HB 175

Department of Legislative Services

Maryland General Assembly
2019 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 175 (Chair, Ways and Means Committee)(By Request - Departmental - Commerce)

Ways and Means

Maryland Research and Development Tax Credit - Sunset Extension

This departmental bill extends the termination date for the research and development (R&D) tax credits to June 30, 2028. **The bill takes effect July 1, 2019, and applies to tax years 2020 through 2026.**

Fiscal Summary

State Effect: General fund revenues decrease by $5.7 million in FY 2022 as a result of tax credits being claimed against the corporate and personal income tax. Transportation Trust Fund (TTF) revenues decrease by $1.0 million and Higher Education Investment Fund (HEIF) revenues decrease by $0.4 million in FY 2022. Future year revenue estimates reflect current year claims and credit carry forwards from previous years. TTF expenditures decrease by $132,000 in FY 2022 due to a reduction in local highway user revenue grants.

($ in millions)	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024
GF Revenue	$0	$0	($5.7)	($7.5)	($8.9)
SF Revenue	$0	$0	($1.4)	($1.8)	($2.2)
SF Expenditure	$0	$0	($0.1)	($0.2)	($0.2)
Net Effect	$0.0	$0.0	($6.9)	($9.1)	($10.8)

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 $132,000 in FY 2022 and by $206,000 in FY 2024. Local income tax revenues increase minimally beginning in FY 2022 due to taxpayers adding back the amount of credits claimed against the personal income tax. Local expenditures are not affected.

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

Analysis

Current Law:

State Income Tax Credit

Chapters 515 and 516 of 2000 established the State R&D Tax Credit Program. There are two types of credits available: (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.

Commerce administers the tax credit application, approval, and certification process and is required to submit an annual report to the Governor and the General Assembly detailing specified information about the tax credit. Before claiming the tax credit, Commerce must certify the amount of R&D expenses incurred by the business. These expenses are certified by February 15 of the calendar year following the year in which the person applied for the tax credit. A person must then either file an amended return to claim the credit in the year in which the qualified expenses were incurred or claim the credit against any of the seven taxable years after the taxable year in which the R&D expenses were incurred.

Except for certain businesses, the tax credit is nonrefundable – the value of the credit may not exceed the tax liability imposed in the tax year. Any unused amount of the credit may be carried forward for seven years after the taxable year in which the expense was incurred. Chapter 109 of 2013 made the R&D credit refundable if the business meets the qualifications of a small business beginning in tax year 2012. The tax credit is 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 assets totaling less than $5 million.

Commerce may not approve annual credits that in the aggregate exceed $12 million – a total of $5.5 million in basic credits and $6.5 million in growth credits. If the amount of credits earned during any year exceeds the aggregate limit, the amount approved for each credit is reduced by a proportional amount of the excess. Companies may claim the credit for qualified R&D expenses through tax year 2019. The program terminates June 30, 2021.

State Sales and Use Tax Exemption

The State exempts from the sales and use tax purchases of tangible personal property for use or consumption in R&D. R&D is defined as basic and applied research in the sciences and engineering and the design, development, and governmentally mandated premarket testing of prototypes and processes. Market research, research in the social sciences or psychology, and other nontechnical activities, routine product testing, sales services, or technical and nontechnical services do not qualify. According to recent estimates, the sales and use tax exemption has a significantly larger fiscal impact than the R&D income tax credit. According to the Department of Budget and Management's *Fiscal Year 2018 Tax Expenditure Report*, the R&D sales and use tax exemption will reduce State revenues by $24.6 million in fiscal 2018.

Federal Research Tax Credit

The goal of the federal research tax credit, originally enacted in 1981, is to increase R&D by reducing its after-tax cost to businesses. To accomplish this, the tax credit is generally equal to the current year qualified research expenditures (QRE) that exceed a base amount. The base amount is designed to approximate the level of R&D that would have occurred in the absence of the credit. Taxpayers may claim either the regular credit, which generally equals 20% of the QRE above the base amount or the alternative simplified credit equal to 14% of QRE that exceeds 50% of the average QRE for the three preceding tax years.

Background: In response to concerns about the impacts of tax credits, Chapters 568 and 569 of 2012 established the Tax Credit Evaluation Act, a legislative process for evaluating certain tax credits. The evaluation process is conducted by a legislative evaluation committee. The committee was required to review and evaluate the R&D tax credit by July 1, 2018. The report can be found on the Department of Legislative Services (DLS) website.

