

CALIFORNIA'S HIGH TECH SECTOR: PROMOTING JOB CREATION AND INNOVATION THROUGH SOUND TAX POLICY

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Summary of Recommendations to Promote Job Creation and Innovation in California

1. Articulate the state's economic, societal and environmental goals to better ensure that tax law changes support attainment of such goals.
2. California has one of the most generous research tax credits among the states and an underutilized jobs credit. Identify why these provisions are not promoting job creation and innovation to the desired level.
3. Consider that not all problems can or should be addressed through the tax system.
4. Credits designed to help a start-up company or one that may have a long product development cycle (such as is common in the biotech area), should be fully or partially refundable or a grant process should be considered instead. A credit designed to provide funds to taxpayers for engaging in a particular activity should be usable against AMT.
5. Conform California law to more favorable depreciation rules of federal MACRS and Section 179 expensing. Encourage Congress to allow the IRS to update depreciable lives, such as for computers and semiconductor manufacturing equipment which generally is too long (5 years). In addition, encourage Congress to modernize Section 179 to apply to both tangible and intangible assets.
6. Expand equity investment incentives of qualified small businesses to other business entity forms (partnership and S corporations).
7. Allow investors in small start-ups to treat all or a portion of any losses as ordinary losses.
8. Consider enacting incentives for individuals investing in start-ups. Such provisions might be modeled after those used in other states, such as Minnesota's Angel Tax Credit or Nebraska's Advantage Microenterprise Tax Credit. Lessons can be learned from the states that have implemented such tax incentives.
9. Be ready with incentives for corporations to utilize cash in California should the federal government enact a repatriation tax break.
10. Review job creation data and modify the jobs credit accordingly.

11. Study the California research tax credit formula and operation to determine how it might be improved to better promote innovation in California. Consider what actions California wants to take should the alternative simplified credit be made permanent and the regular credit not renewed at the federal level.
12. Encourage Congress and the IRS to improve the federal research tax credit including making it permanent.
13. Explore approaches for broadening the personal and corporate income tax base so as to lower the tax rate.
14. Develop a plan to phase out the sales tax on business purchases of manufacturing and R&D equipment. This might be funded by broadening the sales tax base for consumers to include consumption of personal services and digital goods, and to repeal the elective approach to apportionment (adopting the single sales factor approach due to its economic development foundation).
15. Consider whether any state programs and expenditures hinder job creation and innovation in some way, such as excessive paperwork.
16. Consider the bigger picture for innovation that also includes the need for and availability of high quality education opportunities for everyone.
17. To better understand how much the government is investing in R&D and for data analysis, implement accountability measures that track not only direct spending on R&D, but also the spending in the tax law tied to special rules such as the research tax credit.
18. Be ready to respond to possible federal tax reform that may include a lower corporate tax rate paid for with repeal and reduction of numerous tax expenditures. Provide information to the federal tax-writing committees on any California concerns with current proposals.

Introduction

Thank you for the opportunity to testify today regarding the intersection of sound tax policy and promoting job creation and innovation in California.¹ My name is Annette Nellen and I am a professor at San José State University and director of the graduate tax program.² I am both a CPA and attorney. Prior to joining San José State in 1990, I was a tax practitioner with Ernst & Young and worked at the IRS as a revenue agent and lead instructor. My testimony today is based on my over 20 years of experience working with the tax law, particularly considerable time devoted to studying, teaching and writing about the tax treatment of R&D, software, intangibles, the Internet, and e-commerce, as well as tax policy and tax reform. Since 2007, I have focused much of my writing (including blogging) on "21st century taxation," to promote

¹ This testimony draws from earlier testimony to the U.S. Senate Finance Committee on September 20, 2011 for a hearing on tax reform and incentives for innovation (<http://finance.senate.gov/hearings/hearing/?id=ef6a4c10-5056-a032-5212-fbf59e314035>) and the California Assembly Revenue & Taxation Committee on January 13, 2010 for alternatives to the COTCE proposals (http://www.21stcenturytaxation.com/uploads/Testimony_Informational_Hearing_1-13-2010Nellen.pdf).

