

**Franchise Tax Board**

**ANALYSIS OF ORIGINAL BILL**

Author: Mullin, et al. Analyst: Scott McFarlane Bill Number: AB 544  
 Related Bills: See Legislative History Telephone: 845-6075 Introduced Date: February 23, 2015  
 Attorney: Bruce Langston Sponsor: Franchise Tax Board

**SUBJECT:** Research Credit Simplification

**SUMMARY**

This bill would simplify the calculation of the California research credit.

**RECOMMENDATION**

Support.

On December 4, 2013, the three-member Franchise Tax Board voted 2-0, with the Director of Finance abstaining, to generally sponsor the language included in this bill, except that the sponsored language did not include a sunset date for the election of the alternative simplified credit.

**Summary of Suggested Amendments**

Minor technical amendments are suggested.

**REASON FOR THE BILL**

The reason for the bill is to further incentivize businesses to conduct research in California.

**EFFECTIVE/OPERATIVE DATE**

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2016.

**ANALYSIS**

**Federal Law**

**Credit for Increasing Research Activities**

A taxpayer may claim a federal research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses exceed a base amount.

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- *Base Amount* - The base amount for the current year is generally computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). Special rules apply to all other taxpayers (so called start-up firms).<sup>1</sup>

A taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

- *Gross Receipts* - For purposes of measuring gross receipts for the research credit, gross receipts generally means the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from all its activities and from all sources (e.g., revenues derived from the sale of inventory before reduction of cost of goods sold), reduced by returns and allowances. However, gross receipts do not include receipts from the sale or exchange of a capital asset, repayments of loans or similar instruments, or receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business.<sup>2</sup>

## Alternative Credit Calculations

### *Alternative Simplified Credit (ASC)*

For amounts paid or incurred after 2006, taxpayers are allowed to elect to calculate their research credit using the ASC<sup>3</sup> in lieu of the general calculation method described above. The ASC is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The credit rate is reduced to six percent of qualified research expenses if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

An election to use the ASC applies to all succeeding taxable years unless revoked with the consent of the Secretary of the Treasury.

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<sup>1</sup> The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under IRC section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually re-compute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. IRC section 41(c)(3)(B).

<sup>2</sup> Treasury Regulation section 1.41-3(c).

<sup>3</sup> IRC section 41(c)(5).

### *Alternative Incremental Credit (AIC)*

For taxable years beginning after June 30, 1996, and before January 1, 2009, taxpayers were allowed to elect to calculate their research credit using the AIC<sup>4</sup> in lieu of the general calculation method described above. A taxpayer electing the AIC was assigned a three-tiered fixed-base percentage (that was lower than the fixed-base percentage otherwise applicable), and the credit rate likewise was reduced.

Generally, under the federal AIC (that expired after 2008):<sup>5</sup>

- A credit rate of 3 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equaled one percent of the taxpayer's average gross receipts for the four preceding years) but did not exceed a base amount computed by using a fixed-base percentage of 1.5 percent;
- A credit rate of 4 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of 1.5 percent but did not exceed a base amount computed by using a fixed-base percentage of two percent; and
- A credit rate of 5 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of two percent.

An AIC election was not allowed for any year to which an ASC election applied.

## **State Law**

### **Credit for Increasing Research Activities**

California law generally conforms to the federal credit for increasing research activities as of the "specified date" of January 1, 2009,<sup>6</sup> with modifications.

In general, a taxpayer may claim a state research credit equal to 15 percent of the amount by which the taxpayer's California qualified research expenses<sup>7</sup> for a taxable year exceed a base amount (in lieu of the federal credit rate of 20 percent).

Additional modifications include:

- *Base Amount* - California generally conforms to the federal rules for determining the base amount, with the gross-receipts modification described below. However, similar to federal law, a taxpayer's California base amount cannot be less than 50 percent of its current-year California qualified research expenses.

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<sup>4</sup> IRC section 41(c)(4).

<sup>5</sup> Lower credit rates applied to years that preceded 2007, and a special transition rule applied for fiscal year 2006-2007 taxpayers.

<sup>6</sup> R&TC sections 17052.12 and 23609.

<sup>7</sup> Qualified research only includes research conducted in California, RT&C sections 17052.12(d) and 23609(c)(2).

- *Gross Receipts* - California law generally conforms to the federal definition of gross receipts, modified to take into account only those gross receipts from the sale of property held for sale in the ordinary course of business that is delivered or shipped to a purchaser within California, regardless of f.o.b. point or any other condition of the sale.<sup>8</sup>

### **Alternative Credit Calculations**

#### *Alternative Simplified Credit (ASC)*

California law specifically does not conform to the ASC,<sup>9</sup> meaning taxpayers may not elect the ASC for state purposes.

