Department of Legislative Services

Maryland General Assembly
2020 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 507 (Delegate Palakovich Carr, *et al.*)
Ways and Means

Income Tax - Pass-Through Entity - Additional Tax

This bill imposes an additional 4% tax on the distributive share or pro-rata share of income distributed to a member of a pass-through entity (PTE) from the PTE's taxable income that exceeds $1.0 million. The bill does not apply to a sole proprietorship or a PTE that has implemented an employee stock ownership plan (ESOP). **The bill takes effect July 1, 2020, and applies to tax year 2020 and beyond.**

Fiscal Summary

State Effect: General fund revenues increase by $454.5 million in FY 2021 from imposing a 4% tax on PTEs, reflecting the impact of one and one-half tax years. Future years reflect annualization and the projected growth in PTE income. General fund expenditures increase by $211,200 in FY 2021 due to implementation costs at the Comptroller's Office. Future years reflect annualization and ongoing costs.

($ in millions)	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025
GF Revenue	$454.5	$316.5	$328.8	$341.3	$354.1
GF Expenditure	$0.2	$0.1	$0.1	$0.1	$0.1
Net Effect	$454.3	$316.4	$328.7	$341.2	$354.0

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

Local Effect: None.

Small Business Effect: Meaningful.

Analysis

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.

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).

State Revenues: Beginning in tax year 2020, the bill imposes a 4% tax on the distributive or pro-rata share of a PTE member's income distributed from the PTE's taxable income that exceeds $1.0 million. Under current law (10-701.1 of the Tax – General Article), nonresident PTE members may claim a credit for taxes paid by a PTE that is attributable to the nonresident member's share of taxable income. Thus, imposing a 4% tax on PTEs for a nonresident PTE member's distributive or pro-rata share is generally revenue neutral because nonresident members may claim a credit on their nonresident tax return for the taxes paid by the PTE on their behalf.

Under current law, PTEs do not pay taxes on behalf of resident PTE members and resident PTE members cannot claim a credit for taxes paid by PTEs. Thus, the bill is not revenue neutral for the share of income distributed to resident PTE members. Resident PTE income totaled $12.9 billion in tax year 2016, the last year of available data. The Comptroller's Office reports it does not have data on how much of the income is from PTEs with over $1.0 million of taxable income or from PTEs that have ESOPs. Assuming half of the income is subject to the tax, general fund revenues increase by approximately $454.5 million in fiscal 2021, which reflects the impact of tax year 2020 and about one-half of tax year 2021. **Exhibit 1** shows the impact of the tax in fiscal 2021 through 2025.

Exhibit 1
State Revenue Impacts
Fiscal 2021-2015
($ in Millions)

	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025
General Fund	$454.5	$316.5	$328.8	$341.3	$354.1

Source: Department of Legislative Services

State Expenditures: General fund expenditures for the Comptroller's Office increase by $211,200 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. It also includes $150,000 for one-time data processing changes to create a new tax form. 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	150,000
Other Operating Expenses	10,415
Total FY 2021 State Expenditures	**$211,163**

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

Small Business Effect: Generally, PTEs that distribute over $1.0 million of taxable income must pay a 4% tax on the income over $1.0 million. It is unknown how many small businesses are PTEs with distributive taxable income of over $1.0 million and will have higher tax liabilities.

Additional Information

Prior Introductions: None.

Designated Cross File: None.

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

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