NAIOP
MARYLAND CHAPTERS
THE ASSOCIATION FOR COMMERCIAL REAL ESTATE

March 2, 2024

The Vanessa Atterbeary, Chair
House Ways and Means Committee
House Office Building, Room 121
6 Bladen St., Annapolis, MD 21401

Oppose: HB 1515 – Sales Tax on Services

Dear, Chair Atterbeary and Committee Members:

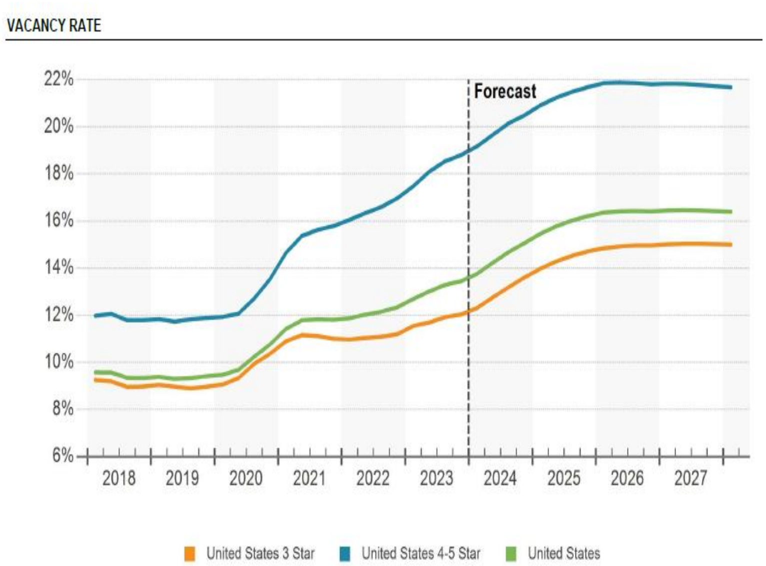
On behalf of the NAIOP Maryland Chapters representing more than 700 companies who develop and own office, mixed-use and light industrial real estate I am writing in opposition to House Bill HB 1515.

NAIOP strongly opposes HB 1515 because expanding the sales tax to services purchased and provided by commercial real estate will:

- Further weaken Maryland's competitive position relative to lower tax, higher growth states.
- Exacerbate the financial pressure on commercial real estate owners and occupants that are struggling to decarbonize buildings, accommodate electric vehicle infrastructure and adjust to a post COVID-19 era where high interest rates, and remote work have resulted in increased office vacancy rates and reduced cash flows.
- Pyramid or repeatedly stack the tax during construction, leasing and renovations inflating costs making the actual tax higher than the advertised rate.
- Exacerbate the disproportionate share of government services financed by commercial real estate taxes and fees.

➢ Exacerbates the financial pressure on commercial real estate owners and occupants.

Commercial real estate owners and occupants are under intense financial pressure; adjusting to a post COVID-19 era where high interest rates and remote work have increased office vacancy rates and reduced cash flows.



Slow employment growth and the trend to hybrid work schedules are leading to further occupancy losses. The full effects of remote and hybrid work have not yet fully played out and will not until existing leases come up for renewal. The graph at right is from the real estate information provider COSTAR and shows that national vacancy rates for are expected to continue to rise into 2025 and reach 22% for the highest quality office buildings.

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➢ Further weakens Maryland's competitive position relative to lower tax, higher growth states.

Almost any office or professional service function in Maryland can be accomplished from a neighboring state. It is only eleven miles from Bethesda to Tysons Corner so commercial real estate in Montgomery County is particularly vulnerable to policy changes that deteriorate the value proposition for companies to locate and remain in Maryland. Vacancy rates and space available for sublease in large office buildings in Montgomery County are 20% Extremely high by historical standards.

The combination of increased Maryland tax rates and the availability of high quality, office space across the Potomac River in Virginia will be a powerful draw which raises legitimate concerns about increased vacancies and weakening rental rates. There is little doubt that, faced with a sales tax on their professional services and an increase in office rents, a significant portion of the creative class that serves commercial real estate will move and serve their Maryland clients from Virginia.

The State of the Economy Report from the Office of the Comptroller[1] documents that despite its many economic and demographic advantages, Maryland's economic growth effectively stalled in 2017, has been stagnant ever since and the state is losing population to lower cost, higher growth states. NAIOP believes that tax increases like HB 1515 will further deteriorate Maryland's economy and competitive position.

Figure 1: Maryland Comparative Economic Growth 2016 – 2023

Geography	GDP Total Growth	Employment Total Growth	Personal Income Per Capita Growth	Real Wages Average Growth
Pennsylvania	6.6%	1.0%	5.6%	5.6%
Virginia	11.2%	5.3%	6.4%	6.5%
United States	13.9%	7.4%	9.5%	7.4%
Maryland	1.6%	1.0%	1.2%	4.3%

Sources: U.S. Bureau of Economic Analysis. U.S. Bureau of Labor Statistics, MD Bureau of Revenue Estimates

The data in the Comptroller's report are troubling but consistent with the experience of NAIOP members who recruit companies to Maryland. They see capital investments and company location decisions disproportionately favoring lower cost, faster growing states.

