**Franchise Tax Board**

# ANALYSIS OF ORIGINAL BILL

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| Author: | Lieu | Analyst: | David Scott | Bill Number: | SB 500 |
| Related Bills: | See Legislative History | Telephone: | 845-5806 | Introduced Date: | February 21, 2013 |
| | | Attorney: | Patrick Kusiak | Sponsor: | |

**SUBJECT**: Research Expenses Credit/20% of Excess Qualified Expenses/ Conformity to Election of Alternative Incremental Credit and Alternative Simplified Credit

## SUMMARY

This bill would do the following:

- Increase the percentages used to compute the credit amount for excess research expenses and for corporate basic research expenses.
- Increase the percentages for the alternative incremental research credit to equal the percentages in place for federal purposes for taxable years beginning prior to January 1, 2009. Conform to the federal election of the alternative simplified credit, federal credit for energy research, and contract research expenses.

## RECOMMENDATION

No position.

## REASON FOR THE BILL

The reason for this bill is to give companies in some of California's most competitive industries an incentive to keep high-paying, high-skill jobs in California by conforming to certain federal research and development (R&D) credit rates and provisions.

## 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, 2013.

| Board Position: | | | Executive Officer | Date |
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**ANALYSIS**

FEDERAL/STATE LAW

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 R&D activities.

The research credit 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.

For taxable years beginning before January 1, 2008, instead of determining the credit based on 20 percent of qualified research expenses in excess of a base amount, a taxpayer could elect to calculate the credit using the method referred to as the alternative incremental research credit. This method applied graduated percentages of 3 percent, 4 percent, and 5 percent, to expenses in excess of1 to 1.5 percent, 1.5 to 2.0 percent , and greater than 2.0 percent, respectively, of average annual gross receipts. This method is no longer available for federal purposes. This method was terminated for federal purpose for taxable years beginning on or after January 1, 2009.

Corporate taxpayers, in addition to the two components listed above, are allowed to include 20 percent of expenses paid to fund basic research at universities and certain nonprofit scientific research organizations.

To be eligible 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.[1]

[1] American Taxpayer Relief Act of 2012, (Public Law 112-240)

*Alternative Simplified Credit*

Taxpayers may elect to use an alternative method for computing the amount of their federal research credit. This method is called the alternative simplified credit (ASC). The federal ASC is equal to 12% of qualified research expenses that exceed 50% of the average qualified research expenses for the three preceding taxable years. The rate is reduced to 6% if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

An election to use the federal ASC applies to all succeeding taxable years, unless revoked with the consent of the Secretary.

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.
- Gross receipts are modified to take into account only those gross receipts from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state, regardless of the f.o.b. point or any other condition of sale.
- The alternative incremental research credit is still available for California taxpayers, but the federal percentages of 3 percent, 4 percent, and 5 percent are reduced to 1.49 percent, 1.98 percent, and 2.48 percent, respectively.

California does not conform to the federal alternative simplified method.

THIS BILL

For taxable years beginning on or after January 1, 2013, this bill would do the following:

- Increase the credit for increasing research expenses to 20 percent of the excess of the qualified research expenses;
- Allow 20 percent of payments to energy research consortium of energy research;
- Allow payments for contract research expenses to include amounts paid to small businesses, universities, and federal laboratories;
- Incorporate the definition of energy research consortium;
- Allow California taxpayers to elect the ASC;
- Allow the use the federal percentages (3, 4, or 5 percent) for the Alternative Incremental Credit

IMPLEMENTATION CONSIDERATIONS-

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

**LEGISLATIVE HISTORY**

AB 1484 (Anderson, 2009/2010), a similar bill, would have increased the credit amount to 20 percent of the excess qualified research expenses and conformed to the federal alternative incremental research credit percentages. AB 1484 failed to pass out of the Assembly by the constitutional deadline.

AB 2278 (Anderson, 2009/2010), a similar bill, would have eliminated the election to use the alternative incremental research credit from the calculation of the research credit and would instead have allowed an election to use the ASC. AB 2278 failed to pass out of the Assembly by the constitutional deadline.

SB 444(Ashburn, 2009/2010), a similar bill, would have increased the credit amount to 20 percent of the excess qualified research expenses and conformed to the federal alternative incremental research credit percentages. SB 444 failed to pass out of the Senate by the constitutional deadline.

SB 1239 (Wyland, 2009/2010), a similar bill, would have increased the credit amount to 20 percent of the excess qualified research expenses and conformed to the federal alternative incremental research credit percentages. SB 1239 failed to pass out of the Senate by the constitutional deadline.

SBX6-9 (Dutton, 2009/2010) a similar bill, would have eliminated the election to use the alternative incremental research creditfrom the calculation of the research credit and would instead have allowed an election to use the ASC. SBX6-9 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.

*Florida* allows corporate taxpayers to claim a corporate income tax credit for certain "eligible costs" for renewable energy technologies investment. *Florida* lacks a comparable credit for personal income taxpayers because *Florida* has no state personal income tax.

*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.

*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 the credit on expenditures for research activity that takes place both within and outside of *Massachusetts*.

*Minnesota* allows two credits for R&D: a general nonrefundable 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 credit is equal to 5 percent 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.

*Michigan* allows corporate taxpayers a credit of 1.9 percent of the expenses of the R&D activities conducted in *Michigan*, and a credit of 3.9 percent of the compensation for services performed in hybrid technology R&D. *Michigan* does not allow a credit for pharmaceutical research.

*New York* allows a credit for qualified emerging technology companies. The credit is equal to 18 percent of the cost of R&D 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. The credit is limited to $250,000 per taxable year. Any excess credit can be refunded or applied as a payment for the following taxable year.

**FISCAL IMPACT**

This bill would not impact the department’s costs.

**ECONOMIC IMPACT**

<u>Revenue Estimate</u>

| Estimated Revenue Impact of SB 500<br>As Introduced February 21, 2013<br>For Taxable Years Beginning On or After January 1, 2013<br>Assumed Enactment After June 30, 2013<br>($ in Millions) | | |
|---|---|---|
| 2013-14 | 2014-15 | 2015-16 |
| - $270 | - $270 | - $270 |

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

**SUPPORT/OPPOSITION**

Support: None provided.

Opposition: None provided.

## ARGUMENTS

Proponents: Some could argue that the increased research expenses credit from this bill would stimulate job creation by offering a tax incentive to businesses that have the ability to employ new workers and expand their current workforce.

Opponents: Some taxpayers may say that with the state's current fiscal situation, additional tax expenditures should be avoided.

## POLICY CONCERNS

The bill would allow a taxpayer to elect to use the alternative incremental research credit for computing the credit. Federal tax law terminated this election as of January 1, 2009, therefore, this election would create a state and federal difference, which is contrary to the state's general federal conformity policy.

## LEGISLATIVE STAFF CONTACT

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