Department of Legislative Services

Maryland General Assembly
2017 Session

FISCAL AND POLICY NOTE
Third Reader - Revised

Senate Bill 364 (Senator Ferguson, *et al.*)
Budget and Taxation Ways and Means

One Maryland Economic Development Tax Credits - Business Incubators, Enterprise Zones, and Regional Institution Strategic Enterprise Zones

This bill expands the applicability of the One Maryland economic development tax credit to include a "business incubator" that (1) establishes or expands in an Enterprise Zone or a Regional Institution Strategic Enterprise (RISE) Zone; (2) meets the number of qualified positions requirement by aggregating the positions created by businesses at the facility; and (3) otherwise meets the eligibility requirements of the credit. The bill specifies additional requirements for the refundable portion of the project tax credit for all business incubators. Nonprofit business incubators may claim the refundable portion of the project tax credit and start-up tax credit in any taxable year following the year in which the project is placed in service or the business locates in an eligible area, respectively.

The bill takes effect June 1, 2017, and applies retroactively to all taxable years beginning after December 31, 2015.

Fiscal Summary

State Effect: No effect in FY 2017, as discussed below. General and special fund revenues decrease in total by *at least* \$3.1 million in FY 2018, escalating to *at least* \$10.9 million in FY 2022, under the assumptions discussed below. Future year revenues continue to decrease by at least \$10.9 million annually thereafter as tax credits continue to be applied by qualified business incubators. The Department of Commerce (Commerce) and the Comptroller can likely handle the bill's requirements with existing budgeted resources.

(\$ in millions)	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
GF Revenue	(\$2.7)	(\$4.7)	(\$6.2)	(\$7.7)	(\$9.3)
SF Revenue	(\$0.5)	(\$0.8)	(\$1.1)	(\$1.4)	(\$1.7)
Expenditure	0	0	0	0	0
Net Effect	(\$3.1)	(\$5.5)	(\$7.3)	(\$9.1)	(\$10.9)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate increase; (-) = indeterminate decrease

Local Effect: Local highway user revenues (LHURs) decrease minimally beginning in FY 2018 from additional One Maryland credits claimed against the corporate income tax (CIT). Expenditures are not affected.

Small Business Effect: Meaningful.

Analysis

Bill Summary: For a business incubator, for any taxable year, the total amount used as a project tax credit or a start-up credit and claimed as a refund may not exceed an amount equal to (1) the amount of tax that the businesses at the business incubator's facility are required to withhold for the taxable year from the wages of qualified employees and (2) 7.5% of the amount paid by businesses at the business incubator's facility to independent contractors who meet specified requirements. A business incubator can claim both the start-up and project tax credits.

Nonprofit business incubators may claim refundable tax credits beginning in the taxable year after the project is placed in service or the business locates in an eligible area (*i.e.*, the second taxable year), rather than after the fifth taxable year under current law. (Businesses that pay wages of at least 250% of the federal minimum wage may claim refundable credits after the third taxable year under current law.)

Current Law/Background: A "business incubator" means a program in which units of space are leased by multiple early stage businesses that share physical common space, administrative services and equipment, business management training, mentoring, and technical support.

One Maryland Program

Generally, under the One Maryland program, businesses that (1) establish or expand a business facility in a priority funding area; (2) are located in a qualified distressed county; and (3) are primarily engaged in specified business activities may be entitled to tax credits for costs related to the new or expanded facility. Baltimore City and Allegany, Dorchester, Somerset, and Worcester counties are currently considered qualified distressed counties.

The credit for start-up costs is the lesser of 100% of eligible start-up costs (up to $500,000), less any credits taken in prior years, or $10,000 multiplied by the number of employees that have filled newly created, qualified positions. The credit for project costs is the lesser of 100% of eligible project costs (up to $5 million), less any credits taken in prior years, or the State income tax liability for the taxable year from the project. Qualifying costs and expenses include those incurred with the acquisition, construction, rehabilitation, installation, and equipping of an eligible project. Eligible costs include land acquisition, performance and contract bonds, insurance, architectural and engineering services, environmental mitigation, and utility installation. The business must expend at least $500,000 in project costs.

Credits may be carried forward up to 14 successive tax years. Generally, a business entity must maintain at least 25 qualified employees at the project to carry over a tax credit from the preceding year. A prorated credit may be taken if the number of qualified positions filled by the business entity falls below 25, but does not fall below 10, and the business entity has maintained at least 25 qualified positions for at least 5 years.

In the first five years of claiming the credit, a business may claim the start-up credit against the company's Maryland income tax liability and the project credit against the income tax attributable to the qualifying project. Beginning in year six, companies generally are able to utilize more of the credit in each tax year – both credits may be claimed as a refund up to the amount of the withholding taxes attributable to the qualified employees working on the project. In addition, the project credit may also be applied to any remaining Maryland income tax liability. Provisions related to the refundable portion of the project and start-up credits apply after the third year after a business locates in a qualified distressed county if the pay of the majority of the qualified positions created from the establishment or expansion of the business facility is at least 250% of the federal minimum wage.

