DEPARTMENT OF TAXATION
2016 Fiscal Impact Statement

1. Patron Timothy D. Hugo

2. Bill Number HB 884

House of Origin:
_____ **Introduced**
_____ **Substitute**
_____ **Engrossed**

3. Committee Passed House and Senate

4. Title Income Tax; Tax Credits for Virginia Research and Development

Second House:
_____ **In Committee**
_____ **Substitute**
__X__ **Enrolled**

5. Summary/Purpose:

This bill would make several changes to the existing Research and Development Expenses Tax Credit and would create a new tax credit, the Major Research and Development Expenses Tax Credit.

This bill would make the following changes to the existing Research and Development Expenses Tax Credit:

- Increase the annual credit cap from $6 million to $7 million;
- Increase the amount of credits each taxpayer may claim;
- Allow a taxpayer to elect to compute the credit using a simplified method in lieu of the current statutory method;
- Extend the sunset date for the credit from taxable years beginning before January 1, 2019 to taxable years beginning before January 1, 2022; and
- Prohibit a taxpayer with Virginia qualified research and development expenses in excess of $5 million from claiming the credit.

This bill would allow taxpayers with Virginia qualified research and development expenses in excess of $5 million for a taxable year to claim the Major Research and Development Expenses Tax Credit. The amount of the credit would be equal to 10 percent of the difference between:

- The Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year; and
- 50 percent of the average Virginia qualified research and development expenses paid or incurred by the taxpayer for the three taxable years immediately preceding the taxable year for which the credit is being determined.

If the taxpayer did not pay or incur Virginia qualified research and development expenses in any one of the three taxable years immediately preceding the taxable year for which the credit is being determined, the credit would equal five percent of the Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year.

The total amount of Major Research and Development Tax Credits that could be issued for each fiscal year would be limited to $20 million.

This bill would be effective for taxable years beginning on or after January 1, 2016.

6. Budget amendment necessary: Yes.

7. Fiscal Impact Estimates are: Preliminary. (See Line 8.)

7b. Revenue Impact:

Fiscal Year	***Dollars***	***Fund***
2015-16	$0	GF
2016-17	$0	GF
2017-18	($5 million)	GF
2018-19	($5 million)	GF
2019-20	($5 million)	GF
2020-21	($5 million)	GF
2021-22	($5 million)	GF

8. Fiscal implications:

Administrative Costs

The Department considers implementation of this bill as routine, and does not require additional funding.

Revenue Impact

This bill would have an annual negative General Fund revenue impact of $21 million beginning in Fiscal Year 2018. However, the $1 million negative revenue impact from increasing the credit cap for the existing Research and Development Expenses Tax Credit, and $15 million of the $20 million negative revenue impact from creating a new Major Research and Development Expenses Tax Credit is assumed in the Introduced Executive Budget. Therefore, if this bill is enacted, a $5 million budget amendment would be required for Fiscal Year 2018.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Research and Development Expenses Tax Credit

Virginia currently allows Research and Development Expenses Tax Credits in an amount equal to 15 percent of the first $234,000 (up to a maximum of $35,100) in Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year or 20 percent of the first $234,000 (up to a maximum of $46,800) of such expenses if the Virginia qualified research was conducted in conjunction with a Virginia public or private college or university, to the extent the expenses exceed the Virginia base amount for the taxpayer. The Virginia base amount is equal to the lesser of:

- The product of the taxpayer's average gross receipts for the four taxable years preceding the credit year and the taxpayer's fixed-base percentage; or

- 50 percent of the taxpayer's Virginia qualified research and development expenses for the credit year.

The fixed-base percentage is a complex computation based on federal law, calculated by dividing the amount of Virginia qualified research and development expenses for the three taxable years preceding the credit year by the amount of gross receipts for the three taxable years preceding the credit year.

