TESTIMONY OF
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LD 1891 – "*An Act to Support Maine Businesses Through a Child Care Tax Credit and a Pass-through Entity Tax*"

Senator Grohoski, Representative Perry, and members of the Taxation Committee – good afternoon, my name is Michael Allen, Associate Commissioner for Tax Policy in the Department of Administrative and Financial Services. I am here today at the request of the Administration to testify Against LD 1891, "*An Act to Support Maine Businesses Through a Child Care Tax Credit and a Pass-through Entity Tax.*"

The Administration opposes the enactment of this complex bill and the creation of a new pass-through entity tax (such a tax is referred to as a "PTET" in this testimony) at this time for the reasons outlined below. However, there is good reason to study the State's taxation of pass-through income, including the possibility of moving the taxation of that income, or some portion of that income, from the member level to the business entity that generated the income. As proponents of LD 1891 have suggested, such a system, if designed and implemented properly, could provide benefits to both taxpayers and the State. While this bill appropriately highlights the need to focus more attention on the State's taxation of pass-through income and consider the impact of the federal SALT deduction limitation on Maine taxpayers, enactment of this legislation without a full understanding of the implications is premature. The Administration therefore recommends amending this bill to create a Resolve directing the Office of Tax Policy to perform such a study and report back the results, along with any suggested legislation, to the Taxation Committee.

Let me begin by providing some background on why this bill is before this committee.

With limited exceptions, pass-through entities, such as partnerships and S corporations, are not subject to federal or Maine income tax. Instead, income of the entity passes through to each member of the entity, and each member is taxed on its share of the entity income.

In 2017, Congress enacted a $10,000 itemized deduction limit on state and local taxes (the SALT Limitation). In recent years, many states have enacted a PTET in response to the SALT Limitation. Generally, a PTET reduces a member's share of non-separately stated income as reflected on a schedule K-1 (or similar form) and, therefore, is not impacted by the SALT Limitation calculation. Most states that have enacted a PTET also allow a credit to each member for all or some portion of that member's share of the tax paid by the entity. Thus, the combination of entity tax and member credit is structured to shift the deduction for SALT taxes to the entity, thereby avoiding the deduction limits for federal tax purposes, while avoiding taxation of the income to the members via the credit against the member's state tax liability. The IRS has largely approved this result (for payments made on or after November 9, 2020) in Notice 2020-75 (proposed regulations pending).

I now turn to the structure of LD 1891 and the tax policy and technical concerns that warrant careful consideration by this Committee and form the basis of the Administration's opposition to LD 1891.

Part A of the bill establishes an elective entity-level income tax on pass-through entities treated as partnerships or subchapter S corporations under the

Internal Revenue Code. The election does not apply to publicly traded partnerships. An entity that makes the election is subject to tax at Maine's highest marginal personal income tax rate. Each member receives a refundable credit, equal to 90% of that member's distributive share of the tax paid by the entity, against that member's Maine tax liability for the tax year, thereby shifting much of the Maine income tax from the member to the pass-through entity. A resident or part-year resident individual who is a member of a pass-through entity subject to a similar entity level tax in another state may also claim a nonrefundable credit for that member's share of the tax paid to the other state by the entity.

The Administration notes that Part A of the bill is not administrable as drafted; there are significant technical issues that require clarification and significant design and policy choices that must be made to create a new tax type that functions smoothly for taxpayers and the State without unexpected burdens or unintended consequences. Importantly, implementing a major new tax for tax year 2023 would be impracticable as taxpayers are already filing 2023 individual income tax returns. Implementation for tax year 2024 in turn would pose undue risk to the administration of other tax types, with Maine Revenue Services in the final year of the implementation of its new tax system (STARS). The earliest this proposal could be practically implemented is January 1, 2025, leaving only a single year of operation before the SALT Limitation is scheduled to sunset on December 31, 2025.

Working through these issues would be a significant undertaking that would stretch the resources of this Committee and the Office of Tax Policy when focusing on other important legislation, such as LD 2000, "An Act to Change the Taxation of Rental Tangible Personal Property to Make It Consistent with the Predominant

Method in Other States' Rental Industry Laws for Sales and Use Tax," might better serve the legislative process.

