

Research and Development Credit

Federal Conformity Can Help State Keep Innovative Edge

Summary

Background

California's research and development (R&D) credit, enacted in 1986, provides an income and corporate tax credit for certain types of R&D expenditures in order to incentivize and reward companies that invest in R&D within California.

In terms of R&D performance, California ranks first among all 50 states. California alone accounts for more than one-fifth of total U.S. R&D. California industry ranked first in R&D expenditures, accounting for \$47.1 billion in 2003. California universities rank No. 5 in U.S. R&D among universities. More than half the R&D performed in the United States by computer and electronics product manufacturers is located in California, Massachusetts and Texas.

California also is the national leader in R&D knowledge capital. It leads the rest of the country by a large margin in percentages of doctoral scientists, doctoral engineers and science and engineering doctorates awarded. In 2004, California received more utility patents than any other state, three times more than those issued to second-place Texas.

Nevertheless, California cannot afford to rest on its laurels. An informal poll of California Chamber of Commerce member companies established that California companies are choosing to relocate and expand R&D activities in other states or countries, in part due to weaknesses in the state's R&D credit. Recent studies show that growing numbers of Silicon Valley professionals are heading to India to start new businesses with U.S. funding or to expand R&D labs for Silicon Valley companies. Meanwhile, the Chinese government has tripled its spending on R&D since 1998.

Current State/Federal Policy

Both the federal government and the state of California offer businesses an R&D credit. The federal R&D credit differs from California's in several ways. One difference is the federal R&D credit is not permanent like California's and must be renewed periodically. The federal R&D credit is better than California's in other respects, however: the federal R&D credit is 20 percent, while California's is only 15 percent; and as a result of 2006 legislation, the federal R&D credit now also offers a desirable new alternative simplified credit not available in California.

When enacted, California's R&D credit for qualified research was only 8 percent. Through legislation, it later was increased to 11 percent in 1996, 12 percent in 1999 and to the current 15 percent in 2000. Unfortunately, legislative proposals in recent years to increase California's R&D credit percentages to conform to federal percentages have foundered.

Recent Legislative Developments

As part of the 2008-09 budget, California imposed a significant two-year limitation on the ability to use the R&D credit. AB 1452 (Committee on Budget) caps all business credits at half the taxpayer's tax liability. The R&D credit, along with the state's enterprise zone credit, is one of the state's two most significant statewide business tax credits. The estimated loss to businesses due to the limit on the business credits is \$900 million.

The 2008-09 budget legislation provided an offsetting improvement for businesses by allowing, effective January 2010, the R&D tax credit to be shared among a related group of affiliate or subsidiary companies, unitary utilization. The improvement will help companies that need the flexibility to allocate earned tax credits within their family of companies, but not all companies will benefit due to different circumstances and structures.

Anticipated Action

The California Chamber of Commerce will continue to promote adoption, over the long term, of other improvements to the state R&D credit as a means to further stimulate R&D activity and investments in California, including:

- Increasing California's R&D credit to 20 percent in conformity with federal law.
- Adopting the alternative simplified credit in conformity with federal law.
- Ending the double taxation currently imposed upon R&D activities — taxation of the equipment used in R&D and then taxation of the product of the R&D when it is sold. California's existing 15 percent R&D tax credit applies only to labor costs and not machinery.

Research and Development Credit (continued)

CalChamber Position

The CalChamber opposes any attempt to undermine, suspend or reduce the R&D credit and will continue to advocate that the state be proactive in maintaining and expanding its leading edge in R&D innovation and talent. This includes strengthening California's R&D credit by bringing it into conformity with positive aspects of the federal R&D credit.

Reasons for Position

- California needs to proactively maintain and expand its leading edge in R&D innovation and talent as it competes for R&D investments, jobs and knowledge capital, not only with other states, but other countries, such as India and China, which are working aggressively to expand their innovation output.
- Strengthening California's R&D credit will bolster R&D activity in both the industry sector and the state's universities, stimulating the state's economy with additional investments and jobs and helping boost state tax revenues.

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