

Department of Legislative Services
 Maryland General Assembly
 2007 Special Session

FISCAL AND POLICY NOTE

House Bill 10 (Delegate Healey, *et al.*)
 Ways and Means and Appropriations

Public School Construction Assistance Act of 2008

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 2009 through 2012. State transfer taxes collected under the bill are dedicated to a special fund, as provided under current law, for specified land preservation purposes.

The bill takes effect January 1, 2009.

Fiscal Summary

State Effect: Special fund revenues could increase by \$7.1 million in FY 2009 and by \$14.1 million annually beginning in FY 2010. Special fund expenditures would increase by a commensurate amount, including approximately \$110,000 for administrative costs. Potential significant increase in general fund and Transportation Trust Fund revenues beginning in FY 2009 from income taxes collected from nonresidents. Future year estimates reflect annualization, stable tax collections, and inflation.

(\$ in millions)	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
GF Revenue	-	-	-	-	-
SF Revenue	7.1	14.1	14.1	14.1	14.1
SF Expenditure	7.1	14.1	14.1	14.1	14.1
Net Effect	\$0	\$0	\$0	\$0	\$0

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

Local Effect: Local recordation and transfer tax revenues could increase by \$24.1 million in FY 2009 and \$48.2 million annually beginning in FY 2010. Local government expenditures for public school construction could increase by up to \$24.1 million in FY 2009 and \$48.2 million beginning in FY 2010 through 2012. State aid under Program Open Space could increase by \$2.7 million in FY 2009 and \$5.3 million annually beginning in FY 2010. **The bill imposes a mandate on a unit of local government.**

Small Business Effect: Potential meaningful impact.

Analysis

Bill Summary: The bill • applies to transfers of controlling interests by entities that 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; • exempts certain transfers (*e.g.*, mergers and dissolutions); and • 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.

Public School Construction Funding

The bill also requires Baltimore City and county governments to dedicate specified amounts of recordation tax revenue to public school construction in fiscal 2009 through 2012. The money in these special funds is intended to supplement planned school construction spending rather than supplant it. For fiscal 2009 only, the amount required is one-half of the amounts specified in the bill.

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 2008, after adjusting for any change in tax rates.

Maryland Park Service

For fiscal 2009 through 2012, up to \$5 million annually from the special fund may be appropriated in the State budget to the Maryland Park Service within the Department of Natural Resources (DNR) to pay for salaries and operating expenses.

DNR must report to the Governor and the General Assembly by October 1, 2009, the results and recommendations of a study to develop and implement a plan to fully fund the operations of the Maryland Park Service using general funds.

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 most 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 homebuyers). 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, Maine, New Jersey, New York, Pennsylvania, Virginia, and Washington; and the cities of Chicago, New York, Philadelphia, and the District of Columbia.

The transfer of a controlling interest is one method of transferring commercial and industrial property and results in no recordation and transfer taxes being paid. 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.

Transfer Tax Distribution

The State transfer tax funds several programs 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.

Public School Construction Program

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; in fiscal 2007 it increased to \$322.7 million.

State Revenues: The bill requires SDAT to collect recordation (local) and transfer (State and local) 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. SDAT has recently identified 220 real estate transactions in calendar 2001 through 2006 that would have resulted in the following recordation and transfer tax collections if the bill was in effect in those years, as shown in **Exhibit 2**.

Exhibit 2
Real Estate Transactions Identified as a Controlling Interest

<u>Calendar Year</u>	<u>Number of Transactions</u>	<u>State Transfer Tax</u>	<u>County Transfer/Recordation Tax</u>
2001	27	\$3,000,000	\$9,300,000
2002	21	3,500,000	9,100,000
2003	22	2,900,000	9,200,000
2004	33	5,300,000	17,800,000
2005	49	8,500,000	33,200,000
2006	68	11,700,000	40,100,000

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 of transfers that occur. 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.

Assuming a commensurate growth in the value of transactions that escape recordation and transfer taxes, and based on the growth of the number of transactions that are subject to tax and those that are not subject to the tax; it is estimated that the bill could generate an additional \$7.1 million in transfer tax revenues in fiscal 2009 and approximately \$14.1 million annually thereafter. The fiscal 2009 estimate reflects the bill's January 1, 2009 effective date.

Exhibit 3 lists some recently identified properties that were transferred through the transfer of controlling interest where the sale price is \$100 million or more.

Exhibit 3
Properties Transferred through the Transfer of Controlling Interest with
Values Over \$100 Million

<u>Property</u>	<u>Location</u>	<u>Date of Transfer</u>
IBM Building	Baltimore City	November 1997
IBM Building	Baltimore City	May 2005
Wyndham Inner Harbor	Baltimore City	August 2005
Wyndham Inner Harbor	Baltimore City	October 2005
Marshfield Business Park	Baltimore County	June 2005
Cove Point LNG Facility	Calvert County	September 2002
Village Centers in Columbia	Howard County	February 2002
Bethesda Towers	Montgomery County	September 2005
Capital Gateway II & IV	Montgomery County	October 2004
The Chase at Bethesda	Montgomery County	January 2006
Executive Plaza North & South	Montgomery County	December 2003
Human Genome	Montgomery County	May 2006
Irvington Center	Montgomery County	April 2006
Metro Park North	Montgomery County	December 2001
Peppertree Farm Apartments	Montgomery County	January 2006
Capitol Office Park	Prince George's County	March 2006

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.

