Date of Hearing: April 30, 2014

ASSEMBLY COMMITTEE ON JOBS, ECONOMIC DEVELOPMENT AND THE ECONOMY
Jose Medina, Chair
AB 1564 (V. Manuel Pérez) – As Amended: April 22, 2014

SUBJECT: Income taxes: research and development credit: credit sale and purchase

SUMMARY: This bill substantially increases the percentage value of the existing research tax credit over a five year period and then returns the rate to the 2013 tax year value. In addition, the bill establishes the Research and Development (R&D) Tax Credit Trade Program (Program), which provides for the sale and purchase previously earned research credits by small research and development (R&D) facilities. Specifically, this bill:

1) Includes legislative findings and declarations relating to the creation of an environment in California that is rich in research and development and supportive of the innovation economy with a highly skilled workforce and a tax system that rewards capital expenditures.

2) Gradually increases the credit percentages for the general research credit (15% to 30%) and the university basic research credit (24% to 39%) over five years, after which both credit percentages would return to current values. *A chart showing the specific increased values of both credits over the five years is provided in Comment 3.*

3) Requires the State Treasurer's Office (Treasurer) to develop and administer a program that allows for the sale and purchase of certain unused research tax credits. And, in doing so, requires the Treasurer to:
   a) Create an internet website through which approved tax payers may sell and purchase previously earned research tax credits;
   b) Certify that the tax payer purchasing the credit has qualified research expenses during the past five years and currently conducts business in California;
   c) Certify that the tax payer selling the research credit has: a research facility in California; earns less than $50 million before income tax, depreciation, and amortization; and has unused research credits from a previous taxable year; and
   d) Notify the Franchise Tax Board (FTB) of each sale or purchase of a credit, as specified.

4) Provides that the FTB is responsible for reviewing the information provided by the Treasurer in order to ensure credits are not being used multiple times.

5) Limits the sale and application of the tax credits in the following ways:
   a) Prohibits an individual tax payer from selling more than $5 million in credits in any given year;
   b) Limits the total amount of credits sold in one calendar year to $100 million;
   c) Requires that the price of credits be based on market value, however, in no case may a credit be sold for less than 75% of its face value; and
   d) Limits the application of a credit toward a tax payer's tax liability to 85% of its face value until the Treasurer has been reimbursed for all start-up costs and 95% of face value thereafter.

6) Provides that if a taxpayer does not reinvest the money received from the sale of research credits into the taxpayer's trade or business or if the purchased credits reduce the taxpayer's tax liability by more than 50%, any remaining unapplied credit shall be canceled and any previously applied credit that was not reinvested or that exceeds 50 percent of the taxpayer's tax liability is to be recaptured, and the taxpayer is liable for any increase in tax attributable to such a recapture. [*This is an exact quote from the bill*]

7) Establishes the Research and Development Tax Credit Trade Fund (Fund) in the State Treasury and requires the Treasurer to deposit into the Fund an amount equal to 15% of the face value of each credit sold until the Treasurer has been fully reimbursed for the cost of developing, creating, and starting the Program and appropriates the money as follows:

   a) Moneys in the amount of 13% of the face value of each credit is appropriated to the Treasurer's Office for the administrative and start-up costs of implementing the Program; and

   b) Moneys in an amount equal to 2% of the face value of each credit is appropriated to the FTB for the administrative costs of implementing the Program.

8) Reduces the amount the Treasurer deposits into the Fund to 5% of the face value of each credit sold once the Treasurer has been fully reimbursed for start-up costs and appropriates the money as follows:

   a) Moneys in an amount equal to 3% of the face value of each credit is appropriated to the Treasurer for ongoing Program administrative costs; and

   b) Moneys in an amount equal to 2% of the face value of each credit is appropriated to the FTB for ongoing administrative costs.

