

House Finance Committee

March 3, 2008

Chairmen Levdansky and Nickol and members of the Committee, thank you for inviting me to appear before you today. And thank you to the folks at Centocor for hosting us.

I am proud to be here testifying in support of expanding the Research and Development Tax Credit. As some of you may know, I led the Research & Development Tax Credit Coalition which spearheaded the legislative effort that culminated with the enactment of the R&D Tax Credit in Act 7 of 1997. I am happy to say that, 10 years later, it is still one of my proudest accomplishments.

While the Coalition no longer exists, I still represent several companies that benefit from its enactment, including GlaxoSmithKline and Johnson & Johnson, the parent entity for Centocor. The Coalition included more than 100 companies, non-profit entities, and other institutions.

OVERVIEW

Before I discuss several specific items, I thought it might be helpful to provide a general overview so you will have a better understanding of the credit's scope and breadth.

While the credit has been in existence since 1997 (and 11 years of credits have been issued), I will only focus on the first 10 years because I am working from the Department of Revenue's Report to the General Assembly issued on March 15, 2007. That Report only covers the first 10 years of the Credit. (A new report will be issued on March 15th and I expect that the information included in it will be consistent with the Report issued last year.)

First, let me give you a couple numbers that will put the importance of this Program in perspective so you can evaluate its value to the Commonwealth as you consider the possibility of improving it.

Since its enactment, 1,055 different taxpayers were awarded some amount of credit according to the Department's Report (page 10).

In the first 10 years, total credits of \$205 million were awarded. That obviously is a substantial amount of taxpayers' funds. I think the expenditure was well worth it and I think you will too when we are finished discussing it.

As the Department stated in last year's Report "[o]verall, it is important to note that the R&D tax credit awarded was relatively small when compared to the amount of money spent by the taxpayers to conduct their research activities in the Commonwealth." (page 12). The Department was talking about a specific sample of companies it had studied but its observation also has to apply to the overall population of companies that were awarded credits.

The companies included in the Department's study were awarded about \$13.9 million in 2006. That is a large number but the Department puts it into perspective when it points out that that amount represents "about 0.9% of their total amount of Pennsylvania research expenditures for the taxpayers in taxable year 2005", which is the year on which the credit awards were based. (pages 11-2) **That's right; the credit represents less than 1% of their total expenditures in Pennsylvania for research and development.** Not included in that calculation is any research and development conducted by them outside of Pennsylvania's borders. Nor are expenditures for anything else conducted in PA – manufacturing, production, administrative operations, etc. – considered. The reimbursement of less than 1% applies only to R&D activities in PA.

To put it into perspective from a different angle, the Department noted that "[i]n tax year 2005, the 379 companies awarded the R&D tax credit in 2006 had total Pennsylvania research expenditures of \$3,168.8 million". (page 15) Thus, taxpayers that spent in excess of 3.1 billion dollars on research in Pennsylvania in one year – and which obviously also spent a significant amount of money on other activities in PA – have split among them credits totaling \$40 million. That represents just 1.2% of their PA research activities.

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THE CREDIT

The credit initially was enacted as part of Act 7 of 1997 and has been modified several times.

First, and most important, the credit does not apply to all research and development activities. Taxpayers are only eligible to apply for a credit to the extent that their R&D activities in the relevant tax year exceed the average of the same activities in the prior 4 years. For example, if a taxpayer averaged \$1 million in Pennsylvania R&D activities for the period 2003-6, it would not be eligible to claim a credit for the first \$1 million of R&D expenditures in the Commonwealth in 2007. If the taxpayer in this example spent \$1.1 million on R&D activities in Pennsylvania in 2007, only the \$100,000 of expenditures in excess of the \$1 million average for the base period would be eligible for the credit.

The credit as originally established by Act 7 was for 10% of the expenditures in excess of the base amount. Thus, in the example above, the additional \$100,000 of expenditures in excess of the \$1 million needed to offset the base period amount would earn a credit of \$10,000. However, as I'll discuss shortly, larger taxpayers have never been awarded even half of the credit they earned.

Act 116 of 2006 increased the percentage for "small" businesses from 10% to 20%. A business qualifies as "small" if it has a "net book value of assets totaling ... less than five million dollars". The rate remained 10% for entities that do not qualify as "small".

Significantly, Act 7 established a limit of \$15 million for credits awarded in any tax year with \$3 million set aside for small businesses. If the applications filed by small businesses do not use up the entire \$3 million set aside for them, any remaining amount may be used by "non-small" businesses (as they are called).

Act 46 of 2003 increased the small business set aside to \$6 million and the total credits that could be awarded in 2004 and thereafter to \$30 million.

Act 116 of 2006 subsequently raised the set aside to \$8 million and the total credit limit to \$40 million beginning with the credits awarded in 2006.

Let me stop here and thank the many members of this Committee who were supportive of the original proposal and the amendments already made to it as well as some or all of the proposed changes.

Even with the growth in the Credit from \$15 million in 1997 to \$40 million today, at no time has the level of credits available to taxpayers come close to meeting the level of credits earned. The disparity between credits earned and credits available to be awarded has varied from less than 20% to a high of 46% for large taxpayers. By that I mean that a “non-small” business that earned a credit of \$10,000 by making expenditures in the tax year of \$100,000 more than the base period average would not get a credit of \$10,000 ... rather, it would only get somewhere between \$1,800 and \$4,600 depending upon the year.

