

# Impacts of Tax Proposals on Life Science Companies

June 18, 2009

NCBIO recognizes the importance of creating additional sources of revenue to fund education and other crucial state services in the wake of the current economic downturn. These comments address only specific, potentially problematic aspects of the tax proposals discussed to date, and are further restricted to policy issues of particular importance to the life science community. NCBIO appreciates the opportunity to offer these recommendations.

**Sales tax on maintenance and repair services will disproportionately burden research and technology-intensive manufacturing operations.** These firms conduct frequent maintenance and calibration of sophisticated analytical and manufacturing equipment. Impacts on small businesses will be particularly severe because these firms will be less able to in-source maintenance activities. *These problems can be largely averted by excluding maintenance and repair of depreciable equipment from sales tax.*

**Mandatory combined reporting will discourage companies without existing tax nexus in North Carolina from locating research & development or other cost-center subsidiaries in the State.** The provision also will encourage pharmaceutical companies without tax nexus in North Carolina to relocate start-up life science firms acquired here. *The tax packages proposed by the Senate and Governor Perdue do not include mandatory combined reporting.*

**Increased Personal Income Tax Rates will depress availability of start-up capital and encourage successful investors to move to lower-tax jurisdictions.** Increasing the State's top individual income tax rate to 8.5% will heighten incentives for successful entrepreneurs to move to lower-tax jurisdictions when gains on investments are expected to be realized.

**Tax changes should preserve incentives for innovation.** The Senate tax proposal preserves the State's existing R&D Tax Credit and the Qualified Business Venture Tax Credit, and promotes research and development by excluding both the sale and maintenance of depreciable R&D equipment from sales tax. The Senate proposal also reduces overall tax rates, thereby reducing disincentives to investments in start-up companies. In addition to retaining existing innovation incentives, NCBIO recommends that the conferees adopt the Founders Credit proposed by Governor Perdue.

**Impacts of franchise taxation on capital formation should be carefully considered.** North Carolina suffers from a relative lack of venture and other start-up capital. Because a business' franchise tax liability is based on its assets, including equity, expansion of the franchise tax base may adversely affect capital formation opportunities. Such impacts should be avoided or minimized.

For more information, contact Sam Taylor at the North Carolina Biosciences Organization, [staylor@ncbioscience.org](mailto:staylor@ncbioscience.org), P.O. Box 14354, Research Triangle Park, NC, 27709. Telephone: (919) 281-8960; Facsimile: (919) 549-7405; Mobile: (919) 306-1030.

# MEMORANDUM



**TO:** Finance Conferees

**FROM:** Sam Taylor

**DATE:** June 18, 2009

**RE:** Tax Proposal Impacts on Life Science Companies

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This memorandum supports the accompanying one-page summary outlining the North Carolina Biosciences Organization's concerns and recommendations regarding state tax law changes currently under consideration by the budget conference committee. NCBio recognizes the importance of creating additional sources of revenue to fund education and other crucial state services in the wake of the current economic downturn. The comments in this memorandum address only specific, potentially problematic aspects of the tax proposals considered to date and are further restricted to policy issues of particular importance to the life science community. Comments regarding impacts on the broader business community have been provided by other groups. NCBio appreciates the opportunity to offer these recommendations.

NCBio respectfully urges the conferees to –

- Avoid sales taxation of maintenance and repair of depreciable equipment;
- Avoid requiring mandatory combined reporting for multistate holding company systems doing business in North Carolina;
- Avoid increasing personal income tax rates;

- Preserve incentives for innovation; and
- Carefully consider whether expansion of the franchise tax will impair capital formation in North Carolina

Rationale for each of these recommendations is set out in further detail below.

**Sales Tax on Maintenance and Repair of Depreciable Equipment.** The House tax proposal would impose sales tax at the general rate on maintenance and repair services. We have been advised that the Senate proposal would exclude both the purchase and maintenance of depreciable equipment from sales tax. NCBIO believes that sales taxation of maintenance and repair services would hurt North Carolina's innovation economy by disproportionately burdening companies with complex manufacturing processes and substantial research and development activities. These types of activities utilize advanced equipment requiring frequent maintenance and calibration. Small companies, in particular, would be disadvantaged by the proposal because they will typically enter into taxable contracts with third parties for maintenance services. Large companies, in contrast, will be more likely to use their employees, whose activities will not be subject to sales tax, to handle maintenance tasks.

