



## Legislative Fiscal Bureau

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November 30, 2005

TO: Members  
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Senate Substitute Amendment 2 to Senate Bill 103: Research Tax Credits for Research and Facilities Related to Designing Internal Combustion Engines for Vehicles

Senate Bill 103, which would provide increased research tax credits for research related to designing and producing internal combustion engines was introduced on March 8, 2005, and referred to the Senate Committee on Job Creation, Economic Development, and Consumer Affairs. SB 103 was withdrawn from that Committee on March 23, and referred to the Joint Committee on Finance. On March 30, the bill was withdrawn from the Joint Committee on Finance and referred back to the Senate Committee on Job Creation, Economic Development, and Consumer Affairs. Senate Substitute Amendment 2 to SB 103 was introduced on May 13, 2005, and was passed by the Senate Committee on Jobs Creation, Economic Development and Consumer Affairs on May 27, 2005, by a vote of 4 to 1. SSA 2 to SB 103 was re-referred to the Joint Committee on Finance on June 9, 2005.

### **CURRENT LAW**

Research Tax Credit. The state research tax credit is provided under the corporate income and franchise tax and is equal to 5% of the increase in a corporation's qualified research expenditures in Wisconsin over the base amount. The "base amount" is calculated by multiplying the taxpayer's average annual gross receipts for the preceding four years by a fixed-base percentage. However, the base amount does not include sales treated as throwback sales in the corporate apportionment formula. The "fixed-base" percentage is the percentage that the taxpayer's total aggregate qualified research expenditures for a specified period is of the taxpayer's total gross receipts for those years. The fixed-base percentage cannot exceed 16%. In addition, the base amount cannot be less than 50% of research expenses in the year for which the credit is claimed.

Consequently, the state research credit is 5% of the lesser of: (a) the excess of current year research expenses over the base amount; or (b) 50% of current year research expenses.

Start-up companies must use a minimum fixed-base percentage of 3% for the first five tax years in which a credit is claimed. As a result, start-up companies must spend 3% of their gross receipts on research in order to qualify for the credit. For years six to ten, the percentages are an increasing portion of the percentage which qualified research expenses bear to gross receipts for certain prior years. A "start-up company" is defined as a firm that, during the five-year period used to compute the fixed-base percentage, has fewer than three taxable years in which the taxpayer had both gross receipts and qualified research expenses.

The tax credit applies only to research expenditures paid or incurred in connection with the trade or business of the taxpayer that are research and development costs in an experimental or laboratory sense. In general, qualifying expenses are noncapital, and do not include spending for buildings and equipment. Qualified research expenditures are the sum of: (a) in-house expenditures for research, wages, and supplies used in research, plus certain amounts paid for research use of laboratories, equipment, computers, or other personal property; and (b) 65% of the amount paid by the taxpayer for qualified research conducted on behalf of the taxpayer. Examples of eligible costs include: (a) the costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property; and (b) the cost of improving this type of property. Qualified research is research which is undertaken for the purpose of discovering information which is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. In addition, substantially all of the activities of research must be elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality.

Corporations may elect to determine the research credit under the federal alternative research credit rules. Under these rules, the research credit is the difference between certain percentages of average gross receipts and actual research expenses.

In all cases, only the expenses for eligible research activities conducted in Wisconsin qualify for the credit. If the credit amount exceeds the corporation's tax liability, it is not refundable, but unused amounts can be carried forward fifteen years to offset future tax liabilities.

For the 2003-04 tax processing year, a total of \$97.1 million in research tax credits, including unused carry-forwards, was claimed, while approximately \$14.2 million was used to offset tax liabilities for that year. The unused credit amounts will be carried forward to offset future tax liabilities. In that year, 324 corporations claimed the research tax credit.

Research Facilities Tax Credit. The research facilities tax credit is provided under the corporate income and franchise tax and is equal to 5% of the annual expenditures for constructing or equipping new facilities or expanding existing facilities in Wisconsin to conduct qualified research activities. Qualified research activities are defined as those eligible for the research

expense tax credit. Eligible capital expenditures include only amounts paid or incurred for tangible depreciable property but do not include expenditures for replacement property. This credit is not refundable, but can be carried forward to offset corporate income and franchise tax liability up to fifteen years.

Aggregate data for processing year 2003-04 indicate that the total amount of research facilities tax credits that were claimed, including carry-forwards, was \$13.7 million. Of that total, approximately \$2.5 million was used to offset tax liabilities, and the remaining unused credit amounts were available to be carried forward to future tax years. A total of 63 corporations claimed the research facilities tax credit.

## **SUMMARY OF SUBSTITUTE AMENDMENT**

Senate Substitute Amendment 2 to Senate Bill 103 would increase the research and research facilities tax credits to 10% for research related to engine production and engine and vehicle design. Specifically, the research tax credit would equal 10% of the increase in a corporation's qualified research expenditures in Wisconsin over the base amount. The research facilities tax credit would equal 10% of the amount paid or incurred to construct and equip new facilities or expand existing facilities used in the state for qualified research. To be eligible for the 10% tax credit, "qualified research expenses" could include only expenses paid or incurred by the claimant for research related to designing internal combustion engines for vehicles, including expenses related to designing vehicles that are powered by such engines and improving production processes for such engines and vehicles. A claimant could compute the 10% research tax credit using a different computation method than it used for computing the 5% research tax credits, and could change the computation method once for each credit without approval from the Department of Revenue.

"Internal combustion engine" would be defined to include substitute products such as fuel cell, electric and hybrid drives. "Vehicle" would mean any vehicle or frame, including parts, accessories, and component technologies, in which an engine is mounted for use in mobile or stationary applications. "Vehicle" would include any truck, tractor, motorcycle, snowmobile, all-terrain vehicle, boat, personal watercraft, generator, construction equipment, lawn and garden maintenance equipment, automobile, van, sports utility vehicle, motor home, bus, or aircraft.

"Frame" would mean:

- a. Every part of a motorcycle, except tires.
- b. In the case of a truck, the control system and the fuel and drive train, excluding any comfort features located in the cab, or the tires.
- c. In the case of a generator, the control modules, fuel train, fuel scrubbing process, fuel mixers, generator, heat exchangers, exhaust train, and similar components.

The 10% research and research facilities tax credits would be provided for tax years beginning after December 31, 2006.

## **FISCAL EFFECT**

Senate Substitute Amendment 2 to Senate Bill 103 would provide an expanded 10% tax credit under the corporate income and franchise tax, for tax years beginning after December 31, 2006, for qualified research expenses related to production and design of internal combustion engines. Based on data compiled by the Department of Revenue from the 2001 corporate income tax sample, it is estimated that the proposed increased research and research facilities tax credits would reduce state corporate income and franchise tax revenues by an estimated \$1.1 million in 2006-07 and \$2.5 million annually thereafter.

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