SUBJECT: Providing a tax credit for certain research and development activities

COMMITTEE: Economic and Small Business Development — committee substitute recommended

VOTE: 5 ayes — J. Davis, Bell, Murphy, E. Rodriguez, Workman

0 nays

4 absent — Vo, Y. Davis, Isaac, Perez

WITNESSES: For — Richard A. (Tony) Bennett, Texas Association of Manufacturers; William Blaylock, Texas Instruments, Dale Craymer, Texas Taxpayers and Research Association; Bill Hammond, Texas Association of Business; Mike Honkomp, Bell Helicopter; Dan Kostenbauder, Hewlett Packard Company; Tom Kowalski, Texas Healthcare and Bioscience Institute; (*Registered, but did not testify*: Kathy Barber, NFIB Texas; Chrissy Borskey, General Electric; Sabrina Brown, Dow Chemical; Raif Calvert, ICUT; Kerry Cammack, Honeywell; Dana Chiodo, Raytheon; Jeff Clark, The Wind Coalition; Brent Connett, Texas Conservative Coalition, Sandy Dochen, IBM; Jeffrey Dodon, The Boeing Company; Jack Erskine, Ebay; Deborah Giles, SHI International, Inc.; Fred Guerra, Dallas Regional Chamber; Patrick Hogan, Texas Technology Consortium; Lisa Hughes, AT&T; Caroline Joiner, National Instruments; Dawn Jones, Intel Corporation; Max Jones, The Greater Houston Partnership; John Kroll, Gemalto, Inc.; James LeBas, Rackspace Hosting; Mike Meroney, Huntsman Corporation; Wendy Reilly, TechAmerica; Jennifer Rodriguez; Lockheed Martin Aeronautics Company; Drew Scheberle, Greater Austin Chamber of Commerce; Carlton Schwab, Texas Economic Development Council; Chris Shields, Greater San Antonio Chamber of Commerce; Daniel Womack, Texas Chemical Council; Geoff Wurzel, TechNet)

Against — Dennis Borel, Coalition of Texans with Disabilities; Eileen Garcia, Texas Forward; Richard Lavine, Center for Public Policy Priorities; Ted Melina Raab, Texas AFT; (*Registered, but did not testify*: Rene Lara, Texas AFL-CIO, Susan Milam, National Association of Social Workers, Texas Chapter)

On — Jon Hockenyos; (*Registered, but did not testify*: Guy Diedrich, Texas A&M University System; Brad Reynolds, Comptroller of Public Accounts; Ed Warren, Comptroller of Public Accounts)

DIGEST: CSHB 800 would provide either a sales tax exemption or a franchise tax credit to entities performing qualified research and development activities in Texas. The bill would use the definitions for "research," and "qualified research" that appear in federal tax law, except that the bill would apply only to research conducted in Texas.

Sales tax exemption. The bill would exempt from sales taxes the sale, storage, or use of depreciable tangible personal property used in qualified research if the property was sold to, stored, or in some way used by a person engaged in qualified research. "Depreciable tangible personal property" would be defined as personal property with a useful life greater than one year and which can be depreciated according to generally accepted accounting principles. The person who bought, stored, or used the property could not claim a franchise tax credit for research and development activities under CSHB 800.

Franchise tax credit. The bill would add Tax Code, ch. 171, subch. M to provide for a franchise tax credit to entities performing qualified research. Entities that claimed a sales tax credit could not also claim a franchise tax credit for the same tax period.

With some exceptions, the franchise tax exemption would equal 5 percent of the difference between an entity's qualified research expenses during the period on which the tax report was based and 50 percent of the average amount of qualified research expenses over the three previous tax reporting periods. Another franchise tax credit would be available to entities that contracted with a public or private higher education institution to perform qualified research.

Report. The comptroller's report on the effect of certain tax provisions delivered to the governor and Legislature before each legislative session, would have to include:

- estimates of the number of persons receiving the sales tax exemption under the bill and the total amount of those exemptions;
- an evaluation of the effect of the sales tax exemptions in combination with franchise tax credits on research and development activity in the state;

- the total number of entities that applied for franchise tax credits;
- the total amount of franchise tax credits;
- the total amount of credits carried forward;
- the amount of qualified research performed in the state;
- employment in research and development in the state;
- economic activity in the state; and
- state tax revenues.

The bill would take effect January 1, 2014. The sales tax credit would not apply to sales tax liability accruing before that date, and the franchise tax credit would apply only to a franchise tax report originally due on or after that date.

SUPPORTERS SAY:

CSHB 800 would reduce the tax burden on research and development activities in Texas and encourage new investments in the state. Research and development activities create high-paying jobs and new technologies. A report commissioned by Texans for Innovation found that the bill would lead to $1.3 billion in additional research and development activity in a relatively short time frame, which would result in $3 billion in total economic activity. The interim Committee on Manufacturing heard from small businesses, which were asking for these credits, as well.

