Impact of MD Tech Tax on Small Business Defense Contractors

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With inputs from the small business community serving our national security customers at Ft. Meade.

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Introduction

Maryland's small business community that supports the national security missions based out of Ft. Meade and the surrounding areas have raised a huge concern over the implementation of the portions of HB 352 related to the "Tech Tax" for performing IT services. We are seeking clarification on the implementation, and requesting potential relief, as there is a chance that if the tax is applied incorrectly, it could greatly damage the small business community that serves as one of the best hopes for recently laid off federal employees to find new employment, serves as major supporters of scholarships and investments in primary school STEM and technology programs, and serve as a major component of the engine that drives innovative technology services and investment in the same in our state.

Background: Building a DCAA Compliant Rate

Some of the challenges this will present for federal defense contractors and subcontractors, compared to commercial businesses in the same business space are related to the federal regulations we must adhere to. One such set of regulations relates to how we are required to build our rates for services. To build a DCAA-compliant rate as a defense contractor, you must accurately allocate and track direct and indirect costs. These are federal regulations that we have no flexibility with, or control over.

Direct Costs

These are costs directly attributable to a specific contract or project (e.g., labor hours for engineers on Project A, materials used for Project B).

Indirect Costs

These are costs that support overall business operations and cannot be directly tied to a single contract (e.g., rent, utilities, administrative salaries). They are allocated to contracts using indirect rates.

Building Indirect Rates

Indirect rates are calculated by dividing the total indirect costs by an appropriate base (e.g., direct labor costs). The common indirect cost pools include:

Fringe Benefits

- Consists of: Costs of employee benefits such as health insurance, paid time off, retirement contributions, and payroll taxes.

Overhead

- Consists of: Costs related to supporting production or operations, such as facility maintenance, equipment depreciation, and indirect labor for supervisors.

General and Administrative (G&A)

- Consists of: Costs related to the overall management and administration of the business, such as executive salaries, accounting, legal, and business development.

How Components Feed into Indirect Costs

1. Fringe, Overhead, and G&A are accumulated into their respective indirect cost pools.
2. Each pool's total cost is divided by a relevant base (e.g., direct labor dollars for overhead, total cost input for G&A) to calculate the indirect rate.
3. These rates are then applied to direct costs on contracts to allocate a portion of the indirect costs.

Why is this important?

Large prime contractors are going to continue to bid utilizing "price to win" models and total cost targets based on current and historical pricing data. This tax, regardless of who directly pays it, will be pushed down to the subcontractors either directly or indirectly, through reduced rates. This forces small business contractors to make one or a combination of the following decisions:

- Reduce Direct Labor: Offer less direct compensation/salary to employees performing on contract.

- Likely outcomes: Directly billable employees will join large business primes not subject to the tax, that can offer higher salaries, reducing the small business workforce, and move these employees under a prime contractor that will not be subject to the tax **(small businesses lose, still does not generate tax revenue)**.

- Reduce Fringe: Offer less benefits to employees.

- Likely outcomes: Employees will join large business primes not subject to the tax, that can offer richer benefits, reducing the small business workforce, and move these employees under a prime contractor that will not be subject to the tax **(small businesses lose, still does not generate tax revenue)**.

- Reduce Overhead: Cut facilities costs and move physical offices virtual, cut qualified overhead staff and services, look for cheaper outsourced resources outside of the state.

- Likely outcomes: Less revenue for commercial real estate, less jobs in the state. **(maybe a wash, or net loss to tax revenue)**

- Reduce G&A: Cut salaries, benefits, and/or jobs for qualified executive, accounting, business development and legal support staff.

- Likely outcomes: Employees will join large business primes not subject to the tax, that can offer better salaries and benefits, reducing the small business workforce, and move these employees under a prime contractor that will not be subject to the tax. Reduction of jobs in the state **(small businesses lose, still does not generate tax revenue)**.

