

Franchise Tax Board

**ANALYSIS OF ORIGINAL BILL**

Author: Dutton, et al. Analyst: Jahna Alvarado Bill Number: SBX6 9  
Related Bills: See Legislative History Telephone: 845-5683 Introduced Date: February 24, 2010  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Research Expense Credit/20 Percent Of Excess Qualified Expenses/Conformity To Election Of Alternative Incremental Credit

**SUMMARY**

This bill would do the following:

- Conform to the federal credit percentage for increasing research activities; and
- Conform to the federal alternative incremental research credit (AIC) percentages in effect on January 1, 2005.

**PURPOSE OF THE BILL**

According to the author’s office, the purpose of this bill is to spur innovation and economic development in the state.

**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, 2010.

**POSITION**

Pending.

**SUMMARY OF SUGGESTED AMENDMENTS**

According to the author’s office, this bill seeks to conform to the federal AIC percentages in effect as of January 1, 2007. Amendments 1, 2, 4, and 5 are provided to achieve this result.

The recent enactment of SB 401 (Stats. 2010, Ch. 14) raises a technical consideration; amendments 3 and 6 are provided to resolve that concern.

Board Position:	Department Director	Date
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## **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 (PIT) 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 AIC 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.<sup>1</sup>

## 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; and
- 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.<sup>2</sup>

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.

## THIS BILL

Under the Personal Income Tax Law and the Corporation Tax Law, this bill would, for taxable years beginning on or after January 1, 2010:

- Increase the credit for increasing qualified research expenses from 15 percent to 20 percent; and
- Increase the state's AIC percentages to equal the federal percentages in effect on January 1, 2005. Thus, the former federal percentages of 2.65 percent, 3.20 percent, and 3.75 percent, would apply for state purposes.

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<sup>1</sup> Emergency Economic Stabilization Act of 2008 (Public Law 110-343).

<sup>2</sup> 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).

## IMPLEMENTATION CONSIDERATIONS

This bill would raise the current State AIC percentages to the federal percentages on January 1, 2005, because the State is in conformity with the federal law as of that date. The author has indicated that the intent is for the State to be in conformity with the federal percentages of 3 percent, 4 percent, and 5 percent set forth in the Tax Relief and Health Care Act of 2006. Amendments 1, 2, 4, and 5 are provided to resolve this concern.

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

## TECHNICAL CONSIDERATIONS

Effective January 1, 2011, the state's general conformity date will change to January 1, 2009. Because this change affects the research credit that this bill would allow, the author may wish to amend this bill to prevent chaptering out changes made by the recently enacted bill, SB 401 (Stats. 2010, Ch. 14). Amendments 3 and 6 are provided to resolve this concern.

## **LEGISLATIVE HISTORY**

AB 1484 (Anderson, 2009/2010) would have made the identical changes to the research credit as this bill. AB 1484 failed to pass out of the Assembly Revenue and Taxation Committee by the constitutional deadline.

AB 2278 (Anderson, 2009/2010) would make the same changes to the research credit as this bill with the exception that AB 2278 would conform to the federal AIC percentages in effect as of January 1, 2007. AB 2278 is currently on suspense in the Assembly Revenue and Taxation Committee.

SB 444 (Ashburn, 2009/2010) would have made the same changes to the research credit as this bill with the exception that SB 444 would have applied to taxable years beginning on or after January 1, 2009. SB 444 failed to pass out of the Senate Committee on Revenue and Taxation by the constitutional deadline.

SBX8 58 (Dutton, Runner, 2009/2010) would have made the same changes to the research credit as this bill. SBX8 58 failed to pass out of the Senate Committee on Rules.

AB 751 (Leiu, et al., 2007/2008) would have made the same changes to the research credit as this bill with the exception that AB 751 would have applied to taxable years beginning on or after January 1, 2007. AB 751 failed to pass out of the Assembly Revenue and Taxation Committee by the constitutional deadline.

SB 359 (Runner, 2007/2008) would have, among other things, increased the credit for increasing research expenses from 15 percent to 16 percent and conformed to the federal AIC. SB 359 failed to pass out of the Senate Committee on Revenue and Taxation by the constitutional deadline. The provisions of SB 359 conforming to the federal AIC are the same as this bill.

SB 928 (Harman, 2007/2008) would have, among other things, raised the credit for increasing qualified research expenses from 15 percent to 20 percent and conformed to the federal AIC rates for taxable years beginning on or after January 1, 2007. SB 928 failed to pass out of the Senate Committee on Revenue and Taxation by the constitutional deadline. The provisions of SB 928 conforming to the federal AIC are the same as this bill.

