

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Ducheny Analyst: Jeani Brent Bill Number: AB 488

Related Bills: See Prior Analysis Telephone: 845-3410 Amended Date: 01/13/2000

Attorney: Patrick Kusiak Sponsor:

SUBJECT: Biotechnology Or Technology Company Research Expenses Credit/Allows Transfer Or Refund of Unused Tax Benefits

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as amended January 3, 2000.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED January 3, 2000, STILL APPLIES.

OTHER - See comments below.

SUMMARY OF BILL

Under the Bank and Corporation Tax Law (B&CTL), this bill would do both of the following:

1. Partnership Allocation of Research Credit: modify the research credit to allow a special allocation of a partnership's credit among certain defined partners. That taxpayer-partner must be either a biotechnology or technology company (as defined) and be in a partnership with a biotechnology or technology company. For such a taxpayer, its share of the partnership's qualified and basic research expenses or share of the credit would equal the sum of (A) the taxpayer's share of either the qualified research expenses and basic research payments or the credit allocated or apportioned to that partner under current law and (B) any portion of another partner's share of expenses or payments that qualify for the credit, or another partner's share of the credit transferred to the taxpayer. The total qualified research expense and basic research payment, or total credit for the income year, with respect to any partner may not exceed 125% of the amount that would be allocated to that partner under current law.
2. Transfer of Research Credit: allow a biotechnology or technology company (as defined) with unused research and development credit carryovers to transfer those credit carryovers to another corporation taxpayer that is (A) in the State of California, (B) a biotechnology or technology company, and (C) is not affiliated with the transferor taxpayer. The taxpayer receiving the transferred tax credit must pay the transferor an amount equal to at least 75% of the value of the transferred tax benefit. The transferor and transferee are affiliated if the same entity directly or indirectly owns or controls 10% or more of the voting rights or 10% of the value of all classes of stock of both taxpayers. The maximum lifetime value of transferred tax benefits that a corporation could transfer would be \$20 million.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Legislative Director

Date

Johnnie Lou Rosas

2-29-00

The bill would require "private financial assistance," which is undefined, to be used for expenses incurred in connection with the operation of a biotechnology company or technology company in this state.

SUMMARY OF AMENDMENT

The January 13, 2000, amendments removed the provisions that would have allowed a biotechnology or technology company with unused research and development credit carryovers to surrender those credits for a refund of 50% of the credit's value. The January 13 amendments also removed the provisions that would have allowed transfer or surrender of the taxpayer's net operating losses.

The January 13, 2000, amendments further defined "biotechnology company" as one primarily engaged in research and development activities as described in North American Industry Classification System (NAICS) Manual Code 541710 and "technology company" as one primarily engaged in computer and electronic product manufacturing as described in NAICS Manual Sector 334.

In addition, the January 13, 2000, amendments added an operative date for the partnership allocation of research credit provisions and included a requirement that, with respect to transferred unused tax benefits, the transferee taxpayer also be a biotechnology or technology company.

The January 13, 2000, amendments added a requirement that the department report to the Legislature on or before January 1, 2005, on the number and costs of the credits transferred pursuant to the bill.

These amendments resolved some of the policy and implementation considerations addressed in the department's analysis of the bill as amended January 3, 2000. Except for the items discussed in this analysis, the department's analysis of the bill as introduced still applies.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. The partnership allocation of research credit provisions specify they would apply to income years beginning on or after January 1, 2000, and before January 1, 2006. The transfer of research credit provisions would apply to income years beginning on or after January 1, 2000, and although it provides no ending income year, the bill specifies that the code section would sunset December 1, 2006.

CONSTITUTIONAL CONSIDERATIONS

The requirement in this bill that a corporation must have either its headquarters or base of operations in California may violate the Commerce Clause of the United States Constitution. Eligibility for the credit allocation provisions and the credit carryover transfer provisions would be limited to only those taxpayers having their corporate headquarters or base of operations in this state, irrespective of the level of such taxpayer's taxable activity in this state, thereby discriminating against taxpayers having their corporate headquarters or base of operations outside of California. Alternatively, providing these tax incentives to all taxpayers that engage in certain activities in this state generally would not be considered a commerce clause violation because the activity itself (conducting research) is being rewarded.

