Department of Legislative Services

Maryland General Assembly
2018 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 310 (The President, *et al.*) (By Request - Administration)
Budget and Taxation

CyberMaryland Act of 2018

This Administration bill creates a tax credit against the State income tax for a qualified buyer who purchases cybersecurity technology from a Maryland company that meets specified requirements. The amount of the credit is equal to 50% of the cost of the technology, not to exceed $50,000 for each qualified buyer. The Department of Commerce (Commerce) must administer the program and may approve a specified maximum amount of tax credits in each year. The bill also exempts from the State income tax the long-term capital gain income that is realized from the sale of an investment in a qualified cybersecurity company. **The bill takes effect July 1, 2018, and applies to tax year 2018 and beyond.**

Fiscal Summary

State Effect: General fund revenues decrease by $2.2 million in FY 2019 due to the incentives specified by the bill. Transportation Trust Fund (TTF) revenues decrease by $73,000 and Higher Education Investment Fund (HEIF) revenues decrease by $30,000 in FY 2019. Future year estimates reflect the exemption of qualified investment gains and tax credits authorized in each year. General fund expenditures increase by $136,800 in FY 2019 due to implementation costs at State agencies. Future year expenditures reflect ongoing expenses.

($ in millions)	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
GF Revenue	($2.2)	($4.1)	($6.0)	($7.9)	($9.8)
SF Revenue	($0.1)	($0.2)	($0.3)	($0.4)	($0.5)
GF Expenditure	$0.1	$0.1	$0.1	$0.1	$0.1
Net Effect	($2.5)	($4.4)	($6.4)	($8.4)	($10.4)

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

Local Effect: Local income tax revenues and local highway user revenues decrease by a total of $204,000 in FY 2019 and by $232,000 in FY 2023. Local expenditures are not affected.

Small Business Effect: The Administration has determined that the bill will have a meaningful impact on small business (attached). The Department of Legislative Services (DLS) concurs with this assessment as discussed below.

Analysis

Bill Summary:

Exemption of Qualified Long-term Capital Gain Income

The bill exempts from the State income tax the long-term capital gain income that is realized from the sale of an investment in a qualified cybersecurity company.

A cybersecurity company is a company organized for profit that is primarily engaged in the development of innovative and proprietary cybersecurity technology. A qualifying company must also meet specified criteria, including requirements that the company (1) has been in active business for no more than five years; (2) has less than 50 full-time employees; (3) has its headquarters and base of operations in the State; (4) is not publicly traded on any exchange; (5) owns or has properly licensed any proprietary technology; and (6) has an aggregate capitalization of at least $100,000. Commerce may also establish reasonable requirements evidencing that the company continues to be primarily engaged in the development of innovative and proprietary cybersecurity technology.

Credit for the Purchase of Qualified Cybersecurity Technology

The bill creates a tax credit against the State income tax for qualified buyers who purchase cybersecurity technology from a cybersecurity business. 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; and (3) owns or has properly licensed any proprietary technology. 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.

Commerce, in consultation with the Maryland Technology Development Corporation, may establish a panel composed of experts in the area of cybersecurity technology in order to assist Commerce in determining if a cybersecurity company meets the bill's requirements.

In tax year 2018, the Secretary of Commerce may approve a total of $2.0 million in tax credits. The maximum amount of authorized tax credits is increased by $2.0 million in each of the next four years – a maximum of $10.0 million in tax credits can be approved in tax year 2022 and each subsequent year.

A qualified buyer may claim an income tax credit equal to 50% of the cost incurred to purchase cybersecurity technology from a qualified cybersecurity company. The credit may not exceed $50,000 for each qualified buyer. Commerce may not certify purchases from a single cybersecurity company that total more than $200,000 in a tax year. Commerce must annually report specified information about the program.

The bill establishes the procedures for claiming the credit and a process for revoking the credit if program requirements are not met. Commerce and the Comptroller must jointly adopt regulations to implement the tax credit application, approval, and monitoring processes.