Among research and development companies, it is common for firms to spend more on maintenance and calibration of equipment than on the original purchase of such items. Taxation of maintenance services is therefore likely to more than double the sales tax burden of owning analytical devices and similar R&D related equipment. Finally, the proposed tax will be particularly burdensome for pre-revenue and other start-up companies, since these firms do not have ongoing revenues and must generally rely on equity investors to fund their activities.

**Mandatory Combined Reporting.** Mandatory combined reporting (MCR) compels multistate holding company systems to pay corporate income tax in North Carolina on the basis of their consolidated earnings. Enactment of this proposal would make North Carolina one of only two states in the Southeast that have adopted MCR.

Mandatory combined reporting unnecessarily limits North Carolina's potential to recruit new businesses to the State. The North Carolina Secretary of Revenue is already statutorily authorized to force combined reporting by related companies on a case-by-case basis. With this and other authorities, the Department of Revenue is already successfully prosecuting abusive transfer pricing by multistate corporations. Imposing combined reporting on all corporations, however, will likely undermine North Carolina's appeal as a business location. For example, companies without tax nexus in North Carolina will be unlikely to consider North Carolina as a location for subsidiary entities functioning as cost centers, since such projects would expose these holding company systems to tax liability in the State without generating any countervailing revenues or profits.

In the context of life science companies, mandatory combined reporting is likely, for the reasons explained above, to discourage large life science companies without existing tax nexus in North Carolina from locating stand-alone research and development centers in the State. For similar reasons, large life science companies acquiring North Carolina start-up companies will not wish to set up new subsidiaries here if the acquiring company does not already have North Carolina tax nexus. In these cases, acquiring companies will be more likely to purchase the assets of target start-ups and require North Carolina employees to relocate or seek other work.

**Increases in Personal Income Tax Rates.** The House tax proposal increases North Carolina's top marginal rate for personal income tax from 7.75% to 8.5%. By increasing personal income taxes rates for wealthy individuals this measure is likely to further depress already low levels of angel investment in the State. In addition, because North Carolina taxes capital gains as ordinary income, the taxes paid by investors in successful exits will be higher – increasing their incentives to relocate to lower-tax jurisdictions.<sup>1</sup>

**Preservation of Tax Incentives for Innovation.** Although the Senate's tax proposal eliminates most corporate and personal income tax deductions,

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<sup>1</sup> NC BIO's proposed capital gains tax exclusion for founders stock, if enacted, would mitigate the impact of proposed higher marginal tax rates on individuals exiting from successful Qualified Business Ventures.

exclusions and exemptions – the package preserves certain credits that are very important to North Carolina’s innovation economy. Primary among these is the corporate research and development tax credit. We are also advised that the Senate package would continue North Carolina’s existing Qualified Business Venture Tax Credit. In the context of sales taxes, the Senate package would eliminate the State’s existing 1%/\$80 sales tax on depreciable equipment. We understand that this measure would apply not only to manufacturing machinery but also to depreciable research and development equipment. These provisions of the Senate package are critical to preserving North Carolina’s innovation economy.

NCBIO also recommends that the Founders Credit proposed by Governor Beverly Perdue be included in the conference tax package. This package is designed to encourage angel investors to invest more in innovation-based start-up companies. The package will have no fiscal impact in the current biennium, and will pay credits only for investments in successful start-up businesses.

**Franchise Tax Implications for Capital Formation.** Although NCBIO is not aware of specific ways in which expansion of the franchise tax to limited liability companies will hurt North Carolina life science firms, we are acutely aware that similar business structures, such as limited partnerships, are very important to capital formation. As suggested above, North Carolina already suffers a relative shortage of venture and angel capital necessary to support the formation of new innovation-based start-up companies. Any impairment of existing capital formation structures would therefore be very detrimental to future life science company formation. We ask that the conferees to give careful consideration to impacts of the proposed franchise tax expansion.

Thank you for your consideration. As always, NCBIO is available to provide further information or assistance of these matters. We can best be contacted by e-mail or telephone. Reach me at [staylor@ncbioscience.org](mailto:staylor@ncbioscience.org) or by mobile telephone at (919) 306-1030.