HB 46

Department of Legislative Services
Maryland General Assembly
2007 Session

FISCAL AND POLICY NOTE

House Bill 46 (Delegate N. King, *et al.*)
Ways and Means

Income Tax - Research and Development Tax Credits - Modifications

This 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 amount of basic credits that can be awarded annually is increased to $5 million and the amount of growth credits is increased to $7 million.

The bill takes effect July 1, 2007 and applies to tax year 2007 and beyond.

Fiscal Summary

State Effect: General fund revenues could decrease by $1.4 million in FY 2009 as a result of the tax credits being claimed against the corporate income tax, with losses increasing to $4.2 million by FY 2011. Transportation Trust Fund revenues could decrease by $446,400 in FY 2009 and by $1.3 million in FY 2011 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 would be greater than shown. Additional general and special fund revenue decreases of $5.6 million from FY 2013 through 2021.

($ in millions)	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
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 $133,900 beginning in FY 2009, with losses increasing to $401,800 by FY 2011.

Small Business Effect: Minimal.

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; $3 million in basic credits and $3 million in growth credits.

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; 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 2005 a business would have been certified for approximately 15% of the total amount of credits it sought. As a result, the effective rate of the credits were 0.4% for the basic credit and 1.6% for the growth credit.

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 1
Credits Applied for and Allowed
By Tax Year
($ in millions)

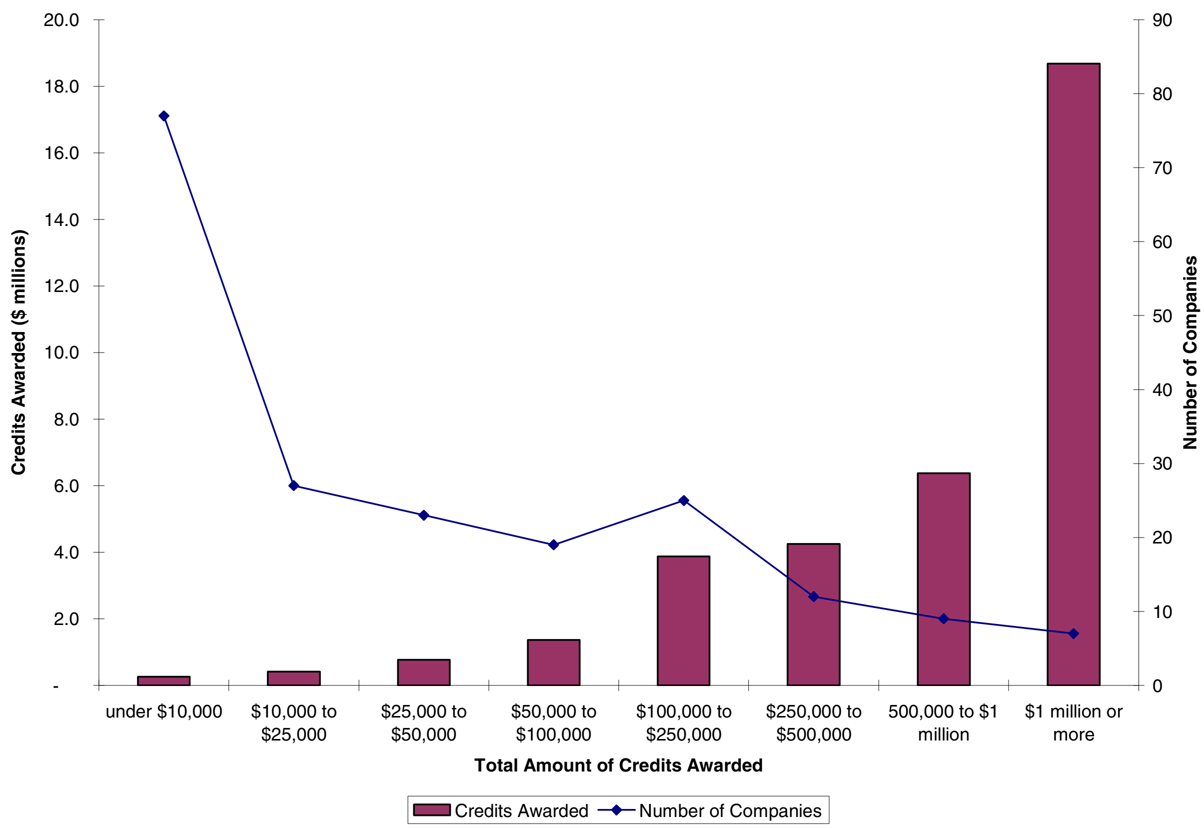
Tax Year	Basic Credit	Growth Credits	Total Credits	Basic Credit Allowed	Growth Credit Allowed	Total Allowed
2000	$8.2	$27.0	$35.1	$3.0	$3.0	$6.0
2001	15.3	30.9	46.2	3.0	3.0	6.0
2002	19.1	14.5	33.6	3.0	3.0	6.0
2003	21.1	27.1	48.2	3.0	3.0	6.0
2004	23.0	15.3	38.3	3.0	3.0	6.0
2005	22.6	18.4	41.0	3.0	3.0	6.0

