HB 606

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FISCAL AND POLICY NOTE
Revised

House Bill 606 (Delegate Glassman, *et al.*)

Environmental Matters Education, Health, and Environmental Affairs

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Maryland Agricultural Land Preservation Program - Installment Purchase Agreements , Schedule of Installments, and Termination of Easements

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This bill authorizes the use of an additional method for the purchase of an easement by the Maryland Agricultural Land Preservation Foundation (MALPF). Specifically, the bill authorizes MALPF to purchase an easement using an installment purchase agreement (IPA). Easements purchased using an IPA are perpetual. Money in the Maryland Agricultural Land Preservation Fund from the sale of tax-exempt general obligation bonds may not be used to purchase easements under an IPA or the existing installment payments option. The Maryland Department of Agriculture (MDA) must adopt regulations and procedures for the purchase of easements under an IPA.

Fiscal Summary

State Effect: While an IPA program could allow MALPF to purchase more easements with the same initial investment, it could also result in a decrease in general fund revenues and Transportation Trust Fund (TTF) revenues related to a decrease in income tax revenues.

Local Effect: To the extent the bill results in a decrease in State income tax revenues from individuals, local income tax revenues will also decrease. Because 30% of the revenues distributed to the TTF from corporate income tax revenues are distributed to local governments, local revenues will decrease to the extent the bill results in a decrease in corporate income tax revenues.

Small Business Effect: Potential meaningful.

Analysis

Bill Summary: When purchasing an easement, MALPF may pay the landowner according to a schedule, up to a maximum term of 15 years, established in an IPA. The IPA must require that MALPF make annual equal payments to the landowner of interest on the outstanding balance of the purchase price. MALPF must pay the landowner the remainder of the purchase price at the end of the term. The IPA must state the total amount of money MALPF will pay the landowner, the interest rate, and the terms of the agreement. The easement must be recorded within 30 days of settlement. Easements purchased using an IPA are not subject to termination at the request of the landowner.

MALPF, in consultation with the Treasurer, must prepare a plan to purchase easements using IPAs with a term of 25 years. The plan, which must be presented to the Governor and the General Assembly by November 1, 2004, must identify a revenue source to be dedicated to the purchase of easements using IPAs.

Current Law: At the time of settlement of the purchase of an easement, the landowner and MALPF may agree upon and establish a schedule of payments such that the landowner may receive consideration for the easement in a lump sum or in installments over a period of up to 10 years from the date of settlement. At the time of settlement, MALPF must notify in writing each landowner who sells an agricultural easement to MALPF of the schedule of anticipated ranges of interest rates to be paid on any unpaid balance after the date of settlement. If a schedule of installments is agreed upon, the Comptroller must retain in the Maryland Agricultural Land Preservation Fund an amount of money sufficient to pay the landowner. The landowner receives interest on any unpaid balance remaining after the date of settlement. The State Treasurer is required to invest the unpaid balance. Any interest earned on the invested unpaid balance must be paid with the installment when due, less one-quarter of 1%.

Any time after 25 years from the date of purchase of an easement, the landowner may request that the easement be reviewed for possible termination of the easement.

Background: An IPA is a contract between the easement purchaser and the easement seller to pay the principal unpaid at settlement as a balloon payment at the end of the term of the agreement and to pay the seller tax-exempt interest on the unpaid principal during the period of the agreement. These contracts are long term. At a minimum, an agreement term is 10 or 15 years; more typically, the term is 20 to 30 years.

The two primary elements of an IPA are the interest installment payments and the payment of the principal. Typically, the payment of the principal at the end of the agreement is funded by investment in long-term stripped-coupon or zero-coupon U.S. Treasury obligations (zeros), where the amount of the principal is secured at a discount contingent on the length of the obligation. The longer the term of the zero, the deeper the discount. Taken out to 25 or 30 years, the principal payment can be funded with an investment in zeros of 20 to 30 cents on the dollar. Taking the term out only 15 years requires an investment in zeros of approximately 60 cents on the dollar. The obligation to pay interest on the principal during the period of the agreement is typically met by pledging a percentage of future revenues to pay the installments.

An IPA can be attractive to a seller because of the tax-advantaged nature of the transaction. First, the seller is able to defer capital gains taxes until the payment of the principal. Second, the seller receives a tax-exempt income stream during the term of the agreement. It can also be attractive because the seller may realize more from such a sale than from an easement sale paid in a lump sum at closing or from MALPF's current installment payments option, which provides less of a tax advantage.

For a purchaser, a well-conceived IPA has three potential advantages.

