SB 523

Department of Legislative Services

Maryland General Assembly
2020 Session

FISCAL AND POLICY NOTE
Enrolled - Revised

Senate Bill 523 (Senator Guzzone, *et al.*)

Budget and Taxation Ways and Means

Income Tax – Pass–Through Entities and Corporations

This bill authorizes a pass-through entity (PTE) to elect to be taxed at the entity level for the income tax. A PTE must pay the tax imposed on nonresident entity members as required under current law. An individual or corporation may claim a tax credit against the State income tax equal to the tax paid by a PTE on the member's share of the PTE's taxable income. Additionally, the bill alters the number of employees that a worldwide headquartered company must have for purposes of the single sales apportionment exemption. **The bill takes effect July 1, 2020, and applies to tax year 2020 and beyond.**

Fiscal Summary

State Effect: General fund, Transportation Trust Fund (TTF), and Higher Education Investment Fund (HEIF) revenues and TTF expenditures may decrease beginning in FY 2021. General fund expenditures increase by $226,200 in FY 2021 due to implementation costs at the Comptroller's Office. Future years reflect annualization and ongoing costs.

(in dollars)	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025
GF Revenue	(-)	(-)	(-)	(-)	(-)
SF Revenue	(-)	(-)	(-)	(-)	(-)
GF Expenditure	$226,200	$99,700	$101,800	$105,300	$109,000
Net Effect	($226,200)	($99,700)	($101,800)	($105,300)	($109,000)

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

Local Effect: Local highway user revenues may decrease beginning in FY 2021. Local expenditures are not affected.

Small Business Effect: Minimal.

Analysis

Bill Summary:

Pass-through Entities

The tax for a PTE that elects to be taxed at the entity level is the sum of the lowest county tax rate imposed and the top marginal State tax rate for individuals applied to the sum of each individual member's distributive or pro rata share of the PTE's taxable income. For entity members, the tax rate is equal to the State corporate income tax rate. The tax required to be paid by a PTE that makes the election may not exceed the sum of all of the members' shares of the PTE's distributable cash flow.

Single Sales Factor Apportionment Exemption

The bill alters the number of employees that a worldwide headquartered company must have for purposes of the single sales apportionment exemption. If the parent corporation is a franchisor, it must be part of a group of corporations that employ at least 400 full-time employees at the parent corporation's principal executive office that is located within the State, among other requirements, to be considered a worldwide headquartered corporation.

Current Law: The PTE income tax return is generally an information return. The entity's income or loss is passed through to the separate members for taxation purposes. If a PTE is owned by a nonresident, it may be subject to the nonresident PTE income tax. A credit may be claimed on a member's income tax return for any tax paid on behalf of a nonresident member by the PTE. The PTE may elect to file a composite return on behalf of qualified nonresident individual members under which the entity would be the agent to receive any refund or to pay any tax due. Nonresident fiduciary and nonresident entity members may not participate in the filing of the composite return.

Single Sales Factor Apportionment

Prior to tax year 2018, corporations were generally required to use either a three-factor apportionment formula of payroll, property, and sales, with sales double weighted or, in the case of a manufacturing corporation, a one-factor formula based on sales, referred to as a single sales factor formula. The apportionment factor is then multiplied by the corporation's modified income to determine Maryland taxable income.

Chapters 341 and 342 of 2018 phase in a requirement that all corporations subject to the corporate income tax, with an exception for specified worldwide headquartered companies, use a single sales factor formula to apportion income to the State. In general, sales represent 60% of the final apportionment factor in tax year 2018, 66.67% of the final apportionment factor in tax year 2019, 71.42% of the final apportionment factor in tax year 2020, 75% of the final apportionment factor in tax year 2021, and 100% of the final apportionment factor in tax year 2022 and beyond. Corporations engaged primarily in manufacturing activities must use a single sales apportionment factor.

A corporation may elect annually to use a three-factor formula that incorporates property, payroll, and a double-weighted sales factor if the corporation included in a group of corporations, including a parent corporation, is a worldwide headquartered company that filed a federal corporate income tax return for the taxable year, filed a specified form with the Securities and Exchange Commission, has its principal executive office in the State, and employs at least 500 full-time employees during a specified period.

To determine the Maryland modified income of a corporation or group of corporations that is a worldwide headquartered company that filed a federal corporate income tax return for the taxable year, gross income from intangible investments, including dividends, interest, royalties, and capital gains from the sale of intangible property, must be included in the calculation of the numerator based on the average of the property and payroll factors.

