Department of Legislative Services
Maryland General Assembly
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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 2005

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 local recordation taxes to be dedicated to school construction for fiscal 2006 through 2009. State transfer taxes collected under the bill are dedicated to land preservation purposes, as provided under current law.

The bill is effective January 1, 2006.

Fiscal Summary

State Effect: Special fund revenues could increase by approximately $6.8 million in FY 2006, reflecting the bill's January 1, 2006 effective date. Special fund expenditure increase of $6.8 million in FY 2006 including $76,300 for administrative costs. Potentially significant general fund and Transportation Trust Fund revenue increase beginning in FY 2006 from income tax collected from nonresidents. Future year estimates reflect stable tax collections and inflation.

(in dollars)	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
SF Revenue	$6,825,000	$13,650,000	$13,650,000	$13,650,000	$13,650,000
GF/SF Rev.	-	-	-	-	-
SF Expenditure	6,825,000	13,650,000	13,650,000	13,650,000	13,650,000
Net Effect	$0	$0	$0	$0	$0

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

Local Effect: Local government revenues could increase by approximately $23.0 million in FY 2006, reflecting the bill's January 1, 2006 effective date, and $46 million annually beginning in FY 2007. Potential local government expenditure increase for public school construction of up to $19.5 million in FY 2006 and $38.9 million in FY 2007 through 2009. **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.

In addition, the bill requires Baltimore City and county governments to dedicate specified amounts of recordation tax revenue to public school construction in fiscal 2006 through 2009. The money in the special fund is intended to supplement planned school construction spending rather than supplant it. The amounts required by each jurisdiction are shown in **Exhibit 2.** For fiscal 2006 only, the amount required is one-half of the amount shown.

The bill provides that for any fiscal year, the amount that a county is required to distribute to a special fund for school construction may not exceed the amount by which total revenue collected from recordation and transfer taxes for that fiscal year exceeds the total amount collected for fiscal 2005, after adjusting for any change in tax rates.

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 is 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 and 2005, most transfer tax revenues were transferred to the State's general fund.

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, school construction funding dropped to $140.5 million in fiscal 2003, $106.3 million in fiscal 2004, and $116.6 million in fiscal 2005. The proposed fiscal 2006 State budget includes $157.6 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.

In fiscal 2004 there were 488 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 $2.33 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 $13.65 million in State special funds and the counties would have realized an additional $45.96 million in transfer and recordation taxes in fiscal 2004 had this bill been in effect at that time. Accordingly, this bill could generate an additional $6.825 million in transfer tax revenues in fiscal 2006 and approximately $13.65 million annually thereafter. The fiscal 2006 estimate reflects the bill's January 1, 2006 effective date.

As a point of reference, SDAT recently identified 25 real estate transactions in calendar 2001, 17 in 2002, 18 in 2003, and 8 in 2004 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	$2,760,000	$8,380,000
2002	2,800,000	7,400,000
2003	2,170,000	7,030,000
2004	1,190,000	4,730,000

Exhibit 1 lists some recently identified properties that were transferred though the transfer of controlling interest.

Exhibit 1
Recently Identified Properties Transferred through the Transfer of Controlling Interest

Property	Location
Annapolis Mall	Anne Arundel County
USInternetworking Headquarters Building	Anne Arundel County
Candler Building (twice)	Baltimore City
IBM Building	Baltimore City
Golden Ring Mall	Baltimore County
Eastpoint Shopping Center	Baltimore County
Cove Point LNG Facility	Calvert County
Westminster Professional Center	Carroll County
Hillcrest Plaza Shopping Center (twice)	Frederick County
Dam and Power Plant at Deep Creek Lake	Garrett County
Winters Run Golf Course	Harford County
Country Village Apartments	Harford County
Oak Court Apartments	Harford County
Fenland Field Apartments	Howard County
Cedar Valley Apartments	Howard County
Archstone Apartments	Howard County
Village Centers in Columbia	Howard County
Montgomery Mall	Montgomery County

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 2004 transactions when approximately $2.33 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: The bill requires SDAT to deduct the administrative cost of administering the program from the transfer taxes collected. Special fund expenditures by SDAT for administering the program would be approximately $76,279 in fiscal 2006 and by $92,518 in fiscal 2007 to hire one charter specialist and one office secretary to assist in the collection of additional recordation and transfer taxes.

As a result, special fund expenditures for land preservation purposes could increase by $6.7 million in fiscal 2006 and by approximately $13.5 million annually thereafter.

Local Fiscal Effect: It is estimated that this bill would generate approximately $22.98 million in fiscal 2006 in additional recordation and transfer taxes and $45.96 million in future years. The estimate for fiscal 2006 reflects the bill's January 1, 2006 effective date.

The bill requires the local governments to dedicate $19.5 million in fiscal 2006 and $38.9 million in fiscal 2007 through 2009 in recordation tax revenue to a special fund for public school construction as shown in **Exhibit 2**. 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 $7.0 million in revenue above and beyond what is required to be dedicated to a special fund for school construction pursuant to the bill. Exhibit 2 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 2006 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: This bill was introduced as HB 1 in the 2004 session and was passed by the House of Delegates; however, no action was taken by the Senate Budget and Taxation Committee. Similar bills were introduced as HB 19 in the 2003 session and HB 557 in the 2002 session. No action was taken by the Ways and Means Committee on HB 19. HB 557 received an unfavorable report from the Budget and Taxation Committee.

Cross File: None.

Information Source(s): State Department of Assessments and Taxation, Montgomery County, Prince George's County, Caroline County, Calvert County, Howard County, Public School Construction Program, Baltimore City, Department of Legislative Services

Fiscal Note History: First Reader - February 1, 2005
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Analysis by: Michael Sanelli

Direct Inquiries to:
(410) 946-5510
(301) 970-5510

Exhibit 2
Recordation and Transfer Tax Revenue and Distribution Required under HB 1
Fiscal 2007 – 2009

	Tax Revenue Dedicated for School Construction Under HB 1	Potential Recordation and Transfer Revenue Generated From HB 1
Allegany	$134,159	$158,426
Anne Arundel	3,741,047	4,417,755
Baltimore City	3,796,684	4,483,456
Baltimore	6,905,510	8,154,629
Calvert	142,275	168,011
Caroline	71,220	84,103
Carroll	395,013	466,466
Cecil	190,379	224,817
Charles	438,074	517,315
Dorchester	164,138	193,828
Frederick	868,966	1,026,151
Garrett	128,007	151,162
Harford	1,089,198	1,286,220
Howard	2,359,156	2,785,897
Kent	84,396	99,662
Montgomery	10,167,822	12,007,124
Prince George's	6,174,497	7,291,385
Queen Anne's	140,433	165,835
St. Mary's	455,964	538,442
Somerset	22,978	27,135
Talbot	276,380	326,374
Washington	432,372	510,583
Wicomico	218,133	257,591
Worcester	523,024	617,633
Total	**$38,919,886**	**$45,960,000**

Note: The fiscal 2006 amount is equal to one-half of the amounts show above.