March 2, 2020

The Honorable Anne R. Kaiser, Chair
House Ways and Means Committee
House Office Building, Room 121
6 Bladen St., Annapolis, MD 21401

Oppose: HB 1628 – Sales Tax on Services

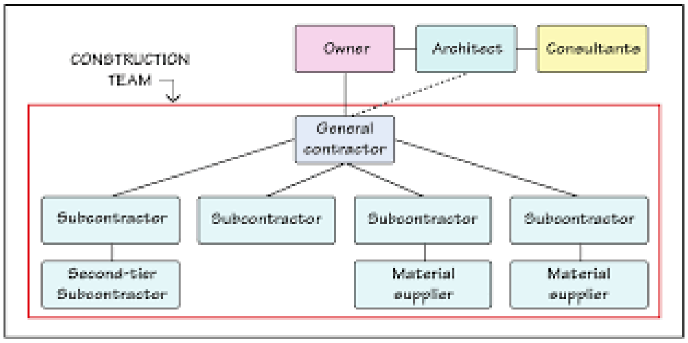
Dear, Chair Kaiser and Committee Members:

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 1628.

Commercial real estate already generates more net tax revenue for local government services than any other land use. NAIOP strongly opposes HB 1628 because expanding the sales tax to services purchased and provided by commercial real estate will: 1) result in pyramiding of the tax during construction making the actual tax higher than the advertised rate; 2) exacerbate the disproportionate share of local government services financed by commercial real estate taxes and fees, and; 3) sets the stage for lower local revenues, locally higher vacancy real estate taxes.

Pyramiding or stacking of 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, overhead and profit would be taxed as a service. As theses 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 transaction costs paid by the ownership entity that are based on valuation such as recordation and transfer taxes and title insurance will increase. Because both the inputs – services - and output – the sale of the building - are subject to tax the embedded costs would be higher than the advertised .5% tax. NAIOP estimates 50% to 60% of commercial construction costs would be subject to a services tax at a cost of $6.50 per square foot.



Further exacerbates the disproportionate share of local government services financed by commercial real estate taxes and fees

One consequence of the failure to reform the state tax structure has been an overreliance on real property, transfer, recordation and excise taxes. According to the Sage Policy Group analysis in Exhibit 4 below, impact fees, transfer, recordation and excise taxes collected by Maryland Counties increased 80% between 2010–2018.

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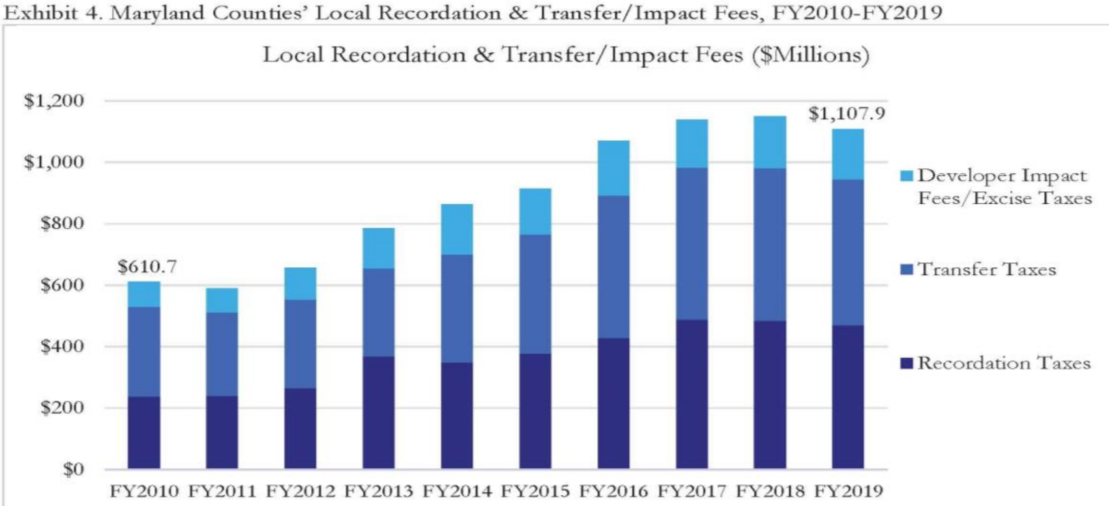
In 2016 the Tax Foundation reported Maryland was 4th in the nation in per capita collection of excise taxes. Commercial real estate companies pay these taxes and fees at disproportionately high rates compared to other industries and the general public.

