

COMMONWEALTH OF PENNSYLVANIA

HOUSE OF REPRESENTATIVES

FINANCE COMMITTEE

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PUBLIC HEARING

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BEFORE: DAVID K. LEVDANSKY, Chairman

Chris Sainato, Member

Rick Taylor, Member

Adam C. Harris, Member

HEARING: Monday, March 3, 2008

Commencing at 2:00 p.m.

LOCATION: Centocor, Incorporated

200 Tournament Drive

Horsham, PA 19044

SPEAKERS: Tom Hess, Mickey Flynn, Joseph Holston

Reporter: Carol Lynn Harriman

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## P R O C E E D I N G S

CHAIRMAN:

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4 I'll begin the meeting of the House  
5 Finance Committee. The subject of today's public  
6 hearing is House Bill 2250. It's legislation to  
7 increase the cap and the utilization of the Research  
8 and Development Tax Credit. Presently, the tax credit  
9 is established in law at \$45 million. This  
10 legislation would both increase the cap from \$45  
11 million to \$75 million, and would set --- increase the  
12 set-aside for small businesses and to make some  
13 changes relative to increasing the utilization of the  
14 tax credit.

15 We structured this so that we have a  
16 panel of three people, Mr. Tom Hess, the chief  
17 financial officer of Adolor corporation, Mickey Flynn,  
18 the President of Pennsylvania Biotech, and Bill  
19 Holston representing GlaxoSmithKline, one of his  
20 clients, today. We structured this so we could have a  
21 relatively --- we welcome your presentation, but we  
22 want to structure this, you know, sort of informally  
23 so that there can be a give and take between the  
24 members of the panel and the members here from the  
25 Finance Committee. And with that, let me have the

1 members introduce themselves starting at my far left.

2 REPRESENTATIVE SAINATO:

3 I'm Representative Chris Sainato. I  
4 represent the Ninth District in Morris County.

5 REPRESENTATIVE TAYLOR:

6 I'm representative Rick Taylor and I'm  
7 hosting this. I'm from Horsham. And I want to  
8 welcome you and the Finance Committee here to testify  
9 today. Just to let you know about Horsham, the area I  
10 represent, it was rated by Money Magazine as the 15th  
11 most memorable township out of their top 100. So one  
12 of the reasons I have to say is because the businesses  
13 like Centocor that offer great jobs to the district  
14 and to the township. And I'm very pleased that we're  
15 having this discussion today on the importance our new  
16 tax credit not only for the state, but for Horsham.

17 REPRESENTATIVE HARRIS:

18 Good afternoon. Representative Adam  
19 Harris. I reside in Juniata County. I represent  
20 Juniata, Mifflin and Snyder. This is my first trip to  
21 the Hatboro area. I really enjoy what I see. I would  
22 agree it is a very livable city. Thank you members of  
23 the panel for being here. This is my first term on  
24 the Finance Committee. So thank you, Chairman, for  
25 having this so I can learn a little bit more about

1 these credits. And it seems like a worthwhile program  
2 we should be expanding.

3 CHAIRMAN:

4 Thank you. And again, I want to thank  
5 the members for traveling, some of which --- Chris I  
6 know for sure had to travel the furthest. It took  
7 everybody a little bit to get here. Sorry I was a  
8 little bit late. I've been traveling since early this  
9 morning. With that, let me turn it over to our  
10 panelists.

11 MR. FLYNN:

12 Okay. I guess I'm going to, Mr.  
13 Chairman, start it off. And I want to thank you very  
14 much for holding this today and also Representative  
15 Taylor for hosting it and other members for being  
16 here, because it was not necessarily an easy trip and  
17 it's not too close to home. But we appreciate you  
18 taking the time to hold us and to hear from us about  
19 the R&D Tax Credit. Some of you know me and know that  
20 I've been heading Pennsylvania Bio now for a little  
21 over two years. And hopefully you'll also know my  
22 extreme passion for our industry since I've been in it  
23 for quite some time. So this is very near and dear  
24 and we're very, very thankful.

25 You know, as we think about Pennsylvania,

1 one of the things that we have to keep in mind that it  
2 is the global center for the bioscientists. I think  
3 that some people forget that, but we are the global  
4 center. And to do that we take that very, very  
5 seriously. You may know that a recent study that  
6 we've conducted, we have over 1,700 establishments  
7 that are dedicated to our industry. And that 1,700  
8 establishments encompasses both the drugs and  
9 pharmaceutical, our medical device and equipment along  
10 with diagnostic companies as well as agricultural feed  
11 stock and chemical, and then finally with research and  
12 testing laboratories, which we have quite a few across  
13 the Commonwealth.

14                   That 1,700 translates to 72,000 that are  
15 directly employed in our industry. But if you  
16 compound that in terms of the compounding effect, we  
17 have over 320,000 that are actually involved in our  
18 industry, and that adds in the other people that help  
19 support us on a daily basis. The economics of that  
20 are far in excess of over \$5 billion a year. So you  
21 can see that from an industry standpoint, the impact  
22 that we do have here in Pennsylvania. And that's the  
23 good news. Okay.

24                   The tough part about it is that we also  
25 open ourselves up to lose that if we're not in a

1 competitive environment. And so it's good to be there  
2 and it's good to have everything working for us. But  
3 it also puts us into an area that I sort of classify  
4 of responsibility. Because from our end of it, all of  
5 us, and I'm including, you know, all of us here in the  
6 room today and those that couldn't be here with us,  
7 that we need to be committed to doing everything we  
8 can to support the continued role of the bioscientist  
9 here in Pennsylvania. And the expansion of the R&D  
10 Tax Credit does exactly that. That's why it's so  
11 important, as you mentioned Mr. Chairman, to bring it  
12 up to \$75 million.

