

Department of Legislative Services
 Maryland General Assembly
 2014 Session

FISCAL AND POLICY NOTE

House Bill 616 (Chair, Ways and Means Committee)(By Request -
 Departmental - Business and Economic Development)

Ways and Means

**Income Tax Credit - Qualified Research and Development Expenses - Credit
 Amounts**

This departmental bill expands the existing research and development (R&D) tax credit by increasing from \$8 million to \$9 million the aggregate amount of credits that the Department of Business and Economic Development (DBED) can approve in each calendar year.

The bill takes effect June 1, 2014, and applies to all R&D tax credits certified after December 15, 2013.

Fiscal Summary

State Effect: General fund revenues decrease by \$391,000 in FY 2015 as a result of additional tax credits being claimed against the corporate income tax, with losses increasing to \$729,000 annually thereafter. The Governor’s proposed FY 2015 budget assumes a revenue decrease of \$774,500 due to expansion of the credit. Transportation Trust Fund (TTF) revenues decrease by \$83,000 and Higher Education Investment Fund (HEIF) revenues decrease by \$30,000 in FY 2015. Future year revenue estimates reflect carry forwards from previous years and expansion of the credit. Expenditures are not affected.

| (in dollars) | FY 2015 | FY 2016 | FY 2017 | FY 2018 | FY 2019 |
|--------------|-------------|-------------|-------------|-------------|-------------|
| GF Revenue | (\$391,000) | (\$551,000) | (\$729,000) | (\$729,000) | (\$729,000) |
| SF Revenue | (\$113,000) | (\$161,000) | (\$189,000) | (\$189,000) | (\$189,000) |
| Expenditure | 0 | 0 | 0 | 0 | 0 |
| Net Effect | (\$504,000) | (\$712,000) | (\$918,000) | (\$918,000) | (\$918,000) |

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

Local Effect: Local highway user revenues distributed from the corporate income tax decrease by about \$8,000 in FY 2015 and by \$13,000 annually beginning in FY 2017. Expenditures are not affected.

Small Business Effect: DBED has determined that this bill has a meaningful impact on small business (attached). The Department of Legislative Services (DLS) disagrees with this assessment as discussed below.

Analysis

Bill Summary: The bill expands the existing R&D tax credit by increasing from \$8 million to \$9 million the aggregate amount of credits that DBED can approve in each calendar year. The amount of basic credits that can be awarded annually is increased from \$4 million to \$4.5 million and the amount of growth credits that can be awarded is also increased from \$4 million to \$4.5 million.

Current Law: Chapters 515 and 516 of 2000 established the Maryland Research and Development Tax Credit. Companies that incur qualified research and development expenses in Maryland are entitled to the credit. There are two types of credits available to businesses: (1) a basic credit equal to 3% of the Maryland qualified research and development expenses paid during the tax year, up to the Maryland base amount; and (2) a growth credit 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 any credits claimed. The R&D credit terminates June 30, 2021.

Chapter 109 of 2013 expanded the R&D tax credit by increasing from \$6 million to \$8 million the aggregate amount of credits that DBED can approve in each calendar year. Chapter 109 also allows the credit to be refundable if the business claiming the credit is a for-profit corporation, limited liability company, partnership, or sole proprietorship that, at the beginning or end of the taxable year in which the eligible R&D expenses are incurred, has net book value assets totaling less than \$5 million.

