HB 128

Department of Legislative Services

Maryland General Assembly
2012 Session

FISCAL AND POLICY NOTE

House Bill 128 (Delegate Arora, *et al.*)
Ways and Means

Taxes - Electing Small Business Trusts State Tax Loophole Elimination Act

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This bill requires, for State income tax purposes, that a fiduciary include the amount of income of an electing small business trust (ESBT) derived from stock in an S corporation for the purpose of calculating federal adjusted gross income.

The bill takes effect July 1, 2012, and applies to tax years 2012 and beyond.

Fiscal Summary

State Effect: General fund revenues increase beginning in FY 2013 due to State income taxes paid by ESBTs. No effect on expenditures.

Local Effect: Local income tax revenues increase beginning in FY 2013. No effect on expenditures.

Small Business Effect: Minimal.

Analysis

Current Law/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 certain 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; (3) State and local taxes and administrative expenses of the trust properly allocable to the S corporation stock; and (4) any interest expense paid or accrued on debt incurred to acquire S corporation stock.

Any portion of income from this separate trust that does not qualify as a capital gain is taxed at the highest rate imposed on estates and trusts, which is currently equal to the highest rate imposed on individuals.

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. As such, the Comptroller's Office advises that income generated from S corporation stock is not taxed for State income tax purposes since federal adjusted gross income is the starting point for the Maryland adjusted gross income of a fiduciary.

Income of an ESBT not resulting from ownership of S corporation stock is generally subject to State income tax.

State Revenues: The Comptroller advises that the number of ESBTs in the State with income from S corporation stock is unknown. The actual increase in State revenues beginning in fiscal 2013 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: HB 219 of 2005 passed the House, but received an unfavorable report from the Senate Budget and Taxation Committee. SB 100 of 2002 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

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ncs/jrb

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