By Request – Departmental – Comptroller)

Ways and Means Budget and Taxation

Taxes - Electing Small Business Trusts - Federal Adjusted Gross Income

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This departmental bill imposes the State income tax on the income of an Electing Small Business Trust (ESBT) that is derived from stock in an S corporation. The bill requires, for State income tax purposes, that a fiduciary include the amount of income of an ESBT from stock in an S corporation for the purpose of calculating federal adjusted gross income.

The bill takes effect July 1, 2005 and applies to tax years 2005 and beyond.

Fiscal Summary

State Effect: Indeterminate increase in State general fund revenues beginning in FY 2006. No effect on expenditures.

Local Effect: Indeterminate increase in local income tax revenues beginning in FY 2006. No effect on expenditures.

Small Business Effect: The Comptroller's Office has determined that this bill has minimal or no impact on small business (attached). Legislative Services concurs with this assessment.

Analysis

Current Law: The State does not currently tax the income of an ESBT that is derived from S corporation stock. Income of an ESBT not resulting from ownership of S corporation stock is subject to State income tax.

Background: ESBTs are organizations defined by Section 1361 (e) (1) of the Internal Revenue Code (IRC). Generally, an ESBT is a trust that only has beneficiaries who are individuals, estates, or certain tax exempt organizations. The interest in such trust cannot have been acquired by purchase and the trust must elect to be treated as an ESBT. Certain trusts generally cannot qualify as an ESBT, including tax exempt trusts, charitable remainder annuity trusts, charitable remainder unitrusts, and qualified subchapter S trusts.

ESBTs are eligible to hold stock in S corporations. Section 641 (c) of the IRC requires that the portion of any ESBT that consists of any stock in S corporations is treated as a separate trust for federal tax purposes. The taxable income of this portion of the trust includes: (1) gains and losses from the sale of S corporation stock; (2) income, losses, or deductions allocated to the trust as an S corporation shareholder; and (3) State and local taxes and administrative expenses of the trust properly allocable to the S corporation stock. Any portion of income from this separate trust is taxed at the highest rate imposed on estates and trusts.

For federal tax purposes, the federal adjusted gross income of the ESBT does not include income derived from stock in an S corporation. The tax on the portion of income derived from stock in an S corporation is calculated separately and added to the tax liability resulting from the ESBT's other income. The Comptroller's Office advises that income generated from S corporation stock is not taxed for State purposes since federal adjusted gross income is the starting point for the Maryland adjusted gross income of a fiduciary.

State Revenues: The Comptroller advises that the number of ESBTs with income from S corporation stock in the State is unknown, but is expected to be minimal. In addition, the IRS advises that data on number of ESBTs nationally are not available. The actual increase in State revenues cannot be reliably estimated and depends on the number and net income of ESBTs affected by the provisions of the bill.

Additional Information

Prior Introductions: SB 100 of 2002, an identical bill, passed the Senate but was not reported from the House Ways and Means Committee.

Cross File: None.

Information Source(s): Comptroller's Office, Internal Revenue Service, Department of Legislative Services

Fiscal Note History: First Reader - February 3, 2005
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