HB 337

Department of Legislative Services

Maryland General Assembly
2023 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 337 (Delegate Palakovich Carr, *et al.*)
Ways and Means

Income Tax – Capital Gains, Dividends, and Foreign–Derived Intangible Income – Alterations (Investing in Marylanders Act of 2023)

This bill (1) imposes an additional State income tax rate of 1% on specified net capital gain income included in an individual's Maryland taxable income; (2) requires an addition modification under the personal and corporate income tax for amounts deducted for dividends paid for real estate investment trusts (REITs); (3) disallows deductions under the corporate income tax for specified amounts deducted for foreign-derived intangible income (FDII) and dividends received from a foreign corporation; and (4) alters corporate income tax provisions relating to the determination of income for corporations and, specifically, the treatment of specified interest and intangible expenses. **The bill takes effect July 1, 2023, and applies to tax year 2023 and beyond.**

Fiscal Summary

State Effect: General fund, Transportation Trust Fund (TTF), and Higher Education Investment Fund (HEIF) revenues increase by an indeterminate but likely significant amount beginning in FY 2024. General fund expenditures increase by $193,900 in FY 2024; future years reflect ongoing costs. TTF expenditures for local highway user revenue grants increase by an indeterminate amount beginning in FY 2024.

(in dollars)	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028
GF Revenue	-	-	-	-	-
SF Revenue	-	-	-	-	-
GF Expenditure	$193,900	$157,600	$164,600	$172,000	$181,100
SF Expenditure	-	-	-	-	-
Net Effect	-	-	-	-	-

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 increase by an indeterminate amount beginning in FY 2024, as discussed below. Local expenditures are not affected.

Small Business Effect: Meaningful.

Analysis

Current Law/Bill Summary:

Additional 1% State Income Tax Rate for Net Capital Gains

Maryland conforms to the federal income tax treatment of net capital gains. However, under current State law, and unlike the treatment of capital gains income under the federal income tax, net capital gains are taxed at the same State income tax rates as other income. **Exhibit 1** shows the State income tax rates under current law.

Exhibit 1
Maryland State Income Tax Rates

Single, Dependent, Married Filing Separately		Joint, Surviving Spouse, Head of Household	
Rate	**Maryland Taxable Income**	**Rate**	**Maryland Taxable Income**
2.00%	$1-$1,000	2.00%	$1-$1,000
3.00%	$1,001-$2,000	3.00%	$1,001-$2,000
4.00%	$2,001-$3,000	4.00%	$2,001-$3,000
4.75%	$3,001-$100,000	4.75%	$3,001-$150,000
5.00%	$100,001-$125,000	5.00%	$150,001-$175,000
5.25%	$125,001-$150,000	5.25%	$175,001-$225,000
5.50%	$150,001-$250,000	5.50%	$225,001-$300,000
5.75%	Excess of $250,000	5.75%	Excess of $300,000

Source: Comptroller's Office; Department of Legislative Services

Under the bill, net capital gain, as defined and determined under the Internal Revenue Code (IRC) (as discussed below), is subject to an additional 1% State income tax rate to the extent included in Maryland taxable income. The additional tax rate does not apply to any amount of capital gain from the sale or exchange of (1) a specified residential dwelling sold for less than $1,000,000 that is the individual's primary residence; (2) specified assets held in a defined contribution plan, defined benefit plan, or similar retirement savings plan; (3) cattle, horses, or breeding livestock held for more than 12 months, as specified; (4) land that is subject to or will be subject to specified easements; (5) property used in a trade or business, the cost of which is deductible under § 179 of the IRC; or (6) affordable housing owned by a nonprofit organization.

Federal Income Tax Treatment of Capital Gains

For purposes of federal income tax, long-term capital gains and losses are distinguished from short-term capital gains and losses. A gain or loss from the disposition of a capital asset held for more than one year is treated as a long-term capital gain or loss; a gain or loss from the disposition of a capital asset that is held for one year or less is treated as a short-term capital gain or loss.

Net capital gain (net long-term capital gain minus net short-term capital loss) is generally taxed at a lower federal income tax rate (0%, 15%, or 20%, depending on the taxpayer's filing status and taxable income) than ordinary income. Net short-term capital gain is taxed as ordinary income with a top marginal rate of 37%.

An individual or other noncorporate taxpayer may deduct up to $3,000 in net capital losses each year; any unused amount of losses may be carried forward indefinitely. For corporate taxpayers, capital losses may only offset capital gains. Any unused net capital loss may be carried forward to future tax years until fully used.

Special rules apply to the sale of collectibles, investment real estate, principal residences, and to taxpayers who make qualifying investments within federal opportunity zones.

