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Research & Development Tax Credit Program and Stranded Credits

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Issue

Briefly explain the state's research and development (R&D) tax credit program. How many "stranded" R&D credits are there? What programs has the legislature enacted in recent years to address these stranded credits?

Summary

Connecticut's R&D tax credit generally applies to (1) R&D spending a business incurs in the state to develop or improve a product and (2) qualifying research payments it makes to nonprofit organizations (CGS § 12-217n). Businesses calculate their tentative R&D tax credit amount according to a statutory schedule and then apply a separate formula to determine the amount they can claim on their corporation income tax returns. The credit amounts generally range from 1% to 6%, depending on the R&D expenses paid or incurred; the amount of R&D credits a business can claim on its corporation income tax return generally may not exceed one-third of its tentative tax credit amount. Businesses may carry forward unused tax credits to subsequent income years until they are fully taken.

Department of Revenue Services (DRS) data for the 2018 income year indicates that there is nearly $1.8 billion in unused or "stranded" R&D credits that Connecticut taxpayers have earned but have not yet applied to reduce their tax liability.

In 2017, the legislature enacted two new programs to allow corporation income taxpayers with stranded credits to use the credits in exchange for undertaking certain capital projects or making

corporate venture fund investments. The capital projects program is designed to allow businesses to exchange stranded credits for a project that (1) expands the business's scale or scope, (2) increases employment at the business, or (3) generates a substantial return to the state's economy. The venture capital investment program allows companies to use stranded credits for making eligible venture capital investments in Connecticut start-up businesses or spin-off companies from the company's R&D department.

The total amount of stranded credits that may be exchanged under these programs is $50 million. According to the Department of Economic and Community Development (DECD), one company has applied and received approval for a credit allocation under the capital projects program, but there has been no activity under the venture capital investment program. The remaining balance for both programs is $44 million.

R&D Credit Program Overview

The state's R&D tax credit is one of two corporation income tax credits available to business taxpayers incurring qualifying R&D spending in Connecticut. The credit generally applies to (1) R&D spending a business incurs in the state to develop or improve a product and (2) qualifying research payments it makes to nonprofit organizations (i.e., nonincremental R&D spending) (CGS § 12-217n). The other credit, known as the research and experimental expenditures (R&E) tax credit, applies to R&D spending a business incurs in Connecticut that exceeds the amount it spent during the preceding income year (i.e., incremental R&D spending) (CGS § 12-217j).

We provide a brief explanation of the R&D tax credit below. For a more detailed description, see OLR Report 2015-R-0217.

Eligible R&D Spending

The R&D credit generally applies to (1) federally-deductible R&D spending a business incurs and (2) qualifying "basic research payments" it makes that are eligible for a federal R&D tax credit. (Basic research payments, as defined under federal law for purposes of the federal R&D tax credit, include payments a business makes to qualifying nonprofit educational institutions, scientific research organizations, or grant organizations.) In both cases, the expenditures or payments must (1) be paid or incurred by the business for R&D and basic research conducted in Connecticut and (2) not be funded by any grant or contract with a public or private entity, unless the entity is included in a combined return with the business paying or incurring the expenses (CGS § 12-217n(b)). In addition, the R&D spending must exclude any R&D expenses that the business claims under the R&E tax credit program (CGS § 12-217n(h)).

Credit Amount

Tentative Tax Credit Amounts. With two exceptions, businesses calculate their tentative tax credit amounts according to the statutory schedule shown in Table 1. The exceptions are for qualified small businesses and certain companies headquartered in an enterprise zone (CGS § 12-217n(c)).

Table 1: Tentative R&D Tax Credit Amounts

R&D Spending	*Credit Percentage*
$50 million or less	1%
Greater than $50 million, up to $100 million	$500,000 plus 2% of R&D spending that exceeds $50 million
Greater than $100 million, up to $200 million	$1.5 million plus 4% of R&D spending that exceeds $100 million
Greater than $200 million	$5.5 million plus 6% of R&D spending that exceeds $200 million

Eligible small businesses (i.e., those with gross incomes for the previous income year of $100 million or less) qualify for a tentative credit of 6% for all of their R&D spending. Companies headquartered in an enterprise zone that (1) employ more than 2,500 people and (2) have annual revenues exceeding $3 billion qualify for a tentative credit of 3.5% of their R&D spending or the generally applicable tax credit percentage, whichever is greater.

