BRIAN E. FROSH
ATTORNEY GENERAL

ELIZABETH F. HARRIS
CHIEF DEPUTY ATTORNEY GENERAL

CAROLYN A. QUATTROCKI
DEPUTY ATTORNEY GENERAL

SANDRA BENSON BRANTLEY
COUNSEL TO THE GENERAL ASSEMBLY

KATHRYN M. ROWE
DEPUTY COUNSEL

JEREMY M. MCCOY
ASSISTANT ATTORNEY GENERAL

DAVID W. STAMPER
ASSISTANT ATTORNEY GENERAL

THE ATTORNEY GENERAL OF MARYLAND
OFFICE OF COUNSEL TO THE GENERAL ASSEMBLY

May 10, 2018

The Honorable Lawrence J. Hogan, Jr.
Governor of Maryland
State House
100 State Circle
Annapolis, Maryland 21401

RE: Senate Bill 228 – "Cybersecurity Incentive Tax Credits"

Dear Governor Hogan:

We have reviewed for constitutionality and legal sufficiency Senate Bill 228 – "Cybersecurity Incentive Tax Credits." The bill extends the cybersecurity investment incentive tax credit in current law, with alterations. The bill also creates a tax credit against the State income tax for a qualified buyer who purchases cybersecurity technology or services from a Maryland company that meets specified requirements. As explained below, the bill raises a significant Commerce Clause issue. Nevertheless, it is our view that the bill is not clearly unconstitutional.

Chapter 390 of 2013 previously established a refundable tax credit for investments in qualified cybersecurity companies. Senate Bill 228 extends the termination date of the cybersecurity investment incentive tax credit to 2023. The bill also changes the program by specifying that the investor who makes the qualifying investment in a Maryland cybersecurity company claims the tax credit instead of the cybersecurity company. The bill also eliminates the time period limitation that prohibits a qualified company from being eligible for the tax credit if the company has been in active business for more than five years. Moreover, the bill specifies that a cybersecurity company includes an entity that becomes duly organized and existing under the laws of any jurisdiction for the purpose of conducting business for profit within four months of receiving a qualified investment and provides for recapture of the credit if the entity does not satisfy this requirement.

The bill creates an additional tax credit against the State income tax for qualified buyers who purchase cybersecurity technology or services from a qualified cybersecurity business. A qualified buyer is any entity that has less than 50 employees in the State and is required to file a State income tax return. The purchase must be made from a cybersecurity company that meets specified criteria, including requirements that the company (1) has its headquarters and base of operations in the State; (2) has less than $5.0 million in annual revenue; (3) is a minority-owned,

woman-owned, veteran-owned, or service-disabled-veteran-owned business or is located in a historically underutilized business zone designated by the United States Small Business Administration; and (4) owns or has properly licensed any proprietary technology or provides cybersecurity service. The business must also be in good standing and current in payment of all State and local tax obligations, and not in default of a contract with, indebted to, or grant from the State or any local government.

When the tax credit for qualified investments in Maryland cybersecurity companies was first enacted in 2013, in our bill review letter, we noted that the bill raised a Commerce Clause issue. The Commerce Clause "prohibits States from legislating in ways that impede the flow of interstate commerce." *Star Scientific, Inc. v. Beales,* 278 F.3d 339, 354-55 (4th Cir. 2002). We also observed, however, that the Supreme Court has not directly addressed whether state tax incentives that reward an investor's in-state activities violate the dormant Commerce Clause. The Court has said that the Constitution "does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry." *Boston Stock Exch. V. State Tax Comm'n*, 429 U.S. 318, 336 (1977). *See also W. Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 199 n.15 (1977) ("We have never squarely confronted the constitutionality of subsidies, and we need not do so now. We have, however, noted that 'direct subsidization of domestic industry does not ordinarily run afoul' of the negative Commerce Clause.") Moreover, the Court has made clear that state taxpayers lack standing in federal court to challenge state tax credits as a violation of the federal Commerce Clause. *DaimlerChrysler Corp. v. Cuno*, 547 U.S. 332 (2006). Accordingly, it was our view that a reviewing court would not find the 2013 legislation unconstitutional.

We continue to have concerns that providing a tax credit for investing in a Maryland cybersecurity company creates an advantage for in-state businesses to raise revenue and arguably ties a taxpayer's effective tax rate to whether an investment involved a local company, and thus risks a determination by a reviewing court that the tax credit is unconstitutional. *See*, *e.g.*, *Boston Stock Exchange v. State Tax Commission*, (striking as discriminatory under the Commerce Clause, a state tax transfer on stocks that was reduced only if the transaction was made through the state's exchanges); *Camp Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564 (1997) (rejecting denial of tax exemption for summer camp that derived business from out-of-staters, explaining it was impermissible for the state "to use discriminatory tax exemptions as a means of encouraging the growth of local trade"); *Chapman v. Comm'r of Revenue*, 651 N.W.2d 825 (Minn. 2002) (holding that allowing deductions for contributions to Minnesota charities but not to non-Minnesota charities violated Commerce Clause).

