Department of Legislative Services

Maryland General Assembly
2018 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 1450 (Delegates Kaiser and D. Barnes)
Ways and Means

Income Tax - Research and Development Tax Credit - Alterations

This bill expands the existing research and development (R&D) tax credit by increasing from $12 million to $14 million the aggregate amount of credits that the Department of Commerce (Commerce) can approve in each calendar year. The bill also requires Commerce to set aside 25% of the maximum amount of the tax credits authorized for small businesses. **The bill takes effect July 1, 2018, and applies to all R&D tax credits certified after December 15, 2017.**

Fiscal Summary

State Effect: General fund revenues decrease by $0.9 million in FY 2019 as a result of additional tax credits being claimed against the corporate and personal income tax. Transportation Trust Fund (TTF) revenues decrease by $0.2 million and Higher Education Investment Fund (HEIF) revenues decrease by $0.1 million in FY 2019. Future year revenue estimates reflect credit carry forwards from previous years and the expansion of credit amounts. Expenditures are not affected.

($ in millions)	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
GF Revenue	($0.9)	($1.2)	($1.5)	($1.5)	($1.5)
SF Revenue	($0.2)	($0.3)	($0.4)	($0.4)	($0.4)
Expenditure	0	0	0	0	0
Net Effect	($1.1)	($1.5)	($1.8)	($1.8)	($1.8)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate increase; (-) = indeterminate decrease

Local Effect: Local highway user revenues distributed from the corporate income tax decrease by about $15,000 in FY 2019 and by $24,000 in FY 2023. Local income tax revenues increase minimally beginning in FY 2019 due to taxpayers adding back the amount of credits claimed against the personal income tax. Local expenditures are not affected.

Small Business Effect: Meaningful.

Analysis

Bill Summary: If the total amount of credits applied for by small businesses is less than 25% of the cap, Commerce must make the unused credits available to taxpayers that are not small businesses. If the amount of credits applied for by small businesses exceeds the 25% set-aside amount, the credit is prorated among small businesses. If the amount of credits applied for by taxpayers excluding small businesses exceeds the aggregate limit less the small business set-aside, the credit is prorated among those taxpayers.

Under current law, a small business is defined as a for-profit corporation, limited liability company, partnership, or sole proprietorship that, at the beginning or end of the taxable year in which the eligible R&D expenses are incurred, has net book value assets totaling less than $5 million. The bill specifies that a small business must also have 50 or fewer employees in the State.

Current Law: Chapters 515 and 516 of 2000 established the State R&D Tax Credit Program. There are two types of credits available: (1) a basic credit equal to 3% of the Maryland qualified R&D expenses paid during the tax year, up to the Maryland base amount; and (2) a growth credit equal to 10% of the Maryland qualified R&D expenses paid during the year that exceed the Maryland base amount.

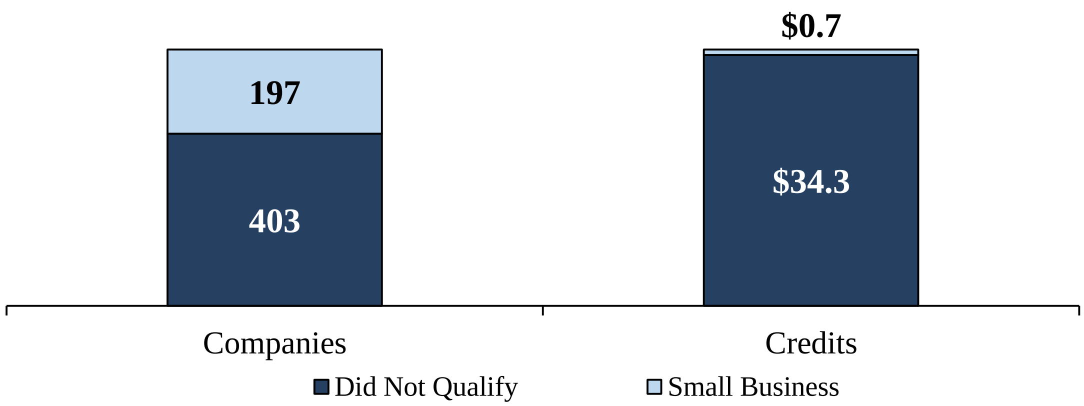
Commerce administers the tax credit application, approval, and certification process and is required to submit an annual report to the Governor and the General Assembly detailing specified information about the tax credit. Commerce may not approve annual credits that in the aggregate exceed $12 million. If the amount of credits earned during any year exceeds the aggregate limit, the amount approved for each credit is reduced by a proportional amount of the excess. The program terminates June 30, 2021.

