Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Authors:	Mullin, Wieckowski, and Vidak	Analyst:	Scott McFarlane	Bill Number:	AB 2330
Related Bills:	See Legislative History	Telephone:	845-6075	Introduced Date:	February 21, 2014
		Attorney:	Bruce Langston	Sponsor:	Franchise Tax Board

SUBJECT: Research Credit Simplification

SUMMARY

This bill would simplify the calculation of the California research credit.

RECOMMENDATION

Support.

On December 4, 2013, the three-member Franchise Tax Board voted 2-0, with the Director of Finance abstaining, to sponsor the language included in this bill.

REASON FOR THE BILL

The reason for the bill is to simplify the calculation of the research credit, eliminate confusing differences between federal and state law, and reduce recordkeeping requirements.

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, 2014.

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, and is 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, 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 taxpayers 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 the simplified credit. The simplified credit 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).

- o 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 taxpayers may instead elect the alternative incremental credit.

- 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 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]

[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).

- 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 generally conforms to the university “basic research” credit, 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.

<u>THIS BILL</u>

This bill would simplify the calculation of the California research credit by generally conforming to federal calculation methods and to the recent federal changes to the credit’s rules for acquisitions, dispositions, and aggregations, as described below.

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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).

Calculating the General Research Credit

This bill would bring California into conformity with the federal calculation methods by eliminating the election to use the alternative incremental credit for taxable years beginning after 2013, and instead would allow taxpayers to elect to use the alternative simplified credit with the following California modifications:

- Qualified research would mean research conducted in California; and
- The California simplified credit would allow a research credit that would be equal to 10.5 percent of California qualified research expenses over a base amount. The base amount would be calculated by multiplying the California qualified research expenses for the three preceding taxable years by 50 percent.[13]

An election to use the simplified credit would apply to all succeeding taxable years unless revoked with the consent of the Franchise Tax Board (FTB).

Acquisitions, Dispositions, and Aggregation of Expenditures

This bill would conform to the recent federal modifications to the special rules that apply for computing the research credit when a major portion of a trade or business (or unit thereof) changes hands, and for the aggregation of expenditures among commonly-controlled or otherwise-related entities.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs or operations.

LEGISLATIVE HISTORY

AB 1546 (Pérez, 2013/2014) 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. AB 1546 has been referred to the Assembly Revenue and Taxation Committee and the Assembly Committee on Jobs, Economic Development, and the Economy.

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

SB 235 (Wyland, 2013/2014) would have increased the general research credit rate (calculated using the regular method) to the federal credit rate of 20 percent, and would have increased the rates of the alternative incremental credit to the previous federal credit rates of three, four, and five percent. SB 235 failed to pass out of the Senate Committee on Governance and Finance.

[13] The credit rate under the California simplified credit would be reduced to 4.5 percent if a taxpayer has no California qualified research expenses in any one of the three preceding taxable years.

AB 1484 (Anderson, 2009/2010) would have increased the general research credit rate (calculated using the regular method) to the federal credit rate of 20 percent, and would have increased the rates of the alternative incremental credit to the previous federal credit rates of three, four, and five percent. 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 rate (calculated using the regular method) to the federal credit rate of 20 percent, would have eliminated the election to use the alternative incremental credit, and would have allowed an election of the alternative simplified credit using federal credit rates. AB 2278 failed to pass out of the Assembly by the constitutional deadline.

SB 444 (Ashburn, 2009/2010) would have increased the general research credit rate (calculated using the regular method) to the federal credit rate of 20 percent, and would have increased the rates of the alternative incremental credit to the previous federal credit rates of three, four, and five percent. SB 444 failed to pass out of the Senate by the constitutional deadline.

SB 1239 (Wyland, 2009/2010) would have, among other things, increased the general research credit rate (calculated using the regular method) to the federal credit rate of 20 percent, and would have increased the rates of the alternative incremental credit to the previous federal credit rates of three, four, and five percent. 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 the following:

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. Massachusetts* 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.

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

This proposal would not significantly impact the department's costs.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Estimated Revenue Impact of AB 2330 As Introduced February 21, 2014 For Taxable Years Beginning On or After January 1, 2014 Assumed Enactment After June 30, 2014 ($ in Millions)		
2014-15	2015-16	2016-17
- $75	- $80	- $80

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 encourage more companies to conduct research in California by simplifying the credit calculation and reducing recordkeeping requirements.

Opponents: Those in opposition to this bill may argue that it should be expanded to conform to the federal energy research credit.

LEGISLATIVE STAFF CONTACT

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