Background: 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. However, PTE income "flows through" and is allocated to the owners of the entity, who pay income tax at the individual level on this income. 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 file as a PTE 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).

Federal Tax Cuts and Jobs Act and States' Response

Under the federal Tax Cuts and Jobs Act of 2017, the maximum state and local tax deduction is limited to $10,000 – $5,000 for married taxpayers filing separately – in aggregate of income or sales taxes, real property taxes, and certain personal property taxes through tax year 2025. In response to this limitation, several states have enacted or proposed legislation subjecting PTEs to an entity-level income tax in order to allow state and local taxes to be deducted notwithstanding the limitation. Under current Internal Revenue Service (IRS) interpretations, taxes paid by entities are fully deductible and not subject to the $10,000 (or $5,000) limitation.

Connecticut, Louisiana, New Jersey, Oklahoma, Rhode Island, and Wisconsin have enacted legislation creating PTE tax plans. The IRS and the U.S. Treasury have not issued formal guidance on these newly enacted state-level PTE tax plans. However, the IRS published regulations that have disallowed workarounds related to government-created charitable funds for a variety of programs whereby donors can receive a state tax credit in exchange for donations.

The Comptroller's Office estimates the bill will reduce federal taxes by approximately $425 million for 139,000 households (although this estimate includes Schedule C income, which is not applicable to the bill).

State/Local Revenues: Under the bill, PTEs may elect to pay taxes on behalf of all members. PTEs that elect to pay taxes will pay a tax rate of 8.25% for corporate PTE members' shares of taxable income, and these corporations will receive a credit for the taxes paid. PTEs making the election also pay tax on behalf of individual PTE members at the highest marginal State income tax rate (5.75%) and the lowest county tax rate (2.25% in tax year 2020). Thus, individual taxpayers receive a State credit for the taxes paid attributable to the 5.75% State tax rate and for the taxes paid attributable to the lowest county tax rate imposed. Accordingly, this provision of the bill is revenue neutral for PTEs paying tax on members' share of taxable income.

Single Sales Apportionment Exemption

Approximately a dozen or fewer corporations will be able to elect to be exempt from the single sales apportionment requirement under the bill. These companies may elect annually to use a three-factor formula that incorporates property, payroll, and a double-weighted sales factor. Thus, general fund, TTF, and HEIF revenues may decrease beginning in fiscal 2021 to the extent that these companies elect to use the double-weighted sales factor apportionment formula. The Comptroller's Office advises that they are not able to disclose the fiscal impact of the bill due to taxpayer confidentiality; however, they do not expect the bill to have a significant fiscal effect and the revenue loss, if any, is likely to be less than $5.0 million annually.

Local governments receive a portion of corporate income tax revenues as local highway user revenues through capital transportation grants. Thus, local highway user revenues may decrease beginning in fiscal 2021 to the extent that corporate income tax revenues decrease.

State Expenditures: General fund expenditures for the Comptroller's Office increase by $226,200 in fiscal 2021, which assumes a six-month start-up delay from the bill's July 1, 2020 effective date. This estimate reflects the cost of hiring two revenue examiners to process and approve tax payments and credits. It also includes $165,000 for one-time data processing changes to the income tax return processing and imaging systems and system testing. The estimate includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Positions	2
Salaries and Fringe Benefits	$50,748
Data Processing Changes	165,000
Other Operating Expenses	10,415
Total FY 2021 State Expenditures	**$226,163**

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

A portion of TTF revenues are used to provide capital transportation grants to local governments. To the extent that TTF revenues decrease as a result of taxpayers altering their apportionment method on the corporate income tax, TTF expenditures decrease by 13.5% of the TTF revenue decrease beginning in fiscal 2021 (9.6% beginning in fiscal 2025). TTF revenues also fund the State capital program; thus, a decrease in TTF revenues decreases expenditures for the State capital program.

Additional Information

Prior Introductions: None.

Designated Cross File: None.

Information Source(s): Comptroller's Office; Tax Analysts; Tax Notes; Internal Revenue Service; Department of Legislative Services

Fiscal Note History: First Reader - February 11, 2020
rh/rjr Third Reader - March 17, 2020
Revised - Amendment(s) - March 17, 2020
Enrolled - April 6, 2020
Revised - Amendment(s) - April 6, 2020

Analysis by: Heather N. MacDonagh

Direct Inquiries to:
(410) 946-5510
(301) 970-5510