13                   And again, part of the 2006 Pennsylvania  
14 budget that we had, it did raise it from \$30 million  
15 to the \$40 million level and it reauthorized it, more  
16 importantly, to 2015, which was also a very, very big  
17 step versus having to do it every single budget cycle.  
18 Companies receive a ten-percent tax credit for the new  
19 R&D expense increases over the base period. And for  
20 the small business, it's a little bit larger at 20  
21 percent.

22                   In the previous budgets, okay,  
23 tradability was a portion of it and that also has been  
24 reauthorized, and quite frankly, is extremely  
25 important, especially to our small companies because

1 it allows them to sell their tax credits and they're  
2 enabled to get upwards of 90 cents on the dollar,  
3 which is also a huge benefit, and that money is then  
4 reinvested back into the companies.

5           And again, we need to do more. We need  
6 to make sure that the R&D Tax Credit is increased  
7 somehow, some way. As you may know, the Department of  
8 Revenue in the report in March indicated that in the  
9 absence of a tax, \$78.6 million in tax credit were  
10 applied for. And therefore, with the \$40 million cap  
11 that we have, we're only able to utilize 51 percent of  
12 it. So that in and of itself is another incentive as  
13 to why we should be able to move that cap off the mark  
14 that it is right now.

15           And then of the top 25 companies that did  
16 receive the tax credit, 16 of those are bioscience  
17 companies. So again, you can see the importance when  
18 you take the industry and then you take what is  
19 available, how our companies then really rely on this  
20 tax credit and utilize it. And that's why we're  
21 advocating, Pennsylvania Bio is advocating on behalf  
22 of the industry to support, Mr. Chairman, your bill to  
23 raise it to \$75 million. We think that there is  
24 enough justification to be able to do that.

25           And you've been given a slide that is



1 there that shows our continuum. Okay. And the common  
2 denominator on that, that reflects the tax policies  
3 that are important to the companies at each stage of  
4 that continuum. And the common denominator is the R&D  
5 Tax Credit cuts across all stages of growth in our  
6 industry. So again, another reason why we want to  
7 make sure that we find a way to increase that up to  
8 the \$75 million level.

9           And again, the competition is global and  
10 it is rapidly increasing for all research activity.  
11 The expansion of the credit will incentivise our  
12 companies to continue to invest in Pennsylvania. And  
13 by continuing the expansion of the credit, we will be  
14 assuring the companies that the credit will be  
15 available during their lengthy drug developing  
16 process. Just to reemphasize that point, it takes us  
17 ten to 15 years to bring a product to market. It's  
18 not something that is for the faint of heart, but it  
19 does take that much time with all of the studies. So  
20 that's why companies knowing that they can count on  
21 that credit, they're able to then utilize that,  
22 because it's monies that they can continue to reinvest  
23 into the research, which is really what we're after.

24           And then again, just --- and I think you  
25 have copies of it, the Research!America just completed

1 a study, and that showed that the industry funded  
2 approximately \$8 billion worth of R&D activity in  
3 Pennsylvania in 2004. And if you add on top of that  
4 the federal government of another \$2.3 billion,  
5 there's an awful lot of research dollars that are  
6 spent within the Commonwealth. So having our cap  
7 raised is going to be a very, very big benefit.

8           And again, that's why the combination of  
9 the industry, what it brings to the Commonwealth, what  
10 it shows as far as the research is concerned, that's  
11 why we want to have more of it to happen here. And we  
12 need to do everything that we can to do exactly that.  
13 We want to make sure that the companies see that  
14 Pennsylvania is keeping the global spotlight and we  
15 want to have that R&D investment into here.

16 And as you know, okay, from the university standpoint,  
17 their concern because the NIH has flattened their  
18 budget. And quite frankly, the cost for living  
19 they're actually doing --- it's costing them more,  
20 because their budgets had not kept pace even with the  
21 cost of living. So as a result, the universities are  
22 looking to the industry to also continue to fund the  
23 R&D.

24           And with that, the tax credits that we've  
25 got, we need to continue to send a message to the

1 companies that Pennsylvania is committed to them. And  
2 by raising the cap on the R&D Tax Credit, it will show  
3 that the Commonwealth supports and encourages, and I  
4 think those are the two things that it --- support is  
5 one thing, but actually encouraging the investment in  
6 R&D is very, very critical. And therefore, we are  
7 asking and we support, Mr. Chairman, your bill to  
8 bring it up to \$75 million. And I'm open to any  
9 questions or anything that you may have or that maybe  
10 you feel I could also comment on.

11 CHAIRMAN:

12 How about if --- just for facilitating  
13 the discussions, how about if we have the presenters  
14 make their --- all three of you make presentations,  
15 Mr. Flynn, and then the members can follow up with any  
16 questions or comments after that?

17 MR. FLYNN:

18 Sure.

19 CHAIRMAN:

20 Okay?

21 MR. FLYNN:

22 Okay.

23 CHAIRMAN:

24 Thank you.

25 MR. HESS:

1                   Great. Thank you, and thanks for coming  
2 out here. My name's Tom Hess. I'm the chief  
3 financial officer for Adolor Corporation. We're a  
4 small biotech company. The difference between us and  
5 a big pharm is we're not encumbered by revenue. We  
6 have to raise every dollar that we spend, different  
7 things, from investors. A big part of it is also  
8 these investments from the research and development  
9 type credits.

10                   At Adolor, we have received about  
11 \$700,000 over the last five years which we put right  
12 back into the local economy. We employ approximately  
13 100 people and our payroll is over \$20 million because  
14 these are very high paying jobs. Almost every  
15 positions we have requires a highly skilled person to  
16 fill. What's nice about the biotech industry is you  
17 look at the size of the payroll and the taxes that  
18 we're contributing to the state, it's the type of  
19 business we want here.