EXISTING LAW:

1) Allows a credit against the taxes imposed under the personal income tax (PIT) and the corporate income tax (CT) for increasing research expenses over a base amount. The credit allowed under the PIT and the CT is equal to 15% of the excess qualified research expenses over the base year amount for the taxable year and, under the CT, 24% for payments to qualified research organizations for basic research. Qualified research expenses must be related to research conducted in California and include amounts paid or incurred for wages and supplies in the conduct of qualified research as well as contract research expenses. Qualified research expenses also include payments made to qualified organizations (including educational institutions and certain scientific research organizations) for basic research.

2) Provides for an alternative research credit calculation under the PIT and the CT. A taxpayer may elect to compute the research credit using the alternative incremental credit calculation. The alternative incremental credit is equal to the sum of three tiers of the qualified research expenses in excess of a base amount; each tier calculated using an increasing percentage. The first tier is 1.49% of the total qualified research expenses for the taxable year that exceeds 1% but not more than 1.5% of the average annual gross receipts; the second tier is 1.98% of the total qualified research expenses for the taxable year that exceeds 1.5% but not 2% of the average annual gross receipts; tier three is 2.48% of the total qualified research expenses for the taxable year that exceeds 2% of the average annual gross receipts.

FISCAL EFFECT: Unknown

COMMENTS:

1) Framing the Policy Issue: This measure proposes to double the value of California's research credits and to allow small R&D facility tax payers to sell unused Research credits to raise cash that can be reinvested in the businesses. Historically, California has enjoyed a comparative advantage for innovation-based industries, not only relative to other states but also to other regions of the world. In the last decade, however, other states, such as Massachusetts, and other countries, such as Singapore, have begun to implement more targeted economic development activities to attract innovation-based industries.

   These changes are a cause for concern and suggest that California cannot be passive or assume that economic advantages which the state enjoyed in the 1990s will continue to be true in the 21st Century. This bill proposes significant changes in both the value of credits and the use of credits as part of an affirmative agenda to attract and grow innovation-based businesses in California. This analysis includes information on the development of the bill, the drivers and challenges of the California economy, and related legislation. Suggested amendments are included in Comment 8 and Comment 10.

2) Legislative Hearings and Research Contributed to Bill: AB 1564 is based on a series of legislative hearings held by the Assembly Committee on Jobs, Economic Development, and the Economy (JEDE). This includes the August 2012 JEDE hearing, which was held jointly with the Assembly Select Committees on High Technology, chaired by Assemblymember Paul Fong, and the Assembly Select Committee on Government Efficiently, Technology, and Innovation, chaired by Assemblymember Joan Buchanan. Central to the Member's deliberations was the rapidly changing global economy and the role California's historic position as a "first mover" among nations played in retaining the state's economic strength. One of the key findings and recommendations from these hearings was the continuing need to maintain California's R&D position within the broader global economy, which includes addressing the financial challenges smaller research facilities face in finding capital.

   Other outcomes from these hearings are documented in research papers, which can be found on the JEDE website ajed.assembly.ca.gov, as well as legislative proposals, which are listed and described later in the analysis. In addition, follow-up to the August 2012 hearing resulted in the establishment of a nonprofit sponsored "Innovation State" web-platform to help Members of the Legislature and the public keep abreast of innovation issues, connect with business and industry leaders, and to facilitate a high-level statewide dialogue on California's innovation future.

3) Research Incentives across the World: Research credits have become an important tool for many developed countries with economies that rely on innovation and technology to drive economic growth. Today, 27 of the 34 OECD (the Organization for Economic Cooperative Development) countries and a number of non-OECD economies give preferential tax treatment to R&D expenditures. These governments support innovation within their economies through a variety of methods including grants, loans, and procurement, as well as providing financial incentives. Tax incentives for business R&D expenditures include allowances and credits, as well as other forms of advantageous tax treatment such as allowing for the accelerated depreciation of R&D capital expenditures.

   AB 1564 increases the credit percentages for the general research credit (15% to 30%) and the university “basic research” credit (24% to 39%) over five years, after which time the credit percentages return to their current values. The chart below shows how the AB 1564 proposed increases would apply over time.

