SB 498

Department of Legislative Services

2013 Session

FISCAL AND POLICY NOTE

Senate Bill 498 (Senator Pugh, *et al.*)
Budget and Taxation

Income Tax - Subtraction Modification and Credit - Creation of a Qualifying Business Enterprise

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This bill exempts from the State income tax specified income generated by the sale of a business entity that results in the creation of a qualified business enterprise as defined by the bill. In order to qualify, the sale of the entity must be made to a buyer who is a small business, disabled veteran-owned small business, woman-owned business, or minority-owned business as specified by the bill.

The bill also creates a tax credit against the State income tax for investments in certain qualified business enterprises. The refundable credit is equal to 50% of the qualified investment, not to exceed $500,000. The amount of credits that the Department of Business and Economic Development (DBED) can award each year cannot exceed the amount of money appropriated to a reserve fund established by the bill.

The bill takes effect July 1, 2013, and applies to tax year 2013 and beyond.

Fiscal Summary

State Effect: General fund expenditures may increase by $10.0 million beginning in FY 2014 due to appropriations to the tax credit reserve fund established by the bill. Administrative costs increase by $254,100 in FY 2014 and by $98,100 in FY 2018. State revenues will decrease significantly and likely by at least $25.0 million annually beginning in FY 2014 due to the subtraction modification. Transportation Trust Fund (TTF) and Higher Education Investment Fund (HEIF) revenues may decrease beginning in FY 2014.

($ in millions)	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
SF Revenue	(-)	(-)	(-)	(-)	(-)
GF/SF Rev.	($25.0)	($25.0)	($25.0)	($25.0)	($25.0)
GF Expenditure	$10.3	$10.1	$10.1	$10.1	$10.1
Net Effect	($35.3)	($35.1)	($35.1)	($35.1)	($35.1)

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

Local Effect: Local highway user revenues distributed from TTF will decrease as a result of credits and subtraction modifications claimed against the corporate income tax. Local expenditures are not affected.

Small Business Effect: Small businesses that qualify for the tax benefits will be positively impacted through lower tax liabilities. Conversely, any small businesses that are competitors of these businesses and do not qualify would be at a competitive disadvantage due to higher relative tax burdens.

Analysis

Bill Summary: The bill exempts from the State income tax specified income generated by the sale of a business entity that results in the creation of a qualified business enterprise as defined by the bill. In order to qualify, the sale of the entity must be made to a buyer who meets certain qualifications and that leads to the creation of a qualified business enterprise.

A qualified buyer must meet the following requirements or be certified/recognized as such:

- **Small business:** a business entity that (1) is certified as a small business by the U.S. Small Business Administration; (2) meets the qualifications under State Finance and Procurement Article Section 14-203; or (3) is not dominant in its field of operation, whose owners have demonstrated at least five years of relevant experience, and qualifies under the criteria and size standards under 13 Code of Federal Relations, Part 121.

- **Veteran-owned:** meets the qualifications under State Finance and Procurement Article Section 14-201 and is recognized by the U.S. Veterans Administration.

- **Minority Business Enterprise (MBE):** (1) meets the qualifications of State Finance and Procurement Article Section 14-301; or (2) recognized as being minority-owned by the National Minority Supplier Development Council.

- **Women-owned Enterprise**: recognized by the Women's Business Enterprise National Council.

A qualified business enterprise is defined as any legal entity, except a joint venture, that is organized to engage in commercial transactions and (1) has its headquarters and base of operations in the State; (2) is more than 50% controlled or owned by a qualified buyer; or (3) is more than 30% owned by a qualified buyer who accepts equity capital from professional institutional investors who contribute majority equity. In addition, the entity must be managed by and have its daily business operations controlled by a qualified buyer.

A qualifying sale is the sale of an entity to a qualified buyer that results in the creation of a qualifying business enterprise.

The subtraction modification includes the income received by a seller who makes a qualifying sale resulting from (1) the sale of the entity; (2) financing any part of the sale; or (3) compensation for ongoing involvement in the qualifying business enterprise. The amount of the subtraction modification is required to be recaptured if within five years of a qualifying sale the business enterprise is no longer a qualified business enterprise.

