HB 1

Department of Legislative Services
Maryland General Assembly
2004 Session

FISCAL AND POLICY NOTE
Revised

House Bill 1 (The Speaker, *et al.*)

Ways and Means and Appropriations Budget and Taxation

Public School Construction Assistance Act of 2004

This bill imposes recordation and transfer taxes on the transfer of real property, with a value of $1.0 million or more, when the transfer is achieved through the sale of a "controlling interest" in a specified corporation, partnership, limited liability company, limited liability partnership, or other form of unincorporated business. Controlling interest is defined as more than 80% of the total value of the stock or the interest in capital and profits.

The bill also requires specified amounts of State and local recordation and transfer taxes to be dedicated to school construction for fiscal 2005 through 2008.

The bill is effective January 1, 2005.

Fiscal Summary

State Effect: Special fund revenues could increase by $5.9 million in FY 2005, reflecting the bill's January 1, 2005 effective date. Special fund expenditure increase of $4.8 million in FY 2005 and $9.6 million in FY 2006 though 2008. Potentially significant general fund and Transportation Trust Fund revenue increase beginning in FY 2005 from income tax collected from nonresidents. General fund expenditures could increase by $72,100 in FY 2005. Future year estimates reflect stable tax collections and inflation.

(in dollars)	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
SF Revenue	$5,851,200	$11,651,100	$11,655,900	$11,661,000	$11,666,500
GF/SF Rev.	-	-	-	-	-
GF Expenditure	72,100	86,700	92,000	97,800	104,000
SF Expenditure	4,800,000	9,600,000	9,600,000	9,600,000	0
Net Effect	$979,100	$1,964,400	$1,963,900	$1,963,200	$11,562,500

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

Local Effect: Local government revenues could increase by $19.4 million in FY 2005, reflecting the bill's January 1, 2005 effective date. Potential local government expenditure increase for public school construction of up to $15 million in FY 2005 and $30 million in FY 2006 through 2008. **The bill imposes a mandate on a unit of local government.**

Small Business Effect: Potential meaningful impact.

Analysis

Bill Summary: The bill: (1) applies to transfers of controlling interests by entities which have tangible assets of which at least 80% are comprised of real property in Maryland that has an aggregate value of at least $1.0 million; (2) exempts certain transfers (*e.g.,* mergers and dissolutions); and (3) requires a report be filed with the State Department of Assessments and Taxation (SDAT) upon the transfer of a controlling interest within 30 days of the final transfer.

The tax is to be imposed on the consideration payable for the transfer of controlling interest in the real property entity reduced by the amount allocable to assets other than the real property. Consideration includes any mortgage, deed of trust, or other lien on the real property directly or beneficially owned by the real property entity and any other debt or encumbrance of the real property entity. The entity has the burden of establishing the consideration related to the real property and if it fails to do so the tax is imposed on the most recent assessed value of the property.

The bill also requires that $4.8 million in State transfer taxes be dedicated to a special fund for school construction in fiscal 2005, as well as $9.6 million in fiscal 2006 through 2008.

In addition, the bill requires the counties to dedicate specified amounts of recordation tax revenue to public school construction in fiscal 2006 through 2008 to put into a special fund for school construction. The money in the special fund is intended to supplement planned spending rather than supplant it. The amounts required by each county are shown in **Exhibit 1.**

Finally, the bill alters the State/local school construction cost share formula for qualified distressed counties for fiscal 2005 through 2008. Legislation (HB 1230) has been introduced based on the recommendations of the Task Force to Study Public School Facilities which would change the current cost share formula. For fiscal 2006-2008, the bill provides distressed counties the greater of the State share in effect July 1, 2005, or 90% or 65% per the current formula. Economically distressed counties are counties where the average unemployment rate over the past two years is 150% of the State average, or where the average per capita income over the past two years is 67% or less of the State average. Seven jurisdictions – Baltimore City and Allegany, Caroline, Dorchester, Garrett, Somerset, and Worcester counties – qualify as economically distressed counties. This distribution only applies to State special fund revenues resulting from the bill for fiscal 2005 through 2008.

	Greater of:		
County	**State/Local Match Current Law**[1]	**or**	**State/Local Match HB 1**
Allegany	75/25		90/10
Baltimore City	90/10[2]		90/10
Caroline	75/25		90/10
Dorchester	70/30		90/10
Garrett	70/30		90/10
Somerset	80/20		90/10
Worcester	50/50		65/35

[1]HB 1230, if passed, would alter the current cost share formula.

