

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Perea Analyst: David Scott Bill Number: AB 33
Related Bills: See Legislative History Telephone: 845-5806 Introduced Date: December 3, 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 (UC) and commercialize the patent in California.

RECOMMENDATION

No position.

Summary of Suggested Amendments

Amendments 1-4 would resolve the technical concerns, below, regarding the definition of “qualified research” and the use of “licensed patent” vs. “qualified patent.” The suggested amendments would amend the bill to use consistent terms.

REASON FOR THE BILL

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, 2013.

ANALYSIS

PROGRAM BACKGROUND

“Patent boxes” incentives (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.

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Typically, a patent box program allows taxpayers to receive a lower tax rate on income that was generated from patented products produced within the country offering the patent box. Additionally, each country has specific conditions for receiving the lower tax rate. Patent boxes differ from Research & Development (R&D) incentives because they provide firms with an incentive for commercialization of innovation, rather than just for the conduct of research.

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

FEDERAL/STATE LAW

Patent Box

Currently, there are no federal or California tax provisions for a “patent box” (see discussion in Program Background above) or a credit for royalties paid for the use and commercialization of patents. However, Federal and California tax law include research and development credits to incentivize research in the United States and California.

Two U.S. patent box bills¹ were introduced in the House of Representatives in 2012. Both of the bills failed to pass out of the House before the end of session. Senator Diane Feinstein is drafting a version of U.S. Patent Box legislation.

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 Law (PITL) and Corporate Tax Law (CTL) 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 also allowed a credit of 20 percent of expenses paid to fund basic research at universities and certain nonprofit scientific research organizations.

¹ Manufacturing Innovation in America Act of 2012, H.R. 6353, 112th Congress, 2nd session, 2012 and Manufacturing Innovation in America Act of 2012, H.R. 6544, 112th Congress, 2nd session, 2012.

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 was extended through 2013.²

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 for the 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.

THIS BILL

This bill would add the following provisions to PITL and CTL:

- Create a tax credit equal to 15 percent of the “qualified royalties” paid by a “qualified taxpayer” during the taxable year.
- Define the following terms:
 - “Commercialize” means the process in which a taxpayer is a licensee of a qualified patent and uses the patent in connection with, or incorporates the patent into, intellectual property or tangible personal property in the manner described, with respect to which a qualified patent is used directly or indirectly in connection with the manufacturing, production, growing, or extraction process with respect to such property, or is incorporated into such property and such incorporation serves a significant commercial purpose.

² American Taxpayer Relief Act of 2012, (Public Law 112-240)

- “Qualified patent” means a patent owned by the UC for an invention where the research and development for that invention was funded, in whole or in part, by amounts eligible for the credit under Section 17052.12³ or 23609.⁴
 - “Qualified royalties” means any royalties paid by a qualified taxpayer for the use of a qualified patent through a license agreement with the UC or another entity.
 - “Qualified taxpayer” means a taxpayer that paid qualified royalties during the taxable year and commercializes, for at least five consecutive years within the state, the licensed patent for which qualified royalties were paid during the taxable year.
- Allow unused credits to be carried over to subsequent tax years for up to nine years.
 - Require the credit to be claimed on a timely filed original return.
 - Define the cut-off date as the last day of the calendar quarter in which the Franchise Tax Board (FTB) determines the available credit limit will be met.
 - Limit the total available credit to one hundred million dollars (\$100,000,000) for all taxable years.
 - Provide that the FTB shall determine the date a return is received.
 - Provide that determinations of the FTB with respect to the cut-off date, the date a return is received, and whether the return has been timely filed may not be reviewed in any administrative or judicial proceeding.
 - Treat disallowed credits as mathematical errors on the return.
 - Require the FTB to track the amount of credits claimed on timely filed original returns, post the cumulative total on its website, and determine when the credit limit is reached for determining the cut-off date.
 - Allow the FTB to prescribe rules, guidelines, or procedures necessary to carry out the purpose of these sections.
 - Exempt the FTB's prescribed rules, guidelines or procedures from the requirements of the Administrative Procedures Act.
 - Repeal the credit on December 1, of the calendar year after the year that the cut-off is met.

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.

1. The patent is required to be owned by the UC, but lacks a requirement that the UC did the work to create the patent. This would allow a credit on royalties for patents that were donated to the UC by a third party, and then licensed by the UC to another third party. If it is the author's intent that research and development needs to be performed at the UC, then the author may wish to amend the language to include this as a requirement.

