

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: V. Manuel Perez Analyst: Diane Deatherage Bill Number: AB 653  
Related Bills: See Legislative History Telephone: 845-4783 Introduced Date: February 21, 2013  
Amended Date: April 16, 2013  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Research and Development Expense Credit Increase/Postsecondary Educational Institution Contribution Credit

### SUMMARY

This bill would do the following:

**Provision No. 1:** Modify the franchise and income tax research credit (Research Credit).

**Provision No. 2:** Create a franchise and income tax credit for qualified taxpayers that contribute to a postsecondary educational institution to provide curriculum, consultation services, or research that leads to job opportunities in the private sector (Contribution Credit).

This analysis only addresses those provisions of the bill that impact the department.

The provisions of the bill will be discussed separately.

This is the department's first analysis of the bill.

### RECOMMENDATION

No position.

### Summary of Amendments

The April 16, 2013, amendments removed all provisions related to legislative oversight of the state's regulatory process, modified the percentage applied to determine the research credit allowed under the personal income tax law (PITL), and eliminated the requirement that a taxpayer report certain research credit utilization information to the Franchise Tax Board.

### Summary of Suggested Amendments

Amendments 1 and 3 would amend the language to include an end date for the modifications proposed in the Research Credit provision.

Amendments 2 and 4 would remove unnecessary duplicative language contained in the definition of qualified taxpayer.

Board Position:  
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\_\_\_\_\_ SA      \_\_\_\_\_ O      \_\_\_\_\_ NAR  
\_\_\_\_\_ N      \_\_\_\_\_ OUA

Executive Officer	Date
Selvi Stanislaus	6/05/13

## ECONOMIC IMPACT – SUMMARY REVENUE TABLE

### Revenue Estimate

	Estimated Revenue Impact of AB 653 As Amended on April 16, 2013 For Taxable Years Beginning On or After January 1, 2014 Assumed Enactment After June 30, 2013 (\$ in Millions)		
	2013-14	2014-15	2015-16
Research Credit	- \$32	- \$150	- \$300
Contribution Credit	- \$95	- \$230	- \$300
Total	- \$127	- \$380	- \$600

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

### REASON FOR THE BILL

The reason for the bill is to develop a long-term economic plan for the state to partner with the private sector's "Innovation Economy" that includes eliminating roadblocks in state law and regulation, and incentivizing investments in capital expenditures and higher education.

### EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2014.

### PROVISION 1: Research Credit

#### ANALYSIS

#### 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 taxpayers 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 allowed a credit of 20 percent of expenses paid to fund basic research at universities and certain nonprofit scientific research organizations that exceed the base period amount (basic research payments), as defined.

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.

### 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 increasing qualified research in California is 15 percent versus the 20 percent federal credit.
- The credit percentage for basic research payments 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 PROVISION

Under the PITL, this provision would incrementally increase the credit percentage applied to qualified research expenses in excess of the base amount from 15 percent to 30 percent over a five year period beginning with taxable year 2014 and ending with taxable year 2018. Under the corporate income tax law (CTL), the credit percentage applied to qualified research expenses in excess of the base amount would be incrementally increased from 15 percent to 40 percent over a five year period beginning with taxable year 2014 and ending with taxable year 2018.

Under the CTL, this provision would also increase the credit percentage applied to basic research payments from the current 24 percent to 40 percent at a rate of 5 percent for three years and one percent in the fourth year over the four taxable years 2014 through 2017. For taxable years beginning on or after January 1, 2018, the credit percentage applied to basic research payments would be reduced from 40 percent to 25 percent.

### IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems.

### TECHNICAL CONSIDERATIONS

Paragraph (3) of subdivision (b) of Revenue and Taxation Code sections 17052.12 and 23609 need to be amended to include an end date for the modifications that currently apply to taxable years beginning on or after January 1, 2000. Amendments 1 and 3 are provided to make this correction.

## LEGISLATIVE HISTORY

AB 2506 (Perez, 2011/2012), would have among other things, similar to this provision, incrementally increased the credit percentage applied to qualified research and basic research expenses and would have required an additional reporting requirement for those taxpayers utilizing the credit. AB 2506 failed to pass out of the Assembly by the constitutional deadline.

AB 1484 (Anderson, 2009/2010) would have increased the credit percentage for qualified research expenses to 20 percent and conformed to the federal alternative incremental credit (AIC) percentages for taxable years beginning on or after January 1, 2010. AB 1484 failed to pass out of the Assembly Revenue and Taxation Committee by the constitutional deadline.

AB 2278 (Anderson, 2009/2010) would have increased the credit percentage for qualified research expenses to 20 percent, conformed to the federal alternative simplified credit, and eliminated the AIC methodology for taxable years beginning on or after January 1, 2010. AB 2278 was held in the Assembly Committee on Revenue and Taxation without further action.

SB 444 (Ashburn, 2009/2010) would have increased the credit percentage for qualified research expenses to 20 percent and conformed to the federal AIC percentages for taxable years beginning on or after January 1, 2009. SB 444 failed to pass out of the Senate Committee on Revenue and Taxation by the constitutional deadline.