² This testimony represents the views of Professor Annette Nellen and not necessarily those of her employer or any organization of which she is a member.

tax reform that follows principles of good tax policy and reflects 21st century ways of living and doing business.³

The topic of this hearing has inherent in it the question of what is the role of a tax system. That is, should a tax system promote job creation and innovation or should it only serve its primary function to raise revenue for government operations? To best meet principles of good tax policy, a tax system should be designed with a broad base and low rates. For example, when special rules applicable to a subset of taxpayers exists, the law becomes more complicated and inequitable in that similar taxpayers are not treated similarly. Yet, designers of the tax system must also recognize that (1) any type of tax by its operation affects business activity, investments and decision-making, and (2) when government determines that it is appropriate to provide some form of assistance to some group or activity, the tax law might be an efficient way to do so.

My remarks address job creation, innovation and taxation in the following areas:

- I. Strategy, assessment and solutions
- II. How job creation and innovation ties to tax system design and reform.
- III. Where current tax rules support job creation and innovation and where improvements might be made to better support (or not hinder) these objectives.
- IV. Additional recommendations

I. Strategy, Assessment and Solutions

At least three questions should be answered before drafting any tax proposals for the purpose of promoting job creation and innovation.

1. What are the state's economic, societal and environmental goals?

When state goals and what is best for the state and its residents are overlooked or not at the forefront, tax changes get made for reasons that can hinder the state's goals. For example, tough budget times often lead to rate increases that hurt business activity in the state and exacerbate existing tax system problems that are usually only made worse with a higher rate (such as volatility and regressivity).

For example, in 2009, a sales tax rate increase to address California budget problems made the sales tax more regressive, hurting low-income taxpayers. In addition, it harmed the business climate because California is in the minority of states that even impose sales tax on manufacturing equipment.

Consideration of the state's economic, societal and environmental goals should lead to consideration of business opportunities, future growth areas, education and skill needs of the workforce and the financial and physical effects on infrastructure and the environment. A focus on helping the state achieve its economic, societal and environmental goals will better focus tax legislation. These goals should be articulated by lawmakers and at the forefront in considering any tax law changes. This focus would, for example, reduce the likelihood of rate increases in a weak economy and instead look for spending cuts both within the tax system ("tax expenditures") and via direct spending.

³ The 21st Century Taxation website and blog can be found at <http://www.21stcenturytaxation.com>.

2. Assuming there is a problem needing resolution, what is that problem?

Identification and articulation of the problem can help in identifying possible solutions. To help identify the problem, data should be gathered (a good amount is already collected by the federal and state governments) to help understand the problem so that an appropriate solution can be crafted. Information should also be gathered from taxpayer surveys and reports from research organizations (universities, OECD, and others).

The focus of this hearing is on innovation and job creation. California has one of the most generous research tax credits among the states. California also has job credits that have not been as fully utilized as projected, as evidenced by unused credits. For example, in 2009, \$400 million was allocated to a new jobs credit. This credit provides up to \$3,000 per new full-time employee hired by a business with 20 or fewer employees. At November 5, 2011, the Franchise Tax Board (FTB) reports that about \$75 million of jobs credits have been claimed.⁴

What is the problem that leads to further consideration of using the tax law to promote job creation and innovation? Why aren't existing tax credits sufficient to address any problem?

3. Once the problem has been identified, solutions should be identified broadly.

While the tax system can be used to create possible solutions to just about any problem, that does not mean it should be so used. There are many ways to solve problems and all should be considered rather than moving immediately to a tax solution. The addition of special tax rules can lead to complexity, possible inequities, reduced transparency, and loss of economic efficiency.

II. The Effect of California's Tax System on Job Creation and Innovation

Investment in R&D has long been viewed by lawmakers, businesses and the public as a key contributor to economic growth.⁵ This perspective has justified government funding of medical research, the space program and many other research activities. In 1981, this view supported creation of a federal research tax credit to address a "concern that the decline in investment in research and development had adversely affected this country's economic growth, productivity gains, and ability to compete in world wide markets."⁶

Certainly, a goal for tax system design should be to support (and not hinder) economic growth. Innovation is a driver of economic growth that can enable U.S. companies to be first to the global marketplace, create operating efficiencies for businesses and households, and lead to

⁴ Assembly Floor analysis to SB 15X3 (2009) indicates expected cost of the jobs credit of \$15 million in 2008-09, \$330 million for 2009-10, \$90 million for 2010-13; http://www.leginfo.ca.gov/pub/09-10/bill/sen/sb_0001-0050/sbx3_15_cfa_20090215_133448_asm_floor.html.

