

SUMMARY ANALYSIS OF AMENDED BILL

Author: Pérez, V. Manuel Analyst: Scott McFarlane Bill Number: AB 1564
 Related Bills: See Prior Analysis Telephone: 845-6075 Amended Date: April 8, 2014
 Attorney: Bruce Langston Sponsor: _____

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

SUMMARY

This bill would increase the credit rates of the research credit temporarily, 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.

SUMMARY OF AMENDMENTS

The April 8, 2014, amendments removed the provision that would have imposed a ten-year carryover limitation on the research credit, resolved the implementation concern regarding amounts that would be deposited into the Research and Development Tax Credit Trade Fund by providing that the reimbursements to GO-Biz and the FTB would be calculated based on the face value of the credit sold or purchased, and made other minor technical changes.

As a result of the April, 8, 2014, amendments, the “This Bill” and “Implementation Considerations” sections of the department’s analysis of this bill as introduced January 29, 2014, have been revised and are provided below. The remainder of the department’s analysis of this bill as introduced January 29, 2014, still applies. The “Technical Considerations,” “Fiscal Impact,” and “Economic Impact” sections are restated for convenience.

THIS BILL

This bill would increase the credit rates of the research credit temporarily, 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

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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	<i>Proposed by This Bill</i>	Current Law	<i>Proposed by This Bill</i>
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%

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 the face value 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 of the face value of each credit sold or purchased 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 the face value 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 of the face value of each credit sold or purchased 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 Require the FTB to Rely on Federal Audits.** 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.

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.¹ 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.² Absent an exception from existing disclosure law, the department would be unable to comply with the requirement to quarterly report to GO-Biz.

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.”)

FISCAL IMPACT

Department staff is unable to determine the costs to administer this bill until the implementation considerations 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.

¹ 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](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.

² R&TC section 19542.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1564 As Amended April 8, 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.

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