Chapter 109 of 2013 made the R&D credit refundable if the business meets the qualifications of a small business beginning in tax year 2012.

Background: In response to concerns about the impacts of tax credits, Chapters 568 and 569 of 2012 established the Tax Credit Evaluation Act, a legislative process for evaluating certain tax credits. The evaluation process is conducted by a legislative evaluation committee. The committee is required to review and evaluate the R&D tax credit by July 1, 2018. The draft report on the credit was completed in November 2017 and can be found on the Department of Legislative Services (DLS) website. One of its recommendations was for the General Assembly to consider setting aside a portion of the R&D tax credits to be allocated for R&D expenditures by small businesses.

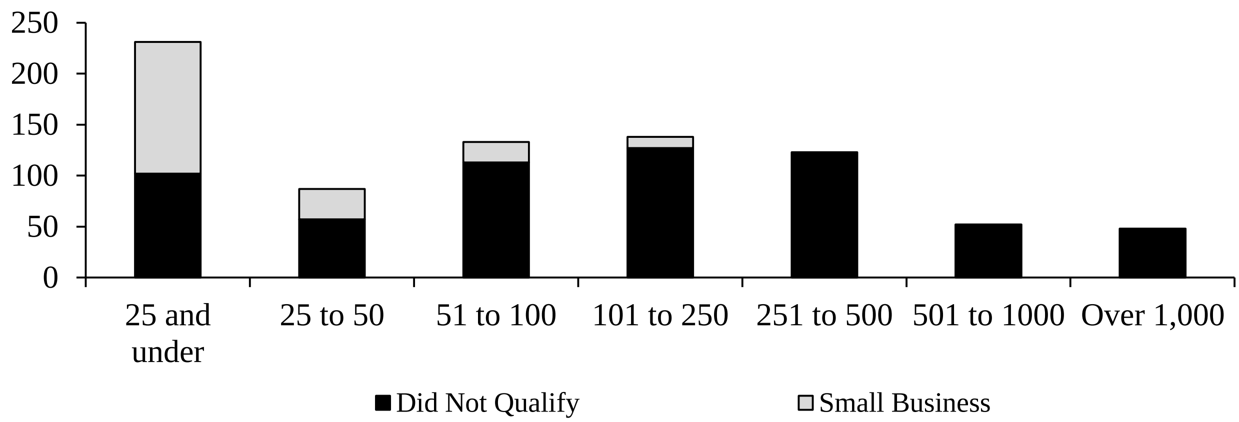
In tax years 2012 through 2015, Commerce awarded 600 companies a total of $35 million in R&D credits. As shown in **Exhibit 1**, about one-third of all companies qualified for the small business refund but only received approximately $750,000 in credits. Only 56% of companies with 25 or fewer employees qualified for the credit. **Exhibit 2** shows the number of companies that qualified for the small business refund based on the business's number of Maryland employees.

Exhibit 1
Small Business Refund
Total Companies and Credits Claimed
Tax Year 2012-2015
($ in Millions)



Source: Department of Commerce; Department of Legislative Services

Exhibit 2
Small Business Refunds by Number of Qualified Maryland Employees



Note: This only includes Maryland employees. It is unknown how many total employees businesses have.
Source: Department of Commerce; Department of Legislative Services

State Revenues: The bill expands the State R&D tax credit by increasing the aggregate amount of credits that can be approved in each calendar year. The bill applies to credits certified after December 15, 2017, and will apply beginning with tax year 2017. A maximum of $14.0 million in credits can be awarded in each tax year. As a result, general fund revenues will decrease by $925,000 in fiscal 2019. TTF revenues will decrease by $159,000 and HEIF revenues will decrease by $65,000 in fiscal 2019. **Exhibit 3** shows the estimated State and local revenue impacts resulting from the proposed expansion.