## PROGRAM BACKGROUND

The department annually releases a report on state tax expenditures. The 2012 State Tax Expenditure Report contains information regarding the usage of the Research Expense Credit for the 2009 taxable year. The relevant section begins on page 47 of the report. The entire report can be viewed by accessing: [https://www.ftb.ca.gov/aboutftb/tax\\_expenditure\\_report\\_2009.pdf](https://www.ftb.ca.gov/aboutftb/tax_expenditure_report_2009.pdf).

## 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.

*Florida* allows a corporate income tax credit of up to 10 percent of the qualified research expenses in excess of the base amount for research performed in the state. For taxpayers that have been in existence less than four years, the maximum tax credit is reduced by 25 percent for each taxable year during the immediately preceding four taxable years that the taxpayer, or a predecessor corporation that was a business enterprise, did not exist. The credit taken in any taxable year may not exceed 50 percent of the business enterprise's remaining net income tax liability after all other credits have been applied. Unused credits may be carried forward up to five years. *Florida* lacks a comparable credit for personal income taxpayers because *Florida* has no state personal income tax.

For taxable years ending on or before December 31, 2015, *Illinois* corporate and individual taxpayers may claim an income tax credit for qualified expenditures that are used for increasing research activities in *Illinois*. The credit equals 6½ percent of the qualifying expenditures. Unused credits generated in taxable years ending on or after December 31, 2004, may be carried forward for up to five years.

*Massachusetts* allows corporate taxpayers to claim an excise tax credit for qualified expenditures that are used for increasing research activities in *Massachusetts*. The credit is 15 percent of the basic research payments and 10 percent of qualified research expenses conducted in *Massachusetts*. Effective for taxable years beginning on or after January 1, 2009, and before January 1, 2018, a certified life sciences company is allowed a refundable credit on expenditures for research activity that takes place both within and outside of *Massachusetts*. Unused credits may be carried forward for up to 15 years.

Effective January 1, 2012, *Michigan* replaced the Michigan Business Tax with a corporate income tax. There is no research credit under the corporate or personal income tax. Taxpayers with unused hybrid technology research and development credits that were certificated under the Michigan Business Tax regime may continue to file Michigan Business Tax returns until the credit is paid or exhausted.

*Minnesota* allows two refundable corporate franchise tax credits for research and development: a general research credit available to all businesses, and a refundable credit allowed to a qualified business for increasing research activities in a biotechnology and health sciences zone. The general research credit is equal to 10 percent (5 percent for the zone-based research credit) for qualified research expenses up to \$2 million. The amount of the credit is reduced to 2.5 percent for expenses exceeding the first \$2 million. Unused credits may be carried forward up to 15 years.

*New York* allows a credit for qualified emerging technology companies. The credit is equal to the sum of 18 percent of the cost of research and development property, 9 percent of the qualified research expenses, and the cost of qualified high-technology training expenditures, limited to \$4,000 per employee, per year, subject to a maximum of \$250,000 per taxable year. Any excess credit can be refunded or applied as a payment for the following taxable year.

## **FISCAL IMPACT**

This provision would modify the calculation of the research credit and require a new form or worksheet to be developed. As a result, this provision would impact the department's printing, processing, and systems modification costs. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

## **ECONOMIC IMPACT**

### Revenue Estimate

Estimated Revenue Impact of Research Credit Provision of AB 653 As Amended April 16, 2013 For Taxable Years Beginning On or After January 1, 2014 Assumed Enactment After June 30, 2013 (\$ in Millions)		
2013-14	2014-15	2015-16
- \$32	- \$150	- \$300

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

## **SUPPORT/OPPOSITION**

Support: California Hispanic Chamber of Commerce (sponsor) and BIOCUM.

Opposition: None identified.

## **ARGUMENTS**

Proponents: Supporters could argue that this bill would stimulate job creation by offering an enhanced research credit to businesses that have the ability to employ new workers.

Opponents: Some could argue that with the state's fragile economy, additional tax expenditures should be avoided.

## **PROVISION 2: Contribution Credit**

### **ANALYSIS**

#### FEDERAL/STATE LAW

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.

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business.

Existing state and federal laws allow deductions from income for charitable contributions. An individual can deduct an amount not to exceed 50 percent of their adjusted gross income.

Charitable contributions made by business entities operating as a sole proprietorship or single member limited liability company, and the flow through amounts from a partnership or S corporation, are reported on the owner's or partner's individual income tax return. Business entities operating as a corporation or S-corporation are allowed deductions for charitable contributions that are limited to 10 percent of the taxpayer's net income. Contributions in excess of 10 percent of net income may be carried over to the following five succeeding taxable years.

A business entity's charitable contributions in excess of the allowed charitable contribution deduction are specifically excluded as a deduction for ordinary and necessary business expenses.

### THIS PROVISION

This provision would create an income and franchise tax credit equal to 25 percent of the qualified contributions made by a qualified taxpayer during the taxable year.

Qualified contributions would be defined as monetary contributions made by a business entity to a postsecondary educational institution for either:

- curriculum or research leading to job opportunities in the private sector, or
- consultation services associated with the establishment of curriculum or research leading to job opportunities in the private sector.