The credit is capped at $6 million per fiscal year. If the total eligible credit requests exceed $6 million for any taxable year, each taxpayer is granted a pro rata amount of credits as determined by the Department. If the total amount of approved credits is less than $6 million for any taxable year, the Department is required to allocate credits of up to $6 million, on a pro rata basis, to taxpayers that are already approved for the credit in an amount equal to 15 percent of the second $234,000 in Virginia qualified research and development expenses paid or incurred by the taxpayer or 20 percent of the second $234,000 in such expenses if the Virginia qualified research was conducted in conjunction with a Virginia public or private college or university.

For Taxable Years 2011 through 2014, the Department approved applications for Research and Development Expenses Tax Credits as follows:

Taxable Year	Number of Applications Approved	Total Amount Approved	Annual Cap
TY 2011	64	$2,139,944	$5,000,000
TY 2012	135	$4,545,634	$5,000,000
TY 2013	193	$4,999,958	$5,000,000
TY 2014	230	$6,193,792	$6,000,000

Federal Research Credit

Primary Method for Determining the Credit

For federal tax purposes, a taxpayer may claim a research credit equal to 20 percent of the excess of the qualified research expenses for the taxable year over the base amount. The federal base amount is equal to the lesser of:

- The product of the taxpayer's average gross receipts for the four taxable years preceding the credit year and the taxpayer's fixed-base percentage; or

- 50 percent of the taxpayer's Virginia qualified research and development expenses for the credit year.

The fixed-base percentage is a complex computation that is determined by dividing the aggregate amount of qualified research expenses of the taxpayer for certain taxable years by the aggregate gross receipts of the taxpayer for such taxable years.

Election of an Alternative Simplified Credit

In lieu of utilizing the primary method for determining the federal research credit, a taxpayer may elect to compute the credit using an alternative simplified method. Under such method, the amount of the credit is equal to the excess of:

- 14 percent of the taxpayer's qualified research expenses for the taxable year; over

- 50 percent of the taxpayer's average qualified research expenses for the previous three taxable years.

If the taxpayer has no qualified research expenses in any one of the three previous taxable years, the credit is equal to 6 percent of its qualified research expenses for the current taxable year.

Renewable Energy Portfolio Standard Program

To encourage the increased use of renewable energy, Virginia allows certain electric utilities to participate in a renewable energy portfolio standard program. An electric utility that participates in a renewable energy portfolio standard program is required to meet certain renewable energy usage goals from Calendar Year 2010 to Calendar Year 2025. As an incentive to participate in such programs, Virginia allows a participating electric utility that meets a renewable energy usage goal to increase its rate of return for selling energy.

Virginia allows electric utilities participating in a renewable energy portfolio standard program to earn credits toward a renewable energy usage goal for making qualified investments. "Qualified investments" are expenses incurred in Virginia by a participating electric utility for certain research and development activities related to renewable or alternative energy sources. Expenses incurred or investments made by a participating electric utility that constitute a "qualified investment" may not be used to claim the Research and Development Expenses Tax Credit.

Proposed Legislation

Existing Research and Development Expenses Tax Credit

This bill would allow a taxpayer claiming the Research and Development Expenses Tax Credit to elect to compute the credit using a simplified method in lieu of the current statutory method. Under such method, the credit would be equal to 10 percent of the difference of:

- The Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year; and
- 50 percent of the average Virginia qualified research and development expenses paid or incurred by the taxpayer for the three taxable years immediately preceding the taxable year for which the credit is being determined.

If a taxpayer electing to use the simplified method did not pay or incur Virginia qualified research and development expenses in any one of the three taxable years immediately preceding the taxable year for which the credit is being determined, the credit would be equal to five percent of the Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year.

This bill would increase the amount of credits a taxpayer may claim to:

- $45,000 of credits for a taxable year; or
- $60,000 of credits for a taxable year if the Virginia qualified research was conducted in conjunction with a Virginia public or private college or university.

This bill would increase the annual credit cap for the Research and Development Expenses Tax Credit from $6 million to $7 million. If the total amount of eligible credit requests is less than $7 million for any taxable year, this bill would require the Department to allocate a supplemental amount of credits to taxpayers that elected to use either the current statutory method or the simplified method. The supplemental allocation of credits would be limited to a maximum of:

- An additional $45,000 of credits for a taxable year; or
- An additional $60,000 of credits for a taxable year if the Virginia qualified research was conducted in conjunction with a Virginia public or private college or university.

