SB 64

Department of Legislative Services
Maryland General Assembly
2010 Session

FISCAL AND POLICY NOTE

Senate Bill 64 (Chair, Budget and Taxation Committee, *et al.*) (By Request - Departmental - Business and Economic Development)

Budget and Taxation | Ways and Means

Maryland Research and Development Tax Credit - Sunset Extension

This departmental bill extends the termination date for the research and development tax credits from June 30, 2012 to June 30, 2021. The time period in which tax credits may be earned is extended to tax years 2011 through 2019.

The bill takes effect July 1, 2010.

Fiscal Summary

State Effect: General fund revenues decrease by $1.9 million in FY 2013 and Transportation Trust Fund (TTF) revenues decrease by $476,400. Future year revenues reflect carry forwards from previous years, extension of the credit, and the current corporate income tax forecast. Additional general and special fund revenue decreases of $37.2 million in FY 2016 through FY 2023. Expenditures are not affected.

($ in millions)	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015
GF Revenue	$0	$0	($1.9)	($3.1)	($4.8)
SF Revenue	$0	$0	($.5)	($.8)	($1.2)
Expenditure	0	0	0	0	0
Net Effect	$.0	$.0	($2.3)	($3.9)	($6.0)

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 $142,900 beginning in FY 2013 and by $365,700 in FY 2015.

Small Business Effect: The Department of Business and Economic Development (DBED) has determined that this bill has minimal or no impact on small business (attached). Legislative Services concurs with this assessment.

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. Eligible expenses may also qualify for a federal credit as discussed below.

Background:

Federal Research Credits

Numerous states and the federal government offer tax incentives designed to promote research and development conducted by businesses. The federal government established a tax credit program in 1981 on a temporary basis that has been extended 13 times, often retroactively. The tax credit has never been a permanent part of federal tax law. The basic design of the credit has been modified several times. For tax years ending after December 31, 2006 through December 31, 2008, five different research credits could be claimed. Two of these credits, the university basic research credit and energy research credit, are targeted to specific research and a limited number of taxpayers qualify. The other three credits are the regular research credit, the alternative incremental research credit, and the alternative simplified credit. These credits apply to general research and development and are simply alternative methods of computing the value of the federal credit. Unlike the State credit, a taxpayer can only claim one of the three credits. The alternative incremental research credit was repealed January 1, 2008, while the other two credits may be claimed through the end of 2009. Although the federal and State credits share many similarities, the federal regular credit and alternative simplified credit are calculated differently than the State basic and growth credits.

A November 2009 U.S. General Accounting Office report examined how the federal credit was being used, determined whether the credit could be improved, and assessed compliance and administrative recordkeeping and cost issues. The report concluded that use of the federal credits was dominated by large corporations, with 549 corporations claiming over one-half of the $6 billion in net credits during 2005. The credit was estimated to reduce the after-tax price of additional research by between 6.4% and 7.3%. GAO also concluded that a substantial portion of the credit is a windfall for taxpayers, earned for spending that would have occurred anyway instead of being used to support potentially beneficial new research. GAO recommended elimination of the basic credit and modifications to the alternative simplified credit to reduce windfalls and improve effectiveness of the credit. GAO also found that credit claims have been contentious, and recommended that the Secretary of the Treasury clarify the definition of qualified research and development expenses and develop documentation standards.

State Research Credits

Chapters 515 and 516 of 2000 established the Maryland Research and Development Tax Credit Program. Companies 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 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 credits claimed. Chapter 90 of 2007 clarified that the State program would still be available if the federal program is repealed or terminated.

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 sought has substantially exceeded the $6 million per year cap. When oversubscribed, the amount approved for each credit is reduced by a proportional amount. For example, in tax year 2005 a business would have been certified for approximately 15% of the total amount of credits it sought. **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.

