

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Aghazarian Analyst: Darrine Distefano Bill Number: AB 291

Related Bills: See Legislative History Telephone: 845-6458 Introduced Date: 02-05-2003

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Research Expenses Credit/24% of Environmental Research & Development Costs

SUMMARY

This bill would increase the credit rate for the qualified research expense credit for environmental research and development costs.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to encourage businesses to invest in research activities to resolve environmental issues and to stimulate the economy.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are included below to correct technical considerations.

ANALYSIS

FEDERAL/STATE LAW

Existing federal law allows taxpayers a research credit that is combined with several other credits to form the general business credit. The research credit is designed to encourage companies to increase their research and development activities.

To qualify for the credit, research expenses must qualify as an expense or be subject to amortization, be conducted in the U.S., and be paid by the taxpayer. The research must be experimental or laboratory research and pass a three-part test as follows:

1. Research must be undertaken to discover information that is technological in nature. The research must rely on the principles of physical, biological, engineering, or computer sciences.
2. Substantially all of the research activities must involve experimentation relating to quality or to a new or improved function or performance.

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Department Director
Gerald H. Goldberg

Date
03/12/03

3. The application of the research must be intended for developing a new business component. This is a product, process, technique, formula, or invention to be sold, leased or licensed, or used by the taxpayer in a trade or business.

Ineligible expenses include seasonal design factors; efficiency surveys; management studies; market research; routine data control; routine quality control testing or inspection; expenses incurred after production; and development of any plant, process, machinery, or technique for the commercial production of a business component unless the process is technologically new or improved. The federal credit expires June 30, 2004.

California conforms to the federal credit with the following modifications:

- The state credit is not combined with other business credits.
- Research must be conducted in California.
- The credit percentage for qualified research in California is 15% versus the 20% federal credit.
- The credit percentage for basic research in California is limited to corporations and is 24% versus the 20% federal credit.
- The percentages for the alternative incremental research portion of the credit are 90% of the federal percentages, as they existed on January 1, 2000, 1.49%, 1.98%, and 2.48%, respectively.

The existing federal and state research credit does not include any preferential treatment for costs related to environmental research and development. However, those costs are included if it meets the criteria of qualified research.

THIS BILL

For environmental research and development costs that meet the criteria of qualified research, this bill would increase the qualified research expense credit percentage from 15% to 24%. The increase would place the credit percentage above the current federal credit percentage rate of 20%. The increase would specifically apply to taxable years beginning on or after January 1, 2003, and before January 1, 2010.

This bill would add and define the term "qualified costs" to include environmental research and development costs that resolve issues of air and storm water pollution, agricultural discharges, and disposal of electronic equipment.

For taxable years beginning on or after January 1, 2010, this bill would remove both eligibility and the preferential credit rate for environmental research and development costs.

IMPLEMENTATION CONSIDERATIONS

This bill uses a term that is undefined, i.e., "environmental research and development costs." The absence of definitions to clarify this term could lead to disputes between taxpayers and the department and would complicate administration of this credit. It is unclear if this term is intended to augment the current research credit by narrowly expanding the definition of qualified research expense so that environmental costs are qualified so long as those expenditures meet the other requirements of the present credit or if it is intended to include all environmental costs regardless of the present requirements of the credit.

This bill introduces and defines the term "qualified costs." However, this term is not used anywhere else in the research credit.

TECHNICAL CONSIDERATIONS

Recent legislation [AB 1122 (Stats. 2002, Ch. 35)] made two changes to the research credit. It deleted obsolete language and conformed to the increased federal percentages for the alternative incremental research portion of the credit. This bill is drafted using an outdated version of the credit. If this bill were to become law, it appears it would have the unintended effect of repealing the federal conformity amendments made by AB 1122. The author's staff has indicated that these changes were not intended. Therefore, Amendments 1 through 4 are provided below in order to prevent the elimination of the changes made by AB 1122.

LEGISLATIVE HISTORY

AB 1122 (Corbett, Stats. 2002, Ch. 35), among other things, conformed state law to federal changes to the research credit that deleted obsolete language and increased the percentage amounts for the alternative incremental research portion of the credit.

AB 2694 (Hollingsworth, 2001/2002) and AB 2702 (Zettel, 2001/2002) would have increased the state alternative incremental research expense credit to equal the federal credit percentages, as they existed on January 1, 1998. Both bills were held in the Assembly Revenue and Taxation Committee.

AB 660 (Nakano, 2001/2002) and AB 1413 (Hollingsworth, 2001/2002) would have increased the alternative incremental research expense credit to equal the prior federal credit percentages, as they existed on January 1, 1998. AB 660 failed to pass out of the Assembly Appropriations Committee and AB 1413 failed to pass out of the Assembly Revenue and Taxation Committee.

SB 1165 (Brulte, 2001/2002) would have increased the credit for qualified research expenses from 15% to 20%. This bill failed to pass out of the Senate Revenue and Taxation Committee.

AB 465 (Nakano, Stats. 2000, Ch. 103) increased the state alternative incremental research expense credit to 85% of the prior federal amount, instead of the existing 80%.

OTHER STATES' INFORMATION

The laws of the following states were reviewed because their tax laws are similar to California's income tax laws.

Florida excludes from the payroll factor for apportionment purposes compensation attributable to Florida that is dedicated exclusively to research and development activities performed pursuant to sponsored research contracts with a state university or certain nonpublic universities. This exclusion is for corporate income tax purposes only as Florida does not have a personal income tax.

Illinois corporate and individual taxpayers may claim an income tax credit for qualified expenditures that are used for increasing research activities in Illinois. The credit equals 6 1/2% of the qualifying expenditures.

