OREGON BUSINESS & INDUSTRY | OBI

Date: Feb 3, 2023

To: Co-Chairs and Members of the Joint Semiconductor Committee
From: Rob O'Neill, Chair, OBI Tax & Fiscal Policy Steering Committee
RE: **Testimony in support and detailed outline of R&D and Investment tax credits for benefit to Oregon semiconductor and manufacturing sectors**

Co-chair Sollman, Co-chair Bynum and members of the committee, I appreciate the opportunity to submit written testimony subsequent to your meeting on Wednesday, January 25, 2023, regarding new possible tax incentives in Oregon.

I am Chair of Oregon Business and Industry's (OBI) Tax and Fiscal Policy Committee. Professionally, I have provided state and local tax and credit and incentive advisory and compliance services to large multistate and multinational companies and their owners in a large range of industries for the past 25 years in Portland, Oregon and live in Washington County.

I am writing to provide my recommendations as it relates to a new Investment Tax Credit (ITC) and the reinstatement of Oregon's Research and Development (R&D) Tax Credit. Bills for each credit have already been introduced in the 2023 Session: HB 2550 includes an ITC, and SB 55 and SB 669 reinstate the R&D credit. I use these bills as a basis of my recommendations to illustrate my recommendations even though these bills may not be the vehicles for their passage.

<u>Investment Tax Credit</u>
HB 2550 creates a new ITC in Oregon. The ITC is an income/excise tax credit for expanding or locating a qualified facility within Oregon.

Oregon can only stand to benefit by positioning itself as a leading destination for new investment. This is even more true with the passing of the CHIPS and Science Act, designed to boost domestic semiconductor manufacturing, and the Inflation Reduction Act, which drastically expands incentives related to clean energy. Other states have been more successful in attracting or retaining businesses by offering their own versions of an ITC. An example, HB 2550 appears to be loosely based on Arizona's Qualified Facility Tax Credit Program.

As many studies have shown, ITC programs have the potential to be self-funded through the additional tax revenues resulting from the creation of new jobs, increased business activity, and property improvements.

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I generally support HB 2550 but with the following recommendations:

1. Provide authority for the Director of the Oregon Business Development Department to waive full-time employment (FTE) method of calculating the credit for certain projects as well as allowing the credit to offset withholding tax pursuant to an agreement.
2. Consider whether to include within the definition of environmental benefit facilities referenced in ORS §§315.341 and 285C.540, CHIPS act eligible facilities under IRC Section 48D, and manufacturing facilities qualifying under IRC Sections 48C, 45X and 45V under the Inflation Reduction Act.
3. Remove the 65% out of state sales restriction to be a qualified facility.
4. Remove the 80% property and payroll restriction to be a qualified facility.
5. Direct Oregon Business Development Department to define by rule any eligibility requirements of a qualified facility.
6. Strike 11(a)-(b) as non-resident owners cannot obtain benefit for a portion of their credit.
7. Strike Section 10 (1) – (3). In the event of transfer, no more than 20% of the original credit amount may be claimed annually either by the transferor or transferee similar to the Agriculture Workforce Housing Tax Credit (ORS 315.169(5)(b)).
8. Allow for the ITC to be refundable over the 5-year scheduled use.
9. Award credits on a first-come first-served basis via a competitive process.
10. Agree with imposing an annual cap, but unused cap can be rolled over for 2 subsequent years and added to the cap for those years.
11. Extend credit carryforward to at least 10 years.

These recommendations are further developed below.

Credit amount. Under HB 2550, the ITC is generally equal to the least of (1) 10% of the investment, (2) $20,000 for each full-time employment position (FTE) associated with the facility, or (3) $30 million if certain conditions are met. Of these three, the $20,000 per FTE method is the most restrictive in its calculation. In order to exceed the $30 million maximum, a qualified facility would need to hire more than 1,500 FTEs ($30,000,000 / $20,000).

I recommend that the Director of the Oregon Business Development Department shall have the ability to waive the FTE method in certain enumerated cases, e.g., automation, manufacturing obsolescence, and mega-projects with more than $1 billion investment. This would create more discretion to attract qualified facilities when and if they make sense or would otherwise lose the project to a competing state.

Bonus credit amounts; environmental investments. Currently, HB 2550 allows the credit amounts to increase for “qualified environmental investments.” In such a case, the

ITC is increased to the least of (1) 20% of the investment, (2) $25,000 per FTE, or (3) $50,000,000.

