

Preliminary Report Highlights on the Research and Development Tax Credit Program

Senate Resolution 20 and House Resolution 127 call on the LB&FC to assess the effectiveness of 18 tax credit programs. Highlights of this preliminary report (a final report covering all the programs is due by March 2010) on the Research and Development (R&D) tax credit program include:¹

- **The R&D program provides tax credits for qualified research conducted in PA that exceeds a base year amount as calculated through a statutory formula.** PA businesses conducting qualified research can receive tax credits, but only for their increases in research expenses over prior years. Businesses with assets over \$5 million or more are eligible for credit of 10% of the excess of qualified expenses over their base amount; for small businesses (under \$5 million) the credit increases to 20%. The R&D tax credit program is administered by the Department of Revenue and is capped at \$40 million annually (with \$8 million set aside for small businesses). The program is scheduled to terminate in December 2015.
- **PA's R&D program is patterned after the federal program.** Although certain features differ (e.g., in the PA program, businesses can sell unused tax credits), PA's R&D statute uses the same definitions as the federal program as to what constitutes "qualified research". Businesses also use IRS Form 6765 (or similar document) when applying for the PA credit.
- **The R&D program receives more applications for credits than are available.** In 2008, 554 businesses received R&D tax credits, 240 of which were small businesses. Applications from these 554 businesses totaled \$82.7 million. Because the program is capped at \$40 million, the tax credits were prorated among eligible applicants as provided for in the program's enabling legislation (Act 1997-7).
- **The Department of Revenue needs to improve how it verifies that tax credits are only awarded for qualified purposes.** The Department of Revenue relies heavily on information businesses are to provide to the IRS when claiming the federal research credit. But the Department does not verify this information with the IRS, and not all businesses claiming the PA credit also claim the federal credit. *Tentative Recommendation:* The Department of Revenue should verify the information its applicants provide against IRS records.
- **The PA R&D application does not require that businesses list where the research was conducted.** In six of the 39 applications we reviewed, the business address on the application was not a Pennsylvania address. While it is quite possible that a non-Pennsylvania business could incur qualified research expenses in Pennsylvania, neither we nor the Department of Revenue had any ready way to verify where the expenses were incurred. *Tentative Recommendation:* The Department of Revenue should revise its R&D tax credit application to require businesses to (1) provide the address where the research is taking place and (2) specifically attest that the research expenses were incurred in Pennsylvania.
- **Although called the Research and Development Tax Credit program, credits can only be awarded for research, not development.** The PA act does not define the terms "research and development," but rather refers to the definition used in the federal research tax credit program. Because businesses can only obtain credits for activities that meet the federal definition of "qualified research," the use of the term "development" in the PA statute is confusing and implies that credits are available for activities other than research. *Tentative Recommendation:* If the R&D Tax Credit program is extended beyond 2015, it be renamed simply the Research Tax Credit.

¹This is a preliminary report, and as such does not include all the findings and information we anticipate including in the final report. These additional findings and information may be material to a reader's conclusions regarding this program.