Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

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Related Bills:	See Legislative History	Telephone:	845-6075	Introduced Date:	January 29, 2014
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Research Credit – Credit Increases, Credit Limitation, Credit Sales, and Audit Rules

SUMMARY

This bill would increase the credit rates of the research credit temporarily, limit the number of years the research credit could be carried over, allow taxpayers to sell and purchase research credits, and impose statutory audit rules to control how the Franchise Tax Board (FTB) audits the research credit.

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for the bill is to incentivize businesses to risk their capital to develop and improve the next generation of cutting-edge technologies.

EFFECTIVE/OPERATIVE DATE

This bill would be effective on January 1, 2015. Certain aspects would be specifically operative for taxable years beginning on or after January 1, 2014. Others changes would be operative for taxable years beginning on or after January 1, 2015, or as of January 1, 2015.

ANALYSIS

FEDERAL/STATE LAW

Federal Law

The federal research credit is the sum of three components—the general research credit, the university "basic research" credit, and the energy research credit, as described below.

The General Research Credit

The general research credit may be claimed for incremental increases in qualified research. A taxpayer may claim a research credit equal to a percentage of the amount by which the taxpayer's qualified research expenses for a taxable year exceed a specified base amount.

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Qualified Research

To be eligible for the credit, the research not only has to satisfy the requirements of Internal Revenue Code (IRC) section 174 that allows taxpayers to elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business that represent research and development costs in the experimental or laboratory sense,[1] but also must be undertaken for the purpose of discovering information that is technological in nature,[2] the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.[3]

Qualified Expenses

Qualified research expenses eligible for the general research credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[4]

Calculating the Credit

The general research credit may be calculated two ways—under the regular method, or taxpayer's may instead elect the alternative simplified credit.

- Regular Method

  For general research expenditures, a taxpayer may claim a federal research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses exceed a base amount.

  - *Base Amount* - The base amount for the current year is generally computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its

[1] Taxpayers may also elect 10-year amortization of certain research expenditures otherwise allowable under IRC section 174 as a deduction.

[2] For purposes of the research credit, information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. Treasury Reg. section 1-41-4(a)(4).

[3] IRC section 41(d)(3).

[4] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under IRC section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in IRC section 501(c)(3) (other than a private foundation) or IRC section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. IRC section 41(b)(3)(C).

total qualified research expenses for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). Special rules apply to all other taxpayers (so called start-up firms).[5]

A taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

- *Gross Receipts* - For purposes of measuring gross receipts for the research credit, gross receipts generally means the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from all its activities and from all sources (e.g., revenues derived from the sale of inventory before reduction of cost of goods sold), reduced by returns and allowances. However, gross receipts do not include receipts from the sale or exchange of a capital asset, repayments of loans or similar instruments, or receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business.[6]

- Alternative Simplified Credit

  For amounts paid or incurred after 2006, taxpayers are allowed to elect to the simplified credit that is equal to 14 percent of qualified research expenses over a base amount.[7] The base amount is calculated by multiplying the average qualified research expenses of the three preceding taxable years by 50 percent. The credit rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

  An election to use the simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary of the Treasury.

The University "Basic Research" Credit

This component of the research credit is only available to corporations,[8] and provides a 20-percent research credit of the excess of:

- 100 percent of corporate cash expenses (including grants or contributions) paid during the taxable year for basic research conducted by universities (and certain nonprofit scientific research organizations), over

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[5] The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under IRC section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually re-compute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. IRC section 41(c)(3)(B).

[6] Treasury Reg. Section 1.41-3(c).

[7] IRC section 41(c)(5).

[8] IRC section 41(e).

- The sum of the greater of two minimum basic research floors plus an amount reflecting any decrease in non-research giving to universities by the corporation during the taxable year as compared to such giving during a fixed-base period, as adjusted for inflation.

The term "basic research" generally means any original investigation for the advancement of scientific knowledge not having a specific commercial objective.

The Energy Research Credit

This component of the research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium, and is commonly referred to as the energy research credit. Unlike the other components of the research credit, the energy research credit is calculated based on all qualified expenditures, not just those in excess of a base amount.