Disallowance of Deductions Relating to Dividends

The bill decouples from federal income tax various deductions relating to dividends and, in particular, deductions relating to dividends received from foreign corporations. Specifically, the bill:

- establishes an addition modification under the personal and corporate income tax for amounts deducted under § 857 of the IRC for dividends paid by a REIT;
- establishes an addition modification under the corporate income tax for FDII deducted under § 250 of the IRC;
- establishes addition modifications for dividends received from foreign corporations that are deducted under § 243 and § 245A of the IRC; and

- alters an existing subtraction modification under the corporate income tax to disallow the subtraction of amounts treated as dividends under § 245 (dividends received from certain foreign corporations) or § 1248 (gains from certain sales or exchanges of stock in certain foreign corporations) of the IRC.

The relevant current law provisions of State law and the IRC are discussed in further detail below.

Dividends Paid Deduction for Real Estate Investment Trusts (IRC § 857): A corporation, trust, or association that operates as a vehicle for investment in real estate and meets various specified requirements may qualify for treatment as a REIT for federal income tax purposes. To qualify for REIT status, a corporation, trust, or association must, among other requirements, derive at least 95% of its gross income from specified passive income sources and at least 75% of its income from specified real estate sources.

In general, for purposes of computing federal taxable income, a REIT that distributes at least 90% of its income to shareholders and otherwise meets all applicable requirements may deduct the amount of dividends paid during the taxable year. Thus, such dividends are subject to income tax only at the shareholder level.

Maryland's income tax generally conforms to the federal tax treatment of REITs, except in the case of "captive REITs," which are more than 50% owned or controlled by a single entity. Chapters 583 and 584 of 2007 disallowed the dividends paid deduction for captive REITs for purposes of Maryland corporate income tax. The Acts defined a captive REIT as a corporation, trust, or association:

- that is considered a REIT for the taxable year under § 856 of the IRC;
- that is not regularly traded on an established securities market; and
- where more than 50% of the voting power or value of the beneficial interests or shares, at any time during the last half of the taxable year, is owned or controlled, directly or indirectly, by a single entity that is subject to the provisions of Subchapter C of Chapter 1 of the IRC.

Deduction of Foreign-Derived Intangible Income (IRC § 250): The federal Tax Cuts and Jobs Act of 2017 (TCJA) authorized a domestic corporation to claim a deduction in an amount equal to specified percentages of its FDII and global intangible low-taxed income, as defined and determined under § 250 of the IRC. For tax years 2018 through 2025, the value of the FDII deduction is 37.5%; for tax years 2026 and beyond, the value of the deduction is reduced to 21.875%. The U.S. Joint Committee on Taxation estimates that the FDII deduction will reduce federal revenues by a total of $72.6 billion in federal fiscal years 2022 through 2026.

Deduction for Dividends Received by Corporations (IRC § 243): Section 243 of the IRC allows corporations to deduct a specified percentage of dividends received from taxable domestic corporations. In general, a corporation may deduct 50% of dividends received; the value of the deduction increases to 65% in the case of dividends received by a corporation with at least 20% ownership in the distributing corporation. A member corporation of an affiliated group of corporations may deduct 100% of dividends received by another member corporation within the same affiliated group. In addition, a small business investment company operating under the Small Business Investment Act of 1958 may deduct 100% of dividends received.

The dividends received deduction allowed under § 243 may be claimed with respect to dividends received by a *foreign successor* of a domestic corporation; however, the deduction is allowed only with respect to dividends from earnings and profits accumulated while the distributing corporation was subject to U.S. income tax.

Deduction for Dividends Received from Certain Foreign Corporations (IRC § 245 and § 245A): Section 245 of the IRC allows a domestic corporation to claim a deduction with respect to the U.S. portion of dividends received from a foreign corporation, other than a passive foreign investment company, that is at least 10% owned by the domestic corporation (10-percent owned foreign corporation). Similar to the dividends received deduction allowed under § 243, a domestic corporation may deduct 50% of the U.S. portion of dividends received; the value of the deduction increases to 65% in the case of a corporation with at least 20% ownership in the distributing corporation. Subject to specified limitations, a corporation may deduct 100% of eligible dividends received from wholly owned foreign subsidiaries during a taxable year in which all of the foreign payer's gross income is effectively connected with the conduct of a trade or business within the United States.

The TCJA allowed domestic corporations to fully deduct the foreign-source portion of dividends received from 10-percent owned foreign corporations (participation dividends received deduction), as specified under § 245A of the IRC.

Gain from Disposition of Stock in Certain Foreign Corporations (IRC § 1248): Pursuant to § 1248 of the IRC, gain recognized by a U.S. person on the disposition of stock in a controlled foreign corporation in which the person owns at least 10% of all classes of voting stock must be treated as a dividend for purposes of federal income tax. Thus, such gains are subject to ordinary income tax rates. However, specified limitations apply to the taxation of such gains in the case of individuals.

Maryland Corporate Income Tax – Deduction for Dividends Received from a Foreign Corporation (Tax-General § 10-307(d)): Under the Maryland corporate income tax, a corporation may claim a subtraction modification for dividends received if the receiving corporation owns, directly or indirectly, at least 50% of the paying corporation's outstanding shares of capital stock and the paying corporation is organized under the laws of a foreign government.