20                   And I'm thinking to the point if people  
21 had the opportunity to watch 60 Minutes last night,  
22 they went to Chillicothe, Ohio, and the big issue  
23 there is the loss of jobs. People were sitting there  
24 somewhat dumbfounded when one manufacturing plant  
25 moved out. Here I think we have an opportunity in

1 Pennsylvania to avoid that, because we can create very  
2 good jobs that will stay there. The nice thing about  
3 biotech, in my previous employer, Vicuron  
4 Pharmaceuticals, we had received about \$600,000 to  
5 \$700,000 also.

6           We developed two drugs. We sold the  
7 company to Pfizer. And what that allowed is the 60  
8 people here became partitionary and went to work and  
9 set up their own companies in this area. So I would  
10 use the analogy it's almost like a dandelion. You  
11 know, once you blow those seeds from the biotech, they  
12 spread all over the area and create more jobs. So it  
13 continues on and on. So those are some of the  
14 benefits.

15           Getting back to Adolor Corporation, what  
16 we've been trying to do since 1994 is develop a drug  
17 called Entereg which is given to patients who have  
18 bowel resections to prevent post-operative ileus, a  
19 very painful condition, even though anyone who's had a  
20 bowel resection, usually it's the result of a colon  
21 cancer, again, a very painful condition. Our goal is  
22 by giving --- administering this drug, it allows  
23 people to get out of the hospital almost a day or two  
24 ahead of schedule. And I think you would probably all  
25 agree getting out of the hospital to avoid staph

1 infections and the other complications, it's very  
2 important. So we think we've got the winner there.

3 But to Mickey's point, it takes a  
4 significant period of time to get this drug approved.  
5 And I think we've all seen information coming out of  
6 the FDA. You know, they're charging \$600,000 just to  
7 file the drug application, but they're understaffed  
8 and they keep delaying everyone's drugs. So it's  
9 becoming a loner and longer process. So what that  
10 requires, is the longer the process is, we need more  
11 cash to keep the company going, hopefully to get the  
12 drug approved and then start generating revenue.

13 Now, in our case, we have been able to  
14 raise money on the outside, but when you get to the  
15 smaller companies, these R&D credits really provide  
16 maybe just another month or two of cash until they can  
17 get another investor in who is willing to commit  
18 money. And you look at an environment where it is  
19 getting very difficult to raise money. Obviously,  
20 this credit will affect not only big companies, but it  
21 will start affecting smaller companies. The ability  
22 to raise cash is really our life work.

23 CHAIRMAN:

24 Thank you. Joe?

25 MR. HOLSTON:

1                   Thank you Chairman, members of the  
2 committee. Thank you for inviting me to appear today  
3 and thank you for the folks at Centocor for hosting  
4 us. I am proud to be here testifying in support of  
5 expanding the Research and Development Tax Credit.

6                   As some of you may know, I led the  
7 Research and Development Tax Credit Coalition, which  
8 spearheaded the legislative effort that culminated  
9 with the enactment of the R&D Tax Credit in Act 7 of  
10 '97. I'm happy to say that ten years later, it's  
11 still one of my proudest accomplishments. While the  
12 Coalition no longer exists, I still represent several  
13 companies that benefit from its enactment, including  
14 GlaxoSmithKline and Johnson & Johnson, the parent  
15 entity for Centocor. The Coalition included more than  
16 100 companies, non-profit entities and other  
17 institutions.

18                   Before I discuss several specific items,  
19 I thought it might be helpful to provide a general  
20 overview so you will have a better understanding of  
21 the credit's scope and breadth. While the credit has  
22 been in existence since 1997, and 11 years of credits  
23 have been issued, I will only focus on the first ten  
24 years because I am working from the Department of  
25 Revenue's Report to the General Assembly issued last

1 March. That report only covers the first ten years.

2 A new report will be issued, I guess, next week.

3           First, let me give you a couple numbers  
4 that will put the importance of this Program in  
5 perspective so you can evaluate its value to the  
6 Commonwealth as you consider the possibility of  
7 improving it. Since its enactment, 1,055 different  
8 taxpayers were awarded some amount of credit according  
9 to the Department's report. In their first ten years,  
10 total credits of \$205 million were awarded. That  
11 obviously is a substantial amount of taxpayer funds.  
12 I think the expenditure was well worth it and I think  
13 you will too when we are finished discussing it.

14           As the Department stated in this last  
15 report, overall, it is important to note that the R&D  
16 Tax Credit awarded is relatively small when compared  
17 to the amount of money spent by the taxpayers to  
18 conduct their research activities in the Commonwealth.  
19 In that case, the Department was talking about a  
20 specific sample of companies it had studied, but its  
21 observation also has to apply to the overall  
22 population of companies that were awarded credits.

23           The companies included in the  
24 Department's study were awarded about \$13.9 million in  
25 2006. That is a large number, but the Department puts



1 it into perspective when it points out that that  
2 amount represents .9 percent of their total amount of  
3 Pennsylvania research expenditure for the taxpayers in  
4 taxable year 2005, which is the year on which the  
5 credit awards were based. That's right. The credit  
6 represents less than one percent of their total  
7 expenditures in Pennsylvania for R&D. Also not  
8 included in that calculation is any research and  
9 development conducted by them outside of Pennsylvania.  
10 Nor are expenditures for anything else conducted in  
11 Pennsylvania, including manufacturing, production,  
12 administrative operations. The reimbursement of less  
13 than one percent applies only to R&D activities.

14           To put it into a different perspective  
15 from a different angle, the Department noted that in  
16 tax year 2005, the 379 companies awarded the R&D tax  
17 credit in 2006 had total Pennsylvania research  
18 expenditures of \$3,168 million. Thus, the taxpayers  
19 that spent in excess of \$3.1 billion on research in  
20 Pennsylvania in one year, and which obviously also  
21 spend a significant amount of money on other  
22 activities in Pennsylvania, have split among them  
23 credits totaling \$40 million. That represents just  
24 1.2 percent of their PA research.

