

Department of Legislative Services
 Maryland General Assembly
 2014 Session

FISCAL AND POLICY NOTE

Senate Bill 858 (Senator Kasemeyer)
 Budget and Taxation

Income Tax - Subtraction Modification - Nonpassive Income of a Pass-Through Entity

This bill exempts from the State income tax the first \$50,000 of income distributed to a member of a pass-through entity (PTE). PTEs include (1) an S corporation; (2) a partnership; (3) a limited liability company (LLC) that is not taxed as a corporation; or (4) a business trust or statutory trust that is not taxed as a corporation. In order to qualify, the income must be nonpassive income as defined by the bill and the PTE must meet specified requirements.

The bill takes effect July 1, 2014, and applies to tax year 2014 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by an estimated \$110.0 million annually beginning in FY 2015 as a result of exempting specified PTE income. General fund expenditures increase by an estimated \$0.2 million in FY 2015 due to implementation costs at the Comptroller’s Office.

(\$ in millions)	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
GF Revenue	(\$110.0)	(\$110.0)	(\$110.0)	(\$110.0)	(\$110.0)
GF Expenditure	\$0.2	\$0.1	\$0.1	\$0.1	\$0.1
Net Effect	(\$110.2)	(\$110.1)	(\$110.1)	(\$110.1)	(\$110.1)

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

Local Effect: Local income tax revenues decrease by an estimated \$70.0 million annually beginning in FY 2015 as a result of exempting specified PTE income. Local expenditures are not affected.

Small Business Effect: Meaningful. Many small businesses are PTEs and will benefit from lower State and local tax liabilities.

Analysis

Bill Summary: The bill exempts from the State income tax the first \$50,000 of income distributed to a member of a PTE. In order to qualify, the income distributed to a member must be nonpassive income. Nonpassive income is income other than income from a passive activity as defined under Section 469 of the Internal Revenue Code and does not include wages, interest, dividends, or capital gains. In addition, the subtraction modification applies only if (1) the taxpayer materially participates in the daily operations of the trade or business; (2) the PTE employs at least one person who is not a member of the PTE; and (3) at least 1,200 aggregate hours of work are performed in the State in the tax year by employees who are not members of the PTE. A qualifying employee must work at least 30 hours in a week for the hours to be considered towards fulfilling the requirement.

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

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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
County Income Tax Rates
Calendar 2014

<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	2.73%	Queen Anne's	3.20%
Carroll	3.04%	St. Mary's	3.00%
Cecil	2.80%	Somerset	3.15%
Charles	3.03%	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: The bill exempts from the State income tax the first \$50,000 in eligible nonpassive PTE income. As a result, general fund revenues will decrease by an estimated \$110.0 million annually beginning in fiscal 2015.

This estimate does not take into consideration individuals altering behavior to take advantage of a lower average tax rate on PTE income. In addition, this may provide an incentive for businesses to change their business structures to a PTE. The degree to which these types of behavior are induced cannot be reliably estimated, but they could significantly decrease general fund revenue. PTE income is volatile, so the actual revenue impact in a tax year could be significantly different than estimated.

State Expenditures: The Comptroller's Office advises that it will incur additional costs beginning in fiscal 2015 as a result of hiring one revenue specialist and incurring

programming expenses. As a result, general fund expenditures increase by \$224,500 in fiscal 2015, which accounts for the bill's July 1, 2014 effective date. It includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Position	1
Salary and Fringe Benefits	\$75,534
Operating Expenses	4,950
Employee Expenditures	\$80,484
Programming Expenditures	<u>\$144,000</u>
Total FY 2015 Expenditures	\$224,484

Future year expenditures reflect full salaries with annual increases and employee turnover as well as annual increases in ongoing operating expenses.

The above estimate assumes that the proposed rate change will be administered as a credit equal to the resulting difference in tax liabilities and does not include any additional expenses necessary to alter the corporate income tax to reflect corporate members of PTEs. The Comptroller's Office advises that expenditures may be significantly greater than estimated.

Local Revenues: The bill exempts from the local income tax the first \$50,000 in eligible nonpassive PTE income. As a result, local income tax revenues will decrease by \$70.0 million annually beginning in fiscal 2015.

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. For each noncorporate member of a PTE that receives at least \$50,000 in income the bill will typically reduce State and local taxes by \$3,873. For example, a PTE that distributes \$100,000 in taxable income to each of its members will reduce each member's State and local taxes from \$7,798 to \$3,925.

Additional Information

Prior Introductions: SB 1 of 2013 would have imposed a State income tax rate of 2.875% and a local income tax rate of no more than 1.6% on all of the taxable income distributed to a member of a PTE. The bill received a hearing in the Senate Budget and Taxation Committee, but no further action was taken.

Cross File: None.

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

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