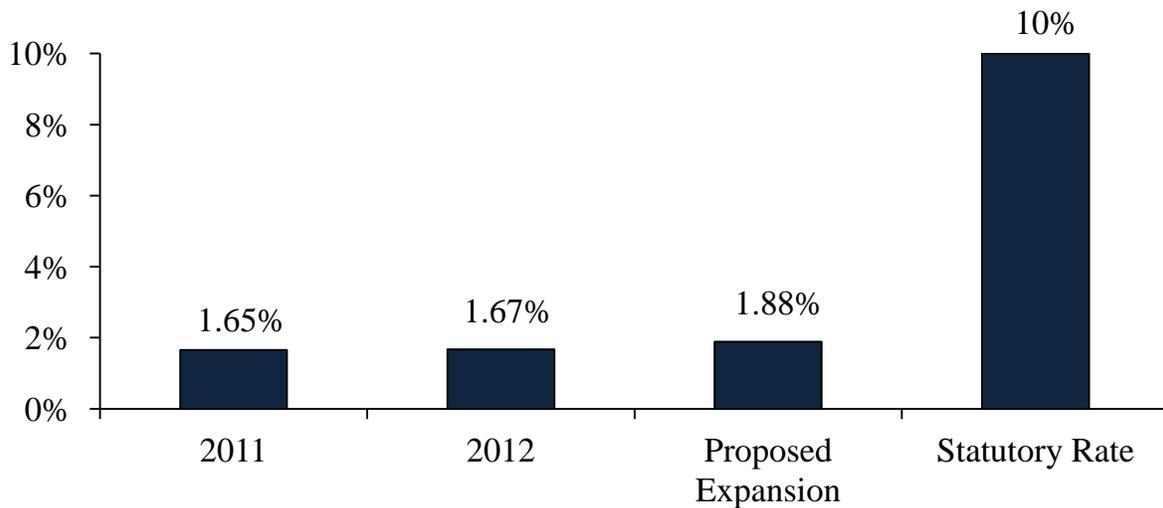
Background:

Maryland R&D Credit

The amount of credits earned in a calendar year has substantially exceeded the aggregate limit; the amount approved for each credit is reduced by a proportional amount of the

excess. For example, DBED reduced from \$29.2 million to \$4.0 million the total amount of basic credits awarded in tax year 2012. In tax year 2011, the basic credit was equal to 0.33% of eligible expenses compared with a statutory rate of 3%, while the growth credit rate was reduced from 10% to 1.65%. In addition, the deductibility of State and local taxes paid for federal income tax purposes, the requirement that companies claiming the credit add back the amount of credit claimed, and credit carry forwards further dilute the amount of the incentive provided. **Exhibit 1** compares the effective rate of the basic credit in calendar 2011 and 2012, the first year in which an additional \$1.0 million in basic credits could be awarded. Exhibit 1 also shows what the effective rate would have been in calendar 2012 if DBED awarded the additional amount of credits proposed by the bill.

Exhibit 1
Effective and Statutory Credit Rates
Basic R&D Credit



Source: Department of Business and Economic Development; Department of Legislative Services

Although the State credit provides very little direct incentive for companies to increase R&D activities, the credit may decrease tax burdens for high-tech companies relative to other companies in the State. Lower taxes for these companies can potentially help spur growth for these companies and assist in the State's ability to attract and retain these companies. However, given that the credit reduces State revenues, these gains must be measured against the negative economic impact of State spending reductions or tax increases necessary to balance the budget.

DBED awarded a total of \$54 million in credits to 284 companies between tax year 2000 and 2008. Ten corporations have earned a little more than one-half of all credits (\$28.5 million). Credits were awarded most to companies in the following sectors: pharmaceutical and medicine manufacturers (38%), bioscience (14%), computers (12%), and aerospace/defense (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.

R&D Credit Research

Since 1981 a federal R&D credit has provided significant subsidies (an estimated \$7.8 billion in tax year 2009) to encourage business investment in research and development. The U.S Government Accounting Office (GAO) issued a report in 2009 stating that, although widespread support for the concept of a credit for increasing research activities exists, concerns have been raised about the cost-effectiveness of the design of the current credit. Specifically, GAO discovered problems related to compliance burdens, an outdated base for the regular credit, and difficulty in determining whether research expenditures qualify for the credit. GAO recommended eliminating the regular credit and issuing additional regulations clarifying the classification of research expenditures. Both the federal definition of qualifying R&D expenditures as well as the federal base amount are incorporated in calculating the value of the State R&D credit.