25           The credit initially was enacted as part

1 of Act 7 of '97 and has been modified several times.  
2 First, and most important, the credit does not apply  
3 to all research and development activities. As Mickey  
4 noted, taxpayers are only eligible to apply for a  
5 credit to the extent that their R&D activities in the  
6 relevant tax year exceed the average of the same  
7 activities in the prior four years. For example, if  
8 the taxpayer averaged \$1 million in Pennsylvania  
9 activities for the period of 2003 to 2006, it would  
10 not be eligible for to claim the credit for the first  
11 \$1 million of R&D expenditures in the Commonwealth in  
12 2007. If the taxpayer in this example spent \$1.1  
13 million on R&D in 2007, only \$100,000 of expenditures  
14 in excess of the \$1 million average for the base  
15 period would be eligible for the credit.

16           The credit as originally established by  
17 Act 7 was for ten percent of the expenditures in  
18 excess of the base amount. Thus, in the example noted  
19 above, the additional \$100,000 of expenditures in  
20 excess of the \$1 million needed to offset the base  
21 period would earn a credit of \$10,000. However, as  
22 I'll discuss shortly, larger taxpayers have never,  
23 before last year, been awarded even half of the credit  
24 they earned.

25           Act 116 of 2006 increased the percentage

1 for small businesses from ten percent to 20 percent.  
2 A business qualifies as small if it has a net book  
3 value of assets totaling less than \$5 million. The  
4 rate remained ten percent for entities that do not  
5 qualify as small.

6           Significantly, Act 7 established a limit  
7 of \$15 million for credits awarded in any tax year  
8 with \$3 million set aside for small businesses. If  
9 the applications filed by small businesses do not use  
10 up the entire \$3 million set aside for them, any  
11 remaining amount may be used by the non-small  
12 businesses, as they are referred to.

13           Act 46 of 2003 increased the small  
14 business set-aside to \$6 million and increased the  
15 total credits that could be awarded in 2004 and  
16 thereafter to \$30 million. Act 116 of 2006  
17 subsequently raised the set-aside to \$8 million and  
18 the total credit limit to \$40 million. Let me stop  
19 here and thank the members of the Committee who were  
20 supportive of the original proposal and have pushed  
21 very hard for the amendments and for additional  
22 amendments. We really appreciate that.

23           As I said, even with the growth in the  
24 credit from \$15 million in 1997 to \$40 million today,  
25 at no time has the level of credits available to

1 taxpayers come close to meeting the level of credits  
2 earned. The disparity between credits earned and  
3 credits available to be awarded has varied from less  
4 than 20 percent to a high of 46 percent for large  
5 taxpayers in '06. As Mickey said, '07 is slightly  
6 over 50 percent. By that I mean that a non-small  
7 business that earned a credit of \$10,000 by making  
8 expenditures in the tax year of \$100,000 more than the  
9 base period average would not get \$10,000. Rather, it  
10 would only get somewhere between \$1,800 and \$4,600  
11 depending upon the year because of the cap.

12           The total tentative credits earned have  
13 ranged from \$50 million to \$78 million during the ten  
14 years covered by the revenue report, with every year  
15 from 2001 onward exceeding \$70 million a year. That  
16 is the reason why large taxpayers have never even  
17 gotten 50 percent of the credit the statute was  
18 designed to produce, although small business have  
19 gotten all of the credits they were eligible for  
20 except for one year when they got 99 percent. So the  
21 small business have essentially gotten their ten  
22 percent or 20 percent, although the one year I think  
23 the credit averaged \$3 million. It went to \$3 million  
24 and maybe \$1,000 or something.

25           In addition to expanding the credit from

1 \$15 million to \$40 million, the Legislature has  
2 adopted several other enhancements to the law over the  
3 past ten years. Act 7 provided the taxpayer could  
4 offset up to 50 percent of their liabilities for CNI,  
5 personal income tax and capital stock/franchise tax.  
6 Any awarded credits that cannot be used to offset tax  
7 liabilities in the current year can be carried forward  
8 for up to 15 years. Act 46 eliminated 50 percent  
9 limitation for credits awarded in 2005 and thereafter.  
10 So the taxpayer would be able to use its credits to  
11 offset its entire tax liability for those three taxes.  
12 Obviously, it doesn't include sales tax.

13           Act 46 also included a tradability  
14 provision, as Mickey mentioned, designed to primarily  
15 help new entities, including biotechs. Act 46  
16 provides that a taxpayer that is not able to use its  
17 credits within one year of when they were awarded can  
18 sell or assign its unused credits to another taxpayer.  
19 The purchasing entity must use them in the tax year it  
20 acquires them and can only offset up to 75 percent of  
21 the purchaser's eligible liabilities.

22           The ability to sell credits is very  
23 important to new entities, as these gentlemen noted.  
24 These entities typically go many years before they  
25 make a profit, if they ever do. In fact, Centocor

1 went well in excess of ten years before it made its  
2 first modest profit, and had losses in excess of  
3 \$1 billion during that time. Thus, the ability of  
4 modern day Centocors to sell their credits and get  
5 real cash today is quite important.

6           Act 46 also requires the Department to  
7 publish the names and amounts of credit recipients  
8 beginning with credits awarded in 2004. A review of  
9 the three reports published by the Department since  
10 company identifiable information became available  
11 indicates that three prominent southeastern  
12 Pennsylvania companies average credits in excess of \$2  
13 million annually. The companies are Merck, Cephalon  
14 and GlaxoSmithKline.