Businesses that spend more than $200 million on R&D in an income year must reduce their tentative tax credit amount if they make certain workforce reductions. The amount of the reduction depends on the extent to which the business reduced its historical Connecticut wage base during the year by transferring work to locations in other states (CGS § 12-217n(f)).

Allowable Tax Credit Amounts. Once a business has calculated its tentative tax credit and applied any wage base reduction, it must calculate its allowable tax credit (i.e., the amount it can claim on its corporation income tax return) according to a three-part formula. The allowable amount may not exceed one-third of its tentative tax credit amount, after applying any wage base reduction (CGS § 12-217n(d)).

Eligible small businesses that cannot claim an R&D credit in any year for which they are eligible because they have no tax liability can exchange the credit for a cash refund. The refund is equal to 65% of the credit amount. To qualify for the exchange, the business must have a gross income for the previous income year of $70 million or less, including income derived from transactions with related entities. A business may not receive more than $1.5 million in tax credit refunds for any one income year (CGS § 12-217ee).

Credit Cap and Carry Forward

The law caps at 50.01% the amount by which a company may reduce its corporation income tax liability using R&D credits and other tax credits (CGS § 12-217zz, as amended by PA 19-117, § 349). Businesses may carry forward unused tax credits to subsequent income years until they are fully taken. They must claim allowable tax credits from prior years before applying credits earned during the current income year (CGS § 12-217n(d)).

Stranded R&D Credits

During the 2017 income year (the most recent year for which data is available), corporation income taxpayers claimed 162 R&D tax credits, totaling nearly $7 million. That same year, taxpayers reported nearly $1.8 billion in R&D credits being carried forward to the 2018 income year. This $1.8 billion figure represents the total unused or "stranded" R&D credits that Connecticut taxpayers have earned but have not yet applied to reduce their tax liability.

Table 2 shows how the amount of stranded R&D credits has grown over the past 10 years. For 2008 through 2017, it provides the number and amount of R&D credits claimed and the total credits carried forward to the subsequent income year. As it shows, R&D credits carried forward have increased from approximately $964 million in 2008 to $1.8 billion in 2017, an 85% increase. The number and amount of credits claimed over this same period remained relatively steady, with the exception of a spike in the amount of credits claimed during the 2015 income year. DECD's 2018 Annual Report (p. 44) indicates that the 2015 increase is due to claims from the Transportation Equipment Manufacturing sector.

Table 2: R&D Credits Claimed and Carried Forward, 2008-2017

Income Year	Credits Claimed		Credits Carried Forward
	Number	Amount	
2017	162	$6,789,883	$1,786,183,639
2016	159	6,343,794	1,736,898,172
2015	162	64,941,509	1,744,999,718
2014	162	8,419,918	1,786,267,915
2013	163	7,003,450	1,751,232,830
2012	145	5,392,832	1,498,739,414
2011	134	4,968,847	1,447,870,674
2010	153	4,585,699	1,226,473,987
2009	155	5,809,064	1,104,048,647
2008	130	4,827,816	963,639,060

Source: Department of Revenue Services' annual reports

Stranded Tax Credit Programs

In 2017, the legislature created two new programs to allow businesses to exchange their stranded (referred to as accumulated in the law) R&D credits for undertaking certain capital projects or making corporate venture fund investments (PA 17-2, June Special Session, §§ 701-703; codified as CGS §§ 12-217aaa & -217bbb). In 2018, the legislature expanded the venture capital stranded credit program by allowing any taxpayer with stranded R&D or R&E credits to transfer or sell their credits to other taxpayers to redeem under the program (PA 18-178, § 50).

Capital Projects

The stranded tax credit program is designed to allow businesses to exchange stranded R&D credits for an in-state capital project that (1) expands the business's scale or scope, (2) increases employment at the business, or (3) generates a substantial return to the state's economy.

