

BILL ANALYSIS

Department, Board, Or Commission Franchise Tax Board	Author Atkins & Mullin	Bill Number AB 437
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SUBJECT

Research Expenses Credit/Reduce Excess Carryover Credit/R&D-Small Business Grant Program

SUMMARY

This bill would, under the Personal Income Tax (PITL) and Corporation Tax Laws (CTL), establish a Research and Development (R&D) Small Business Grant Program.

This analysis only addresses the provisions of the bill that impact the department's programs and operations.

REASON FOR THE BILL

The reason for this bill is to maximize the utilization of the research credit by providing small businesses cash grants regardless of tax liability.

EFFECTIVE/OPERATIVE DATE

Assuming enactment during this legislative session, this bill would be effective January 1, 2016. The tax provisions are operative for each taxable year beginning on or after January 1, 2017, and before January 1, 2022. This bill also specifically provides that on or after January 1, 2017, and before January 1, 2024, a qualified small business may apply for a one-time cash grant of a percentage of the excess credit amount from taxable years beginning on or after January 1, 2015, and before January 1, 2017.

FEDERAL/STATE 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 taxpayers subject to PITL 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, taxpayers subject to CTL 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.

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Date
9/9/15

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.

Federal Grant Program

Congress, in the American Recovery and Reinvestment Act of 2009, in an effort to create an incentive for businesses to install alternative energy systems, authorized grants in lieu of the business energy credit for energy property placed in service in 2009 and 2010, or placed in service after 2010 if construction began on the project before 2011 and is completed by December 31, 2016.

For federal and state purposes, grants are taxable to recipients unless specifically exempted by statute.

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.

Under the CTL, taxpayers are allowed to assign certain eligible credits, as specified. "Assignment" refers to the ability of a taxpayer that is a member of a combined reporting group to elect to transfer certain unused credits to a related corporation. The election to transfer any credit is irrevocable once made and is required to be made on the taxpayer's original return for the taxable year in which the assignment is made.

Current state law lacks a grant program similar to the program proposed by this bill.

THIS BILL

R&D Small Business Grant Program

On or after January 1, 2017, and before January 1, 2024, a qualified small business may apply for a grant as follows:

10 Percent - Grant

Beginning January 1, 2017, a “qualified small business” may apply for and receive a one-time grant in an amount equal to 10 percent of any “excess credit amount” that is attributable to taxable years beginning on or after January 1, 2015, and before January 1, 2017, available for carryover into taxable years beginning on or after January 1, 2017, for research credits allowed under current law.¹ In order to receive a grant, the qualified small business, partner, or S corporation shareholder of a qualified small business would be required to:

- Apply for a grant on a timely filed original return filed with the Franchise Tax Board (FTB) using electronic technology in a form and manner prescribed by the FTB for the taxable year beginning on or after January 1, 2016.
- Apply to the FTB for a certificate indicating the amount equal to 10 percent of the excess credit amount attributable to taxable years beginning on or after January 1, 2015, and before January 1, 2017, available for carryover into taxable years beginning on or after January 1, 2017, for a credit allowed under current law.

The FTB would be required to supply the qualified small business with a certificate within 90 days of receiving the return with the application.

15 Percent - Grant

For taxable years beginning on or after January 1, 2017, and before January 1, 2022, a qualified small business may annually apply for a grant equal to 15 percent of any excess credit amount attributable to the taxable year in which the credit was allowed under current law. In order to receive a grant, the qualified small business would be required to:

- Apply for a grant on a timely filed original return to the FTB using electronic technology in a form and manner prescribed by the FTB for each taxable year beginning on or after January 1, 2017.
- Apply to the FTB for a certificate indicating the amount equal to 15 percent of the excess credit amount that is attributable to the taxable year in which a credit is allowed under current law, and available for carryover to the following year.

The FTB would be required to supply the qualified small business with a certificate within 90 days of receiving the return.