⁵ As noted by the Treasury Department: "Investments in research and experimentation produce the technological advancements that are an important determinant of productivity growth and improvements in U.S. living standards." See, Treasury, *Investing in U.S. Competitiveness: The Benefits of Enhancing the Research and Experimentation (R&E) Tax Credit*, 3/25/11, page 3; <http://www.treasury.gov/resource-center/tax-policy/Documents/Research%20and%20Experimentation%20report%20FINAL.PDF>.

⁶ *TSR, Inc. and Sub. v. Comm'r.*, 96 TC 903 (1991) summarizing the 1981 legislative history that added IRC Section 44F (now Section 41) as part of the Economic Recovery and Investment Act (ERTA) (P.L. 97-34; 8/13/81).

greater economic development that supports many businesses. In addition, the tax law should not hinder job creation through excessive taxation or compliance costs.

Innovation can factor into tax system design in at least the following ways, listed and then explained below:

- Consideration in helping the system meet the tax principle of economic growth and efficiency.
- Use of the tax law as a vehicle for addressing the societal or spillover benefits inherent in R&D and for economic development.
- Tax administration and compliance.

First, one principle of good tax policy is *economic growth and efficiency*. In its framework of describing ten principles of good tax policy, the AICPA Tax Division⁷ describes "economic growth and efficiency" as "the tax system should not impede or reduce the productive capacity of the economy." This should be considered along with another principle – neutrality. A neutral tax system is one where the tax rules do not affect decision-making. This may sometimes seem to be in opposition to the economic growth and efficiency principle. It is not. Any tax system will have some effect on decision-making; it cannot be avoided. For example, a sales tax has an inherent effect on one's decision to buy a taxable item.

The economic growth and efficiency principle guides tax system design by minimizing adverse effects of the tax. For example, an income tax by its nature allows businesses to consider asset depreciation in measuring income. The selection of the depreciation life and method should not impede economic growth. For example, use of a 20-year depreciable life for a computer will enable measurement of taxable income, but will have an adverse effect on economic growth.

Second, the tax system serves as one possible approach to address the fact that there are often spillover benefits to society of private investment in R&D.⁸ This position has been noted as an economic justification for the research tax credit. In a 1985 study on the effectiveness of the credit, the Joint Economic Committee stated:

“[T]he total rate of return on private R&D greatly exceeds the private rate of return. That is, private R&D gives rise to benefits to society at large well in excess of the profits it generates for the company that funds the R&D. Such "spillover benefits" or "neighborhood effects" thereby put R&D into the class of goods such as public health and sanitation, education, clean air and water, and defense that fall into the sphere of governmental responsibility.”⁹

A company conducting research and incurring costs may not be able to completely reap the rewards of its research because some of the benefit will spill over to others. For example, although research leading to an innovative new drug can be protected by a patent to help a company obtain the economic benefits of its research, the fruits of the research will be enjoyed by others upon the patent's expiration. In addition, the existence of the patent and the knowledge gained from the research that created it may lead to developments by others for which the original inventor may not be fully compensated. Because a

⁷ AICPA, *Tax Policy Concept Statement No. 1 – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (2001); available at <http://www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/TAXLEGISLATIONPOLICY/Pages/TaxReform.aspx>; the author of this testimony was the lead author of this AICPA report.

⁸ Another approach for compensating for the spillover benefits are direct government payments or grants.

⁹ "The R&D Tax Credit: An Evaluation of Evidence On Its Effectiveness," A Staff Study prepared for the use of the Joint Economic Committee, 8/23/85, page 4.

company may not receive all of the return from its research investment, but will instead share some of it with society, there is justification for public support of such research.

Also, the risks associated with R&D may lead to underinvestment in it, as noted by Congress when it enacted the research tax credit in 1981.

The OECD observes: “Given the contribution of research and development (R&D) to productivity growth, economic performance and the achievement of social objectives, it is generally agreed that governments have a role in encouraging appropriate R&D levels and expenditures.”¹⁰

Providing compensation for the spillover benefits and encouragement for greater investment in R&D through the tax law rather than via direct government subsidy (such as a grant) enables market forces to identify appropriate R&D activities rather than a government agency. The tax approach, though, adds some complexity to the tax law and makes the tax agency a reviewer of qualified research rather than an agency with scientific and technological expertise. A tax-based subsidy should consider this side effect in the design of the tax provision (such as by not making the definitions of qualified research too complicated to administer through the tax law).