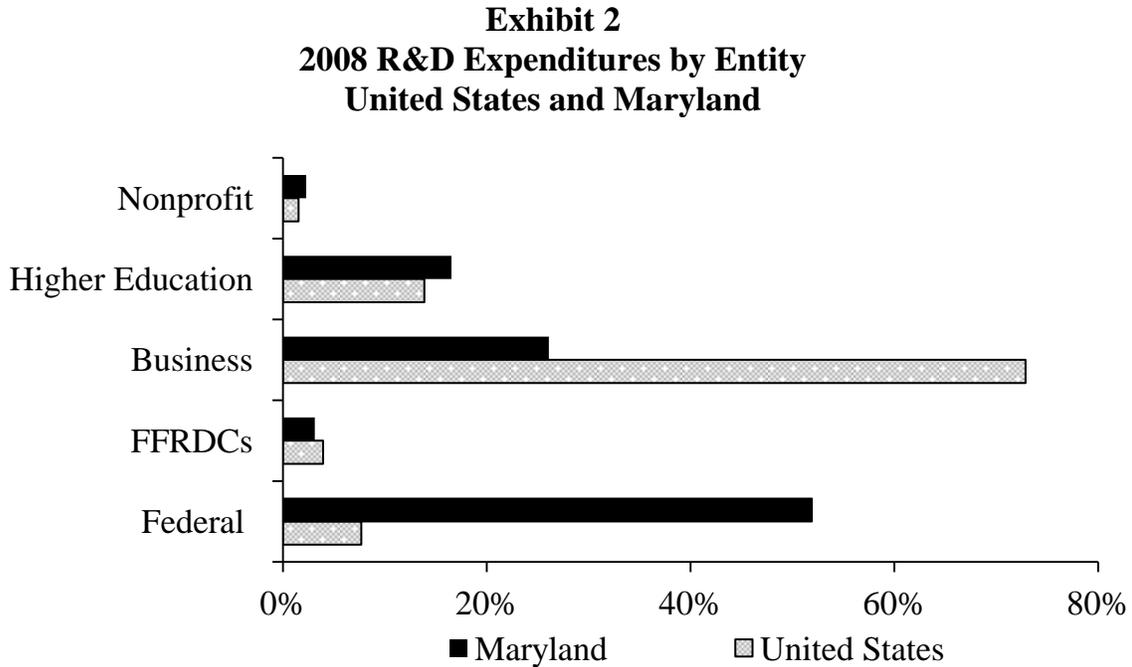
According to the Texas Legislative Budget Board, 43 states currently have a R&D tax incentive. Of the states that provide a nonrefundable income tax credit, 17 states limit the maximum amount of credits that can be awarded.

Maryland R&D

The National Science Foundation estimates that R&D expenditures totaled \$403 billion in the United States in calendar 2008. These R&D activities were conducted by the federal government, federally funded research and development centers (FFRDCs), businesses, institutions of higher education, and other nonprofit organizations and was equal to 2.8% of U.S. Gross Domestic Product (GDP).

Maryland had the sixth highest amount of R&D expenditures nationally (\$16.6 billion) and ranked third in R&D intensity, which is the ratio of R&D expenditures relative to the size of the State's economy. Given its proximity to Washington, DC and the many federal institutions within Maryland, the federal government contributed substantially to the R&D activities conducted in the State. Research conducted by the federal government comprised a little less than one-third of all R&D in the State, and the federal government funded three-fourths of all research conducted in Maryland (including federally funded research conducted by businesses and institutions of higher education),

compared with 28% nationally. **Exhibit 2** shows the distribution of R&D in Maryland and the United States by the type of entity conducting the research.



FFRDC: Federally funded R&D Center

R&D data for Maryland have not been adjusted to eliminate double counting of funds and will overstate the total amount relative to national totals, which have been adjusted.

Source: National Science Foundation

Exhibit 3 compares calendar 2008 R&D expenditures in Maryland with other states in the eastern United States. Nationally, California reported the most R&D (\$81.3 billion) while New Mexico was the most R&D intensive, reflecting the impact of the Los Alamos FFRDC.

