Statement to the House Tax Committee re HF 277 – Research Credit Modified
IBM Corporation
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Thank you Chair Marquart, Representative Robbins, and distinguished Committee Members for your review of this testimory. This statement is submitted on behalf of IBM in support of House File Bill 277.

The purpose of this statement is to briefly describe IBM's research activities in Minnesota, address the general theory of Research and Development ("R&D") tax credits, the changes House File Bill 277 makes, the history of the existing Minnesota credit and comparable history with the Federal credit, the limitations of the existing Minnesota credit and benefits that the Alternative Simplified Credit could provide, and current credits in other major research development states.

IBM has maintained a presence in Rochester since 1956 and has had a long history of hardware development and manufacturing of IBM systems. As the information technology (IT) industry has changed through the years, IBM in Rochester has also transformed by adapting its mission to the continually changing technology space. IBMers in Rochester continue to be key in the development and support of enterprise servers and supercomputers and leads in IBM Systems software and chip development, contributing to IBM's Quantum computing efforts. Our workforce in Rochester is comprised mainly of scientists and programmers developing solutions in healthcare through Watson Health, cloud platforms, and cognitive and analytic systems. This shift in focus to producing computing ideas, specifically patentable computing ideas, has led to IBM leading the United States in patented inventions for 28 consecutive years with IBM Rochester contributing as a leader in patents in Minnesota. HF 277 will help our Rochester facility remain competitive.

The underlying purpose of most R&D incentives is to encourage local investment and employment. An R&D credit is a perfect way to meet those goals because a taxpayer must have in-state operations that conduct research activities. A company cannot generate a Minnesota R&D credit for any activity outside the state. However, it is equally key to recognize that most developed nations provide R&D incentives, and almost all of the States that have an income-based tax, provide an R&D credit. Therefore, if most taxing jurisdictions provide the incentive, the rate of return on the research investment must be competitive to encourage investments in Minnesota. A primary factor to determine the return on investment of an R&D incentive is the complexity and cost of compliance with the credit regime.

HF 277 will make Minnesota more competitive by simplifying the R&D credit regime. It will explicitly provide taxpayers with an alternative calculation method; but will not require any taxpayer to change if they do not want to. It reduces a multistep analysis to a few easy calculations. HF 277 recognizes the changes federal and state governments have made to modernize the R&D incentive, but it keeps in place the

main requirement: that only R&D activities conducted in Minnesota will be eligible for the credit.

To better understand the impact of HF 277 , it is helpful to take a quick look at the current Minnesota R&D credit incentive and how it has not kept pace with the federal or other state systems.

In 1982 Minnesota became the first state to enact an R&D tax credit modeled after the Federal R&D tax credit, which was enacted in 1981. Since 1982, very little has changed with the Minnesota R&D credit incentive whereas the Federal and several states significantly expanded their R&D credit incentives. The credit calculation adopted by Minnesota in 1982 is based on the original Federal R&D credit designed to capture only incremental investments in R&D activities. This means that current-year Minnesota based R&D investment must be incrementally greater than a base period in order to qualify for an R&D credit. The theory for this type of credit is the state rewards companies that grow investment activity relative to a static base. The detriment is that the static base period adopted by Minneosta (currently almost 40 years old), may have been determined at a time when a taxpayer's operations were drastically different. As such, the use of a static base fails to account for R&D done as part of a dynamic and ever-changing process. The term R&D evokes a sense of change for the better. A static measurement does not account for economic changes or improvements and efficiencies in research operations.

The static "fixed base" approach that Minnesota currently applies is only one of the methods available for computing the Federal R&D credit, under the Internal Revenue Code (IRC) this method is referred to as the Regular Research Credit (RRC). The current "fixed base" approach requires a taxpayer to calculate its credit by comparing gross receipts and qualified research expenses (QRE) for the period 1984 through 1988, to the average of the preceding four years gross receipts and current year QRE.

 The "fixed base" adds to the complexity of calculating the allowable credit. As time elapsed between 1988 and the present day, the limits of the RRC began to emerge. Congress recognized these limitations and modified the IRC to provide an alternative method to acknowledge the limitations associated with the RRC. The main reasons for considering a different model were:

- Significant record keeping requirements (back to tax years 1984-1988) made audit verification more difficult,
- The burdensome requirement imposed on taxpayers to track the impact of acquisitions, mergers and dispositions on the "fixed base",
- Acknowledgement that QRE and gross receipts may not grow at the same pace, hindering a company's ability to generate a credit

The nature of the IT industry has changed since the mid 1980's, as a result a company's gross receipts and QRE from 40 years ago may not be relevant or representative of a company's current year gross receipts and QRE. More simply put, the existing Minnesota credit is based on what a company was doing 40 years ago.

During that time frame, IBM's business has transformed. In addition to producing and developing systems, software, and solutions, IBM also delivers technology and business services and support to our clients. This change has led to the recognition of gross receipts that were not in the "fixed base".

To address the complexities and inequities of the RRC, in 2006 Congress enacted the Alternative Simplified Credit (ASC). It is an election available to the taxpayer. In simplest terms, to qualify for the ASC, a taxpayer should

1. Make the election.
2. Determine current year QRE.
3. Calculate 50% of the three prior year average QRE.
4. Subtract step 3 from step 2.
5. Apply the credit percentage recovery rate to the product of step 4.

The ASC addresses the limitations imposed by the RRC:

- Simplifies the calculation of the claimed credit,
- Reduces the record keeping burden and makes the credit easier to audit,
- Bases the calculation on a more recent set of business factors

Enactment of the ASC would incentivize growth and efficiencies in research operations and reward innovation, investment, and employment in Minnesota. Additionally, it would make Minnesota more competitive with the other states that have enacted an alternative credit, such as TX, MA, WI, and CA.

Minnesota would be taking a significant step to encourage R&D investment in the state by enacting the elective Alternative Simplified Credit in HF 277 .

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