Increased Research Values 2014 to 2019		
Taxable	**General Research Credit**	**University "Basic Research" Credit**

Year	Credit Rates		Credit Rates	
	Current Law	Proposed in AB 1564	Current Law	Proposed in AB 1564
2013 (current)	15%	No change	24%	No change
2014	15%	18%	24%	27%
2015	15%	21%	24%	30%
2016	15%	24%	24%	33%
2017	15%	27%	24%	36%
2018	15%	30%	24%	39%
2019	15%	15% (current value)	24%	24% (current value)
Source: FTB analysis of AB 1564				

In OECD's review of developed economies, the organization reports that the overall tax subsidy rates for R&D often differ by size of business. Australia, Canada, France, Korea, the Netherlands and Portugal give more generous treatment to small and medium size businesses than to large firms. In addition, R&D related incentives also tend to be more generous to younger firms, as in Australia, France and the United Kingdom. In 2011, the Russian Federation, Korea, France and Slovenia provided the most combined support for business R&D as a percentage of GDP. R&D tax credits were worth $8.3 billion in the United States, followed by France and China. California currently has the highest R&D credit in the U.S. This bill would increase the value of the California substantially, as well as allow for the sale of credits by mall firms to raise revenues to reinvest in the tax payer's business.

4) Drivers in California's Future Economy: For decades, California has been known as a place where innovation and creativity flourishes. A 2007 study on California's global competitiveness identified eight key dominant and emerging industry clusters including high-tech manufacturing, biotech and clean technologies. In 2011, California remained the number one state in the U.S. for attracting foreign direct investment and venture capital (51% of total dollars). Over 931,000 Californians are employed in high tech jobs, and biotech continues to be a dominant industry sector in both Northern and Southern California providing $115 billion in annual revenues and employing 267,271 individuals.

While research shows that the state is uniquely positioned to be a preferred global partner in the areas of innovation, science, and technology, the state also needs to adapt to the reality of a growing talent pool in other countries and the global redistribution of manufacturing abroad. Emerging economies around the world are striving to become leaders in innovation and not merely "copycat" economies of the U.S.

Although these dynamics may pose challenges to current leading technology centers, for California they offer new opportunities for collaboration and cooperation. A quick look at California's top 10 exports (chart below) shows that the state is already exporting important value added products across the world and contributing to a global supply chain of manufacturing.

California's Top 10 Exports in 2013 (based on movement of goods)					
Rank	**Description**	**2012 Value**	**2013 Value**	**2013 % Share**	**% Change, 2012 - 2013**
---	**Total CALIFORNIA Exports and % Share of U.S. Total**	**161,880**	**168,128**	**10.6**	**3.9**
---	**Total, Top 25 Commodities and % Share of State Total**	**55,750**	**58,127**	**34.6**	**4.3**
1	CIVILIAN AIRCRAFT, ENGINES, AND PARTS	5,799	7,488	4.5	29.1
2	DIAMONDS, NONINDUSTRIAL, WORKED	4,537	5,581	3.3	23.0
3	MACHINE FOR RECP/CONVR/TRANS/REGN OF VOICE/IMAGE	4,477	4,753	2.8	6.2
4	PETROL OIL BITUM MINERAL (NT CRUD) ETC	3,611	4,105	2.4	13.7

	NT BIO				
5	ALMONDS, FRESH OR DRIED, SHELLED	2,455	3,166	1.9	29.0
6	ANTISERA, BLOOD FRACTIONS & IMMUNOLOGICAL PRO	1,927	2,470	1.5	28.2
7	PHONES FOR CELLULAR NTWKS OR FOR OTH WIRELESS	1,276	2,276	1.4	78.4
8	MACHINES FOR MAN. SEMICONDUTOR DEVICES/ELEC I	2,051	2,228	1.3	8.6
9	PARTS & ACCESSORIES FOR ADP MACHINES & UNITS	4,351	2,144	1.3	-50.7
10	ELECTRONIC INTEGRATED CIRCUITS, NESOI	1,988	2,138	1.3	7.5
					Source: U.S. Census Bureau