The bill also establishes an Investment Income Tax Credit Reserve Fund. The total amount of tax credit certificates issued by DBED in each fiscal year cannot exceed the amount appropriated to the reserve fund in the State budget. The bill requires the Governor to make an appropriation to the reserve fund in each year but does not require an amount. Any amount of money in the fund that is not expended in the fiscal year is rolled over into the next fiscal year. An investor who makes an investment in a qualified business enterprise can claim a credit equal to 50% of the investment, not to exceed $500,000.

Current Law/Background: Under federal income tax guidelines, the sale of a business usually is not the sale of one asset. Instead, all the assets of the business are sold and each asset is treated as being sold separately for determining the treatment of gain or loss. Assets must be classified as capital assets, depreciable property used in the business, real property used in the business, or property held for sale to customers, such as inventory or stock in trade. The gain or loss on each asset is figured separately. Although each class of asset can be taxed differently under the federal income tax each is taxed as ordinary income for State income tax purposes to the extent the income is apportioned to Maryland.

Related State Programs

Prior to the enactment of Chapters 252 and 253 of 2011 (HB 456/SB 120) and Chapter 154 of 2012 (HB 1370), State law established a goal that at least 25% of the total dollar value of each agency's procurement contracts be awarded to MBEs, including subgoals of 7% for African American-owned businesses and 10% for woman-owned businesses. As of January 2013, a new statewide goal had not been issued by the Governor's Office of Minority Affairs (GOMA), so the 25% statewide goal remains in effect. GOMA issued subgoal guidelines in July 2011, which are still in effect.

The guidelines state that subgoals may be used only when the overall MBE goal for a contract is greater than or equal to the sum of all recommended subgoals for the appropriate industry, plus two percentage points. For a complete description of the MBE program, please see the **Appendix – Minority Business Enterprise Program**.

The Small Business Reserve program, established in 2004, requires most State procurement units to structure their procurements so that at least 10% of the total dollar value of their procurements is made directly to small businesses. Under regulations adopted by the Department of General Services, each agency must prepare an annual forecast of its total procurement spending. The agency must then develop a plan to allocate at least 10% of its forecasted spending to contracts for small businesses serving as prime contractors. Small businesses are either a certified minority-owned business or a business other than a broker that is independently owned and operated, not a subsidiary of another firm, and not dominant in its field of operation and must meet other specified criteria.

The Maryland Small Business Development Financing Authority (MSBDFA) was established to provide financing incentives to create and expand small businesses with a focus on those owned by socially or economically disadvantaged persons in the State. The program offers a variety of incentives in the form of loans and guarantees with the primary goal of providing access to capital resulting in the creation and retention of jobs. DBED has contracted with Meridian Management Group, Inc. to oversee the marketing and monitoring of the MSBDFA program and its clients. The Governor's proposed fiscal 2014 budget includes $1.8 million in funding for the program.

Under the State Video Lottery Terminal Program, 1.5% of net video lottery terminal proceeds are distributed to the Small, Minority, and Woman-owned Business Investment Account. Subject to specified transfers, it is estimated that $10.0 million in funding will be available in fiscal 2014 and $21.4 million in fiscal 2017.

Local school systems are required to adopt procedures consistent with the State's MBE policies on public school construction contracts.

The Military Personnel and Service-Disabled Veteran Loan Program requires DBED, in consultation with the Department of Veterans Affairs, to establish a program to provide no-interest loans to service-disabled veterans and specified businesses owned by or employing military reservists or National Guard personnel called to active duty. The Governor's proposed fiscal 2014 budget includes $300,000 in funding for the program.

State Fiscal Effect:

Appropriations to the Reserve Fund

The bill requires the Governor to appropriate money to the reserve fund but does not specify an amount. Based on the funding provided to other existing State tax credit programs and the relative number of eligible businesses and assuming a fully funded and viable program, State expenditures will increase by $10.0 million annually beginning in fiscal 2014. To the extent that the Governor provides less money to the reserve fund, the increase in general fund expenditures will be less. However, there is no limit on the amount that can be appropriated to the reserve fund.

Administrative Expenses

The bill requires DBED to administer the tax credit and DBED indicates it will need one tax credit program administrator. General fund expenditures will increase by an estimated $86,700 in fiscal 2014, which reflects the bill's July 1, 2013 effective date. This estimate includes a salary, fringe benefits, and ongoing operating expenses.

The Comptroller's Office reports that it would incur a one-time expenditure increase of $167,400 in fiscal 2014 to add the subtraction modification and credit to the personal and corporate income tax returns. This includes data processing changes to the SMART income tax return processing and imaging systems and system testing.