If the Department determines that the amount of eligible supplemental credits exceeds $7 million, it would be required to prorate such supplemental credits.

This bill would extend the sunset date for the existing Research and Development Expenses Tax Credit from taxable years beginning before January 1, 2019 to taxable years beginning before January 1, 2022.

This bill would require that taxpayers submit applications for the credit no later than July 1 of the calendar year following the close of the taxable year in which expenses that are eligible for the credit were paid or incurred.

This bill would prohibit a taxpayer with Virginia qualified research and development expense in excess of $5 million from claiming the existing Research and Development Expenses Tax Credit. Such taxpayer could be eligible to claim the Major Research and Development Expenses Tax Credit instead.

Major Research and Development Expenses Tax Credit

This bill would allow taxpayers with Virginia qualified research and development expenses in excess of $5 million for a taxable year to claim the Major Research and Development Expenses Tax Credit. Such credit would be effective for taxable years beginning on or after January 1, 2016, but before January 1, 2022. The amount of the credit would be equal to 10 percent of the difference between:

- The Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year; and

- 50 percent of the average Virginia qualified research and development expenses paid or incurred by the taxpayer for the three taxable years immediately preceding the taxable year for which the credit is being determined.

If the taxpayer did not pay or incur Virginia qualified research and development expenses in any one of the three taxable years immediately preceding the taxable year for which the credit is being determined, the credit would be equal five percent of the Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year.

“Virginia qualified research” would include qualified research as defined for federal income tax purposes that is conducted in Virginia.

“Virginia qualified research and development expenses” would include qualified research expenses for federal income tax purposes incurred for Virginia qualified research.

The total amount of credits that could be issued for each fiscal year would be limited to $20 million. If approved applications for the credit exceed $20 million for any taxable year, each taxpayer would be granted a pro rata amount of credits as determined by the Department.

This bill would require that taxpayers submit applications for the credit no later than July 1 of the calendar year following the close of the taxable year in which expenses that are eligible for the credit were paid or incurred. No taxpayer would be permitted to claim credits in excess of 75 percent of the income tax imposed on the taxpayer for the taxable year. Any credit not usable for the taxable year for which the credit was first allowed may be carried over to the extent usable for the next ten taxable years or until the total amount of credit has been utilized, whichever occurs sooner.

A taxpayer would not be permitted to utilize expenses that were used to claim the credit as the basis for claiming any other Virginia income tax credit.

The amount of any credit attributable to a partnership, limited liability company, or electing small business corporation (S corporation) would be required to be allocated to the individual partners, members, or shareholders in proportion to their ownership interest in such entities or in accordance with a written agreement entered into by such individual partners, members, or shareholders.

No taxpayer that is an electric utility participating in a renewable energy portfolio standard program would be eligible for the Major Research and Development Expenses Tax Credit with regard to any expense incurred or investment made by the participating utility that constitutes a qualified investment for purposes of such program.

This bill would prohibit a taxpayer from claiming the Major Research and Development Expenses Tax Credit for otherwise qualified research and development expenses that are paid for or incurred for research conducted in Virginia on human cells or tissue derived from induced abortions or from stem cells obtained from human embryos. This prohibition would not apply to research conducted using stem cells other than embryonic stem cells.

The Department would be required to develop and publish guidelines, exempt from the provisions of the Administrative Process Act, regarding the process for applying for the credit. The Department would also be required to adopt guidelines to prescribe standards for determining when research and development is considered conducted in Virginia for purposes of allowing the credit. In adopting such guidelines, the Department would be permitted to consider:

- The location where the research and development is performed;
- The residence or business location of the taxpayer or taxpayers conducting the research and development;
- The location where supplies used in the research and development are consumed; and
- Any other factors that the Department deems to be relevant.

This bill would be effective for taxable years beginning on or after January 1, 2016.

<u>Similar Bills</u>

Senate Bill 58 is identical to this bill.

Date: 3/7/2016 MTH
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