



DEPARTMENT OF AUDITS AND ACCOUNTS

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Honorable Brett Harrell
Chairman, House Ways and Means
133 State Capitol
Atlanta, Georgia 30334

SUBJECT: Fiscal Note
House Bill (LC 34 5494)

Dear Chairman Harrell:

The bill would establish the Alternative Simplified Credit (ASC) as an alternative means of claiming a state income tax credit for research and development (R&D) activities. The ASC would equal 7 percent of the value of qualified ASC R&D expenditures as defined in the federal Internal Revenue Code Section 41, except only expenditures from research activity in Georgia would be qualified for the state credit. The bill would be effective for all tax years beginning on or after January 1, 2020. The bill leaves unchanged the existing state income tax credit for R&D activities.

Impact on State Revenue

Georgia State University's Fiscal Research Center (FRC) estimated state revenue reductions of approximately \$10 million to \$12 million annually for FY 2021 through FY 2024. Absent other available data, the estimate is based on the growth rate of federal R&D credits once an alternative method was introduced in 2006. Given the length of time since the federal credit introduction, the recession that likely impacted R&D credits later in the decade, and other factors, Georgia may experience a different growth rate in R&D credits. Further discussion of FRC's analysis is included in the appendix.

Table 1. Projected Revenue Loss, LC 34 5494

<i>(\$ millions)</i>	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024
State Revenue Loss	\$3.7	\$10.8	\$11.9	\$9.7	\$10.3

Impact on State Expenditures

The Department of Revenue would incur one-time and ongoing costs as a result of the bill. One-time costs of approximately \$7,500 would be incurred for form updates, regulation drafting, as well as supplies and pre-employment expenses for an additional tax examiner. An additional tax examiner to account for additional taxpayers claiming the credit would cost \$85,000 annually.

Sincerely,



Greg S. Griffin
State Auditor



Kelly Farr, Director
Office of Planning and Budget

GSG/KF/mt

Analysis by the Fiscal Research Center

Under current law, Georgia allows a tax credit of 10 percent of qualified R&D expenditures over their base amount, where the base amount equals the firm's gross receipts for the current taxable year multiplied by the lesser of 30 percent or the average of the ratio over the past three years of a firm's qualified research expenses to state gross receipts.

This legislation modifies current law by establishing an alternative tax credit for qualified research expenditures. This alternative credit is modeled after the existing federal ASC. The federal ASC provides a 14 percent credit for qualified research expenditures which are in excess of 50 percent of the base amount, where the base amount equals the average research expenses over the past three years. In the case of a firm with no research expenses in the past three years, the ASC rate is 6 percent. The proposed legislation establishes a state ASC with a rate of 7 percent. Because the proposed legislation does not make a distinction between firms with past research expenses or not, the estimate assumes that the same rate would apply in both cases. Because the legislation does not alter the definition of qualified expenses, the estimate assumes these remain unchanged from their current definition under present law.

Based on our understanding of the proposed ASC structure, firms with high taxable income but relatively low R&D expenses will be more likely to use the ASC formula compared to the existing credit. This is because under the current credit structure the qualified expenditure threshold equals the minimum of 30 percent of a firm's taxable income for that year or the average of the ratio over the past three years of a firm's qualified expenses to taxable income. Therefore, the existing tax credit favors firms with low taxable income and higher qualified expenditures. Under the proposed ASC, the value of the credit is not determined by the level of taxable income and is only a function of the average qualified expenditures over the past three years.

Examples of ASC Impact

If the subject legislation has an effect on research activities in Georgia, it is likely to reduce state revenues. This is because: (1) some firms that would otherwise take the existing R&D credit will switch to the ASC and become eligible for a larger credit; (2) firms that do not currently qualify for the credit could become eligible with the introduction of the ASC. These two possibilities are developed in further detail below.

1. Does the eligible credit amount increase under the ASC?

In the example shown below, the firm currently receives a tax credit of \$8,500 for their research activities. Based on our understanding of the proposed ASC, the example firm would receive a credit equal to \$15,167 under the ASC which is a gain of 78 percent. The degree to which the firm receives more under the ASC compared to the current credit is dependent on the value of a firm's taxable income relative to its average qualified expenses over the past three years. The higher a firm's taxable income, the more the firm must spend on R&D in order to exceed the base amount and earn credits under current law.