It is estimated that the income tax collected from nonresidents from these sales could be significant, due to the value of properties transferred in this manner. 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 \$58,100 in fiscal 2009 and \$102,000 in fiscal 2010 to hire one charter specialist and one office secretary to assist in the collection of additional recordation and transfer taxes. Future year administrative expenditures increase to \$119,900 in fiscal 2013.

As a result, total special fund expenditures for land preservation purposes and by the Maryland Park Service could increase by \$7.0 million in fiscal 2009 and by approximately \$14.0 million annually thereafter. Under the bill, \$5 million annually for a four-year period could be provided to the Maryland Park Service to pay for salaries and operating expenses. The remaining State revenues would be dedicated to land preservation programs, as provided under current law.

Local Fiscal Effect: The bill could increase local recordation and transfer taxes by an estimated \$24.1 million in fiscal 2009 and \$48.2 million in future years as shown in **Exhibit 4**. The estimate for fiscal 2009 reflects the bill's January 1, 2009 effective date.

The bill requires local governments to dedicate \$24.1 million in fiscal 2009 and \$48.2 million in fiscal 2010 through 2012 in recordation tax revenue to a special fund for public school construction as shown in Exhibit 4. 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.

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 2008, after adjusting for any change in tax rates. Exhibit 4 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 estimated revenue increase equals the amount of new school construction funding specified in the bill.

Local governments would also receive additional State aid under Program Open Space, totaling \$2.7 million in fiscal 2009 and \$5.3 million annually beginning in fiscal 2010, as shown in **Exhibit 5**.

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 *2004 Statistics of*

U.S. Businesses by the U.S. Census Bureau indicates that there are 96,047 firms in Maryland that have fewer than 20 employees and another 10,994 that have between 20 and 99 employees. The report indicates that the total number of Maryland firms, with employees, is 112,268.

Additional Information

Prior Introductions: This bill is similar to HB 475 of 2007 as amended and approved by the House. The Senate Budget and Taxation Committee took no action on the bill. A similar proposal was introduced as HB 1294 in the 2006 session, which was not acted upon by the House Appropriations and Ways and Means committees; it is also the same as HB 1 of the 2005 session, as amended and approved by the House. No action was taken by Budget and Taxation. The bill was also introduced as HB 1 in the 2004 session and was passed by the House; however, no action was taken by Budget and Taxation. Similar bills were introduced as HB 19 in the 2003 session and HB 557 in the 2002 session. No action was taken by Ways and Means on HB 19. HB 557 was passed by the House, but received an unfavorable report from Budget and Taxation.

Cross File: None.

Information Source(s): State Department of Assessments and Taxation, Montgomery County, Public School Construction Program, Department of Legislative Services

Fiscal Note History: First Reader - November 2, 2007
mcp/hlb

Analysis by: Michael Sanelli

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

Exhibit 4
Potential Increase in Local Recordation and Transfer Taxes and Amounts
Dedicated for School Construction Under HB 10
Fiscal 2009 and 2010

County	FY 2009	FY 2010	Percent of Total
Allegany	\$83,088	\$166,177	0.3%
Anne Arundel	2,316,937	4,633,875	9.6%
Baltimore City	2,351,395	4,702,790	9.8%
Baltimore	4,276,780	8,553,560	17.7%
Calvert	88,115	176,230	0.4%
Caroline	44,109	88,217	0.2%
Carroll	244,643	489,286	1.0%
Cecil	117,907	235,815	0.5%
Charles	271,311	542,623	1.1%
Dorchester	101,655	203,310	0.4%
Frederick	538,176	1,076,352	2.2%
Garrett	79,278	158,556	0.3%
Harford	674,572	1,349,143	2.8%
Howard	1,461,093	2,922,185	6.1%
Kent	52,269	104,538	0.2%
Montgomery	6,297,261	12,594,522	26.1%
Prince George's	3,824,043	7,648,086	15.9%
Queen Anne's	86,974	173,948	0.4%
St. Mary's	282,392	564,783	1.2%
Somerset	14,231	28,462	0.1%
Talbot	171,170	342,340	0.7%
Washington	267,780	535,561	1.1%
Wicomico	135,096	270,192	0.6%
Worcester	323,924	647,848	1.3%
Total	\$24,104,200	\$48,208,400	100.0%

Exhibit 5
Increased State Aid Under Program Open Space
Fiscal 2009 and 2010

County	FY 2009	FY 2010	Percent of Total
Allegany	\$29,400	\$58,700	1.1%
Anne Arundel	312,400	624,800	11.8%
Baltimore City	280,100	560,300	10.5%
Baltimore	353,400	706,800	13.3%
Calvert	31,000	61,900	1.2%
Caroline	13,700	27,500	0.5%
Carroll	70,200	140,300	2.6%
Cecil	36,200	72,300	1.4%
Charles	63,700	127,300	2.4%
Dorchester	11,700	23,500	0.4%
Frederick	72,600	145,100	2.7%
Garrett	14,500	28,900	0.5%
Harford	103,900	207,900	3.9%
Howard	184,300	368,600	6.9%
Kent	8,700	17,500	0.3%
Montgomery	464,200	928,300	17.5%
Prince George's	399,400	798,800	15.0%
Queen Anne's	18,700	37,400	0.7%
St. Mary's	35,200	70,400	1.3%
Somerset	8,500	16,900	0.3%
Talbot	19,600	39,200	0.7%
Washington	55,300	110,600	2.1%
Wicomico	36,900	73,900	1.4%
Worcester	34,900	69,700	1.3%
Total	\$2,658,500	\$5,316,600	100.0%