HB 1581

Department of Legislative Services

Maryland General Assembly
2005 Session

FISCAL AND POLICY NOTE

House Bill 1581 (Delegate Hixson)
Ways and Means

Tax Compliance - Pass-Through Entities - Real Estate Investment Trusts

This bill: (1) increases the pass-through entity (PTE) tax imposed on nonresident partnerships, limited liability corporations (LLCs), and S corporations by including the lowest county tax rate imposed, raising the tax from 4.75% to 6%; (2) imposes the PTE tax at a rate of 7% on nonresident entities; and (3) imposes Maryland income tax on nonresidents' dividend income received from a real estate investment trust (REIT) under Section 856 of the Internal Revenue Code (IRC) to the extent the income of the REIT is derived from real property located in the State.

The bill takes effect July 1, 2005 and applies to tax year 2005 and beyond.

Fiscal Summary

State Effect: General fund revenues would increase by approximately $6.2 million in FY 2006 due to increasing the PTE tax on nonresidents. In addition, general fund and Transportation Trust Fund (TTF) revenues could increase significantly in FY 2006 and beyond due to expanding the PTE tax to nonresident entities. Also, general fund revenues could increase significantly in FY 2006 and beyond due to imposing State income tax on REIT dividend income derived from real property located in the State. General fund expenditures would increase by $115,000 in FY 2006 due to one-time tax form changes and computer expenses.

($ in millions)	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
GF Revenue	$6.2	$2.1	$2.2	$2.2	$2.3
SF Revenue	-	-	-	-	-
GF Expenditure	.1	0	0	0	0
Net Effect	$6.1	$2.1	$2.2	$2.2	$2.3

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

Local Effect: Local highway user revenues distributed from the TTF would increase in FY 2006 and beyond.

Small Business Effect: Minimal.

Analysis

Bill Summary: The bill increases the PTE tax imposed on nonresidents and expands the tax to include nonresident entities and nonresident dividend income to the extent the income is derived from real property in the State. PTEs are required to pay the PTE tax on behalf of its nonresident members and nonresident entities. PTEs include: (1) an S corporation; (2) a partnership; (3) an LLC that is not taxed as a corporation by the State; and (4) REITs. For a REIT, nontaxable income includes the amount of dividends distributed to members of the REIT but does not include the applicable tax base of the REIT that is included in Maryland modified income.

The bill exempts from the PTE tax a publicly-traded PTE that has agreed to file with the Comptroller an annual information return reporting the name, address, taxpayer identification number, and other information requested by the Comptroller of each nonresident or nonresident entity member whose receives more than a $500 share of the PTE's nonresident taxable income. The bill, however, expands nonresident taxable income to include dividends received from a REIT to the extent the income of the REIT is derived from real property in the State.

The bill also provides that a nonresident member or entity may claim a credit when filing Maryland taxes for the amount of PTE tax paid on behalf of the nonresident entity or member and that the Comptroller may provide by regulation for the filing of composite returns by nonresident entities.

Current Law: A tax of 4.75% is applied to the sum of each nonresident's share of income of a partnership, LLC, and S corporation. The tax is assessed on the proportion of income attributable to: (1) a partnership's and LLC's nonresident distributive share; and (2) an S corporation's nonresident shareholder pro rate share. The tax is paid by the S corporation, LLC, or partnership on behalf of the nonresident member. Each nonresident member who files a Maryland income tax return is allowed to claim a credit for the amount of taxes paid on its behalf by the S corporation, LLC, or partnership. The lowest county income tax rate currently imposed is 1.25%.

The State does not currently tax nonresident dividend income received from a REIT regardless of whether REIT income is derived from real property located in the State.

Background: REITs are organizations that act as investment agents for their shareholders enabling small investors to pool their resources together to invest in real estate that they might not otherwise be able to invest in individually. A REIT is not taxed at the entity-level if it distributes all of its earnings and profits because, unlike other corporations, it is entitled to claim a deduction for dividend payments against its ordinary income. This tax savings, combined with the pooling of funds with other investors, makes REITs a popular investment choice.

Under this special tax treatment under the IRC, REITs are technically treated as corporations, with an entity level tax being imposed on a REIT's taxable income and with dividends paid by the REIT also being taxable to the investors in the REIT. In effect, however, the federal income tax treatment of REITs and their shareholders is similar to the treatment of pass-through entities, with no entity level tax being imposed, because a qualifying REIT is allowed a deduction for dividends paid as long as 90% of the REIT's taxable income is distributed to its shareholders.

The special federal income tax treatment of REITs results in an anomalous treatment of REITs and their shareholders for State income tax purposes. At the entity level, REITs are in effect treated the same as pass-through entities, with the federal deduction for dividends paid to shareholders flowing through to eliminate any taxable income of the REIT for State income tax purposes. However, for shareholders, dividends received from REITs are not treated as pass-through income, so that dividends are taxed only by a shareholder's state of residence. As a result, only REIT dividends received by Maryland residents (and possibly REIT dividends received by corporations otherwise having nexus with the State) are subject to the Maryland income tax, regardless of the extent to which the REIT's income is derived from sources within Maryland.