The total tentative credits earned have ranged from \$50 million to \$78 million during the ten years covered by Revenue’s Report; with every year from 2001 onward exceeding \$70 million. That is the reason why large taxpayers have never gotten even 50% of the credit the statute was designed to produce. (Small businesses have gotten all of the credits they were eligible except for 1 year, when they got in excess of 99% of the eligible amount.)

In addition to expanding the Credit from \$15 to \$40 million, the Legislature has adopted several other enhancements to the law over the past 10 years.

Act 7 provided that taxpayers could offset up to 50% of their liabilities for Corporate Net Income Tax, the Personal Income Tax, and the Capital Stock/Franchise Tax. Any awarded credits that can not be used to offset tax liabilities in the current tax year can be carried forward for up to 15 years. Act 46 eliminated the 50% limitation for credits awarded in 2005 and thereafter.

Act 46 also included a tradability provision designed to primarily help new entities, including biotechs. Act 46 provides that a taxpayer that is not able to use its credits within one year of when they are awarded can sell or assign its unused credits to another taxpayer. The purchasing entity must use them in the tax year it acquires them and can only offset up to 75% of their eligible liabilities.

The ability to sell credits is very important to new entities ... particularly entities in the pharmaceutical and biotech industries. These entities typically go many years before they make a profit – if they ever do. In fact, Centocor went well in excess of 10 years before it made its first modest profit and had losses in excess of \$1 billion during that time. Thus, the ability of modern day Centocors to sell their credits and get real cash today is quite important.

Act 46 also requires the Department to publish the names and amounts of credit recipients beginning with credits awarded in 2004.

A review of the three Reports published by the Department since company identifiable information became available indicates that 3 prominent Southeastern, PA companies averaged credits in excess of \$2 million annually. The companies are Merck, Cephalon, and GlaxoSmithKline.

My client, GlaxoSmithKline, has been awarded the largest amount of credits in each of the last three years: \$7.7 million in 2004, \$4.1 million in 2005, and \$5.1 million in 2006. In order to be awarded those credits, GSK has had to increase its expenditures by approximately \$188 million over the base period for the credit awarded in 2004, \$95 million for 2005, and \$112 million for 2006. And keep in mind that each year's increase goes into the base period calculation for the following years so the actual increase, in order to receive the \$16.9 million of credits, really is greater than the \$395 million you might have calculated by adding up the 3 specific increases. Additionally, it is important to remember that GSK was conducting a significant amount of research in Pennsylvania prior to 1997 and continued to expand that amount throughout the entire period the credit has existed. Without disclosing company specific information, it is safe to say that GSK's total expenditures in the Commonwealth prior to the three years in question were already quite significant.

I think the simple example of a company that has been awarded a \$2 million credit each year since the credit's enactment provides a great tool for understanding the value of the Research and Development Tax Credit.

As I said earlier, credits are awarded for the increased value of qualified investments tied to a rolling base. If you assume a company had no qualified R&D expenditures for 1993-6 (the base period), it would still need to invest nearly \$93 million in qualified expenditures in 1997 in order to receive a \$2 million credit. To receive that same \$2 million credit for each

of the next 9 years, a company would have to spend \$1,461,573,554 in qualified investments over the 10 year period. Thus, to get \$20 million of tax credits in that ten year period, it would have had to spend in excess of 70 times that amount.

subsequent
The reason the total amount is more than 50% higher than the number you would obtain if you multiplied \$93 million by 10 is largely because of the multiplier effect created by including the new credits in the base period for the ~~prior~~ year. This requirement that an entity continue to expend ever increasing amounts on research in Pennsylvania in order to obtain credits was a key component of the original concept. It was never the intent that an entity that maintained a steady level of research in Pennsylvania would get a credit. The program was designed to encourage additional research in the Commonwealth each year, not to subsidize existing research.

CONCLUSION

As I said earlier, I think the Pennsylvania R&D Tax Credit is a wonderful return on investment for the Commonwealth.

By providing a credit in the following tax year for expenditures already made – in contrast to grants in anticipation of future actions – we are sure we are getting our bang for the buck.

By tying eligibility for the credit to expansion of an entity's research and development activities in Pennsylvania, you are ensuring that the taxpayer is making an ever increasing investment in Pennsylvania. And at the risk of being redundant I'll reiterate, it is only for research and development done in the Commonwealth. Activities outside of the State's borders are not considered.

And I would be remiss if I did not point out that the credit is only for actual hard dollars spent on research and development – it does not apply to administrative overhead.

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

For these reasons I would ask that you consider improving the Program by increasing the cap to \$75 million as well as making several changes sought by the small entities – the ability to sell the credits immediately rather than having to wait a year and the ability of the purchaser to carry forward a credit it purchases. Both of these proposals would assist these entities in obtaining the greatest possible amount of cash for their credits as soon as they can.

Thank you for your attention and the opportunity to appear before you today. I'd be happy to answer any questions.