According to the Sage Policy Group analysis these taxes represent a growing percentage of general fund revenues, "FY2010, *revenues from real estate-related taxes/fees such as recordation and transfer taxes, impact fees, and excise taxes represented about 5 percent of local governments' total general fund revenues. That share reached 7.5 percent in FY2019. Real estate-related revenue has generally climbed faster than revenue from other sources."*

Some of this increase can be explained by higher transaction volume and valuations. But during this time local governments, reluctant to increase broader taxes, increased the recordation and transfer tax rates to fund public services including education. Another inflationary factor has been the influence of local governments converting to construction excise taxes. Unlike the impact fees they replaced, the amount of an excise tax does not have to be closely related to the actual cost of providing public facilities to serve new development.

Exhibit 4. Maryland Counties' Local Recordation & Transfer/Impact Fees, FY2010-FY2019



Source: Maryland Department of Legislative Services (DLS). "Overview of Maryland Local Governments, Finances and Demographic Information" reports.

Over the same time period, the commercial real estate tax base expanded by $50b and increased to 24% of the state-wide tax base in 2018 from 19% in 2010. The increase in commercial base offset almost equal declines in the residential and agricultural tax base. The operation of the constant yield tax rate formula means that commercial property owners are paying a larger percentage of the cost of local services than a decade ago.

2010-2018 The Commercial Real Property Tax Base Increased $50b, Offsetting Declines in Other Classes

	2010	2011	2012	2013	2014	2015	2016	2017	2018	10-18
Residential	598.7	577.4	530.0	501.0	489.6	502.2	531.1	536.7	554.2	-44.5
Commercial	135.4	140.0	145.9	143.5	160.9	169.0	169.0	177.1	185.2	49.8
Agricultural	13.6	13.5	12.7	12.1	11.8	11.9	12.0	12.2	12.3	-1.3

Values in Billions of Dollars, Source: SDAT Annual Reports

Some of this asset appreciation is due to the fundamental strength of the economy. It would be a mistake, however, for the Assembly to underestimate the upward pressure that the current ultra-low interest rate environment has put on commercial real estate valuations. Institutional investors from around the world, seeking better return on investment than government bonds, have invested heavily in commercial real estate elevating prices beyond, in some cases, what can be supported by the rate of job growth in Maryland.

Sales Tax on Property Management Services - Lower Local Revenues and Higher Vacancy Adjacent to Virginia

Groups as diverse as the Tax Foundation and the Maryland Center on Tax Policy have advised against taxing commercial real estate property management.

All the costs of providing management services to commercial real estate buildings are taxable under HB 1628. Leasing services could be taxed twice - once as a service, then when long-term leases are recorded in the land records. Increases in operating expenses necessarily decrease the operating income and the valuation of commercial real estate. Reduced values will put downward pressure on local tax revenues at a time when the Kirwan matching funds are due.

The local effects will be felt hardest in business centers adjacent to Virginia. It is only 11 miles from Bethesda to Tysons Corner. 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.

Since real estate taxes provide a large percentage of local revenues, it seems likely real estate will be asked to pay more by local governments as they seek ways to raise educational matching funds. Passing HB 1628 would almost certainly mean real estate would pay disproportionate levels of tax at both the state and local levels.

Conclusion

When the sales tax was introduced to Maryland in 1947, the economy looked very different from today. In 1947, services comprised 38% of personal consumption nationwide. At the end of 2019, services comprised 69% of personal consumption expenditures. 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 caused the state to fall short of its economic development potential.

Maryland's goals for education outcomes and its tax structure are based in equity and uniformity. As it applies to commercial real estate, HB 1628 does not reach these goals.

For these reasons, NAIOP respectfully recommends your unfavorable report on HB 1628.

Sincerely,
T.M. Ballt

Tom Ballentine, Vice President for Policy
NAIOP – Maryland Chapters, *The Association for Commercial Real Estate*

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