Definitions

“Excess credit amount” would mean the amount of credit that exceeds tax or net tax, as applicable, for the first taxable year the credit is allowable and may be carried over to reduce tax or net tax in the following taxable year. In the case of a pass-thru entity, for credits attributable to taxable years beginning on or after January 1, 2017, “excess credit amount” would mean the amount of credit allowed to be passed through to partners or shareholders.

¹ Revenue and Taxation Code (R&TC) sections 17052.12 and 23609.

“Qualified small business” would mean a taxpayer that meets all of the following requirements for the taxable year with respect to the credit for which a grant is authorized:

- The taxpayer was allowed a research credit.²
- The taxpayer has gross receipts of \$5 million dollars or less for the taxable year. Gross receipts would mean gross receipts reduced by returns and allowances, as defined in Section 41(c)(7) of the Internal Revenue Code.
- The taxpayer is not an affiliated corporation that is properly treated as a member of a combined reporting group, and no grant would be awarded with respect to a credit that may be assigned.
- Is organized as one of the following business entities:
 - Corporation.
 - Partnership.
 - Limited partnership.
 - Limited liability company, whether classified as a corporation, partnership or disregarded as a separate entity.
- Was in existence and filed income tax returns³ for the two taxable years preceding the taxable year for which taxpayer applied for a grant.

Allocations

The FTB would allocate the certified amounts based on the aggregate applicable amount for the calendar year in which the certificate was issued. The aggregate applicable amount that may be certified for the calendar year beginning January 1, 2017, would be \$100 million, not to exceed \$50 million for each taxable year beginning January 1, 2015, and January 1, 2016. The aggregate applicable amount could not exceed \$50 million for each calendar year beginning on or after January 1, 2018, and before, January 1, 2024, regardless of the taxable year to which the grant relates.

The FTB would allocate the certificates to the qualified small business, partners, or S corporation shareholder on a first-come-first-served basis, determined by the date the taxpayer’s original return is received by the FTB. If the returns of two or more qualified small businesses returns are received on the same day and the amount of the credit remaining to be allocated is insufficient to be allocated fully to each, the credit remaining would be allocated to those qualified small businesses on a pro rata basis. The date a return is received would be determined by the FTB, and the determination as to the date a return is received and whether a return has been timely filed may not be reviewed in any administrative or judicial proceeding.

² Ibid.

³ Under Part 10.2 (commencing with section 18401) of Division 2 of the R&TC.

Pass-thru Entities

For purposes of the research credit under the PITL, a pass-thru entity would mean a partnership or S corporation, and under the CTL, a pass-thru entity would mean a partnership.

For grants with respect to taxable years beginning on or after January 1, 2015, and before January 1, 2017, the FTB would issue the certificate, under the PITL, to the qualified small business, partners, or S corporation shareholders. For grants with respect to taxable years on or after January 1, 2017, the FTB would issue the certificate to the partnership or S Corporation.

A certificate, under the CTL, would not be issued to an S corporation with respect to the research credit allowed.

Recapture

To the extent the amount of the certificate issued by the FTB is based on a request from a qualified small business, partner, or S corporation shareholder, any amount of the credit finally allowed that is less than the amount of the credit that provided the basis for the grant, the amount of the grant attributable to the credit not allowed would be treated as a deficiency, and assessed and collected as a tax.

General Provisions

The FTB would be authorized to prescribe rules, guidelines, or procedures necessary or appropriate to carry out the purposes of the grant program, including any guidelines regarding the allocation of the certificates issued. These rules, guidelines, and procedures, would be exempt from the rules for regulations in the Administrative Procedures Act.

The Controller upon receipt of the certificate issued to the qualified small business, partner, or S corporation shareholder would pay the qualified small business the grant amount indicated on the certificate.

For taxable years beginning on or after January 1, 2017, and before January 1, 2024, gross income does not include any grant received by a taxpayer.

The grant program would remain in effect only until January 1, 2024, and as of that date is repealed, unless a later statute is enacted before January 1, 2024, that deletes or extends the date.