I support the bonus credit amounts, but recommend that the environmental benefit facilities to also include:

1) renewable energy resource equipment manufacturing facility as referenced and under ORS §§315.341 and 285C.540, in order to tie to existing definitions,
2) CHIPS act eligible facilities under IRC Section 48D, and
3) Manufacturing facilities qualifying under IRC Sections 48C, 45X and 45V, to attract more clean energy manufacturing to Oregon under Inflation Reduction Act eligible activities.

In the future, it may make sense to add renewable energy/clean fuel production as part of the definition or as a separate program.

Transferability. Under HB 2550, the ITC may be transferred to a taxpayer subject personal income, corporate income, or corporate excise taxes. The credit's "5-year period begins with the tax year in which the transferee pays for the credit."
I recommend that the transferability provisions mirror those of the Agriculture Workforce Housing Tax Credit (ORS 315.163 to 315.169). Namely, I recommend that the ITC be transferable in whole or in part, with the transferee only able to utilize up to 20% of the original credit amount per year. For example, if a person purchases $200,000 of a $1,000,000 credit, it could use the full amount of the transferred credit in one year versus having to claim over a 5-year period.

Refundability. HB 2550 currently does not allow for refund of the ITC. I recommend that Oregon's ITC be fully refundable annually over its 5-year period. Entities earning the ITC would still have the option to monetize the credit in whole in order to access capital quickly. Refundability would make Oregon more competitive with states like New York, which has a fully refundable ITC. I do not recommend that the ITC is 100% refundable all in Year 1 of the credit. Transferring it all in year 1 should be allowed however, but the transferees use would still be over 5 years.

Application process. I recommend that ITC awards be awarded on a first-come first-served basis via competitive process. This would allow the Oregon Business Development Department to ensure the best projects for the people of Oregon receive incentives.

Annual limitation. HB 2550, as currently written, leaves open the annual program limitation. I recommend an annual limitation of at least $250M. Arizona's program, for example, has a $125M annual limitation.

Carryforward. The ITC currently has a four-year carryforward. Due to potential size of the credit, I recommend this be increased to at least 10 years to allow claimants to fully utilize the credit.

Research and Development Tax Credit

SB 669 simply reinstates the R&D credit for tax years beginning on or after January 1, 2023, and before January 1, 2029. SB 55 reinstates the R&D credit for tax years starting January 1, 2024 and before January 1, 2030, but also makes a few changes to the program. SB 55 allows 75% of the credit be refundable for taxpayers with fewer than 150 employees and increases the R&D credit rate from 5% to 15% or 24% depending on size of the tax base. SB 55 also increases the credit cap from $1M to $9M.

While I support the return of the R&D credit, I do not recommend reinstating the credit that was allowed to sunset 2017 without any technical modifications. The prior credit simply did not provide any benefit to start-ups or businesses in loss positions. The Legislative Revenue Office (LRO) examined the R&D credit in 2017 using the most recent data available at that time (2014), and found that 376 corporations claimed a total of $85.6 million in tax credits, but only $15.2 million was used to reduce tax liability.[1] In other words, the prior credit was only 18 percent effective. In its report, the LRO offered potential modifications, including making the R&D credit refundable and extending it to non-corporate taxpayers. Other states' R&D credits are a major component of any incentive package offered to relocating or expanding businesses.

To be competitive, and in light of state's desire to be a leader for semiconductor and other tech expansion, there's no reason why Oregon can't offer the nation's best R&D credit and also be a program that is right for Oregon.

I recommend the reinstatement of the R&D credit with the following recommendations:

1. Extend to other business structures, e.g., partnerships and LLCs, and allow it to offset personal income tax.
2. Allow for refundability, subject to limitations.
3. Allow transferability, subject to limitations.
4. Allow certain large employers a R&D tax credit offset against Oregon withholding tax, subject to limitations.
5. Increase credit rate to 15% across all calculation methods.
6. Maintain existing Oregon alternative method under ORS § 317.154 but eliminate throwback sales under ORS § 314.665(2)(b).
7. Increase the annual credit cap from $1M to $15M.

[1] Legislative Revenue Office, "Tax Credit Review: 2017 Session", Feb 8, 2017, *available at* https://www.oregonlegislature.gov/lro/Documents/RR%202_17%20expiring%20tax%20credits.pdf.

8. Make retroactive to January 1, 2023.

These recommendations are further developed below.

