NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: House Bill 1415 (Second Edition)

SHORT TITLE: Alternative R&D Tax Credit.

SPONSOR(S): Representatives Wainwright and Daughtridge

FISCAL IMPACT (Millions)

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09
REVENUES					
State General Fund		-15.8	-22.0	-23.4	-13.9

PRINCIPAL DEPARTMENT AFFECTED: The corporate income tax is administered by the Department of Revenue. The enactment of the bill should not affect the Department ‘s budget requirements.

EFFECTIVE DATE: Business activities undertaken on or after July 1, 2005. The new credit sunsets on January 1, 2009.

BILL SUMMARY: Under the current Bill Lee Act (tax incentives for industry recruitment) there is a credit for research and development expenditures. The incentive is in the form of two alternative credits available to taxpayers: (1) a credit of 5% of the increase in research and development expenses that are apportioned to North Carolina or (2) a credit of 25% of the State's apportioned share of the federal alternative incremental credit (helps start-up companies).

The legislation moves the State research and development credit out of the Bill Lee Act and allows taxpayers the option of using the existing credit system (incremental credit or alternative credit) or a new restructured credit. The new credit contains the following features:

- The credit is no longer limited to just certain types of businesses.
- The taxpayer must still satisfy requirements relating to wage standard, health insurance, environmental impact, and safety and health programs.
- The credit may not exceed 50% of tax, with a 15-year carry forward.
- The new credit is a flat rate for qualified North Carolina research expenses, based on federal definitions of this term.

The structure for the new credit is based on two steps. First, the taxpayer may take one of the following credit amounts:

- Small business (annual gross receipts below $1 million) - 3%.
- Research conducted in Tier 1, 2, or 3 (distress tiers under Bill Lee Act) - 3%.
- Other research costs - 1% for expenses up to $50 million, 2% for expenses between $50 million and $200 million, and 3% for expenses above $200 million.

Next, for research payments to North Carolina research universities, the taxpayer may take an additional credit of 15%.

ASSUMPTIONS AND METHODOLOGY: Data compiled by the Department of Revenue from a review of the tax returns of taxpayers taking the existing credit indicates usage of $7.0 million per year. There were 216 applications for the credit in 2000 and 141 in 2001. These numbers may differ from the number of taxpayers taking the credit because the credit can be taken against either the franchise or the income tax.

The Department of Commerce staff, in conjunction with the Department of Revenue, has reviewed the tax returns for the largest 25 taxpayers taking the current R & D credit. These companies generated 77% of the R & D credit for 1999-2001. From the tax return detail supplied by these companies, Commerce was able to simulate the impact of the new credit.

For other potential users, the starting point in developing a simulation was a National Science Foundation survey of R & D spending for 1988. The data is compiled by state but is not broken down in enough detail to allow an industry-specific calculation of the impact of the credit. To achieve this end, Commerce “sensitized” the NSF data by using information from the 1997 Economic Census of the Census Bureau and wage data from the N.C. Employment Security Commission. This enabled the creation of industry average of research and development spending. In addition, Commerce discussed research activity with universities across the state.

The Department of Commerce, in cooperation with the Department of Revenue, determined from a review of tax returns that companies applying for the R & D credit, on average, are able to use 32% of the credit. This usage rate was applied to the categories of the new credit.

After the potential credits were calculated under the new system, it was determined that the additional annual revenue loss would be $13.2 million for the 2005 tax year if all taxpayers were able to use the new credit. However, the ability of a taxpayer to choose between the existing credit system and the new credit adds $3.0 million to the cost of the bill, bringing the total annualized cost for the 2005 tax year to $16.2 million.

The new credit is effective for eligible research expenditures made on or after July 1, 2005. Thus, there will be no impact on the 2004-05 fiscal year. For 2005-06, the fiscal effect is based on 50% of the 2005 tax year impact (equals $8.1 million) due to the July 1 effective date plus the impact on estimated tax payments for the 2006 tax returns. For the purpose of this analysis, we have assumed that 45% of the annualized amount of the 2006 tax year credit would be taken during the April-June 2006 period based on the “safe harbor” provision requiring estimated payments of at least 90% of annual liability during the tax year (for four payments). This equals to $7.7 million, bringing the total 2005-06 impact to $15.8 million.

For future years, the annual impact of the credit overhaul is expected to grow at a rate of 6%. This assumption ties closely to the forecast of North Carolina personal income growth as projected by Global Insight (forecasting firm used by Office of State Budget and Management) and Economy.com (forecast used by Fiscal Research Division). The future fiscal year estimates are based on the assumption that 45% of the annual tax year impact will occur during the April-June period of the tax year and the remainder during the July-March period (subsequent fiscal year).

Finally, the estimates have been adjusted for the fact that, under current law, the Bill Lee Act credits for research and development sunset on January 1, 2006, and the new credit expires on January 1, 2009.

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