Considering the first two points above, recognition of an economic justification for government support of R&D should be balanced with the need for a tax system to strive to meet the principles of simplicity, equity, neutrality and transparency. At the state level, consideration of the use of a tax credit to address spillover effects must also consider whether such effect has already been adequately addressed by the federal credit. In such case, a state credit likely serves the purpose of directing state competition for R&D to the state. Thus, the state R&D credit should be viewed more as an economic development tool.

Third, innovation should be considered in improving the administration of a tax system. For example, new web-based tools might be used to streamline the calculation, assessment and collection of taxes. Administration of the tax system should not be overlooked in tax reform, which often tends to look only at changing the tax base and rate.

III. Current Rules – Areas of Support for Job Creation and Innovation and Areas for Improvement

Areas that Support Job Creation and Innovation

California tax law includes a few provisions that incentivize or support job creation and innovation in some way. These provisions include:

- R&T Section 17053.80 provides a \$3,000 credit per new full-time employee for certain small businesses (noted earlier).
- Various other credits for job creation, such as R&T Section 17053.47 -- Credit for hiring disadvantaged in manufacturing enhancement.
- R&T Section 24365, generally follows IRC Section 174, Research and experimental expenditures, which allows taxpayers to deduct research or experimentation expenses incurred in connection with a trade or business.
- R&T Section 23609 allows for a permanent credit for increasing research activities.

¹⁰ OECD, *Tax Incentives For Research and Development: Trends and Issues*, page 4; <http://www.oecd.org/dataoecd/12/27/2498389.pdf>.

- R&T Section 24416.20, allows for a net operating loss to be carried over to use in other years.
- R&T Section 18152.5 allowing a partial exclusion for gain from certain small business stock – may help a "qualified small business" C corporation obtain equity financing.
- R&T Section 18151 provides that California conforms to IRC Section 1235, Sale or exchange of patents, which allows individual inventors to treat certain patent dispositions as producing long-term capital gain income, rather than ordinary income.

The federal tax law also includes some provisions to encourage job creation and innovation including a deduction for R&D expenditures and a research credit. At the federal level, the research tax credit (IRC Section 41) is a temporary provision that will expire for the 15th time on December 31, 2011 (its first expiration was December 31, 1985). The federal work opportunity tax credit (IRC Section 51(c)(4)) also expires December 31, 2011.

Areas for Improvement

Some tax provisions can operate in such a manner as to have the unintended effect of hindering job creation and innovation and some may be in need of modernization to better reflect today's ways of doing business. In a tax policy analysis, these provisions would raise red flags under the economic growth and efficiency principle. A few of these provisions are explained next.

- 1) *Limitations of tax credits:* Tax credits rate well under the principle of equity in that they are worth the same to all taxpayers regardless of tax bracket. However, they may not rate well under the principle of economic growth and efficiency. Most tax credits are nonrefundable and may only be used to reduce regular tax, not AMT.

If a credit is designed to encourage a particular activity or help reduce the costs of risky investments that may have high rates of return, the benefit will be lost if the taxpayer owes no regular tax (such as due to an NOL) or owes AMT.

Possible solutions: Any credit designed to help a start-up company or one that may have a long product development cycle (such as is common in the biotech area), should be fully or partially refundable or a grant process should be considered instead. For example, the American Recovery and Reinvestment Act of 2009 (PL 111-5; 2/17/09; §1603) provided a grant in lieu of credit program for certain energy credits, administered by the Treasury Department. This allowed a cash benefit to be received by taxpayers even if they did not have sufficient tax liability to claim a credit. The grant approach may also enable funds to be received by taxpayers more quickly than under the credit avenue. However, the grant process would likely prove too costly and cumbersome for the thousands of taxpayers that claim the research credit, but may be helpful to start-up companies.

A credit designed to provide funds to taxpayers for engaging in a particular activity should be usable against AMT.