The number of companies claiming the credit has increased substantially since the program was established while the amount of credits available has not changed. As a result of oversubscription and concomitant reduction in the value of the credit, the credit provides a very limited direct incentive for companies to increase research and development. In tax year 2007, the basic credit was equal to 0.37% of eligible expenses compared with a statutory rate of 3% while growth credit rate was reduced from 10% to 0.65%. In addition, the deductibility of State and local taxes paid for federal income tax purposes, requirement that companies claiming the credit add-back the amount of credit claimed, and carry forwards further dilute the amount of incentive provided. For example, Legislative Services estimates that the incentive provided by the basic credit was less than 0.2%, which translates to a company receiving $1,938 for conducting an additional $1 million in qualified research and development activities.

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
2006	20.8	19.2	40.0	3.0	3.0	6.0
2007	24.1	46.4	70.5	3.0	3.0	6.0
2008	26.3	23.0	49.3	3.0	3.0	6.0

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

Tax	Basic	Growth
2000	41	42
2001	75	69
2002	97	62
2003	101	68
2004	103	67
2005	107	75
2006	99	78
2007	120	83
2008	133	93

Although the credit provides very little direct incentive for companies to increase research and development activities, the credit decreases tax burdens for "hi-tech" companies relative to other companies in the State. Lower taxes for these companies can both help spur growth at the companies and assist in the State's ability to attract and retain these "high-tech" companies.

DBED has awarded a total of $54 million in credits to 284 companies from tax year 2000 through 2008. Similar to the federal credit, use of the credit has been dominated by a few large corporations. A little more than one-half of all credits ($28.5 million) has been awarded to 10 companies. **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 (38%), bioscience (14%), computers (12%), and aerospace/defenses (11%). 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 extends the tax credit program to tax years 2011 through 2019. As a result, State revenues decrease by $2.3 million in fiscal 2013, $3.9 million in fiscal 2014, and $6.0 million annually beginning in fiscal 2015**.** Although the extension is effective tax year 2011, before claiming the tax credit DBED must certify the amount of research and development expenses. DBED certifies expenses 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 2013 and that companies do not adjust estimated payments. To the extent that companies adjust estimated payments in anticipation of earning credits, revenues losses will occur in fiscal 2011 and 2012.

Revenues will decrease by an additional $37.2 million in fiscal 2016 and beyond due to extension of the credit and credits being carried forward from previous fiscal years. The estimated revenue loss due to the extension of the tax credit program is based on the following facts and assumptions:

- $6 million in credits would be awarded in each tax year (in every year of the existing tax credit, these maximum has been awarded);
- 100% of credits would be claimed against the corporate income tax;
- according to the Comptroller's Office, from tax year 2000 through 2006 about one-half of the credits earned in each year was claimed in that tax year;
- one-quarter of credits will be claimed in the tax year after the credit was earned and another one-quarter of credits will be claimed in the third tax year after the credit was earned;

- any credit claimed is added back to federal adjusted gross income, resulting in additional tax liabilities of 8.25% on the add-back; and
- the amounts claimed during the first two fiscal years are reduced by 15% and 5% based on the current Board of Revenue Estimates corporate income tax forecast.

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 $49.5 million from the expansion of the tax credit. This cost reflects a total of $54.0 million in tax credits awarded offset by the requirement that businesses add back to federal adjusted gross income by the amount of credits claimed.

Local Revenues: Local highway user revenues will decrease as a result of credits claimed against the corporate income tax. Local highway user revenues will decrease by $142,900 in fiscal 2013, $239,600 in fiscal 2014, and by $365,700 annually beginning in fiscal 2015.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Department of Business and Economic Development, Comptroller's Office, U.S. General Accounting Office, Department of Legislative Services

Fiscal Note History: First Reader - January 26, 2010
ncs/hlb

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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%**

ANALYSIS OF ECONOMIC IMPACT ON SMALL BUSINESSES

TITLE OF BILL: Business & Economic Development – Research and Development Tax Credit – Sunset Extension

BILL NUMBER: SB 64

PREPARED BY: Department of Business and Economic Development

PART A. ECONOMIC IMPACT RATING

This agency estimates that the proposed bill:

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

OR

___ WILL HAVE MEANINGFUL ECONOMIC IMPACT ON MARYLAND SMALL BUSINESSES

PART B. ECONOMIC IMPACT ANALYSIS

The proposed legislation will have no impact on small business in Maryland.