[2]For fiscal 2005 the State match for Baltimore City is 90% for the first $20 million allocated by the State and 75% for funding in excess of $20 million. For fiscal 2006 and thereafter the State match for Baltimore City is 75%.

Current Law: Real property can be effectively transferred without payment of transfer and recordation taxes by transferring controlling interest or ownership of the entity if the property is owned by a corporation, limited liability company, or partnership.

The counties and Baltimore City are authorized to impose locally established recordation tax rates on any business or person: (1) conveying title to real property; or (2) creating or giving notice of a security interest (*i.e.*, a lien or encumbrance) in real or personal property, by means of an instrument of writing.

The State and counties also impose a transfer tax. The State transfer tax rate is 0.5% of the consideration payable for an instrument of writing conveying title to, or a leasehold interest in, real property (0.25% for first-time Maryland home buyers). In some jurisdictions a local property transfer tax may be imposed on instruments transferring title to real property. A distinction is made in the local codes between instruments transferring title such as a deed and certain leaseholds and instruments securing real property such as a mortgage. Except in Prince George's County, mortgages are not subject to the tax.

Background: Numerous other jurisdictions in the country currently tax the transfer of the controlling interest in an entity owning real property: California, Connecticut, Delaware, the District of Columbia, Illinois, New York, New York City, Pennsylvania, Philadelphia, and Washington.

The transfer of a controlling interest has become a typical method of transferring commercial and industrial property in order to avoid paying recordation and transfer taxes. The sale of a property through the transfer of a controlling interest is not recorded in land records, and are therefore difficult to track.

The mandate that real property be assessed at its market value is jeopardized for commercial and industrial properties if these transfers are not known to the assessor. This can lead to entire classes of properties being improperly assessed, typically too low.

State transfer tax revenues are special fund revenues dedicated for specific programs and are distributed as follows: 3% of total revenues are earmarked to defray administrative costs and $1 million to cover debt service expenses. The remaining revenues are approximately dedicated to the following: Program Open Space (76%), Agricultural Land Preservation Fund (17%), Heritage Conservation Fund (2%), and Rural Legacy Program (5%). Approximately 50% of Program Open Space revenues are distributed to local Program Open Space programs. In fiscal 2004, most transfer tax revenues were transferred to the State's general fund. Similar changes have been proposed for fiscal 2005.

The Bridge to Excellence in Public Schools Act of 2002 requires local school systems to provide full-day kindergarten for all students and to make publicly-funded pre-kindergarten available for economically disadvantaged four-year-old children. Many local school systems need to add additional classroom space in order to meet these mandates. At the same time, State funding for public school construction has declined considerably over the last two years. After averaging more than $250 million annually from fiscal 1999 to 2002, funding dropped to $140.5 million in fiscal 2003 and $106.3 million in fiscal 2004. The proposed fiscal 2005 State budget includes $100 million for public school construction.

State Revenues: The bill requires SDAT to collect recordation and transfer taxes when real property is transferred by means of selling a controlling interest in a business entity that owns Maryland real property.

Because this type of transaction is not currently subject to these taxes, it is difficult to estimate the exact amount of revenue that could be generated by the bill. However, in 1992 SDAT reviewed transfers of controlling interests to see if they were transactions designed to avoid the recordation and transfer taxes. Based on that review, SDAT determined that these transactions avoided $1.9 million in State transfer taxes and $6.4 million in county recordation and transfer taxes.

During that year, there were 147 sales of single-parcel commercial properties where more than $500,000 was paid that were subject to recordation and transfer taxes. The total consideration for these sales was $324 million.

In fiscal 2003, there were 385 sales of single-parcel commercial or industrial properties where more than $1.0 million was paid that were subject to the recordation and transfer taxes. The total consideration for these transfers was $1.8 billion. Assuming a commensurate growth in the value of transactions that escape recordation and transfer taxes, based on the growth of the number of transactions that are subject to tax, it is estimated that the State would have collected an extra $12.9 million in State special funds and the counties would have realized an additional $43.33 million in transfer and recordation taxes in fiscal 2003 had this bill been effective then. It is estimated that this bill would generate an additional $5.9 million in transfer tax revenues in fiscal 2005 and approximately $11.7 million annually thereafter. The fiscal 2005 estimate reflects the bill's January 1, 2005 effective date.

