

HOUSE BILL REPORT

HB 1454

As Reported by House Committee On:

Finance

Title: An act relating to business and occupation tax credits and deferrals for research and development and high technology job creation.

Brief Description: Eliminating the expiration date on certain business and occupation tax credits and deferrals.

Sponsors: Representatives Morris, Cairnes, Gombosky, Bush, O'Brien, Linville, Anderson, Kirby, Tom, Grant, Kessler, Sullivan, Roach, Benson, Newhouse, Chandler, Orcutt, Nixon, Woods, Rockefeller, McMahan, Campbell, Pflug, Upthegrove and Ruderman.

Brief History:

Committee Activity:

Finance: 2/4/03, 3/10/03 [DP].

Brief Summary of Bill

- Extends the business and occupation tax credit allowed to high technology businesses for certain expenditures associated with research and development (R&D) indefinitely.
- Extends the sales and use tax deferral/exemption for certain expenditures associated with R&D and pilot scale manufacturing indefinitely.

HOUSE COMMITTEE ON FINANCE

Majority Report: Do pass. Signed by 7 members: Representatives Gombosky, Chair; Cairnes, Ranking Minority Member; Orcutt, Assistant Ranking Minority Member; Ahern, Morris, Roach and Santos.

Minority Report: Do not pass. Signed by 2 members: Representatives McIntire, Vice Chair; and Conway.

Staff: Mark Matteson (786-7145).

Background:

Business and Occupation, Retail Sales, and Use Taxes

The Business and Occupation (B&O) tax is Washington State's major business tax. The tax is imposed on the gross receipts of business activities conducted within the state. Revenues are deposited to the state general fund. A business may have more than one B&O tax rate, depending on the types of activities conducted. The rate at which gross receipts derived from research and development activities are taxed depends on whether the business is for-profit or nonprofit. For-profit firms pay at a rate of 1.5 percent; nonprofits pay at a rate of 0.484 percent.

The B&O tax does not permit deductions for the costs of doing business, such as payments for raw materials and wages of employees. Nonetheless, there are many exemptions for specific types of business activities and certain deductions and credits permitted under the B&O tax statutes.

The retail sales tax applies to the selling price of tangible personal property and of certain services purchased at retail. The tax base includes construction and equipment purchase costs, as well as costs for labor and services associated with the construction. The tax is levied at a 6.5 percent rate by the state. Cities and counties may levy a local tax at a rate up to a maximum of 3.1 percent; currently, local rates levied range from 0.5 percent to 2.4 percent. Sales tax is paid by the purchaser and collected by the seller.

The use tax is imposed on items used in the state that were not subject to the retail sales tax, and includes purchases made in other states and purchases from sellers who do not collect Washington sales tax. The state and local rates are the same as those imposed under the retail sales tax. Use tax is paid directly to the Department of Revenue (Department).

Research and Development Tax Incentives

In 1994 the Legislature enacted several tax incentives to encourage additional research and development (R&D) in the high-technology sector. The legislation allows businesses that conduct R&D or pilot scale manufacturing activities in advanced computing, advanced materials, biotechnology, electronic device technology or environmental technology and that make certain expenditures to be eligible for a credit against state B&O tax and for an exemption from state and local retail sales and use taxes.

To qualify for the high technology B&O tax credit for R&D, a firm's annual expenditure for research and development must exceed 0.92 percent of the firm's B&O taxable receipts. For for-profit firms, the amount of tax credit is equal to 1.5 percent of the firm's expenditure for R&D, excluding capital improvement costs. For nonprofit organizations conducting R&D, the credit is equal to 0.484 percent of the R&D expenditures. To claim the credit, an applicant must file an affidavit with the Department that includes the amount of credit claimed, an estimate of anticipated R&D expenditures

for the year for which the credit is claimed, an estimate of taxable income for the year, and other information that the Department deems necessary to administer the credit. If the firm's annual expenditure for R&D fails to exceed 0.92 percent of taxable receipts, the firm is liable for an amount equal to the amount of credit taken, plus interest. A maximum of \$2 million in credit is available each year to an eligible firm. The statute is set to expire on December 31, 2004.

Under the 1994 legislation, the same high-technology businesses eligible for the B&O tax credit for R&D spending were made eligible to receive a deferral from retail sales and use taxes for qualified expenditures. Purchases and acquisitions that qualify include those on construction and equipment related to R&D or to pilot scale manufacturing. To receive the deferral, an applicant is required to submit an application to the department before beginning construction or equipment purchases. The application must include the location of the project, current employment, new employment estimates, estimated wages related to the project, estimated or actual cost data, time schedules for completion and operation, and other information required by the department.

