House Legislative Analysis Section
House Office Building, 9 South
Lansing, Michigan 48909
Phone: 517/373-6466

R & D TAX INCENTIVES FOR PFIZER

House Bill 6073 as enrolled
Public Act 588 of 2002
Sponsor: Rep. Barb Vander Veen

Senate Bill 1315 as enrolled
Public Act 587 of 2002
Sponsor: Sen. Don Koivisto

Third Analysis (10-21-02)
Committee: Energy and Technology

THE APPARENT PROBLEM:

In July 2002 Pfizer Inc. and Pharmacia Corporation announced that the two pharmaceutical companies had reached agreement on a plan for Pfizer to acquire Pharmacia. Although Pfizer is based in New York City and Pharmacia is based in New Jersey, both companies have operations in Michigan—Pfizer in Ann Arbor and Pharmacia in Kalamazoo, Portland, and Richland. The plan is subject to Federal Trade Commission approval, but many experts expect the deal to go through, since there is little overlap in the companies' product lines and thus little basis for antitrust concerns. As might be expected, the prospect of a merger has fueled speculation about the fate of Pharmacia's research and development operations and employees in southwestern Michigan. In a July 15, 2002 press release, Pfizer announced that it hopes that the consolidation will result in "peak year synergies", i.e., cost savings, of about $2.5 billion by 2005. A July 21, 2002 article in the *Kalamazoo Gazette* stated that officials of both companies "expect the majority of cost savings to come from Pharmacia" and that analysts "expect Pharmacia employees at the company's offices in New Jersey to be most affected by the transition". Still, such expectations provide no guarantees, and business leaders in southwestern Michigan would prefer to take a proactive approach to ensure that Pfizer builds on Pharmacia's strong ties to the area rather than risking the loss of several thousand jobs and the financial costs that such massive job cuts would involve.

According to committee testimony, one of the biggest drawbacks to doing business in Michigan is the lack of research and development tax incentives. Business leaders have suggested that this places the state at a significant competitive disadvantage with respect to the 22 states that allegedly do offer R&D tax incentives, when it tries to attract new companies and retain companies currently operating here. Local government officials and business leaders are supporting legislation that would give certain tax breaks to Pfizer, as well as any other pharmaceutical company that met the bills' eligibility requirements, and would authorize local governments to give Pfizer (and potentially other pharmaceutical companies) other tax breaks.

THE CONTENT OF THE BILLS:

House Bill 6073 and Senate Bill 1315 would provide tax incentives targeted at pharmaceutical companies that employ at least 8,500 persons in the state within a 100-mile radius, at least 5,000 of whom are engaged in the research and development of pharmaceuticals.

House Bill 6073 would amend the Single Business Tax Act (MCL 208.39f) to allow certain pharmaceutical companies to take a single business tax credit for qualified research expenses that relate to the companies' pharmaceutical-based business activity in the state. Specifically, an eligible pharmaceutical company could claim an SBT credit equal to 6.5 percent of the amount by which its qualified research expenses for in-state pharmaceutical-based business activity ("qualified research expenses") paid in a given tax year exceeded the average of the qualified research expenses that it paid during the immediately preceding three years. The credit could be claimed for tax years that began after December 31, 2002. Other provisions of the bill are described below:

Maximum credit. The amount of a credit for any tax year could not exceed 200 percent of the taxpayer's average qualified pharmaceutical research expenses for the three immediately preceding tax years. The total of all credits allowed could not exceed $10 million for any single tax year.

Carryforward. The credit would be nonrefundable but could be carried forward as an offset to the taxpayer's tax liability in subsequent tax years for seven years or until the excess credit was used up, whichever came first.

Credit on consolidated basis. A member of an affiliated group as defined in the SBT act, a controlled group of corporations as defined in the Internal Revenue Code, or an entity under common control as defined in the Internal Revenue Code would be required to determine the credit on a consolidated basis.

