HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: HB 607 Tax Credits for Research and Development
SPONSOR(S): Plakon and others
TIED BILLS: **IDEN./SIM. BILLS:** SB 1184

	REFERENCE	ACTION	ANALYST	STAFF DIRECTOR
1)	Economic Development Policy Committee		Tait	Kruse
2)	Finance & Tax Council			
3)	Economic Development & Community Affairs Policy Council			
4)				
5)				

SUMMARY ANALYSIS

Thirty-two states and, if re-enacted, the federal government offer eligible businesses a research and development tax credit, which is intended to stimulate scientific or technological advances, leading to high-wage, high-skilled jobs.

HB 607 creates a research and development tax credit against Florida corporate income taxes. The Florida tax credit is modeled after the federal research tax credit in Title 26 U.S. Code section 41 and incorporates some of its definitions.

The tax credit is equal to 10 percent of the difference between a company's qualified research and development expenditures in the current taxable year and its average research and development expenditures over the previous 4 tax years. Other key points include:

- To qualify for the tax credit, business entities must be a target industry business as defined in 288.106(1)(o), F.S.
- A research and development tax credit may not exceed 50 percent of a business' corporate tax liability in a tax year, after any other corporate tax credits have been applied.
- A business may carry forward, for up to 5 years, any unused tax credit.
- Unused tax credits may be transferred or sold to other business entities, at no less than 75 percent of their face value. The purchaser or assignee must use the tax credit in the taxable year the purchase or transfer of credit is made.

In addition, the Department of Revenue is directed to adopt rules to implement and administer the new research and development tax credit.

The Revenue Estimating Conference determined the bill will have a recurring negative of $15 million. The Department of Revenue estimates it will cost $51,339 in recurring expenditures and $30,277 in non-recurring expenditures to administer the bill's provisions.

The bill has an effective date of July 1, 2010, although tax credits cannot be used to offset corporate income taxes until the following year.

HOUSE PRINCIPLES

Members are encouraged to evaluate proposed legislation in light of the following guiding principles of the House of Representatives

- Balance the state budget.
- Create a legal and regulatory environment that fosters economic growth and job creation.
- Lower the tax burden on families and businesses.
- Reverse or restrain the growth of government.
- Promote public safety.
- Promote educational accountability, excellence, and choice.
- Foster respect for the family and for innocent human life.
- Protect Florida's natural beauty.

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. EFFECT OF PROPOSED CHANGES:

Present Situation
The "U.S. Research and Experimentation Tax Credit" was created in 1981 as part of the Economic Recovery Tax Act, a comprehensive package of initiatives designed to boost the competitiveness of U.S. businesses and encourage investment and savings by American taxpayers during a period of economic recession.[1]

The tax credit expired December 31, 2009; however, there is filed legislation in both the United States Senate and the United States House of Representatives to extend the research credit through 2010 and to increase and make permanent the alternative simplified research credit.[2]

Originally the credit was 25 percent of qualified research expenditures in excess over the previous year's expenditures, and the types of expenditures that qualified were limited to scientific or experimental research. Over the years, the tax credit formula has been modified several times and the types of eligible expenses broadened.

Under the most recent federal law, "qualified research expenses" include wages paid to in-house research staff, supplies used in research activities (not including land, improvements to land or certain depreciable property), and up to 65 percent of funds paid to contracted personnel for qualified research.[3] "Qualified research" included a company's expenditures that are technological in nature and which are intended to be useful in the development of a new or improved business process, product, software, formula, invention or other business component that will be used by the company or which the company intends to sell, license or lease.[4]

The federal tax credit was an incremental tax credit because a company is only rewarded if it increases its research and development spending over a predetermined base period. The amount of the federal

[1] "The U.S. Research and Experimentation Tax Credit in the 1990s" by Francisco Moris. National Science Foundation Report #NSF05-316 published July 2005. Retrieved at http://www.nsf.gov/statistics/infbrief/nsf05316/, and "The Prospects for Economic Recovery," prepared by the Congressional Budget Office. Published February 1982. Pertinent information on pages 87-93. Retrieved at http://www.cbo.gov/ftpdocs/51xx/doc5135/doc03b-Part8.pdf. Sites last visited Feb. 26, 2010.
[2] Senate Resolution 1203. http://thomas.loc.gov/cgi-bin/bdquery/D?d111:82:./temp/~bdetmT::|/bss/d111query.html|. House Resolution 422. Retrieved at http://thomas.loc.gov/cgi-bin/bdquery/D?d111:6:./temp/~bdV52T::. Sites last visited Feb. 26, 2010.
[3] 26 USC sec. 41(b).
[4] 26 USC sec. 41(d).