One Maryland Tax Credit Evaluation

In response to concerns about the impacts of tax credits, Chapters 568 and 569 of 2012 established the Tax Credit Evaluation Act, a legislative process for evaluating certain tax credits. The evaluation process is conducted by a legislative evaluation committee. The committee was required to review and evaluate the One Maryland economic development tax credit by July 1, 2014. The final report on the credit was completed in August 2014 and can be found on the Department of Legislative Services (DLS) website.

Chapter 303 of 1999 established the One Maryland economic development tax credit, designed to assist in paying for both project expansion and start-up costs for certain businesses that add at least 25 qualified employees in distressed counties. The One Maryland tax credit is a high-value, low-utilization credit compared to other business tax credits. As of March 2016, Commerce had certified a total of $236.3 million in One Maryland tax credits. Companies generally have 15 years to claim the entire amount of the credit (the DLS report found that only about one-third of credits had been claimed at that time). Existing projects will continue to decrease State revenues significantly over time – a revenue loss that will occur independent of the losses that will result from new projects going forward.

Enterprise Zones

The Enterprise Zone Tax Credit Program, established in 1982, is intended to encourage economic growth within economically distressed areas of the State and to increase employment of the chronically unemployed. The Secretary of Commerce may only designate an area as an Enterprise Zone if it is in a priority funding area and satisfies at least one criterion related to economic distress.

Pursuant to the Tax Credit Evaluation Act of 2012, DLS evaluated the Enterprise Zone tax credit. The final report on the credit was completed in August 2014 and can be found on the DLS website.

Data from the report indicates that the State reimburses local governments for one-half of the cost of the Enterprise Zone property tax credit. From fiscal 2001 to 2014, State reimbursements to local governments totaled $131.2 million. In fiscal 2014, about 850 properties earned a total of $27.8 million in property tax credits, of which the State reimbursed $13.9 million. Since tax year 2000, an annual average of $900,000 in Enterprise Zone income tax credits had been claimed. About one-third of all Enterprise Zones have businesses concentrated within manufacturing, fabrication, transportation, warehousing, distribution, and research and development. This concentration typically results from either Enterprise Zone local standards restricting credit eligibility to these activities and industries or the establishment of the zone within an industrial or business park that has similar requirements.

There are currently 31 Enterprise Zones in 17 counties including Baltimore City. The largest Enterprise Zones are in Baltimore City and Harford and Prince George's counties. A list of all of the Enterprise Zones and a map of the current zones can be found on Commerce's website.

Regional Institution Strategic Enterprise Zones

Chapter 530 of 2014 established the RISE Zone program, which is administered by Commerce. The program provides specified income and property tax credits to qualifying business entities located within a geographic area designated as a RISE Zone. To be eligible to qualify, a business entity must:

- evidence an intention to (1) make a significant financial investment or commitment in an area of the State that the applicant intends to become a RISE Zone; (2) use the resources and expertise of the applicant to spur economic development and community revitalization in an area of the State that the applicant intends to become a RISE Zone; and (3) create a significant number of new jobs within a RISE Zone;

- have a demonstrated history of community involvement and economic development within the communities that the applicant serves; and
- meet the minimum financial qualifications established by the Secretary of Commerce.

RISE Zones must be located in the immediate proximity of a private or public four-year higher education institution or community college. Currently, two RISE Zones have been approved. One is located directly adjacent to the University of Maryland, Baltimore Campus (UMB), in the university's BioPark and the other is adjacent to the University of Maryland, College Park Campus (UMCP). The University of Maryland Baltimore County (UMBC) and Salisbury University (SU) are also partially through the process of establishing RISE Zones.

Existing or Planned Business Incubators in Existing or Planned Eligible Zones

DLS is aware of seven existing or planned business incubators that are located in existing or planned eligible zones. There are four existing business incubators in existing zones: one at UMCP in the UMCP RISE Zone and three existing incubators affiliated with Johns Hopkins University (JHU) in Enterprise Zones. In addition, one business incubator is located in UMBC's proposed RISE Zone, one proposed business incubator will be located in the existing UMB RISE Zone, and one proposed business incubator will be located in the existing UMCP RISE Zone. An *eighth* incubator *may* be located at the proposed SU RISE Zone.

DLS notes that there are likely more eligible business incubators than those listed above, and the bill may provide sufficient incentive to create additional business incubators.

State Fiscal Effect: Under the assumptions discussed below, general and special fund revenues decrease in total by *at least* $3.1 million in fiscal 2018, escalating to *at least* $10.9 million in fiscal 2022. Future year revenues continue to decrease by at least $10.9 million annually thereafter as tax credits continue to be applied by qualified business incubators. The effect on general and special fund revenues is shown in **Exhibit 1**. Actual revenue losses in any year could easily exceed these amounts, as discussed further below.

