

Department of Legislative Services
Maryland General Assembly
2000 Session

FISCAL NOTE
Revised

Senate Bill 309 (Senator Hogan. *et al.*)

Budget and Taxation

Maryland Research and Development Tax Credit

This bill creates income tax credits for “Maryland qualified research and development expenses” incurred by individuals or corporations. The total amount of credits claimed in any year may not exceed \$6 million.

The bill is effective July 1, 2000 and it is applicable to all taxable years beginning after December 31, 1999, but before January 1, 2005. The bill sunsets June 30, 2006.

Fiscal Summary

State Effect: Total annual revenue loss of \$6 million for FY 2002 through FY 2006. The distribution of the loss between the general fund and the Transportation Trust Fund (TTF) depends upon the number of claims against the corporate income tax and the number of claims against the personal income tax. A portion of the loss to the TTF will be passed through to local jurisdictions. General fund expenditure increase of \$125,300 in FY 2002 and ongoing expenditures of approximately \$95,000 for as long as the credit is in effect.

Local Effect: To the extent that credits are taken by corporations, local revenues would decline as a portion of the corporate income tax is distributed to the TTF from which a distribution to local governments is made. The maximum loss to local jurisdictions as a result of the bill would be \$260,000.

Small Business Effect: Minimal.

Analysis

Bill Summary: The bill defines Maryland qualified research and development expenses as expenses incurred for research and development conducted in the State. The definition reflects allowable expenses defined under specified Internal Revenue Code provisions, including: (1) in-house research expenses (i.e., services, supplies, and wages); and (2) contract research expenses. The bill allows an individual or corporation to claim a credit against the State income tax in an amount equal to 3% of the Maryland qualified research and development expenses, not exceeding the "Maryland base amount" for the individual or corporation, incurred in a taxable year.

In addition to the nonincremental credit described above, the bill further allows an individual or corporation to claim a credit in an amount equal to 10% by which the Maryland qualified research and development expenses paid or incurred by the individual or corporation during the taxable year exceeds the Maryland base amount for the individual or corporation.

Before a credit may be claimed, the individual or corporation must apply to the Department of Business and Economic Development (DBED) by September 15 of the calendar year following the end of the taxable year in which the expense was incurred. DBED must certify that the applicant is eligible for the credit by December 15 of that same year. DBED must adopt regulations that set standards to be used in determining whether the research or development was conducted in the State.

To claim the credit, the individual or corporation must file an amended income tax return for the taxable year in which the expense was incurred and attach a copy of the certification issued by DBED.

The total amount of credits approved by DBED may not exceed \$10 million for any taxable year. If the total amount of credits applied for exceeds \$10 million, DBED must approve a prorated amount for each eligible applicant.

The bill requires DBED and the Comptroller to jointly assess the cost of the research and development tax credit program and the program's success in increasing the level of investment in research and development activities and attracting and retaining businesses that engage in research and development in Maryland. DBED and the Comptroller must issue a report of their findings to the General Assembly by December 15, 2005.

Current Law: There are no Maryland income tax credits for research and development expenses. However, there is a sales tax exemption for tangible personal property for use or consumption in research and development. Also, research and development personal property is exempt from assessment for the local personal property tax.

Background: A federal research and development tax credit was enacted in 1986 and is in effect through 2004. A company may claim a credit for 20% of the amount by which the company increases its qualified research expenditures (in-house research and contract research) over a base amount. A company may also claim a credit for 20% of basic research payments defined as cash payments by a corporation to a qualified organization for basic research. Additionally, there is a federal tax deduction allowed for defined expenses. A broader definition of research is applied to determine the federal deduction for research expenses. A corporation may not claim on its federal tax return both a credit and a deduction for the same expenses.

Under the bill's provisions, a company could either claim both the federal credit and the Maryland credit, or it could take the federal deduction and the Maryland credit. The federal deduction flows through to Maryland taxes under current law and the bill, lowering the federal adjusted gross income used to determine Maryland's tax liability. Therefore a Maryland company could take the federal deduction, lowering its Maryland tax liability, and then claim the credit established by the bill.