AB 2032 (Lieu, 2005/2006) would have increased the amount of the credit for increasing research expenses from 15 percent to 18 percent. AB 2032 failed to pass out of the Assembly Revenue and Taxation Committee.

AB 2567 (Arambula, 2005/2006) would have conformed the amount of the credit for increasing research expenses to the amount allowed at the federal level. AB 2567 failed to pass out of the Assembly Revenue and Taxation Committee.

AB 483 (Harman, 2001/2002) and SB 1165 (Brulte, 2001/2002) would have increased the credit for increasing research expenses from 15 percent to 20 percent. 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 (Alquist, Stats. 2000, Ch. 107) increased the state credit for increasing research expenses from 12 percent to 15 percent.

## **PROGRAM BACKGROUND**

The department annually releases a report on state tax expenditures. The 2009 State Tax Expenditure Report contains information regarding the usage of the Research Expense Credit. The relevant section is attached as Appendix A. The entire report can be viewed by accessing: [http://www.ftb.ca.gov/aboutftb/Tax\\_Expenditure\\_Report\\_2009.pdf](http://www.ftb.ca.gov/aboutftb/Tax_Expenditure_Report_2009.pdf).

## **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, for certain "eligible costs" for renewable energy technologies investment. *Florida* lacks a comparable credit for personal income taxpayers because *Florida* has no state PIT.

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 15 percent of the basic research payments and 10 percent of qualified research expenses conducted in *Massachusetts*. Effective for taxable years beginning on or after January 1, 2009, and before January 1, 2018, a certified life sciences company is allowed the credit on expenditures for specified research activity that takes place both within and outside of *Massachusetts*.

*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 \$2,000,000 per taxable year, performed in hybrid technology research and development. To qualify for the 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 a credit of 30 percent of the qualified contributions to a qualified research and development business, not to exceed \$300,000. *Michigan* does not allow a credit for pharmaceutical research.

*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.

*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. Any excess credit can be refunded or applied as a payment for the following taxable year.

**FISCAL IMPACT**

This bill would not impact the department’s costs.

**ECONOMIC IMPACT**

Revenue Estimate

This bill would result in the following revenue losses:

Estimated Revenue Impact of SBX6 9 As Introduced February 24, 2010 Operative For Taxable Years Beginning On or After January 1, 2010 Enactment Assumed After June 30, 2010 (\$ in Millions)				
	2010-11	2011-12	2012-13	2013-14
Total revenue impact	-\$175	-\$165	-\$155	-\$150

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

## **ARGUMENTS/POLICY CONCERNS**

This bill would continue to allow the AIC and, due to general conformity, would conform to the federal AIC percentages in effect on January 1, 2005. Under federal law, the AIC was terminated at the federal level for taxable years beginning after December 31, 2008.<sup>3</sup> The federal change creates additional differences between federal and California tax law, thereby increasing the complexity of California tax return preparation. If conformity with federal law is the author's intent, the author may wish to amend this bill to eliminate the AIC election and allow the alternative simplified credit.

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<sup>3</sup> Emergency Economic Stabilization Act of 2008 (Public Law 110-343).

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SBX6 9  
AS INTRODUCED FEBRUARY 24, 2010

AMENDMENT 1

On page 3, line 26, after "Code," insert:  
as amended by Section 104(b) of Public Law 109-432,

AMENDMENT 2

On page 3, line 27, strike "apply." and insert:  
apply, except as otherwise provided.

AMENDMENT 3

On page 4, after line 15, insert:

SECTION 1.5. Section 17052.12 of the Revenue and Taxation Code is amended to read:

17052.12. For each taxable year beginning on or after January 1, 1987, there shall be allowed as a credit against the "net tax" (as defined by Section 17039) for the taxable year an amount determined in accordance with Section 41 of the Internal Revenue Code, except as follows:

(a) For each taxable year beginning before January 1, 1997, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "8 percent."

(b)(1) For each taxable year beginning on or after January 1, 1997, and before January 1, 1999, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "11 percent."

(2) For each taxable year beginning on or after January 1, 1999, and before January 1, 2000, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "12 percent."

(3) For each taxable year beginning on or after January 1, 2000, and before January 1, 2010, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "15 percent."

(4) For each taxable year beginning on or after January 1, 2010, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code shall apply.

(c) Section 41(a)(2) of the Internal Revenue Code, relating to basic research payments, shall not apply.

(d) "Qualified research" shall include only research conducted in California.

(e) In the case where the credit allowed under this section exceeds the "net tax," the excess may be carried over to reduce the "net tax" in the following year, and succeeding years if necessary, until the credit has been exhausted.

(f)(1) With respect to any expense paid or incurred after the operative date of Section 6378, Section 41(b)(1) of the Internal Revenue Code is modified to exclude from the definition of "qualified research expense" any amount paid or incurred for tangible personal property that is eligible for the exemption from sales or use tax ~~provided by~~ under Section 6378.