At the same time, we also continue to believe that the cybersecurity tax credit is not clearly unconstitutional. The Supreme Court has acknowledged that there is a "delicate balancing of the national interest in free and open trade and a State's interest in exercising its taxing powers." *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 403 (1984). "It is a laudatory goal in the design

of a tax system to promote investment that will provide jobs and prosperity to the citizens of the taxing State. States are free to structur[e] their tax systems to encourage the growth and development of intrastate commerce and industry." *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 385-86 (1991) (upholding a Michigan single business tax that was a value added tax levied against entities having business activity within Michigan).

> Without exception, all states offer tax and non-tax incentives in one form or another... A multistate review of tax incentives clearly demonstrates their pervasive use and the dynamic environment in which they are employed, as well as their role as a significant feature of the states' contemporary taxing regimes. In fact, the use of incentives is so pervasive that a state-by-state compendium detailing relevant constitutional, legislative, administrative and judicial authority could easily rival any metropolitan area's yellow pages for shelf space.

Philip M. Tatarowicz, *Federalism, The Commerce Clause, And Discriminatory State Tax Incentives: A Defense of Unconditional Business Tax Incentives Limited to In-State Activities of The Taxpayer*, 60 Tax Law. 835, 848-49 (2007). "Simply put, the law in this area is indeterminate, and the answer to the question whether all or any particular [tax] credit falls on the right or wrong side of the line is equally unclear." Paul V. McCord, *The Dormant Commerce Clause and the MBT Credit and Incentive Scheme: You Can't Get There from Here*, 53 Wayne L. Rev. 1431, 1433 (2007).

Our Commerce Clause concerns also are present with the provision of the bill providing a tax credit for a "qualified buyer," that is, "any entity that has fewer than 50 employees in the State," who buys from a "qualified seller," which is, among other things, a company that "has its headquarters and base of operations in the State." The burden on interstate commerce is arguably less, however, because the pool of buyers and sellers who benefit from the tax credit do not include all in-state companies selling cybersecurity products or services. The bill sponsors testified that the bill serves several purposes, including providing incentives to small cybersecurity businesses and increasing the likelihood that businesses will buy cybersecurity products and services, which will not only protect those business' systems but also protect the data of their customers. *See CDR Systems Corp. v. Oklahoma Tax Comm'n.*, 339 P.3d 848, 856-57 (Okla. 2014) (holding that capital gains deductions for taxpayers headquartered in Oklahoma did not violate dormant Commerce Clause, explaining that "[e]ncouraging investment in Oklahoma's economy is not economic protectionism because the deduction in no way burdens out-of-state competitors; rather the deduction is a mechanism to entice those out-of-state companies to locate in state").

We also considered whether the tax credit preference for purchases from minority- or women-owned businesses is a race- or gender-based distinction. The Equal Protection Clause provides that no state shall "deny to any person within its jurisdiction the equal protection of the laws." U.S. Const. amend. XIV. The Maryland Constitution contains no equal protection clause,

but "the concept of equal protection is embodied in the due process requirement of Article 24" of the Maryland Declaration of Rights. *Tyler v. City of College Park*, 415 Md. 475, 499 (2010). A government program that uses a race or gender classification is constitutional only if it is narrowly tailored to support a compelling government interest. *City of Richmond v. J.A. Croson Co.*, 488 U.S. 469 (1989); *Adarand Constructors, Inc. v. Pena*, 515 U.S. 200 (1995). "Because a race or gender-conscious program is constitutionally suspect, the Supreme Court has essentially put the burden on a government entity with such a program to justify the program with findings based on evidence." 91 Op. Att'y Gen. 181, 183 (2006). Here, however, in addition to providing a tax credit for purchases from minority- and women-owned businesses, Senate Bill 228 also provides a tax credit for purchases from veteran-owned and service-disabled-veteran-owned businesses, and businesses located in a historically underutilized business zone as well as businesses with less than $5 million in annual revenue.

In summary, there is no doubt a risk that a court would find the tax credits offered in Senate Bill 228 violate the Commerce Clause. With regard to the tax credit preference for purchases from minority- or women-owned businesses, the Department of Commerce should work with the Office of Attorney General to ensure that the program is conducted consistent with constitutional requirements. Nevertheless, it is our view that the bill is not clearly unconstitutional.

Sincerely,

Brian E. Frosh
Attorney General

BEF/SBB/kd

cc: The Honorable John C. Wobensmith
Chris Shank
Victoria L. Gruber