#### *Alternative Incremental Credit (AIC)*

California conforms to the federal AIC as of the “specified date” of January 1, 2009, modified to provide that the federal December 31, 2008, termination date does not apply—meaning taxpayers may continue to elect the AIC under California law even though an AIC election may no longer be made for federal purposes.<sup>10</sup> Under the California AIC:<sup>11</sup>

- A credit rate of 1.49 percent applies to the extent that a taxpayer's current-year California qualified research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but does not exceed a base amount computed by using a fixed-base percentage of 1.5 percent;
- A credit rate of 1.98 percent applies to the extent that a taxpayer's current-year California qualified research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but does not exceed a base amount computed by using a fixed-base percentage of two percent; and
- A credit rate of 2.48 percent applies to the extent that a taxpayer's current-year California qualified research expenses exceed a base amount computed by using a fixed-base percentage of two percent.

An election to use the California AIC applies to all succeeding taxable years unless revoked with the consent of the Franchise Tax Board (FTB).

### **THIS BILL**

This bill would simplify the California research credit by conforming to the ASC for taxable years beginning on or after January 1, 2016, and before January 1, 2023, and would eliminate the AIC for taxable years beginning on or after January 1, 2016.

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<sup>8</sup> R&TC sections 17052.12(g)(3) and 23609(h)(3).

<sup>9</sup> R&TC sections 17052.12(g)(4) and 23609(h)(4).

<sup>10</sup> R&TC sections 17052.12(h) and 23609(i).

<sup>11</sup> R&TC sections 17052.12(g)(1) and 23609(h)(1).

The ASC would be modified for California purposes to provide that qualified research would mean research conducted in California, and the credit would equal 10.5 percent of California qualified research expenses that exceed 50 percent of the average California qualified research expenses for the three preceding taxable years. The credit would equal 4.5 percent of California qualified research expenses if a taxpayer has no California qualified research expenses in any one of the three preceding taxable years.

An election to use the ASC would apply to all succeeding taxable years that begin before January 1, 2023, unless revoked with the consent of the FTB.

This bill would additionally conform to recent federal modifications to special rules that apply for purposes of the research credit when a major portion of a trade or business (or unit thereof) changes hands, and for the aggregation of expenditures among commonly-controlled or otherwise-related entities.

### **IMPLEMENTATION CONSIDERATIONS**

Implementing this bill would not significantly impact the department's programs or operations.

### **TECHNICAL CONSIDERATIONS**

Amendments are suggested to make minor technical changes.

### **LEGISLATIVE HISTORY**

AB 2330 (Mullin, et al., 2013/14) would have conformed to the ASC for taxable years beginning on or after January 1, 2015, and before January 1, 2022, eliminated the AIC for taxable years beginning on or after January 1, 2015, and conformed to recent federal rule changes relating to acquisitions and aggregations of expenditures. AB 2330 was held in the Assembly Appropriations Committee.

AB 1564 (Pérez, 2013/2014) would have increased the credit rates of the research credit temporarily, limited the number of years that the research credit could be carried over, allowed taxpayers to sell and purchase research credits, and imposed statutory audit rules to control how the FTB audits the research credit. AB 1564 was held in the Assembly Appropriations Committee.

AB 653 (Pérez, 2013/2014) would have provided temporary incremental increases to the California research credit rates. AB 653 was held in the Assembly Appropriations Committee.

SB 235 (Wyland, 2013/2014) would have increased the California research credit rate to the federal credit rate of 20 percent, and would have increased the California AIC rates to three, four, and five percent. SB 235 was referred to the Senate Governance and Finance Committee, but its hearing was cancelled at the request of the author.

### **OTHER STATES' INFORMATION**

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to *California's* economy, business entity types, and tax laws. A review of these states' laws found that most provide their own research credit for research conducted within their state, as described below.

*Florida* allows a corporate research tax credit of 10 percent of qualified research expenses in excess of a base amount for research conducted within *Florida*. The combined total amount of tax credits that may be granted to all business enterprises during any calendar year is \$9 million; taxpayers must apply for the credit, which is allocated in the order in which applications are received. *Florida's* base amount is the average of the taxpayer's qualified research expenses in *Florida* allowed under IRC section 41 for the four taxable years preceding the taxable year for which the credit is determined.

*Illinois* allows an individual and corporate tax research credit of 6.5 percent of qualified research expenses in excess of a base amount for research conducted within *Illinois*. *Illinois'* base amount is the average amount of *Illinois* research expenses for the prior three years.

*Massachusetts* allows corporate taxpayers to claim an excise-tax research credit of 10 percent of qualified research expenses in excess of a base amount for research conducted within *Massachusetts*. *Massachusetts* uses the federal definition of gross receipts to compute its base amount, and that base amount is calculated similar to federal law, using only state amounts.

*Michigan* replaced the Michigan Business Tax with a corporate income tax for taxable years beginning on or after January 1, 2012. There is no research credit under the state's new corporate or personal income tax.

