HB 1250

Department of Legislative Services

Maryland General Assembly
2016 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 1250 (The Speaker, *et al.*) (By Request - Maryland Economic Development and Business Climate Commission)

Ways and Means

Income Tax - Pass-Through Entities - Exemption

This bill exempts from the State income tax the first $20,000 of nonpassive income that is distributed to a member of a pass-through entity (PTE) who materially participates in the day-to-day operations of the trade or business. An eligible PTE must employ at least one person who is not a member of the PTE and those nonmember employees must work in aggregate at least 1,200 hours within the State during the taxable year.

A PTE includes (1) a sole proprietorship; (2) an S corporation; (3) a partnership; (4) a limited liability company that is not taxed as a corporation; or (5) a business trust or statutory trust that is not taxed as a corporation. Individuals with federal adjusted gross income (FAGI) of over $200,000 and married couples filing a joint return with FAGI of over $250,000 are ineligible for the subtraction modification. By March 1 of 2018, 2019, and 2020, the Comptroller must submit to the Governor and the General Assembly a report on the impacts of the PTE exemption.

The bill takes effect July 1, 2016, and applies to tax year 2016 and beyond.

Fiscal Summary

State Effect: General fund revenues decrease by an estimated $63.0 million annually beginning in FY 2017 as a result of exempting specified PTE income. General fund expenditures increase by $50,900 in FY 2017 due to implementation costs at the Comptroller's Office.

($ in millions)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
GF Revenue	($63.0)	($63.0)	($63.0)	($63.0)	($63.0)
GF Expenditure	$0.1	$0	$0	$0	$0
Net Effect	($63.1)	($63.0)	($63.0)	($63.0)	($63.0)

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

Local Effect: Local income tax revenues decrease by an estimated $38.4 million annually beginning in FY 2017 as a result of exempting specified PTE income. Local expenditures are not affected.

Small Business Effect: Meaningful. Many small business owners that are members of PTEs would benefit from reduced State and local tax liabilities.

Analysis

Current Law/Background:

Taxation of PTEs

A PTE is a business structure that avoids the double taxation imposed on an ordinary corporation. A corporation's income generally is taxed at the corporate level and taxed again at the individual level when income is distributed as dividends (cash) to the owners or shareholders. Unlike for a corporation, income recorded by a PTE "flows through" and is allocated to the owners of the entity. The owners of the PTE pay income tax at the individual level on this amount. Owners may choose the type of entity to form for a variety of reasons, including the number of owners, liability protection, profit distribution, ease of formation, and tax treatment.

In order for a business to be treated as a PTE, the entity must organize under State law and make an election to do so on the entity's federal income tax return. PTEs generally fall within one of five categories: sole proprietorship, general partnership, limited partnership, limited liability company, and S-corporation (a corporation that is taxed as a PTE). Each type of entity has different characteristics that make it more or less desirable depending on the type of business being established. PTEs have grown in popularity and make up the vast majority of businesses and over half of net business income nationally. In addition, PTEs account for significant portions of the private-sector workforce and payroll.

Exhibit 1 shows the State individual 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
Rate	**Maryland Taxable Income**	**Rate**	**Maryland Taxable Income**
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. **Exhibit 2** shows the county income tax rates for tax year 2016.

Exhibit 2
County Income Tax Rates
Tax Year 2016

County	Rate	County	Rate
Allegany	3.05%	Harford	3.06%
Anne Arundel	2.50%	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	3.03%	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	1.75%

Kansas, Ohio, and Oregon have recently altered their individual income tax structures to provide more favorable tax treatment of reported income derived from PTEs.

Maryland Economic Development and Business Climate Commission

In March 2014, the President of the Senate and the Speaker of the House of Delegates appointed the Maryland Economic Development and Business Climate Commission to focus on the State's economic development structure and incentive programs in order to make recommendations to the Presiding Officers. The commission's 26 members come from a broad spectrum of backgrounds and have had business involvement in many states, as well as abroad.

A report containing 10 findings and 32 recommendations was submitted to the Presiding Officers in February 2015. The principal finding of the commission is that Maryland has not nearly reached its potential in growing business and creating jobs. The recommendations in the report address various short- and long-term aspects of this principal finding and related findings. As a result, five pieces of legislation were enacted into law during the 2015 session that addressed many of the commission's recommendations.

In March 2015, the Presiding Officers asked the commission to review and make recommendations on certain tax issues affecting economic development and the State's business climate. In a report issued in January 2016, the commission offered 14 recommendations to improve the State's business tax structure, 13 of which were proposed for implementation at the present time and a fourteenth, a reduction in individual income taxes, that should be implemented when other recommendations have been assimilated and the State's revenues and economy have strengthened.

The commission found that Maryland's current tax structure is a detriment to the State's competitiveness in attracting and retaining businesses as well as in creating jobs and expanding the revenue base of the government itself. The commission also found, however, that the State has many competitive advantages, particularly an educational system that has helped produce one of the most highly qualified workforces in the nation.

This bill would implement one of the commission's recommendations, to provide an individual income tax exemption for certain income of specified members of PTEs.

The January 2016 report of the commission can be found here.

State Revenues: The bill exempts from the State income tax the first $20,000 of nonpassive income that is distributed to a member of a PTE who meets specified conditions. As a result, the Comptroller's Office estimates that general fund revenues decrease by $141.4 million annually beginning in fiscal 2017. However, the Comptroller's estimate does not account for whether a PTE has a qualifying employee as required by the bill, so the Department of Legislative Services (DLS) estimates the revenue impact to be significantly lower. Based on an analysis of business owners by the U.S. Department of Treasury, DLS estimates that 30% of income from sole proprietorships and 80% of income from other PTEs are from PTEs with qualifying employees. As a result, DLS estimates that general fund revenues decrease by $63.0 million annually beginning in fiscal 2017.

This estimate does not take into consideration individuals altering behavior to take advantage of lower average taxes on PTE income. For example, this may provide an incentive for businesses to change their business structures to become a PTE. The degree to which these types of behavior are induced cannot be reliably estimated, but it could significantly decrease general fund revenues. In addition, 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 would incur programming expenses of $50,900 in fiscal 2017 to add the subtraction modification to its tax system, and it can complete the annual reporting requirement with existing resources. The Comptroller's Office advises that it will not be able to thoroughly verify whether a taxpayer materially participates in the day-to-day operations of the trade or business or whether the required employment hours are met.

Local Revenues: The bill exempts eligible PTE income from the local income tax. As a result, DLS estimates that local income tax revenues decrease by $38.4 million annually beginning in fiscal 2017.

Small Business Effect: PTEs that are small businesses are meaningfully impacted by their members paying lower taxes. A subtraction modification of $20,000 equates to approximately $950 in lower State taxes and $640 in lower local taxes for a qualifying PTE member.

Additional Information

Prior Introductions: None.

Cross File: SB 841 (The President)(By Request - Maryland Economic Development and Business Climate Commission) - Budget and Taxation.

Information Source(s): Comptroller's Office, State Department of Assessments and Taxation, U.S. Department of the Treasury, Department of Legislative Services

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