

Department of Legislative Services
 Maryland General Assembly
 2005 Session

FISCAL AND POLICY NOTE
Revised

Senate Bill 217
 Budget and Taxation

(The President, *et al.*) (By Request – Administration)

Ways and Means

Research and Development Tax Credit

This Administration bill extends the sunset date for the research and development tax credits from June 30, 2006 to June 30, 2012. The bill also limits to seven the number of years unused credits can be carried forward. The time period in which tax credits may be earned is extended to tax years 2005 through 2010. The Department of Business and Economic Development (DBED) is required to report annually to the Governor and the General Assembly by January 10 of each year on the administration of the tax credit.

The bill takes effect July 1, 2005.

Fiscal Summary

State Effect: General fund revenues could decrease by approximately \$1.4 million in FY 2007 as a result of the tax credits being claimed against the corporate income tax, with losses increasing to \$4.2 million by FY 2009. Transportation Trust Fund loss of approximately \$446,400 in FY 2007 increasing to \$1.3 million by FY 2009 as a result of credits being claimed against the corporate income tax. To the extent that credits are claimed earlier than estimated, revenue losses in these years will be greater than estimated. Additional general and special fund revenue decreases of approximately \$16.8 million from FY 2011 through 2021.

(\$ in millions)	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
GF Revenue	\$0	(\$1.4)	(\$2.8)	(\$4.2)	(\$4.2)
SF Revenue	0	(.4)	(.9)	(1.3)	(1.3)
Expenditure	\$0	\$0	\$0	\$0	\$0
Net Effect	\$0	(\$1.9)	(\$3.7)	(\$5.6)	(\$5.6)

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

Local Effect: Local highway user revenues would decrease as a result of tax credits claimed against the corporate income tax. Local revenues would decrease by approximately \$133,900 beginning in FY 2007, with losses increasing to approximately \$401,800 by FY 2009.

Small Business Effect: The Administration has determined that this bill has minimal or no impact on small business (attached). Legislative Services concurs with this assessment. The attached assessment does not reflect amendments to the bill.

Analysis

Current Law: The tax credit terminates June 30, 2006 and may only be applied to tax years beginning in 2000 and ending in 2004.

Background: Chapters 515 and 516 of 2000 established the research and development (R&D) income tax credit. Businesses that incur qualified research and development expenses in Maryland are entitled to the credit. The total credits approved may not exceed \$6 million in a tax year. There are two types of R&D credits available to businesses: (1) the Basic Research and Development Credit is equal to 3% of the Maryland qualified research and development expenses paid during the tax year, up to the Maryland base amount; and (2) the Growth Research and Development Credit is equal to 10% of the Maryland qualified research and development expenses paid during the year that exceed the Maryland base amount. Research and development expenses are typically counted as a business expense and are deducted from State tax liability. In addition to the State tax credit, companies can qualify for a federal R&D credit.

Exhibit 1 lists the amount of qualifying credits applied for and the amount of credits allowed due to the credit cap since the inception of the program. In every year the amount of credits applied for has substantially exceeded the \$6 million per year cap. When it is oversubscribed, the amount approved for each credit is equal to the proportional share of the total credits applied for in the tax year. For example, in tax year 2003 a business would have been certified for 12% of the amount of credits it sought. Under the current program a business can carry forward its approved credit for 15 years.

Exhibit 1
Credits Applied for and Allowed
By Tax Year

<u>Tax Year</u>	<u>Basic Credit</u>	<u>Growth Credits</u>	<u>Total Credits</u>	<u>Basic Credit Allowed</u>	<u>Growth Credit Allowed</u>	<u>Total Allowed</u>
2000	\$8,165,471	\$26,961,562	\$35,127,033	\$3,000,000	\$3,000,000	\$6,000,000
2001	15,256,435	30,948,106	46,204,541	3,000,000	3,000,000	\$6,000,000
2002	19,058,446	14,533,548	33,591,993	3,000,000	3,000,000	\$6,000,000
2003	21,066,000	27,127,800	48,193,800	3,000,000	3,000,000	\$6,000,000

Exhibit 2 lists the number of qualifying taxpayers that have applied for the credit by tax year. In some cases, a taxpayer may apply for both credits in a tax year.

