

# ANALYSIS OF AMENDED BILL

Author: Atkins & Mullin Analyst: Jane Raboy Bill Number: AB 437  
 See Legislative Introduced Date: February 19, 2015 and  
 Related Bills: History Telephone: 845-5718 Amended Date: April 13, 2015  
 Attorney: Bruce Langston Sponsor \_\_\_\_\_

<b>SUBJECT:</b>	Research Expenses Credit/Reduce Excess Carryover Credit/R&D-Small Business Grant Program
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**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.

**RECOMMENDATION**

No position.

**Summary of Amendments**

As introduced on February 19, 2015, this bill would establish the R&D-Small Business Grant Program and would allow a qualified small business to obtain a grant payment for unused credits.

The April 13, 2015, amendments made several technical and substantive changes relating to the R&D-Small Business Grant Program and modified the responsibilities of the Franchise Tax Board (FTB).

This is the department’s first analysis of the bill.

**REASON FOR THE BILL**

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

**EFFECTIVE/OPERATIVE DATE**

As an appropriation, the bill would be effective upon enactment. The tax provisions are specifically operative for each taxable year beginning on or after January 1, 2016, and before January 1, 2025. This bill also provides that as of January 1, 2016, qualified taxpayers may apply for a one-time cash grant of a percentage of the excess credit amount from a taxable year beginning on or after January 1, 2015, as specified.

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## **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 personal income tax taxpayers 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, corporate taxpayers 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.

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 CTL, taxpayers are allowed to assign certain eligible credits to taxpayers that are members of a combined reporting group. "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, 2016, and before January 1, 2025, a qualified small business may apply for and receive a grant as follows:

Beginning January 1, 2016, 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, 2014, and before January 1, 2016, available for carryover into taxable years beginning on or after January 1, 2016, for research credits allowed under current law<sup>1</sup>. 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 FTB using electronic technology in a form and manner prescribed by the FTB for the taxable year beginning on or after January 1, 2015;
- 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, 2014, and before January 1, 2016, available carryover into taxable years beginning on or after January 1, 2016, 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 application.

“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 would be allowed a research credit.<sup>2</sup>
- 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, by excluding gross receipts which are effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico, or any possession of the United States.
- 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.
- The taxpayer has been certified by the Governor's Office of Business and Economic Development as an eligible qualified small business.

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<sup>1</sup> R&TC sections 17052.12 and 23609.

<sup>2</sup> Ibid.

“Excess credit amount” would mean the amount of credit that exceeds tax for the taxable year the credit is earned and available for carry over to reduce tax in the following year.

For taxable years beginning on or after January 1, 2016, and before January 1, 2025, 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, partner, or S corporation shareholder 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, 2016.
- Apply to the FTB for a certificate indicating the amount equal to 15 percent of the amount that is attributable to the taxable year available for carryover to the following taxable year in which the credit is allowed under current law.
- The FTB would be required the qualified small business with a certificate within 30 days of receiving the application.

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, 2016, would be \$100 million, not to exceed \$50 million for each taxable year beginning January 1, 2014, and January 1, 2015. The aggregate applicable amount could not exceed \$50 million for each calendar year beginning on or after January 1, 2016, and before, January 1, 2026, 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 an application or return is received would be determined by the FTB, and the determination whether the application or return has been timely filed may not be reviewed in any administrative or judicial proceeding.

#### *Pass-thru Entities*

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

For grants with respect to taxable years beginning on or after January 1, 2014 and before January 1, 2016, the FTB would issue the certificate to the qualified small business, partners, or S corporation shareholders. For grants with respect to taxable years on or after January 1, 2016, the FTB would issue the certificate to the partnership or S corporation.

A certificate would not be issued to an S corporation with respect to the CTL 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.

### *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. The Governor's Office of Business and Economic Development, upon application by a taxpayer, would certify the taxpayer as a qualified small business that meets the following requirements 1) the taxpayer was allowed a research credit, 2) the taxpayer has gross receipts for the taxable year of \$5,000,000 or less and 3) the taxpayer is not an affiliated corporation that is properly treated as a member of a combined reporting group.

For taxable years beginning on or after January 1, 2016, and before January 1, 2025, gross income does not include any grant received by a taxpayer.

The grant program would remain in effect only until January 1, 2026, and as of that date is repealed, unless a later enacted statute is enacted before January 1, 2016, that deletes or extends the date.

