

SUMMARY ANALYSIS OF AMENDED BILL

Author: Buchanan, et al. Analyst: Jahna Alvarado Bill Number: AB 1565
 Related Bills: See Prior Analyses Telephone: 845-5683 Amended Date: June 9 and June 16, 2010
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Research And Development Tax Credit Area

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED

May 28, 2009, STILL APPLIES.

OTHER – See comments below.

SUMMARY

This bill would establish the Research and Development Tax Credit Area (RDTCA) program and would allow a tax credit for qualified taxpayers conducting research within a designated RDTCA.

SUMMARY OF AMENDMENTS

The June 9, 2010, amendments removed all of the bill’s provisions that would have modified the research credit and replaced them with provisions that would establish the RDTCA program and RDTCA research income tax credit.

The June 16, 2010, amendments added provisions that would exclude existing geographically targeted economic development areas (G-TEDAs) from an RDTCA, modify the RDTCA research credit, modify the definition of qualifying research, and add several coauthors.

As a result of the amendments, the “Purpose Of The Bill,” “Effective/Operative Date,” “Federal Law,” “State Law,” “This Bill,” “Implementation Considerations,” “Technical Considerations,” “Fiscal Impact,” and “Economic Impact” discussions have been revised.

Board Position:	Asst. Legislative Director	Date
<input type="checkbox"/> S <input type="checkbox"/> NA <input type="checkbox"/> NP <input type="checkbox"/> SA <input type="checkbox"/> O <input type="checkbox"/> NAR <input type="checkbox"/> N <input type="checkbox"/> OUA <input checked="" type="checkbox"/> PENDING	Patrice Gau-Johnson	06/23/10

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to create new permanent jobs in California and promote economic development and environmental protection by establishing a tax credit for research and development occurring within a designated area.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2011, and before January 1, 2016.

POSITION

Pending.

Summary of Suggested Amendments

Amendments 1 and 2 are suggested to correct an inconsistent reference. Amendment 3 is provided to suggest appropriation language to fund the department's costs to implement the provisions of this bill.

ANALYSIS

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

FEDERAL 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.

The research credit for personal income tax taxpayers is determined as the sum of:

1. 20 percent of the qualified research expenses incurred during the taxable year that exceeds the base amount, as defined, and
2. 20 percent of the amount paid or incurred during the taxable year on research undertaken by an energy research consortium.

In addition to the two components listed above, corporate taxpayers are allowed a credit of 20 percent of expenses paid to fund basic research at universities and certain nonprofit scientific research organizations.

Prior to January 1, 2009, federal law allowed a taxpayer to elect the alternative incremental credit method to determine their research credit.

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; 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 paid or incurred after December 31, 2009.¹

Existing federal law provides special tax incentives for empowerment zones and enterprise communities to provide economic revitalization of distressed urban and rural areas.

STATE LAW

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 percent versus the 20 percent federal credit.
- The credit percentage for basic research in California is limited to corporations (other than S Corporations, personal holding companies, and service organizations) and is 24 percent versus the 20 percent federal credit.
- The percentages for the alternative incremental research portion of the credit are 1.49 percent, 1.98 percent, and 2.48 percent, which varies from the federal percentages (2.65 percent, 3.20 percent, and 3.75 percent) as they existed on the current conformity date of January 1, 2005.²

¹ Emergency Economic Stabilization Act of 2008 (Public Law 110-343).

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

Corporate taxpayers that are members of a combined reporting group may make a one-time, irrevocable assignment of eligible credits, as defined, to an eligible assignee, as defined. Assigned credits can reduce tax for taxable years beginning on or after January 1, 2010.

Under the Government Code, existing state law provides for the designation of enterprise zones (EZs), Local Agency Military Base Recovery Areas (LAMBRAs), a Targeted Tax Area (TTA), and two Manufacturing Enhancement Areas (MEAs). Using specified criteria, the Department of Housing and Community Development (DHCD) designates these economic development areas from the applications received from the governing bodies.

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within economic development areas. These incentives include a sales or use tax credit, hiring credit, business expense deduction, and special net operating loss treatment. Two additional incentives include net interest deduction for businesses that make loans to businesses within the economic development areas and a tax credit for employees working in an enterprise zone.

Effective January 1, 2011, the state's general conformity date will change to January 1, 2009, for taxable years beginning on or after January 1, 2010. As a result, this bill's references to the Internal Revenue Code would be references to the Internal Revenue Code in effect as of January 1, 2009.

THIS BILL

This bill would, under the Government Code, authorize the Department of Housing and Community Development (DHCD), until January 1, 2016, to designate RDTCA and would establish a tax credit for research expenses paid or incurred by qualified taxpayers operating a trade or business within a designated RDTCA.

