SB 196

Department of Legislative Services

Maryland General Assembly
2021 Session

FISCAL AND POLICY NOTE
Enrolled - Revised

Senate Bill 196 (Chair, Budget and Taxation Committee)(By Request - Departmental - Commerce)

Budget and Taxation Ways and Means

Economic Development – Research and Development Tax Credit – Alterations

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This departmental bill extends the termination date for the research and development (R&D) tax credit to June 30, 2025. The bill also alters the tax credit by (1) eliminating the basic credit; (2) increasing to $12 million the amount of growth tax credits that can be awarded in each tax year; (3) requiring the Department of Commerce to set aside $3.5 million of the total tax credits awarded annually to qualified small businesses; (4) limiting to $250,000 the maximum value of the tax credit; (5) defining net book assets for the purpose of determining small business eligibility; and (6) establishing the purpose of the program. **The bill takes effect July 1, 2021, and applies to tax years 2021 through 2025.**

Fiscal Summary

State Effect: General fund revenues decrease by $6.1 million in FY 2023 as a result of tax credits being claimed against the corporate and personal income tax. The Governor's proposed FY 2022 budget assumes a $6.5 million general fund reduction in FY 2022. Transportation Trust Fund (TTF) revenues decrease by $1.0 million and Higher Education Investment Fund (HEIF) revenues decrease by $0.4 million in FY 2023. Future year revenue estimates reflect credit carry forwards from previous years and current year tax credit claims. TTF expenditures decrease by about $150,000 annually beginning in FY 2023.

($ in millions)	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026
GF Revenue	$0	($6.1)	($7.6)	($8.9)	($8.9)
SF Revenue	$0	($1.5)	($1.9)	($2.2)	($2.2)
SF Expenditure	$0	($0.1)	($0.2)	($0.1)	($0.1)
Net Effect	$0.0	($7.4)	($9.3)	($10.9)	($10.9)

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 $150,000 annually beginning in FY 2023. Local income tax revenues increase minimally beginning in FY 2023 due to taxpayers adding back the amount of credits claimed against the personal income tax. Local expenditures are not affected.

Small Business Effect: Commerce has determined that this bill has a meaningful impact on small business (attached). The Department of Legislative Services concurs with this assessment. (The attached assessment does not reflect amendments to the bill.)

Analysis

Bill Summary: Commerce must annually award $3.5 million in tax credits to qualified small businesses and may award up to $8.5 million in tax credits to all other businesses. The bill establishes the process for prorating the tax credits for each type of business if the amount of credits sought exceeds the amount available and reallocating tax credits if the amount of tax credits sought is less than the amount available for each type of business.

Under current law, a business that meets certain requirements, including net book value assets totaling less than $5.0 million, can claim a refundable tax credit. The bill defines net book value assets as the total of a business's net value of assets, including intangibles but not including liabilities, minus depreciation and amortization.

The bill specifies that the purpose of the R&D tax credit is to foster increased research activities and expenditures in Maryland.

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. Through tax year 2020, Commerce may award $12.0 million in aggregate tax credits annually – $5.5 million in basic credits and $6.5 million in growth credits. Except for certain businesses, the tax credit is nonrefundable – the value of the credit may not exceed the tax liability imposed in the tax year. Any unused amount of the credit may be carried forward for seven years after the taxable year in which the expense was incurred. 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. The tax credit is refundable if the business claiming the credit is 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 assets totaling less than $5 million.

The program terminates June 30, 2022.

Background:

Other R&D Tax Incentives

The State exempts from the sales and use tax purchases of tangible personal property for use or consumption in R&D. R&D is defined as basic and applied research in the sciences and engineering and the design, development, and governmentally mandated premarket testing of prototypes and processes. Market research, research in the social sciences or psychology, and other nontechnical activities, routine product testing, sales services, or technical and nontechnical services do not qualify.

The federal research tax credit, originally enacted in 1981, generally is equal to the current year qualified research expenditures (QRE) that exceed a base amount. The base amount is designed to approximate the level of R&D that would have occurred in the absence of the credit. Taxpayers may claim either the regular credit, which generally equals 20% of the QRE above the base amount or the alternative simplified credit equal to 14% of QRE that exceeds 50% of the average QRE for the three preceding tax years.

Department of Legislative Services Evaluation of the State Research and Development Tax Credit

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 was required to review and evaluate the R&D tax credit by July 1, 2018. The report can be found on the Department of Legislative Services (DLS) website.

DLS concluded that the State R&D tax credit is not a key component in fostering innovation and creating long-term economic growth. Having a skilled workforce appears to be a more significant factor in creating long-term growth. DLS found that the design and implementation of the R&D tax credit decreases its effectiveness. These findings include:

- In contrast to the federal and most State R&D tax credits, the design of the State R&D tax credit is much more likely to provide windfall credits for R&D activities that would have occurred in the absence of the credit. This is primarily due to the basic credit that provides tax credits for a business's total recent R&D expenditures rather than for incremental increases.
- The concentration of R&D tax credit claims within a few, large companies is greater than in other tax credit programs that have been evaluated by DLS. About one-third of all companies qualified for the small business refund but only received about 2% of the total credits awarded in tax years 2012 through 2015.