Position	1
Salary and Fringe Benefits	$81,555
Operating Expenses	5,190
DBED Expenditures	**$86,745**
Comptroller Expenditures	**$167,400**
Total FY 2014 Expenditures	**$254,145**

Future year expenditures reflect a full salary with annual increases and employee turnover as well as annual increases in ongoing operating expenses.

Tax Credit Revenue Impacts

Within 15 days after the end of each fiscal year, DBED is required to notify the Comptroller of the total amount of credit certificates that were issued during the fiscal year. Upon this notification, the Comptroller is required to transfer from the reserve fund to the general fund the total amounts stated in the credit certificates that were issued during the fiscal year. A portion of corporate income tax revenues are distributed to the TTF and HEIF. As a result, general fund revenues may increase while TTF and HEIF revenues may decrease.

For illustrative purposes only, if $10.0 million is appropriated to the reserve fund in fiscal 2014 and 80% of all credits are claimed against the personal income tax and the remaining amount is claimed against the corporate income tax, general fund revenues may increase by $450,900. TTF revenues will decrease by $330,900 and HEIF revenues will decrease by $120,000.

Subtraction Modification Revenue Impacts

The bill exempts from the State income tax specified income from the sale of a business entity that results in the creation of a qualified business enterprise as defined by the bill beginning in tax year 2013.

A seller can exempt income resulting from a qualifying sale, from financing any part of the sale, or for compensation for ongoing involvement in the business. According to the U.S. Census Bureau, in 2007 there were 167,000 minority-owned businesses, 172,000 women-owned businesses, 71,000 disabled veteran-owned firms, and 516,400 small businesses. Given the sources of income that could be excluded, the large benefit conveyed to sellers, the large number of businesses that could qualify, and lack of provisions requiring certification, revenue losses will be significant and likely will be at least $25 million annually.

The Regional Economic Studies Institute published a compensated study to examine the potential impacts of the bill. It estimated that one typical qualifying sale would decrease State revenues assessed on capital gains by $1.3 million. This amount does not include other income that could be exempted under the bill.

Additional Information

Prior Introductions: None.

Cross File: HB 564 (Delegate Branch, *et al.*) - Ways and Means and Economic Matters.

Information Source(s): U.S. Census Bureau, Regional Economic Studies Institute, Department of Legislative Services

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Appendix – Minority Business Enterprise Program

The State's Minority Business Enterprise (MBE) program, which is scheduled to terminate July 1, 2016, requires that a statewide goal for MBE contract participation be established biennially through the regulatory process under the Administrative Procedure Act. The biennial statewide MBE goal is established by the Special Secretary for the Governor's Office of Minority Affairs (GOMA), in consultation with the Secretary of Transportation and the Attorney General. In a year in which there is a delay in establishing the overall goal, the previous year's goal applies. The Special Secretary is also required to establish biennial guidelines for State procurement units to consider in deciding whether to establish subgoals for different minority groups recognized in statute. In a year in which there is a delay in issuing the guidelines, the previous year's guidelines apply.

Prior to the enactment of Chapters 252 and 253 of 2011 (HB 456/SB 120) and Chapter 154 of 2012 (HB 1370), State law established a goal that at least 25% of the total dollar value of each agency's procurement contracts be awarded to MBEs, including subgoals of 7% for African American-owned businesses and 10% for woman-owned businesses. As of January 2013, a new statewide goal had not been issued by GOMA, so the 25% statewide goal remains in effect. GOMA issued subgoal guidelines in July 2011, summarized in **Exhibit 1**, which are still in effect. The guidelines state that subgoals may be used only when the overall MBE goal for a contract is greater than or equal to the sum of all recommended subgoals for the appropriate industry, plus two percentage points.

Exhibit 1
Subgoal Guidelines Issued July 2011

	Construction	Architectural/ Engineering	Maintenance	Information Technology	Services	Supplies/ Equipment
African American	7%	6%	8%	7%	7%	6%
Hispanic	–	2%	3%	2%	–	–
Asian	4%	–	3%	–	4%	5%
Women	–	9%	–	8%	12%	10%
Total	**11%**	**17%**	**14%**	**17%**	**23%**	**21%**
Total +2	**13%**	**19%**	**16%**	**19%**	**25%**	**23%**

Source: Governor's Office of Minority Affairs

There are no penalties for agencies that fail to reach the statewide target. Instead, agencies are required to use race-neutral strategies to encourage greater MBE participation in State procurements.