- 2) *Depreciation weaknesses:*

- *No MACRS:* For C corporations, California has not conformed to the federal MACRS system (1986) that generally allows for shorter lives and more rapid depreciation methods. Where other states use a shorter depreciable life and accelerated depreciation for certain assets, California companies can face

competitive disadvantages. Depreciation lives that are too long may discourage businesses from investing in certain assets. If the assets are ones for which manufacturers qualified for the research tax credit, part of the underlying purpose for the credit – to encourage economic growth and higher productivity levels may not be fully achieved.¹¹ Lack of conformity to federal MACRS also creates costs for additional recordkeeping needed just for state purposes.

Possible solutions: Conform California depreciation rules to federal MACRS. Encourage Congress to allow the IRS to update depreciable lives, such as for computers and semiconductor manufacturing equipment which generally is too long (5 years).

- *Section 179 non-conformity:* IRC Section 179 helps small and medium size businesses by allowing a specified dollar amount of tangible personal property to be expensed rather than depreciated. The benefit is simpler recordkeeping and a lower after-tax cost for the equipment. At the federal level, the dollar amounts have been increased for economic stimulus purposes. Also, on a temporary basis, at the federal level, Section 179 also applies to off-the-shelf software purchases. Both tangible and intangible assets are crucial to businesses operating in today's information age. Section 179 is out-dated for only applying to tangible personal property.

Possible solution: Conform California law to federal Section 179 dollar amounts and assets. This will also simplify recordkeeping for businesses. In addition, encourage Congress to modernize Section 179 to apply to both tangible and intangible assets.

2) *Funding biases and missed opportunities:*

- *R&T Section 18152.5 (IRC Section 1202):* These rules provide a benefit to non-corporate taxpayers (such as individuals) who acquire original issue “qualified small business stock.” If the stock is held over 5 years, only 50% of the gain is taxable to the shareholder.¹² These provisions are an incentive for non-corporate taxpayers to invest in qualified small businesses. However, they only apply to stock issued by a C corporation.
- *Unfavorable treatment of a loan to a start-up:* A start-up company, which might consist of one or just a few individuals with an innovative idea to explore, will have limited sources of funds. Such a venture is too risky for traditional type loans. Credit card financing is often used as a last resort, but has very high interest

¹¹ For example, a report of the House Committee on Small Businesses noted that small businesses are reluctant to replace heating and ventilation systems even though doing so would enable them to have more energy efficient equipment. The Committee notes that the disincentive is due to the 39-year life for such equipment that likely has a life of only 15 to 20 years. Per the report, “By reducing the 39-year depreciation holding period, the tax code could be updated to both encourage investment and promote the use of green technologies.” *Seven Ways to Stimulate the Economy by Updating the Internal Revenue Code*, 4/10/08, page 10; <http://democrats.smallbusiness.house.gov/Reports/small-business-committee-tax-report.pdf>.

¹² Recent economic stimulus legislation has temporarily increased the gain exclusion percentage for federal income tax purposes.

rates. The start-up may not yet be at a stage to consider setting up a formal business structure such as a corporation that can issue stock to potentially attract funds. And, the venture may not have the funds for setting up such a structure. The founders may seek loans from friends and family members. These potential lenders may be reluctant though because in addition to the risk, if the debt cannot be repaid, the loss will be a short-term capital loss (IRC Section 166(d)).

If a C corporation could be set up (time and costs can be prohibiting factors though), original issue stock held by individual investors would likely be IRC Section 1244 stock (if the capitalization is \$1 million or less). If Section 1244 stock becomes worthless, the shareholder can treat up to \$50,000 of the loss as ordinary (\$100,000 if MFJ); such loss would otherwise be a capital loss.

Possible solutions: Not all ventures involved in innovative work operate as C corporations. Yet such ventures are equally in need of funding. Consideration should be given to whether an incentive comparable to IRC Section 1202 can be offered to individuals who invest in qualified partnerships or S corporations.

To help provide funds to start-up ventures, consideration should be given to modifying either IRC Section 166(d) or Section 1244 to allow all or part of any investment loss to be treated as ordinary. To prevent abuse, particularly where the venture is not a corporation (registered with a state), some other documentation should be required of the venture, such as registering as a business with the state or city and issuance of a copy of that documentation along with a description of the venture and amount of funds loaned.