Current Law:

Long-term Capital Gains

Under the federal income tax, gains or losses reflected in the value of an asset are generally not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain is generally included in income. The difference between the sale amount and the asset basis – which is typically the purchase price – is a capital gain or a capital loss. In order to qualify as a long-term capital gain, investments must generally be held for at least one year. Maryland conforms to the federal income tax treatment of net capital gains. However, unlike the federal income tax, net capital gains are taxed at the same State tax rates as other income.

Cybersecurity Investments

Qualified investments in cybersecurity companies may qualify for a tax credit under the Cybersecurity Investment Incentive Tax Credit Program, as discussed below. The requirements that a company must meet for the program are similar to those proposed by the bill.

Background:

Cybersecurity Investment Incentive Tax Credit

Chapter 390 of 2013 established a refundable tax credit for investments in qualified cybersecurity companies. Commerce administers the tax credit application, approval, and certification process. The Governor is required to appropriate at least $2.0 million to the reserve fund in each fiscal year. The Governor's proposed fiscal 2019 State budget includes $2.0 million in funding for the program.

A qualified Maryland cybersecurity company can claim a credit equal to 33% of a qualified investment, not to exceed $250,000. Chapter 504 of 2016 increased the value of the tax credit if the qualified cybersecurity company in which an investment is made is located in Allegany, Dorchester, Garrett, or Somerset counties. The value of the credit for investments made in companies in there counties is equal to 50% of the investment, not to exceed $500,000. The credit is subject to recapture if the investor, within two years, sells the ownership interest in the company.

The Montgomery County Cybersecurity Tax Credit Supplement Program provides additional funds to cybersecurity companies that receive a State tax credit and have their headquarters and base of operations in Montgomery County. The credit is equal to 50% of the State credit received, not to exceed 15% of the amount appropriated to the Montgomery County program. Montgomery County provided $483,000 to the program in fiscal 2017.

Early-stage Cybersecurity Investments

Many early-stage cybersecurity companies face a funding gap when trying to develop a new product as traditional loans are often not available or sufficient relative to their capital needs. Companies employ different strategies to overcome these financing challenges, including securing financing from a variety of sources throughout the company's early development. Companies also seek to merge or be acquired by a more established company or turn public by offering an initial public offering.

Investors often provide a loan and/or acquire equity in the company in exchange for making investments in early-stage companies. In the earliest stage of the company's financing, seed capital is used to start the business and is often contributed by company founders and principals and the friends and family of those individuals. After a company has used its seed capital, it will offer rounds of investment which is often purchased by a variety of investors including angel investors and venture capitalists. Venture capital and angel investments are highly speculative – most of the companies that receive funding will ultimately fail. Because the investments are risky, investors seek to generate large returns that offset the losses on other investments. Investors will often sell the investment when the company's valuation and liquidity has increased or when the company issues an initial public offering or merges with another company. Early-stage investors typically have an investment holding period of 5 to 10 years.

Nationally, in the last several years an average of 50 private cybersecurity companies that have less than 50 employees and have been in business for five years or less have merged with another company. The average valuation of these companies at the time of the merger was $46.9 million. After a company merges with another company it typically, but not always, maintains a presence in the state in which it was previously headquartered.

In calendar 2017, an estimated 17 cybersecurity companies with the same attributes described previously were headquartered in Maryland and were actively raising private investment. At the end of calendar 2017, these companies had received a total of $144.9 million in investments. The average valuation of each company after the investment was equal to $14.4 million.

State Revenues: The bill (1) creates an income tax credit for qualified buyers who purchase specified cybersecurity technology and (2) exempts from the State income tax the long-term capital gain resulting from an investment in a qualified cybersecurity company. As a result, general fund revenues will decrease by $2.2 million in fiscal 2019. TTF revenues will decrease by $73,000 and HEIF revenues will decrease by $30,000 in fiscal 2019. **Exhibit 1** shows the estimated State and local revenue impacts resulting from the proposed tax incentives.