- An IPA system creates the potential for the purchaser to buy more easements upfront for the same amount of funds (or the same for less money) and service the IPAs by pledging future revenues. In effect, it allows the purchaser the possibility of leveraging funds to buy easements upfront in return for the commitment of future revenues (or taking on debt). The longer the agreement, the greater the leveraging potential based on the greater discount in purchasing zeros.

- An IPA system may allow the purchaser to purchase easements on property at current prices (when those properties are still undeveloped) rather than purchase them later at higher prices or lose them to development altogether. (A fundamental problem in strategic land preservation is how to keep from losing critical land to development over the time period necessary to secure the funds to purchase easements on that land.)

- Because offering an IPA option could increase participation by landowners otherwise not interested in selling easements (particularly those landowners most affected by capital gains issues), more competition for offers could lead to greater discounting on the part of sellers seeking an offer. As a result, the purchaser would be able to buy more easement acreage with the same funds.

While IPA installments are typically funded by pledging future revenues, and the payment of the principal at the end of the agreement is typically funded by investing in zeros, IPA installments and balloon payments can be funded in other ways. The form of financing chosen can have an impact on the potential benefits of the program. For example, installment payments can be funded by investing in an interest-paying bond.

Or, the balloon payment can be funded from future revenues. It is possible with a long enough time frame to fund the IPA from the amount of the original easement offer by a combination of zeros and interest-bearing investments (bonds), but such IPAs obviate the benefit of leveraging for the purchaser and can lead to somewhat less attractive interest rates to sellers. Such a self-funded IPA option is the basis for the IPA program in Carroll County. The ability to develop a successful self-funded IPA program depends upon the time frame of the IPA; the longer the time frame, the more likely a self-funded IPA program will succeed.

In a December 2003 report on Maryland's land conservation programs, Governor Ehrlich stated an objective of identifying potential revenue sources for land preservation, including acquiring land with IPAs whenever possible in order to leverage limited State funds and provide tax benefits to participating landowners.

Several counties, including Anne Arundel, Calvert, Carroll, Frederick, Harford, and Howard counties, have IPA programs.

State Fiscal Effect: The Governor's proposed fiscal 2005 budget includes $17.1 million for MALPF easement purchases ($8.6 million in PAYGO special funds, which is largely local matching funds; $3.5 million in PAYGO federal funds; and $5.0 million in general obligation bonds), not including $13.1 million in special funds from transfer tax revenues, which are diverted to the general fund contingent on enactment of the Budget Reconciliation and Financing Act of 2004 (SB 508) or similar legislation. Although the extent to which landowners would choose the IPA option is unknown, an IPA program could allow MALPF to purchase more easements with the same initial investment. The bill could have tax implications for the State if a landowner who would otherwise sell an easement to MALPF under the current lump sum or installment payment option chooses the IPA option instead.

Ability to Leverage the Purchase of Additional Easements

Under the current installment payment system, no particular fiscal advantage is realized by the State. The cost to the State of investing and arranging for annual payments is covered by the one-quarter of 1% interest that is forgone by the seller. Under the bill, the ability to leverage the purchase of additional easements with the same amount of funding will largely depend on the specifics of the IPA program established (as discussed above in the Background Section) and the extent to which landowners choose this option.

Tax Implications

Under the current system, the purpose of using the installment payment option for the seller is to spread the payments over two to 10 years to minimize the impact of the easement sale on tax liability. Each installment is fully taxable for capital gains, but the liability for those taxes is spread equally over the term of the installments. Any interest earned from the investment by the Treasurer of the unpaid principal is taxable as income. Under an IPA system, all or most capital gains taxes are deferred for the term of the agreement. Further, IPAs are typically structured so that interest payments received by sellers are exempt from federal and State income taxes.

The extent to which farmers selling easements to MALPF are liable for the individual income tax versus the corporate income tax is unknown. Any decrease in individual income tax revenues will reduce general fund revenues. Seventy-six percent of all corporate income tax revenues are distributed to the general fund and 24% are distributed to the TTF.

Small Business Effect: Under a typical IPA program, all or most capital gains taxes are deferred for the term of the agreement. In addition, farmers who face income variability, need supplemental income, or need additional income in retirement could use this payment option to provide a guaranteed tax-free income stream for the length of the term. Finally, some IPAs are structured to permit the agreement to be securitized at the landowner's option after an initial restricted period. At that point, landowners could sell IPAs to realize capital gains whenever they choose.

Additional Information

Prior Introductions: Similar legislation was introduced as HB 827 of 2003. The bill received an unfavorable report from the House Environmental Matters Committee.

Cross File: None.

Information Source(s): Maryland Department of Agriculture, Treasurer's Office, Department of Legislative Services

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