

**Franchise Tax Board**

**ANALYSIS OF AMENDED BILL**

Authors: Perea and Beall Analyst: David Scott Bill Number: AB 1818

Related Bills: None Telephone: 845-5806 Amended Date: March 29, 2012

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Royalties Paid For Patent Credit

**SUMMARY**

This bill would provide an income or franchise tax credit to taxpayers that pay royalties for a patent owned by the University of California and commercialize the patent in California.

**RECOMMENDATION**

No position.

**Summary of Amendments**

The bill, as introduced on February 21, 2012, made a technical, non-substantive change to the Revenue and Taxation Code (R&TC).

The March 29, 2012, amendments removed all of the bill's provisions, related to the technical non-substantive change to the R&TC, and replaced them with the provisions discussed in this analysis. This is the department's first analysis of the bill.

**Summary of Suggested Amendments**

Amendments 1 through 4 are suggested to simplify the definition of the costs that can be incurred, in producing the invention, to be those costs as described under the federal research and development credit rules, but incurred in California.

**REASON FOR THE BILL**

According to the author's office, the purpose of this bill is to reduce the financial risk involved with innovation, which in turn will bring more products to the marketplace and create more jobs in California.

**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, 2012.

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## **ANALYSIS**

### FEDERAL/STATE LAW

#### Patent Box

Currently, there are no federal or California tax provisions for a “patent box” (see discussion below, including Program Background) or a credit for the payment of royalties for the use and commercialization of patents.

#### Research and Development Credit

##### 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 Alternative Incremental Credit 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, 2011.<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.
- 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 of 3 percent, 4 percent, and 5 percent in effect as of January 1, 2009, the state's current conformity date.

### THIS BILL

This bill would:

- Provide a tax credit for payments by a "qualified taxpayer" for "qualified royalties".
- Define "qualified royalties" as royalties paid, as a result of a license agreement, with the University of California, or other entity, for use of a "qualified patent."
- Define a "qualified patent" as a patent owned by the University of California and the research and development costs to create the patent was funded by costs that qualify for the California R&D credit.
- Define a "qualified taxpayer" as a taxpayer that pays qualified royalties for the use of the patent and commercializes the patented invention in California.
- Allow unused credits to be carried over to subsequent tax years until exhausted without expiring.

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<sup>1</sup> Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312).  
of 2010" (Public Law 111-312).

## 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.

- The bill fails to specify the amount of the credit. Until the credit amount or percentage is defined the bill could not be implemented.
- The term "commercialize" is undefined in the bill. Without a definition, the term could be broadly interpreted and may lead to disputes between the department and taxpayers. Some taxpayers may argue that simply selling a product in the state is "commercializing." If it is the author's intent that the product must be produced in this state for a specified period, the author may wish to amend the bill to specify what level of activity must be met to satisfy the commercialization requirement.
- The definition of "qualified patent" states that "the research and development for that invention was funded, in whole or in part, by amounts eligible for the credit under Section 17052.12 or 23609". The California research and development credit contains a number of complexities that may result in disputes between the department and taxpayers. A simplified approach would be to have the research and development consist of costs described in Internal Revenue Code section 41(e)( basic research payments to universities), as modified by R&TC sections 17052.12 and 23609. Amendments number 1 to 4 would resolve this concern.

## **PROGRAM BACKGROUND**

These incentives or "patent boxes" (so-called because there is a box to check on the tax form) generally allow corporate income from the sale of patented products to be taxed at a lower rate than other income. Eight nations (seven in Europe, plus China) have enacted patent box regimes that incentivize firms to patent and produce products from the innovations. A ninth country, the U.K., is set to put in place the incentive in 2013.

Typically, a patent box program allows taxpayers to receive a lower tax rate on income that was generated by the use of certain intellectual property and meeting specified conditions of use. Patent boxes differ from R&D incentives because they provide firms with an incentive for commercialization of innovation, rather than just for the conduct of research. Commercialization of innovation is a key driver for economic growth and jobs.

This bill does not function as a "patent box" per se, but rather is a credit for the payment of royalties for a patent.

## **OTHER STATES' INFORMATION**

There are no states that allow a credit for payments of royalties or have "patent boxes."

## **FISCAL IMPACT**

The implementation of this bill would require the department to create a new tax form, establish a new credit code, and make minor system changes. These changes would not have a significant impact on the department's costs. If it is the intent of the bill to add a "patent box" to the form, these costs would increase because additional changes would have to be made to current tax forms as well as to current systems. As the bill continues to move through the legislative process, the additional costs will be identified and an appropriation will be requested, if necessary.

## **ECONOMIC IMPACT**

### Revenue Estimate

Without a specified credit amount, the department is unable to provide a revenue estimate at this time.

## **SUPPORT/OPPOSITION**

Support: None provided.

Opposition: None provided.

## **ARGUMENTS**

Proponents: Some may argue that this type of tax incentive would increase California's competitiveness not only by spurring firms to invest more in innovation, but also by linking the tax incentive to success at commercializing innovation, which is important for growth, competitiveness, and job creation.

Opponents: Some may argue that patent box type incentives fail to actually address market failure because firms already have all the incentives they need to commercialize innovation in the marketplace.

## **POLICY CONCERNS**

This bill fails to require the qualified taxpayer to maintain the production of the product for any defined minimum amount of time. This lack of definition would allow a taxpayer to begin production in California and then to transfer the production out of state without any consequences, such as a recapture of the used credits.

This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

This bill would allow for an unlimited carryover period. Consequently, the department would be required to retain the carryover on the tax forms indefinitely. Recent credits have been enacted with a carryover period limitation because experience shows credits typically are exhausted within eight years of being earned.

This bill allows a credit for royalties paid to an “other entity” besides the University of California. This could lead to the possibility of the following situation. Company A could license the patent from the University and pay royalties for which they could be entitled to a credit. Company A could subsequently sublicense the patent to Company B for royalties. Company B would also be entitled to a credit as long as the patent was owned by the University of California. The author may wish to add language that would limit the credit to the initial acquirer of the license to use the patent from the University of California.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO

AB 1818 Royalties Paid for Patent Credit  
As Amended March 29, 2012

AMENDMENT 1

On page 2, strikeout lines 9 and 10, and insert:

costs for that invention are defined in subsection (e) of Internal Revenue Code section 41, as modified by Revenue and Taxation Code sections 17052.12 or 23609.

AMENDMENT 2

On page 2, between lines 17 and 18, insert:

(4) "Qualified Research and Development" means qualified research as defined in subdivision (d) of Internal Revenue Code section 41, as modified by Revenue and Taxation Code sections 17052.12 or 23609.

AMENDMENT 3

On page 2, strikeout lines 32 and 33, and insert:

costs for that invention are defined in subsection (e) of Internal Revenue Code section 41, as modified by Revenue and Taxation Code sections 17052.12 or 23609.

AMENDMENT 4

On page 3, before line 1, insert:

(4) "Qualified Research and Development" means qualified research as defined in subdivision (d) of Internal Revenue Code section 41, as modified by Revenue and Taxation Code sections 17052.12 or 23609.