State Law

California law generally conforms to the federal research credit as of the "specified date" of January 1, 2009,[9] with modifications. California generally conforms to the general research credit and the university "basic research" credit, but does not conform to the energy research credit. For purposes of the California research credit, the terms "qualified research" and "basic research" include only research conducted in California.

The General Research Credit

The California general research credit may be calculated two ways—under the regular method, or taxpayer's may instead elect the alternative incremental credit.

- The Regular Method

  California conforms to the regular method with modifications. For general research expenditures, a taxpayer may claim a state research credit equal to 15 percent of the amount by which the taxpayer's California qualified research expenses for a taxable year exceed a base amount (in lieu of the federal credit rate of 20 percent).

  Additional modifications include the following:

  Base Amount - California generally conforms to the federal rules for determining the base amount, with the gross-receipts modification described below. And, similar to federal law, a taxpayer's California base amount cannot be less than 50 percent of its current-year California qualified research expenses.

  Gross Receipts - California law generally conforms to the federal definition of gross receipts to calculate the credit under the regular method, modified to take into account only those gross receipts from the sale of property held for sale in the ordinary course of business that is delivered or shipped to a purchaser within California, regardless of f.o.b. point or any other condition of the sale.[10]

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[9] R&TC sections 17052.12 and 23609. The January 1, 2009, "specified date" of conformity means that to the extent that California conforms to provisions of the Internal Revenue Code (IRC), it conforms to those provisions as in effect on January 1, 2009, except as otherwise provided.

[10] R&TC sections 17052.12(g)(3) and 23609(h)(3).

- The Alternative Incremental Credit

  California conforms to the alternative incremental credit with modifications,[11] as described below:

  Credit Rates & Base Amounts - Under the California incremental credit:[12]

  - A credit rate of 1.49 percent applies to the extent that a taxpayer's current-year California qualified research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but does not exceed a base amount computed by using a fixed-base percentage of 1.5 percent;
  - A credit rate of 1.98 percent applies to the extent that a taxpayer's current-year California qualified research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but does not exceed a base amount computed by using a fixed-base percentage of two percent; and
  - A credit rate of 2.48 percent applies to the extent that a taxpayer's current-year California qualified research expenses exceed a base amount computed by using a fixed-base percentage of two percent.

The University “Basic Research” Credit

California conforms to the federal rules relating to university “basic research” expenses, modified to provide that the California credit rate is 24 percent instead of the federal rate of 20 percent. Similar to federal law, only corporations qualify for this separate component of the research credit. Additionally, California modifies the term “basic research” to include any basic or applied research that includes scientific inquiry or original investigation for advancement of scientific or engineering knowledge or the improved effectiveness of commercial products, except that “basic research” does not include any of the following:

- Basic research in social sciences, arts or humanities;
- Basic research for purposes of improving a commercial product if the improvements relate to style, taste, cosmetic, or seasonal design factors; or
- Any expenditure paid or incurred to ascertain existence, location, extent, or quality of any deposit of ore or other mineral, including oil or gas.

Unlimited Credit Carryover

The California research credit has an unlimited credit carryover period, meaning that in the case where there is more research credit than can be used in any taxable year, the excess credit may be carried forward to be used to reduce tax the subsequent year, and succeeding years, until the credit is exhausted.

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[11] Although the alternative incremental credit expired for federal purposes in 2008, California continues to allow it.

[12] R&TC sections 17052.12(g)(1) and 23609(h)(1).

THIS BILL

This bill would increase the credit rates of the research credit temporarily, limit the number of years that the research credit could be carried over, allow taxpayers to sell and purchase research credits, and impose statutory audit rules to control how the FTB audits the research credit.

Temporary Credit Rate Increases

This bill would gradually increase the credit percentages for the general research credit and the university "basic research" credit over five years, after which the credit percentages would return to the current-law amounts, as shown in the table below:

Taxable Year	General Research Credit Credit Rates		University "Basic Research" Credit Credit Rates	
	Current Law	*Proposed by This Bill*	Current Law	*Proposed by This Bill*
2014	15%	18%	24%	27%
2015	15%	21%	24%	30%
2016	15%	24%	24%	33%
2017	15%	27%	24%	36%
2018	15%	30%	24%	39%
2019	15%	15%	24%	24%

Limitation on Credit Carryovers

This bill would create a new ten-year credit-carryover limitation by providing that in the case that the research credit exceeds the amount of tax it may offset, it may be carried forward to reduce tax in the following year, and the succeeding nine years if necessary, until the credit has been exhausted.

