SB 218

Department of Legislative Services
Maryland General Assembly
2006 Session

FISCAL AND POLICY NOTE

Senate Bill 218 (The President, *et al.*) (By Request – Administration)
Budget and Taxation

Business and Economic Development - Research and Development Tax Credit

This Administration bill expands the existing research and development (R&D) tax credit by increasing to $12 million the aggregate amount of credits that the Department of Business and Economic Development (DBED) can approve in each year. The bill also limits the maximum annual value of the basic and growth credits to $500,000 each.

The bill takes effect July 1, 2006 and applies to tax year 2006 and beyond.

Fiscal Summary

State Effect: General fund revenues could decrease by approximately $1.4 million in FY 2008 as a result of the tax credits being claimed against the corporate income tax, with losses increasing to $4.2 million by FY 2010. Transportation Trust Fund revenues could decrease by approximately $446,400 in FY 2008 and by $1.3 million in FY 2010 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 $11.2 million from FY 2012 through 2021.

($ in millions)	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
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 being claimed against the corporate income tax. Local revenues would decrease by approximately $133,900 beginning in FY 2008, with losses increasing to approximately $401,800 by FY 2010.

Small Business Effect: A small business impact statement was not provided by the Administration in time for inclusion in this fiscal note. A revised fiscal note will be issued when the Administration's assessment becomes available.

Analysis

Current Law: Chapter 98 of 2005 extended the termination date of the tax credit program to June 30, 2012. Credits may only be applied for through tax year 2010. DBED can approve a total of $6 million in credits in each tax year. There is no limit on the maximum value of the credit, but is subject to reduction based on the amount of credits applied for in a tax year as discussed below.

Background: Chapters 515 and 516 of 2000 established the 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 (the average R&D expenses over the last four years); 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. Businesses claiming the credit are required to add-back to Maryland adjusted gross income the amount of R&D tax credits claimed. 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 2004 a business would have been certified for approximately 16% of the total amount of credits it sought. As a result, the effective rate of the credits were 0.39% for the basic credit and 1.96% for the growth credit.

Exhibit 1
Credits Applied for and Allowed
By Tax Year

Tax Year	Basic Credit	Growth Credits	Total Credits	Basic Credit Allowed	Growth Credit Allowed	Total Allowed
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
2004	23,055,938	15,312,158	38,368,097	2,997,272	3,001,183	5,998,455

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

Tax Year	Basic	Growth
2000	41	42
2001	75	69
2002	97	62
2003	101	68
2004	103	67
Five-year Average	**83**	**62**

Historically, a substantial share of the credits earned has been awarded to a few taxpayers. For example, through tax year 2003, 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 distributional impact of increasing the total cap to $12 million and limiting each credit to a maximum value of $500,000 had these provisions been in effect in tax year 2004. Taxpayers claiming the credit are separated by thirds, where the top third represents the largest amount of credits claimed and the bottom third represents the lowest amount of credits claimed.

Exhibit 3
Total and Average Credits Claimed
Current Law and SB 217

	Current Law	SB 217	Current Law	SB 217
Basic Credit				
Top third	2,770,395	5,352,277	81,482	157,420
Middle third	194,736	489,757	5,728	14,405
Bottom third	32,141	80,834	918	2,310
Total	2,997,272	5,922,868		
Growth Credit				
Top third	2,739,664	5,156,478	124,530	234,385
Middle third	222,495	724,610	10,113	32,937
Bottom third	39,024	118,912	1,697	5,170
Total	3,001,183	6,000,000		

Increasing the total amount of growth credits available would have increased the effective rate of the growth credit from 1.96% to 3.92%, and combined with the maximum value of $500,000, would be 6.79% for businesses claiming less than a $500,000 credit. Increasing the total basic credits available would have increased the effective rate of the basic credit from 0.39% to 0.78%, and combined with the maximum value of $500,000 would be 0.98% for businesses claiming less than a $500,000 credit.

State Revenues: This bill increases by $6 million the amount of credits that can be awarded in tax years 2006 through 2010. As a result, revenues would decrease by $1.9 million in fiscal 2008, $3.7 million in fiscal 2009, and $5.6 million in fiscal 2010 and beyond. Although the expansion would be effective tax year 2006, 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 could be done is in fiscal 2008.

Revenues would decrease by an additional $11.2 million in fiscal 2012 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 additional $6 million in credits would be reached in each tax year (in every year of the existing tax credit, these credits would have been awarded except for the basic credit in the first year of the program);
- 100% of credits would 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. 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 $27.9 million from the expansion of the tax credit. This total cost reflects a total of $30 million in tax credits awarded offset by the requirement that businesses add back to federal adjusted gross income the amount of credits claimed.

Additional Information

Prior Introductions: None.

Cross File: HB 311 (The Speaker, *et al.*) (By Request – Administration) – Ways and Means.

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