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
2005	107	75
Six-year Average	**87**	**64**

Historically, a substantial share of the credits earned has been awarded to a few companies. For example, approximately one-half of all credits awarded (approximately $17.7 million) have been awarded to 6 out of the nearly 200 companies that have been awarded credits since program inception. **Exhibit 3** lists the number of companies and amount of credits awarded to these companies by the total amount of credits awarded.

Exhibit 3
Number of Companies and Credits Awarded by Total Credits Awarded



Appendix 1 lists the amount of credits awarded by industry classification for tax year 2005. Credits were awarded most to companies in the following sectors: pharmaceutical and medicine manufacturers (39%), bioscience (14%), computers (13%), and aerospace/defenses (12%). Legislative Services estimates that a little over half of the companies that were awarded credits in tax year 2005 were headquartered in Maryland – these companies were awarded approximately 37% of all credits.

State Revenues: This bill increases by $6 million the amount of credits that can be awarded in tax years 2007 through 2010. As a result, State revenues would decrease by $1.9 million in fiscal 2009, $3.7 million in fiscal 2010, and $5.6 million in fiscal 2011 and 2012. Although the expansion would be effective tax year 2007, 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 2009 and that companies do not adjust estimated payments in fiscal 2008. To the extent that companies adjust estimated payments in anticipation of earning credits, revenues losses could occur in fiscal 2008.

Revenues would decrease by an additional $5.6 million in fiscal 2013 through as late as 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);
- 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 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 is added back to federal adjusted gross income, resulting in additional tax liabilities of 7% on the add-back.

The estimated schedule of credits claimed is subject to substantial variation given the inconstant interaction among the credit, profitability of companies claiming the credit, other credits earned by the companies, federal tax liability, and net operating losses from current or different tax years. 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. The Comptroller's Office estimates that in tax year 2002 and 2003, $3.9 million and $2.7 million in credits were claimed and allowed. The Comptroller's Office advises, however, that it cannot determine how much of this was carried forward, if any, from previous tax years nor how much was carried forward from tax year 2002 and 2003.

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 $22.3 million from the expansion of the tax credit. This cost reflects a total of $24 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: HB 984 of 2006, an identical bill, was not reported from the House Ways and Means Committee. Similar bills were also introduced in the 2006 session as SB 218/HB 311. SB 218 was not reported from the Senate Budget and Taxation Committee. HB 311 passed the House and received a favorable report from the Senate Budget and Taxation Committee but did not pass the Senate.

Cross File: SB 232 (Senator Hogan, *et al.*) – Budget and Taxation.

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

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Analysis by: Robert J. Rehrmann

Direct Inquiries to:
(410) 946-5510
(301) 970-5510

Appendix 1
Credits Awarded by Business Classification
Tax Year 2005

Sector	Companies	Percent of Total Credits Awarded
Manufacturing	**49**	**68.2%**
Pharmaceutical and Medicine	14	37.6%
Medical Equipment and Supplies	6	3.3%
Chemical, Metal, and Plastics	10	2.5%
Food	2	1.7%
Multisector	1	3.4%
Electrical Equipment and Electronics	8	7.9%
Motor Vehicle and Transportation Equipment	4	0.4%
Aerospace / Defense	4	11.4%
Computers	**22**	**12.2%**
Computer Equipment Producer	5	6.6%
Software Development	7	1.8%
Computer System Design and Related Services	10	3.8%
Telecommunications	**1**	**2.7%**
Professional, Scientific, Technical Services	**30**	**15.6%**
R&D, Engineering Services, Technical Consulting	6	1.5%
Bioscience Companies	24	14.1%
Other	**5**	**1.3%**
Total	**107**	**100.0%**