

Minnesota Research and Development Tax Credit

What is the Minnesota research and development credit?

Minnesota allows businesses conducting research and development to claim research credits against their corporate franchise taxes or individual income taxes (for pass-through tax entities, such as LLCs and S corporations). The credit's computations are based on definitions under the federal tax credit for increasing research activities, except the research must be done in Minnesota.

What is the policy rationale for the research credit?

There are two basic rationales for research credits:

- It is widely recognized that businesses under-invest in research and development, because some of benefits of research go to society generally and cannot be captured solely for the business and its owners. Others can copy or build on their research, siphoning off some of the benefit. Research credits, including the federal and Minnesota credits, help overcome this barrier by providing tax benefits for qualifying research.
- State credits, such as Minnesota's, have a general "economic development" purpose—that is, they seek to encourage businesses to do more research in Minnesota to create jobs and other economic benefits for Minnesota residents. The credits help the state to compete for research investment by businesses. Some published academic research supports the view that state credits help to achieve this end.

What types of research expenses qualify?

Under the federal definition used by Minnesota, "qualifying research expenses" must be made to discover technological information that is applied to develop a new or improved business component (e.g., a product or process). The expenditures could be intended to improve quality, performance, reliability or something similar. The expenditures typically are for wages of the business's employees, supplies purchased, or amounts paid to contractors to do research for the business. Expenditures on equipment do not qualify, but instead qualify for separate expensing benefits under federal and state tax law.

Is the credit incremental?

The credit applies to research over a base amount. The federal definition of "qualified research expenses" is limited to the *increase* in research expenditures over a "base amount," making the credit an "incremental" credit. This base amount is expressed as a percentage of the business's gross receipts (Minnesota gross receipts for the Minnesota credit). The percentage is determined for each business based on the percentage its research spending was of its 1984-1988 gross receipts (for the businesses starting up after 1988, 3 percent is used) with a maximum of 16 percent. This incremental credit structure is intended to make the credit more cost effective in stimulating research by disallowing the credit for the

normal or basic research the business would otherwise do. For example, a business whose research is a constant percentage of its gross receipts would not be allowed the credit, because it had not increased its research “effort.”

50-percent limit applies. The credit cannot exceed 50 percent of the business’s research expenditures and many businesses’ credits are determined under that rule, because their research is well above their base amount. This typically occurs for Minnesota-based multistate businesses, because their base amounts are calculated using Minnesota gross receipts, a relatively low amount, while their Minnesota research often relates to their entire operations. Since these businesses qualify for a credit based on 50 percent of their research spending, their credits are really not incremental or dependent on increasing their research.

How is the credit computed?

The Minnesota credit has a two-tiered rate structure; a higher rate (10 percent) applies to the first \$2 million of Minnesota qualified research expenses and a lower rate (4 percent) for the amount over that. The 2017 Legislature increased the lower tier rate to 4 percent from 2.5 percent, effective for tax year 2017.

Is the credit refundable?

The credit is not refundable; it cannot exceed the liability for tax. (For three tax years, 2010 through 2012, the credit was refundable.) However, a unitary business (that is, a business with two or more corporations or other entities that are part of one business) may allocate the credit among its individual corporations to fully use the credit. If the credit still exceeds the liability for tax, it can be carried over and used to reduce taxes in later tax years (for up to 15 tax years).

How much does the credit reduce tax revenues?

The Minnesota Department of Revenue’s (DOR) *Tax Expenditure Budget* (February 2016) estimated that for fiscal year 2017, \$50.2 million in corporate franchise tax credits will be allowed and \$18.5 million in individual income tax credits. The *Tax Expenditure Budget* also reports that expensing of research and development costs provides tax expenditures for fiscal year 2017 of \$16 million (under the corporate franchise tax) and \$600,000 (under the individual income tax) for research and development expenditures.

How does Minnesota’s credit compare to credits in other states?

Minnesota was the first state to enact a research and development credit in 1981. Most states with corporate taxes now have credits for some types of research expenditures. These credits vary considerably and it is difficult to generalize about them. Some states, like Minnesota, follow the basic federal credit. Other states use different—both more expansive or narrower—definitions of the types of research that qualify for their credits. Some states target their credits to specific types of businesses (e.g., high technology companies), while others follow the alternative, as well as the basic, federal research credit rules. Several states have credit rates that are higher than Minnesota’s first tier (10 percent) rate and most allow rates higher than second tier (4 percent) rate. Finally, some state credits are not incremental, but rather apply to all qualifying research done in the state.

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