³ California PIT credit for research expenses.

⁴ California CTL credit for research expenses.

2. The treatment of a credit claimed by a taxpayer that fails to meet the specified five year commercialization period is not specified. If it is the author's intention that the credit be disallowed if the commercialization period requirement is unmet, the author may wish to amend this bill to include a credit recapturing scheme.
3. The "qualified patent" is required to be funded by amounts that meet the requirements for California's Research and Development credit. Typically, it would be the taxpayer paying the royalty that would be audited, for purposes of verifying the credit. The costs incurred by the UC would not be part of that verification process. As a result, a taxpayer who has paid royalties to the UC would not be able to show the necessary documentation to support the funding requirement because the UC, not the taxpayer, would have control of the expenses incurred to produce the patent.

Taxpayers would need a mechanism to receive documentation that the patent expenses incurred by the UC meet the requirement to be a qualified patent. The author may wish to amend the bill to include certification language that would specify the responsibilities of both the certifying agency and the taxpayer.

4. A "qualified taxpayer" would be required to commercialize the patent for five consecutive years. The language does not clarify if those are taxable years or calendar years, or when the first year begins. The author may wish to amend the bill to clarify this issue.

TECHNICAL CONSIDERATIONS

The bill language defines "qualified research," however; the term does not appear in the text of the bill other than in that definition. Suggested amendments 1 and 3, would remedy this technical consideration.

The paragraphs in the bill language, defining a "qualified taxpayer," use the term "licensed patent". There is no definition of a "licensed patent" in the bill and the remainder of the bill language uses the term "qualified patent". In order to eliminate any confusion on the part of taxpayers, suggested amendments 2 and 4 would change "licensed patent" to "qualified patent" and remedy this technical consideration.

LEGISLATIVE HISTORY

AB 1818 (Perea and Beall, 2011/12) was substantially similar to this bill. It would have allowed a tax credit of 15 percent of the royalties paid for a UC owned patent that was used in manufacturing, production, growing, or an extraction process for commercial purposes. AB 1818 did not pass out of the Assembly Appropriations Committee by the constitutional deadline.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York laws do not provide a credit/deduction comparable to the credit allowed by this bill. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

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.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 33 As Introduced December 3, 2012 For Taxable Years Beginning On or After January 1, 2013 Assumed Enactment After June 30, 2013 (\$ in Millions)		
2013-14	2014-15	2015-16
-\$22	-\$22	-\$24

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

LEGAL IMPACT

This bill would restrict this tax credit to qualified products commercialized in California. This bill could raise constitutional concerns under the Commerce Clause of the United States Constitution because it could appear to favor in-state businesses. On August 28, 2012, (*Cutler v. Franchise Tax Board*), the Court of Appeal issued a unanimous opinion holding that California's Qualified Small Business Statute is unconstitutional. Specifically, the Court of Appeal held that the California-heavy requirements of this investment incentive statute discriminate against interstate commerce, and therefore violate the federal dormant commerce clause. While no court decision has yet invalidated, as a general matter, state income tax credits that provide an incentive for in-state activity, i.e., property placed in service in the state, employees employed in the state, etc., targeted tax credits such as the Royalties Paid for Patent Credit that are conditioned on location in California may be subject to constitutional challenge.

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 this type of tax incentive fails to actually address market failure because firms already have all the incentives they need to commercialize innovation in the marketplace.

POLICY CONCERNS

This bill allows a credit for royalties paid to the UC or any "other entity". This could result in multiple taxpayers being allowed a credit for royalties paid to use the same patent. For example, Company A could license the patent from the UC and pay royalties for which they could be entitled to a credit. If Company A subsequently sublicenses the patent to Company B for royalties, Company B would also be entitled to a credit. 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 UC.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO
AB 33 Royalties Paid for Patent Credit

AMENDMENT 1

On page 2, line 16, strikeout "amounts" and insert:

qualified research

AMENDMENT 2

On page 2, line 26, strikeout "licensed" and insert:

qualified

AMENDMENT 3

On page 4, line 10, strikeout "amounts" and insert:

qualified research

AMENDMENT 4

On page 4, line 20, strikeout "licensed" and insert:

qualified