Exhibit 3
Projected Impact on State and Local Revenues
Fiscal 2019-2023

	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
Total State Revenue	**($1,149,000)**	**($1,494,000)**	**($1,838,000)**	**($1,838,000)**	**($1,838,000)**
General Fund	(925,000)	(1,202,000)	(1,479,000)	(1,479,000)	(1,479,000)
HEIF	(65,000)	(85,000)	(105,000)	(105,000)	(105,000)
TTF	(159,000)	(207,000)	(254,000)	(254,000)	(254,000)
State	*(144,000)*	*(187,000)*	*(230,000)*	*(230,000)*	*(230,000)*
Local	*(15,000)*	*(20,000)*	*(24,000)*	*(24,000)*	*(24,000)*

HEIF: Higher Education Investment Fund
TTF: Transportation Trust Fund

Before claiming the tax credit, Commerce must certify the amount of R&D expenses incurred by the business. These expenses are certified on December 15 of the calendar year following the end of the taxable year in which the qualifying expenses occurred. A business must then file an amended return to claim the credit – it is assumed this could be done beginning in fiscal 2019 and that companies do not adjust estimated payments. To the extent that companies adjust estimated payments in anticipation of earning credits, revenue losses will be greater in fiscal 2019.

Local Revenues: Local highway user revenues will decrease by $15,000 in fiscal 2019 and by $24,000 in fiscal 2023, as shown in Exhibit 3. Local income tax revenues will increase minimally beginning in fiscal 2019 due to taxpayers adding back the amount of credits claimed against the personal income tax.

Small Business Effect: Chapter 121 of 1995 requires all fiscal and policy notes prepared by DLS to provide an assessment of the economic impact of the legislation on small businesses. The Act defines a small business as a corporation, partnership, sole proprietorship, or other business entity, including affiliates, that (1) is independently owned and operated; (2) is not dominant in its field; and (3) employs 50 or fewer full-time employees. This definition of a small business differs from the proposed definition under the R&D Tax Credit Program, which defines a small business as a for-profit corporation, limited liability company, partnership, or sole proprietorship that, at the beginning or end of the taxable year in which the eligible R&D expenses are incurred, has net book value assets totaling less than $5 million and 50 or fewer employees in the State. Thus, some small businesses, as defined for the purpose of fiscal and policy notes, will benefit from the bill while others may receive a smaller credit.

Small businesses, as defined by the R&D Tax Credit Program, benefit from the bill due to the proposed expansion of the credit and because the program has been oversubscribed in every year. Commerce may not approve annual R&D tax credits beyond the aggregate limit, so the amount approved for each credit is reduced by a proportional amount of the excess. Commerce reduced the total tax credits awarded in tax year 2015 from $82.1 million to $9.0 million, so in tax year 2015, the basic credit was equal to 0.39% of eligible expenses compared with a statutory rate of 3.0%, while the growth credit rate was reduced from 10.0% to 0.95%. By having the 25% set-aside, small businesses (as defined by the R&D Tax Credit Program) are likely to receive all of the credits that they qualify for instead of having their credits prorated.

In tax year 2015, when the cap on the aggregate credits was $9.0 million, 51 small businesses, as defined for fiscal and policy note purposes and that also met the definition of a small business under the R&D Tax Credit Program, received $141,077 in R&D credits though they qualified for $1.3 million in R&D credits. If the 25% set-aside was in place in tax year 2015, these businesses would have each on average received approximately $22,300 in tax credits instead of $2,800. Under the bill, these small businesses would on average receive up to $20,000 more in additional R&D tax credits annually, though credits could be less if more small businesses participate in the program. Meanwhile, small businesses with 50 or fewer employees and more than $5 million in net book value assets may receive several hundred dollars less in R&D tax credits.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Department of Commerce; Comptroller’s Office; Department of Legislative Services

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