Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Escutia | Analyst: Marion Mann DeJong | Bill Number: SB 1501

Related Bills: See Legislative History | Telephone: 845-6979 | Amended Date: 03/25/2004

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Research Expenses Credit/Reduce To 10% Of Excess/FTB Report To Controller Additional Money Accrued As A Result Of Decreased Credit & Assist Preparing Report

SUMMARY

This bill would reduce the amount of the research credit. Revenue increases resulting from reducing this credit would be used to fund grants for student financial aid.

This analysis will not address the bill's student financial aid provision, as it does not impact the department or state income tax revenue.

SUMMARY OF AMENDMENTS

The March 25, 2004, amendments deleted the provisions of the bill as introduced, relating to school facilities and inserted the provisions relating to the research credit and student financial aid. This is the department's first analysis of this bill.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to provide a steady source of financial aid for higher education to low-income students.

EFFECTIVE/OPERATIVE DATE

As an urgency statute, this bill would become effective immediately upon enactment. The bill specifies that the changes to the research credit would apply to taxable years beginning on or after January 1, 2004.

POSITION

Pending.

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.

Board Position:			Department Director	Date
_____ S	_____ NA	_____ NP		
_____ SA	_____ O	_____ NAR	Gerald H. Goldberg	4/16/04
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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.
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, so the California percentages are 1.49%, 1.98%, and 2.48%, respectively.

<u>THIS BILL</u>

For taxable years beginning on or after January 1, 2004, this bill would reduce the credit percentage for qualified research in California from 15% to 10%. The credit percentage for basic research in California for corporations would be reduced from 24% to 20%. Revenue increases resulting from reducing this credit would be used to fund grants for student financial aid.

This bill would also require the Franchise Tax Board to estimate the amount of money that accrued during the previous fiscal year as a result of the reduction of the research credit. This estimate would be due on June 1, 2005, and June 1 of each fiscal year thereafter. Thus, on June 1, 2005, the department would estimate the amount of money accrued from January 1, 2004, the date the bill is operative, to June 30, 2004, the end of the fiscal year immediately preceding June 1, 2005.

This bill would require the Franchise Tax Board to assist the Controller in preparing an annual report regarding the money transferred to the Student Aid Commission as a result of this bill.

IMPLEMENTATION CONSIDERATIONS

This bill would require the department to estimate the amount of revenue increase resulting from this bill during the 2003/04 fiscal year by June 1, 2005, with a similar estimate each fiscal year thereafter. These amounts would then be transferred to the Student Aid Commission for disbursement. The author should note that the estimate would occur before actual revenue is received since returns can be filed up to six months after the end of a taxable year (e.g. October 15, 2005, for calendar year taxpayers). In addition, the bill does not provide a method to adjust subsequent estimates once actual data is available for a prior year.

LEGISLATIVE HISTORY

AB 291 (Aghazarian, 2003/2004) would have increased the credit rate for the qualified research expense credit for environmental research and development costs. AB 291 failed to pass the house of origin by the constitutional deadline.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. *Florida* and *New York* do not allow a research credit, but the other states provide the following credits.

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 6.5% 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 6.5% 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.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of SB 1501 As Amended March 25, 2004 Effective for tax years beginning on or after 1/1/2004 Enacted by 5/1/2004 $ Millions				
	2003-04	2004-05	2005-06	2006-07
Lower research credit rate	+$2	+$28	+$40	+$40

All revenue gains would be transferred to the Student Aid Commission for educational expenditures.

This analysis does not consider the possible 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 gain due to reducing the qualified research rate from 15% to 10%, and basic research rate from 24% to 20% was estimated for 1998 using a sample of corporate tax returns. Data from 1998 was used because that is the most recent data available for special samples.

Next, the estimated 1998 revenue gain was extrapolated to future years based on reported aggregate research credit claimed by California corporations from 1998 to 2002, and Department of Finance December 2003 projected annual growth rates of corporate taxable profits. Finally, the revenue impact for businesses subject to the Personal Income Tax law was assumed to be equal to 5% of the corporate impact. This 5% is the ratio of research credits claimed under Personal Income Tax law relative to corporations for the 2001 tax year.

The projected amount of research credits claimed under both Corporate and Personal Income Tax laws in 2003/04 under the existing 15% rate is projected to be about $450 million, which includes prior year carryovers. If the qualified research rate is lowered to 10%, the amount of research credits reduces by $120 million. Since many corporations have carryover research credits, a smaller portion of this amount, 30%, actually results in a revenue savings. The net revenue gain is ($120)(30%) = $36 million for taxable year 2004, $28 million for fiscal year 2004/05.

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