Background

California tax law requires corporations that are considered unitary to file a combined report. When corporations are included in a combined report, many tax attributes remain associated with the specific entity that generated them. For example, Net Operating Losses (NOLs) are computed separately by each corporate member of the combined group and may only be deducted by the corporation that reported the NOL, not by other affiliated companies. Similarly, for many years, tax credits could only be used by the entity undertaking the credit-generating activity. As part of the budget deal of 2008, AB 1452 provided that usage of corporate credits in tax years 2008 and 2009 would be limited to 50 percent of tax liability and that California would allow credits to be transferred from one member of a combined group to another member (on returns for tax years beginning on or after July 1, 2008) and used by the receiving entity on tax years beginning on or after January 1, 2010. As part of this legislation, the Franchise Tax Board (FTB) was instructed to write this report on the usage and economic impact of these credit transfers.

Amount and Type of Credit Transferred

Table 1 presents data on credit transfers by tax year. In tax years 2009 - 2011, $2.5 billion of credits have been transferred from one entity to another within 383 combined taxpayer groups. $747 million of the transferred credits have been used by 275 taxpayer groups to reduce tax liability.

Table 1
Transferred Credits by Taxable Year

Taxable Year	Transfers			Usage		
	Number of Taxpayers	Amount of Credit (Millions)	Percentage of Total Transfers	Number of Taxpayers	Amount of Credit (Millions)	Percentage of Total Usage
2009	156	$1,558	62%	n/a	n/a	n/a
2010	225	$617	24%	194	$486	65%
2011	253	$353	14%	226	$261	35%
Total*	383	$2,528	100%	275	$747	100%

*Taxpayers that transfer or use credits in more than one tax year are counted only once in the total number of taxpayers.

Tables 2a, 2b, and 2c present credit transfers and usage by type of credit. The Research and Development Credit (R & D) accounts for 82 percent of credits transferred from 2009 through 2011 and 90 percent of credits that were used to reduce liability in 2010 and 2011.

Table 2a **Transferred Credits by Credit Type 2009**			
Credit Name	**Transfers**		
	Number of Taxpayers	**Amount of Credit (Millions)**	**Percentage of Total**
Research and Development	109	$1,258	81%
Zones \a	35	$290	19%
Other \b	12	$11	1%
Total\e	156	$1,558	100%

Table 2b **Transferred Credits by Credit Type 2010**						
Credit Name	**Transfers**			**Usage**		
	Number of Taxpayers	**Amount of Credit (Millions)**	**Percentage of Total**	**Number of Taxpayers**	**Amount of Credit (Millions)**	**Percentage of Total**
Research and Development	154	$572	93%	139	$455	94%
Zones \a	55	$25	4%	37	$19	4%
Other \b	16	$20	3%	18	$13	3%
Total \e	225	$617	100%	194	$486	100%

a\ Zones include Enterprise Zones, Los Angeles Revitalization Zone, and Targeted Tax Areas.

b\ Other includes Employer Childcare Program, Low-Income Housing, and Manufacturer's Investment.

Table 2c **Transferred Credits by Credit Type 2011**						
Credit Name	**Transfers**			**Usage**		
	Number of Taxpayers	**Amount of Credit (Millions)**	**Percentage of Total**	**Number of Taxpayers**	**Amount of Credit (Millions)**	**Percentage of Total**
Research and Development	179	$251	71%	158	$221	85%
Zones \c	66	$42	12%	60	$35	13%
Other \d	8	$60	17%	7	$5	2%
Total \e	253	$353	100%	225	$261	100%

c\ Zones include Enterprise Zones and Targeted Tax Areas.

d\ Other includes Film Credit, Low-Income Housing, and Manufacturer’s Investment.

e\ Detail may not add to total due to rounding.

Concentration of Usage

The usage of transferred credits is highly concentrated. As seen in table 3, the 3 largest users of credits in 2010 used 52 percent of all credits claimed and the top 25 taxpayers used 89 percent of the credits claimed. In 2011, the top 3 used 37 percent and the top 25 used 80 percent of the credits claimed.