Thirty states have enacted research and development income tax credits. The credits vary in scope and amount, although the majority of the credits are incremental, granting the credit for expenditures over a certain base or average amount. Only Connecticut and West Virginia have non-incremental tax credits. The Connecticut credit is similar to the bill's proposed credit except that the Connecticut credit is not capped. It is estimated that the total Connecticut credit claimed in 1997 was \$55.4 million.

State Revenues: There is no precise estimate of the amount of research and development expenditures in Maryland that would apply to the bill's provisions. Based on studies conducted by the National Science Foundation (NSF), Maryland companies spent \$970 million on industrial research and development in 1997. It is not clear how closely the NSF's definition of research and development expenditures matches the bill's definition. Further, it is estimated that the total federal credit that will be claimed for federal fiscal 2001 will be \$2.7 billion. Based on the estimate of Maryland's share of U.S. research expenditures (3.7%), a 3% credit that is based on the federal model would cost approximately \$22.7 million. However, because the 3% credit as proposed by the bill differs from the federal credit in that it is non-incremental, an uncapped credit would likely exceed \$22.7 million. The addition of the 10% incremental tax credit will further increase the credits claimed. It is estimated that the growth rate for Maryland research and development expenditures is 4.3%.

The bill caps the total amount of the allowable credit at \$6 million; \$3 million for the non-incremental credit and \$3 million for the incremental credit. Credits taken on personal

income tax returns result in a reduction of general fund revenues. Seventy-five percent of the credits taken on corporate income tax returns result in a general fund reduction and the remaining 25% result in a TTF reduction because of the distribution of corporate income tax revenue to the TTF. A portion of the reduction in TTF revenues is applied to the Gasoline and Motor Vehicle Revenue Account (GMVRA) within the TTF. The GMVRA is a shared revenue source, of which 70% is allocated to the TTF and 30% is allocated to the local jurisdictions.

At this time, the number of credits that would be claimed on personal or corporate income tax returns cannot be reliably estimated. However, for illustrative purposes only, and assuming that only corporations would claim the credit, general fund revenues would decrease by \$4.5 million annually beginning in fiscal 2002. The impact is delayed due to the fact that returns must be amended by September 15 in the following year after the taxable year. TTF revenues would decrease by \$1.2 million annually. To the extent that individuals and not corporations claim the credit, the impact to the TTF would be less and the impact on the general fund would increase.

State Expenditures: DBED must certify that the applicant for the tax credit is eligible for the credit by December 15 of the year following the taxable year. General fund expenditures could increase by an estimated \$125,300 in fiscal 2002, which accounts for the fact that DBED will not be required to process certifications until the year after the first taxable year (beginning after December 31, 1999). This estimate reflects the cost of hiring one business analyst and one part-time clerical employee to process the research and development tax credit certifications. It includes salaries, fringe benefits, one-time start-up costs, one-time computer programming costs, and ongoing operating expenses.

Salaries and Fringe Benefits	\$76,000
Operating Expenses	<u>49,300</u>
Total FY 2002 State Expenditures	\$125,300

Future year expenditures reflect: (1) full salaries with 4.5% annual increases and 3% employee turnover; and (2) 1% annual increases in ongoing operating expenses.

Local Revenues: The GMVRA is distributed 70% to the TTF and 30% to local jurisdictions. The local distribution is split with Baltimore City receiving the greater of \$157,500,000 or 11.5% plus 30% of the increase in the remainder over fiscal 1998 and the remainder distributed to the 23 counties and then shared with municipal corporations within

each county. If all credits were taken against the corporate income tax, the maximum loss to the jurisdictions would be about \$260,000 each year.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Department of Business and Economic Development, Comptroller of the Treasury, National Science Foundation, Department of Legislative Services

Fiscal Note History: First Reader - February 20, 2000
cm/jr Revised - Senate Third Reader - March 31, 2000

Analysis by: Jody J. Minnich

Direct Inquiries to:
John Rixey, Coordinating Analyst
(410) 946-5510
(301) 970-5510