

Maryland enacts optional election allowing pass-through entities to pay income tax with respect to resident members

Overview

On May 7, 2020, Senate Bill 523 (S.B. 523) was enacted into law without signature.¹ This tax alert highlights the notable Maryland tax law changes that are contained in S.B. 523 including:

- An optional election for pass-through entities (PTEs) to pay income tax imposed with respect to resident members' shares of distributive income
- Applicable tax rates for PTEs that elect to pay income tax imposed on resident members
- A corresponding income tax credit for corporate and individual PTE members
- Expansion of certain income tax credits for taxes paid to another state by a PTE

This Tax Alert summarizes these law changes that are effective July 1, 2020 applicable for tax years beginning after December 31, 2019.

Optional entity-level taxation election for PTEs

Under current law, any PTE (S corporation, partnership, limited liability company not taxed as a corporation, or business trust not taxed as a corporation) doing business in Maryland must pay a tax for each nonresident individual and nonresident entity partner or shareholder.² The nonresident tax paid by a PTE is "treated as a tax imposed on the nonresident or nonresident entity members that is paid on behalf of the nonresidents or nonresident entities by the pass-through entity."³ Tax paid on behalf of a nonresident member that is also a PTE is allocated to the upper tier partners of the nonresident PTE member. The nonresident PTE member must file a Maryland income tax return to flow up the credit for nonresident tax paid.

Effective for tax years beginning after December 31, 2019, S.B. 523 allows a PTE to elect to pay tax at the entity level with respect to the distributive shares of certain resident members of the PTE.⁴ The tax paid for any taxable year may not exceed the total sum of all members' share of distributable cash flow from the PTE.⁵ The tax does not apply to members of a PTE that meet the definition of a real estate investment trust (REIT) under § 856 of the Internal Revenue Code (IRC) or tax exempt entities under IRC § 501.⁶

Applicable tax rates for the PTE level income tax

Qualifying PTEs that elect to pay taxes at the entity level must pay the corporate income tax rate (currently 8.25%) on entity members' distributive shares of taxable income.⁷ PTEs with individual members that make the election must pay tax on behalf of individual PTE members at the highest marginal state income tax rate (currently 5.75%) and the lowest county tax rate (currently 2.25%, for a combined rate of 8% for tax year 2020) applied to individual members' distributive shares of taxable income.⁸

Income tax credit for corporate and individual members

The election to pay tax imposed on resident members at the PTE level does not eliminate the members' filing responsibility. Under S.B. 523, PTE members can claim a corresponding state credit for taxes paid at the entity level.⁹

¹ A copy of the senate bill is accessible [here](#).

² Md. Code Ann., Tax-Gen. § 10-102.1(a)(7)

³ Md. Code Ann., Tax-Gen. § 10-102.1(c)(1)

⁴ Md. Code Ann., Tax-Gen. § 10-102.1(b)(2)(II), 10-102.1(f)(1). Note that a PTE may not elect to pay tax at the entity level on behalf of a resident PTE member, which is itself required to comply with the withholding provisions in its capacity as a PTE.

⁵ Md. Code Ann., Tax-Gen. § 10-102.1(d)(3)(II)

⁶ Md. Code Ann., Tax-Gen. § 10-102.1(f)(2)

⁷ Md. Code Ann., Tax-Gen. § 10-102.1(d)(2)(II)

⁸ Md. Code Ann., Tax-Gen. § 10-102.1(d)(2)(I)

⁹ Md. Code Ann., Tax-Gen. § 10-102.1(e)

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Corporate members would receive a credit for the attributable taxes paid by the PTE at the corporate income tax rate. Individual members would receive a state credit for the taxes paid attributable to the 5.75% state tax rate plus the lowest county tax rate imposed. If the amount of credit exceeds the tax otherwise due, then the excess amount of credit over tax will generally trigger an overpayment that is refundable to the individual or corporate member.

Credit for taxes paid to another state

S.B. 523 also expands certain provisions that allow residents to claim a credit for taxes paid to another state by a PTE. Members of all PTEs, rather than only shareholders of S corporations, who are Maryland residents may claim a credit against state income tax for taxes paid to other states equal to the member's pro rata share of the tax paid by the PTE.¹⁰

Considerations

Taxpayers should consult with their tax advisers regarding the tax implications of the election for PTEs to be taxed at the entity level for Maryland income tax purposes.

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¹⁰ Md. Code Ann., Tax-Gen. § 10-703
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