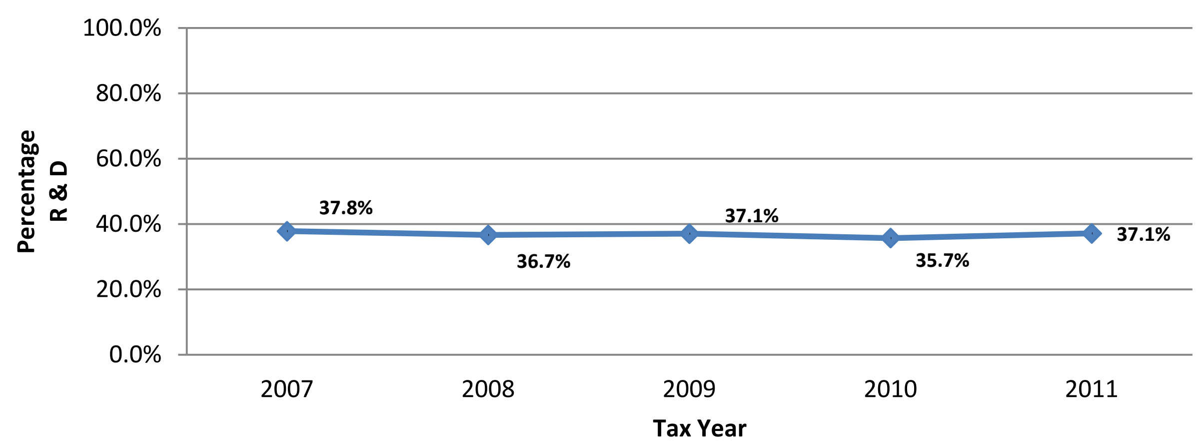
Table 3 **Percentage of Transferred Credit Used**		
Number of Taxpayers	**Percentage of Total 2010**	**Percentage of Total 2011**
Top 3 Taxpayers	52%	37%
Top 10 Taxpayers	71%	59%
Top 25 Taxpayers	89%	80%

Effect on Economic Activity

The legislation enacting credit transfers instructs the FTB to analyze the effect of allowing transfers on economic activity. The legislation asks the FTB to consider the effect of all transfers and specifically to consider the effects of three types of credits: the R & D credit, economic incentive credits (primarily the Enterprise Zone credits), and the low-income housing credits. This report will not provide an analysis of low-income housing credits because the number of taxpayers that reduced their tax liability by transferring these credits each year is so small (less than 3) that a public analysis of their economic performance would violate the FTB's rules on disclosure of confidential taxpayer information. Economic incentive credits also account for a relatively small portion of the usage of transferred credits (about 7 percent of the total). We suspect that the impact of these transfers was relatively small because, while these credits can now be used by any entity in a combined group, they can still only be used to offset income earned in the specific locations designated as eligible for generating the credits (i.e., within an Enterprise Zone). Because of their relative insignificance and because subsequent legislation has eliminated these credits, this report will not provide a detailed analysis of economic incentive credits.

To assess the impact of transferred R & D credits on economic activity, we considered two questions: First, did taxpayers that benefited from transferring credits within their combined group increase their R & D activity in California once transfers were allowed, and second, did these corporations increase other types of activities in California? To answer the first question, we compared R & D investments for taxpayers that reduced their tax liability by transferring credits within their combined group to those that did not. The analysis is based on data on Total Qualified Research Expenses reported to the FTB on lines 9 and 26 of Form 3523. We captured data from these lines for all years from 2007 through 2011 for all firms that filed tax returns between 2009 and 2011. For each year we tabulated the qualified research expenses for taxpayers that benefitted from credit transfers (i.e., used transferred credits to reduce the tax liability of the combined group) and for those that did not. If credit transfers have a significant effect on research activity, the share of expenditures undertaken by taxpayers using transferred credits should increase after the adoption of credit sharing. Chart 1 presents the percentage of qualified research activity in each year undertaken by firms that benefitted from credit transfers. The percentage of expenditures by firms benefitting from credit transfers appears to be about the same before and after the adoption of transfers, so there does not appear to be any direct effect of allowing transfers on economic activity.