"Profit" or "fee" does not ever enter the discussion, because this is a fixed amount dictated by both federal regulations and prescribed to subcontractors by their Primes. Federal regulations make it impossible to "just take it out of profit," assuming there is even enough of a margin to take it out of. The tax now represents a “cost of doing business” and whoever is paying it MUST build it into their rate calculations, passing the State Tax onto the federal government.

Impact of the HB 352 Tech Tax on local defense contractors

Maryland Based Companies - Competitive Disadvantage

- The 3% tax puts Maryland-based companies (specifically subcontractors, which are mostly small businesses) at an immediate pricing disadvantage.
- Out-of-state competitors can undercut bids simply by not being subject to this tax.

Harm to Federal Contracting Viability

- Federal subcontracts, especially in DoD/NSA, are fixed-price (set years ahead of time) with no room to add tax costs.
- Many companies operate on margins of 5-7%; a 3% tax makes these contracts unviable.
- Businesses will stop hiring in Maryland and may reduce current staff.
- Lower profit margins will force cuts to salaries, benefits, or headcount.

Damage to Small Business Ecosystem

- Large primes (often out-of-state) will have a built-in cost advantage over local subcontractors.

- Subcontractors may lose contracts or be forced to operate at a loss.
- Support businesses (accounting, HR, real estate) will suffer as small firms struggle or close or large businesses will shift these operations to outside of MD in low cost of living states.
- Over time, jobs will shift from small business employers to large out of state businesses.

Loss of Cleared and Skilled Talent

- Companies may no longer be able to retain highly skilled, security-cleared employees.
- Reduced margins eliminate the ability to carry staff between contracts.

Undermining Maryland's Strategic Goals

- This tax contradicts efforts to build Maryland into the cybersecurity capital of the U.S.
- Innovators and small tech firms, key to that strategy, are being pushed out or will never be created in the first place. This provision and other taxes in this Budget Reconciliation and Financing Act are a dis-incentive to the creation of new businesses in Maryland.

Reduced Community Investment & Support

- Contractors may cut funding to local (k-12 schools) STEM, workforce development, and veteran transition programs.
- This impacts students, jobseekers, and transitioning military members in Maryland.
- Local nonprofits like AFCEA and the Fort Meade Alliance depend heavily on sponsorships and donations from Maryland-based contractors.
- These organizations fund STEM grants for local schools, scholarships for students, and other community programs.
- As companies face tighter margins and relocate operations, these critical community investments are at risk --- hurting students, educators, and workforce development in the region.

Long-Term Economic Harm

- Drives jobs, revenue, and innovation out of state.
- Shrinks the personal income and corporate tax base --- may ultimately reduce overall state revenue.

Business Relocation

- Companies are actively forming entities in states like Delaware to avoid the tax.
- New initiatives, SaaS platforms, and hiring plans are being moved out of Maryland.
- States like West Virgina are already capitalizing on this to try to poach our technology businesses. An example sent to one company in our community already:

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HOUSE OF DELEGATES
WEST VIRGINIA LEGISLATURE

April 7, 2025

Mr. Jacob Stokes
President
Belay Technologies, Inc.
7021 Columbia Gateway Drive, Suite 125
Columbia, MD 21046

Dear Mr. Stokes,

I recently read about the challenges Belay Technologies is facing due to Maryland's new 3% sales tax on information technology services. Understanding the significant impact this may have on your operations, I would like to extend an invitation to consider **Mineral County, West Virginia**, as a strategic location for your company's future growth and success.

A Thriving Defense and Technology Ecosystem

Mineral County is home to the **Allegany Ballistics Laboratory (ABL)**, a government installation under the Naval Sea Systems Command (NAVSEA), currently operated by **Northrop Grumman**. ABL serves as a hub for research, development, and production of advanced defense technologies, providing an environment conducive to collaboration and innovation for companies like Belay Technologies.

