ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Beall	Analyst:	Jahna Alvarado	Bill Number:	AB 79
Related Bills:		Telephone:	845-5683	Introduced Date:	January 3, 2011
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: University Of California Venture Development Fund Contributions Credit

SUMMARY

This bill would create an income and franchise tax credit for contributions made to a University Venture Development Fund (the UVDF credit).

This bill would also make changes to the Education Code. This analysis is limited to the changes that would impact the department.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to encourage direct private investment in California's cleantech, nanotech, and biotech industries.

EFFECTIVE/OPERATIVE DATE

The UVDF credit would be effective January 1, 2012, and specifically operative for taxable years beginning on or after January 1, 2011.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

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.

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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.

Generally, the federal research credit for personal income tax (PIT) taxpayers is the sum of two components:

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 by the taxpayer in carrying on any trade or business of the taxpayer during the taxable year to an energy research consortium.

The federal corporate research credit includes a third component that is equal to 20 percent of the excess of cash payments made to universities and certain nonprofit scientific research organizations during the year over the base period amount (the basic research payments).

Under federal law, a taxpayer may elect the Alternative Simplified Credit (ASC) method to determine the qualified research expense component of the research credit.

Prior to January 1, 2009, federal law allowed a taxpayer to elect the Alternative Incremental Credit (AIC) method to determine the qualified research expense component of 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 research credit does not apply to any expenses paid or incurred after December 31, 2011.[1]

[1] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312)

Under state law, unless otherwise provided, if a taxpayer fails to pay the amount of tax shown due on a return by the original due date of the return, a penalty would be imposed in the amount of five percent of the unpaid tax plus an additional 0.5 percent of the unpaid tax for each month or part of a month it remains unpaid. The maximum penalty is 25 percent of the unpaid tax.

Generally, if a taxpayer underpays an installment of estimate tax, a penalty is calculated on the unpaid amount from the due date of the estimated tax installment to the date payment is received, or to the due date of the return, whichever is earlier. The penalty is computed at the same rate as interest for the period of underpayment. The underpayment penalty is inapplicable to underpayments resulting from a change in law that becomes operative in the same taxable year as the year the law is enacted.

THIS BILL

This bill would, under the Education Code, authorize the Regents of the University of California to create a UVDF for each university campus for the purpose of receiving contributions to be used to pay for qualified research expenses. The Regents would be requested to notify the Franchise Tax Board (FTB) of the establishment of each UVDF and to provide a letter to each contributor certifying the contribution and its use for qualified research expenses as defined in the Education Code.

This bill would, under the Revenue and Taxation Code, for taxable years beginning on or after January 1, 2011, provide a credit against tax in an amount equal to 50 percent of the amount contributed by a taxpayer during the taxable year to any UVDF, as certified by the Regents of the University of California.

A taxpayer would be required to provide the certification letter to the FTB upon request.

The maximum aggregate UVDF credit available to all taxpayers would be limited to $200 million.

The FTB would be required to allow the UVDF credit on a first-to-file basis until the maximum aggregate credit was reached.

This bill would allow any unused UVDF credit to be carried over until exhausted.

A contribution that was the basis for any other credit or deduction reported by the taxpayer would be ineligible for the UVDF credit.

IMPLEMENTATION CONSIDERATIONS

Department staff have identified the following implementation considerations. Additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

This bill would request that the Regents of the University of California issue a certification letter for qualifying UVDF contributions and would require a taxpayer to obtain a certification letter. This inconsistency between requested and required actions could result in the denial of the UVDF credits in situations where certification letters were not issued. The author may wish to amend this bill to require the issuance of certification letters or require the Regents to provide an annual report to the FTB that details the certified donations made during the year or both.

This bill fails to limit the amount of contributions that could be certified by the Regents. This could result in reported credits that far exceed the aggregate limit specified in the Revenue and Taxation Code. To reduce taxpayer uncertainty, the author may wish to amend this bill to limit the amount of contributions that could be certified to the amount that would be equal to the aggregate limitation.

This bill uses terms that are undefined, i.e., “maximum amount of credit available,” and “first-to-file basis.” The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit.

Under the terms of this bill, the credit could be reported on either an originally filed return or an amended return. Additionally, a taxpayer would be allowed to file an amended return, as allowed by statute, to reverse the credit. As a result, the aggregate use of the credit would increase as original returns are filed, and could either increase or decrease as amended returns are received. It is unclear how credits denied because the aggregate credit limit had been reached would be tracked and whether previously denied credits would be allowed in the event that the aggregate credit amount allowed subsequently drops below the limit. The author may wish to amend this bill to specify that the amount of certified contributions would be limited to the amount that would generate credits at or below the stated aggregate credit limit.

Because this bill is silent on the applicability of the underpayment penalties, a taxpayer denied the UVDF credit because the aggregate credit limit had been reached would be subject to these penalties. If this is contrary to the author’s intent, this bill should be amended.

Generally, credits subject to an aggregate limit include provisions that provide for speed and ease of administration and taxpayer certainty such as:

- Excluding the FTB’s determinations from any administrative or judicial review process. For example, the determination of “first-to-file;”
- Specifying that a disallowance of the credit shall be treated as a math error;
- Specifying that the FTB may prescribe rules, guidelines, or procedures necessary and appropriate; and
- Excluding the regulations from the Administrative Procedures Act.

TECHNICAL CONSIDERATIONS

On page 4, line 7, and page 5, line 1, strikeout the phrase “maximum aggregate amount of credit” and insert the phrase “maximum aggregate credit amount” for consistent terminology when referring to the $200 million cap on the UVDF credit.

OTHER STATES’ INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to similarities to California's economy, business entity types, and tax laws.

These states do not offer a credit similar to the credit proposed in this bill.

Oregon allows a credit for up to 60 percent of qualifying contributions to a UVDF within the state. Annual credit use is limited to 20 percent of the qualifying contribution, $50,000, or the state tax liability, whichever is less. Excess credits may be carried forward until exhausted. The total UVDF contributions eligible for tax credits is capped at $10 million to the Oregon University System and $4 million to the Oregon Health and Science University. Under Oregon law, 20 percent of the income a University receives as a result of the use of grants from its UVDF is transferred from the University to the state's general fund. The University may then make additional credit certifications up to the amount of the transfer made to the general fund.

FISCAL IMPACT

The department's costs to administer this bill are unable to be determined until implementation concerns have been resolved. As the bill continues to move through the legislative process and implementation concerns are resolved, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Estimated Revenue Impact of AB 79 For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011 ($ in Millions)				
2011-12	2012-13	2013-14	2014-15	2015-16
-$98	-$35	-$8	-$5	-$4

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

SUPPORT/OPPOSITION

Support: None identified to date.

Opposition: None identified to date.

ARGUMENTS

Pro: Creating a credit to encourage investment in research activities performed on a University of California campus could provide a source of funding to offset the record budget cuts the University system is facing.

Con: Some taxpayers may say that with the state's current fiscal crisis, additional tax expenditures should be avoided.

POLICY CONCERNS

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 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.

LEGISLATIVE STAFF CONTACT

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