Exhibit 3
R&D Expenditures by State
Calendar 2008

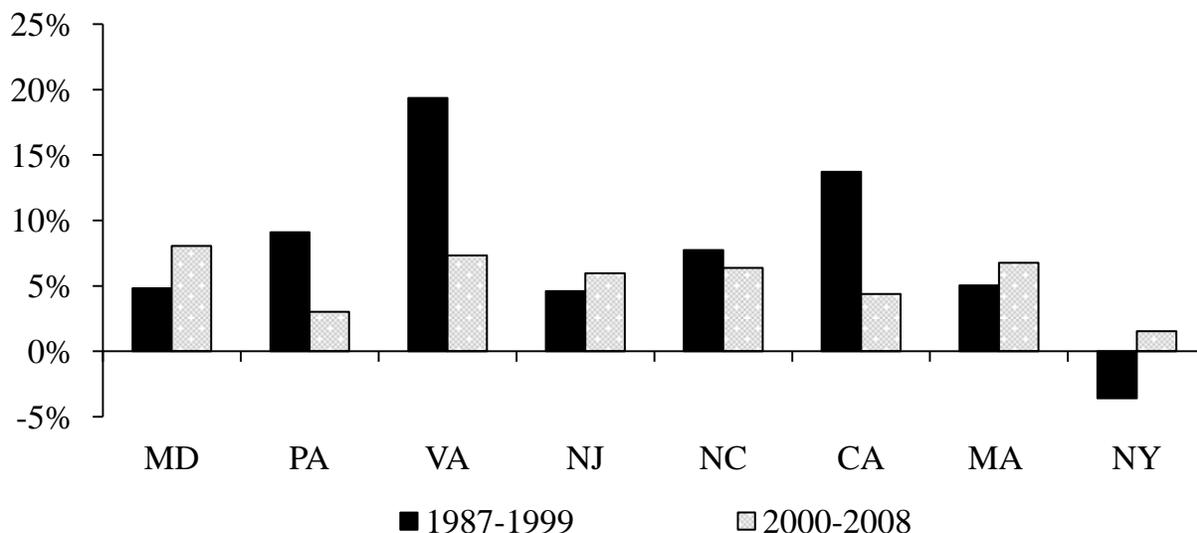
| <u>State</u> | <u>R&D Total</u> | <u>R&D Rank</u> | <u>Federally Funded</u> | <u>R&D Intensity % GDP</u> | <u>R&D Intensity Rank</u> |
|--------------|----------------------|---------------------|-------------------------|--------------------------------|-------------------------------|
| CT | 11,322 | 12 | <i>n/a</i> | 5.1% | 5 |
| DC | 5,946 | 19 | 90% | 6.2% | 2 |
| MA | 20,090 | 4 | 24% | 5.5% | 4 |
| NC | 8,612 | 14 | 20% | 2.1% | 25 |
| NJ | 20,713 | 2 | 7% | 4.3% | 7 |
| NY | 16,486 | 7 | 28% | 1.5% | 34 |
| PA | 13,068 | 9 | 19% | 2.4% | 19 |
| VA | 11,472 | 11 | 66% | 2.9% | 11 |
| MD | 16,605 | 6 | 75% | 5.9% | 3 |
| U.S. | 403,040 | | 28% | 2.8% | |

Source: National Science Foundation; U.S. Bureau of Labor Statistics

Although Maryland ranks high in overall R&D, total business R&D expenditures were equal to 1.5% of the State's economy in 2008, less than the national rate of 2.0%. In addition, businesses in Maryland are more dependent on federal funding – a little less than one-third of Maryland business R&D is federally funded, compared with 11% of business R&D in other states.

From 1987 through 2008 the total amount of business R&D in Maryland not funded by the federal government increased by 6.8% annually, which was slightly higher than the growth rate for all R&D conducted in the State. The growth rate has accelerated; from 2000 through 2008 the growth rate was 8.1%, slightly lower than the overall State R&D growth rate of 8.5%. **Exhibit 4** compares the annual growth rate for nonfederal business R&D in two periods, 1987-1999 (before the State R&D credit) and 2000-2008, in Maryland and several other states. These numbers do not reflect the full impact of the Great Recession, which will likely dampen future growth rates. Overall, the growth rate of business R&D in each state is highly correlated with the growth of total R&D conducted in the State. All of the states listed in Exhibit 4 have an R&D tax incentive with various levels of funding. For example, Virginia offers a similar amount of funding as Maryland while Pennsylvania has expanded its credit funding in several stages from \$15 million in 2000 to \$55 million currently. California, Virginia, and Maryland had the highest overall growth rates, while Maryland's rate of growth was the highest in the second time period.

Exhibit 4
Average Annual Growth in Business R&D
Calendar 1987-1999 and 2000-2008



Note: Business R&D includes amounts not funded by the federal government.

