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May 7, 2007

The Honorable Martin O'Malley
Governor of Maryland
State House
Annapolis, Maryland 21401-1991

RE: Senate Bill 945 and House Bill 1257

Dear Governor O'Malley:

We have reviewed and hereby approve for constitutionality and legal sufficiency Senate Bill 945 and House Bill 1257, identical bills, entitled "Income Tax - Captive Real Estate Investment Trusts." We write to discuss our conclusion that the retroactivity provision of the bill is constitutional.

Senate Bill 945 and House Bill 1257 provide for the addition of an amount equal to the dividends paid deduction allowed under the Internal Revenue Code for the taxable year to the federal taxable income to determine the Maryland modified income of a captive REIT. The purpose of this change, as reflected by the Fiscal and Policy Note on the bill, is to limit the ability of corporations to use REITs to avoid State taxes. The note describes one way to use an REIT to avoid taxes as follows:

The rental REIT method can be utilized by large multistate retailers. A retailer would form a REIT that would own the real property associated with its retail stores. The parent company subject to State income taxes makes rental payments to the REIT that owns the property, which reduces State income tax liabilities by shifting income from the parent company to the REIT. The REIT files a State income tax return, but claims the dividends paid deduction that a REIT is entitled to claim. The parent company deducts for State income tax purposes the amount of rent paid to the REIT. The dividends are ultimately distributed back to the parent

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company through a holding company located in a state such as Delaware, since this type of income is not taxed there. When the parent company receives the dividends, it is not taxed by the State as it is able to deduct them since the dividends were received from a subsidiary.

Section 2 of the bill provides that the Act “shall take effect July 1, 2007, and shall be applicable to all taxable years beginning after December 31, 2006.” Thus, the bill applies to the current taxable year although it was enacted and will take effect after the beginning of this year.

Both the United States Supreme Court and the Maryland Court of Appeals have repeatedly upheld retroactive application of tax changes against challenges based on the Due Process Clause. For example, in *United States v. Carlton*, 512 U.S. 26 (1994), the Supreme Court upheld an amendment to the federal estate tax, retroactive to the adoption of the provision in question in October of the prior year to close an inadvertent loophole in the original law. The Court held that the provision was adopted as a curative measure, *id.* at 31, that it established only a modest period of retroactivity, *id.* at 32, and that “[t]ax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code,” *id.* at 33. *Cf.*, *United States v. Hudson*, 299 U.S. 498 (1937) (Retroactivity for period that law was under consideration). And in *Stockdale v. Atlantic Insurance Company of New Orleans*, 87 U.S. (20 Wall.) 323, 331 (1874), the Court recognized that “the right of Congress to [impose a new tax] by a new statute, although the measure of it was governed by the income of the past year, cannot be doubted.”

In *Diamond Match Company v. State Tax Commission*, 175 Md. 234 (1938), the Court of Appeals held that a special franchise tax passed in a special session in 1936, and applicable to companies in business in the State on January 1, 1936 was constitutionally applied to a company that dissolved on March 31, 1936. The Court specifically found that the retroactive application to the beginning of the year did not affect either vested or contractual rights. *Id.* at 245-246. And in *National Can Corporation v. Tax Commissioner*, 220 Md. 418, (1959) *app.dis.* 361 U.S. 534 (1960) the Court upheld brief retroactivity of a provision intended to provide authority for a method of assessment that had been held invalid in a previous case, saying that “if the legislature possessed the power in the first place to authorize the levy and collection of the taxes in question, then it had the power, by retrospective act, to cure any defect which may have obtained in the assessment and collection of such a tax.” *Id.* at 440. However, while a tax is not invalid simply because it is retroactive, there are limits on how far the State may go. *See*

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Comptroller v. Glenn L. Martin Co., 216 Md. 235 (1958) (Change made in 1957 to reverse 1956 decision could not be made retroactive to enactment of sales and use taxes in 1947); *Washington National Arena v. Prince George's Co.*, 287 Md. 38, *cert. denied*, 449 U.S. 834 (1980) (Authorization for higher recordation tax could not be made retroactive to enactment of tax eight years earlier). As with retroactivity in other areas of the law, the primary consideration is whether retroactive application would violate vested rights, a determination that involves consideration of such factors as whether it works a substantial injustice, was anticipated at the time of the transaction, the length of time involved and whether the change in the law is a minor one. *Waters Landing Limited Partnership v. Montgomery County*, 337 Md. 15, 29 (1994).

Senate Bill 945 and House Bill 1257 have a modest period of retroactivity, affecting only the current tax year and those in the future. Moreover, the change cannot be said to work a substantial injustice where the aim is to ensure fair taxation and eliminate an unfair competitive advantage on the part of large chain stores. Nor can it be seen as unanticipated where the Comptroller already arguably has the authority to address this problem under Tax General Article §§ 10-109 and 10-306.1, and has announced the intention to use these sections for that purpose. Press Release, *Franchot Closes Corporate Tax Loophole* (March 6, 2007).

For these reasons, it is our view that the retroactivity provision of Senate Bill 945 and House Bill 1257 is constitutional.

Very truly yours,

/s/

Douglas F. Gansler
Attorney General

DFG/KMR/kmr

cc: Joseph Bryce
Secretary of State
Karl Aro
The Honorable Richard S. Madaleno, Jr.
The Honorable Sheila Ellis Hixson