Another possible solution to encourage investment in start-ups engaged in R&D and innovative work is to provide a tax credit to the investor. This could be similar in concept to the New Market Tax Credit (Section 45D).

Some states have enacted tax incentives for individuals investing in start-ups. For example, Minnesota's Angel Tax Credit "provides incentives to investors or investment funds that put money into startup and emerging companies focused on high technology or new proprietary technology." The credit is refundable.¹³

Another approach would be to provide tax credits to the person starting the venture. For example, Nebraska's Advantage Microenterprise Tax Credit Act provides "tax credits to applicants for creating or expanding microbusinesses that contribute to the revitalization of economically distressed areas through the creation of new or improved income, self-employment, or other new jobs in the area."¹⁴ Such a credit should be refundable; it need not include the requirement to locate in a particular area. The Corporation for Enterprise Development (CFED) observes that this type of credit can also help tax administration and address the tax gap because the new

¹³ Minnesota Department of Employment and Economic Development, Angel Tax Credit; http://www.positivelyminnesota.com/Business/Financing_a_Business/DEED_Business_Finance_Programs/Angel_Tax_Credit.aspx.

¹⁴ Nebraska Dept. of Revenue, Nebraska Advantage Microenterprise Tax Credit Act; <http://www.revenue.ne.gov/incentiv/microent/microent.html>.

entrepreneur will respond to the “positive incentive” to enter the tax system in order to claim the credit.¹⁵

Lessons can be learned from the states that have implemented these types of tax incentives to better ensure that any plan to use them in California benefits from them.

- 3) *Opportunity for R&D cash:* The federal research tax credit only rewards research performed in the U.S. In evaluating the after-tax costs of R&D activities, companies with foreign subsidiary earnings offshore, may find it is not cost effective to repatriate those earnings to be used in U.S. R&D activities. In addition, many countries offer research incentives which can further encourage the funds to remain offshore.

Possible solution: Encourage Congress to enact some type of repatriation tax holiday to encourage corporations to bring earnings (cash) to the U.S. A requirement could be added that the funds be used for innovation projects (R&D, worker training, purchase of R&D equipment, hiring, etc.). Should such legislation be enacted, California should be ready with incentives to encourage investment of the cash in California.

IV. Additional Recommendations

- 1) Review job creation data and modify the jobs credit accordingly

The \$3,000 jobs credit enacted in 2009 is underutilized. Consideration should be given to expanding the size of eligible employer form the current maximum of 20 employees. A recent *Wall Street Journal* article summarized net job creation data from the U.S. Bureau of Labor Statistics data for companies with less than 500 employees. The findings for 1992 through 2010:¹⁶

Company size based on number of employee	Net new jobs from 1992 through 2010
1 – 9	13%
10 – 49	19%
50 – 99	10%
100 – 499	22%
500 – 999	7%
1,000 or more	29%

¹⁵ CFED, "Policy Innovation: New Entrepreneur Tax Credit," http://scorecard.cfed.org/downloads/pdfs/innovationBriefs/InnovBrief_NETC.pdf. CFED suggests that to be effective, the credit should be available to sole proprietors, include a system for reaching out to eligible entrepreneurs, have a system for tracking who is using the credit to help measure its effectiveness, and keep the credit simple so it is easy to administer, such as by utilizing information that already exists on other tax forms.

¹⁶ Carl Bialik, "Sizing Up the Small-Business Jobs Machine," *Wall Street Journal*, October 15, 2011; <http://online.wsj.com/article/SB10001424052970203914304576630973840478808.html>.

Job creation data should be examined to get a better sense of what size businesses would best benefit from the incentive (perhaps those with under 500 employees). In addition, consideration should be given to modifying the incentive to be sure it results in concurrent (rather than delayed) cash benefit. For example, some portion of the credit could be made refundable. Alternatively, the credit could be against employer-paid payroll taxes rather than income taxes.

2) Study the California research tax credit formula and operation

California has not conformed to the alternative simplified credit that exists at the federal level in addition to the regular credit. It is likely that if the federal research credit is made permanent, it will only be for the simplified credit (see for example, S. 1577 (112th Congress)). One simplification of the simplified credit is that gross receipts are not part of the credit computation. Consideration should be given to conforming to the federal alternative simplified research credit and determining if California should continue to use the regular credit should it permanently expire at the federal level.