Although the bill takes effect June 1, 2017, and is retroactive to tax year 2016, it is assumed that Commerce does not certify any projects until fiscal 2018. Projects begun prior to the effective date of the bill likely do not qualify for the credit because the law requires an applicant to notify Commerce of its intent to apply for certification *before* hiring qualified employees. However, an existing business incubator of sufficient size can continuously qualify for new project tax credits under the bill as new businesses move in over time. A business incubator is designed to foster new businesses over a period of several years, after which successful businesses move to larger, permanent locations (and failing businesses cease operations).

Exhibit 1
General and Special Fund Revenue Impacts
Fiscal 2018-2022
($ in Millions)

	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
General Fund	($2.7)	($4.7)	($6.2)	($7.7)	($9.3)
HEIF	(0.1)	(0.2)	(0.3)	(0.4)	(0.5)
TTF	(0.3)	(0.6)	(0.8)	(1.0)	(1.2)
Total	**($3.1)**	**($5.5)**	**($7.3)**	**($9.1)**	**($10.9)**

HEIF: Higher Education Investment Fund
TTF: Transportation Trust Fund
Note: Numbers may not sum to total due to rounding.

Source: Department of Legislative Services

According to the DLS evaluation of the One Maryland tax credit, the average credit awarded under the One Maryland program is $3.6 million. About one-third of all projects have been awarded the maximum $5.5 million credit. As noted above, DLS is aware of seven existing or planned business incubators that are located in existing or planned eligible zones, four of which are located in existing zones, and the other three are in some stage of planning. Further, there are likely more eligible business incubators than these, and the bill may provide sufficient incentive to create additional business incubators.

This estimate assumes:

- four projects are certified in tax year 2017 (in the first half of fiscal 2018) and three more are certified in tax year 2018 (fiscal 2018/2019) for the maximum credit amount of $5.5 million (reflecting the four known eligible and three likely soon-to-be eligible business incubators discussed above);
- three projects are certified annually beginning in tax year 2019 (fiscal 2019/2020), one for the maximum credit amount of $5.5 million and two for the average credit amount of $3.6 million (consistent with historic trends);
- the full amount of the credit is applied evenly over seven tax years; and
- 75% of the credits are applied to CIT and 25% to the personal income tax.

Any change in these assumptions alters the timing and amount of the revenue losses. Future RISE Zone and Enterprise Zone designations and/or a proliferation of business incubators likely increase the above estimate. Business incubators are a growing trend around institutions of higher education, which is where RISE Zones are located. Also, as discussed above, the business incubator model is designed to continuously grow new businesses. For these reasons, the above estimate is likely conservative – actual revenue losses in any year could easily exceed the amounts discussed above.

The estimate does not treat nonprofit or for-profit business incubators differently in terms of the amount of the credits claimed each year. Most of the known business incubators are nonprofits – the refundable portion of the credit is limited to the amount of tax that the businesses at the business incubator's facility are required to withhold for the taxable year from the wages of qualified employees and 7.5% of the amount paid by businesses at the business incubator's facility to independent contractors who meet specified requirements. Spreading the tax credit over seven taxable years roughly approximates the amount that a nonprofit business incubator is likely able to claim for a project with 25 qualified employees.

Commerce and the Comptroller can likely handle the bill's requirements with existing budgeted resources. To the extent that demand for the program exceeds either agency's ability to absorb the bill's administrative requirements, general fund expenditures increase for additional staff.

Local Revenues: Local governments receive a portion of Transportation Trust Fund revenues as LHURs for the purpose of constructing and maintaining local roads. Therefore, LHURs decrease by *at least* $33,000 in fiscal 2018, escalating to *at least* $115,000 in fiscal 2022, and by a similar amount annually thereafter, as a result of additional One Maryland credits being claimed against CIT.

Small Business Effect: The bill offers a high-value tax credit to business incubators that would otherwise be ineligible to receive it. These business incubators benefit directly from up to a $5.5 million tax credit, per eligible project.

Additional Information

Prior Introductions: SB 560 of 2016, a similar bill, passed the Senate with amendments and received a hearing from the House Ways and Means Committee, but no further action was taken.

Cross File: HB 1007 (Delegate A. Washington, *et al.*) - Ways and Means.

Information Source(s): Department of Commerce; Comptroller's Office; University System of Maryland; State Department of Assessments and Taxation; Baltimore City; Montgomery County; Department of Legislative Services

Fiscal Note History: First Reader - February 21, 2017
mm/rhh Third Reader - April 5, 2017
Revised - Amendment(s) - April 5, 2017
Revised - Updated Information - April 5, 2017

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