

Department of Legislative Services
 Maryland General Assembly
 2019 Session

FISCAL AND POLICY NOTE
 First Reader

House Bill 204 (Delegate Luedtke, *et al.*)
 Ways and Means

Income Tax - Subtraction Modification - Employee-Owned Businesses

This bill creates a subtraction modification against the State individual and corporate income tax for any income from a qualified transfer of stock or membership interest of a Maryland corporation or limited liability company (LLC). If the qualified transfer is to a direct share ownership plan, the subtraction is limited to the lowest amount of stock or membership interest transferred to any tenured employee during the taxable year multiplied by the number of all tenured employees. **The bill takes effect July 1, 2019, and applies to tax year 2019 and beyond.**

Fiscal Summary

State Effect: General fund, Transportation Trust Fund (TTF), and Higher Education Investment Fund (HEIF) revenues and TTF expenditures decrease by a potentially significant amount beginning in FY 2020. General fund expenditures increase by \$139,000 in FY 2020 at the Comptroller’s Office.

(in dollars)	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024
GF/SF Rev.	(-)	(-)	(-)	(-)	(-)
GF Expenditure	\$139,000	\$0	\$0	\$0	\$0
SF Expenditure	(-)	(-)	(-)	(-)	(-)
Net Effect	(\$139,000)	(-)	(-)	(-)	(-)

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

Local Effect: Local income tax revenues and local highway user revenues decrease beginning in FY 2020. Local expenditures are not affected.

Small Business Effect: Potential meaningful.

Analysis

Bill Summary: A qualified transfer is the transfer of any amount of stock or membership interest of a corporation or LLC to an employee stock ownership plan (ESOP), an employee ownership trust, or a direct share ownership plan, if:

- the stock or membership interest has voting power at least equal to the class of stock or membership interest of the employer having the greatest voting power;
- the stock or membership interest has dividend rights at least equal to the class of stock or membership interest of the employer having the greatest dividend rights; and
- in the case of a transfer to a direct share ownership plan, the largest amount of stock or membership interest transferred to any employee does not exceed a multiple of 10 times the smallest amount of stock or membership interest transferred to any tenured employee.

A tenured employee is an employee or independent contractor who has provided at least 1,000 hours of services to the employer within the preceding 12 months or worked the number of hours specified in an ESOP, employee ownership trust, or direct share ownership plan. An employer includes at least two people treated as a single employer under specified provisions of the Internal Revenue Code (IRC).

Current Law: No similar State income tax subtraction modification exists.

The Broadened Ownership Act declares the public policy view of the General Assembly that an ESOP, as defined by the IRC, makes an important contribution toward the broadening of capital ownership, increases the income and financial security of the residents of the State, assures the residents of the State greater control of their economic futures, improves productivity and labor-management relations, contributes to the national effort to combat inflation, strengthens the free enterprise system, and puts Maryland in the forefront of contemporary economic trends.

ESOPs are defined as stock bonus plans – or a combination of stock bonus plans and money purchase plans – that are qualified under IRC Section 401(a) and designed to invest primarily in employer securities. Stock bonus plans are designed to provide benefits similar to those of a profit-sharing plan, except that the employer contributions are not necessarily dependent on profits and the benefits are distributable in stock of the employer company. Money purchase plans are arrangements under which an individual account is maintained for each participant to which an employer makes fixed or determinable contributions.

ESOPs provide a means for employees to have an ownership interest in the companies for which they work. ESOPs can be categorized into two main types: the basic ESOP, which is essentially a stock bonus plan designed to invest in employer securities, and the leveraged ESOP, which is used as a financing vehicle for the employer. Most ESOPs are leveraged.

ESOPs are subject to many requirements set out in the federal tax code and receive a number of federal tax benefits.

The Maryland Securities Act exempts certain transactions related to ESOPs from registration and filing requirements, including the sale of securities to an ESOP, the accrual of interests of participants in ESOP, and any distribution made under ESOP to participants or beneficiaries.

Background: The National Center for Employee Ownership (NCEO) reports there are 130 ESOPs covering 324,755 employees in Maryland in 2015. NCEO advises that ESOPs are commonly used to provide a market for the shares of departing owners of successful closely held companies, to motivate and reward employees, or to take advantage of incentives to borrow money for acquiring new assets in pretax dollars.

Other states provide similar tax incentives for transfers to qualifying ESOPs. To the extent not already excluded, Iowa and Missouri both exempt 50% of the net income from taxation if a company is sold to an ESOP that owns at least 30% of the stock.

For tax year 2016, the Iowa Department of Revenue reports only six forms claimed an Iowa capital gains deduction on the sale of employer securities to an ESOP, averaging \$268,200 per form and totaling \$1.6 million in deductions. Taxpayers between the age of 35 and 54 filed 83.3% of all forms. Half of the forms were filed by taxpayers with an adjusted gross income above \$250,000.

State Revenues: Subtraction modifications may be claimed beginning in tax year 2019. As a result, general fund, TTF, and HEIF revenues will decrease by a potentially significant amount beginning in fiscal 2020. However, the amount of the revenue decrease depends on the income from qualified transfers of the stock or membership interest of a Maryland corporation or LLC, and the taxpayers' tax liabilities, which cannot be reliably estimated.

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of \$139,000 in fiscal 2020 to add the subtraction modification to the personal and corporate income tax returns. This includes data processing changes to the SMART income tax return processing and imaging systems and system testing.

A portion of TTF revenues are used to provide capital transportation grants to local governments. To the extent that TTF revenues decrease as a result of taxpayers claiming the subtraction modification against the corporate income tax, TTF expenditures decrease by 13.5% of the TTF revenue decrease.

Local Revenues: Local income tax revenues decrease by about 3% of the total net State subtraction modifications claimed against the personal income tax beginning in fiscal 2020. To the extent that subtraction modifications are claimed against the corporate income tax, local highway user revenues decrease beginning in fiscal 2020.

Small Business Effect: Small businesses that provide a qualified transfer of stock or membership interest to an employee stock ownership plan, an employee ownership trust, or a direct share ownership plan may benefit from the subtraction modification.

Additional Information

Prior Introductions: HB 876 of 2018 received a hearing in the House Ways and Means Committee, but no further action was taken. Its cross file, SB 498 of 2018, received a hearing in the Senate Budget and Taxation Committee, but no further action was taken.

Cross File: None.

Information Source(s): Comptroller's Office; State Department of Assessments and Taxation; National Center for Employee Ownership; Iowa Department of Revenue; Department of Legislative Services

Fiscal Note History: First Reader - February 4, 2019
sb/hlb

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