Since Texas discontinued its research and development tax credit in 2006, the state's share of business-funded research and development activity has declined. Today, Texas is one of four states that does not offer a research and development incentive of some type, putting the state at a disadvantage. Massachusetts offers a 10 percent credit for qualified research expenses, as well as a sales tax exemption. Even though Texas is three times the size of Massachusetts, the research and development economy of Massachusetts is the same size as that of Texas. A research and development tax credit would incentivize this state's manufacturing industries by encouraging innovation and efficiency in applying new technologies and producing new products. The Texas Healthcare & Bioscience Institute and those within the life sciences industry represent the types of groups that would take advantage of the incentive.

The bill also would incentivize partnerships between the private sector and higher education institutions, which would expand opportunities for innovation and learning. The state has several programs that send state tax dollars into its colleges and universities for research. A better concept would be to incentivize the vastly larger private sector to send its funds into Texas schools to encourage teachers and students to come up with new patents and build the state's capacity for research and development. California offers a research and development credit of upwards of 24 percent for entities contracting with higher education institutions. Incentives like this work, as California has 23 percent of the nation's research and development, whereas Texas has about 5 percent. In addition, with the sequester affecting federal research dollars going to Texas universities, the bill would provide an opportunity for higher education to receive money from the private sector.

By allowing companies to choose between the sales tax exemption and franchise tax credit, the greatest number of businesses would be incentivized. Some companies would benefit from the sales tax credit and others would benefit primarily from franchise tax relief. CSHB 800 would align with the definitions in federal tax law, which would provide simplicity to these taxpayers.

The committee substitute added language that would limit the sales tax credit to the use of personal property, which would consist of software and equipment. Retail companies in Texas could claim the sales tax credit only if they used software and equipment for qualified research. Companies want reliability and sustainability. If they move to Texas, they want to know they will be able to take advantage of tax credits into the future.

Under the proposed incentive, if Texas were to forego $100 million in taxes, it would only be in a case where the state had at least $2 billion in increased research and development activity. Also, the bill would only provide benefits when a firm's research and development activity was greater than half of the average activity over the previous three years. The 83rd Legislature is already taking steps to restore cuts to social services from the last session, and legislators advocating passage of CSHB 800 also have supported measures like HB 5 by Aycock, which would strengthen the state's emphasis on career training. Texas has never had as much revenue as it does today, and now is the time to give tax relief to taxpayers.

The fiscal note does not account for the dynamic consequences that would accompany the tax credits and exemptions in CSHB 800, which would entice businesses to conduct research and development activities here. The bill would lead to follow-on capital being invested in Texas. If a company moved its research and development activities to the state, many of its other business functions, such as sales and distribution, might follow. Other businesses, such as a supplier to a the company moving its research and development here, also could come to the state.

OPPONENTS SAY:

Texas should take advantage of its improved fiscal situation to restore funding for public education, social services, and other priorities instead of offering more tax breaks to big business. According to estimates from the comptroller's office, corporations with fewer than 100 employees accounted for only around 12 percent of the old research and development tax credits. Historically, tax credits of the sort proposed by CSHB 800 have been used primarily by well established companies, not start-ups.

It is noteworthy that under the old tax credit, Dallas and Travis counties accounted for 60 percent of the total credits taken. Also, Texas' national ranking for both total spending and intensity related to research and development remained relatively constant over the last two decades. This occurred before, during, and after availability of the old tax credit. There is no reason to believe the tax breaks under this bill would be more successful in spurring research and development and associated economic development in Texas. The money also would be better spent on investments in workforce training and infrastructure because these are also factors companies consider before moving to a state.

Even in the improved economic climate, Texas cannot afford the cost of the tax breaks and exemptions proposed in the bill. According to the Legislative Budget Board (LBB) the cost of the proposed tax credits and exemptions to general revenue would be $221 million in fiscal 2014-15. The effects of the bill would include a further reduction of $18 million in franchise tax revenue flowing into the Property Tax Relief Fund, which was established by the Legislature in 2006 to offset reductions of school property taxes. These lost revenues would have to be offset with general revenue funds. When the state budget comes to the floor of the Texas Legislature, a lawmaker is not allowed to introduce a new cost item into the budget unless something else can be removed. This bill should include a means for paying for the expense of these tax credits and exemptions.

OTHER OPPONENTS SAY:

Like the federal research and development tax credit, this bill should include a Sunset date for the proposed tax credits to force the Legislature to review the data and decide if the tax credit was effective and efficient.

Under the state's previous research and development tax credit, retail trade food stores and retail trade home furniture companies claimed credits. The bill should be changed to focus on the industries deemed a priority.

NOTES:

The committee substitute differs from the bill as filed in that CSHB 800 would:

- add a definition for depreciable tangible personal property;
- require the comptroller to include certain analyses regarding the sales and franchise tax credits within its biennial report on certain tax provisions;
- add an exception to how the franchise tax credit would be calculated when the taxable entity contracted with a higher education institution in the state; and
- changed the bill's effective date from October 1, 2013 to January 1, 2014.

According to the LBB, CSHB 800 would have a negative impact on general revenue funds of $221.16 million in fiscal 2014-15. The bill also would result in a direct revenue loss to the Property Tax Relief Fund of $18 million over the same period. There would be a corresponding loss of sales tax revenue to local taxing jurisdictions.

The companion bill, SB 859 by Deuell, was referred to the Senate Finance Committee's Subcommittee on Fiscal Matters on March 18.