tax credit could be determined by three different methods, depending in part on how long the company has been in business. Under the basic formula, the tax credit was equal to 20 percent of the current tax year's qualified research and development expenses over the base amount, which is calculated using a ratio of qualified research and development expenses and gross receipts during the period of 1984 through 1988.[5] Newer companies could use simpler formulas that compared current year research and development spending with past years. Business entities that did not pay federal corporate income tax, such as "S corporations" and partnerships, were allowed to "pass-thru" their federal research credits to shareholders or partners, based on these individuals' shares in such business entities.[6]

For the 2005 federal tax year, the amount of research tax credits taken directly was nearly $6.4 billion, with another $136.2 million claimed via "pass-throughs."[7] Manufacturing companies claimed 71 percent of the federal research tax credits. Wages comprised about 68 percent of the qualified expenses.[8]

Other states' R&D tax credits

Thirty-two states have enacted a research and development tax credit.[9] The majority of the states appear to use the federal definitions for credit eligibility and follow the federal formula for establishing a base time period. The statutory credit percentages range from Minnesota's 2.5 percent of the difference between current research and development expenses and the average from a past, fixed period, to Hawaii's non-incremental 20 percent tax credit on all qualified research and development expenditures each year. All but three states use the federal tax credit's incremental approach to computing their research and development credits.

States with an R&D Tax Credit and the Maximum Statutory Credit Amount			
Arizona (11%)	Indiana (5%)	Missouri (6.5%)	Pennsylvania (10%)
California (15%)	Iowa (6.5%)	Montana (5%)	Rhode Island (16.9%)
Connecticut (6%)	Kansas (6.5%)	Nebraska (3%)	South Carolina (5%)
Delaware (10%)	Louisiana (8%)	New Jersey (10%)	Texas (5%)
Georgia (10%)	Maine (5%)	North Carolina (5%)	Utah (6%)
Hawaii (20%)	Maryland (10%)	North Dakota (4%)	Vermont (10%)
Idaho (5%)	Massachusetts (10%)	Ohio (7%)	West Virginia (10%)
Illinois (6.5%)	Minnesota (2.5%)	Oregon (5%)	Wisconsin (5%)

Source: Federal Reserve Bank of San Francisco, August 2007

Some states allow the tax credit to be taken only against their state income tax, while others allow it to be taken against a variety of state tax liabilities. Also, some states offer the highest tax credit rate to research and development activities done in conjunction with university partners, while others make no distinction.

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[5] 26 USC sec. 41(c).
[6] 26 USC sec. 41(g).
[7] Internal Revenue Service, Statistics of Income Division. Retrievable at: http://www.irs.gov/taxstats/article/0,,id=164402,00.html. Last visited Feb. 26, 2010.
[8] Ibid.
[9] "Beggar thy Neighbor? The In-State, Out-of-State, and Aggregate Effects of R&D Tax Credits." Daniel J. Wilson of the Federal Reserve Bank of San Francisco. Retrievable at: http://www.frbsf.org/publications/economics/papers/2005/wp05-08bk.pdf Last visited Feb. 26, 2010.

Viewpoints on Research and Development Tax Credits[10]

Supporters of research and development tax credits say they are necessary to keep the United States competitive with other nations, to create high-wage jobs, and to fuel technological innovation in business and industry. Some economists have written research papers questioning the positive impact of research and development tax credits and whether they are cost-effective. The General Accounting Office has published reports in 1989 and in 1996 about the federal research tax credit that evaluate the tax credit's return on investment compared with foregone tax revenues.

Statistics

Internationally, the United States, in 2006, ranked first in research and development expenditures, at $344 billion, most of it spent on defense research.[11] The nation's research and development expenditures as a measure of the Gross Domestic Product have remained stable over the last several years at 2.6 percent, which ranks seventh internationally.[12]

According to research provided by Enterprise Florida, Inc., in 2005 Florida's per capita industry-performed research and development was roughly 31 percent of the national average. At 23 cents per capita, Florida's private-sector research and development expenditures is lower than several of its competitor states, including New York (at 49 cents per capita), Virginia (58 cents per capita), North Carolina (59 cents per capita), California ($1.40 per capita), and Massachusetts ($2.07 per capita). Similarly, private-sector research and development investment in Florida comprises a lower percentage of total research and development investment, at 64 percent, than the national average of 71 percent and that of several competitor states.