Exhibit 1
Projected Impact on State and Local Revenues
Fiscal 2019-2023

	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
Investment Exemption	($350,000)	($350,000)	($350,000)	($350,000)	($350,000)
Tax Credit	(2,000,000)	(4,000,000)	(6,000,000)	(8,000,000)	(10,000,000)
Total	**($2,350,000)**	**($4,350,000)**	**($6,350,000)**	**($8,350,000)**	**($10,350,000)**
General Fund	($2,247,000)	($4,144,100)	($6,041,100)	($7,938,100)	($9,835,100)
HEIF	(30,000)	(60,000)	(90,000)	(120,000)	(150,000)
TTF	(73,000)	(145,900)	(218,900)	(291,900)	(364,900)
State	*(66,000)*	*(131,900)*	*(197,900)*	*(263,900)*	*(329,900)*
Local	*(7,000)*	*(14,000)*	*(21,000)*	*(28,000)*	*(35,000)*
Local Income Tax Revenues	(197,000)	(197,000)	(197,000)	(197,000)	(197,000)

HEIF: Higher Education Investment Fund
TTF: Transportation Trust Fund

This estimate is based on the number of cybersecurity companies that could qualify for the investment incentive and assumes that the maximum amount of authorized credits are awarded in each year. To the extent Commerce does not award the maximum amount, revenue losses will be less than estimated.

State Expenditures: General fund expenditures increase by $136,800 in fiscal 2019 due to implementation costs at the Comptroller's Office and Commerce, as described below.

Department of Commerce

DLS estimates that Commerce will need one program administrator to implement the program. As a result, general fund expenditures for Commerce will increase by $72,750 in fiscal 2019, which reflects the bill's July 1, 2018 effective date. It includes a salary, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Position	1
Salary and Fringe Benefits	$67,235
Operating Expenses	5,515
Total FY 2019 Expenditures	**$72,750**

Future year expenditures reflect annual increases and employee turnover and ongoing operating expenses.

Comptroller's Office

DLS estimates that the Comptroller's Office will incur a one-time expenditure increase of $64,000 in fiscal 2019 to add the tax credit and subtraction modification. This amount includes data processing changes to the SMART income tax return processing and imaging systems and systems testing.

Local Revenues: Local highway user revenues will decrease by $7,000 in fiscal 2019 and by $35,000 in fiscal 2023 as a result of credits claimed against the corporate income tax, as shown in Exhibit 1. Local income tax revenues will decrease by $197,000 annually beginning in fiscal 2019 due to the exemption of qualified capital gains.

Small Business Impact: Small businesses that sell and purchase cybersecurity technology may benefit from the subsidy provided for the purchase of qualified technology. Less than 20 cybersecurity companies may benefit from the exemption of investment gains to the extent companies receive additional investment. DLS notes that there is likely significant overlap with these companies and existing State programs, including the cybersecurity investment incentive tax credit.

Additional Information

Prior Introductions: None.

Cross File: HB 364 (The Speaker, *et al.*) (By Request - Administration) - Ways and Means.

Information Source(s): Department of Commerce; Comptroller's Office; Pitchbook.com; Department of Legislative Services

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ANALYSIS OF ECONOMIC IMPACT ON SMALL BUSINESSES

TITLE OF BILL: CyberMaryland Act of 2018

BILL NUMBER: SB 310/HB 364

PREPARED BY: Chris Carroll

PART A. ECONOMIC IMPACT RATING

This agency estimates that the proposed bill:

____ WILL HAVE MINIMAL OR NO ECONOMIC IMPACT ON MARYLAND SMALL BUSINESS

OR

__X__ WILL HAVE MEANINGFUL ECONOMIC IMPACT ON MARYLAND SMALL BUSINESSES

PART B. ECONOMIC IMPACT ANALYSIS