History and Rationale of the MBE Program

In 1989, the U.S. Supreme Court held in the *City of Richmond v. J.A. Croson Co.*, that state or local MBE programs using race-based classifications are subject to strict scrutiny under the equal protection clause of the Fourteenth Amendment to the U.S. Constitution. In addition, the ruling held that an MBE program must demonstrate clear evidence that the program is narrowly tailored to address actual disparities in the marketplace for the jurisdiction that operates the program. As a result, prior to each reauthorization of the State's MBE program, the State conducts a disparity study to determine whether there is continued evidence that MBEs are underutilized in State contracting.

The most recent disparity study was completed in February 2011 and serves as the basis for the most recent reauthorization of the MBE program. It found continued and ongoing disparities in the overall annual wages, business earnings, and rates of business formation between nonminority males and minorities and women in Maryland. For instance, average annual wages for African Americans (both men and women) and nonminority women were 33% lower than for comparable nonminority males. It also found continued disparities in the use of MBEs compared to their availability in the marketplace to perform work in designated categories of work. For instance, African American-owned businesses were paid 4.5% of State construction contract dollars, but they make up 9.7% of the construction sector in the State. Woman-owned businesses were paid 8.5% of maintenance contract dollars, despite making up 18.0% of the maintenance contract sector. Similar disparities were found in other contracting sectors and for other MBE categories.

Another disparity study is due by December 31, 2015, prior to the July 1, 2016 termination date for the MBE program. (The program has been reauthorized six times since 1990, most recently by Chapter 154 of 2012.) **Exhibit 2** provides MBE participation rates for major Executive Branch agencies for fiscal 2011, the most recent year for which data is available.

Requirements for MBE Certification

An MBE is a legal entity, other than a joint venture, that is:

- organized to engage in commercial transactions;
- at least 51% owned and controlled by one or more individuals who are socially and economically disadvantaged; and

- managed by, and the daily business operations of which are controlled by, one or more of the socially and economically disadvantaged individuals who own it.

MBEs include not-for-profit entities organized to promote the interests of physically or mentally disabled individuals. There are no restrictions on the size or management structure of not-for-profit entities that can be considered MBEs.

A socially and economically disadvantaged individual is defined as a citizen or legal U.S. resident who is African American, Native American, Asian, Hispanic, physically or mentally disabled, a woman, or otherwise found by the State's MBE certification agency to be socially and economically disadvantaged. An MBE owned by a woman who is also a member of an ethnic or racial minority group is certified as either owned by a woman or owned by a racial or ethnic minority, but not both. The Maryland Department of Transportation is the State's MBE certification agency.

A socially disadvantaged individual is someone who has been subject to racial or ethnic prejudice or cultural bias within American society because of his or her membership in a group and without regard to individual qualities. An economically disadvantaged individual is someone who is socially disadvantaged whose ability to compete in the free enterprise system has been impaired due to diminished capital and credit opportunities compared with those who are not socially disadvantaged. An individual with a personal net worth in excess of $1.5 million, adjusted annually for inflation, is not considered economically disadvantaged. The inflation-adjusted limit for calendar 2013 is $1,615,663.

Exhibit 2
MBE Participation Rates, by Agency
Fiscal 2011

Agency	% MBE Participation
Aging	30.7%
Agriculture	6.9%
Budget and Management	10.5%
Business and Economic Development	43.9%
Education	20.3%
Environment	25.2%
Executive Department	14.0%
General Services	33.9%
Health and Mental Hygiene	46.1%
Higher Education Commission	14.0%
Housing and Community Development	21.9%
Human Resources	8.4%
Information Technology	13.7%
Juvenile Services	8.9%
Labor, Licensing, and Regulation	36.1%
Morgan State University	22.3%
Natural Resources	10.9%
Planning	8.3%
State Police	8.8%
Public Safety and Correctional Services	33.0%
Transportation – Aviation Administration	26.2%
Transportation – Motor Vehicle	46.7%
Transportation – Office of the Secretary	29.5%
Transportation – Port Administration	7.8%
Transportation – State Highway	26.1%
Transportation – Transit Administration	16.8%
Transportation – Transportation Authority	25.4%
University System of Maryland	19.7%
Veterans Affairs	18.2%
Statewide Total[1]	**23.8%**

[1]Includes additional non-Cabinet agencies.

Source: Governor's Office of Minority Affairs