Department of Legislative Services

Maryland General Assembly
2022 Session

FISCAL AND POLICY NOTE
Third Reader

Senate Bill 561 (Senator Feldman, *et al.*)
Budget and Taxation Ways and Means

Income Tax - Subtraction Modification - Employee-Owned Businesses

This bill creates a subtraction modification against the State individual and corporate income tax for any income from a qualified transfer of stock or membership interest of a Maryland corporation or limited liability company (LLC). If the qualified transfer is to a direct share ownership plan, the subtraction is limited to the lowest amount of stock or membership interest transferred to any tenured employee during the taxable year multiplied by the number of all tenured employees. **The bill takes effect July 1, 2022, and applies to tax year 2022 and beyond.**

Fiscal Summary

State Effect: General fund, Transportation Trust Fund (TTF), and Higher Education Investment Fund (HEIF) revenues and TTF expenditures decrease by a potentially significant amount beginning in FY 2023. General fund expenditures increase by $68,000 in FY 2023 for the Comptroller's Office.

Local Effect: Local income tax revenues and local highway user revenues decrease beginning in FY 2023. Local expenditures are not affected.

Small Business Effect: Potential meaningful.

Analysis

Bill Summary: A qualified transfer is the transfer of any amount of stock or membership interest of a corporation or LLC to an employee stock ownership plan (ESOP), an employee ownership trust, or a direct share ownership plan, if:

- the stock or membership interest has voting power at least equal to the class of stock or membership interest of the employer having the greatest voting power;
- the stock or membership interest has dividend rights at least equal to the class of stock or membership interest of the employer having the greatest dividend rights; and
- in the case of a transfer to a direct share ownership plan, the largest amount of stock or membership interest transferred to any employee does not exceed a multiple of 10 times the smallest amount of stock or membership interest transferred to any tenured employee.

A tenured employee is an employee or independent contractor who has provided at least 1,000 hours of services to the employer within the preceding 12 months or worked the number of hours specified in an ESOP, employee ownership trust, or direct share ownership plan. An employer includes at least two people treated as a single employer under specified provisions of the Internal Revenue Code (IRC).

Current Law: No similar State income tax subtraction modification exists.

ESOPs are defined as stock bonus plans – or a combination of stock bonus plans and money purchase plans – that are qualified under IRC Section 401(a) and designed to invest primarily in employer securities. Stock bonus plans are designed to provide benefits similar to those of a profit-sharing plan, except that the employer contributions are not necessarily dependent on profits and the benefits are distributable in stock of the employer company. Money purchase plans are arrangements under which an individual account is maintained for each participant to which an employer makes fixed or determinable contributions.

ESOPs provide a means for employees to have an ownership interest in the companies for which they work. ESOPs can be categorized into two main types: the basic ESOP, which is essentially a stock bonus plan designed to invest in employer securities, and the leveraged ESOP, which is used as a financing vehicle for the employer. Most ESOPs are leveraged.

ESOPs are subject to many requirements set out in the federal tax code and receive a number of federal tax benefits.

The Maryland Securities Act exempts certain transactions related to ESOPs from registration and filing requirements, including the sale of securities to an ESOP, the accrual of interests of participants in ESOP, and any distribution made under ESOP to participants or beneficiaries.

The National Center for Employee Ownership reports there were 114 ESOPs covering 25,127 participants in Maryland in 2019.

State Revenues: Subtraction modifications may be claimed beginning in tax year 2022. As a result, general fund, TTF, and HEIF revenues decrease by a potentially significant amount beginning in fiscal 2023. However, the amount of the revenue decrease depends on the income from qualified transfers of the stock or membership interest of a Maryland corporation or LLC, and the taxpayers' tax liabilities, which cannot be reliably estimated.

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of $68,000 in fiscal 2023 to add the subtraction modification to the personal and corporate income tax returns. This includes data processing changes to the income tax return processing and imaging systems and systems testing.

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 claiming the subtraction modification against the corporate income tax, TTF expenditures decrease by 13.5% of the TTF revenue decrease (9.6% beginning in fiscal 2025).

Local Revenues: Local income tax revenues decrease by about 3% of the total net State subtraction modifications claimed against the personal income tax beginning in fiscal 2023.

Local governments receive a portion of corporate income tax revenues as local highway user revenues through capital transportation grants. Thus, to the extent that subtraction modifications are claimed against the corporate income tax, local highway user revenues decrease beginning in fiscal 2023.

Small Business Effect: Small businesses that provide a qualified transfer of stock or membership interest to an employee stock ownership plan, an employee ownership trust, or a direct share ownership plan may benefit from the subtraction modification.

Additional Information

Prior Introductions: HB 204 of 2019 and HB 876 of 2018 each received a hearing in the House Ways and Means Committee, but no further action was taken. SB 409 of 2019 and the cross file of HB 876, SB 498 of 2018, each received a hearing in the Senate Budget and Taxation Committee, but no further action was taken.

Cross File: HB 403 (Delegate Korman) - Ways and Means.

Information Source(s): Comptroller's Office; State Department of Assessments and Taxation; National Center for Employee Ownership; Department of Legislative Services

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