HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: CS/HB 671 Research and Development Tax Credits
SPONSOR(S): Workman and others
TIED BILLS: **IDEN./SIM. BILLS:** SB 942

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR or BUDGET/POLICY CHIEF
1) Economic Development & Tourism Subcommittee	14 Y, 0 N, As CS	Tecler	Kruse
2) Rulemaking & Regulation Subcommittee			
3) Finance & Tax Committee			
4) Economic Affairs Committee			

SUMMARY ANALYSIS

Thirty-two states and 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. The bill creates a research and development tax credit against Florida corporate income taxes that is modeled after the federal research tax credit and incorporates some of its definitions, which may have the effect of stimulating private sector economic activity. 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. The bill provides that the tax credit may not exceed 50 percent of a business' corporate tax liability in a tax year, and 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.

The bill directs the Department of Revenue to adopt rules to implement and administer the new research and development tax credit.

The bill has a negative recurring fiscal impact of $15 million on state revenue.

The bill has an effective date of July 1, 2011, although tax credits cannot be used to offset corporate income taxes until January 1, 2012.

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. EFFECT OF PROPOSED CHANGES:

Issue Background

Federal R&D Tax Credit

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 federal tax credit expired on December 31, 2009. However, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 reinstated the tax credit through tax year 2011.[2]

Over the years, the tax credit formula has been modified several times and the types of eligible expenses broadened. Under current 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" includes 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 is 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 tax credit that can be redeemed is determined by three different methods, depending in part on how long the company has been in business.

- Under the basic formula, the tax credit is 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 use simpler formulas that compare current year research and development spending with past years. Business entities that do not pay federal corporate income tax, such as "S" corporations and partnerships, are allowed to "pass-thru" their federal research credits to shareholders or partners, based on their shares in such business entities.[6]

State R&D Tax Credits

Thirty-two states have enacted a research and development tax credit.[7] 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

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[1] "The U.S. Research and Experimentation Tax Credit in the 1990s" by Francisco Moris. National Science Foundation Report #NSF05-316, July 2005, http://www.nsf.gov/statistics/infbrief/nsf05316/, and "The Prospects for Economic Recovery," Congressional Budget Office, February 1982, http://www.cbo.gov/ftpdocs/51xx/doc5135/doc03b-Part8.pdf. (sites last visited 03/16/2011).

[2] P.L.111 - 312, December 17, 2010.

[3] 26 U.S.C. s. 41(b).

[4] 26 U.S.C. s. 41(d).

[5] 26 U.S.C. s. 41(c).

[6] 26 U.S.C. s. 41(g).

[7] "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, http://www.frbsf.org/publications/economics/papers/2005/wp05-08bk.pdf. (last visited 03/16/2011).

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.

Viewpoints on Research and Development Tax Credits[8]

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.[9]

Statistics

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).

[8] 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. May 1999. 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. November 1993. http://www.taxfoundation.org/publications/show/591.html.; and
- National Association of Manufacturers, http://www.nam.org.

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, National Bureau of Economic Research. April 1998. 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. 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 Subsidize it? Rachel Griffith, Institute for Fiscal Studies. http://www.ifs.org.uk/bns/bn12.pdf. (all sites were last visited on 03/16/2011).

[9] GAO/GGD-89-114, http://archive.gao.gov/d26t7/139607.pdf and GAO/GGD-96-43, http://www.gao.gov/archive/1996/gg96043.pdf.

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.

<u>Changes Made By the Bill</u>

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.

Research & Development Tax Credit

<u>Definitions</u>
"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(2)(t).

"Target Industry Business" means a corporate headquarters business or any business that is engaged in one of the target industries identified by the Governor's Office of Tourism, Trade, and Economic Development, in consultation with Enterprise Florida, Inc.

"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.

<u>Tax credit</u>
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 20th for qualified research expenses incurred within the preceding calendar year, and credits shall be granted in the order in which completed applications are received.

<u>Rules</u>
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 of July 1, 2011, for tax years beginning on or after January 1, 2012.

B. SECTION DIRECTORY:

Section 1: 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 2: Creates s. 220.194, F.S., relating to a research and development tax credit.

Section 3: Provides an effective date of July 1, 2011, for tax years beginning on or after January 1, 2012.

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

   The Revenue Estimating Conference determined the bill will have negative fiscal impact of $5 million in cash for FY 2011-2012 and negative $15 million in cash for FYs 2012-2013, 2013-2014, and 2014-2015. Further, the conference adopted a negative annualized impact of $15 million for FYs 2011-2012, 2012-2013, 2013-2014, and 2014-2015.

2. Expenditures:

   The Department of Revenue estimates the bill will have an insignificant operational impact on the Department.

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:

None.

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

   Not Applicable. This bill does not appear to affect county or municipal governments.

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:

None.

IV. AMENDMENTS/ COMMITTEE SUBSTITUTE CHANGES

On March 22, 2011, the Economic Development and Tourism Subcommittee adopted an amendment that removed the whereas clauses in the bill.

The bill was reported favorably as a committee substitute and the analysis has been updated to reflect the adopted amendment.