Chart 1
Percentage of R & D Expenditures for Taxpayers Using Transferred Credits between 2007 and 2011



The second possibility we considered is that allowing the transfer of R & D credits may induce taxpayers to move other activities related to R & D into California. For example, a taxpayer might expand a manufacturing facility in California only if they can use credits transferred from their research entity to their manufacturing entity. To test this possibility, we looked at apportioning taxpayers who claim R & D credit. We merged data from our Corporation Tax Sample on the taxpayers' payrolls and property located both inside and outside of California with the data described above. There are approximately 2,100 apportioning taxpayers that claimed R & D credits and whose payroll and property data were captured in at least one Corporation Tax Sample during the period 2007-2011. If credit transfers are affecting economic activity, the proportion of taxpayers' payroll and property located in California should increase for taxpayers that can transfer credits relative to those that do not upon the adoption of transfers. This analysis is complicated by the fact that in 2011, California allowed taxpayers to elect a single sales factor apportionment method. Taxpayers making that election no longer report their payroll and property factors to the FTB, so those taxpayers cannot be included in the analysis that year. Chart 2a presents the results of this analysis from 2007 – 2010 for all taxpayers reporting both R & D expenses and apportionment factors.

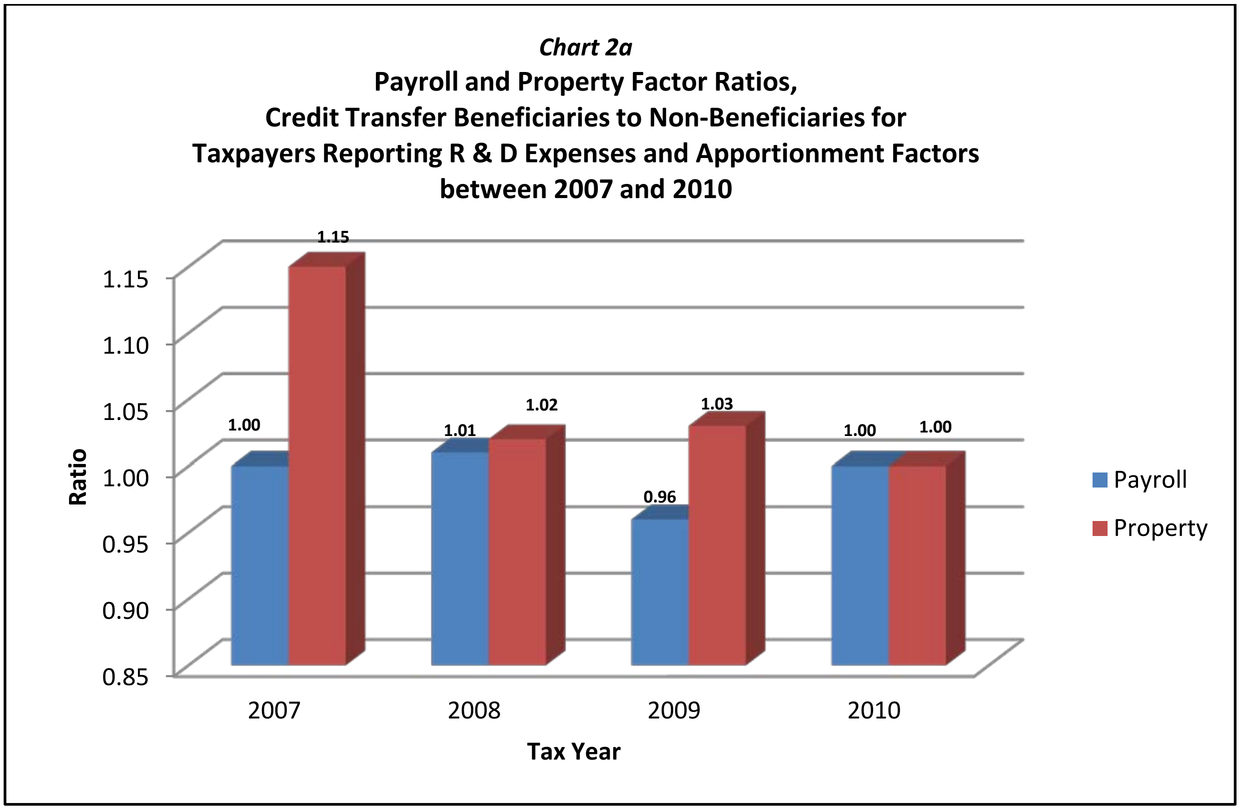


Chart 2b presents the same analysis extended to 2011, but restricted to taxpayers with R & D expenses that report apportionment factors in 2011. For taxpayers claiming transferred credits, total California payroll was divided by total payroll for each year. The same ratio was calculated for taxpayers not claiming transferred credits. For the larger sample, this ratio was exactly the same for both groups of taxpayers in 2007 before the introduction of transfers and in 2010 when transferred credits could be used. The ratio of California property to total property was higher for users of transferred credits than for nonusers in 2007, but was the same for both groups in 2010. For those taxpayers that reported apportionment factors in 2011, both the payroll and property factor ratios were lower after the adoption of credit transfers than before. Since these ratios did not increase for users of transferred credits relative to nonusers upon the adoption of credit transfers, this analysis does not find an economic impact of allowing credit transfers.

