Washington State
House of Representatives
Office of Program Research

BILL ANALYSIS

Finance Committee

HB 2772

Brief Description: Streamlining the administration of tax incentive programs.

Sponsors: Representatives Linville, Kristiansen, P. Sullivan, Grant, Haler, Morris, Ericks, Fromhold, Kessler, B. Sullivan, Kilmer, Hunter, McCoy, Simpson, Morrell and Tom.

Brief Summary of Bill

- Consolidates and streamlines the provisions of the high-tech research and development sales and use tax deferral, the rural county/distressed area sales and use tax deferral, and fruit and vegetable processing sales and use tax deferral.
- Extends the date by which eligible businesses may apply for credit under the business and occupation tax credit program for job creation.
- Modifies accountability provisions in recent tax incentive programs to provide consistency.
- Allows the Department of Revenue to disclose certain taxpayer information in statutorily required studies of tax incentive programs if the number of participating taxpayers is very small.

Hearing Date: 1/27/06

Staff: Mark Matteson (786-7145).

Background:

Retail sales and use, business and occupation taxes. The retail sales tax applies to the selling price of tangible personal property and of certain services purchased at retail. The use tax applies if retail sales tax has not been collected. Both the state and local governments impose sales and use taxes; the average combined rate is 8.5 percent statewide. Sales taxes are collected by the seller from the buyer at the time of sale. Use tax is remitted directly to the Department of Revenue. State revenues are deposited to the State General Fund.

The business and occupation (B&O) tax is imposed on the gross receipts of business activities conducted within the state, without any deduction for the costs of doing business. A business may have more than one B&O tax rate, depending on the types of activities conducted. The tax rate for manufacturing activity is 0.484 percent and for services generally is 1.5 percent, for example. Revenues are deposited in the State General Fund.

High-technology research and development tax deferral. In 1994, the Legislature enacted a deferral from sales and use taxes to encourage additional research and development (R&D) in the high-technology sector. The legislation, modified most recently in 2004, allows businesses and state universities 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 deferral from state and local retail sales and use taxes. Federal contractors that make qualified purchases or acquisitions on approved projects are also eligible.

Under the incentive program, sales and use taxes are deferred on expenditures on qualified buildings and equipment used for eligible R&D or pilot scale manufacturing. With respect to buildings, qualifying expenditures are those on the construction of new structures, or expansion or renovation of existing structures, for the purpose of increasing floor space or production capacity. Qualifying building expenditures also include plant offices and other facilities that are an essential or an integral part of a structure used for the eligible R&D or pilot scale manufacturing. With respect to equipment, expenditures must be used for fixtures, equipment, and support facilities that are an integral and necessary part of the eligible R&D or a pilot scale manufacturing operation.

To receive the deferral, an applicant is required to submit an application to the Department of Revenue (Department) before making equipment purchases or the initiation of construction, defined as when the building permit is issued. 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.

Participants are required to complete an annual survey and provide information on the amount of sales tax exemption; number of new products, trademarks, patents, and copyrights; number of jobs and the percent of full-time, part-time and temporary jobs; wages by salary band; and number of jobs with employer provided health and retirement benefits. The Department may request additional information necessary to measure the results of the program. Information reported in the survey is confidential except the amount of sales tax exemption claimed. The survey is due by March 31 in the year after the Department determines the project is operationally complete and in each of the seven following years. A business that fails to submit a complete survey in any year is required to pay 12.5 percent of all deferred taxes.

The Department must use the information received through the survey to study the deferral program and report to the Legislature by December 2009 and December 2013. The reports must measure the effect of the program on job creation, the number of jobs created for Washington residents, company growth, the introduction of new products, the diversification of the state's economy, growth in research and development investment, the movement of firms or the consolidation of firms' operations into the state, and such other factors as the Department selects.

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. In1995, 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. If the firm becomes ineligible, then one-eighth of the deferred taxes, multiplied by the remaining number of years that the qualified use is required, must be repaid. The Department may not issue new deferral certificates after January 1, 2015.

