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Testimony of
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Submitted for the Record of the
Maryland House of Delegates Ways and Means Committee
Hearing on H.B. 262, Opportunity Zone Tax Deduction Reform Act of 2021
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Chair Kaiser and Members of the Ways and Means Committee, I am Michael Mazerov, a Senior Fellow with the State Fiscal Policy division of the Center on Budget and Policy Priorities in Washington, D.C. 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, to help inform debates and achieve better policy outcomes. I appreciate the opportunity to submit this testimony for the record in support of H.B. 262. Delegate Palakovich Carr'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 the 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 Maryland state will be investing in opportunity zone funds with some or all their projects located outside the state. Opportunity zones are intended to be an economic development program; it makes no sense 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.

Several states, including Alabama, California, Mississippi, and Pennsylvania, do not conform to the opportunity zone tax breaks because their personal or corporate income taxes do not automatically link to the federal provisions. Three states plus the District of Columbia have proactively decoupled. North Carolina is the only state that has completely decoupled, for both its individual and corporate income tax. Arkansas, the District of Columbia, 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 am 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 in August 2019 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. Addressing the public health emergency and the state fiscal crisis it created understandably took priority for state lawmakers last year, but I think it is likely that other states will seriously consider decoupling this year to avoid an unnecessary and unjustified revenue loss from this program. Decoupling legislation has already been introduced in New York and Oregon, for example.

Some Maryland legislators may be tempted to go the route of the District, Hawaii and Arkansas and preserve state capital gains tax breaks for opportunity zone projects located in Maryland. 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,[1] 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.[2] 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 does not 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 have 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.[3] 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 relatively few benefits from many opportunity zone projects is all the more troubling. Finally, as highlighted in an analysis 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."[4]

For all these reasons, complete decoupling from the federal opportunity zone capital gains breaks, as proposed by H.B. 262, is the right policy choice for Maryland. Thank you again for the opportunity to submit testimony for today's hearing.

Notes

[1] R.J. Reynolds Tobacco Company v. City of New York Department of Finance, 1997. https://www.leagle.com/decision/1997243237ad2d61242.

[2] Cutler v. Franchise Tax Board, 2012. https://cases.justia.com/california/court-of-appeal/b233773.pdf?ts=1396114286.

[3] Jeff Ernsthausen and Justin Elliott, "One Trump Tax Cut Was Meant to Help the Poor. A Billionaire Ended Up Winning Big," ProPublica, June 19, 2019. https://www.propublica.org/article/trump-inc-podcast-one-trump-tax-cut-meant-to-help-the-poor-a-billionaire-ended-up-winning-big.

[4] Samantha Jacoby, "Final Opportunity Zone Rules Could Raise Tax Break's Cost," February 3, 2020. https://www.cbpp.org/blog/final-opportunity-zone-rules-could-raise-tax-breaks-cost.