

**Department of Legislative Services
Maryland General Assembly
2006 Session**

FISCAL AND POLICY NOTE

House Bill 1294 (Delegate Healey, *et al.*)
Ways and Means and Appropriations

Public School Construction Assistance Act of 2006

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 2007 through 2010. State transfer taxes collected under the bill are dedicated to land preservation purposes, as provided under current law.

The bill is effective January 1, 2007.

Fiscal Summary

State Effect: Special fund revenues could increase by approximately \$8.4 million in FY 2007, reflecting the bill’s January 1, 2007 effective date. Special fund expenditures could increase by \$8.4 million in FY 2007 including \$78,100 for administrative costs. Potentially significant general fund and Transportation Trust Fund revenue increase beginning in FY 2007 from income tax collected from nonresidents. Future year estimates reflect annualization, stable tax collections, and inflation.

(in dollars)	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
SF Revenue	\$8,375,000	\$16,750,000	\$16,750,000	\$16,750,000	\$16,750,000
SF Expenditure	8,375,000	16,750,000	16,750,000	16,750,000	16,750,000
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 \$28.2 million in FY 2007, reflecting the bill's January 1, 2007 effective date, and \$56.4 million annually beginning in FY 2008. Potential local government expenditure increase for public school construction of up to \$23.0 million in FY 2007 and \$46.0 million in FY 2008 through 2010. **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 2007 through 2010. 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 3**. For fiscal 2007 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 2006, 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: Several other jurisdictions in the country currently tax the transfer of the controlling interest in an entity owning real property: California, Connecticut, Delaware, Illinois, New York, Pennsylvania, and Washington; and the cities of the District of Columbia, New York, and Philadelphia.

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.

The State transfer tax funds several programs in the Department of Natural Resources (DNR) and the Maryland Department of Agriculture. A portion of State transfer tax revenues (3%) is earmarked to defray administrative costs within DNR, the Department of General Services, and the Maryland Department of Planning. The remainder of the revenue is dedicated to various programs including Program Open Space (POS), the Maryland Agricultural Land Preservation Fund (MALPF), Rural Legacy, and the Heritage Conservation Fund. **Exhibit 1** shows the distribution of State transfer tax revenues after administrative costs are deducted.

Exhibit 1
Distribution of State Transfer Tax Revenues

POS	75.15%
POS Land Acquisition	1.00%
MALPF	17.05%
Rural Legacy	5.00%
Heritage Conservation Fund	<u>1.80%</u>
Total	100.0%

Of the transfer tax revenues distributed to POS, \$3 million may be transferred by an appropriation in the State budget or by budget amendment to the Maryland Heritage Areas Authority Financing Fund within the Department of Housing and Community Development. Of the remaining funds, half is allocated for State acquisition and half is allocated to local governments for acquisition and development of land for recreation and open space purposes.

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 prekindergarten 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 declined considerably between 2003 and 2005. After averaging more than \$250 million annually from fiscal 1999 to 2002, school construction funding dropped to \$156.5 million in fiscal 2003, \$116.5 million in fiscal 2004, and \$125.9 million in fiscal 2005. In fiscal 2006, funding increased to \$250.0 million. The proposed fiscal 2007 State budget includes \$280.9 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 \$2.3 billion. In fiscal 2005 there were 585 single-parcel commercial properties that sold for over \$1.0 million, with a total consideration of \$3.2 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 \$16.8 million in State transfer taxes and the counties would have realized an additional \$56.4 million in transfer and recordation taxes in fiscal 2005 had this bill been in effect at that time. Accordingly, this bill could generate an additional \$8.4 million in transfer tax revenues in fiscal 2007 and approximately \$16.8 million annually thereafter. The fiscal 2007 estimate reflects the bill's January 1, 2007 effective date.

As a point of reference, SDAT recently identified 25 real estate transactions in calendar 2001, 17 in 2002, 18 in 2003, 8 in 2004, and 6 in 2005 that would have resulted in the following recordation and transfer tax collections if the bill was in effect in those years:

<u>Calendar Year</u>	<u>State Transfer Tax</u>	<u>County Transfer/Recordation Tax</u>
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
2005	1,920,000	7,190,000

Exhibit 2 lists some recently identified properties that were transferred through the transfer of controlling interest.

Exhibit 2
**Recently Identified Properties Transferred through the Transfer of
Controlling Interest**

<u>Property</u>	<u>Location</u>
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 2005 transactions when approximately \$3.2 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% are 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 \$78,058 in fiscal 2007 and \$94,441 in fiscal 2008 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 \$8.3 million in fiscal 2007 and by approximately \$16.6 million annually thereafter.

Local Fiscal Effect: It is estimated that this bill would generate approximately \$28.2 million in fiscal 2007 in additional recordation and transfer taxes and \$56.4 million in future years. The estimate for fiscal 2007 reflects the bill's January 1, 2007 effective date.

The bill requires the local governments to dedicate \$23.0 million in fiscal 2007 and \$46.0 million in fiscal 2008 through 2010 in recordation tax revenue to a special fund for public school construction as shown in **Exhibit 3**. 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 \$10.5 million in revenue above and beyond what is required to be dedicated to a special fund for school construction pursuant to the bill. Exhibit 3 shows the amount of revenue that could be received by 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 2007 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 *2003 Statistics of U.S. Businesses* by the U.S. Census Bureau indicates that there are 79,671 firms in Maryland that have fewer than 20 employees and another 10,628 that have between 20

and 99 employees. The report indicates that the total number of Maryland firms, with employees, is 109,251.

Additional Information

Prior Introductions: This bill is identical to HB 1 of the 2005 session, as amended and approved by the House. No action was taken by the Senate Budget and Taxation Committee. The bill was also introduced as HB 1 in the 2004 session and was passed by the House; 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 House Ways and Means Committee on HB 19. HB 557 was passed by the House, but received an unfavorable report from the Senate Budget and Taxation Committee.

Cross File: None.

Information Source(s): State Department of Assessments and Taxation, Montgomery County, Prince George's County, Maryland State Department of Education, Department of Legislative Services

Fiscal Note History: First Reader - March 6, 2006
ncs/hlb

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Exhibit 3
Recordation and Transfer Tax Revenue and Distribution Required under HB 1294
Fiscal 2008 – 2010

	Tax Revenue Dedicated for School Construction <u>Under HB 1294</u>	Potential Recordation and Transfer Revenue Generated <u>From HB 1294</u>
Allegany	\$158,426	\$194,483
Anne Arundel	4,417,755	5,423,188
Baltimore City	4,483,456	5,503,842
Baltimore	8,154,629	10,010,535
Calvert	168,011	206,249
Caroline	84,103	103,244
Carroll	466,466	572,629
Cecil	224,817	275,983
Charles	517,315	635,051
Dorchester	193,828	237,941
Frederick	1,026,151	1,259,692
Garrett	151,162	185,564
Harford	1,286,220	1,578,950
Howard	2,785,897	3,419,937
Kent	99,662	122,344
Montgomery	12,007,124	14,739,815
Prince George's	7,291,385	8,950,826
Queen Anne's	165,835	203,578
St. Mary's	538,442	660,986
Somerset	27,135	33,310
Talbot	326,374	400,653
Washington	510,583	626,786
Wicomico	257,591	316,216
Worcester	<u>617,633</u>	<u>758,200</u>
Total	\$45,960,000	\$56,420,000

Note: The fiscal 2007 amount is equal to one-half of the amounts show above.