The business entity and the postsecondary educational institution must agree that there is a substantial potential for the future employment of students as a result of the contribution.

Qualified taxpayer would mean a business entity that makes a qualified contribution to a postsecondary educational institution.

Unused credits could be carried forward until exhausted.

The department would be authorized to develop rules, guidelines, or procedures as necessary and appropriate. Standards, criteria, procedures, determinations, rules, notices, and guidelines necessary to implement this provision would be exempt from Administrative Procedure Act<sup>1</sup> requirements.

### 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.

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<sup>1</sup> The [Administrative Procedure Act \(APA\)](#) establishes rulemaking procedures and standards for state agencies in California. The requirements set forth in the APA are designed to provide the public with a meaningful opportunity to participate in the adoption of state regulations and to ensure that regulations are clear, necessary and legally valid. The APA is found in the California Government Code, commencing with section 11340.

The provision is silent on how, when, by whom, and what information would be provided to the department to confirm eligibility for the credit. As a result, verification of the credit would require the department to request substantiating documents from the taxpayer. In order to reduce taxpayer burden and provide for ease of administration, it is recommended that the provision be amended to include certification language specifying the certifying agency and the responsibilities of both the certifying agency and the taxpayer. Additionally, the author may wish to consider amending this provision to require certification by the postsecondary educational institution that the taxpayer would be required to provide to the department upon request.

This provision uses phrases that are undefined, i.e., “business entity,” “curriculum or research leading to job opportunities in the private sector,” “substantial potential,” “postsecondary educational institution.” The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit.

### TECHNICAL CONSIDERATIONS

The definition of qualified taxpayer unnecessarily duplicates language that appears in the definition of a qualified contribution. Amendments 2 and 4 are provided to eliminate the duplication.

### **LEGISLATIVE HISTORY**

SB 594 (Steinberg, et al., 2013/2014) would among other things, establish the Career Pathways Investment Credit for career exploration activities, curriculum and professional development programs, and middle school or high school programs that create career pathways, as defined. This credit would be allocated and certified by the Superintendent of Public Instruction. SB 594 has passed in the Senate and is currently pending before the Assembly.

AB 2506 (Perez, 2011/2012) would have, among other things, created an income and franchise tax credit identical to the credit in this provision. AB 2506 failed to pass out of the Assembly by the constitutional deadline.

SB 974 (Steinberg, et al., 2009/2010) would have, among other things, created an income and franchise tax credit identical to the credit in this provision. SB 974 was held in the Assembly Committee on Jobs, Economic Development, and the Economy.

### **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.

*Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* laws do not provide a credit comparable to the credit allowed by this provision.

## FISCAL IMPACT

Department staff is unable to determine the costs to administer this bill until the implementation considerations have been resolved. As the bill continues to move through the legislative process and the implementation concerns are resolved, costs will be identified and an appropriation will be requested, if necessary.

## ECONOMIC IMPACT

### Revenue Estimate

Estimated Revenue Impact of Contribution Credit Provision of AB 653 As Amended April 16, 2013 For Taxable Years Beginning On or After January 1, 2014 Assumed Enactment After June 30, 2013 (\$ in Millions)		
2013-14	2014-15	2015-16
- \$95	- \$230	- \$300

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

## SUPPORT/OPPOSITION

Support: California Hispanic Chamber of Commerce (sponsor) and BIOCOM

Opposition: None identified.

## ARGUMENTS

Proponents: Supporters could argue that this bill would stimulate job creation by offering a credit to business entities for contributions to postsecondary educational institutions that are used to develop job opportunities in the private sector.

Opponents: Some could argue that with the state's fragile economy, additional tax expenditures should be avoided.

## POLICY CONCERNS

This provision would allow a credit for qualified contributions that, in some circumstances, could also be deductible as a business expense or charitable contribution. Generally, a credit is allowed in lieu of a deduction in order to eliminate multiple tax benefits for the same item of expense.

This bill would allow a credit for contributions to postsecondary educational institutions located inside and outside of California. Historically, tax credits have been designed to provide incentives for taxpayers to perform various actions or activities within the state that they may not otherwise undertake. But if the bill were to be amended to restrict this credit to contributions to postsecondary educational institutions located in California, this 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 facially discriminates against interstate commerce, and therefore violates 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 that are conditioned on location in California may be subject to constitutional challenge.

This provision lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of a credit by the Legislature.

This provision would allow for an unlimited carryover period. Consequently, the department would be required to retain the carryover on the tax forms indefinitely. Recent credits have been enacted with a carryover period limitation because experience shows credits typically are exhausted within eight years of being earned.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 653  
AS AMENDED APRIL 16, 2013

AMENDMENT 1

On page 14, strikeout line 21, and insert:

and before January 1, 2014, the reference to "20 percent" in Section 41(a)(1) of the Internal

AMENDMENT 2

On page 17, line 21, strikeout "to a postsecondary educational institution"

AMENDMENT 3

On page 18, strikeout line 21, and insert:

and before January 1, 2014, both of the following shall apply:

AMENDMENT 4

On page 23, line 4, strikeout "to a postsecondary educational institution"