Selling and Purchasing Credits

This bill would require the Governor's Office of Business and Economic Development (known as "GO-Biz") to develop and administer a program to allow the sale and purchase of research credits.

The FTB would be required to notify GO-Biz on a quarterly basis of all taxpayers that claim the research credit and the amount of credit claimed.

GO-Biz would be required to create an Internet Web site through which taxpayers could, by January 1, 2017, sell or purchase research credits. Taxpayers would be allowed to request approval from GO-Biz to sell or purchase research credits, and after such a request, GO-Biz would be required to approve a taxpayer before that taxpayer could sell or purchase research credits, as follows:

- *Approval to Sell*: GO-Biz would be required to approve a taxpayer to sell research credits if that taxpayer has a facility in which research and development occurs in this state; less than $50 million in earnings before income tax, depreciation, and amortization; and unused research credit from a previous taxable year.
- *Approval to Purchase*: GO-Biz would be required to approve a taxpayer to purchase research credits if that taxpayer has had qualified California research expenses within the past five years and that taxpayer conducts a trade or business in this state.

If a taxpayer is approved to sell or purchase research credits, GO-Biz would be required to create an online account for the taxpayer to log into in order to sell or purchase research credits. Each taxpayer would be allowed to sell or purchase up to $5 million of research credits per taxable year. The price of research credits would be based on the open-market demand.

If a taxpayer does not reinvest the money received from the sale of research credits into the taxpayer's trade or business or if the purchased credits reduce the taxpayer's tax liability by more than 50 percent, any remaining unapplied credit that is not reinvested or that exceeds 50 percent of the taxpayer's tax liability would be recaptured, and the taxpayer would be liable for any increase in tax attributable to such a recapture.

GO-Biz would be required to notify the FTB on a quarterly basis of each sale or purchase of a research credit, the identity of the taxpayer that purchased the credit, and the amount of credit sold. The FTB would be required to review this information to ensure that a research credit is not being used multiple times.

This bill would establish in the State Treasury the Research and Development Tax Credit Trade Fund. Until GO-Biz would be fully reimbursed for its costs of developing, creating, and starting the Research and Development Tax Credit Trade Fund, 15 percent of each credit sold or purchased on the Internet Web site (as established by GO-Biz) would be deposited into the Research and Development Tax Credit Trade Fund for purposes of funding this proposed program. Of that 15 percent, 13 percent would be appropriated to GO-Biz for the administrative and start-up costs of implementing this program, and 2 percent would be appropriated to the FTB for its administrative costs of this program. The remaining 85 percent would be allowed to be used as a credit against the acquiring taxpayer's tax liability.

Once GO-Biz would be fully reimbursed for its costs of developing, creating, and starting the program to purchase and sell research credits, five percent of each credit sold through the GO-Biz Internet Web site would be deposited into the Research and Development Tax Credit Trade Fund for the purpose of funding the Research and Development Tax Credit Trade Program. Of that five percent, three percent would be appropriated to GO-Biz for its administrative costs of implementing this program, and two percent would be appropriated to the FTB for its administrative costs of administering this program. The remaining 95 percent would be allowed to be used as a credit against the acquiring taxpayer's tax liability.

Audit Rules

This bill would require the FTB to perform the following audit procedures if a taxpayer filed for a research credit and was not allowed that credit:

1. **Use a Risk-Based Approach to Conduct an Audit.** The FTB would be required to focus on identifying areas of a taxpayer's trade or business in which there may be subjectivity in determining whether an employee of the taxpayer is performing qualified research or nonqualified research, and the percentage of that employee's time that is devoted to performing qualified research.
2. **Require an Explanation of the Taxpayer's Trade or Business.** The FTB would require that the taxpayer provide a general explanation of its trade or business, the role of research and development in its business, the development of new and improved products, and software.
3. **Determine if a Federal Audit has Been Conducted and, if so, Rely on that Audit.** The FTB would be required to determine whether the Internal Revenue Service (IRS) has conducted an audit of the federal research credit, and if so, request a copy of the federal audit report. If the IRS has conducted an audit, the FTB would be required to rely upon the findings of the federal audit, subject to verifying that the research activities and costs were incurred in this state.
4. **Conduct a Tour of the Taxpayer's Facilities.** The FTB would be required to conduct a tour of the taxpayer's facilities and interview employees of the taxpayer that are performing qualified research. The physical tour would be conducted prior to the FTB arriving at a determination that the taxpayer's activities do not qualify as qualified research, and would be required to include the area in which research is performed and follow a product or process through its life cycle beginning with development and ending with production.
5. **Identify Employee Types.** The FTB would be required to identify the types of employees dedicated to research, production, or administrative duties, or a mixture of any of those activities.

This bill would provide that the FTB may perform the following audit procedures if a taxpayer filed for a research credit and was not allowed that credit and the auditor deems it necessary:

1. **General Project Information.** The FTB could ask the taxpayer to provide examples of research projects from examination years and to describe projects that are currently under development.
2. **Step-by-Step Description of the Development Process.** The FTB could ask the taxpayer to explain each step of the development process, where mixed-services are performed, and distinguish between production or administrative functions and research.

This bill would additionally provide that:

- If the FTB determines a particular expense to not be a qualified research expense, then a taxpayer would be allowed an opportunity to provide additional supporting records. If an adjustment in whether an expense is considered a qualified research expense is necessary based on the taxpayer's additional supporting records, the FTB would be required to explain and document the discrepancy;

- An adjustment based upon mere criticism of a taxpayer's workpapers, study, methods, or vague disallowance for law of substantiation, without actual information or evidence that contradict a taxpayer's documents or evidence could not be upheld; and
- A lack of substantiation would be a valid reason for disallowing a credit when the taxpayer submits only vague testimony.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns regarding the selling and purchasing of research credits and the audit rules. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

Selling and Purchasing Credits

Credits Disallowed After Being Sold and Purchased

GO-Biz could approve the sale or purchase of a taxpayer's research credit before a federal or state audit of the credit is completed. This could result in research credits being sold and purchased before they could be confirmed at audit, and the bill fails to specify how credits that would be approved for sale and purchase and then subsequently disallowed at audit would be, or could be, recaptured.

Recapture Requirement

This provision would create a recapture rule to provide that if a taxpayer sells a credit and does not reinvest the money received from the sale of the credit into the taxpayer's trade or business or if the purchased credits reduce the taxpayer's tax liability by more than 50 percent, any remaining unapplied credit would be cancelled and any previously applied credit that was not reinvested or that exceeds 50 percent of the taxpayer's tax liability would be recaptured, and the taxpayer would be liable for any increase in tax attributable to the recapture of any credit previously allowed under proposed Government Code section 12097.

It is unclear what the phrase "reinvest the money from the sale of the credit into the taxpayer's trade or business" would mean. Without a specific definition, credit recapture based on this condition would seldom, if ever, occur.

Amounts to Be Deposited into the Research and Development Tax Credit Trade Fund

This bill would require that a specified percentage of each credit sold or purchased would be set aside to reimburse GO-Biz and the FTB for the administrative costs of implementing and maintaining the Research and Development Tax Credit Trade Fund. It is unclear whether the percentage would be applied to the face amount of the credit sold or purchased or, if sold at a discount, the price paid to acquire the credit. For example, if $100 of credit is purchased for $80, and the 15-percent rate applied, would the amount to be deposited in the fund be 15 percent of $100 or 15 percent of $80?

Audit Rules

Undefined Phrases and Credit Studies

This provision would provide that if the FTB determines a particular expense to not be a qualified research expense, then a taxpayer would be allowed an opportunity to provide additional supporting records. If an adjustment in whether an expense is considered a qualified research expense is necessary based on the taxpayer's additional supporting records, then the FTB would be required to explain and document the discrepancy. An adjustment based upon mere criticism of a taxpayer's workpapers, study, methods, or vague disallowance for law of substantiation, without actual information or evidence that contradict a taxpayer's documents or evidence could not be upheld. A lack of substantiation would be a valid reason for disallowing a credit when the taxpayer submits only vague testimony.