(2) For each taxable year beginning on or after January 1, 1998, the reference to "Section 501(a)" in Section 41(b)(3)(C) of the Internal Revenue Code, relating to contract research expenses, is modified to read "this part or Part 11 (commencing with Section 23001)."

(g)(1) For each taxable year beginning on or after January 1, ~~2000~~ 2000, and before January 1, 2010:

(A) The reference to ~~"2.65~~ "3 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~~ "4 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~~ "5 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."

(2) For each taxable year beginning on or after January 1, 2010, Section 41(c)(4) of the Internal Revenue Code, relating to election of alternative incremental credit, shall apply.

~~(2)~~

(3) Section 41(c)(4)(B) shall not apply and in lieu thereof an election under Section 41(c)(4)(A) of the Internal Revenue Code

may be made for any taxable year of the taxpayer beginning on or after January 1, 1998. That election shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Franchise Tax Board.

~~(3)~~

(4) Section ~~41(e)(6)~~41(c)(7) of the Internal Revenue Code, relating to gross receipts, is modified to take into account only those gross receipts from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state, regardless of f.o.b. point or any other condition of the sale.

~~(4)~~

(5) Section 41(c)(5) of the Internal Revenue Code, relating to election of alternative simplified credit, shall not apply.

(h) Section 41(h) of the Internal Revenue Code, relating to termination, shall not apply.

(i) Section 41(g) of the Internal Revenue Code, relating to special rule for passthrough of credit, is modified by each of the following:

(1) The last sentence shall not apply.

(2) If the amount determined under Section 41(a) of the Internal Revenue Code for any taxable year exceeds the limitation of Section 41(g) of the Internal Revenue Code, that amount may be carried over to other taxable years under the rules of subdivision (e); except that the limitation of Section 41(g) of the Internal Revenue Code shall be taken into account in each subsequent taxable year.

(j) Section 41(a)(3) of the Internal Revenue Code shall not apply.

(k) Section 41(b)(3)(D) of the Internal Revenue Code, relating to amounts paid to eligible small businesses, universities, and federal laboratories, shall not apply.

(l) Section 41(f)(6), relating to energy research consortium, shall not apply.

#### AMENDMENT 4

On page 7, line 13, after "Code," insert:

as amended by Section 104(b) of Public Law 109-432,

AMENDMENT 5

On page 7, line 14, strike "apply." and insert:

apply, except as otherwise provided.

AMENDMENT 6

On page 8, after line 2, insert:

SEC. 2.5. Section 23609 of the Revenue and Taxation Code is amended to read:

23609. For each taxable year beginning on or after January 1, 1987, there shall be allowed as a credit against the "tax" (as defined by Section 23036) an amount determined in accordance with Section 41 of the Internal Revenue Code, except as follows:

(a) For each taxable year beginning before January 1, 1997, both of the following modifications shall apply:

(1) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "8 percent."

(2) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "12 percent."

(b)(1) For each taxable year beginning on or after January 1, 1997, and before January 1, 1999, both of the following modifications shall apply:

(A) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "11 percent."

(B) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "24 percent."

(2) For each taxable year beginning on or after January 1, 1999, and before January 1, 2000, both of the following shall apply:

(A) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "12 percent."

(B) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "24 percent."

(3) For each taxable year beginning on or after January 1, 2000, and before January 1, 2010, both of the following shall apply:

(A) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "15 percent."

(B) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "24 percent."

(4) For each taxable year beginning on or after January 1, 2010, both of the following shall apply:

(A) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code shall apply.

(B) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "24 percent."

(c)(1) With respect to any expense paid or incurred after the operative date of Section 6378, Section 41(b)(1) of the Internal Revenue Code is modified to exclude from the definition of "qualified research expense" any amount paid or incurred for tangible personal property that is eligible for the exemption from sales or use tax ~~provided by~~ under Section 6378.

(2) "Qualified research" and "basic research" shall include only research conducted in California.

(d) The provisions of Section 41(e)(7)(A) of the Internal Revenue Code, shall be modified so that "basic research," for purposes of this section, includes any basic or applied research including scientific inquiry or original investigation for the advancement of scientific or engineering knowledge or the improved effectiveness of commercial products, except that the term does not include any of the following:

(1) Basic research conducted outside California.

(2) Basic research in the social sciences, arts, or humanities.

(3) Basic research for the purpose of improving a commercial product if the improvements relate to style, taste, cosmetic, or seasonal design factors.

(4) Any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas).

