

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Ashburn Analyst: Jahna Alvarado Bill Number: SB 444
Related Bills: See Legislative History Telephone: 845-5683 Introduced Date: February 26, 2009
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Research Expenses Credit/20% Of Excess Qualified Expenses/Conformity To Election Of Alternative Incremental Credit

SUMMARY

This bill would do the following:

- Increase the credit for increasing research expenses to 20 percent of the excess of the qualified research expenses, and
- Conform to the federal alternative incremental research credit (AIC) percentages.

PURPOSE OF THE BILL

According to the author’s staff, the purpose of this bill is to encourage the creation of new jobs within the state and improve domestic competitiveness.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2009.

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.

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.

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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 and Development (R&D) 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

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 vary from the federal credit.

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

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

Total business credits are limited to 50 percent of a specified amount for taxable years beginning on or after January 1, 2008, and before January 1, 2010, for taxpayers with net “business income” Personal Income Tax Law (PITL) or “income subject to tax” Corporate Tax Law (CTL) of \$500,000 or more. Under PITL, “business income” means income from a trade or business (including partnerships and S corporations), rental activities, and a farming business. The carryover period for any amounts in excess of the specified limitation is extended for the number of taxable years that the credit was not allowed.

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

This bill would raise the credit for increasing qualified research expenses from 15 percent to 20 percent for taxable years beginning on or after January 1, 2009.

This bill would also fully conform to the federal AIC for taxable years beginning on or after January 1, 2009.

IMPLEMENTATION CONSIDERATIONS

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

LEGISLATIVE HISTORY

AB 765 (Caballero, 2009/2010) would increase the credit for increasing qualified research expenses to 20 percent incrementally over a four year period beginning in taxable year 2011. AB 765 is scheduled to be heard in the Assembly Revenue and Taxation Committee on May 18, 2009.

AB 751 (Leiu, et al., 2007/2008) is identical to this bill and would have applied to taxable years beginning on or after January 1, 2007. AB 751 failed to pass out of the first house by the constitutional deadline.

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 first house by the constitutional deadline. The provisions of SB 928 conforming to the federal AIC are the same as this bill.

SB 359 (Runner, 2007/2008) would have, among other things, increased the Qualified Research Expense Credit from 15 percent to 16 percent and conformed to the federal AIC. SB 359 failed to pass out of the first house by the constitutional deadline. The provisions of SB 359 conforming to the federal AIC are the same as this bill.

AB 2032 (Lieu, 2005/2006) would have increased the amount of the Qualified Research Expense Credit from 15 percent to 18 percent. AB 2032 failed to pass out of the Assembly Revenue & Taxation Committee.

AB 2567 (Arambula, 2005/2006) would have conformed the amount of the Qualified Research Expense Credit 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 qualified 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 qualified research expense from 12 percent to 15 percent.

PROGRAM BACKGROUND

The department annually releases a report on state tax expenditures. The 2008 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/taxExp08.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 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 6½ percent of the qualifying expenditures.

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 research activity that takes place both within and outside of *Massachusetts*.

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. The amount of the credit is reduced to 2.5 percent for expenses exceeding the first \$2 million.

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 performed in hybrid technology research and development. 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.

Beginning in 2005, *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

The revenue losses from this bill would be:

| Estimated Revenue Impact of SB 444 Effective for tax years BOA 1/1/2009 Enacted by 6/1/2009 \$ in Millions | | | | |
|---|---------|---------|---------|---------|
| | 2009-10 | 2010-11 | 2011-12 | 2012-13 |
| Increased % of qualified research expenses allowed for R&D credit | -\$38 | -\$63 | -\$55 | -\$58 |
| Higher AIC credit rates | -\$2 | -\$2 | -\$2 | -\$2 |
| Total | -\$40 | -\$65 | -\$57 | -\$60 |

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

Revenue Discussion

The revenue impact was estimated as follows. First, the revenue loss due to the increased percentage, 20 percent versus the existing 15 percent, of qualified research allowed for the regular R&D credit was estimated using a corporate microsimulation model based on the 2006 FTB credit samples. For each corporation in the sample, the tax liabilities under the current and proposed laws were simulated based on the corporation's taxable income, net operating losses, qualified R&D expenses, the current and proposed R&D credit rates, the stock of available credits, and various enacted tax laws that would affect credit usage. A portion of the additional research credit generated in a particular year would be used in that year. Taxpayers without sufficient tax liability would be unable to fully use the additional credit. Unused credit would be carried forward to subsequent years. The unused corporate R&D credit is currently approximately \$10 billion.

Simulation results indicate that if the qualified research credit rate were increased to 20 percent for the 2006 tax year, approximately \$700 million of additional research credit would be generated; however, only approximately \$50 million of this amount could be used to reduce tax liability. This \$50 million revenue loss for the 2006 taxable year is then extrapolated to each year included in this analysis based on the latest Department of Finance forecast of California corporate tax liability. For example, extrapolating the approximated \$50 million corporate revenue loss for the 2006 taxable year to the 2011 taxable year results in a corporate loss of approximately \$52 million for tax year 2011.

The AIC currently accounts for approximately two percent of the qualified research credit claimed. The relative percentage increases in the AIC rates under this bill are much higher than that of the qualified research credit rate. Therefore it is assumed that the revenue loss due to the higher AIC rates would be approximately four percent of the loss from the higher qualified research credit rate. The estimated revenue loss for 2011 attributable to the increased AIC percentage is approximately \$2 million, $\$52 \text{ million} \times 4\% \approx \2 million .

The PIT revenue impact was calculated as a fraction of the corporate revenue impact and is assumed to be equal to the ratio of PIT R&D credits to corporate R&D credits claimed in 2006, approximately six percent. The estimated PIT revenue loss for 2011 is then approximately \$3 million, $(\$52 \text{ million} + \$2 \text{ million}) \times 6\% \approx \3 million .

The total revenue impact on a calendar year basis is the sum of the above three components. For taxable year 2011 this is approximately -\$57 million, $-\$52 \text{ million} - \$2 \text{ million} - \$3 \text{ million} = -\57 million .

The calendar year result was then fiscalized to derive the results shown in the table above.

ARGUMENTS/POLICY CONCERNS

This bill would continue to allow the AIC and would conform to the federal AIC percentages. Recent federal law ² terminated the AIC at the federal level for taxable years beginning after December 31, 2008. The federal change creates additional differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

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² Emergency Economic Stabilization Act of 2008 (Public Law 110-343).

Appendix A

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.

For tax year 2005, the most recent data available, the amount of R&D credits applied was \$55 million for PIT and \$952 million under the Corporate Tax. The R&D credit was applied on 3,274 PIT returns and 1,823 corporate tax returns filed for tax year 2005.

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 an 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 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 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-fourth 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.