Data should be collected to determine if businesses have any challenges in utilizing the research credit and how it affects decisions on where to locate R&D activities. Questions should also explore any FTB examination issues exist and efforts should be made to resolve them. For example, a task force of taxpayers and FTB personnel could discuss how to utilize IRS examination results, recordkeeping and other examination issues.

3) Encourage Congress and the IRS to improve the federal research tax credit

Possible improvements for the federal research tax credit include:

- Make the research credit permanent (it currently expires for the 15th time on December 31, 2011).
- The regular credit's base years of 1981 to 1988 are arguably too old to justify what a credit should be more than 20 years later.¹⁷ Also, records may not exist or be adequate to enable an acquirer business to accurately calculate the regular credit. Consideration should be given to either updating the base years and having a system enacted for regular updates or repealing the regular credit.
- Consider removing or modifying the 50% base limitation for the regular credit as it has the effect of reducing the credit generated on higher amounts of QREs which likely indicates that more research was conducted.¹⁸ Avoid adding a minimum base requirement to the ASC as it

¹⁷ As noted by Treasury: "The regular credit formula, which determines the base amount with reference to the firm's research intensity (the ratio of its research spending to gross receipts) in the 1984 to 1988 period, clearly is outdated. There is little reason to believe that the firm's ratio of research spending to gross receipts from more than two decades ago, when multiplied by its average gross receipts over the prior four years, is an appropriate base for the taxpayer. In the context of a permanent R&E credit, that base amount will become increasingly irrelevant and arbitrary." Treasury Dept., *Investing in U.S. Competitiveness: The Benefits of Enhancing the Research and Experimentation (R&E) Tax Credit*, 3/25/11, page 8; <http://www.treasury.gov/resource-center/tax-policy/Documents/Research%20and%20Experimentation%20report%20FINAL.PDF>. Similarly, see GAO, *Tax Policy: The Research Tax Credit's Design and Administration Can Be Improved*, GAO-10-136, 11/6/09, page 16; <http://www.gao.gov/products/GAO-10-136>.

¹⁸ The 2009 GAO report, supra, page 16, suggests that the effect of the 50% base limit for the regular credit was to create a "windfall" for those taxpayers subject to it. It may be that this interpretation is because the nature of the regular credit formula results in a tax credit of 10% of current year QRE when the 50% base limit applies. Thus, it doesn't look like an incremental credit in that situation. The GAO statement takes the perspective that the

reduces the value of the credit for companies with significant increases in QREs, which is what the credit is intended to encourage and reward.¹⁹

- Consider only having one formula for the research tax credit for simplification purposes. The use of two different formulas requires taxpayer time to evaluate which is better in any year. Multiple credits also mean additional time spent by the IRS providing guidance. S. 1577 (112th Congress) proposes to let the regular credit expire and make the ASC permanent, with a higher rate. Advantages of this approach include that fewer definitions are involved (for example, “gross receipts” is only relevant for the regular credit), taxpayer and IRS time need not be spent trying to verify QRE and gross receipts for a set of years in the past for which they may not have adequate records.
- Allow the research tax credit to be used against AMT.
- Allow small and start-up businesses to have a refundable credit.
- To reduce audit difficulties and disputes, restate the purpose of the credit and what types of research activities qualify. In addition, the IRS should be encouraged to follow the GAO recommendation to “organize a working group that includes IRS and taxpayer representatives to develop standards for the substantiation of QREs that can be built upon taxpayers’ normal accounting approaches, but also exclude practices IRS finds of greatest threat to compliance, such as high-level surveys and claims filed long after the end of the tax year in which the research was performed.”²⁰
- To address concerns regarding credits claimed for the first time on amended returns, additional information can be provided and requested on business tax returns to help ensure that all taxpayers are aware of what R&D expenditures may qualify for a credit. For example, a statement can be provided explaining the credit with the question, did you engage in qualified research? There will be times when taxpayers may need additional time beyond the extended due date to compute their research credit, such as due to an acquisition or time needed to gather the necessary records to calculate the credit or determine how much of the R&D was qualified research.
- Review Section 41 in light of the types of business activities of today rather than the 1980s. In particular, consider whether the general exclusion for internal-use software should be clarified to be sure that it is not overly broad given the nature of how software is used today and of web-based technologies.
- Evaluate what an appropriate research credit benefit should be. This evaluation should consider the economics of spillover benefits and benefits to be derived to the economy from greater private investment in R&D, what other countries do to stimulate greater R&D spending, and the interaction with other tax incentives.
- As corporate tax reform discussions focus on reducing the corporate tax rate, consideration should be given to the global competitive realities that not only do other OECD countries have a lower statutory rate, but also tend to offer research tax incentives as well.

taxpayer had too low of a base amount. Another perspective, illustrated in the next footnote, is that current year QRE were higher than in base years and the 50% limit prevents all of the QRE increase from getting full benefit of the credit.