As a point of reference, SDAT recently identified 25 real estate transactions in calendar 2001, 19 in 2002, and 7 in 2003 that would have resulted in the following recordation and transfer tax collections if the bill was in effect in those years:

Calendar Year	State Transfer Tax	County Transfer/Recordation Tax
2001	$2,690,000	$8,150,000
2002	3,260,000	8,680,000
2003	775,000	2,990,000

Out-year revenues would fluctuate depending on the real estate market and the number of transfers. Additionally, the imposition of taxes on these transactions may reduce the number that occurs. The actual increase in revenues depends on the number of transfers of controlling interest in real property entities and the consideration attributable to the real property.

Because the bill requires all transactions to be reported to SDAT, the Comptroller will now be able to track nonresidents involved in real property transactions. Nonresidents are required to pay income tax on the net gain from real estate transactions, but to the extent they were done through the transfer of controlling interest, the Comptroller had no mechanism with which to track these types of transactions.

Based on fiscal 2003 transactions where approximately $2.2 billion was paid in consideration in sales of controlling interest, it is estimated that the income tax collected from nonresidents from these sales could be significant. However, because the amount of net gain from each of these transactions cannot be reliably estimated, the exact amount of income tax generated cannot be predicted.

To the extent that nonresident corporations pay more income tax, 76% of corporate income taxes are distributed to the general fund and 24% is distributed to the Transportation Trust Fund. Revenue derived from entities paying the individual income tax is distributed to the general fund.

State Expenditures: General fund expenditures by SDAT could increase by approximately $72,095 in fiscal 2005 and by $86,694 in fiscal 2006 for the costs of hiring one charter specialist and one office secretary to assist in the collection of additional recordation and transfer taxes.

Special fund expenditures for school construction would increase by $4.8 million in fiscal 2005 and by $9.6 million in fiscal 2006 through 2008 as required by the bill.

Local Fiscal Effect: It is estimated that this bill would generate approximately $19.4 million in fiscal 2005 in additional recordation and transfer taxes and $38.9 million in future years. The estimate for fiscal 2005 reflects the bill's January 1, 2005 effective date.

The bill requires the local governments to dedicate $15 million in fiscal 2005 and $30 million in fiscal 2006 through 2008 in recordation tax revenue to a special fund for public school construction as shown in Exhibit 1. The bill intends that these funds be used to supplement what is currently budgeted for school construction. As a result, the bill could result in more spending on school construction than might otherwise occur.

Based on the estimated revenues resulting from the bill, the counties could receive approximately $9 million in revenue above and beyond what is required to be dedicated to a special fund for school construction pursuant to the bill. **Exhibit 1** shows the amount of revenue that could be distributed to each county as a result of the bill and the amount that is required to be dedicated to the special fund for school construction (the fiscal 2005 amount is equal to one-half of the amount listed below).

Small Business Effect: This bill could increase the costs of small businesses purchasing or selling real property through a sale of the controlling interest. The *1998 Survey of U.S. Business* by the U.S. Census Bureau indicated that 92.9% of the firms in Maryland had less than 50 employees.

Additional Information

Prior Introductions: Similar bills were introduced as HB 19 in the 2003 session and HB 557 in the 2002 session. HB 557 received an unfavorable report from the Budget and

Taxation Committee. No action was taken by the Ways and Means Committee on HB 19.

Cross File: None.

Information Source(s): State Department of Assessments and Taxation, Comptroller's Office, Maryland State Department of Education, Maryland Association of Counties, Public School Construction Program, Caroline County, Carroll County, Kent County, Montgomery County, Wicomico County, Department of Legislative Services

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Exhibit 1
Recordation and Transfer Tax Revenue and Distribution Required under HB 1
Fiscal 2006

	Tax Revenue Dedicated for School Construction Under HB 1	**Potential Recordation and Transfer Revenue Generated From HB 1**
Allegany	$103,412	$134,159
Anne Arundel	2,883,652	3,741,047
Baltimore City	2,926,538	3,796,684
Baltimore	5,322,865	6,905,510
Calvert	109,668	142,275
Caroline	54,897	71,220
Carroll	304,482	395,013
Cecil	146,747	190,379
Charles	337,673	438,074
Dorchester	126,520	164,138
Frederick	669,812	868,966
Garrett	98,669	128,007
Harford	839,569	1,089,198
Howard	1,818,471	2,359,156
Kent	65,054	84,396
Montgomery	7,837,548	10,167,833
Prince George’s	4,759,390	6,174,497
Queen Anne’s	108,248	140,433
St. Mary’s	351,464	455,964
Somerset	17,712	22,978
Talbot	213,038	276,380
Washington	333,278	432,372
Wicomico	168,140	218,133
Worcester	403,155	523,024
Total	**$30,000,000**	**$38,919,886**