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Testimony of
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Before the
Maryland House of Delegates Ways and Means Committee

Hearing on H.B. 337, Investing in Marylanders Act of 2023
February 9, 2023

Chair Atterbeary and Members of the Ways and Means Committee, I'm 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 in fiscally responsible, 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 policy debates and achieve better policy outcomes. I appreciate the opportunity to submit testimony in support of H.B. 337. Delegate Palakovich Carr's bill would impose a surcharge on capital gains income and repeal a number of unwarranted corporate tax giveaways. My comments are limited to these latter provisions.

Decoupling from the federal deduction for foreign-derived intangible income

One provision of the bill would decouple Maryland's corporate tax code from the deduction for "foreign-derived intangible income" (FDII) established by the 2017 Tax Cuts and Jobs Act. This provision provides a lower federal corporate tax rate than would ordinarily apply to income derived from, for example, the licensing of patents to corporations' foreign affiliates that are manufacturing products abroad for sale abroad. It was enacted to incentivize corporations to conduct more of the research and development that led to the creation of the patented technology within the United States.

There is little evidence that the FDII deduction has achieved that goal. But even were that not the case, it simply is not appropriate for states – given their balanced budget requirements – to forgo vital revenue to further a national economic policy objective. That is especially the case when there is no guarantee that the incentivized activity will actually occur in the state forgoing the revenue – as is the inherent case with FDII since it is a nationwide deduction subtracted from nationwide gross income before the net income resulting from the subtraction is apportioned to Maryland. Realizing

this, 22 of the 45 states levying corporate income taxes have disallowed the FDII deduction.[1] Maryland should follow suit.

Decoupling from the federal tax breaks for real estate investment trusts

Real estate investment trusts (REITs) are corporations that own a portfolio of real estate assets – which may be both physical real estate itself and mortgages. REITs were authorized to enable small investors to invest in a diversified portfolio of real estate in the same way that mutual funds allow them to invest in a diversified portfolio of stocks. To incentivize such investment, REITs are largely exempt from the corporate income tax. If they pay out at least 90 percent of their annual income as dividends to their investors, they may deduct those dividends from their taxable incomes. The federal government taxes the dividend income of the investors.

Maryland, like nearly all states, conforms to this federal tax treatment of REITs. The problem is that the vast majority of the owners of REITs investing in Maryland real estate likely live outside the state – meaning that Maryland, unlike the federal government, is not picking up on the individual income tax side what it is losing on the corporate income tax side. Maryland is providing many services – such as police and fire protection and road access – to this real estate, but it is receiving no income tax from the profits those services are helping to generate.

This bill proposes to decouple from this federal tax treatment by disallowing the deductibility of the dividends the REIT pays to its investors and taxing REITs to the same extent that all other corporations are taxed. New Hampshire has already done so, since it does not levy an individual income tax and inherently can't pick up any individual income tax on REIT dividends even by its residents. Hawaii lawmakers enacted such a bill several years ago (which the governor unfortunately vetoed), because they learned that many of the most valuable hotels, resorts, shopping malls, and other real estate catering to tourists were owned by people on the mainland. I recently urged the current District of Columbia Tax Review Commission to decouple as well for similar reasons.

Maryland should decouple from federal REIT treatment to ensure that it is receiving its fair share of tax on the profits of all commercial real estate within its borders – profits its services are helping to make possible. REITs own only about 10 percent of all commercial real estate,[2] so it is clear that the vast majority of real estate developers are able to obtain sufficient capital for their investment without the federal tax subsidy that the REIT tax break provides – let alone any additional subsidy from states.

Aligning Maryland's related-party interest and royalty addback requirements with the Multistate Tax Commission model addback statute

As this committee heard last week in taking testimony on H.B. 46, as a state not requiring combined reporting, Maryland is extremely vulnerable to a variety of corporate tax avoidance techniques that

[1] Katherine Loughead, "Biden Administration Changes to GILTI and FDII Will Yield Automatic State Tax Increases," Tax Foundation, May 2021, p. 12.

[2] National Association of Real Estate Investment Trusts, "Estimating the Size of the Commercial Real Estate Market in the U.S.," https://www.reit.com/data-research/research/nareit-research/estimating-size-commercial-real-estate-market-us-2021.

involve the shifting of income earned in the state onto the books of related out-of-state corporations that Maryland does not have jurisdiction to tax. Combined reporting remains the only comprehensive solution to such strategies.

That said, many years ago Maryland amended its corporate tax law to nullify two of those techniques by disallowing royalty and interest deductions when paid to other members of the corporate group. These are referred to "addback" provisions, because they require the adding back to taxable income of such payments that would have initially been allowed due to Maryland's conformity with federal tax calculations of taxable income.

In light of widespread interest among non-combined reporting states in the adoption of addback requirements, in 2006 the Multistate Tax Commission adopted a model for states to look to. It was the product of a careful, multiyear development process that attempted to maximize the ability of such provisions to mitigate tax avoidance through related-party interest and royalty payments, while allowing corporations to make legitimate related-party payments not motivated by tax avoidance.

H.B. 337 proposes to amend the existing addback provision in several ways to align it more closely with the MTC model and strengthen its ability mitigate abusive income shifting. Two of these changes are particularly noteworthy. To allow legitimate intra-group payments, current Maryland law and the MTC model assume that the payments do not have a tax avoidance motivation if the recipient of the payment will pay tax on it at a reasonable rate in the state(s) in which it is subject to tax. Under the current Maryland law, that "reasonable rate" is deemed to be four percent. H.B. 337 would change that to three percentage points below the top statutory rate, a standard that many states using the MTC model have adopted. Under current Maryland law, that would deem any taxation in the recipient state at an effective rate less than 5.25 percent to reflect a tax avoidance motivation – triggering the addback requirement.

Second, and more importantly, H.B. 337 would adopt a new provision present in the MTC model declaring that payment of the royalty or interest to a related party included in a combined report in one or more combined reporting states would not count in calculating the aggregate effective rate of tax to which the recipient was subject. This is a critical provision, because corporations now routinely use so-called "East-West" tax strategies to undermine these related party provisions. They pay their royalties and interest to related companies located in combined reporting states, where the payments have no tax effect and are netted out in the tax calculation. Without this provision, corporations could circumvent the requirement for addback by making royalty and/or interest payments to a related company located in a high-tax-rate combined reporting state.

Finally, H.B. 337 would repeal a provision that exempts banks from the related party interest addback law. This exemption is an invitation to massive tax avoidance, since banks' entire business is based on receiving and paying interest.

In sum, until Maryland sees fit to mandate combined reporting, it is vital that the related party addback provision be as watertight as possible, and the proposed changes in H.B. 337 will go a long way toward achieving this.

I thank the committee again for the opportunity to submit written testimony on H.B. 337 and recommend a favorable report on the bill. I may be reached at mazerov@cbpp.org if committee members have any questions.