### *R&D Credit*

For taxable years beginning on or after January 1, 2016, 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 PITL, in the case of a pass-thru entity, the amount of the credit that may be passed through would be reduced by the amount reflected on the certificate. "Pass-thru entity would mean a partnership or an S corporation.
- Under 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.

## **IMPLEMENTATION CONSIDERATIONS**

Implementing this bill would require changes to existing tax forms and instructions and information systems, which would significantly impact the department's programs and operations.

## **TECHNICAL CONSIDERATIONS**

On page 3, lines 19 and 20, the phrase "the amount of credit that may be passed through shall be reduced" should read, "the amount of credit that may be passed through to a partner or shareholder shall be reduced" to correctly identify the pass-thru.

On page 3, line 29, page 8, line 16, and page 13, line 23, the phrase "Part 10.2." should read, "Part 10.2, of Division 2, (commencing with Section 18401)."

On page 10, line 18, the phrase "Section 23036, and may be carried over" should read, "Section 23036, as applicable, for the first taxable year the credit is allowable and may be carried over".

On page 10, line 30, the phrase "for the taxable year" is duplicative and unnecessary.

On page 11, line 8, the phrase "and receive" should be deleted because it is unnecessary.

On page 11, lines 29 and 30, and page 12, line 5, the phrase, "shall apply" should read, "by applying".

On page 11, line 40, and on page 12, line 1, the phrase ", partner, or "S" corporation shareholder, as applicable," is unnecessary and should be deleted.

On page 12, lines 7 through 10, the phrase, "the amount that is attributable to the taxable year and available for carryover to the following year in which a credit is allowed under Section 17052.12 or 23609" should read "the excess credit amount that is attributable to the taxable year in which a credit is allowed under Section 17052.12 or 23609, and available for carryover to the following taxable year".

On page 12, line 11, the phrase, "within 30 days" should read "within 90 days".

On page 12, line 22, the phrase, "January 1, 2016," should read "January 1, 2017."

## **LEGISLATIVE HISTORY**

AB 544 (Mullin, et al., 2015/2016) would simplify the California research credit. AB 544 is currently in the Assembly Revenue & Taxation 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](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

This bill would require the development of an application process for electronic filing and services, grant certification, database development and testing, and a noticing system to allow for a new grant program under the PITL and CTL. As a result, this bill would significantly impact the department's programs and operations. The additional costs will be developed as the bill moves through the legislative process. It is recommended that the bill be amended to include appropriation language that would provide funding to implement this bill. Lack of an appropriation will require the department to secure the funding through the normal budgetary process, which will delay implementation of this bill.

## ECONOMIC IMPACT

### Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB437 As Amended April 13, 2015 Assumed Enactment After June 30, 2015 (\$ in Millions)		
2015-16	2016-17	2017-18
- \$22	- \$27	- \$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, staff determined that companies with \$5 million or less in gross receipts generated approximately \$130 million of R&D 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. Using the Department of Finance growth rates, this amount was grown<sup>3</sup> to calculate a 2014 and 2015 R&D unused credit balance totaling \$160 million that would be available beginning in 2016 for eligible taxpayers to receive a grant. Although specific data is unavailable, staff assumes that the

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<sup>3</sup> Indexed using Department of Finance forecasts.

number of taxpayers applying for the R&D grant is expected to double over a 5-year period. The increase in the number of taxpayers that would apply for the R&D grant includes non-filers, startups, disregarded entities, and other pass-thru entities currently conducting R&D 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 is then applied. For taxable year 2015, the FTB expects approximately \$30 million in grant requests to be made. The tax year estimates are converted to fiscal year estimates, and then rounded to arrive at the estimates shown in the table above.

## **SUPPORT/OPPOSITION**

Support: Baybio, Biocom, California Health Care Institute, and National Federation of Independent Businesses.

Opposition: None provided.

## **ARGUMENTS**

Proponents: Supporters could argue that this bill would stimulate job creation by allowing small businesses to elect to receive a grant for a portion of their unused research credit.

Opponents: Some could argue that the grant program this bill would allow is overly narrow and should be expanded.

## **POLICY CONCERNS**

This bill would establish a cash grant for which federal law has no counterpart, thus increasing nonconformity.

## **LEGISLATIVE STAFF CONTACT**

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