(e)(1) In the case of a taxpayer engaged in any biopharmaceutical research activities that are described in codes 2833 to 2836, inclusive, or any research activities that are described in codes 3826, 3829, or 3841 to 3845, inclusive, of the Standard Industrial Classification (SIC) Manual published by the United States Office of Management and Budget, 1987 edition, or any other biotechnology research and development activities, the provisions of Section 41(e)(6) of the Internal Revenue Code shall be modified to include both of the following:

(A) A qualified organization as described in Section 170(b)(1)(A)(iii) of the Internal Revenue Code and owned by an institution of higher education as described in Section 3304(f) of the Internal Revenue Code.

(B) A charitable research hospital owned by an organization that is described in Section 501(c)(3) of the Internal Revenue Code, is exempt from taxation under Section 501(a) of the Internal Revenue Code, is not a private foundation, is designated a "specialized laboratory cancer center," and has received Clinical Cancer Research Center status from the National Cancer Institute.

(2) For purposes of this subdivision:

(A) "Biopharmaceutical research activities" means those activities that use organisms or materials derived from organisms, and their cellular, subcellular, or molecular components, in order to provide pharmaceutical products for human or animal therapeutics and diagnostics. Biopharmaceutical activities make use of living organisms

to make commercial products, as opposed to pharmaceutical activities that make use of chemical compounds to produce commercial products.

(B) "Other biotechnology research and development activities" means research and development activities consisting of the application of recombinant DNA technology to produce commercial products, as well as research and development activities regarding pharmaceutical delivery systems designed to provide a measure of control over the rate, duration, and site of pharmaceutical delivery.

(f) In the case where the credit allowed by this section exceeds the "tax," the excess may be carried over to reduce the "tax" in the following year, and succeeding years if necessary, until the credit has been exhausted.

(g) For each taxable year beginning on or after January 1, 1998, the reference to "Section 501(a)" in Section 41(b)(3)(C) of the Internal Revenue Code, relating to contract research expenses, is modified to read "this part or Part 10 (commencing with Section 17001)."

(h)(1) For each taxable year beginning on or after January 1, ~~2000~~2000, and before January 1, 2010:

(A) The reference to ~~"2.65~~ "3 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~~ "4 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~~ "5 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."

(2) For each taxable year beginning on or after January 1, 2010, Section 41(c)(4) of the Internal Revenue Code, relating to election of alternative incremental credit, shall apply.

~~(2)~~

(3) Section 41(c)(4)(B) shall not apply and in lieu thereof an election under Section 41(c)(4)(A) of the Internal Revenue Code may be made for any taxable year of the taxpayer beginning on or after January 1, 1998. That election shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Franchise Tax Board.

~~(3)~~

(4) Section ~~41(c)(6)~~41(c)(7) of the Internal Revenue Code, relating to gross receipts, is modified to take into account only those gross receipts from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state, regardless of f.o.b. point or any other condition of the sale.

~~(4)~~

(5) Section 41(c)(5) of the Internal Revenue Code, relating to election of the alternative simplified credit, shall not apply.

(i) Section 41(h) of the Internal Revenue Code, relating to termination, shall not apply.

(j) Section 41(g) of the Internal Revenue Code, relating to special rule for passthrough of credit, is modified by each of the following:

(1) The last sentence shall not apply.

(2) If the amount determined under Section 41(a) of the Internal Revenue Code for any taxable year exceeds the limitation of Section 41(g) of the Internal Revenue Code, that amount may be carried over to other taxable years under the rules of subdivision (f), except that the limitation of Section 41(g) of the Internal Revenue Code shall be taken into account in each subsequent taxable year.

(k) Section 41(a)(3) of the Internal Revenue Code shall not apply.

(l) Section 41(b)(3)(D) of the Internal Revenue Code, relating to amounts paid to eligible small businesses, universities, and federal laboratories, shall not apply.

(m) Section 41(f)(6) of the Internal Revenue Code, relating to energy research consortium, shall not apply.

SEC. 2.6. Section 1 and section 2 of this bill shall be operative for taxable years beginning on or after January 1, 2010, and before January 1, 2011, and are repealed as of January 1, 2011. Section 1.5 and section 2.5 of this bill shall become operative as of January 1, 2011.

## Appendix A

The California R&D credit is a credit that normally is taken in conjunction with the Federal Research Credit. The calculation to determine the amount of creditable California research expenses generally conforms to the federal calculation with one exception: 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 federal R&D credit’s second purpose is to encourage taxpayers to conduct 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 other states in attracting and maintaining research and development 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 California 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 without cost. 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 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, etc.) 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-fourth of this credit is actually available to reduce tax in the year that it is generated. The inability to fully use the credit (because there is insufficient tax to offset) undoubtedly reduces the incentive provided by the existence of the credit.