15           My client, GlaxoSmithKline has been  
16 awarded the largest amount of credits in each of the  
17 last three years: \$7.7 million in 2004, \$4.1 million  
18 in 2005 and \$5.1 million in 2006. In order to be  
19 awarded these credits, Glaxo has had to increase its  
20 expenditures by approximately \$188 million over the  
21 base period for the credit awarded in 2004, an  
22 additional \$95 million in 2005, and \$112 million for  
23 2006. And keep in mind that because each year's  
24 increase goes into the base period calculation for  
25 subsequent years, the actual increase in order to

1 receive the \$16.9 million is not the \$395 million  
2 calculation if you just added the three numbers.  
3 Practically speaking, it's significantly more than  
4 that.

5           Additionally, it is important to remember  
6 that Glaxo was conducting a significant amount of  
7 research throughout the entire period prior to 1997,  
8 continued to expand throughout the entire period and  
9 it continues to expand today. Without disclosing  
10 company specific information, it is safe to say that  
11 Glaxo's total expenditures in the Commonwealth prior  
12 to the three years in question were already quite  
13 significant.

14           I think the simple example of a company  
15 that has been awarded a \$2 million credit each year  
16 since the credit's enactment provides a great  
17 illustration tool to help understanding the value of  
18 the R&D credit because it can get somewhat  
19 complicated. As I said, credits are awarded for the  
20 increased value of qualified investments tied to a  
21 rolling base. If you assume a company had no  
22 qualified investments for 1993 to '96, which would be  
23 the base period for '97, it would still need to invest  
24 nearly \$93 million in qualified expenditures in 1997  
25 in order to receive a \$2 million credit. To receive

1 the same \$2 million credit for each of the next nine  
2 years, a company would have had to spend  
3 \$1,461,573,554 in qualified investments over the ten  
4 year period. Thus, to get \$20 million of tax credits  
5 in that ten-year period, it would have had to spend in  
6 excess of 70 times that number.

7           The reason the total amount is more than  
8 50 percent higher than the number you obtained, you  
9 would multiply the \$93 million by ten, it is largely  
10 because of the multiplier effect created by including  
11 the new credits in the base period for the subsequent  
12 year. This requirement that an entity continue to  
13 expend ever increasing amounts on research in  
14 Pennsylvania in order to obtain credit was a key  
15 component of the original concept. It was never the  
16 intent that an entity that maintained a steady level  
17 of research in Pennsylvania would get a credit. The  
18 program was designed to encourage additional research  
19 in the Commonwealth each year, not to subsidize  
20 existing research.

21           In conclusion, as I said earlier, I think  
22 the Pennsylvania R&D Tax Credit is a wonderful return  
23 on investment for the Commonwealth. By providing a  
24 credit in the following tax year for expenditures  
25 already made --- by that I mean the company would get



1 credit in '07 for expenditures in '06. But by  
2 providing that, in contrast to giving grants in  
3 anticipation of future actions, we are sure we are  
4 getting out bang for the buck.

5           By tying eligibility for the credit to  
6 expansion of an entity's research and development  
7 activities in Pennsylvania, you are ensuring that the  
8 taxpayer is making an ever increasing investment in  
9 Pennsylvania. And at the risk of being redundant I'll  
10 reiterate, it's only for research and development done  
11 in Pennsylvania. Activities outside of the State's  
12 borders are not considered. And I would be remiss if  
13 I did not point out that the credit is only for actual  
14 hard dollars spent on research and development. It  
15 does not apply to administrative overhead.

16           Additionally, while I can't speak for all  
17 of the taxpayers which receive the credit, it is  
18 important to note that the vast majority of them, the  
19 jobs being created by the expansion are the jobs we  
20 always talk about creating, well paying jobs that we  
21 would be proud to have our children have.

22           I'll just mention very briefly while  
23 there is some discussion as to what it costs to bring  
24 a new drug to market, the current investment is \$800  
25 million. There's some estimates as high as \$1.2

1 billion depending upon the nature of the developer.

2                   For these reasons, I would ask that you  
3 consider improving the program by increasing the cap  
4 to \$75 million as well as making several changes  
5 sought by the smaller entities: the ability to sell  
6 the credit immediately rather than having to wait a  
7 year, and the ability of the purchaser to carry  
8 forward a credit it purchases rather than having to  
9 use it in the year purchasing or losing it. Both of  
10 these proposals would assist these entities in  
11 obtaining the greatest possible amount of cash for  
12 their credits as soon as they can, which as Tom  
13 mentioned, it may be that they need the money that  
14 month to stay in business. Thank you for your  
15 attention and the opportunity to appear before you  
16 today. I'd be happy to answer any questions.

17                   CHAIRMAN:

18                   Do the members have any questions? Mr.  
19 Taylor?

20                   REPRESENTATIVE TAYLOR:

21                   The tax credit, is this limited only to  
22 bio and pharma or could it be for consumer products or  
23 other different programs that your research and  
24 development --- companies have done research on?

25                   MR. HOLSTON:

1 I had the opportunity to work for  
2 Innovative Solutions and Support, Exton, back in 2000,  
3 2003, a small company. And you might recognize it  
4 because it's been in the news lately. We did the  
5 equipment at that time for the KC-130 fueling tankers.  
6 They're now forbidden to be --- that generation is  
7 being replaced. It's a small company of about 100  
8 folks, all highly paid jobs because it's mostly  
9 software-driven equipment. We were eligible because  
10 our incremental research and development and  
11 expenditures kept increasing, so we could apply for it  
12 there. So it's not limited to just pharm. It's all  
13 of those who do research and development.