¹⁹ For example, under the ASC, if current year QRE = \$500 and the average of the prior 3 years of QRE is \$150, a credit of \$59.5 is generated (14% x [\$500 x (50% x \$150)]). This rewards the taxpayer for a greater amount of QRE (and QR) in the current year. If the base were limited to 50% of current year QRE, the taxpayer’s credit would be reduced to \$52.5 (14% x [\$500 x (50% x \$250)]).

²⁰ GAO, *Tax Policy: The Research Tax Credit's Design and Administration Can Be Improved*, GAO-10-136, 11/6/09, page 40; <http://www.gao.gov/products/GAO-10-136>.

- 4) Explore approaches for broadening the personal and corporate income tax base so as to lower the tax rate. Tax expenditures for the personal income tax and corporate income/franchise tax should be reviewed to identify items that can be eliminated or reduced that would also enable the tax system to better meet principles of simplicity, equity, neutrality and transparency. In addition, the choice of apportionment method for multistate business income should be repealed with single sales factor used in recognition of the reality that the corporate income tax has is becoming more of an economic development vehicle than a revenue generating vehicle among states today.
- 5) Develop a plan to phase out the sales tax on business purchases of manufacturing and R&D equipment. This can be funded by broadening the sales tax base for consumers to include consumption of personal services and digital goods.
- 6) Consider whether any state programs and expenditures hinder job creation and innovation in some way, such as excessive paperwork.
- 7) Consider the bigger picture for innovation that also includes the need for and availability of high quality education opportunities for everyone. Relevant education to promote innovation extends beyond science, math and engineering but also includes liberal studies and entrepreneurial business knowledge and skills. CSU and UC fees should be affordable to all California residents who meet the admissions criteria.
- 8) Consider the recent work of OECD on fostering innovation (see the *Innovation Strategy: Getting a Head Start on Tomorrow*). This project aims to help answer the questions of how governments can better encourage greater innovation and how government can be innovative.²¹
- 9) To better understand how much the government is investing in R&D and for data analysis, implement accountability measures that track not only direct spending on R&D, but also the spending in the tax law tied to special rules such as the research tax credit.²² A unified budget should be used that shows both direct and indirect ("tax expenditures") for key spending categories (education, R&D, housing, etc.).
- 10) Monitor federal discussions and proposals for tax reform and how they affect the State of California and its citizens and businesses. In 2011, the Senate Finance and House Ways and Means Committees held over 20 hearings on various aspects of tax reform. In November 2011, House Ways and Means Committee Chairman Camp introduced legislative language for a territorial (rather than worldwide) tax system and proposed reducing the corporate tax rate from 35% to 25%. He seeks comments on the proposal and plans to introduce individual and business tax reforms at a later date.²³ The tax committees of the California legislature, Legislative Analysts Office, Department of Finance and FTB should consider issuing comments to Congressman Camp and participating in future hearings on tax reform to be sure the state's perspectives and concerns are noted.

²¹ OECD, *OECD Innovation Strategy: Getting a Head Start on Tomorrow* (May 2010);

http://www.oecd.org/document/15/0,3746,en_2649_34273_45154895_1_1_1_1,00.html

²² A good example, is the White House's R&D Dashboard. It should include both direct spending and tax expenditures. See <http://www.whitehouse.gov/blog/2011/02/10/rd-dashboard-makes-federal-rd-data-transparent-and-accessible>.

²³ This plan is available at <http://waysandmeans.house.gov/taxreform/>.

I hope this testimony on promoting job creation and innovation is helpful in your crucial work to improve California's tax laws to enable them to meet principles of good tax policy and address today's ways of living and doing business. I would be pleased to take your questions. Thank you.