DLS recommended (1) considering alternative policies for encouraging R&D expenditures, such as providing research grants to Maryland universities or matching a portion of the federal Small Business Innovative Research program funds and (2) improving the program by simplifying the tax credit and targeting the credit to new and small technology companies.

State Revenues: The bill alters and extends the tax credit program beginning with tax year 2021. A maximum of $12.0 million in growth credits can be awarded each year. It is assumed that companies do not adjust estimated payments in anticipation of earning credits. As a result, general fund revenues will decrease by $6.1 million in fiscal 2023. TTF revenues will decrease by $1.0 million, and HEIF revenues will decrease by $0.4 million in fiscal 2023. **Exhibit 1** shows the impact of the bill in fiscal 2022 through 2026.

Exhibit 1
Projected State Fiscal Impact
($ in Millions)

	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026
General Fund	$0.0	($6.1)	($7.6)	($8.9)	($8.9)
HEIF	0.0	(0.4)	(0.5)	(0.6)	(0.6)
TTF	0.0	(1.0)	(1.3)	(1.5)	(1.5)
Total Revenues	**$0.0**	**($7.6)**	**($9.5)**	**($11.0)**	**($11.0)**
TTF Expenditures	**$0.0**	**($0.1)**	**($0.2)**	**($0.1)**	**($0.1)**

HEIF: Higher Education Investment Fund
TTF: Transportation Trust Fund

State Expenditures: A portion of TTF revenues are used to provide capital transportation grants to local governments. Thus, any decrease in TTF revenues from corporate tax revenues results in a 13.5% decrease in TTF expenditures to local governments (9.6% beginning in fiscal 2025). Accordingly, TTF expenditures decrease by about $150,000 annually beginning in fiscal 2023.

Local Revenues: Local governments receive a portion of corporate income tax revenues as local highway user revenues through capital transportation grants. Under this bill, local highway user revenues decrease by about $150,000 annually beginning in fiscal 2023. Local income tax revenues will increase minimally beginning in fiscal 2023 due to taxpayers adding back the amount of credits claimed against the personal income tax.

Additional Information

Prior Introductions: None.

Cross File: None.

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

Fiscal Note History:	First Reader - January 26, 2021
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ANALYSIS OF ECONOMIC IMPACT ON SMALL BUSINESSES

TITLE OF BILL: Economic Development – Research and Development Tax Credit – Alterations

BILL NUMBER: SB 196

PREPARED BY: Michael Siers

PART A. ECONOMIC IMPACT RATING

This agency estimates that the proposed bill:

___ WILL HAVE MINIMAL OR NO ECONOMIC IMPACT ON MARYLAND SMALL BUSINESS

OR

_X_ WILL HAVE MEANINGFUL ECONOMIC IMPACT ON MARYLAND SMALL BUSINESSES

PART B. ECONOMIC IMPACT ANALYSIS

Research and Development (R&D) activities are critical to the growth of a dynamic economy. Developing new technologies and innovations helps a company differentiate itself from its competitors and gain a competitive advantage. This competitive advantage then allows the firm to expand, allowing it to support more workers and strengthen the tax base in a given region. Additionally, the innovations from these firms often have some sort of social good, including gains in productivity. However, R&D is expensive and this expense inhibits many firms from fully investing in new technologies. However, it is in Maryland's best interest to incentivize R&D, in order to ensure that Maryland companies are the most competitive in the market.

In 2000, Maryland established the Research and Development Tax Credit in order to help boost R&D spending. However, the program became a victim of its own success and was oversubscribed. As it is currently structured, applicants receive a pro-rated share of the total amount allocated for the program. In some instances, some qualified firms received tax credits of as little as $1. Unfortunately, this likely means that the tax credit has not provided enough assistance to meaningfully influence R&D spending decisions by Maryland firms.

Therefore, the proposed legislation updates the Research and Development Tax Credit in a number of key ways. For one, it eliminates the basic credit and focuses on providing tax credits for new R&D activities. Additionally, the proposed legislation provides caps on the credit a company can receive and creates a small business set-aside. These changes will improve the tax credit. For example, by providing a small business set-aside, the proposed legislation helps precisely those businesses which often have the hardest time accessing enough capital to sustain R&D. Additionally, by focusing on new R&D spending, the tax credit will especially help startups and companies finalizing key innovations.

If the Research and Development Tax Credit is updated, the State should see a significant positive economic impact. A recent study analyzed entrepreneurship measures for all counties in 25 states between 1990 and 2010 and estimated how state-level R&D tax credits influenced entrepreneurship.[1] The study found that "the introduction of state R&D tax credits is associated with around 7% increase in the rate of net new business formation." The main impact of the R&D tax credits, the authors found, occurs more than five years after the policy is enacted, as firms have time to alter their behaviors. Because Maryland's program was over-subscribed, the proposed changes may act in some ways as if Maryland is enacting a new R&D tax credit, and the State should see positive effects in terms of entrepreneurship in the long-run as a result. This will lead to a more robust State-level economy and establish Maryland as a home for innovation and entrepreneurship.

1 https://www.nber.org/papers/w26099.pdf