RDTCA designations would be limited to areas located within the jurisdiction of a city incorporated on or after July 1, 2000, or an Innovation Hub (iHub) designated by the Business, Transportation and Housing Agency.

² The federal rates were increased for taxable years beginning on or after January 1, 2007, to 3 percent, 4 percent, and 5 percent respectively. Tax Relief and Health Care Act of 2006, section 104(b) (P.L. 109-432).

A city or iHub jurisdiction would be authorized to submit a proposal requesting an RDTCA designation that would include the geographical boundaries of the proposed RDTCA, and the expected number of targeted new, permanent jobs that would be created. Each proposal would be evaluated on the following criteria:

- The benefit to the state from the proposed RDTCA that exceeds the expected tax credit that this bill would allow;
- The increase in new, permanent jobs within the state attributable to the proposed RDTCA;
- The reduction of greenhouse gases, air or water pollution, or energy consumption beyond the requirements of federal or state law or regulations;
- The increase in energy efficiency beyond the requirements of federal or state law or regulations; and
- Any other factor DHCD deems appropriate.

The RDTCA research credit that this bill would allow would be available to qualified taxpayers for taxable years beginning on or after January 1, 2011, and before January 1, 2016, and would be in lieu of the existing research credit. The RDTCA research credit would be calculated similarly to the existing research credit with the exception that the percentage of excess research expenses that would be allowed as a credit would be increased from 15 percent to 20 percent.

A qualified taxpayer would be defined as a taxpayer that conducts research and development within a research and development tax area in the alternative energy sources or advanced transportation technologies fields, as defined.

Research and development tax area would be defined as a research and development tax area established within the state pursuant to Government Code section 7092, but excluding any area designated as an EZ, TTA, MEA, or LAMBRA, collectively referred to as G-TEDAs.

The RDTCA research credit would be limited to the amount of tax due on income earned within the RDTCA and would not be eligible for assignment to unitary affiliates.

Any credit amount in excess of the tax attributable to RDTCA income could be carried forward until exhausted. Utilization of the amount carried forward would be limited to qualified taxpayers that perform research and development within a research and development area during the taxable year the carryforward amount would be applied.

This bill would define a number of terms and phrases, including, "city," "department," "iHub," "Research and Development Tax Credit Area," "area," "alternative sources," "advanced transportation technologies," "research and development," and "research and development tax area."

This bill would require the Legislative Analyst's Office to provide a report on the effectiveness of the RDTCA program to the Legislature. The report would be due between January 1, 2016, and December 31, 2016, and would be required to include the following evaluating factors:

- The number of jobs created within California by the RDTCA program;
- The number of businesses that remained in or relocated to California as a result of the RDTCA program;
- The amount of state and local revenue and economic activity generated by the RDTCA program; and
- The amount of reduction in greenhouse gases, air pollution, water pollution, or energy consumption as a result of the program.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill would allow a credit for taxpayers engaged in research and development activity within a designated area that is in either the alternative energy sources or advanced transportation technologies fields. Typically, credits involving areas for which the department lacks expertise are certified by another agency or agencies that possess the relevant expertise. The certification language would specify the responsibilities of both the certifying agency and the taxpayer.

The RDTCA research credit would be allowed in lieu of the existing research credit. Because of structural differences between the RDTCA research credit and the existing research credit, (e.g. the RDTCA credit would be limited to the tax attributable to RDTCA income and would be ineligible for assignment to unitary affiliates), a taxpayer that would be eligible for the existing research credit and a "qualified taxpayer" for the RDTCA research credit could prefer the existing research credit. For clarity, the author may wish to amend this bill to explicitly state that the RDTCA research credit would be controlling in these situations if that is the author's intent.

Because the definition of "research and development tax area" in the Revenue and Taxation Code would exclude specified G-TEDAs, it is unclear whether a taxpayer that operated within an RDTCA as defined under the Government Code, whose boundaries partially overlapped the boundaries of a specifically excluded G-TEDA, would be a "qualified taxpayer" for purposes of the RDTCA research credit. Lack of clarity could lead to disputes between taxpayers and the department and would complicate the administration of this credit.

It is unclear whether amounts paid by a qualified taxpayer to a recipient that is located outside of an RDTCA would be considered research conducted within an RDTCA. If it is the author's intention that "conducted within an RDTCA" would include all payments made by a qualified taxpayer without regard to the location of the recipient, the author may wish to amend this bill.

It is unclear whether the term “area” as used in the definition of “research and development tax area” means “area” as it would be defined in the Government Code, or as defined for common use. Because lack of clarity could lead to disputes between taxpayers and the department and would complicate the administration of this credit, it is suggested that this bill be amended.

Because this bill is silent on the expiration of an RDTCA designation, an RDTCA designation would remain in effect in perpetuity. If it is the author’s intention that RDTCA designations would be effective for a limited period, this bill should be amended.