As originally enacted, the program required deferred sales and use taxes to be repaid starting the third year after which the project was put into operation. In 1995 the Legislature modified the incentive, making it an outright exemption if the firm taking the deferral continued to use the facilities or equipment for a qualified use for at least eight years. No new deferral/exemption certificates may be issued under the program after June 30, 2004.

The Department of Revenue is required under the 1994 legislation to do an assessment of the program in 1997, 2000, and 2003. The Department has estimated that about 500 firms utilize the B&O credit for R&D expenditures, resulting in savings of over \$30 million annually. About 60 businesses each year take the deferral/exemption from sales and use taxes, resulting in annual savings of about \$60 million.

Summary of Bill:

The provisions that terminate the business and occupation tax credit and the sales and use tax deferral/exemption provided to high-technology firms for operational and capital expenditures relating to research and development and to pilot-scale manufacturing are removed, making the incentives permanent.

Appropriation: None.

Fiscal Note: Available.

Effective Date: The bill takes effect 90 days after adjournment of session in which bill

is passed.

Testimony For: For the foreseeable future, the technology sector is the only sector in this state anticipated to have growth. It is imperative that we make the investments to ensure that this sector will grow as much as it possibly can in this state. There should be a review from time to time, however, to make sure that tax incentives should be used in the most effective and appropriate manner. We have a constitutional obligation to make sure that the policies that we pass here have the anticipated outcomes desired.

In 1994 when the original legislation was passed, it was intended that the University of Washington (University) be included. In fact, the Fred Hutcheson Center applied for and received a deferral. However, the Department of Revenue audited the University in 1999 and found that we did not meet the definition of "person" under the statute. We are requesting that the underlying language be amended to include the University. The University has received a lot of research and development dollars, but we can't continue to maintain growth without additional help.

Washington is the only state that imposes a tax on the gross receipts of businesses. In other states with corporate net income taxes, amounts spent on R&D would be deductible from taxable income. We are asking for a level playing field. The firms in this industry are highly mobile. We have to make sure that there are incentives here that equal the incentives elsewhere. The R&D expenditures will help the future of manufacturing in this state. In addition, it is just as important for firms across the nation.

High technology is a positive force in this state. Since the time the original credit was enacted, employees in R&D have grown from 75,000 to 136,000. Washington high-tech employment growth has outpaced national growth by 30 percent. In addition, R&D jobs bring high wages with them. Excluding software, wages were as high as \$68,000 annually; with software, average income was \$118,000 per year. Wage growth has outpaced national wage growth in the high-tech sector by 45 percent.

The R&D incentives have enabled companies to invest in the state. One example is Phillips Ultrasound, a Bothell firm. The R&D tax deferral was a deciding factor to construct a new research facility in Washington State. A second example is Data IO Corporation, a leading provider of chip programming equipment. Recently the company shut down a facility in Germany and moved the operations to Washington, in part because of the availability of the tax incentives. Another example is Palladin Data Systems, which supplies IT services to other companies, and uses the credit to support 5 percent of its full time work force.

The biotechnology and biomedical industries also have utilized the R&D incentives. There are four components to successful bioscience industries: 1) strong academic research institutions; 2) successful technology transfer from those institutions; 3) access to venture capital; and 4) a skilled work force. These tax incentives for us equal venture

capital. Venture capital leads to successful bioscience communities, which lead to economic growth for the state and new life-saving technologies.

We're a small company located in Bellevue, with 24 employees. The R&D credit has been very beneficial to us. We have three patents, with over 70 claims, and three additional patents currently pending. We consider ourselves a technology company. We do not have a direct sales force. We sell under original equipment manufacturer (OEM) relationships, where we license our technology to others for use in their products.

These incentives have created high-wage, high-skilled jobs that have a multiplier effect: for each one of these jobs created, there are three additional ones created, which create new sales tax and other revenues. Regarding benchmarks, current law already requires the Department of Revenue to measure job growth, effects on the state economy, and others. So I'm not sure if more data is needed, or simply clarification.

We feel that the use of these incentives has been successful in environmental remediation efforts, in improving pollution control technologies, and in the innovation of natural resource technologies. The incentives have enabled improvement in the environment and growth in environmental jobs.

Testimony Against: None.

Testified: (In support) Representative Morris, prime sponsor; Lew McMurrin, WSA; Charlie Osenbaugh, Timeline, Inc.; Nancy Atwood, AeA; Vicki Austin, Washington Biotechnology & Biomedical Association; Ron Newbry, Washington Economic Development Council; and Jerry Smedes, N.W. Environmental Business Council.

(Comments) Mary Welsh, Department of Revenue.