Businesses must apply to DECD to use their stranded credits under this program. The application must include (1) a detailed plan of the capital project, (2) the project's term and estimated cost, and (3) the amount of stranded tax credits the business proposes to use. The DECD commissioner must (1) perform an econometric analysis of each proposed project and (2) approve only those projects that he determines will generate state revenue in excess of the amount of stranded tax credits proposed for use.

The DECD commissioner, in consultation with DRS and the Office of Policy and Management, must determine when a business may claim its stranded tax credits. He may not approve a business's use of the credits before its capital project has generated enough revenue to cover the credits' cost to the state. Stranded credits may be claimed against the corporation business and sales and use taxes.

Venture Capital Investments

Businesses have two options for using stranded tax credits in exchange for venture capital investments: tax credit auctions (termed "innovation investment fund tax credit auctions") or agreements in lieu of auctions. In either case, they may exchange stranded R&D or R&E credits for qualifying investments.

The DECD commissioner must continue to hold auctions or proactively seek agreements until at least two deals with different corporate venture funds are reached, after which he may hold additional auctions or seek additional agreements at his discretion. DECD may hold auctions or enter into agreements for five years after the first auction or agreement, whichever is earlier.

Auctions. The law requires the DECD commissioner, in consultation with the DRS commissioner and Connecticut Innovations (CI) CEO, to hold tax credit auctions whenever and as often as he determines is appropriate and effective.

For each auction, the DECD commissioner, in consultation with the CI CEO, must specify the (1) information that a bid must include, (2) submission deadline, and (3) minimum number of cents for each dollar of accumulated credits that may be bid. Bidders must submit sealed bids. The DECD commissioner, in consultation with the CI CEO, must select the winning bid or bids based on the amount the bidder proposes to invest and the amount of stranded tax credits the bidder proposes to exchange, as well as any other criteria they deem appropriate.

The DECD commissioner must invest the amount received from the winning bidder or bidders in the winning bidder's corporate venture fund. All investments must be made under the advisement of a CI representative, who must be a member of the corporate venture fund's investment committee. The law also requires that the:

1. amount invested into a corporate venture fund under this program be between $5 million and $10 million;

2. investments be in (a) in-state startup businesses or (b) in-state spin-off companies from the bidder's R&D department;

3. portion of profits from such investments be divided evenly between the bidder and the state, which must deposit its portion into the General Fund; and

4. bidder must agree to reinvest the profits attributable to such investments in the bidder's venture fund.

Agreements in Lieu of Auctions. Instead of holding a tax credit auction, the DECD commissioner may, in consultation with the CI CEO, enter into an agreement with a taxpayer that has accumulated tax credits to allow the taxpayer to use the credits in exchange for making an investment in its corporate venture fund under the same conditions that apply to investments made through auctions. The number of cents per dollar of accumulated tax credit may be negotiated by the DECD commissioner, in consultation with the DRS commissioner, with the taxpayer.

Claiming Credits. Beginning July 1, 2020, the credits allowed for corporate venture fund capital investments may be claimed against the (1) sales and use tax or (2) corporate business tax, regardless of any applicable tax credit caps. Taxpayers may not claim any credits until the second full income year after making the investment and must claim them according to a schedule agreed to by the DECD commissioner, in consultation with the DRS commissioner, and the taxpayer.

Transferred Credits. By law, businesses may sell, assign, or otherwise transfer stranded R&D or R&E credits, in whole or in part, to another business to redeem under the venture capital stranded credit program. The stranded credits may only be transferred once.

Aggregate Cap

The total amount of credits that may be exchanged under either the capital projects or venture capital investment program is $50 million.

To date, DECD has received and approved one application under the capital projects program. ASML US LLC received a $6 million credit allocation in FY 18; the company is expected to create 524 jobs and spend over $82.91 million on construction and equipment over the project's six-year timeframe (2018 Annual Report, pp. 16-17). There have been no tax credit auctions or agreements under the venture capital investment program. The current balance for both programs is $44 million.

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