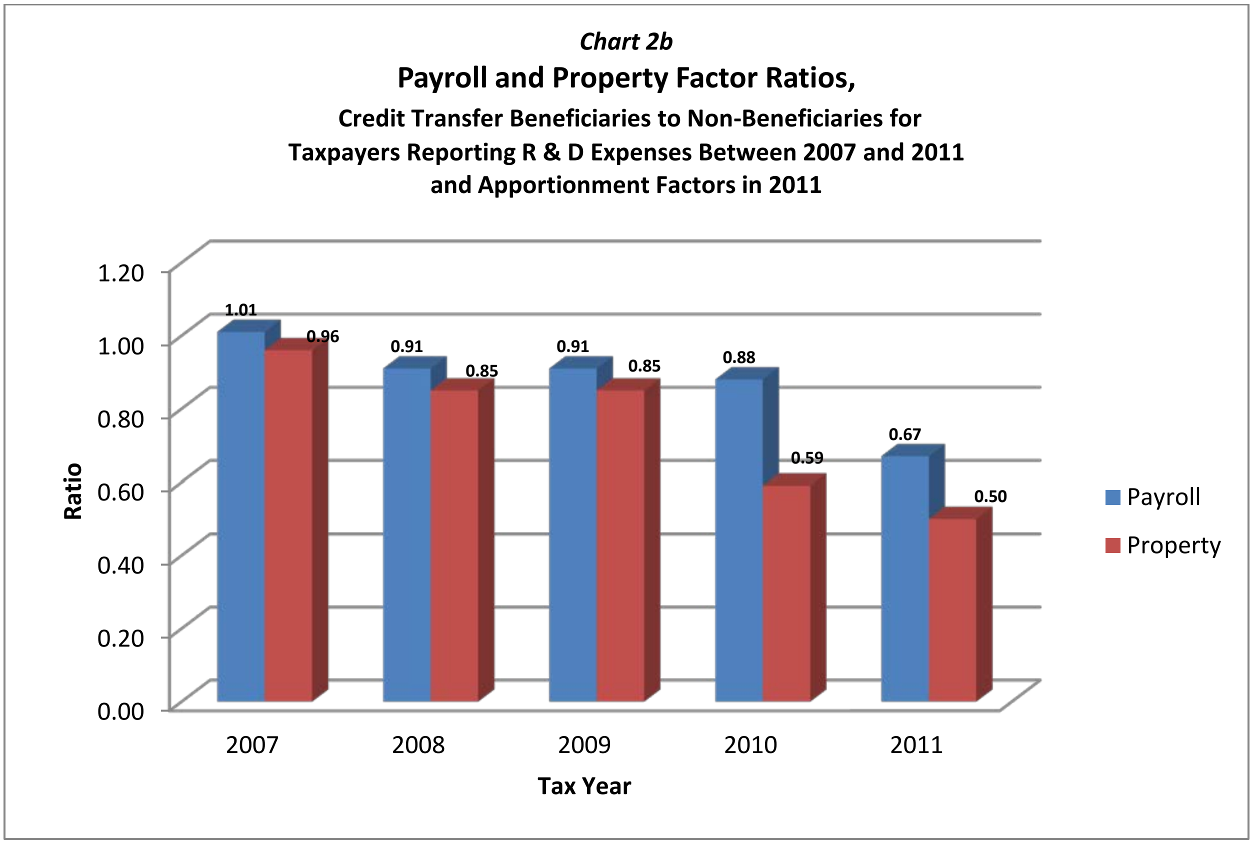


Chart 2b
Payroll and Property Factor Ratios,
Credit Transfer Beneficiaries to Non-Beneficiaries for
Taxpayers Reporting R & D Expenses Between 2007 and 2011
and Apportionment Factors in 2011
1.20
1.00
0.80
0.60
0.40
0.20
0.00
Ratio
1.01
0.96
0.91
0.85
0.91
0.85
0.88
0.59
0.67
0.50
2007
2008
2009
2010
2011
Tax Year
Payroll
Property