On the other hand, individuals and entities that receive REIT dividends are generally required to report it as income for federal purposes. For states that use federal adjusted gross income as the starting point for calculating state taxable income (as does Maryland), residents are generally subject to state tax on the income received from REIT dividends, regardless of the source of those dividends. For instance, Maryland residents pay State tax on REIT dividend income, even if the income of the REIT is derived entirely from property outside of the State.

As of January 24, 2005, according to the State Department of Assessments and Taxation (SDAT) there were 320 active REITs organized in the State. According to the National Association of Real Estate Investment Trusts (NAREIT), two-thirds of publicly-traded REITs are organized in Maryland. NAREIT provided data on the 60 REITs it advises own Maryland properties. These REITs owned 579 Maryland properties with an aggregate real estate price of approximately $8 billion. The minimum amount of properties owned by each REIT was 1, the maximum was 87, and the median value was

4. According to NAREIT, REITs paid out approximately $12.4 billion nationally to shareholders in 2004.

State Revenues: Effective tax year 2005, the bill: (1) increases the PTE tax on nonresidents; (2) imposes a 7% PTE tax on nonresident entities; and (3) taxes nonresident REIT income to the extent it is derived from real property in the State. Each of the fiscal impacts is discussed separately below.

Increasing the PTE Tax on Nonresidents

Increase in General Fund Revenues
($ in Millions)

FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
$6.2	$2.1	$2.2	$2.2	$2.3

General fund revenues would increase by $6.2 million in fiscal 2006, which represents the impact of one and one-half tax years. Future fiscal years reflect the impact of one-half of prior tax year and one-half of current tax year. This estimate is based on the following facts and assumptions: (1) PTE tax revenues totaled approximately $38 million in tax year 2003; (2) the amount is estimated to increase 2% annually from 2004 through 2010; and (3) 20% of the amount paid is not otherwise filed for on a Maryland tax return.

Imposing a PTE Tax of 7% of Nonresident Entities

The bill imposes a PTE tax of 7% on nonresident entities. The Comptroller's Office advises that it cannot reliably estimate the revenue increase resulting from imposing this tax. Currently, 16 states have some level of partnership tax on all nonresident partners, including corporations. The Comptroller's Office and Legislative Services contacted these states for an estimate of how much income the nonresident entity PTE tax is estimated to generate. The states that responded advised that data were not available for how much PTE tax was collected from nonresident entities.

Imposing State Taxes on Dividends Distributed by REITs to Nonresidents

The actual amount of additional revenue generated by this provision depends on the amount of dividends distributed by a REIT from real property in the State to nonresidents and cannot be reliably estimated.

The bill imposes State taxation on dividends that are distributed by REITs to nonresidents to the extent the REIT's income is derived from property in the State. If a publicly-traded REIT files information annually with the Comptroller on any nonresident that receives at least $500 in a tax year, the REIT does not have to pay a PTE tax on behalf of nonresidents who receive these dividends. The nonresident is liable for paying the State tax. Publicly-traded REITs that do not elect to provide this information and privately-held REITs are required to pay the PTE tax on behalf of nonresidents that receive these dividends.

In the case of dividends distributed from a publicly-traded REIT that elects to inform the Comptroller of required information on nonresidents that receive dividends, significant compliance difficulties exist in collecting State tax liabilities from these nonresidents. The Comptroller's Office would likely send the nonresident an assessment based on information provided by the REIT. If a nonresident does not voluntarily remit the tax liability, the Comptroller's Office has limited options in pursuing the nonresident.

The amount of revenue collected by the State would decrease or be offset over time to the extent that: (1) other states reciprocate and impose taxes on Marylanders who receive REIT dividend income from property located those states; and/or (2) unfavorable tax treatment imposed on Maryland REITs relative to other states causes REITs to divest themselves of Maryland properties. If Maryland imposes taxes on nonresidents, the states in which these individuals reside could lose revenue if it currently imposes an income tax. These individuals could claim a tax credit against their state income tax if they file a Maryland income tax for the amount of tax paid to Maryland for REIT dividends received. Likewise, if states reciprocate and impose taxes on Maryland residents who receive REIT dividend income from property located in these states, these Maryland residents could claim a credit against the Maryland income tax for the amount of taxes paid to other states.

State Expenditures: The Comptroller's Office reports that it would incur a one-time general fund expenditure increase of $115,000 in fiscal 2006 in order to add an additional line to the individual, corporate, and PTE returns to include the PTE tax for nonresident entities.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): State Department of Assessments and Taxation, Comptroller's Office, National Association of Real Estate Investment Trusts, Department of Legislative Services

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mp/hlb

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