Credit, assignable. A taxpayer could assign all or a portion of its credit but could not assign *in any tax year* more than 40 percent of the total amount of the credit allowed *for that year*. A credit assignment would be irrevocable and would have to be made in the tax year in which the qualified research expenses were paid. If the taxpayer both claims and assigns portions of the credit, the taxpayer must claim the portion it claims in the tax year in which the qualified research expenses were paid. An assignee could not subsequently assign a credit or any portion of a credit. A credit assignment would have to be made on a form prescribed by the Revenue Bureau of the Department of Treasury. The assignee would have to attach a copy of the completed assignment form to its annual tax return, for the tax year in which the assignment was made and the assignee first claimed a credit, which would be the same tax year.

Eligibility. To be eligible for the credit, a company would have to meet the following three criteria. First, the company would have to be engaged primarily in the manufacturing, research and development, and sale of pharmaceuticals. Second, the company could have no less than 8,500 employees located in the state, all of whose primary places of employment would have to be located within a 100-mile radius of one another. Third, of the 8,500 or more employees located in the state, at least 5,000 would have to be engaged primarily in the research and development of pharmaceuticals.

Senate Bill 1315 would amend the Michigan Renaissance Zone Act (MCL 125.2688a) to specifically allow the board of the Michigan Strategic Fund to designate a renaissance zone as a "pharmaceutical renaissance zone". Currently, the act allows the strategic fund to designate up to five renaissance zones. The pharmaceutical renaissance zone would be created to promote and increase the research, development, and manufacturing of pharmaceutical products of an "eligible pharmaceutical company," as defined above. The pharmaceutical renaissance zone would have to be designated not later than 18 months after the bill's effective date, and any city, village, or township in which the zone was to be located would have to consent to the zone's creation.

Businesses that are located in and conduct business in renaissance zones are eligible for certain tax exemptions from, deductions from, and credits for the SBT, city and state income tax, and city utility users tax act. Property located in a renaissance zone is also eligible for certain tax exemptions.

BACKGROUND INFORMATION:

As it was introduced and passed by the Senate, Senate Bill 1315 would have allowed the strategic fund to designate a renaissance zone as an "alternative energy zone". Since that time the legislature has accomplished this by enacting Public Act 512 of 2002.

House Bills 5726 and 6077 would provide additional tax incentives to eligible pharmaceutical companies. House Bill 5726 would amend the General Property Tax Act to authorize local governments to exempt such companies from taxes on new personal property. House Bill 6077 would amend the Michigan Economic Growth Authority Act to allow such companies to apply for and receive Single Business Tax credits.

FISCAL IMPLICATIONS:

The Senate Fiscal Agency estimates that under House Bill 6073 Pfizer would qualify for the maximum $10 million credit each year beginning with the 2003 tax year. This loss in single business tax revenue would affect general fund/general purpose revenue. Key issues regarding this bill include:

• It appears that the only company that would qualify for this credit would be Pfizer after it has taken over Pharmacia. It also appears that, at present, Pfizer and Pharmacia combined have slightly over 5,000 employees in Michigan involved in their research and development (R&D) activities. As a result, in order to qualify for the credit, they would have to maintain this level of research and development activity in Michigan after the takeover.

• The criteria for a company to qualify for the credit would have to be met within 18 months of the effective date of the bill. If the company met all of the criteria 18 months after the bill's effective date, but did not continue to meet the criteria 24 months after the effective date, it appears that the company would still qualify for the credit.

• The bill would allow a qualifying company to assign or sell 40 percent of its credits to other companies. Presumably, a company would assign only those credits that it would not be able to use itself. The credits could be sold to any other company, whether based in Michigan or outside of Michigan. Other companies would be interested in these credits because they could be used to offset the company's single business tax liability.

• There could be a timing problem in the bill in regard to when assigned credits would have to be claimed by the other company. The bill would require that the assigned credits be claimed in the tax year in which the R&D expenses were incurred, but the credits could not be calculated until after the tax year was over because the credits would be dependent on the total R&D expenses incurred during the tax year. Therefore, there is no way that the assigned credits could be claimed in the same tax year.