With its diverse population and access to world-class research universities and national laboratories, the state is a highly prized academic and research partnership. As early as 2004, the state had bi-national research initiatives with Canada and Iceland on renewable energy and other technologies. The University of California at San Diego has a multi-year manufacturing initiative with Mexico, supporting economic growth on both sides of the border. As California's economy becomes increasingly integrated within the global economy and centers of innovation across the world, maintaining a business climate, including tax structure that supports R&D activities is vital.

5) Challenges to California's Competitiveness: A consensus of research recognizes that innovation-based industries are primary drivers of economic competitiveness in today's global economy. California is a leader in many cutting-edge industries and home to many world-leading businesses; however, California's business climate is a cause of concern.

JEDE tracks a variety of surveys, indexes, and reports that assess California's business climate, and the general consensus is that California's biggest weakness in attracting and retaining businesses is that California is a high cost state. Business climate indexes that focus on taxes and costs consistently score California poorly. California has the 2nd highest income tax burden in the nation, and the 11th highest sales tax burden. Relative to the cost of doing business, California has the 8th highest average retail cost of electricity. Even among high cost states, California has challenges as seen by the state's ranking as 16th in the nation relative to educational attainment of residents age 25 or older. Other state rankings: Massachusetts (1st) and New York (9th).

A recent survey of manufacturers illuminates several of the deficiencies of California's business climate. Of the 18% of manufacturers that considered expanding in California in 2011, only 2.2% chose California. This compares poorly with other major states such as Ohio (12% consideration rate, capturing 11.3% of national manufacturer expansion/relocations), Texas (11% consideration rate, capturing 6.9% expansions/relocations), and North Carolina (10% consideration rate, capturing 7.2% expansions/relocations). The reasons most commonly cited for not expanding in California were the costly regulatory environment, high taxes, high labor costs, and insufficient incentives and credits.

According to the California Hispanic Chambers of Commerce, AB 1564 is strategically designed to address these challenges. Leading the strategy is the increase in the California research credit, which, based on similar legislation expects could increase state R&D investments by an additional $5.2 billion. Continuing California's competitiveness through deeper and more flexible research credits including the sale of unused credits is expected to further drive regional collaboration and commercialization of new products. The California Hispanic Chamber of Commerce believes that access to these new technologies will give California manufactures an advantage, as will the state's recently approved sales

tax exclusion on manufacturing related equipment including biotech, pharmaceuticals and information technologies.

6) Opposition to the Bill: The American Federation of State, County and Municipal Employees (ASCME) is opposed to the measure, as amended on April 8, 2014. The ASCME letter states that the increase in the value of research credits is unjustifiably high and that the sale of credits creates the possibility for abuse. The letter also notes that California has the nation's highest R&D credit, almost rivaling the federal credit.

7) Costly Package: AB 1564 enhances the state research credit, a key incentive for attracting and expanding innovation based industries including providing a new capital source for smaller size research facilities. The exact cost of the measure has yet to be estimated by the FTB, but it is estimated to be in the billions. Unfortunately when these estimates are complete there will be no dynamic analysis of what the incentives might bring to California nor the impact of not responding to the changing global economy will mean to California workers, businesses and the tax base.

8) Amendments: Below is a list of issues that the author may wish to address to clarify its purpose and ensure the successful implementation of the Credit Trade Program.

   a) Authorize the Treasurer to contact for the management of a trading platform;
   b) Remove the limitation that a tax payer purchasing credits must have had qualified research expenses in the last five years;
   c) Direct the Treasurer, in consultation with FTB, to design and implement a process for qualifying credits to be sold;
   d) Remove the $5 million limitation on the purchase of credits (the bill would still place a $5 million limitation of the sale of credits and the bill already has a prohibition for using purchased credits to reduce the tax payers tax liability by more than 50%);
   e) Allow for the carry forward of unsold credits to the following year, as specified;
   f) Require an annual report on the sale of credits:
   g) Sunset the authority to sell credits on January 1, 2020: and
   h) Make other related changes.

