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Pass-Through Profits Over $1 Million Should Be Taxed at Corporate Rate

Testimony of Michael Mazerov, Senior Fellow, Center on Budget and Policy Priorities, Before the Maryland House of Delegates Ways and Means Committee

Chair Atterbeary, Vice Chair Wilkins, and members of the Ways and Means Committee, I'm Michael Mazerov, a Senior Fellow with the State Fiscal Policy division of the Center on Budget and Policy Priorities in Washington, D.C. The Center is a nonpartisan research and policy institute that pursues federal and state policies designed to reduce poverty and inequality and to restore fiscal responsibility in equitable and effective ways. We apply our expertise in budget and tax issues and in programs and policies that help low-income people to help inform debates and achieve better policy outcomes. I appreciate the opportunity to submit testimony in support of the provision of H.B. 1007, which proposes to equalize the Maryland tax treatment of corporations and high-profit pass-through entities. That provision is found on pp. 8-9 of the PDF version of the bill and would add a new Section 10-102.2 to the Maryland tax code.

The provision would tax the profits of pass-through entities above $1 million that are distributed to their owners at the same 8.25 percent rate at which taxable ("C") corporation profits are taxed. The new tax would not apply to sole proprietors. Pass-throughs are businesses that are not subject to the corporate income tax. They are exempt either because they are not corporations — for example, they are partnerships or limited liability companies (LLCs) — or because they are corporations that qualify to be exempt from the corporate income tax under the conditions set forth in Subchapter S of the Internal Revenue Code. They are called pass-throughs because their profits are passed through to the tax returns of their owners and taxed there. The owners of S corporations are almost always individuals, while the owners of partnerships and LLCs can be individuals or other businesses — including taxable corporations and other pass-throughs.

In recent years, many states, including Maryland, changed their tax treatment of pass-throughs to exploit a loophole in federal tax law. The change preserved the original intent of the pass-through treatment — to ensure that the profits of these businesses were subject to only one layer of tax rather than potentially being taxed at both the business level and the individual level when paid out as cash dividends or partnership distributions. The change preserved one level of taxation but moved it back up to the business level. By making this change, states were effectively able to allow pass-through owners to deduct an unlimited amount of state tax in calculating the federal tax due on the profits rather than be subject to the $10,000 limit on this deduction that would otherwise apply to individuals under the cap on state and local tax deductions enacted as part of the 2017 federal tax bill.

Pass-through treatment, that is, exemption from the corporate income tax, was initially intended to benefit small businesses. And initially it *did* benefit those businesses. But now many pass-through businesses are not small. For example, many multi-billion-dollar hedge funds and energy companies are organized as master limited partnerships or other types of pass-throughs.[1]

Moreover, many pass-throughs have much higher profits than many small corporations that *are* subject to the corporate income tax; the IRS reported that in 2020 there were roughly 390,000 taxable corporations with average profits below $1 million, representing 90 percent of all taxable corporations with profits.[2] If this many corporations with profits below $1 million are subject to the standard corporate income tax, surely it is fair to expect pass-throughs with profits above $1 million to pay tax as corporations. Since many pass-throughs get all or most of the non-tax benefits of taxable corporations — most importantly, their owners' liability for the debts of the business are limited to their equity investments — there is no longer any justification for not treating them for tax purposes as corporations.

Accordingly, H.B. 1007 proposes to impose the 8.25 percent corporate tax rate on the profits over $1 million that pass-throughs distribute to their owners. Profits plowed back into the business would not be subject to the tax. Even if they were distributed and subject to tax, they would still receive more favorable tax treatment than profits distributed as dividends to regular corporate shareholders, since the first dollar of corporate dividends paid are subject to personal income tax while the first $1 million would not be taxable under the proposal. Moreover, as previously noted, pass-through owners benefit enormously from being able to fully deduct the state taxes due on their profit income — a tax break not available to people who work for wages. And, finally, many pass-through owners benefit from the effective exclusion of 20 percent of their profits from federal income tax, another costly and unwarranted giveaway included in the 2017 federal tax bill.[3]

Maryland would not be alone in making this fully justified and overdue change. California, Massachusetts, and Illinois also impose taxes on the profits of some types of pass-throughs. Kentucky imposes a gross receipts tax. New Hampshire, Tennessee, and Texas tax pass-throughs essentially the same way they tax regular corporations.

Large pass-throughs differ little from taxable corporations and should therefore be taxed as such. I therefore urge the committee to retain this provision and favorably report H.B. 1007, as the Center also strongly supports its enactment of a corporate tax throwback rule and worldwide combined reporting. I thank the Committee for the opportunity to submit written testimony. I may be reached at mazerov@cbpp.org if Committee members have any questions.

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[1] See John D. McKinnon, "More Firms Enjoy Tax-Free Status," *Wall Street Journal*, January 10, 2012.

[2] See: https://www.irs.gov/pub/irs-soi/20co04ccr.xlsx.

[3] This tax break is nominally written as a deduction but is essentially an exclusion.