

Department of Legislative Services
 Maryland General Assembly
 2015 Session

FISCAL AND POLICY NOTE
 Revised

Senate Bill 488

(Senator King, *et al.*)

Budget and Taxation

Ways and Means

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

This bill expands the existing research and development (R&D) tax credit by increasing from \$9 million to \$14 million the aggregate amount of credits that the Department of Business and Economic Development (DBED) can approve in each calendar year, phased in over five years.

The bill takes effect July 1, 2015, and applies to all R&D tax credits certified after December 15, 2014.

Fiscal Summary

State Effect: General fund revenues decrease by \$633,000 in FY 2016 as a result of additional tax credits being claimed against the corporate and personal income tax. Transportation Trust Fund (TTF) revenues decrease by \$126,000 and Higher Education Investment Fund (HEIF) revenues decrease by \$46,000 in FY 2016. Future year revenue estimates reflect carry forwards from previous years and the phased-in expansion of the credit. Expenditures are not affected.

(in dollars)	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020
GF Revenue	(\$633,000)	(\$1,340,000)	(\$2,081,000)	(\$2,821,000)	(\$3,560,000)
SF Revenue	(\$172,000)	(\$326,000)	(\$505,000)	(\$684,000)	(\$864,000)
Expenditure	0	0	0	0	0
Net Effect	(\$805,000)	(\$1,666,000)	(\$2,586,000)	(\$3,505,000)	(\$4,424,000)

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 \$12,000 in FY 2016 and by \$59,000 in FY 2020. Local income tax revenues increase minimally beginning in FY 2016 due to taxpayers adding back the

amount of credits claimed against the personal income tax. Local expenditures are not affected.

Small Business Effect: Any small business that incurs eligible expenses could be positively impacted by the increased credit amount. A few large corporations, however, claim a majority of the tax credits.

Analysis

Bill Summary: The bill expands the existing R&D tax credit by increasing from \$9.0 million to \$14.0 million the aggregate amount of credits that DBED can approve in each calendar year. This increase is phased in over five years. Once fully phased in, the amount of basic credits that can be awarded annually is increased from \$4.5 million to \$7.0 million, and the amount of growth credits that can be awarded is also increased from \$4.5 million to \$7.0 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 beginning with tax year 2012. 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. Chapter 525 of 2014 increased from \$8 million to \$9 million the aggregate amount of credits that DBED can approve in each calendar year beginning with tax year 2013.

Background:

Maryland R&D Credit

The amount of credits earned has substantially exceeded the aggregate limit each year; 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.

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 earned a little more than one-half of all credits (\$28.5 million) during that time period. Credits were awarded most to companies in the following sectors: pharmaceutical and medicine manufacturers (38%); bioscience (14%); computers (12%); and aerospace/defense (11%). The Department of 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 Accountability 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. Most states currently have a R&D tax incentive, including all of Maryland's surrounding states.

State Revenues: The bill expands the State research and development tax credit by increasing the aggregate amount of credits that DBED can approve in each calendar year. The bill applies to credits certified after December 15, 2014, and will apply beginning with tax year 2014. DBED can award a maximum of \$10.0 million in tax year 2014, \$11.0 million in tax year 2015, \$12.0 million in tax year 2016, \$13.0 million in tax year 2017, and \$14.0 million beginning in tax year 2018 and each year thereafter. As a result, general fund revenues will decrease by \$633,000 in fiscal 2016. TTF revenues will decrease by \$126,000, and HEIF revenues will decrease by \$46,000 in fiscal 2016.

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 2016 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 2016.

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

- DBED will award the maximum amount of credits in each tax year;
- 95% of credits are claimed against the corporate income tax with the remaining amount claimed against the personal 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 or Maryland modified income; and
- about three-fourths of all credits claimed in tax year 2012 were refundable.

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 \$12,000 in fiscal 2016, \$22,000 in fiscal 2017, \$34,000 fiscal 2018, \$47,000 in fiscal 2019, and \$59,000 in fiscal 2020. Local income tax revenues increase minimally beginning in

fiscal 2016 due to taxpayers adding back the amount of credits claimed against the personal income tax.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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Analysis by: Robert J. Rehrmann

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