In addition to Northrop Grumman, **IBM** maintains a presence at the Robert C. Byrd Hilltop Office Complex within ABL, focusing on information management and strategic consulting. The presence of these industry leaders underscores the region's commitment to supporting defense and technology enterprises.

Pro-Business Environment

West Virginia offers a pro-business climate with:

- **No digital services tax**, allowing technology companies to operate without additional financial burdens.
- **Stable and affordable energy costs**, with Mineral County served by **FirstEnergy**, ensuring predictable utility expenses.
- **Ongoing efforts to eliminate the state personal income tax**, enhancing the financial appeal for both businesses and employees.

Skilled Workforce and Educational Support

Mineral County provides access to a skilled workforce, supported by:

- **Proximity to Potomac State College**, a West Virginia University campus offering programs aligned with industry needs.
- **Frankfort High School**, consistently achieving one of the highest graduation rates in the state, reflecting the area's strong educational foundation.

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Quality of Life

Beyond business advantages, Mineral County offers a high quality of life with:

- **Outdoor recreational opportunities**, including Jennings Randolph Lake, whitewater rafting, and nearby ski resorts.
- **Scenic trails**, such as the C&O Canal National Historical Park and the Great Allegheny Passage Trail, bordering the county.

Invitation to Meet State Leadership

To further explore the opportunities available in West Virginia, I invite you to visit our state capital to meet with:

- **Speaker of the House Roger Hanshaw**
- **Secretary of Commerce Dr. Matthew Herridge**

These meetings can provide valuable insights into the state's commitment to fostering a supportive environment for technology companies and discuss potential incentives tailored to your business needs.

I will be sending you a comprehensive guide detailing available properties, incentives, and the support our team can provide to facilitate a smooth transition. I would welcome the opportunity to discuss how Belay Technologies can benefit from relocating to Mineral County and to arrange a visit at your convenience.

We believe that Mineral County offers the strategic advantages and supportive environment that Belay Technologies needs to continue its growth and success. We look forward to the possibility of welcoming you to our community.

Warmest regards,

Delegate Gary G. Howell

HB 352 Tech Tax Enforcement Challenges and State Burden

Enforcement challenges:

- How will the State police what NAICS codes my contracts are awarded under, especially those that are classified?

- If my revenue is 100% generated from the federal government, can the state levy a tax on the federal government?
    - Are Prime contractors exempted?
    - Are subcontractors exempted? If not, how will the Prime account for the tax on Cost Plus type contracts and not have the tax be passed through the federal government?
- How will the cybersecurity exemption apply?
    - Who determines a company is a qualified cybersecurity business (QCB)?
    - What if the scope of work as detailed in my contract only partially relates to cybersecurity tasking? How would a company itemize that?
    - What if the work is classified, how can a company itemize the type of work and revenue associated with it? How would the state be able to verify?

Burden to the State:

- Will the State provide an exemption for contracts operating prior to the July 1, 2025 effective date? If not, the contractor can request an equitable adjustment in accordance with FAR 552.243-71 Equitable Adjustments. Who is responsible for payment of the equitable adjustment, the State or Federal Gov't?
- Will the state provide guidance, training seminars on how to collect sales tax as most professional service-only providers have never had to collect and remit a sales tax?
- Will the state provide an incentive or exemption for small businesses that have to invest in additional resources (i.e, consulting services, additional accounting software, etc.) to comply?

