Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Lieu | Analyst: Rachel Coco | Bill Number: AB 2032

Related Bills: See Legislative History | Telephone: 845-4328 | Introduced Date: February 14, 2006

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Research Expenses Credit/Increase Amount

SUMMARY

This bill would increase the amount of the qualified Research Expense credit for increasing research expenditures from 15% to 18%.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to increase the amount of the credit for increasing research expenditures in order to continue encouraging businesses to increase their research and development programs.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment. The increase in the credit percentage for increasing research expenditures would be operative for taxable years beginning on or after January 1, 2007.

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.

To qualify for the credit, research expenses must qualify as an expense or be subject to amortization, be incurred 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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3. The application of the research must be intended for developing a new or improved 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; or 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 does not apply to any expenses incurred after December 31, 2005. There is pending federal legislation, S 2020, which would extend the credit to apply to expenses incurred during 2006.

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 expenses in California is 15% versus the 20% federal credit.
- The credit percentage for basic research payments in California, limited to corporations, is 24% versus the 20% federal credit.
- The percentages for the alternative incremental research portion of the credit are less than the federal credit.

The California research credit is allowed for taxable years beginning on or after January 1, 1987, and is permanent.

THIS BILL

This bill would increase the amount of the qualified research expense credit from 15% to 18% for taxable years beginning on or after January 1, 2007.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill could be accomplished during the department's normal annual updates.

LEGISLATIVE HISTORY

AB 2567 (Arambula, 2005/2006) would conform the amount of the qualified research expense credit to the amount allowed at the federal level. AB 2567 is currently awaiting committee assignment at the Assembly rules desk.

AB 483 (Harman, 2001/2002) and SB 1165 (Brulte, 2001/2002) both would have increased the credit for qualified research expenses from 15% to 20%. AB 483 was held in the Senate Revenue and Taxation Committee. SB 1165 failed to pass out of the originating house by the constitutional deadline.

AB 511 (Stats. 2000, Ch. 107) increased the state credit for qualified research expense from 12% to 15%.

SB 705 (Stats. 1999, Ch. 77) increased the state credit for qualified research expense from 11% to 12%.

PROGRAM BACKGROUND

The department annually releases a report on state tax expenditures. Appendix 1 contains information from the 2005 State Tax Expenditure Report regarding the usage of the Research Expenses Credit.

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.

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 allows corporate taxpayers to 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 payments and 10% of qualified research expenses conducted in *Massachusetts*.

Minnesota allows corporate taxpayers a credit equal to 5% for qualified research expenses up to $2 million. The amount of the credit is reduced to 2.5% for expenses exceeding the first $2 million.

Beginning in 2005, *New York* allows a credit for qualified emerging technology companies. The credit is equal to 18% of the cost of research and development property, 9% of the qualified research expenses, or the costs of high-technology training expenditures paid by the taxpayer. The credit is limited to $250,000 per taxable year.

Florida does not allow a research credit.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses:

Estimated Revenue Impact of AB 2032 As introduced February 14, 2006 Assumed Enactment by 6/1/2006 $ Millions				
	2006-07	2007-08	2008-09	2009-10
Increase Research Expense Credit percentage	-$15	-$55	-$55	-$60

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The above revenue impact was estimated as follows. First, the revenue loss due to higher regular research credit rate was estimated for 2003 using a sample of corporate tax returns. For each corporation in the sample, the additional amount of research credit that could be generated under the new law was simulated taking into account its incremental qualified research expenses, and the new and higher research credit rate. Not all additional generated research credit could be used to reduce taxes in the current year. Corporations with high tax liabilities might be able to use all additional generated research credit to reduce their taxes in the current year. Corporations with low tax liabilities might have to carry some or all additional generated research credit over to future years. The simulated revenue impact for each corporation was then statistically weighted and summed up to the population level. Next, the estimated 2003 revenue loss was extrapolated to future years based on DOF projected annual growth rates of corporate taxable profits as of October 2005. Finally, the revenue impact for businesses under the PIT law was assumed to be equal to 6 percent of the corporate impact. This 6 percent is the ratio of research credits claimed under PIT law relative to corporations for the 2003 tax year.

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Appendix I

Research and Development Expenses Credit

This provision allows taxpayers to claim a credit for a portion of their incremental R&D expenses. Incremental expenses are calculated as increases in the ratio of a taxpayer's current-year R&D expenses to gross sales relative to a four-year base period. The credit is equal to 15 percent of qualified incremental R&D expenses, and 25 percent of qualified incremental "basic" R&D expenses. Basic R&D is research conducted at qualified universities or scientific research organizations. Since 1998, California has allowed taxpayers to elect an alternative formula for calculating their R&D credit based upon a relative percentage of the Federal Alternative Incremental Credit amount (as adjusted for the difference in the California and federal credit percentages). Once made, the alternative formula election is binding for all future years.

Amount:
In tax year 2002, the amount of credits applied was $25 million under PIT, and $422 million under the Corporate Tax.

Number of Tax Returns Affected:
In tax year 2002, credits were applied on 2,312 PIT returns and 1,666 Corporate Tax returns.

Distributional Analysis:
The tables below present information on the distribution of R&D credits by size of firm and by industry. Firms with gross receipts greater than $1 billion account for only two percent of returns claiming the R&D credit, but 33 percent of credits used. The Manufacturing sector accounts for over 50 percent of the number of returns and over 60 percent of the amount of R&D credit applied. Within this sector, pharmaceuticals claimed the largest amount of R&D credit, accounting for just over 2 percent of returns but almost 37 percent of R&D credit applied.