Effect of Proposed Changes

The bill creates s. 220.194, F.S., which authorizes a research and development tax credit against state corporate income taxes. The tax credit is 10 percent of the difference between the current tax year's research and development expenditures and the average of research and development expenditures over the previous 4 tax years. However, if the business has existed fewer than 4 years, then the credit amount is reduced by 25 percent for each year the business did not exist within the 4-year base period.

The bill provides several definitions:

- "Business enterprise" means "any corporation as defined in s. 220.03(1)(e) that is also a target industry business as defined in s. 288.106(1)(o)."
    - "Target industry business" means a corporate headquarters business or any business that is engaged in one of the target industries identified pursuant to the following criteria developed by the office in consultation with Enterprise Florida, Inc.:
        - Future growth
        - Stability
        - High wage
        - Market and resource independent
        - Industrial base diversification and strengthening

[10] A sampling of sites with reports and other information in support of research and development tax credits include: "Boosting Technological Innovation through the Research and Experimentation Tax Credit." Robert D. Atkinson/Progressive Policy Institute. Published May 1, 1999. Found at: http://www.ppionline.org/ppi_ci.cfm?knlgAreaID=140&subsecID=293&contentID=1411.html.; "The Research and Experimentation Tax Credit." Chris Edwards/The Tax Foundation. Published November 1, 1993. Found at http://www.taxfoundation.org/publications/show/591.html.; and the National Association of Manufacturers website at http://www.nam.org. GAO/GGD-89-114 is found at http://archive.gao.gov/d26t7/139607.pdf. GAO/GGD-96-43 is found at http://www.gao.gov/archive/1996/gg96043.pdf. A sampling of sites with reports that question the value of R&D tax credits as zero-sum, at best, include: "Does Government R&D Policy Mainly Benefit Scientists and Engineers?" Austan Goolsbee. Presented at the National Bureau of Economic Research. April 1998. Found at http://www.nber.org/papers/w6532. "Beggar thy Neighbor? The In-State, Out-of-State, and Aggregate Effects of R&D Tax Credits." Daniel J. Wilson/Federal Reserve Bank of San Francisco. Found at http://www.frbsf.org/publications/economics/papers/2005/wp05-08bk.pdf.; and "How Important is Business R&D for Economic Growth and Should the Government Subsidise it? Rachel Griffith/Institute for Fiscal Studies. Found at http://www.ifs.org.uk/bns/bn12.pdf. These sites were last visited on Feb. 26, 2010.

[11] Briefing Note on the United States. Organisation for Economic and Cooperative Development's Science, Technology and Industry Scoreboard 2007. Retrievable at http://www.oecd.org/dataoecd/19/11/39695454.pdf. Last visited Feb. 26, 2010.

[12] Organisation for Economic and Cooperative Development's Science, Technology and Industry Scoreboard 2007. Retrievable at http://www.oecd.org/dataoecd/19/11/39695454.pdf. Last visited Feb. 26, 2010.

        - Economic benefits
    - The list of such target industries is compiled annually by the Office of Tourism, Trade, and Economic Development
    - Target industry business may not include any industry engaged in retail activities; any electrical utility company; any phosphate or other solid minerals severance, mining, or processing operation; any oil or gas exploration or production operation; or any firm subject to regulation by the Division of Hotels and Restaurants of the Department of Business and Professional Regulation
- "Qualified research expenses" are defined as research expenses qualifying for the federal credit under section 41 of the Internal Revenue Code for in-house or contract research expenses within Florida. Not eligible is research and development conducted out of state, research excluded by the federal code, and research and development conducted by a business enterprise that is not within its principal business activity.

The state tax credit taken in any tax year may not exceed 50 percent of the company's remaining net corporate income tax liability under ch. 220, F.S., after all other credits to which the business is entitled have been applied.

Any unused credits may either be carried forward by the business that originally earned them for up to 5 years following the year in which the qualified research expenses were incurred. Or, they may be assigned or sold to another "business enterprise" for no less than 75 percent of their value. In the latter instance:

- The business that earned research and development tax credits may assign or sell them if it has not claimed the credits within one year of the Department of Revenue having approved them.
- The business entity that has been assigned the credits or has purchased them must use the credits in the tax year in which they were purchased or assigned.