Massachusetts's corporate taxpayers, but not individuals, may claim an income tax credit for qualified expenditures that are used for increasing research activities in Massachusetts. The credit is 15% of the basic research expenses and 10% of qualified research expenses conducted in Massachusetts. If a taxpayer has qualified research expenses for defense related activities, these must be calculated separately from the non-defense related activities.

Michigan corporate taxpayers may claim an income tax credit equal to 6 1/2% of qualified research expenses that relate to their pharmaceutical research and development.

Minnesota corporate taxpayers may claim an income tax credit for those qualified research expenses that are used for increasing research activities in Minnesota. The credit is a fixed based percentage based on Minnesota sales and receipts and qualified research expenses.

New York does not allow a research credit.

None of these states provide an income tax credit specifically for environmental research and development costs.

In addition, none of these states specifically include environmental research and development costs within the current income tax credit. Most of these states use the federal definition for research expenses.

FISCAL IMPACT

This bill is not expected to significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in revenue losses as follows:

Estimated Revenue Impact of AB 291 As Introduced February 5, 2003 Effective for tax years 1/1/2003 Enacted after 6/30/2003 \$ Millions		
2003-04	2004-05	2005-06
-\$30	-\$40	-\$40

Since the bill does not specify the degree of air and storm water pollution reductions necessary to qualify under this bill, this estimate should be considered conservative.

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The above revenue impact was estimated as follows: First, the revenue loss due to existing regular research credit rate of 15% was estimated using a sample of 1998 corporate tax returns claiming a research credit. Next, the revenue loss due to the proposed higher credit rate of 24% was simulated using the same data. The difference between these two amounts is the total revenue impact of raising the regular research credit rate from 15% to 24% for all qualified research expenses. The estimated 1998 sample was projected to future years based on the reported aggregate research credit claimed by California corporations from 1998 to 2000, and the Department of Finance's December 2002 projected annual growth rates of corporate taxable profits.

Finally, the revenue impact for businesses under the Personal Income Tax (PIT) was assumed to be equal to 6.5% of the corporate impact. This 6.5% is the ratio of research credits claimed under PIT law relative to corporations for the 1999 tax year.

The projected amount of research credit claimed under both PIT and Corporation tax laws in 2002/03 under the existing 15% rate is projected to be about \$550 million. If the regular research credit rate is raised from 15% to 24%, the amount of research credit claimed is projected to be \$650 million, an increase of \$100 million. The specific amount attributable to "environmental" abatement is unknown. For this analysis, it is assumed that it could equal one-third of currently qualified research, or about \$30 mil.

It should be noted that the size of the revenue impact depends on the definition of qualified environmental research and development costs. A more precise definition for this term would likely reduce the amount of qualified environmental research costs and therefore the overall revenue impact. As the bill is currently proposed, virtually all research aimed at reducing energy and water consumption, agricultural discharges, and the disposal/size of electronic equipment would qualify for the proposed higher credit rate.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 291
As Introduced February 5, 2003

AMENDMENT 1

On page 4, strikeout lines 37 and 38, and on page 5, strikeout lines 1 to 19 inclusive, and insert:

(g) (1) For each taxable year beginning on or after January 1, 2000:

(A) The reference to "2.65 percent" in Section 41(c)(4)(A)(i) of the Internal Revenue Code is modified to read "one and forty-nine hundredths of one percent."

(B) The reference to "3.2 percent" in Section 41(c)(4)(A)(ii) of the Internal Revenue Code is modified to read "one and ninety-eight hundredths of one percent."

(C) The reference to "3.75 percent" in Section 41(c)(4)(A)(iii) of the Internal Revenue Code is modified to read "two and forty-eight hundredths of one percent."

AMENDMENT 2

On page 7, strikeout lines 18 to 38 inclusive, and insert:

(g) (1) For each taxable year beginning on or after January 1, 2000:

(A) The reference to "2.65 percent" in Section 41(c)(4)(A)(i) of the Internal Revenue Code is modified to read "one and forty-nine hundredths of one percent."

(B) The reference to "3.2 percent" in Section 41(c)(4)(A)(ii) of the Internal Revenue Code is modified to read "one and ninety-eight hundredths of one percent."

(C) The reference to "3.75 percent" in Section 41(c)(4)(A)(iii) of the Internal Revenue Code is modified to read "two and forty-eight hundredths of one percent."

AMENDMENT 3

On page 11, strikeout lines 8 to 29 inclusive, and insert:

(h) (1) For each taxable year beginning on or after January 1, 2000:

(A) The reference to "2.65 percent" in Section 41(c)(4)(A)(i) of the Internal Revenue Code is modified to read "one and forty-nine hundredths of one percent."

(B) The reference to "3.2 percent" in Section 41(c)(4)(A)(ii) of the Internal Revenue Code is modified to read "one and ninety-eight hundredths of one percent."

(C) The reference to "3.75 percent" in Section 41(c)(4)(A)(iii) of the Internal Revenue Code is modified to read "two and forty-eight hundredths of one percent."

AMENDMENT 4

On page 15, strikeout lines 8 to 28 inclusive, and insert:

(h) (1) For each taxable year beginning on or after January 1, 2000:

(A) The reference to "2.65 percent" in Section 41(c)(4)(A)(i) of the Internal Revenue Code is modified to read "one and forty-nine hundredths of one percent."

(B) The reference to "3.2 percent" in Section 41(c)(4)(A)(ii) of the Internal Revenue Code is modified to read "one and ninety-eight hundredths of one percent."

(C) The reference to "3.75 percent" in Section 41(c)(4)(A)(iii) of the Internal Revenue Code is modified to read "two and forty-eight hundredths of one percent."