Source: National Science Foundation

State Revenues: The bill expands the State research and development tax credit by increasing to \$9.0 million the aggregate amount of credits that DBED can approve in each calendar year. The bill applies to credits certified after December 15, 2013, and will apply beginning with tax year 2013. As a result, general fund revenues will decrease by \$391,000 in fiscal 2015. TTF revenues will decrease by \$83,000, and HEIF revenues will decrease by \$30,000 in fiscal 2015. The Governor’s proposed fiscal 2015 budget assumes a revenue decrease of \$774,542 due to expansion of the credit.

Before claiming the tax credit, DBED must certify the amount of research and development expenses incurred by the business. DBED certifies expenses on 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 this could be done beginning in fiscal 2015 and that companies do not adjust estimated payments. To the extent that companies adjust estimated payments in anticipation of earning credits, revenue losses will be greater in fiscal 2015.

The estimated revenue loss due to the expansion is based on the following facts and assumptions:

- the full \$9 million in credits will be awarded each tax year;
- 100% of credits are 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 second 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 amount of the credit; and
- 10% of all credits claimed will be refundable.

To the extent that credits are claimed sooner than estimated, revenue losses will occur earlier than estimated.

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 \$8,000 in fiscal 2015, \$11,000 in fiscal 2016, and \$13,000 annually beginning in fiscal 2017.

Small Business Impact: DBED has determined that the bill has a meaningful impact on small businesses. According to DBED, 10% of all companies claiming the R&D credit in tax year 2012 were small businesses.

DLS notes that of the \$8.0 million in credits awarded in tax year 2012, 98.4% was awarded to companies that were not small businesses. The 19 companies identified by DBED as a small business claimed a total of \$127,000 in credits with the typical company claiming a credit of a little more than \$2,000. DBED has awarded 427 companies a total of \$80 million in credits in tax years 2000 through 2012, with about three-quarters or \$60.0 million awarded to 38 companies.

In addition, Chapter 109 of 2013 allows the credit to be refundable if the business claiming the credit is a small business. As defined by Chapter 109, a small business generally has net book value assets totaling less than \$5 million, without limitation as to the sales or number of employees the business may have. This provision applied beginning with tax year 2012 – information is not yet available on the extent to which this provision has been utilized by small businesses.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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ncs/jrb

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ANALYSIS OF ECONOMIC IMPACT ON SMALL BUSINESSES (SFY 2014)

TITLE OF BILL: Income Tax Credit – Maryland Qualified Research and Development Expenses – Credit Amounts

BILL NUMBER: HB 616

PREPARED BY: Mikra Krasniqi and Mark Vulcan (Department of Business and Economic Development)

PART A. ECONOMIC IMPACT RATING

This agency estimates that the proposed bill:

WILL HAVE MINIMAL OR NO ECONOMIC IMPACT ON MARYLAND SMALL BUSINESS

OR

X WILL HAVE MEANINGFUL ECONOMIC IMPACT ON MARYLAND SMALL BUSINESSES

PART B. ECONOMIC IMPACT ANALYSIS

The Maryland Research and Development Tax Credit (R&D) statute provides for two (2) tax credits for qualified *Maryland* research and development, a *Basic* research credit for research expenditures equal to or less than the average expenditure of previous years and a *Growth* tax credit for research expenditures in excess of previous years' average. The basic credit is 3% and the growth credit is 10%. The credits were limited to \$3 million for the basic credit and \$3 million of the growth credit from TYs 2000 to 2011.

This proposal would increase the limit of the basic credit and growth credit to \$4.5 million each, for a total limit of \$9 million annually.

This legislation would have a meaningful positive impact on start-ups and small businesses that conduct research and development in either *Basic* or *Growth* category. It is a well-established fact that small businesses, especially start-ups, are the engine of job growth in Maryland. In 2011, for example, new employment among small and young businesses accounted for 37% of all jobs created in the State. More importantly, start-ups play an outsized role in the expansion of employment accounting for more than 56% of all jobs created within the small business category.

The data from 2012 indicate that about 10% of all firms that submitted an application for the tax credit refund were small businesses. While this percentage may sound relatively low, it is important to put these numbers in context that over 9,000 new and small business establishments were formed in 2011 in Maryland. Given the improving economy, firm creation is expected to grow even more in the coming years. Increasing the tax credit, therefore, is critical especially for

these start-ups which typically need all the help they can get in expanding their business activity and staying in the market. The credit can also incentivize more small and young firms to engage in R& D activities, which in turn, may contribute to their improved productivity and competitiveness.