The maximum amount of research and development credits that may be approved by the Department of Revenue during any calendar year is $15 million. Applications may be filed with the department on or after March 20 for qualified research expenses incurred within the preceding calendar year, and credits shall be granted in the order in which completed applications are received.

Finally, the department is permitted to adopt rules related to its administration of this program, including, but not limited to, rules prescribing forms, application procedures and dates, and notification or other procedures for the sale or assignment of a credit. The department may also establish guidelines for making an affirmative showing of credit and any evidence needed to substantiate a claim for credit under this section.

The bill also amends s. 220.02, F.S., which establishes the order in which a corporate taxpayer may claim the research and development tax credit, compared to all other potential corporate income tax credits. The research and development tax credit is to be applied last.

The bill has an effective date July 1, 2010, for tax years beginning on or after January 1, 2011. This latter date is important because corporate income tax filers typically use January-December as their fiscal year to conform to the federal tax period.

B. SECTION DIRECTORY:

Section 1: Creates s. 220.194, F.S., relating to a research and development tax credit.

Section 2: Amends s. 220.02, F.S., relating to the order in which credits against the corporate income tax or the franchise tax are applied.

Section 3: Provides an effective date of July 1, 2010, for tax years beginning on or after January 1, 2011.

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

   None.

2. Expenditures:

   The Revenue Estimating Conference determined the bill will have a recurring negative fiscal impact of $15 million. The Department of Revenue estimates it will cost $51,339 in recurring expenditures and $30,277 in non-recurring expenditures to administer the bill’s provisions.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

   None.

2. Expenditures:

   None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

The tax credits provided by this bill may induce the expansion of the research and development efforts of eligible Florida companies and may attract out-of-state corporations to relocate to Florida.

D. FISCAL COMMENTS:

During the 2009 legislative session, a similar bill was analyzed by the Revenue Estimating Conference and it was determined that there would be a negative fiscal impact to the state of $15 million to the state’s General Revenue Fund for FY 2009-2010. The REC assumed that all of the available research and development credits would be taken each fiscal year, based on a trend analysis.

HB 607 differs from the bill that was analyzed last year in that the definition of “business enterprise” restricts business eligible to receive the tax credit to “any corporation as defined in s. 220.03(1)(e) that is also a target industry business as defined in s. 288.106(1)(o).” This may reduce the total fiscal impact to the state.

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

   None.

2. Other:

   None.

B. RULE-MAKING AUTHORITY:

The Department of Revenue is permitted to adopt rules related to its administration of this program, including, but not limited to, rules prescribing forms, application procedures and dates, and notification or other procedures for the sale or assignment of a credit. The department may also establish guidelines for making an affirmative showing of credit and any evidence needed to substantiate a claim for credit under this section.

C. DRAFTING ISSUES OR OTHER COMMENTS:

There is inconsistency in the use of the terms “credit year,” “calendar year,” and “taxable year.” Also, the terms “principal business activity,” “predecessor corporation,” and “net income tax liability” are not defined.

The Department of Revenue expressed concerns that the definition of “business enterprise” includes only corporations that are target industry businesses as defined in s. 288.106(1)(o), F.S. The department is not familiar with the type of businesses or the specific businesses that qualify as target industry businesses. In addition, the department is uncertain if business enterprises eligible for the research and development tax credit must be eligible for the target industry program and if a business enterprise may claim both the research and development tax credit and the target industry incentive.

The bill does not set filing deadlines or state the specific information to be provided in applying for the credit. While the bill does grant the Department of Revenue authority to adopt rules related to the administration of this program, the sponsor may wish to file an amendment adding those administrative provisions to comply with the current Administrative Procedures Act.

Lines 116-129 of the bill provides that a credit may be assigned or sold if a “claim for allowance” has not been filed within one year following the date on which the department first approved the credit. Since credits are based on a company’s research and development expenditures each tax year, and since companies can wait until 9 months to file their tax returns, it may be clearer to rewrite the provision so that a tax credit can be transferred if the company is unable to use it in the year it was incurred or approved by the Department of Revenue.

IV. AMENDMENTS/COUNCIL OR COMMITTEE SUBSTITUTE CHANGES