14 CHAIRMAN:

15 Representative, I'm looking at last  
16 year's Department of Revenue report where in the  
17 appendix they list the taxpayers who received a credit  
18 from the largest to the smallest. And included in the  
19 top ten are Comcast as well as Lockheed-Martin. As  
20 you go further down the list, you'll find other ---  
21 primarily in the scientific research, although it can  
22 be computers, essentially development of anything.  
23 Practically speaking, I think until you get to a  
24 certain size, that's how we're pinning you down to  
25 apply for the credit. But with it doubling to 20

1 percent, it becomes worth it. So I mean, if you look  
2 at the latter pages, there are a lot of small  
3 non-biotech companies, but there are --- for example,  
4 Boeing has gotten it, Alcoa has gotten it.

5 REPRESENTATIVE TAYLOR:

6 Do you find with, especially the smaller  
7 businesses, that they keep the credit or that they  
8 sell it?

9 MR. HOLSTON:

10 They would sell it.

11 MR. FLYNN:

12 Yeah, I would say --- in our case, we've  
13 had to sell because we have no profit to offset. We  
14 don't pay income taxes for federal and state purpose  
15 because we're --- in Adolor's case, we've been losing  
16 money since 1994. At this point, we've spent over  
17 \$500 million trying to develop our set of drugs. So  
18 we've always run a loss, so we have to sell it. And  
19 as he said, we usually get 90 cents on the dollar  
20 right away. And in our case, this year, right at year  
21 end, we ended up buying a new mass spectrometer. some  
22 people might recognize it from CSI. They put the  
23 little drop of blood in it. It spins it around and  
24 tells them --- we'd buy one of those, but it's a  
25 \$400,000 piece of equipment. Again, that's the type

1 of thing we were able to apply our \$150,000 right to  
2 that piece of equipment. What that allows the --- we  
3 had one piece of equipment, but we can only screen so  
4 many new compounds. By getting the second machine, we  
5 were able to have a couple more folks and now we can  
6 screen twice as many compounds.

7 MR. HESS:

8 And that'll hold true for all of the  
9 small companies. Once they get their credit, if they  
10 can sell it, they will sell it quickly because they  
11 want their money. It could be for payroll, but it's  
12 just to keep going. But they reinvest that back, and  
13 90 percent of it is going to go back right into  
14 research.

15 REPRESENTATIVE TAYLOR:

16 So that is an example of the multiplier  
17 type thing ---?

18 MR. HESS:

19 Yes. Absolutely.

20 REPRESENTATIVE TAYLOR:

21 Okay. Thank you. That was my question.

22 CHAIRMAN:

23 Thanks, gentlemen. I had about six  
24 really good questions, but Joe's wonderful summary of  
25 the Act of '97 to today actually answered most of my

1 questions. So I guess I'll start with this one. It  
2 sounds like we have a pretty good national standing as  
3 far as we are getting dollars to these people that are  
4 trying to develop drugs, trying to develop products.  
5 What other states are maybe competitive with us, maybe  
6 becoming more aggressively competitive with us? What  
7 can we do to keep up with them and maybe do a little  
8 better?

9 MR. HESS:

10 Well, if you look from a competition  
11 standpoint, okay, just across the board, you've got  
12 over 40 states that have actually invested more money  
13 into the bioscience. We were just talking just prior  
14 to here, Kansas just put in \$3 billion. Okay. Up in  
15 Massachusetts, they just passed a bill for \$1 billion  
16 that's going to be spread over ten years. And that's  
17 just here in the U.S. That's not counting offshore,  
18 what Ireland has done, what Singapore is doing, what  
19 India is doing. So when you look at it, this piece of  
20 our competition, they have a good R&D Tax Credit into  
21 play. It's just one of the elements that we need to  
22 make sure that we have, because everybody recognizes  
23 the economics that our industry brings to them  
24 locally. And so nobody wants to walk away from that.  
25 These are very high paying jobs. You're talking on

1 average \$70,000. And you get up into the Ph.D. level,  
2 you're talking \$85,000, \$90,000, \$100,000. And you  
3 know, then you get into equipment, like Tom said, a  
4 mass spec, \$400,000. That's not unusual. So it's  
5 extremely competitive.

6 CHAIRMAN:

7 It sounds like if we think of it as a  
8 race, if we would stumble, there are states ready  
9 to ---.

10 MR. HESS:

11 That will jump on us, literally jump on  
12 us. And that's why it's so important that we work so  
13 hard to keep every --- keep the companies here within  
14 Pennsylvania. I mean, that's why, you know, we push  
15 this, we push the NOLs, we push ---. The things that  
16 are going to be business tax related issues are the  
17 things that are going to help our company stay here  
18 and continue to grow. You've got an industry that's  
19 got nothing but upside potential. So you know, when  
20 you look at it that way, you say, well, why wouldn't  
21 you invest, you know. You find every way you can and  
22 it comes back to showing that the Commonwealth is  
23 supportive, and more importantly, encourages the  
24 research and development.

25 MR. HOLSTON:

1           If I could just clarify something I said  
2 earlier so that you understand. These gentleman are  
3 not paying corporate income tax. They still probably  
4 have a small capital stock franchise liability. But I  
5 don't want to leave anybody with the impression that  
6 personal income tax is not being paid. When Tom was  
7 saying his payroll is \$20 million, that's \$600,000  
8 Pennsylvania personal income tax being paid by his  
9 employees. Plus they're paying sales tax, they're  
10 paying property tax, they're paying a bunch of taxes.  
11 And I just didn't want anybody to think, well, nobody  
12 is paying taxes. The employees are paying taxes.

13                   CHAIRMAN:

14           If I could just follow up, you mentioned  
15 about selling your credits. Who can you sell them to?  
16 Is there only eligible entities? Can you sell to any  
17 Pennsylvania business or ---?