Exhibit 2
Number of Qualifying Taxpayers Applying for Tax Credit
By Type and Tax Year

<u>Tax Year</u>	<u>Basic</u>	<u>Growth</u>
2000	41	42
2001	75	69
2002	97	62
2003	101	68
Four-year Average	79	60

In the four-year history of the credit, a substantial share of the credits earned has been awarded to a few taxpayers. On average, 45% of available credits have been awarded to three taxpayers in each year. Five credits have exceeded \$1 million with a maximum award of approximately \$1.8 million.

Exhibit 3 lists the amount of credits that have been identified as being claimed on tax returns for each tax year from 2000 to 2002.

Exhibit 3
R&D Credits Claimed

<u>Tax Year</u>	<u>Amount Claimed</u>
2000	\$1,765,909
2001	3,886,164
2002	1,246,826

The amounts claimed represent amended returns filed after the tax year. The Comptroller's Office advises that due to difficulties in identifying credits claimed on amended returns in the years after the tax year, the data are likely incomplete – particularly for tax year 2000. In addition, not all of the amount claimed is always fully absorbed by the taxpayer. The Comptroller's Office estimates that one-third of the amount claimed is carried forward. Based on this data, there is an existing liability or pipeline of credits that have been earned but either not claimed or carried forward of approximately \$13.4 million. This amount does not include the \$6.0 million in credits that have been earned in tax year 2003 and are yet to be claimed.

State Revenues: This bill extends the tax credit program to tax years 2005 through 2010. As a result, revenues will decrease by \$1.9 million in fiscal 2007, \$3.7 million in fiscal 2008, and \$5.6 million in fiscal 2009 and beyond. Although the tax credit is available for tax year 2005, before claiming the tax credit a business must have the amount of qualifying expenses certified by DBED. This certification is performed by DBED by 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 that the earliest this can be done is in fiscal 2007.

Revenues will decrease by an additional \$16.8 million in fiscal 2011 through 2021 as companies carry forward credits earned in previous tax years despite the termination of the tax credit program (and have three years to file an amended return for the last tax year credits can be carried forward). The estimated revenue loss due to the extension of the tax credit program is based on the following facts and assumptions:

- the cap of \$6 million will be reached in each tax year (in every year of the existing tax credit the cap has been reached);
- 100% of credits will be claimed against the corporate income tax;
- one-third of credits will be claimed in the tax year after the credit was earned;

- one-third of credits will be claimed in the second tax year after the credit was earned and another one-third of credits will be claimed in the third tax year after the credit was earned; and
- any credit claimed has to be added back to federal adjusted gross income, resulting in additional tax liabilities of 7% on the add-back.

Legislative Services advises that due to the limited history of the existing tax credit and concentration of the tax credit, the estimated schedule of credits claimed is subject to substantial variation. For example, an increase in the profitability in a few of the companies claiming the larger amounts of credits would substantially increase the amount of credits claimed in a fiscal year. In addition, the bill provides that businesses may only carry forward the tax credit 7 years instead of 15 under current law. This is expected to accelerate the amount of credits claimed by businesses compared with the existing history of the credit. To the extent that credits are claimed sooner than estimated, revenue losses will occur sooner than estimated. This does not change the total estimated cost of \$33.5 million from the extension of the tax credit. This total cost reflects a total of \$36 million in tax credits awarded offset by the requirement that businesses add back to federal adjusted gross income the amount of credits claimed.

The bill decreases the amount of time credits can be carried forward from 15 years to 7. The Comptroller's Office advises that this can be construed to apply to credits that have already been earned from tax year 2000 through 2004. Limiting carry forward provisions on existing credits earned could decrease State revenues in fiscal 2008 through 2010 if businesses accelerate the claiming of credits. This revenue loss would be offset by less credits being claimed in the out-years.

Additional Information

Prior Introductions: None.

Cross File: HB 247 (The Speaker, *et al.*) (By Request – Administration) – Ways and Means.

Information Source(s): Department of Business and Economic Development, Comptroller's Office, Department of Legislative Services

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