DLS concluded that the State R&D tax credit is not a key component in fostering innovation and creating long-term economic growth. Having a skilled workforce appears to be a more significant factor in creating long-term growth. DLS found that the design and implementation of the R&D tax credit decreases its effectiveness. These findings include:

- In contrast to the federal and most State R&D tax credits, the design of the State R&D tax credit is much more likely to provide windfall credits for R&D activities that would have occurred in the absence of the credit. This is primarily due to the basic credit that provides tax credits for a business's total recent R&D expenditures rather than for incremental increases.
- The concentration of R&D tax credit claims within a few, large companies is greater than in other tax credit programs that have been evaluated by DLS. About one-third of all companies qualified for the small business refund but only received about 2% of the total credits awarded in tax years 2012 through 2015.

DLS recommended (1) considering alternative policies for encouraging R&D expenditures, such as providing research grants to Maryland universities or matching a portion of the federal Small Business Innovative Research program funds and

(2) improving the program by simplifying the tax credit and targeting the credit to new and small technology companies.

State Revenues: The bill extends the State R&D tax credit in tax years 2020 through 2026. A maximum of $12.0 million in credits can be awarded in each tax year. It is assumed that companies do not adjust estimated payments in anticipation of earning credits. As a result, general fund revenues will decrease by $5.7 million in fiscal 2022. TTF revenues will decrease by $977,000 and HEIF revenues will decrease by $402,000 in fiscal 2022. **Exhibit 1** shows the estimated State revenue impacts resulting from the proposed extension. The proposed extension of the credit will decrease revenues by a total of $77 million in fiscal 2022 through 2035.

Exhibit 1
Projected Impact on State Revenues
Fiscal 2022-2026

	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026
Total State Revenue	**($7,060,000)**	**($9,266,000)**	**($11,031,000)**	**($11,031,000)**	**($11,031,000)**
General Fund	(5,681,000)	(7,457,000)	(8,877,000)	(8,877,000)	(8,877,000)
HEIF	(402,000)	(527,000)	(628,000)	(628,000)	(628,000)
TTF	(977,000)	(1,282,000)	(1,526,000)	(1,526,000)	(1,526,000)

HEIF: Higher Education Investment Fund
TTF: Transportation Trust Fund

State Expenditures: TTF expenditures for local highway user revenue grants will decrease as a result of credits claimed against the corporate income tax. TTF expenditures will decrease by $132,000 in fiscal 2022, $173,000 in fiscal 2023, and $206,000 in fiscal 2024.

Local Revenues: Local highway user revenues will decrease by $132,000 in fiscal 2022 and $206,000 in fiscal 2024. Local income tax revenues will increase minimally beginning in fiscal 2020 due to taxpayers adding back the amount of credits claimed against the personal income tax.

Small Business Effect: According to Commerce, small businesses will benefit from the proposed tax credit extension. DLS notes that large corporations claim the majority of tax credits and a minor percentage of funding provided to the program will benefit small businesses.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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an/hlb

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ANALYSIS OF ECONOMIC IMPACT ON SMALL BUSINESSES

TITLE OF BILL: Research and Development Tax Credit Sunset Extension

BILL NUMBER: HB175

PREPARED BY: Mikra Krasniqi, Department of Commerce

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

This proposal would extend the sunset for the Research and Development Tax Credit Program to June 30, 2028. The R&D program remains crucial in creating a competitive environment with other states and stimulating business research. The program offers business tax credits for qualified R&D expenses and is capped at $5.5 million and $6.5 million for Growth R&D. Currently, the program's sunset is June 30, 2021 applicable for tax years prior to January 1, 2020. The last application cycle would be November 15, 2020 for any expenses during tax year 2019.

Since a significant number of small businesses and startups don't have the tax liability to claim the credit and have asset values below $5 million, they may apply for a refund. The 2018 legislative session provided more flexibility by changing filing date and also allowing firms to amend their tax returns to claim the tax credit. The R&D program is a popular incentive tool as seen in the growth of applicants, which increased from 181 in 2011 to 268 in 2016.

	Number of Applicants	Total R&D Expenses Incurred ($millions)	Basic Credits applied for ($millions)	Growth Credits applied for ($millions)	Basic Credit Oversubscription	Growth Credit Oversubscription
TY 2011	181	$1,105	$27.70	$18.20	9.2	6.1
TY 2012	204	$1,213	$29.20	$23.90	7.3	5.9
TY 2013	200	$1,152	$27.90	$22.30	6.2	5
TY 2014	231	$1,473	$32.30	$39.80	7.2	8.8
TY 2015	229	$1,635	$34.90	$47.20	7.8	10.5
TY 2016	268	$1,654	$33.10	$55.10	6.0	8.5

Amending the sunset would benefit small businesses by providing them with a predictable financial incentive tool for seven more years and reduce any hurdle or uncertainty that may come as a result of the 2020 sunset.