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California Tax Policy and Biotechnology

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California Tax Incentives Used by Biotechnology Industries

California Has a Number of Tax Programs That Benefit Biotechnology Industries

- Research and Development Tax Credit—California Revenue and Taxation Code Sections 17052.12 and 23609.
- Research and Development Accelerated Depreciation—California Revenue and Taxation Code Sections 17201 and 24365.
- Manufacturers' Investment Credit (Carryover of existing credits only)—California Revenue and Taxation Code Sections 17053.49 and 23469.
- Net Operating Loss Carryover—California Revenue and Taxation Code Sections 17276 and 24416.
- Manufacturers' Investment Exemption—California Revenue and Taxation Code Section 6377.
- Other General Tax Incentives.

Some of the Above Programs Are Geared Towards Increasing General Economic Activity and Investment

Other Programs Specified Have Specific Provisions Directed Towards Biotechnology Activities

Research and Development Tax Credit

Basic Program Outline

- Equal to 15 percent of qualified research and development (R&D) expenditures and 24 percent of basic research expenditures.
- Available for both Personal Income Tax (PIT) and Corporation Tax (CT) taxpayers.
- Incremental credit based on the increase in R&D expenditures over a base period of previous expenditures.
- Unused credits may be carried over into future tax years until they are fully used.

Research Expenditure Requirements

- *Qualified* R&D expenditures under the program must be technological in nature and have business applications. Qualified research activities may be carried out by the taxpayer.
- *Basic research* under the program must advance scientific knowledge or improve performance of existing products (CT only). Basic research activities must be conducted by qualified research institutions which, for biotechnology companies, includes certain medical organizations and research hospitals.

Additional Program Information

- Generally conforms to similar federal program (Internal Revenue Code Section 41).
- The credit for qualified R&D expenditures was increased from 11 percent to 12 percent for 1999 and to 15 percent for 2000 and thereafter.
- More generous program rules apply with respect to the amount of qualified expenditures that can be claimed by start-up companies.
- Research expense deductions are reduced by a tax equivalent amount whenever the R&D tax credit is claimed.
- Estimated foregone revenue from the R&D credit for 2003-04 is $34 million for PIT and $625 million for CT. Approximately $5 billion in R&D credits have been carried over from prior years and remain unclaimed.

Research and Development Accelerated Depreciation

☑ Basic Program Outline

- Allows taxpayers to (1) immediately deduct as an expense or (2) more rapidly amortize certain capital expenditures related to research, development, and experimentation.
- Available for both PIT and CT taxpayers.
- Generally, no deduction is allowed for R&D expenditures that have been claimed as a credit under the R&D tax credit program.

☑ Additional Program Information

- California generally conforms to a similar federal program (Internal Revenue Code Section 174).
- Estimated foregone revenue from accelerated depreciation of R&D expenses for 2003-04 is $6 million for PIT and $170 million for CT.

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Net Operating Losses (NOLs)

Basic Program Outline

- A deduction for operating losses from business activities is available to PIT and CT taxpayers.
- If the NOL amount cannot be used by the taxpayer in the year that it is incurred, a portion can generally be carried over into subsequent tax years for a period of up to ten years.
- Prior to 2004, only a percentage of losses could be carried over. Beginning in 2004, 100 percent of losses can be carried over and be deducted beginning in 2005.
- New businesses, small businesses, and (under certain conditions) taxpayers engaged in biopharmaceutical or biotechnology businesses, have been allowed for several years to deduct 100 percent of NOL carryovers.

Additional Program Information

- The most recent change in the carryover percentage occured in Chapter 488, Statutes of 2002 (AB 2065, Oropeza), as part of the 2002-03 budget agreement.
- Federal law generally allows 100 percent carryover for a period of 20 years and a carryback of up to two years. In other respects, California generally conforms to Internal Revenue Code Section 172.
- Currently, approximately $155 billion in unclaimed NOLs remain "on the books."
- Due to a temporary suspension of NOL deductions, revenue losses in 2002-03 and 2003-04 were limited to claims on prior years' returns. In 2004-05, revenue losses are estimated to be $500 million.