Eligible entities. The R&D credit, as previously enacted, and under SB 55 and SB 669, may only be earned by corporations. Other business entities or business structures conduct R&D and should be provided the same incentive. In order to make the R&D credit more effective, I recommend extending it to other business structures, e.g., partnerships and LLCs and allow it to offset personal income tax to allow for full utilization and equity among businesses that operate as a pass-through entity.

Refundability. SB 55 allows the R&D to be refundable at 75% of the credit amount by taxpayers with fewer than 150 employees. Arizona also allows for refund of its R&D credit at 75%; New York allows for full refundability. In order to stay competitive, I recommend that Oregon allow refunds at 80% of the credit amount and limit to small businesses with less than $10M in gross receipts. To further reduce state expenditure, I recommend an annual cap of total refunds at $25M.

Transferability. The R&D credit, as previously enacted, and under SB 55 and SB 669, do not allow for transferability. Some other states allow for transfer, including New Jersey, which is often considered to have the most attractive R&D credit. I recommend that Oregon's credit be transferable with a minimum transfer price of 80% and subject to the revocation provisions of ORS § 315.061. I also recommend considering an annual transfer limitation and per-taxpayer lifetime transfer limitation. Finally, I recommend capping all transfers to $100 million per year, which is similar to New Jersey.

Oregon Withholding Offset. For certain large employers in the state (e.g., >1,000 full time employees) and subject to an agreement with Oregon Business Development Department, provide for a provision to allow for these taxpayers to apply their Oregon R&D tax credit to their Oregon employee withholding tax. Along with this provision, I recommend an annual cap of withholding tax offset be adopted with this option (e.g., $25M annually to align with small business set aside).

Credit rate. SB 55 increases the R&D credit rate from 5% to 15% or 24% depending on size of the tax base. I recommend increasing the credit rate to a flat 15% regardless of the calculation methodology used for ease of administration, which would be among the most attractive rate in the country.

Oregon alternative calculation. Oregon's R&D credit alternative calculation under ORS § 317.154 would be reinstated under both SB 55 and SB 669. Under the alternative calculation, the R&D credit equals 5% of the amount of expenses that exceed 10% of a business' Oregon sales. Oregon sales, in the case, means a business' sales factor numerator for purposes of income tax apportionment.

Oregon, however, has a "throwback" provision where Oregon sales include sales of tangible personal property if (1) the property is shipped from an office, store, warehouse, factory, or other place of storage in Oregon and (2) the taxpayer is not taxable in the state of the purchaser. In simpler terms, if that sale is not taxed in another jurisdiction, it is "thrown back" to Oregon and gets included in the business' Oregon sales factor numerator, increasing Oregon income tax paid.

In the case of a manufacturer in Oregon that is not taxable elsewhere, its Oregon sales is inflated due to this throwback provision, thus the R&D credit is decreased when using the alternative calculation. For example, suppose an Oregon manufacturer and Oregon service provider both have $1,000,000 of total sales, and only $100,000 of sales to Oregon customers. Assuming the manufacturer is not taxable elsewhere, its Oregon sales for purposes of the alternative calculation would be $1,000,000, as $900,000 would be thrown back. The service provider, on the other hand, would have Oregon sales of just $100,000. If both businesses had $200,000 of qualifying R&D expenses, the service provider would calculate an R&D credit of $190,000 ($200, 000 – [10% * 100,000]) while the manufacturer would calculate an R&D credit of just $100,000 ($200,000 – [10% * 1,000,000]).

In order to make Oregon's R&D credit more attractive to in-state manufacturers and to make the alternative calculation more uniform among taxpayers, I recommend maintaining existing Oregon alternative method under ORS § 317.154 but redefine Oregon sales to eliminate throwback sales under ORS § 314.665(2)(b).

Annual limitation. SB 55 also increases the credit cap per taxpayer from $1M to $9M. I recommend increasing the cap further to $15M to support larger businesses conducting more extensive R&D activities.

Effective date. SB 669 reinstates the R&D credit for tax years beginning on or after January 1, 2023, and before January 1, 2029 while SB 55 applies to tax years starting January 1, 2024 and before January 1, 2030. I recommend making the new R&D credit retroactive to January 1, 2023 to capture new investments and keep existing businesses in Oregon.

I fully support the Committee's work on these matters. Please do not hesitate to reach out should you have any questions. I can be reached at rob.oneill@mossadams.com or 503-478-2339.
Sincerely,

Rob O'Neil