18                   MR. HESS:

19           Anybody who's making money. Yeah.  
20 Absolutely.

21                   MR. FLYNN:

22           And that's one of the benefits to this  
23 system that was set up. To me it's a very efficient  
24 way to get money back in the process. The form is  
25 very simple. We have to track our R&D spending



1 anyhow, so it's very easy to complete the form and  
2 turn around and sell it to a broker. So to me, it's a  
3 very efficient way to get money back into the system.  
4 And a representative from Penn State area and a  
5 representative from Pittsburgh, we've got these two  
6 great universities and I certainly wanted to talk ---  
7 they say there's a brain drain in Pennsylvania even  
8 though we've got great universities here, but we lose  
9 a lot of people. You know, I'm from Pittsburgh  
10 originally, and I think that's a big issues out that  
11 way. We've got these two great universities and  
12 others that have large science backgrounds, and I know  
13 there's companies popping up in Pittsburgh and up in  
14 State College. The biotech people start tying this  
15 all together, I think it really builds a fortress  
16 around the state.

17 CHAIRMAN:

18 And just one other point. I guess want  
19 to highlight something that I didn't know, and I want  
20 to make sure I'm understanding this correctly. You  
21 have to have a four-year history in Pennsylvania  
22 before you're eligible to apply for this; correct?

23 MR. HOLSTON:

24 Correct.

25 CHAIRMAN:

1           So you can't come in in March of 2008 and  
2 go right to the Department of Revenue ---?

3           MR. HOLSTON:

4           No. You would have to have at least one  
5 year history.

6           CHAIRMAN:

7           One year of history?

8           MR. HOLSTON:

9           The average is four, but if you were in  
10 business one year, you could apply for the second  
11 years. So if you started in '05, you could apply in  
12 '07 for your activities in '06.

13          CHAIRMAN:

14          Okay. Thank you.

15          MR. FLYNN:

16          Because you're looking for incremental  
17 spending. That's the beauty about this. In our case  
18 at Adolor, if we drop off on R&D --- let's say we get  
19 our product approved and say we're happy, no more R&D.  
20 We fall for that --- it's only rewarding people who  
21 are spending more on R&D in 2008 than they spent in  
22 2007.

23          MR. HOLSTON:

24          And it's not just --- like Tom says, it's  
25 not spending more on R&D --- when he stops R&D. He's

1 not stopping R&D.

2 CHAIRMAN:

3 Right.

4 MR. HOLSTON:

5 It's just you're stopping the expansion  
6 so that --- you know, I mean, a number of the  
7 companies are talking about --- probably spend in  
8 excess of \$1 billion in Pennsylvania each year on R&D.  
9 So if they would only spend \$1 billion again, they  
10 don't get a dime.

11 MR. FLYNN:

12 Right. So it's only rewarding people who  
13 are making the extra increases ---.

14 REPRESENTATIVE TAYLOR:

15 Just a follow-up question. I guess from  
16 the Department of Revenue, has it been traditionally  
17 that the full --- been taken advantage of the --- what  
18 is it, \$45 million right now?

19 MR. HESS:

20 \$40 million right now.

21 REPRESENTATIVE TAYLOR:

22 \$40 million right now. Has \$40 million  
23 been extended in credits?

24 MR. HOLSTON:

25 As far as I know, no.

1                   REPRESENTATIVE TAYLOR:

2                   I think there was one year, Joe, you said  
3 that ---?

4                   MR. HOLSTON:

5                   Well, the small guys have always used ---  
6 the total amount, whether it's \$15 million or  
7 \$40 million, has always been applied for. What I'm  
8 trying to find is the whole list of the summaries of  
9 what had been applied ---. It's always been out  
10 there. Now, if there's a period of time --- okay. In  
11 '97 there was \$66 million applied for. There was \$15  
12 million available. \$56 million, \$53 million, \$59  
13 million, \$71 million, \$74 million, \$70 million.  
14 That's when it was switched to \$30. \$70 million,  
15 \$65 million in '05. Now it's ---.

16                   MR. FLYNN:

17                   \$78.6 million was the last one.

18                   MR. HOLSTON:

19                   So it's always been over subscribed.

20                   REPRESENTATIVE TAYLOR:

21                   So in other words, there is the huge  
22 demand to get these credits, and it would be used for  
23 purposes to help the company?

24                   MR. HOLSTON:

25                   Absolutely.

1                   CHAIRMAN:

2                   Just a couple questions for myself.  
3 First off, what do our border states do, you know,  
4 Maryland, New Jersey, New York, Ohio? Do they have a  
5 comparable R&D Tax Credit in their state?

6                   MR. HESS:

7                   New Jersey does. Okay. But I think they  
8 bunch it together with tradabilities. They do have a  
9 tradability. they do have an R&D Tax Credit, yeah. I  
10 don't know about New York or Maryland. I don't know.  
11 We can find out.

12                   CHAIRMAN:

13                   Yeah. I would just be curious to see  
14 what our competitor states --- you know, if they have  
15 an R&D, how does it work?

16                   MR. HESS:

17                   Right.

18                   CHAIRMAN:

19                   The second thing is, is there a federal  
20 R&D Tax Credit as well?

21                   MR. HOLSTON:

22                   Yes, there is. One of the advantages of  
23 the credit is, from the Pennsylvania Department of  
24 Revenue's perspective, expenses are determined  
25 federally whether it's research or non-research. So

1 the IRS is making all those calculations. The only  
2 question Pennsylvania has to decide is, when the  
3 company says it's in PA, is the person really working  
4 in PA? Now, the federal credit, a couple of things,  
5 is unlimited. So there is no cap. And what I was  
6 checking, I got an e-mail this weekend from someone.  
7 We checked New Jersey, New York, Ohio, Delaware. They  
8 have no caps on their credits. So I'm not sure if  
9 Maryland has one. But our neighbors are not saying if  
10 you earned \$10,000, you get \$10,000.

11 CHAIRMAN:

12 And if we didn't have a cap, you're  
13 saying last year we would have paid ---?

14 MR. HESS:

15 \$78 million.

