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Testimony of

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Before the

Maryland Senate Budget and Taxation Committee

Hearing on S.B. 263, Opportunity Zone Deduction Reform Act of 2020

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Chairman Guzzone and Members of the Budget and Taxation Committee, I'm Michael Mazerov, a Senior Fellow with the State Fiscal Policy division of the Center on Budget and Policy Priorities in Washington. The Center is a non-partisan research and policy institute that pursues federal and state policies designed to reduce poverty and inequality and to restore fiscal responsibility in equitable and effective ways. We apply our expertise in budget and tax issues and in programs and policies that help low-income people, in order to help inform debates and achieve better policy outcomes. I appreciate the opportunity to testify this afternoon in support of S.B. 263. Senator Rosapepe's bill would decouple Maryland's individual and corporate income taxes from the capital gains tax breaks for investments in federal opportunity zones created by the 2017 federal tax legislation.

The federal opportunity zone program provides a combination of temporary and permanent reductions in the federal income tax that would otherwise be due on capital gains realized from both the sale of non-zone assets rolled over into "qualified opportunity funds" and the subsequent sale of investments in the funds themselves. Both individuals and corporations can invest in these funds, which in turn invest in real estate developments and operating businesses within designated opportunity zones. Under existing law, Maryland's individual and corporate income taxes provide these same tax breaks because Maryland uses Federal Adjusted Gross Income and Federal Taxable Income, respectively, as the starting point for the calculation of these two taxes.

The most important reason Maryland should decouple its own individual and corporate income taxes from the opportunity zone capital gains breaks is to avoid subsidizing investments in opportunity zone projects located outside our state. The stated investment strategy of many of the funds is to invest in a portfolio of projects in opportunity zones potentially located anywhere in the United States. Others intend to invest in a broader region that may include Maryland, such as the mid-Atlantic. Still others have been established to invest in a single project in a single zone, many of which, again, will be outside Maryland. In short, it is likely that many Maryland residents and many corporations taxable in our state will be investing in opportunity zone funds with some or all their projects located outside the state. It makes no sense whatsoever for Maryland to forgo vitally needed revenue to subsidize out-of-state investments that will provide no benefit to the state's economy or treasury.

Although a few states do not conform to the opportunity zone tax breaks because their personal or corporate income taxes do not automatically link to the federal provisions, to my knowledge only three states to date have proactively decoupled. North Carolina is the only state that has completely decoupled, for both its individual and corporate income tax. Arkansas and Hawaii have decoupled for investments located in other states but grant the tax breaks for investments located in in-state opportunity zones, a misguided policy I will get back to in a moment. As for the rest of the states, I'm convinced that the fact that they are forgoing revenue to subsidize investments in out-of-state zones has simply not hit policymakers' radar screens in most cases. I called attention to this problem in a presentation I gave last August at a meeting of the NCSL Task Force on State and Local Taxation, and it was clear to me from the reaction of the twenty or so legislators present that the issue had occurred to no more than a handful. Likewise, a recent article in the New Hampshire Business Review highlighted the surprise of several members of the tax-writing committees in learning that their corporate income tax was vulnerable to erosion from these tax breaks even though the state does not levy an individual income tax. I am confident that if Maryland takes the completely justified step of decoupling from these unwarranted tax breaks it will draw additional attention to the issue and thereby encourage more states to follow in its footsteps. For example, I have been working with grassroots tax activists in Oregon who are seeking similar decoupling legislation, and they have brought Senator Rosapepe's bill to the attention of their legislators. They are optimistic that Oregon, too, will decouple by the end of its session in early March.

Some Maryland legislators may be tempted to go the route of Hawaii and Arkansas and preserve state capital gains tax breaks for opportunity zone projects located in our state. I strongly urge against this. First, it would raise significant and likely insoluble enforcement problems for the state given that many of the opportunity zone funds will be making investments in multiple states. The capital gains from non-zone investments that will be rolled over into the opportunity zone funds will become subject to taxation no later than 2026, which in many cases will be before opportunity zone projects will be completed. In that event, how could a state determine what share of the initial investment should be granted deferred taxation and/or a lower effective tax rate because it was associated with an in-state investment? Likewise, the state would have to devise – and enforce on its own, since the Internal Revenue Service has no interest in the issue – complicated rules for apportioning the capital gain on any subsequent sale of an interest in an opportunity zone fund between in-state and out-of-state opportunity zone projects.

Second, if Maryland sought to limit the capital gains tax breaks to opportunity zone projects located within its borders, it would be at risk of having that policy overturned by a court holding it to be a violation of the U.S. Constitution's Dormant Commerce Clause prohibition on discrimination against interstate commerce. Courts have held, for example, that limiting the tax benefits of accelerated depreciation write-off to in-state facilities constitutes such a violation, and several years ago a California court held that a state law that sought to limit a capital gains break for the sale of stock in small businesses to businesses located in California was also unconstitutional. Maryland would be at risk of a court issuing a similar decision if it sought to limit opportunity zone capital gains breaks to in-state businesses and, as a remedy, authorizing all residents and all corporations with Maryland nexus that had invested in out-of-state opportunity zone projects to retroactively seek the same tax break for those investments.

Complete decoupling is the right choice. Decoupling doesn't eliminate Maryland's participation in the opportunity zone program, of course. It just means that the federal government will subsidize investments in Maryland opportunity zones with capital gains tax breaks, not Maryland. Because federal income taxes are considerably higher than Maryland's, if any tax breaks incentivized those investments – and even that is questionable – it was the federal tax breaks. There is no justification for Maryland layering on its own.

I've stressed the profound illogic of Maryland forgoing tax revenue to subsidize investment in out-of-state opportunity zone projects, but I would be remiss in not observing that even were this not occurring serious questions about the propriety of forgoing state revenue to subsidize in-state opportunity zone investments should be raised. There is considerable evidence that capital gains tax breaks will flow to many projects that would have occurred anyway and, in some cases, were already planned – no better illustrated than by the controversy surrounding the qualification of the Port Covington development in Baltimore for opportunity zone breaks. There is growing evidence that many of these projects will be oriented toward high-end residential, commercial, and entertainment uses that not only will do little if anything to benefit low-income neighborhoods and their residents but actually create a high probability of displacing them. Given that only capital gains may be used to finance opportunity zone funds, and given that this type of income is overwhelming received by the richest Americans, the possibility that low-income people might receive relative few benefits from many opportunity zone projects is all the more troubling. Finally, as highlighted earlier this week by one of my colleagues on the Center's federal tax policy team, rather than "curb[ing] opportunities for abuse and ensur[ing] that opportunity zones fulfill their ostensible purpose of benefiting low-income areas, final Treasury Department regulations "took some questionable business giveaways that were included in its [initially] proposed regulations and actually expanded them."

For all these reasons, complete decoupling from the federal Opportunity zone capital gains breaks, as proposed by S.B. 263, is the right policy choice for Maryland. Thank you again for the opportunity to testify today.