• The assigned credits could create a situation in which more than one taxpayer was claiming credits, with the total of the claimed credits exceeding $10 million, which would exceed the annual allowable maximum of all credits. The bill does not indicate how this issue would be resolved. (9-26-02)

The House Fiscal Agency reports that Senate Bill 1315 would have no fiscal impact on the state or on local units of government. (9-24-02)

ARGUMENTS:

For:

With Pfizer's anticipated buyout of Pharmacia, many people in the state are speculating about what will happen to Pharmacia's Michigan operations when the restructured company takes advantages of its "synergies". The bills would create tax incentives for Pfizer to keep Pharmacia's research and development operations in Michigan going. (Any other pharmaceutical company meeting the specific criteria of the bills would be eligible for the incentives, but officials believe that Pfizer is the only company that would qualify.) Twenty-two other states offer research and development incentives, and without offering a competitive package, the Kalamazoo area and the state could risk losing a major employer—Kalamazoo County's biggest employer—and the economic benefits that come with it. Southwest Michigan First, a local economic development corporation, has estimated that 2,000 or more high-skilled R&D jobs could be in jeopardy. A potential loss of so many good jobs is clearly sufficient reason for concern, yet local government officials and business leaders also warn that Pfizer's exodus would also represent a significant loss for the Life Sciences Corridor, which is an integral component of the state's larger economic diversification strategy. Thus, the entire state—not just the greater Kalamazoo region—stands to lose if Pfizer takes its jobs elsewhere. Some experts expect that the Pfizer is more likely to layoff Pharmacia's New Jersey employees than its Michigan employees as a result of the deal. And some experts have even suggested that layoffs of Pharmacia employees might not be such a bad thing, since they would create a pool of highly skilled labor for Michigan's smaller biotech companies. Nonetheless, business leaders and governmental officials in southwestern Michigan prefer to take a proactive approach to ensure that Pfizer retains the high-skilled research and development workers currently working for Pharmacia.

Because Kalamazoo area leaders are sensitive to Pfizer's need for flexibility, the legislation has been drafted to protect at least 5,000 R & D jobs in the state, within a 100-mile radius. This would allow Pfizer to keep its Ann Arbor operations, where approximately 3,000 workers work in R&D, and its Kalamazoo area operations, where there are over 2,000 R&D workers, going. While nothing in the legislation would preclude Pfizer from creating 2,000 new R&D jobs in the Ann Arbor area and shutting down its Kalamazoo area operations, Kalamazoo area leaders are confident that they can offer an attractive package to any potential employer, let alone one with facilities already in place. The legislation would help Kalamazoo area leaders and the state remind Pfizer that Michigan is an attractive place to do business.

Against:

In the press release announcing the planned buyout, Pfizer boasted: "Already the leading pharmaceutical company in the United States and Canada, Pfizer with Pharmacia will move from fourth to first in Europe; from third to first in Japan; and from fifth to first in Latin America in pharmaceutical sales." Pfizer also observed that "[t]he companies' combined R&D budget for 2002 exceeds $7 billion, making it by far the largest privately funded biomedical research organization in the world." Whether or not the FTC raises any antitrust concerns, the new and improved Pfizer would certainly not be lacking funds for research and development. While no one wants Pfizer to leave the state, clearly the company can afford to pay its fair share in taxes.

In a related concern, some people believe that pharmaceutical companies' huge profits would suggest that they can afford to lower drug prices. In the House Energy and Technology Committee an amendment was offered to tie-bar House Bill 5726 to House Bill 5930, which would create the Michigan Prescription Drug Fair Pricing Act.

Response:

Whether or not Pfizer can afford to pay the amount of taxes that it would have to pay without the breaks is beside the point. The state has a vital interest in retaining jobs that may be lost. With 22 other states offering R&D tax incentives, Michigan cannot afford to take the risk of losing Pfizer jobs.

Any legislation concerning prescription drug prices involves complex issues that should be considered separately. The FTC is expected to approve Pfizer's buyout of Pharmacia on November 15, 2002, and without the tax incentives in hand, Michigan leaders will be unprepared to talk specifics with Pfizer.

Analyst: J. Caver