Between 2012 and 2020 Maryland lost an average of just over eight thousand residents per year to other states. 57% of the residents leaving the state had incomes of $100,000 or higher. The top five destinations for outmigration were faster-growing states where the cost of living is lower than Maryland: Florida, Virginia, North Carolina, Texas, and South Carolina.

Maryland's Gross Domestic Product effectively stalled in 2017, has been stagnant ever since and lags both the national growth rate and the growth rate of neighboring states. Between 2016 and 2023 Maryland economic growth was 1.6% compared to the national average of 13.9% and Virginia's total growth of 11.2%.

Employment in Maryland is only 1% higher than it was in the fourth quarter of 2016, compared to 7.5% higher nation-wide and 5.3% higher in Virginia.

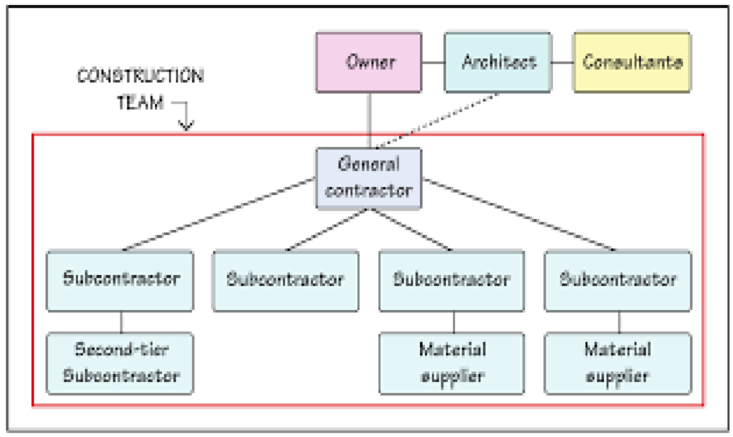
➢ Pyramids or stacks the tax at each level of land development and construction process.

Applying the sales tax to construction services and labor would result in the pyramiding of sales taxes as multiple service providers from legal, engineering, architecture, specialty subcontractors and general contractors all collect sales tax at various stages of the land development and construction process. Charges for supervision, labor,

[1] Maryland State of the Economy - 2023, Comptroller of Maryland

overhead and profit would be taxed as a service. As these taxes are embedded in invoices and handed upstream from subcontractors to contractors, to the general contractor and eventually to the developer, production costs will inflate the final purchase price of the building.

The grossed-up taxes will t also increase the transaction and financing costs. Title reports and insurance, legal services for document preparation and recording of deeds will add layers of tax at each step of the process. The transaction costs paid by the ownership entity that are based on valuation such as recordation and transfer taxes and title insurance will increase.



Post sale, costs of providing management services to commercial real estate buildings would be taxable Leasing services could be taxed three times - once as a service, then when long-term leases are recorded in the land records then as income to individuals and entities that supplied the services.
The repeated application of tax to the inputs, the services, and outputs result in embedded costs that would be higher than the advertised tax rate.

➢ <u>Further exacerbates the disproportionate share of local government services financed by commercial real estate taxes and fees.</u>

Commercial real estate generates more net tax revenue than any other class of property. Changes to valuations have resulted in commercial property owners paying a larger percentage of the cost of government services than a decade ago. Over the last 13 years, the commercial real estate tax base expanded by $72B and increased to 24% of the state-wide tax base in 2022 up from 19% in 2010. The increase in commercial base offset slow growth in residential tax base and a flat agricultural tax base.

2010-2023 The Commercial Real Property Tax Base Increased $72b, Offsetting Slow Residential Growth

	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**'10- '23**	**Pct**
Residential	598.7	577.4	530.0	501.0	489.6	502.2	531.1	536.7	554.2	571.1	588.7	608.4	632.3	33.6	6%
Commercial	135.4	140.0	145.9	143.5	160.9	169.0	169.0	177.1	185.2	190.8	198.5	203.0	208.1	72.7	54%
Agricultural	13.6	13.5	12.7	12.1	11.8	11.9	12.0	12.2	12.3	12.4	12.6	13.0	13.4	0.2	1%

Values in Billions of Dollars, Source: SDAT Annual Reports

During this time local governments, reluctant to increase broader taxes, have increased the recordation and transfer tax rates to fund public services including education. Several have structured the taxes to apply higher tax rates to commercial real estate transactions.

<u>90Conclusion</u>

When the sales tax was introduced to Maryland in 1947, the economy looked quite different from today. In 1947, services comprised 38% of personal consumption nationwide. After years of a tax code so poorly aligned with economic activity, the cost of providing government services has increasingly been embedded in the land development entitlement process and in increased marginal costs for commercial fees and taxes. This has hurt affordability in the multifamily sector, increased debt in the commercial and industrial sectors and eroded

Maryland's competitive position with lower tax, higher growth states. An increase in sales taxes on real estate would be a poor policy choice that would worsen these conditions.

For these reasons, NAIOP respectfully recommends your unfavorable report on HB 1515.

Sincerely,

T.M. Ballentine

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NAIOP – Maryland Chapters, *The Association for Commercial Real Estate*

cc: House Ways and Means Committee Members
Nick Manis – Manis, Canning Assoc.