Research Credit

For taxable years beginning on or after January 1, 2017, in the case where the FTB has issued a certificate for a grant, the following rules would apply:

- The excess credit amount that may be carried over by a taxpayer would be reduced by the amount reflected on the certificate.
- Under the PITL, in the case of a pass-thru entity, the amount of the credit that may be passed through to a partner or shareholder would be reduced by the amount reflected on the certificate. Pass-thru entity would mean a partnership or an S corporation.
- Under the CTL, in the case of a pass-thru entity, the amount of the credit that may be passed through to a partner would be reduced by the amount reflected on the certificate. Pass-thru entity would mean a partnership.

LEGISLATIVE HISTORY

AB 544 (Mullin, et al., 2015/2016) would simplify the California research credit. AB 544 failed to pass out of the Assembly Appropriations Committee.

PROGRAM BACKGROUND

The department annually releases a report on state tax expenditures. The "California Income Tax Expenditures Compendium of Individual Provisions" contains information regarding the usage of the Research Expense Credit for the 2011 taxable year. The relevant section begins on page 19 of the report. The entire report can be viewed by accessing: https://www.ftb.ca.gov/aboutftb/tax_expenditure_report_2011.pdf.

OTHER STATES' INFORMATION

Review of *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* laws found no comparable grant payments for unused tax credits. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

Department staff estimates a cost of approximately \$664,000 to develop an application process for electronic filing and services, grant certification, database development and testing, and a noticing system to implement the R&D Small Business Grant Program. In order to meet the 90-day certification process, these costs assume the taxpayer would be required to e-file their return (including a grant application). Additionally, the cost assumes a volume of approximately 5,000 returns per year, based on a credit allocation of \$50 million dollars per fiscal year. Beginning with fiscal year 2017/2018, ongoing costs would be \$344,000 annually. The department will pursue a budget augmentation if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 437 Assumed Enactment After June 30, 2015 (\$ in Millions)		
2015-16	2016-17	2017-18
n/a	- \$22	- \$27

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

Revenue Discussion

Using 2012 tax return data, it was determined that companies with \$5 million or less in gross receipts generated approximately \$130 million of research credits that were not used to offset tax liabilities. This amount was reduced by approximately 50 percent to account for companies who do not meet the definition of a qualified small business as defined in this bill. The amount was further reduced by approximately 5 percent for businesses that did not file or were not in existence for the two taxable years preceding the grant application. Using the Department of Finance growth rates, this amount was grown⁴ to calculate a 2015 and 2016 research unused credit balance totaling \$170 million that would be available beginning in 2017 for eligible taxpayers to receive a grant. Although specific data is unavailable, it is assumed that the number of taxpayers applying for the grant is expected to double over a 5-year period. The increase in the number of taxpayers that would apply for the grant includes startups, disregarded entities, and other pass-thru entities currently conducting research activity yet not reporting the credit on their return because the entity has no tax liability. The applicable percentage of the grant as provided in this bill was then applied. The FTB expects approximately \$30 million in prior year grant requests would be made beginning on or after January 1, 2017. The tax year estimates are converted to fiscal year estimates, and then rounded to arrive at the estimates shown in the table above.

APPOINTMENTS

None.

⁴ Indexed using Department of Finance forecasts.

SUPPORT/OPPOSITION⁵

Support: BIOCOM, California Asian Chamber of Commerce, California Association for Microenterprise Opportunity, California Chamber of Commerce, California Healthcare Institute, California Life Sciences Association, California Metals Coalition, Flex Tech Alliance, National Federation of Independent Business, SEMI, and Small Business California.

Opposition: California Tax Reform Association.

VOTES

	Date	Yes	No
Concurrence	09/02/15	80	0
Senate Floor	09/01/15	32	0
Assembly Floor	05/18/15	79	0

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⁵ As noted in the Senate Governance and Finance bill analysis dated July 6, 2015.