Other General Tax Incentives

☑ **California makes various other types of tax incentives available to all types of business that engage in particular types of investment or activities. These incentives include:**

- Exemption from minimum tax for qualified new businesses.
- Exemption from the Alternative Minimum Tax for certain small businesses.
- Partial exclusion of capital gains on small business stock.
- Exclusion of income for corporations electing "Water's Edge" designation.
- Reduced corporate taxation of income for Subchapter S corporations.

☑ **Various federal tax incentives also are available. These include:**

- Tax credit of 20 percent for qualified R&D expenditures and basic research payments.
- Accelerated depreciation for certain research and experimental expenditures.

Tax Incentives Raise Various Issues

Tax Treatment Typically Has a Limited Effect on Investment Decisions

- Investment decisions by businesses and individuals are likely more strongly affected by cost factors, technological factors, and overall economic circumstances than by state and federal tax policy.
- When tax policies do result in impacts, the federal effect overshadows the state effect, due largely to relative tax rates.

Programs May Have Sizeable Revenue Costs

- In order to generate enough benefits to have a sizeable effect in terms of investments, tax incentive programs may result in large revenue losses, at least in the short term.
- Some of the benefits from tax incentives, in terms of increased economic activity, may not occur until a significant amount of time has elapsed, while state revenue losses tend to be immediate.
- The effectiveness of state tax policies can be significantly diminished by "leakages" to other states and the federal government (due to the deductibility of state taxes).

Most Programs Will Result in Providing Some Tax Benefits to Taxpayers Whose Behavior Is Not Affected

- While tax incentives can encourage additional investment under the right circumstances, a portion of the benefits will go to those who would have undertaken particular investments even in the absence of the special tax treatment—resulting in winfall benefits.

Legislative Considerations Related toTax Incentives

Incentives That Are Adopted Should Include Specific Performance Criteria

- Establishing performance threshholds using established data—such as employment levels—may be a suitable approach in some cases.
- In other situations, additional data may need to be provided by the taxpayer or other sources in order to allow for a thorough analysis of the program.
- In general, tax incentives should be limited to a particular time period and either sunset or be subject to periodic review to determine their effectiveness.

Some Approaches Can Improve the Efficiency of Tax Incentives

- The incentive aspect of a tax program can usually be increased by restricting the availability of the program such that only the "incremental" expenditure is eligible for favorable treatment—as has been attempted with the R&D tax credit.
- "Monetizing" certain tax incentives could provide capital for businesses with start-up and expansion needs. This could be restricted to a certain dollar amount or to firms meeting certain criteria in order to limit state revenue losses.

Alternative Approaches May Be Worth Legislative Consideration

- Broad-based tax reductions—if budgetarily feasible—are generally a more equitable approach of granting tax relief.
- Direct expenditures—such as through the University of California system—may have a more direct impact on particular activities and can target specific areas of market failure.

Tax Programs In Selected Other States

State of New York

- Deferral of capital gain on sale of emerging technology investments (PIT and CT).
- Tax credit for investment in R&D property (PIT and CT).
- Tax credit based on employment and capital investment for emerging technology companies (PIT and CT).
- Exemption of personal property related to R&D activities (sales and use tax).

Commonwealth of Massachusetts

- Accelerated depreciation of R&D property (PIT and CT).
- Tax credit for investment in R&D property (PIT and CT).
- Tax credit for increased investment in R&D expenditures (PIT and CT).

State of New Jersey

- Upon approval, biotechnology businesses can sell their unused NOLs and R&D tax credits to any corporate taxpayer.
- The sale must be for at least 75 percent of the value of the tax benefit.
- Participation in the program is subject to an application process and limited to $40 million in transferred credits annually.
- Hawaii and Connecticut have similar programs in place.