9) Related Legislation: Below is a list of related legislation.

   a) *AB 250 (Holden and V. Manuel Pérez) California Innovation Hub Program*: This bill codified and expanded the California Innovation Hub Program at the Governor's Office of Business and Economic Development for the purpose of stimulating economic development and job creation through the coordination of federal, state and local innovation-supporting resources. Status: Signed by the Governor, Chapter 530, Statutes of 2013.

   b) *AB 653 (V. Manuel Pérez) California Innovation and Jobs Act*: This bill would have established the California Innovation and Jobs Act, which increases the maximum value of the research and development credit and would have codified the California Innovation Hub Program. Status: Returned to the Assembly Desk pursuant to House deadlines, 2013.

   c) *AB 699 (Portantino and V. Manuel Pérez) State Economic and Innovation Strategy*: This bill would have updated the requirements for the development of a State Economic Development Strategy, especially in the areas of technology and innovation, and requires it be submitted to the Legislature by May 1, 2010. Status: Held in Assembly Appropriations Committee in 2009.

d) *AB 744 (John A. Pérez) Office of Intellectual Property*: This bill requires the Department of General Services to assist state agencies in the management and development of intellectual property that was developed by state employees or with state funding. Among other duties, the department is required to develop a database of state-owned intellectual property starting January 1, 2015. Status: Signed by the Governor, Chapter 463, Statutes of 2012.

e) AB 879 (*Bocanegra*) NOL Sales: This bill would have authorized the Treasurer, in cooperation with the Franchise Tax Board, to establish a corporation business tax benefit certificate transfer program to allow a qualified California company - specifically new or expanding emerging technology and biotechnology companies meeting the bill's criteria - to transfer their unused net operating losses (NOLs) to other taxpayers subject to California's corporation tax. Status: Held in Assembly Appropriations Committee, 2013.

f) *AB 894 (V. Manuel Pérez) California Manufacturing Competitiveness Act of 2011*: This bill would have established a loan and loan guarantee program to enable the state to draw down federal dollars to support the retooling and expansion of manufacturing in California. Status: Vetoed by the Governor, 2011

g) *AB 2506 (V. Manuel Pérez) California Innovation and Jobs Act*: This bill would have increased the state R&D credit from 15% to 40%, eliminated sales tax on manufacturing equipment, authorized a new tax credit for private investments in postsecondary institutions, required state agencies to submit regulatory actions to the Legislature 60 days prior to submitting those actions to the Office of the Administrative Law, and authorized the creation of regional innovation boards. Status: Held in the Assembly Committee on Business, Professions, and Consumer Protection in 2012.

h) *AB 2711 (Portantino, Arambula, Price and Salas) State Technology and Innovation Strategy*: This bill would have required the Secretary of the Business, Transportation and Housing Agency to develop a comprehensive state technology and innovation strategy to guide future state expenditures and activities. Status: Held under submission in the Assembly Committee on Appropriations in 2008.

10) Double Referral: This measure has been double referred by the Assembly Committee on Rules to two policy committees. On April 28, 2014, the bill passed the Assembly Committee Revenue and Taxation. As a condition for moving the bill, the author agreed to remove the provisions relating to the sale of previously earned research credit. Time constraints due to the May 2, 2014 fiscal deadlines will require the author to take the amendments in the Assembly Committee on Jobs, Economic Development and the Economy. [*No official vote was posted from that hearing at the time this analysis was published.*]

REGISTERED SUPPORT / OPPOSITION:

Support

California Hispanic Chamber of Commerce

Opposition

American Federation of State, County and Municipal Employees

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