Legislative Fiscal Bureau

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April 5, 2005

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Assembly Bill 206: Corporate Income and Franchise Tax--Super Research Tax Credit

Assembly Bill 206 was introduced on March 14, 2005, and referred to the Joint Committee on Finance.

CURRENT LAW

Both a research and research facilities tax credit are currently provided under the state corporate income and franchise tax.

Research Tax Credit. The state research tax credit is equal to 5% of the increase in a corporation's qualified research expenditures in Wisconsin over the base amount. The "base amount" is calculated by multiplying the taxpayer's average annual gross receipts for the preceding four years by a fixed-base percentage. However, the base amount does not include sales treated as throwback sales in the corporate apportionment formula. The "fixed-base" percentage is the percentage that the taxpayer's total aggregate qualified research expenditures for a specified period is of the taxpayer's total gross receipts for those years. The fixed-base percentage cannot exceed 16%. In addition, the base amount cannot be less than 50% of research expenses in the year for which the credit is claimed. The state research credit is 5% of the lesser of: (a) the excess of current year research expenses over the base amount; or (b) 50% of current year research expenses.

Start-up companies must use a minimum fixed-base percentage of 3% for the first five tax years in which a credit is claimed. As a result, start-up companies must spend 3% of their gross receipts on research in order to qualify for the credit. For years six to 10, the percentages are an increasing portion of the percentage which qualified research expenses bear to gross receipts for certain prior years. A "start-up company" is defined as a firm that, during the five-year period used to compute the fixed-base percentage, has fewer than three taxable years in which the taxpayer had both gross receipts and qualified research expenses.

The tax credit applies only to research expenditures paid or incurred in connection with the trade or business of the taxpayer that are research and development costs in an experimental or laboratory sense. In general, qualifying expenses are noncapital, and do not include spending for buildings and equipment. Qualified research expenditures are the sum of: (a) in-house expenditures for research, wages, and supplies used in research, plus certain amounts paid for research use of laboratories, equipment, computers, or other personal property; and (b) 65% of the amount paid by the taxpayer for qualified research conducted on behalf of the taxpayer. Examples of eligible costs include: (a) the costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property; and (b) the cost of improving this type of property. Qualified research is research which is undertaken for the purpose of discovering information which is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. In addition, substantially all of the activities of research must be elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality.

Corporations may elect to determine the research credit under the federal alternative research credit rules. Under these rules, the research credit is the difference between certain percentages of average gross receipts and actual research expenses.

In all cases, only the expenses for eligible research activities conducted in Wisconsin qualify for the credit. If the credit amount exceeds the corporation's tax liability, it is not refundable, but unused amounts can be carried forward fifteen years to offset future tax liabilities.

For the 2002-03 tax processing year, a total of $92.4 million in research tax credits, including unused carry-forwards, was claimed, while approximately $11.4 million was used to offset tax liabilities for that year. The unused credit amounts could be carried forward to offset future tax liabilities. In that year, about 300 corporations claimed the research tax credit.

<u>Research Facilities Tax Credit</u>. The research facilities tax credit is equal to 5% of the annual expenditures for constructing or equipping new facilities or expanding existing facilities in Wisconsin to conduct qualified research activities. Qualified research activities are defined as those eligible for the research expense tax credit. Eligible capital expenditures include only amounts paid or incurred for tangible depreciable property, but do not include expenditures for replacement property. This credit is not refundable, but can be carried forward to offset corporate income and franchise tax liability up to fifteen years.

Aggregate data for processing year 2002-03 indicate that the total amount of research facilities tax credits that were claimed, including carry-forwards, was $11.1 million. Of that total, approximately $300,000 was used to offset tax liabilities, and the remaining unused credit amounts were available to be carried forward to future tax years. A total of 59 corporations claimed the research facilities tax credit.

SUMMARY OF BILL

Assembly Bill 206 would create a super research tax credit under the state corporate income and franchise tax. The credit would equal the amount of qualified research expenses in excess of 150% of the average amount of qualified research expenses paid or incurred by the corporation in the three tax years immediately preceding the tax year for which the credit was claimed. Unused credits could be carried forward up to 15 years to offset future tax liabilities. Qualified research expenses would be the same as those used for the current research tax credit. Current law research tax credit provisions related to adjustments for acquisitions and dispositions, annualization for part-year returns, and proration for expenses that are part in-state and part out-of-state would apply. The Department of Revenue would administer the tax credit, and current law provisions related to change of ownership would also apply.

If AB 206 takes effect prior to July 31, 2005, the super research tax credit would first apply to tax years beginning on or after January 1, 2005. Otherwise, the tax credit would first apply to tax years beginning on or after January 1, 2006.

FISCAL EFFECT

The fiscal effect of AB 206 was developed by the Department of Revenue, and is based on data from research tax credits included in the 1999 and 2001 corporate income and franchise tax samples. Since data for the prior three years of research expenses is not available, research expenses claimed in 1999 were used as base expenses. The bill does not specify a different treatment for corporations with no prior year research expenses. In those cases, the estimated fiscal effect assumes that all research expenses would be eligible for the super research tax credit. Based on the data included in the tax samples, it is estimated that the super research tax credit would reduce corporate income and franchise tax revenues by $10 million annually. To the extent actual prior year expenses differ from those that were simulated, the actual fiscal effect could vary from the estimate.

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