*Minnesota* allows a two-tiered individual and corporate tax research credit for research conducted within *Minnesota*: (1) for qualified research expenses up to \$2 million, the credit is 10 percent of expenses in excess of a base amount; and (2) for qualified research expenses in excess of \$2 million, the credit is 2.5 percent of expenses in excess of a base amount. *Minnesota* uses the federal definition of gross receipts to compute its base amount, and that base amount is calculated similar to federal law, using only state amounts.

*New York* allows a research credit equal to 50 percent of the taxpayer's federal research, subject to a limit of 3 percent of qualified research expenses attributable to research conducted in *New York*. The research credit is only available to firms in targeted industries such as biotechnology, pharmaceutical, cutting-edge technology, clean technology, green technology, financial services, agriculture and manufacturing.

## **FISCAL IMPACT**

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

## **ECONOMIC IMPACT**

### **Revenue Estimate**

| Estimated Revenue Impact of AB 544<br>As Introduced February 23, 2015<br>Assumed Enactment After June 30, 2015<br>(\$ in Millions) |         |         |
|--|---------|---------|
| 2015-16  | 2016-17 | 2017-18 |
| - \$24   | - \$85  | - \$100 |

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

## Revenue Discussion

Using tax-return data, a micro-simulation model was used to estimate the revenue impact of eliminating the AIC and allowing the ASC at a general rate of 10.5 percent for the 2016 taxable year. The simulation assumed that taxpayers that have been electing the AIC would instead elect ASC, and that taxpayers that have been calculating their research credit using the general calculation method would elect the ASC if it increases the amount of their credit. The simulation results in an estimated loss of approximately \$85 million for the 2016 taxable year.

The testimated \$85 million 2016 taxable-year loss is grown,<sup>12</sup> converted to fiscal years and then rounded to arrive at the estimates shown in the table above.

## SUPPORT/OPPOSITION

Support: The Franchise Tax Board.

Opposition: Unknown.

## ARGUMENTS

Proponents: Those in support of this bill may argue that it would encourage more companies to conduct research in California by simplifying the calculation of the research credit and reducing its recordkeeping requirements.

Opponents: Those in opposition to this bill may argue that temporary simplification of the research credit would result in uncertainty that would diminish the incentive to invest in long-term research projects in California.

## LEGISLATIVE STAFF CONTACT

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<sup>12</sup> "Grown" means indexed for projected growth using forecasts from the Department of Finance.

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|-------------|-----------------|
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PROPOSED AMENDMENTS TO  
AB 544, AS INTRODUCED FEBRUARY 23, 2015

AMENDEMENT 1

On page 3, line 32, strikeout "Code", and insert:

Code, relating to election,

AMENDEMENT 2

On page 3, line 37, after "succeeding taxable years", insert:

beginning before January 1, 2016,

AMENDEMENT 3

On page 4, line 17, after "taxable years", insert:

beginning before January 1, 2023,

AMENDEMENT 4

On page 4, line 20, strikeout "Code" and insert:

Code, relating to election of alternative simplified credit,

AMENDEMENT 5

On page 4, line 21, after "Section 41(c)(5)", insert:

of the Internal Revenue Code, relating to election of alternative simplified credit,

AMENDEMENT 6

On page 4, line 35, ~~passthrough~~, and insert:

pass-thru

AMENDEMENT 7

On page 4, line 39, ~~Code~~, and insert:

Code, relating to general rule,

AMENDEMENT 8

On page 4, line 40, ~~Code~~, and insert:

Code, relating to special rule for pass-thru of credit,

AMENDEMENT 9

On page 5, line 3, ~~Code~~, and insert:

Code, relating to special rule for pass-thru of credit,

AMENDEMENT 10

On page 8, line 16, ~~Code,~~, and insert:

Code, relating to election,

AMENDEMENT 11

On page 8, line 21, after “succeeding taxable years”, insert:

beginning before January 1, 2016,

AMENDEMENT 12

On page 9, line 1, after “taxable years”, insert :

beginning before January 1, 2023,

AMENDEMENT 13

On page 9, line 4, ~~Code~~, and insert:

Code, relating to election of alternative simplified credit,

AMENDEMENT 14

On page 9, line 5, after “Section 41(c)(5)”, insert:

of the Internal Revenue Code, relating to election of alternative simplified credit,

AMENDEMENT 15

On page 9, line 19, ~~passthrough~~, and insert:

pass-thru

AMENDEMENT 16

On page 9, line 23, ~~Code~~, and insert:

Code, relating to general rule,

AMENDEMENT 17

On page 9, line 24, ~~Code~~, and insert:

Code, relating to special rule for pass-thru of credit,

AMENDEMENT 18

On page 9, line 27, ~~Code~~, and insert:

Code, relating to special rule for pass-thru of credit,