

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Brulte Analyst: Jeani Brent Bill Number: SB 1495

Related Bills: See Legislative History Telephone: 845-3410 Introduced Date: 02/15/2000

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Research Expenses Credit/Increase to 15% of Excess Expenses/Minimum Base Not Less Than 20%

### SUMMARY

Under the Personal Income Tax Law and the Bank and Corporation Tax Law, this bill would increase the state credit for "qualified research expenses" from 12% to 15% and would decrease the minimum threshold for the taxpayer's base amount in computing the research expenses credit from not less than 50% to not less than 20% of the taxpayer's current year qualified research expenditures.

This bill would also make changes to the Vehicle License Fee Law. These changes do not affect the department and are not discussed in this analysis.

### EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would apply to taxable and income years beginning on or after January 1, 2000.

### LEGISLATIVE HISTORY

AB 1953 (2000) and AB 2592 (2000) also would increase the qualified research expenses credit percentage and decrease the minimum threshold for computing the credit.

SB 705 (Stats. 1999, Ch. 77) increased the state credit for "qualified research expenses" from 11% to 12%.

AB 68 (1999) would have increased the qualified research expenses credit percentage and decreased the minimum threshold; failed to pass out of the first house by January 31 of the second year of the session.

SB 465 (1999/2000) would increase the alternative incremental research expenses credit to 100% of the federal amount.

### SPECIFIC FINDINGS

**Existing federal law** provides for a research tax credit equal to 20% of the amount by which a taxpayer's qualified research expenditures for a taxable year increased over its base amount for that year.

### Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

### Department Director

### Date

Alan Hunter for GHG

3/27/00

A 20% research tax credit also applies to the excess of (1) 100% of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the "university basic research credit."

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding taxable years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three taxable years from 1984 through 1988, then its "fixed-base percentage" is the percentage that its total qualified research expenditures for the 1984-1988 period is of its total gross receipts for that period (subject to a maximum percentage of 16%). All other taxpayers, including any firm that had both gross receipts and qualified research expenses in the first taxable year beginning after 1983 (so-called "start-up firms"), are assigned a fixed-base percentage of 3%.

In computing the credit, a taxpayer's base amount may not be less than 50% of its current-year qualified research expenditures. To prevent artificial increases in research expenditures by shifting expenditures among commonly-controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer. Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage.

Taxpayers are allowed to elect an alternative incremental research credit regime; however, this alternative incremental credit would not be impacted by this bill and therefore will not be discussed in this analysis.

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; (3) 65% of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses"); and (4) 75% of amounts paid to a research consortium for qualified research if the research consortium is a tax-exempt organization and is organized and operated primarily to conduct scientific research, and the qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

To be eligible for the credit, the research must not only satisfy the existing research expenses deduction requirements, but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors. In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control.

Expenditures attributable to research conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

**Existing state law** conforms with specific modifications to the federal research credit.

**This bill** would increase the state credit for "qualified research expenses" from 12% to 15% and would decrease the minimum threshold for the taxpayer's base amount in computing the research expenses credit from not less than 50% to not less than 20% of the taxpayer's current year qualified research expenditures, thereby making this latter provision of state law no longer in conformity with that aspect of the federal credit.

**This bill** also would decrease the "basic research" percentage of the credit from 24% to 20%, thereby conforming this provision of state law with the federal credit.

#### Implementation Considerations

Implementing this bill would occur during the department's normal annual system update.

#### Technical Considerations

If the author does not intend to decrease the "basic research" percentage, amendments 1 and 2 would preserve existing law.

### FISCAL IMPACT

#### Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue impact of this bill is estimated to be revenue losses as shown below:

Revenue Impact of SB 1495 Assumed Enacted after 6/30/2000			
Losses in \$ Millions			
2000-01	2001-02	2002-03	2003-04
(\$29)	(\$47)	(\$57)	(\$62)

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

Revenue Estimate Discussion

The revenue impact of this proposal is estimated in the following manner. The research credits generated under current and proposed laws are simulated for each corporation in a sample of the 50 corporations with the largest research and development expenses. These simulations take into account specific micro-economic data for each corporation such as gross receipts, wage, property, and sales factors, net income, historical research expenditures, and detailed tax and financial data. The results of the simulations are weighted statistically to the population level. The revenue losses are estimated as the differences between the taxes simulated under current and proposed laws. The Department Of Finance forecast of corporate profits is used to extrapolate the estimates to future years.

Revenue impact for the Personal Income Tax Law is assumed to be equal to 5% of the Bank and Corporation Tax Law impact and is added to the corporate impact.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 1495  
As Introduced February 15, 2000

AMENDMENT 1

On page 6, line 5, strikeout "both" and insert:

all

AMENDMENT 2

On page 6, line 10, after "(B)" insert:

The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "24 percent."

(C)