The implementation concerns with this provision are significant, and include the following:

- *Undefined Phrases* – The phrases "vague testimony," "mere criticism," and "vague disallowance for law of substantiation" are undefined. The absence of definitions to clarify these phrases would lead to disputes with taxpayers over their meanings.

- *Credit Studies* - Over the past several years, there has been a growing trend whereby taxpayers or their representatives submit prepackaged material, generally referred to as "studies," to support the underlying research credit. These "studies" are usually delivered to auditors in multiple binders, and often set forth the methodology employed in preparing the research credit claim. Federal auditors have generally found that these prepackaged "studies" fail to substantiate that the taxpayer paid or incurred qualified research expenses as claimed, and instead are found, after extensive review, to contain information not germane to the audit.[13] It appears that this provision would require the FTB to allow any research credit if it's based on a taxpayer's "study" even though such a "study" would generally not contain the information necessary to substantiate the credit.

Disclosure of Tax-Return Information

The bill would require the FTB to notify GO-Biz on a quarterly basis of all taxpayers that claim the research credit and the amount of credit claimed. However, the department is prohibited from disclosing or making known in any manner confidential tax-return information unless an exception is specifically provided.[14] Absent an exception from existing disclosure law, the department would be unable to comply with the requirement to quarterly report to GO-Biz.

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[13] See the IRS Audit Technique Guide: Credit for Increasing Research Activity (i.e. the Research Tax Credit) at: http://www.irs.gov/Businesses/Audit-Techniques-Guide:-Credit-for-Increasing-Research-Activities-(i.e.-Research-Tax-Credit)-IRC-%C2%A7-41*---Table-of-Contents, see item 2. Determining the Scope, Prepackaged Submissions.

[14] R&TC section 19542.

TECHNICAL CONSIDERATIONS

This bill would refer to the research credit as the "research and development tax credit" in numerous places. For consistency with IRC section 41(a), the reference should instead be the "research credit." Additionally, the author may want to consider similar changes to the proposed names of the "Research and Development Tax Credit Trade Program" and the "Research and Development Tax Credit Trade Fund."

This bill would require the department to focus on identifying areas of a taxpayer's trade or business in which there may be subjectivity in determining whether an employee of the taxpayer is performing qualified research or nonqualified research, and the percentage of that employee's time that is devoted to performing qualified research. This requirement would use present-tense descriptions; however, because the research credit is based on research activities that have occurred in the past, the author may want to consider using past-tense descriptions (e.g., "determining whether or not an employee of the taxpayer performed qualified research or nonqualified research.")

LEGISLATIVE HISTORY

AB 653 (Pérez, 2013/2014) would have temporarily provided incremental increases to the general research credit percentage using the regular calculation method, up to a maximum credit rate of 30 percent, and would have temporarily provided incremental increases to the university "basic research" credit percentage, up to a maximum credit rate of 40 percent. AB 653 was held in the Assembly Appropriations Committee.

AB 1484 (Anderson, 2009/2010) would have increased the general research credit percentage using the regular calculation method to the federal credit rate of 20 percent, and would have increased the the incremental credit rates to the federal credit rates of three, four, and five percent (the rates that were in effect for federal purposes as of 2008). AB 1484 failed to pass out of the Assembly by the constitutional deadline.

AB 2278 (Anderson, 2009/2010) would have increased the general research credit percentage using the regular calculation method to the federal credit rate of 20 percent, would have eliminated the election to use the alternative incremental credit method, and would have allowed the election of the alternative simplified credit using federal credit rates. AB 2278 failed to pass out of the Assembly by the constitutional deadline.

SB 235 (Wyland, 2013/2014) would have increased the general research credit percentage using the regular calculation method to the federal credit rate of 20 percent, and would have increased the the incremental credit rates to the federal credit rates of three, four, and five percent (the rates that were in effect for federal purposes as of 2008). SB 235 failed to pass out of the Senate Committee on Governance and Finance.

SB 444 (Ashburn, 2009/2010) would have increased the general research credit percentage using the regular calculation method to the federal credit rate of 20 percent, and would have increased the the incremental credit rates to the federal credit rates of three, four, and five percent (the rates that were in effect for federal purposes as of 2008). SB 444 failed to pass out of the Senate by the constitutional deadline.