POLICY CONSIDERATIONS

This bill raises the following policy considerations.

1. Generally, tax credits are allowed only to the taxpayer that actually incurs the related expense. Under current state law, only the low-income housing credit statute specifically permits the credit to be transferred to a taxpayer other than the taxpayer that actually incurs the related expenses. The low-income housing credit allows transfer of the credit to the purchaser of the property or between affiliated corporations if the affiliation is 100% ownership. Conversely, this bill would allow earned tax credits that could not be immediately used by the taxpayer incurring the expenses to be transferred to unaffiliated transferees. This bill thereby would create a state tax law precedent by allowing tax credits to be transferred from the taxpayer who incurred the expenses to **any** other taxpayer (irrespective of whether such transferee is an affiliate). Thus, this bill would allow tax credits to be realized by taxpayers that did not incur the actual out-of-pocket expense on which the tax credits are based, thereby providing a benefit to one taxpayer for the action of another taxpayer.

Further, this bill essentially would create a system of "tax benefit transfers" similar to the old federal safe harbor leasing regime. However, tax credits transferable under federal safe harbor leasing rules were limited to tax credits and related deductions for the purchase of certain property, and the transfer was accomplished by a nominal sale-lease back of that property in which the rights of the parties to the various tax benefits were clearly defined. Moreover, under the old federal safe harbor leasing rules, the federal tax treatment of the various forms of consideration flowing between the parties to the transaction were clearly defined, which differs from this bill.

The research tax credit is based on various expenses such as wages, supplies, rental charges, etc. Since this credit is based on expenses, rather than capitalized amounts as was the case under the old federal safe harbor leasing rules, it may be difficult to clearly apply that body of federal tax law in analyzing the proper tax treatment of the tax benefit transfer payments. Thus, absent further legislative clarification, it is unclear how the payments made by the taxpayer purchasing the tax credits under this bill or receiving an enhanced special allocation of the research tax credit under this bill would be treated for California tax purposes by both the seller and purchaser of these tax credits.

2. This bill would allow special allocation of the research credit among partners and transfer of the credit to unaffiliated corporations. However, it would not allow the credit to be transferred between affiliated corporations, establishing differing treatment for partners and unaffiliated corporations than the treatment allowed to affiliated corporations. Moreover, this bill would provide a tax benefit for taxpayers filing under the B&CTL (corporations) that would not be provided to other similarly situated taxpayers that file under the Personal Income Tax Law (PITL) (individuals, sole proprietors, partners, shareholders). Thus, this bill would provide differing treatment based solely on the type of entity, regardless of whether the entity is engaged in the same type of activity.

IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation considerations. These implementation considerations would make it very difficult, if not impossible, to properly implement this bill. Additional concerns may be raised as the department continues to analyze the bill. Department staff is willing to assist the author with any necessary amendments to resolve these concerns.

1. This bill is silent with regard to the proper tax treatment by the transferor and the transferee of the amount paid for the transfer of the tax benefits. It appears that the transferor would include the amount received for the tax credit in income, and the transferee arguably could receive a business expense deduction for the purchase of the tax credit. In the absence of clarification, disputes may arise between taxpayers and the department about the proper tax treatment of the amount paid for the transfer of a tax credit under this bill.
2. This bill leaves unclear when the transferee taxpayer first could use the transferred tax credit carryover. Specifically, it is unclear whether the transferee taxpayer's first opportunity to use the transferred tax credit carryover would be in the same income year as the transferor earned the tax credit or whether the transferee only could use the transferred tax credit in the succeeding income year (and subsequent income years if limited).
3. The bill does not address whether only the entire unused tax credit may be transferred or whether portions of the unused tax benefit would be allowed to be transferred. If portions of the unused tax credit may be transferred, the bill does not address whether or how one tax credit may be divided among multiple transferees.
4. If audit results modify the research credit that has been transferred for consideration, it is unclear which taxpayer would be responsible for the additional tax from the audit adjustment. The bill should clarify how adjustments to the amount of the credit would be handled by the department after the credit is transferred. Moreover, since the department's audit of the transferor taxpayer's return may occur after normal expiration of the statute of limitations (i.e., under a waiver), it may be necessary for the department to request a waiver of the transferee taxpayer's statute of limitations to allow the department to adjust the transferee's tax liability if the department determines that part or all of the claimed tax benefit should be disallowed.

