Department of Legislative Services

Maryland General Assembly
2018 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 521 (Delegate Tarlau, *et al.*)
Ways and Means

Income Tax - Research and Development Credit - Small Business Set-Aside

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This bill requires the Department of Commerce (Commerce) to set aside 20% of the maximum amount of the research and development (R&D) tax credits authorized for small businesses. If the total amount of credits applied for by small businesses is less than 20% 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 exceed the 20% 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. **The bill takes effect July 1, 2018, and applies to all R&D tax credits certified after December 15, 2017.**

Fiscal Summary

State Effect: Requiring Commerce to set aside 20% of R&D tax credits for small businesses does not alter the fiscal impact of the program beyond that provided under current law.

Local Effect: None.

Small Business Effect: Meaningful.

Analysis

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.

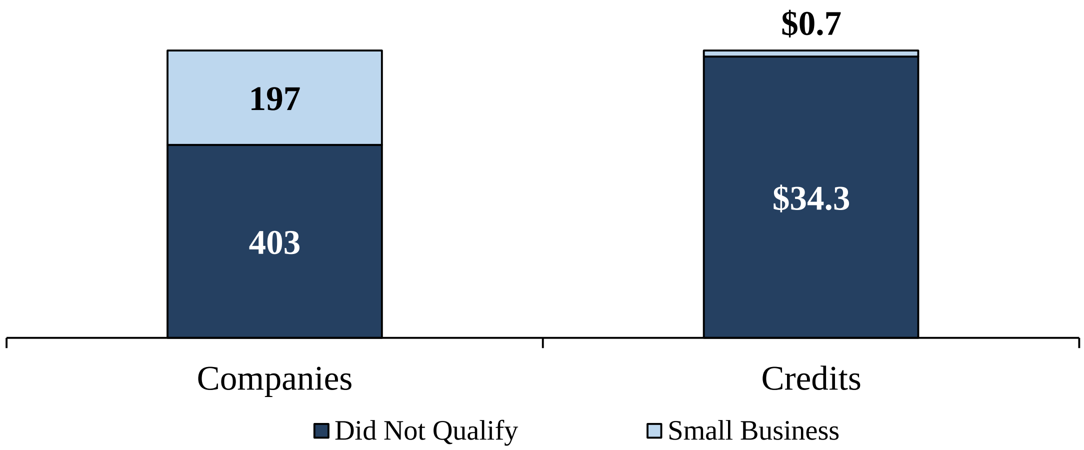
Commerce administers the tax credit application, approval, and certification process and is required to submit an annual report to the Governor and the General Assembly detailing specified information about the tax credit. Commerce may not approve annual credits that in the aggregate exceed $12 million. 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. Chapter 109 of 2013 defined 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.

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.

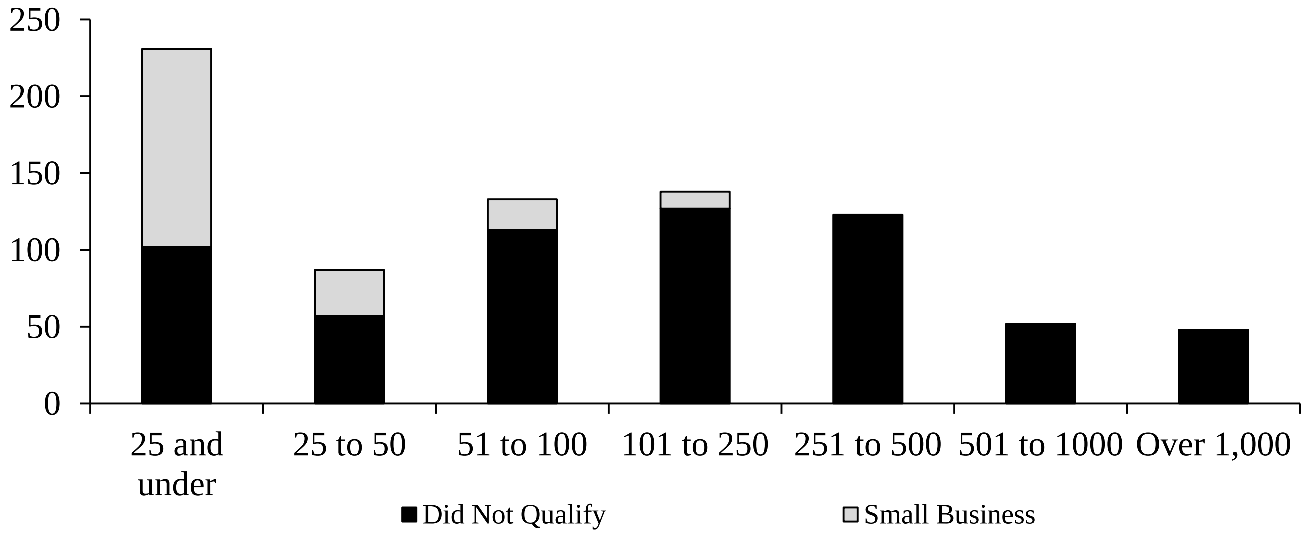
In tax years 2012 through 2015, Commerce awarded 600 companies a total of $35 million in R&D credits. As shown in **Exhibit 1**, about one-third of all companies qualified for the small business refund but only received approximately $750,000 in credits. Only 56% of companies with 25 or fewer employees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

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 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. 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 because the R&D Tax Credit 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 20% 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 meet 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 20% 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 of 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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