16 CHAIRMAN:

17 So at least raising it to \$75 million  
18 puts us pretty much at where the demand for the  
19 program was last year.

20 MR. HESS:

21 That's correct. And to be honest, Dave,  
22 I think you're going to see, first of all, the  
23 expansion is going to continue to go up. Of course,  
24 you have the 20 percent for the small guys. The other  
25 thing is, quite frankly, if you're a larger company,

1 it's fine to say I get a \$10,000 credit. But if I  
2 know you're only going to give me \$4,600, I'm really  
3 only getting \$4,600. So I think when it gets closer  
4 to people getting 100 cents on the dollar what they  
5 earned, you'll probably get another incremental bump  
6 from people applying. \$75 million basically gets you  
7 close one way or the other to what's out there.

8 CHAIRMAN:

9 Okay. And it really is, you know,  
10 important, especially for the startups and the biotech  
11 companies, that we shorten the tradability to one  
12 year.

13 MR. FLYNN:

14 Right.

15 CHAIRMAN:

16 Okay.

17 MR. HESS:

18 They become eligible so they don't have  
19 to wait a year. That would be the other piece. Okay.  
20 To eliminate that would be really beneficial. Because  
21 that's just that much quicker that they can get that  
22 money and reinvest it.

23 MR. HOLSTON:

24 Tom, for example, with that credit on  
25 December 15th of '07, for his '06 money he expended

1 --- so if he spent money in '06, December of '07 the  
2 Department will say you have whatever, however ---  
3 \$100,000, whatever. He can't spend it or sell it to  
4 anybody else until December 15th, '08. So what we're  
5 talking about eliminating that deadline is he knows  
6 he's got this piece of paper, but you've given it to  
7 him. It's been awarded. Now he's going to sit and  
8 wait a year. He knows he's going to sell it because  
9 he's not making money. It's kind of silly to say it's  
10 going to sit there for a year.

11 CHAIRMAN:

12 One final question, Joe. Is the federal  
13 program --- I mean, the state program is basically if  
14 you qualify for the additional increase in R&D  
15 expenditures over the rolling four-year average. Does  
16 the federal program work similar to that?

17 MR. HOLSTON:

18 Similar but not exactly. I'll yield to  
19 Tom. There's a 16-percent cap ---.

20 MR. FLYNN:

21 I just did my tax revision, so I could  
22 maybe give it a shot. The federal R&D credit is  
23 similar in the sense that we go through and say,  
24 here's how much we spent with R&D. What's in that  
25 calculation are qualified --- salaries of our



1 biologists and --- plus 60 percent of outside costs,  
2 because in our business, we tend to use a lot of  
3 consultants in the area. So 60 percent of those  
4 dollars are eligible. And it goes through this  
5 incremental approach.

6           So I've got I think \$9 million in federal  
7 R&D tax credits on my books, but I can't use it until  
8 we start turning profit. But I've got ten years of  
9 NOIs behind me, so I have to go through the  
10 calculation, but it's really not worth much for me.  
11 It's sort of a big exercise for nothing. We can't  
12 sell those credits, and that's the difference. While  
13 there certainly are great things about the  
14 Pennsylvania R&D credit, we're trying to get it from  
15 that \$40 million to \$75 million dollar level. I think  
16 it does show --- it shows other companies that  
17 Pennsylvania is moving in the right direction. And I  
18 think momentum is a big part of this exercise.

19           CHAIRMAN:

20           Go ahead with questions.

21           REPRESENTATIVE TAYLOR:

22           And I guess this is to Mickey Flynn,  
23 because you are the president of Pennsylvania Bio.  
24 Has this tax credit attracted any businesses to come  
25 into Pennsylvania?

1                   MR. FLYNN:

2                   I wouldn't say that in and of itself that  
3 it has attracted. I think in combination with all of  
4 the other things that we do offer and why we've got  
5 the workforce here, the quality of life, okay, that  
6 combination has attracted companies to come here,  
7 very, very much so. But in and of itself, no.  
8 Because they're going to look at the total package of  
9 what you're going to offer. But this is a very  
10 critical piece as they think about their R&D and how  
11 much they are going to spend. So it becomes a very  
12 important thing.

13                   CHAIRMAN:

14                   And just in closing, just let me say  
15 this. The reason why this issue is important for me  
16 and I think for Pennsylvania as a whole is that our  
17 whole competitive --- our companies can compete in a  
18 global economy now. And if we don't stay competitive  
19 --- and I don't mean just pharmaceuticals and biotech.  
20 I mean basic manufacturing, too, chemical, glass,  
21 steel, you know, aluminum, and everything else. If we  
22 don't retain out competitive advantage, our companies  
23 are going to be at risk in a global marketplace.

24                   And key to our competitive advantage is  
25 investment in research and development. So it's the

1 new technologies, the new products, the new processes  
2 that's going to help Pennsylvania corporations compete  
3 in a global marketplace. And this tax credit gives an  
4 incentive to companies to increase their expenditures  
5 in research and development, and strengthen our  
6 competitive advantage for our companies in a global  
7 economy.

8                   And I know it's likely to be a tough  
9 budget year, but I have to think of all of the things  
10 that we can do for our business community. I think  
11 this is probably, you know, the most strategic change  
12 in the Tax Code that we can undertake that will have a  
13 far bigger economic impact than just \$30 million  
14 expansion from \$45 million to \$75 million. So with  
15 that, I appreciate your insights and your comments and  
16 your testimony. I thank the members for traveling.  
17 And I'm looking forward to working with everybody to  
18 try to make this happen in the context of this year's  
19 budget.

20                   \* \* \* \* \*

21                   HEARING CONCLUDED AT 2:47 P.M.

22                   \* \* \* \* \*

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24  
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