

Department of Legislative Services
Maryland General Assembly
2013 Session

FISCAL AND POLICY NOTE

Senate Bill 1 (Senator Brinkley)
Budget and Taxation

Income Tax - Pass-Through Entity - Maximum Rate

This bill changes the State individual income tax rate for income distributed to a member of a pass-through entity (PTE) to 2.875%. The bill also changes the county individual income tax rate for income distributed to a member of a PTE to a maximum tax rate of 1.6%. PTEs include (1) an S corporation; (2) a partnership; (3) a limited liability company (LLC) that is not taxed as a corporation by the State; and (4) a business trust or statutory trust that is not taxed as a corporation by the State.

The bill takes effect July 1, 2013, and applies to tax year 2013 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by an estimated \$370.0 million annually as a result of taxing PTE income at a 2.875% rate. General fund expenditures increase by an estimated \$7.0 million in FY 2014 for one-time start-up costs.

(\$ in millions)	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
GF Revenue	(\$370.0)	(\$370.0)	(\$370.0)	(\$370.0)	(\$370.0)
GF Expenditure	\$7.0	\$0	\$0	\$0	\$0
Net Effect	(\$377.0)	(\$370.0)	(\$370.0)	(\$370.0)	(\$370.0)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Local revenues decrease by an estimated \$212.0 million annually beginning in FY 2014 from changing the maximum tax rate on PTE income to 1.6%. Expenditures are not affected.

Small Business Effect: Meaningful. Many small businesses are PTEs, so most of those businesses would benefit from paying a lower income tax rate.

Analysis

Current Law: There is no special tax treatment for income distributed to a member of a PTE. **Exhibit 1** shows the State income tax rates under current law.

Exhibit 1 Maryland State Income Tax Rates Current Law

Single, Dependent Filer, Married Filing Separate		Joint, Head of Household, Widower	
<u>Rate</u>	<u>Maryland Taxable Income</u>	<u>Rate</u>	<u>Maryland Taxable Income</u>
2.00%	\$1-\$1,000	2.00%	\$1-\$1,000
3.00%	\$1,001-\$2,000	3.00%	\$1,001-\$2,000
4.00%	\$2,001-\$3,000	4.00%	\$2,001-\$3,000
4.75%	\$3,001-\$100,000	4.75%	\$3,001-\$150,000
5.00%	\$100,001-\$125,000	5.00%	\$150,001-\$175,000
5.25%	\$125,001-\$150,000	5.25%	\$175,001-\$225,000
5.50%	\$150,001-\$250,000	5.50%	\$225,001-\$300,000
5.75%	Excess of \$250,000	5.75%	Excess of \$300,000

The counties and Baltimore City are required to levy a local income tax on their residents. The tax is assessed as a percentage of the taxpayer's Maryland taxable income. Counties are authorized to set a local income tax rate of at least 1% but not more than 3.2%. The tax rate is a flat rate, as counties are not authorized to impose the tax at different rates. Generally, each incorporated municipality shares in its county's income tax revenues by receiving a portion of the county income taxes paid by the municipality's residents. **Exhibit 2** shows the county income tax rates under current law.

Exhibit 2
Maryland County Income Tax Rates
Calendar 2013

<u>County</u>	<u>Rate</u>	<u>County</u>	<u>Rate</u>
Allegany	3.05%	Harford	3.06%
Anne Arundel	2.56%	Howard	3.20%
Baltimore City	3.20%	Kent	2.85%
Baltimore	2.83%	Montgomery	3.20%
Calvert	2.80%	Prince George's	3.20%
Caroline	2.63%	Queen Anne's	3.20%
Carroll	3.05%	St. Mary's	3.00%
Cecil	2.80%	Somerset	3.15%
Charles	2.90%	Talbot	2.40%
Dorchester	2.62%	Washington	2.80%
Frederick	2.96%	Wicomico	3.20%
Garrett	2.65%	Worcester	1.25%

The Comptroller's expenses that are necessary to administer the income tax are paid by distributions from State and local income tax revenues. These costs include the amount necessary to administer the local income tax.

State Revenues: It is estimated that imposing a 2.875% rate on PTE income will decrease State revenues by an estimated \$370.0 million annually. This estimate does not take into consideration individuals altering behavior to take advantage of a lower tax rate on PTE income. A PTE that has traditionally paid out some of its income in the form of wages may shift more income to PTE business earnings to take advantage of the lower rate. In addition, the rate change provides an incentive for sole proprietors to change their business structures to a PTE because sole proprietorships are not entitled to the lower tax rate. The degree to which these types of behavior are induced cannot be reliably estimated, but they could significantly decrease general fund revenue. Also, PTE income has traditionally been very volatile from year-to-year, much like corporate income. For these reasons, the revenue estimates are kept static over the five-year period, though the actual tax effect from the bill could vary drastically in future years.

State Expenditures: The bill could place a significant administrative burden on the Comptroller's Office. The Comptroller's Office estimates a one-time expenditure increase of \$7.0 million, which includes \$4.6 million for the necessary programming changes and \$2.4 million to do a complete systems test. Programming changes include changes to the Comptroller's integrated tax system, electronic filing, Internet filing,

compliance interfaces, and data warehouse modeling. Additional minimal one-time expenses for developing, printing, and distributing new forms and instructions would also be incurred.

Local Revenues: Taxing PTE income at a maximum rate of 1.6% decreases local revenue by an estimated \$212.0 million annually. All of the counties, except Worcester County, will have revenues decrease significantly by imposing a maximum rate of 1.6% on PTE income, instead of the current maximum rate of 3.2%.

In Worcester County, the county income tax rate is 1.25%, which is lower than the maximum rate that the bill proposes for PTE income. If Worcester County decides to tax PTE income at the maximum rate of 1.6%, county revenues would increase.

Small Business Effect: Businesses that are PTEs would be meaningfully impacted by their members paying lower taxes. Many of the impacted businesses would be small businesses. However, if a member of a PTE currently has an effective tax rate of less than 2.875%, the member would pay higher taxes.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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