SB 1239 (Wyland, 2009/2010) would have increased the general research credit percentage calculated using the regular calculation method to the federal credit rate of 20 percent, and would have increased the the incremental credit rates to the federal credit rates of three, four, and five percent (the rates that were in effect for federal purposes as of 2008). SB 1239 failed to pass out of the Senate 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. A review of these states' laws found that each state provides its own research credit for research conducted within the state, as described below. None these states were found to allow the sale and purchase of research credits.

Florida allows a corporate research tax credit of 10 percent of qualified research expenses in excess of a base amount for research conducted within Florida. The combined total amount of tax credits that may be granted to all business enterprises during any calendar year is $9 million; taxpayers must apply for the credit, which is allocated in the order in which applications are received. *Florida's* base amount is the average of the taxpayer's qualified research expenses in *Florida* allowed under IRC section 41 for the four taxable years preceding the taxable year for which the credit is determined.

Illinois allows an individual and corporate tax research credit of 6.5 percent of qualified research expenses in excess of a base amount for research conducted within *Illinois*. *Illinois*' base amount is the average amount of *Illinois* research expenses for the prior three years.

Massachusetts allows corporate taxpayers to claim an excise-tax research credit of 10 percent of qualified research expenses in excess of a base amount for research conducted within *Massachusetts.*

Michigan replaced the Michigan Business Tax with a corporate income tax for taxable years beginning on or after January 1, 2012. There is no research credit under the state's new corporate or personal income tax.

Minnesota allows a two-tiered individual and corporate tax research credit for research conducted within *Minnesota*: (1) for qualified research expenses up to $2 million, the credit is 10 percent of expenses in excess of a base amount; and (2) for qualified research expenses in excess of $2 million, the credit is 2.5 percent of expenses in excess of a base amount. *Minnesota* uses the federal definition of gross receipts to compute its base amount, and that base amount is calculated the same way as the federal base amount under the regular method, using only state amounts.

New York allows a research credit equal to 50 percent of the taxpayer's federal research, subject to a limit of 3 percent of qualified research expenses attributable to research conducted in *New York*. The research credit is only available to firms in targeted industries such as biotechnology, pharmaceutical, cutting-edge technology, clean technology, green technology, financial services, agriculture, and manufacturing.

FISCAL IMPACT

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved, but anticipate such costs would be significant, particularly for periods occurring before the department would begin to receive its reimbursement of costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1564 As Introduced January 29, 2014 For Taxable Years Beginning On or After January 1, 2014 Assumed Enactment After June 30, 2014 ($ in Billions)				
2014-15	2015-16	2016-17	2017-18	2018-19
- $1	- $3.1	- $2.3	- $1.7	- $1.4

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

SUPPORT/OPPOSITION

Support: Unknown.

Opposition: Unknown.

ARGUMENTS

Proponents: Those in support of this bill may argue that it would substantially increase the tax incentive to conduct research in this state.

Opponents: Those who oppose this bill may argue that it would inadvertantly create opportunities to overstate research credits.

POLICY CONCERNS

Audit Rules in General

Enacting statutory rules to control how the FTB audits a particular credit would be unprecedented, and could result in improper claims for research credit that would be difficult for the department to disallow due to the audit restrictions this bill would impose. The department is not aware of any comparable audit restrictions under federal law or any other state's law.

Requirement that the FTB Obtain Evidence to Contradict a Taxpayer's Documents or Evidence

This bill would provide that an adjustment based upon mere criticism of a taxpayer's workpapers, study, methods, or vague disallowance for law of substantiation, without actual information or evidence that contradicts a taxpayer's documents or other evidence would not be upheld. This proposed rule would shift the burden of proof from the taxpayer to the FTB with respect to research credits; however, because taxpayers control their records, it would be impractical to assume that the FTB would be able to obtain information or evidence contradicting the documents or other evidence that such a taxpayer would choose to provide.

Furthermore, this rule would contradict the general rule that authorizes the FTB to require taxpayers provide information or make available for examination or copying any books, papers, or other data that may be relevant in ascertaining the correctness of any tax return.[15]

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[15] R&TC section 19504.