LD 2000 can serve as a good model for further action on this bill, LD 1891. Over the summer and fall Maine Revenue Services has devoted significant resources to analyzing LD 2000 and related sales tax issues facing the State and prepared an integrated package that the Administration will be including in the Governor's proposed supplemental budget. The Administration recommends a similar approach to LD 1891, wherein the Office of Tax Policy studies the issues raised by the bill, and, to the extent warranted by that study, returns with a more polished product that can better serve the ongoing needs of the State. The proposed study would also consider whether a PTET in Maine should be a permanent change, and thereby independent of the federal government's impending decision regarding the sunsetting or extension of the SALT cap.

Part B of the bill creates the nonrefundable business-supported childcare credit for employers that provide childcare services for children of its employees. The credit applies to tax years beginning on or after January 1, 2023. The credit is equal to the lower of $10,000 and $1,000 for each child of an employee for which the employer is providing childcare services. Unused credit may be carried forward for up to 15 years.

A similar credit was previously available in Maine. Except for the carryover of unused credit amounts, a nonrefundable employer-assisted day care credit could be claimed for tax years beginning on or after January 1, 1988, and before January 1, 2016. The credit was limited to the lower of $5,000, 20% of the costs incurred to provide day care services for children of employees, or $100.00 for each child of an employee enrolled in day care services. For tax years beginning after 2000, the credit amount was doubled if the day care services provided was for quality childcare services. Due to lack of use and for tax simplification the credit was sunset as part of the comprehensive tax package included in the State's 2016-2017 biennial budget.

The intent of linking the childcare credit to the pass-through entity tax appears to be using the proposed tax to fund the proposed credit. While it is possible that entity-level the tax would raise revenue, that revenue potential is largely based on the federal SALT Limitation, due to expire at the end of 2025. Due to this expiration, the credit is only a short term, and at best uncertain, funding mechanism that is unlikely to be able to support a long-term credit. Linking these disparate proposals is therefore not recommended and the Administration strongly suggests considering any childcare credit separately from the creation of a new PTET.

Expanding access to childcare has been, and continues to be, an important goal of the Administration. Parents need high quality affordable childcare in order to go to work and kids need a safe place to learn and grow during the day. Towards that goal, the Administration has invested heavily to increase access to high-quality care and support for Maine's childcare workforce in line with the Office of Child and Family Services' Child Care Plan for Maine and to strengthen Maine's education and early care system and provide critical supports to children, youth and their families. The Administration will provide additional information and updates at the work session on these initiatives.

As proposed, the Administration has significant concerns that the childcare credit would be unable to accomplish its goals of increasing access to childcare in the State. The Administration also notes the following technical concerns regarding Part B of the bill:

- The bill should define "dependent care assistance plan" or cite the Code if it is intended to refer to dependent care flexible spending accounts.
- The bill should clarify whether "children of the employee" includes stepchildren and grandchildren, etc.
- Proposed 36 MRSA §5217-G(1)(B)(2) should refer to the Department of Health and Human Services.
- For purposes of evaluation of the credit, the bill does not detail the public policy objective or provide performance measures by which to determine whether the policy objectives have been achieved.
- The bill will provide an additional benefit for employers that have claimed the cost of providing childcare as an ordinary and necessary business expense under the Internal Revenue Code, Section 162(a).
- The bill does not extend the proposed credit to employers subject to insurance premiums tax under Title 36, Part 4, Chapter 357.
- As proposed, the credit allowed by the bill could exceed the actual funds expended by the employer to provide childcare services.

The estimated fiscal impact is not currently available.

Estimated administrative costs are still under review. The cost to add additional lines to the individual, fiduciary, and corporate income tax and franchise tax returns, add a new entity level tax type return and worksheets for affected taxpayers to calculate the tax, update check stub messages and notices, make federal tape changes, and perform systems testing are $487,421. Depending on the number of affected taxpayers, additional staffing may also be required to process and audit the tax returns.

The Administration looks forward to working with the Committee on the bill; representatives from MRS will be here for the Work Session to provide additional information and respond in detail to the Committee's questions. I would be happy to respond to any questions you may have now.