Alternatively, if the claimed tax benefit of the transferor is disallowed only in part, it is unclear how this disallowance would be allocated between the transferor and the transferee, especially if the statute of limitations has expired for one, but not both, of the affected taxpayers.

5. The bill uses inconsistent terms to describe limitations regarding the amount of tax credits that could be transferred. The bill would allow a biotechnology or technology taxpayer to transfer unused tax benefit so long as the transferee taxpayer pays an amount equal to at least 75% of the value of the transferred tax benefit. The bill defines the value of the transferred tax benefit for a tax credit carryover as the value of the credit.

This definition leaves unclear whether the value of the transferred tax credit carryover would be the actual value of the remaining carryover or the credit amount, regardless of whether any portion had been used previously by the transferor.

6. If the amount of tax credits transferred during a year does not exceed the maximum annual amount, it is unclear whether the remaining maximum amount could be transferred to the succeeding year and thereby increase the next year's maximum amount.
7. This bill uses various terms that are not defined, such as "highly educated," "highly trained," "corporation business taxpayer," and "private financial assistance." Further, terms are used inconsistently and in unusual context that add confusion to the provisions. Undefined terms and unclear definitions can lead to disputes between taxpayers and the department.
8. The reporting requirement for the department uses unclear terminology. It is unclear whether the number of credits transferred means the number of actual transfers that occur, or the dollar amount of such transfers. Further, it is unclear what the term "costs" is intended to address in the department reporting requirement, since costs could be read to include merely the total tax impact of credits utilized or to include the sales price of the credit together with the tax consequences of the sale.
9. The bill is unclear regarding whether a partner in a partnership with a single partner that is a biotechnology or technology company would be allowed to transfer that non-biotech partner's share of qualified research expenses and basic research payments or share of the research credit to the partner that is a biotechnology or technology company. The bill appears to limit the partnership allocation rules to those partnership with at least two partners that are biotechnology or technology companies.

TECHNICAL CONSIDERATION

In defining "unused tax benefits," this bill refers to provisions of Section 23609, which prescribe carryover rules, but erroneously references subdivision (d) of Section 23609 rather than subdivision (f).

LEGISLATIVELY MANDATED REPORTS

This bill would require the department report to the Legislature on or before January 1, 2005, on the number and costs of the credits transferred pursuant to the bill.

FISCAL IMPACT

Departmental Costs

If the bill is amended to resolve the constitutional and implementation considerations addressed in this analysis, the department's costs are not expected to be significant.

Tax Revenue Estimate

It is not possible to project in advance the response of biotechnology and technology companies that would transfer unused research credits at 75% of their tax value for any given year. The impact of the special allocation of partnership credits between partners is speculative since, under current law, a partnership may allocate credits among its partners in whatever manner is specified in the partnership agreement.

Revenue effects would include both cash-flow acceleration of tax credit usage and absolute revenue losses. The former would reflect more immediate use of tax credits by transferees rather than later by transferors, and the latter would reflect the fact that some transferors never would use all the potential tax benefits.

The following data compiled from department records shows the current research expenses credit activity.

- It can be assumed that taxpayers that qualify for the research expenses credit likely would qualify under the provisions of this bill.
- In 1997, 1,696 corporations reported \$675 million of expenses subject to the research credit.
 - 1,482 corporations used \$349 million in research credits to reduce their tax;
 - 958 corporations reported \$326 million of unused credits;
 - Of this unused credit amount, \$267 million was for California domiciled corporations (the universe that likely would qualify under this bill).
- It is likely that some corporations with losses do not file the research credit form since they could not use the credit. Thus, it is likely that the stock of unused research expenses credits is substantially larger than reflected in the figures above.

BOARD POSITION

Pending.