Example Calculation #1 –

Assume the following:

Qualified expenses for 2019 = \$325,000, Taxable income for 2019 = \$800,000

Qualified expenses for 2018 = \$300,000, Taxable income for 2018 = \$750,000

Qualified expenses for 2017 = \$200,000, Taxable income for 2017 = \$600,000

Qualified expenses for 2016 = \$150,000, Taxable income for 2016 = \$500,000

Compute credit under current Georgia method –

Ratio of qualified expenses to taxable income for 2018 = 0.40

Ratio of qualified expenses to taxable income for 2017 = 0.33

Ratio of qualified expenses to taxable income for 2016 = 0.30

Average ratio of qualified expenses to taxable income for the three prior years = 0.34

Threshold ratio of qualified expenses to taxable income for the three prior years = 0.30

Current law credit base for 2019 = $\$800,000 \times 0.30 = \$240,000$

Current law credit rate = 0.10

Current law credit for 2019 = $0.10 \times (\$325,000 - \$240,000) = \$8,500$

Compute credit under proposed ASC -

Average of qualified expenses for three prior years = \$216,667

ASC base for 2019 = $0.50 \times \$216,667 = \$108,333$

ASC credit rate = 0.07

ASC for 2019 = $0.07 \times (\$325,000 - \$108,333) = \$15,167$

2. Will additional firms apply for the credit?

In the example shown below, the high taxable income increases the base over which expenditures would be qualified for a credit. Because the existing level of qualified expenses does not exceed this threshold, no credit is earned under current law. On the other hand, because the ASC calculation does not include the firm's level of taxable income, the firm would qualify for a credit using that formula.

Example Calculation #2–

Assume the following:

Qualified expenses for 2019 = \$325,000, Taxable income for 2019 = \$2,000,000

Qualified expenses for 2018 = \$300,000, Taxable income for 2018 = \$1,500,000

Qualified expenses for 2017 = \$200,000, Taxable income for 2017 = \$1,250,000

Qualified expenses for 2016 = \$150,000, Taxable income for 2016 = \$1,000,000

Compute credit under current Georgia method –

Ratio of qualified expenses to taxable income for 2018 = 0.20

Ratio of qualified expenses to taxable income for 2017 = 0.16

Ratio of qualified expenses to taxable income for 2016 = 0.15

Average ratio of qualified expenses to taxable income for the three prior years = 0.17

Threshold ratio of qualified expenses to taxable income for the three prior years = 0.30

Current law credit base for 2019 = $\$2,000,000 \times 0.17 = \$340,000$

Current law credit rate = 0.10

Current law credit for 2019 = \$0, because qualified expenditures do not exceed the base amount of \$340,000

Compute credit under proposed ASC -

Average of qualified expenses for three prior years = \$216,667

ASC base for 2019 = $0.50 \times \$216,667 = \$108,333$

ASC credit rate = 0.07

ASC for 2019 = $0.07 \times (\$325,000 - \$108,333) = \$15,167$

Calculation of the Estimate

The estimate provided in Table 1 is consistent with estimates of this credit presented in the FY 2020 tax expenditure report and assumes a current law baseline of \$87 million in CY 2020. The federal ASC was introduced in 2006. Over the 2005-2008 period, the total value of federal R&D credits increased by 13 percent in 2006, 14 percent in 2007, and 0.6 percent in 2008. Applying these growth rates to the baseline of Georgia R&D credits, provides the estimate presented in Table 1.

The estimate is speculative for several reasons. First, the growth rates in 2008 are likely significantly impacted by the recession, thus it is possible that projected growth wouldn't slow in the third year to the degree assumed, absent a recession. Under that scenario, the fiscal impact would increase. In addition, the annual utilization of the credit is especially volatile over the earlier periods because the federal credit was allowed to expire and was then reinstated, typically retroactively, before being made permanent in 2015. Finally, the growth in total federal credits in the early years of availability of the ASC that would have occurred anyway, absent the ASC, cannot be known. Thus, the growth in total credits may only be partially attributable to the ASC and the historical growth rates may overstate the ASC's impact.