This bill does not limit the number of years for the carryover period. The department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits typically are exhausted within eight years of being earned.

TECHNICAL CONSIDERATIONS

Paragraph (3) of subdivision (b) of sections 17052.66 and 23609.66 of the Revenue and Taxation Code refers to the phrase “research and development tax area” as defined in Chapter 12.9 of the Government Code. These references need to be amended, as it should be “research and development tax credit area” to correspond to the definition in the Government Code. Amendments are provided.

LEGISLATIVE HISTORY

AB 2428 (Buchanan, 2009/2010) would have established a 10-year Green Technology Zone Pilot Program and two credits for taxpayers subject to the Personal Income Tax Law that operated a trade or business within a designated green technology zone. The geographically designated zone that AB 2428 would have authorized is similar to the research and development tax credit area that this bill would authorize. AB 2428 was held in the Assembly Revenue and Taxation Committee.

AB 1527 (Arambula, 2007/2008) would have, among other things, established a 20 percent credit for research conducted in California that would have been dedicated to the development of cleantech technologies. AB 1527 failed to pass out of the Assembly Committee on Revenue and Taxation 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 allows corporate taxpayers to claim a corporate income tax credit for tax years beginning on or after January 1, 2007, and before January 1, 2011, for certain “eligible costs” for renewable energy technologies investment. To be eligible for this credit, a taxpayer must apply for, and receive, an allocation from the Florida Energy and Climate Commission (prior to July 1, 2008, to the Department of Environmental Protection). Allocations are made on a first-come, first-served basis and the certificate of allocation must be filed with the tax return. *Florida* lacks a comparable credit for personal income taxpayers because *Florida* has no state personal income tax.

The *Illinois* income tax credit for qualified expenditures that are used for increasing research activities in *Illinois* is unavailable for tax years beginning on or after July 30, 2009.

Massachusetts allows corporate taxpayers to claim an excise tax credit for qualified expenditures that are used for increasing research activities in *Massachusetts*. The credit is equal to 15 percent of the basic research payments and 10 percent of qualified research expenses. *Minnesota* allows two credits for research and development: a general nonrefundable credit available to all businesses, and a refundable credit allowed to a qualified business for increasing research activities in a biotechnology and health sciences zone. The credit is equal to 5 percent for qualified research expenses up to \$2 million; for expenses exceeding the first \$2 million, the amount of the credit is reduced to 2.5 percent.

Michigan allows corporate taxpayers a credit of 1.9 percent of the expenses of the research and development activities conducted in *Michigan*, and a credit of 3.9 percent of the compensation for services, not to exceed \$2 million per taxable year, performed in hybrid technology research and development. To qualify for the hybrid technology research and development credit, the taxpayer must have entered into an agreement before April 1, 2007, with the Michigan Economic Growth Authority. For taxable years 2009 and 2010, *Michigan* allows corporate taxpayers, upon approval by the Michigan Economic Growth Authority, a refundable credit of 30 percent of the qualified contributions to a qualified research and development business, not to exceed \$300,000.

New York allows a credit for qualified emerging technology companies. The credit is equal to 18 percent of the cost of research and development property, 9 percent of the qualified research expenses, and the cost of qualified high-technology training expenditures, limited to \$4,000 per employee, per year. The credit is limited to \$250,000 per taxable year per taxpayer. Any excess credit can be refunded or applied as a payment for the following taxable year.

FISCAL IMPACT

Staff estimates a cost of approximately \$66,000 to develop, program, and test system changes. Due to the current fiscal environment and the need for increased resources necessary to implement other pending bills, implementation of this bill is contingent on funding. Accordingly, suggested language is provided in Amendment 3 to fund the department’s implementation costs for this bill. If this bill is enacted without appropriation language, the department will pursue a budget augmentation (“legislative budget change proposal”) through the normal budgetary processes, which could delay implementation of the bill’s provisions to July 1, 2011. If approval of a legislative budget change proposal is denied, the department may be unable to implement the provisions of this bill.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB1565 As Amended June 16, 2010 Operative For Tax Years Beginning On or After January 1, 2011, and Before January 1, 2016 Enactment Assumed by September 30, 2010 (\$ in Millions)		
2010-11	2011-12	2012-13
-\$2	-\$9	-\$20

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

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1565
AS AMENDED JUNE 16, 2010

AMENDMENT 1

On page 4, line 39, after "tax" insert:

credit

AMENDMENT 2

On page 8, line 27, after "tax" insert:

credit

AMENDMENT 3

On page 11, after line 28, insert:

SEC. 6. The sum of Sixty six thousand dollars (\$66,000) is hereby appropriated to the Franchise Tax Board in augmentation of its support budget.