Department of Legislative Services
Maryland General Assembly
2017 Session

FISCAL AND POLICY NOTE
Third Reader - Revised

House Bill 240 (Delegate Walker)
Ways and Means Rules

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 $12 million the aggregate amount of credits that the Department of Commerce (Commerce) can approve in each calendar year.

The bill takes effect July 1, 2017, and applies to all R&D tax credits certified after December 15, 2016.

Fiscal Summary

State Effect: General fund revenues decrease by $1.9 million in FY 2018 as a result of additional tax credits being claimed against the corporate and personal income tax. Transportation Trust Fund (TTF) revenues decrease by $0.3 million and Higher Education Investment Fund (HEIF) revenues decrease by $0.1 million in FY 2018. Future year revenue estimates reflect credit carry forwards from previous years and the expansion of credit amounts. Expenditures are not affected.

($ in millions)	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
GF Revenue	($1.9)	($2.1)	($2.2)	($2.2)	($2.2)
SF Revenue	($0.5)	($0.5)	($0.5)	($0.5)	($0.5)
Expenditure	0	0	0	0	0
Net Effect	($2.4)	($2.6)	($2.8)	($2.8)	($2.8)

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

Local Effect: Local highway user revenues distributed from the corporate income tax decrease by about $32,000 in FY 2018 and by $37,000 in FY 2022. Local income tax revenues increase minimally beginning in FY 2018 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 amounts. 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 $12.0 million the aggregate amount of credits that Commerce can approve in each calendar year. The amount of basic credits that can be awarded annually is increased from $4.5 million to $5.5 million, and the amount of growth credits that can be awarded is increased from $4.5 million to $6.5 million.

Current Law: Chapters 515 and 516 of 2000 established the Maryland Research and Development Tax Credit. Companies that incur qualified R&D 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 R&D expenses paid during the tax year, up to the Maryland base amount, and (2) a growth credit equal to 10% of the Maryland qualified R&D expenses paid during the year that exceed the Maryland base amount. R&D expenses can typically be deducted as a business expense, resulting in lower federal and State income tax liabilities. Businesses claiming the credit are required to add back to federal adjusted gross income or Maryland modified 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 can be approved in each calendar year. Chapter 109 also allowed 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 can be approved in each calendar year.

Background:

Maryland Research and Development 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, Commerce 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.

Commerce 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 frequently 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.

Research and Development 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 R&D. 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 an R&D tax incentive, including all of Maryland's surrounding states.

State Revenues: The bill expands the State R&D tax credit by increasing the aggregate amount of credits that can be approved in each calendar year. The bill applies to credits certified after December 15, 2016, and will apply beginning with tax year 2016. A maximum of $12.0 million in credits can be awarded in each tax year. As a result, general fund revenues will decrease by $1.9 million in fiscal 2018. TTF revenues will decrease by $334,000 and HEIF revenues will decrease by $137,000 in fiscal 2018.

Before claiming the tax credit, Commerce must certify the amount of R&D expenses incurred by the business. These expenses are certified 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 2018 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 2018.

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

- the maximum amount of credits will be awarded 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 were 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;
- about three-fourths of all credits claimed in tax year 2012 were refundable; and
- any credit claimed is added back to federal adjusted gross income or Maryland modified income.

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 $32,000 in fiscal 2018, $34,000 in fiscal 2019, and $37,000 annually beginning in fiscal 2020. Local income tax revenues increase minimally beginning in fiscal 2018 due to taxpayers adding back the amount of credits claimed against the personal income tax.

Additional Information

Prior Introductions: As amended by the Senate Budget and Taxation Committee, SB 211 of 2016 proposed to expand the maximum amount of annual R&D credits to $12 million. SB 211 passed the Senate and received a favorable with amendments report from the House Ways and Means Committee, but no further action was taken. Its cross file, HB 477, received a favorable with amendments report from the House Ways and Means Committee, but no further action was taken. As amended by the Senate Budget and Taxation Committee, SB 488 of 2015 proposed to expand the maximum amount of annual R&D credits to $14 million, phased in over five years. SB 488 passed the Senate and received a hearing in the House Ways and Means Committee, but no further action was taken.

Cross File: SB 200 (Senator King, *et al.*) - Budget and Taxation.

Information Source(s): Comptroller's Office; Department of Commerce; Department of Legislative Services

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