Alterations to Determination of Income for Corporations

Under current law, § 10-306.1 of the Tax-General Article requires a corporation, in determining Maryland modified income, to add back otherwise deductible interest expenses or intangible expenses if the expenses are directly or indirectly paid to one or more related members, as defined.

However, an exception applies if the corporation establishes, as determined by the Comptroller, that:

- the transaction giving rise to the payment did not have as a principal purpose the avoidance of tax;
- the interest expense or intangible expense was paid pursuant to arm's-length contracts at an arm's-length rate of interest or price; and
- (1) during the same taxable year, the related member directly or indirectly paid, accrued, or incurred the interest expense or intangible expense to a person who is not a related member; (2) the amounts received by the related member are subject to an aggregate effective tax rate of at least 4%, as specified; or (3) the corporation and related member are banks.

Under the bill, a corporation must establish such conditions *by clear and convincing evidence.* The bill further alters the conditions under which the exception applies – specifically:

- for cases in which an exception is allowed based on the aggregate effective tax rate of the amounts in question, (1) the measure of any tax imposed by a foreign nation that has entered into a comprehensive tax treaty with the U.S. government must be equal to or greater than the tax imposed by Maryland and (2) the aggregate effective tax rate imposed on the amounts received by the related member must be equal to or greater than the State corporate income tax rate minus 3% (which, based on the current State corporate income tax rate, equates to 5.25%); and
- an exception may not be allowed on the basis that the corporation and related member are banks.

The bill makes various further alterations with respect to the determination of the effective tax rate imposed by a jurisdiction for purposes of § 10-306.1.

State Revenues:

Additional 1% State Income Tax Rate for Net Capital Gains

As discussed above, the bill imposes an additional 1% State income tax rate on net capital gains income, subject to specified exceptions. Thus, general fund revenues increase by an indeterminate amount beginning in fiscal 2024. The amount of the increase, however, cannot be reliably estimated due to the lack of available data on the sources of Maryland capital gains income. For purposes of context only, the Comptroller's Office estimates that, if the additional tax rate were applicable to *all* capital gains income reported by taxpayers, general fund revenues would increase by approximately $157 million annually on average; actual revenue increases would be less due to the exceptions provided under the bill. The Comptroller's Office further notes that capital gains income is volatile, so the revenues generated from the bill's additional income tax rate for capital gains income are likely to be volatile.

Disallowance of Specified Deductions Relating to Dividends

As discussed above, the bill disallows various deductions relating to dividends for purposes of Maryland income tax. With the exception of the bill's addition modification for dividends paid by a REIT, these changes apply exclusively to the corporate income tax. Thus, general fund, TTF, and HEIF revenues increase by an indeterminate but potentially significant amount beginning in fiscal 2024 to the extent the bill results in additional personal and corporate income tax liability. However, the precise effect cannot be reliably estimated due to data limitations.

State Expenditures:

General Fund Expenditures

As discussed above, the bill requires a clear and convincing evidence standard for purposes of establishing an exception to the addition modification required for corporate taxpayers under Tax-General § 10-306.1 (relating to interest and intangible expenses paid to related members). It is anticipated that the change will increase the complexity and time involved in processing corporate income tax returns such that additional personnel are needed within the Comptroller's Office.

Thus, general fund expenditures for the Comptroller's Office increase by $193,933 in fiscal 2024, which accounts for the bill's July 1, 2023 effective date. This estimate reflects the cost of hiring two additional full-time revenue specialists to process tax returns. It includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses. This estimate also includes one-time programming expenses associated with the implementation of the bill's alterations to the personal income tax rate for capital gains income.

Positions	2
Salaries and Fringe Benefits	$119,115
Programming Expenses	60,000
Other Operating Expenses	14,818
Total FY 2024 State Expenditures	**$193,933**

Future year expenditures reflect elimination of one-time costs and annual increases in ongoing operating expenses.

Transportation Trust Fund Expenditures

To the extent the bill results in additional corporate income tax revenues, TTF expenditures for local highway user revenue grants increase by an indeterminate amount beginning in fiscal 2024. The precise impact cannot be reliably estimated, as discussed above.

Local Revenues: Local income tax revenues and local highway user revenues increase to the extent the bill results in additional personal and corporate income tax liability, respectively. However, the precise impact cannot be reliably estimated.

Small Business Effect: Small business partnerships, S corporations, limited liability companies, and sole proprietorships may be meaningfully impacted by the bill's changes with respect to the taxation of capital gains income under the personal income tax, which may result in higher income tax liabilities for affected small business taxpayers with net capital gains. However, the bill's additional income tax rate for capital gains income does not apply to the sale of business property deductible under § 179 of the IRC – a deduction which is generally available to smaller sized enterprises.

Additional Information

Prior Introductions: With respect to the bill's provisions relating to capital gains income, similar legislation has been introduced within the last three years. See HB 201 of 2021 and HB 222 of 2020.

Designated Cross File: None.

Information Source(s): Comptroller's Office; CCH AnswerConnect; U.S. Joint Committee on Taxation; Department of Legislative Services

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