Practical and Actionable Solutions for Mitigation of Impacts of HB 352 Tech Tax

Clarify if Existing Maryland Tax Code Would Apply to Small Federal Subcontractors

Based on our research, we think current MD tax code already provides exclusions on "sale for resale"

https://law.justia.com/codes/maryland/tax-general/title-11/subtitle-2/section-11-225/

Specifically *11-101(h)(3)(iii): "A retail sales does not include… a sale of a taxable service if the buyer intends to resell the taxable service in the form that the buyer receives or is to receive the service."*
In the case of a subcontractor/prime contractor relationship with the federal government, this language seems to preclude the subcontractor from having to charge for a service that is passed directly through to the end customer.
Clarification that this would actually cover the situations outlined, subcontracting to a prime on a federal contract, this would help alleviate a lot of the worry of the small business community.
If this existing code does not protect us, to help ensure the Budget Reconciliation and Financing Act is implemented in a way that supports both Maryland's economy and its critical role in national security, we offer the following policy considerations:

Explicit Exemption for Subcontracted National Security Work

Provide a "Sale for Resale Exemption" in the regulation(s) created by the Comptroller. This type of exemption is a well-established and long-standing tradition or precedent for sales taxes. Moving away from this well-established practice would be very disruptive. This exemption could be created broadly for all Federal work, or narrowly for just NSA and/or DoD business. Additional details are provided below.
[This is our preferred approach and would avoid the most serious short and long-term impacts to Maryland's National Security subcontracting community.]

Apply Only to Contracts Priced After July 1st, 2025

Applying only to contracts that are priced or re-priced (rather than simply awarded) after the implementation date will allow subcontractors to adjust their cost models and prices and potentially reduce the impacts to their business.
[This would mitigate the near-term concerns of Maryland's National Security subcontracting community, but it would not address the significant long-term impact on the competitiveness of these businesses.]

Delayed Implementation or Grace Period

Provide a transition window to allow businesses time to assess the forthcoming compliance requirements from the Comptroller, adjust financial models, and engage necessary accounting or legal support.
Delaying the implementation until after the next session of the legislature would provide an opportunity for the impacts of this legislation to be more fully considered. This legislation was rushed forward without thinking of the short-term and long-term impacts to the State.
[This would address the near-term concerns of Maryland's National Security subcontracting community, but it would not address the significant long-term impact on the competitiveness of these businesses.]

Offsetting Tax Credits for Workforce Investment

Consider offering incentives to firms that employ cleared personnel or invest in Maryland-based training, STEM, or community development programs, reinforcing the mutual value between the State and national security contractors.
[This would partially address the near-term concerns of Maryland's National Security subcontracting community and would partially address the long-term impact on its competitiveness.]

Sale for Resale Exemption Implementation Specifics

Example language from Texas: (c) A sale for resale does not include the sale of tangible personal property or a taxable service to a purchaser who acquires the property or service for the purpose of performing a service not listed as a taxable service under Section 151.0101, regardless of whether title transfers to the service provider's customer, unless the tangible personal property or taxable service is purchased for the purpose of performing a contract, or a subcontract of a contract, for a service, including a taxable service under Section 151.0101, with any branch of the Department of Defense, Department of Homeland Security, Department of Energy, National Aeronautics and Space Administration, Central Intelligence Agency, National Security Agency, National Oceanic and Atmospheric Administration, or National Reconnaissance Office to the extent allocated and billed to the contract with the federal government.

Source: https://statutes.capitol.texas.gov/Docs/TX/htm/TX.151.htm#151.0101

- At a minimum, it should be in Maryland's interest to safeguard the economic engine and cybersecurity industry centered on business with Fort Meade. This could be done by exempting at least NSA, but potentially also DISA and DoD (which could include Aberdeen).
- Eligibility for this *Sale for Resale Exemption* would be demonstrated through a *Resale Certificat*e such as the one depicted below. This simple certificate would avoid much of the costly compliance and audit issues the Comptroller is facing in implementing this tax.

Suggested Blanket Resale Certificate

This is to certify that all tangible personal property or taxable services purchased from:

_____

are intended for resale as tangible personal property or for use or incorporation as a material or part of other tangible personal property to be produced for sale.

This certificate shall be considered as a part of each order we shall give, provided that the order bears our Maryland sales and use tax registration number, and is to continue in force until revoked.

Buyer's Name _____ Buyer's Address _____

Signature _____ Buyer's MD Sales and Use Tax Registration No. _____ Date _____