Distribution of Research and Development Credit Used by Size of Gross Receipts: 2002

Size of Gross Receipts	Returns and Credit		Percent of Total	
	Returns	Credit Applied ($ Millions)	Returns	Credit Applied
Above $1 billion	30	138	2%	33%
$500 million - $1 billion	128	189	8%	45%
$100 - $500 million	14	14	1%	3%
$50 - $100 million	382	45	23%	11%
$10 - $50 million	100	15	6%	4%
Below $10 million	986	13	59%	3%
Unknown	26	8	2%	2%
Total	1,666	422	100%	100%

Research and Development Credits Applied by Industrial Subsector: 2002				
Industrial Subsector	Returns and Credit		Percent of Total	
	Returns	Credit Applied ($ Millions)	Returns	Credit Applied
Food and Kindred Products	165	3	10%	1%
Chemicals and Allied Products	55	11	3%	3%
Pharmaceuticals	20	96	1%	23%
Electrical and Electronic Equipment	234	90	14%	21%
Other Manufacturing	374	62	22%	15%
Other	818	161	49%	38%
Total	1,666	422	100%	100%

Source: 2002 Corporate Tax Sample
Detail may not add to total due to rounding

Discussion:
The California R&D credit is a credit that normally is taken in conjunction with the Federal Research Credit. The calculation of the amount of research expenses creditable in California generally conforms to the calculation for federal purposes, with the exception that the California credit only applies to research activities conducted in California.

At the federal level, there are two reasons to encourage R&D. The first is that, without extra incentives, industry will typically do less R&D work than would be optimal for society. This is because R&D activity often produces "positive externalities;" i.e., benefits to people other than the person doing the R&D. The federal R&D credit reduces the after-tax cost of R&D investments, which should lead to an increase in R&D activity. Since state R&D credits also reduce the after-tax cost of R&D, they too will induce an increase in the overall level of R&D spending. The second purpose of the federal R&D credit is to encourage taxpayers to do their R&D in the United States, rather than in another country.

Since the structure of the California R&D credit generally conforms to that of the federal credit, the California credit will produce both of these same effects. It will contribute to an overall increase in R&D activity, and it will encourage R&D activity to be undertaken in California rather than elsewhere. Because California's contribution to total R&D spending is smaller than the federal government's contribution, the first effect – global increases in R&D activity -- is somewhat less important to state policy than to federal policy. The second effect -- regional competition -- is a relatively more important motivator for state policy. This is because it may be easier for some R&D firms to move their activity to another state than it would be for them to move it to another country, and many states besides California offer R&D credit. Therefore, a California credit may be necessary for the state to remain competitive with these other states in attracting and maintaining research business activity.

Both effects of the California R&D credit, the increase in the overall amount of R&D activity, and the increase in the proportion of this activity that takes place in California must be considered in evaluating the success of the California R&D credit. The desirability of the increase in overall R&D activity is dependent on the level of the federal R&D credit (and credits offered by other states and countries). If the federal credit is too low, the added R&D incentives provided by states collectively could generate productive additional R&D activity. Alternatively, if the federal credit has already induced optimal levels of R&D, any increases in overall R&D spending induced by additional state credits will be inefficient and hurt overall economic performance. It is not known whether the federal R&D credit is currently set at the optimal level.

The R&D credit may be viewed as successfully maintaining the competitiveness of the California R&D industry only if R&D activity is undertaken in California that would not have been undertaken here in the absence of the credit. The amount of R&D activity that would not have taken place in California in the absence of the credit is unknown. Credits granted for R&D that would have occurred even in the absence of the credit may be considered a windfall.

There are two possible benefits to attracting the R&D business to California. The first is the addition of the R&D jobs themselves. If this were the only benefit, the R&D industry should be singled out for this special benefit only if jobs in this industry are substantially more desirable than jobs in other industries in the state. The second potential benefit from bringing R&D to California is that other California businesses may be able to adopt innovations developed locally more rapidly than they can adopt innovations developed elsewhere. If this is the case, many California businesses, not just those receiving this credit, will gain an advantage over their rivals in other states. This advantage is not a result of being able to obtain technological information more quickly. Given the global communications network, information can be transported across continents relatively quickly and costlessly. The advantage to California may come through something economists call *economies of agglomeration. Economies of agglomeration* are defined as “a reduction in production costs that results when firms in the same or related industries locate near one another.”

Thus, for example, if the R&D credit encourages some pharmaceutical companies to locate their research facilities in an area of California, that will, likewise, encourage the growth of pharmaceutical research support firms (such as material suppliers, pharmaceutical manufacturers, universities doing biological and chemical research, chemical engineers) to be attracted to that area. Subsequently, with the growth of the support industries, other pharmaceutical firms will be attracted to the area. There are clearly many agglomeration economies within California (high-technology in Silicon Valley and motion pictures in Hollywood are two obvious examples). However, many factors contribute to the development and growth of agglomeration economies. Because of the complexity of agglomeration economies, the extent to which the California R&D credit has actually encouraged the development or growth of any agglomeration economies is not known.

We also note that less than one-third of this credit is actually available to reduce tax in the year that it is generated. The inability to use the credit (because of a lack of tax to reduce) undoubtedly reduces the incentive provided by the existence of the credit.