High-tech R&D B&O tax credit. Businesses and qualifying nonprofit organizations that conduct R&D in advanced computing, advanced materials, biotechnology, electronic device technology or environmental technology may claim a credit under the B&O tax for certain operational expenditures. The credit is provided to organizations that make R&D expenditures in excess of 0.92 percent of taxable income. The credit is based on the product of a certain rate, defined initially as the person's average tax rate but which is phased up to 1.5 percent over time, and the qualifying expenditures in excess of 0.92 percent of taxable income.

A business claiming the high tech R&D credit must submit an annual survey with the same substantive and reporting deadline requirements as for the high tech R&D deferral program. While the public disclosure requirements are also similar, in situations in which the amount of credit reported by a business on the survey is different than the amount actually reported by the business on its tax return or otherwise allowed by the Department, the Department may disclose the latter. The survey must be submitted electronically, unless cumulative tax relief to the taxpayer from taking any of the tax incentives that require surveys or reports is $1,000 or less. A business that fails to submit a survey as a result of circumstances beyond the control of the taxpayer may receive an extension to file of up to 30 days from the date that the Department notifies the taxpayer of such extension. Failure to submit a survey, unless an extension has been granted, results in loss of eligibility to earn a credit in the year the survey is due.

The Department must study and report on the program to the Legislature by December 2009 and 2013. The reports must measure the effect of the program on job creation, the number of jobs created for Washington residents, company growth, the introduction of new products, the diversification of the state's economy, growth in research and development investment, the movement of firms or the consolidation of firms' operations into the state, and such other factors as the Department selects.

Rural county/distressed area sales and use tax deferral program. The rural county and distressed area tax deferral, as originally enacted in 1985, provided a deferral of sales and use taxes due on certain expenditures by firms that engaged in manufacturing, research and development, or computer programming activities in counties with high rates of unemployment. Electric utilities are ineligible to participate, with the exception of investments in certain cogeneration projects. In 1999, the program was changed so that the incentive is available in any rural county, defined as a county with population density less than 100 people per square mile, and in counties with community empowerment zones (CEZs). Firms that use the deferral in counties with CEZs must meet certain employment requirements, relating to the level of deferral requested. Employees hired pursuant to the requirements must be residents of the CEZs. In 2004, the program was extended to qualifying businesses in Island County.

The deferral applies to expenditures on the same sort of qualified buildings and equipment as under the high-tech R&D sales and use tax deferral. To receive the deferral, a firm must apply to the Department prior to the initiation of building construction or acquisition of equipment. While not defined in statute, the Department has issued a rule that provides that initiation of construction is the date that breaking ground occurs. The application contains the same information as under the high-tech R&D deferral.

Participants in the sales and use tax deferral program are required to complete an annual survey. Requirements with respect to content, disclosure, reporting deadlines, and enforcement are the same as the high-tech R&D deferral.

Since 1994, repayment of deferred taxes has been waived, subject to the firm maintaining eligibility requirements. If the firm fails to maintain eligibility, the amount of deferred taxes outstanding is immediately due. The Department may not issue new deferral certificates after July 1, 2010.

Deferral of sales and use tax for fruit and vegetable processor projects. In 2005, the Legislature enacted a new sales and use tax deferral program beginning July 1, 2007, for fruit and vegetable processing, cold storage warehousing, and related research and development businesses. These businesses may defer sales and use taxes on expenditures on the same sort of qualified buildings and equipment as under the high-tech R&D deferral. The deferral eligibility enforcement requirements are the same as under the high-tech R&D deferral.

To receive the deferral, an applicant is required to submit an application to the Department before the initiation of construction, defined as when the building permit is issued, or equipment purchases. The application information is the same as under the high-tech R&D deferral.

Persons claiming the deferral are required to complete an annual survey. The information requirements are the same as for the high-tech R&D deferral, except that the survey does not concern the number of new products, trademarks, patents, or copyrights. Disclosure and reporting deadline requirements are the same as under the high-tech R&D deferral.

The Department may not issue new deferral certificates after July 1, 2012.

B&O tax exemption for fruit and vegetable processing. As part of the 2005 tax legislation for fruit and vegetable processors, a B&O tax exemption is provided for amounts received from the canning, preserving, freezing, processing, or dehydrating of fresh fruits and vegetables and from selling at wholesale fresh fruits and vegetables canned, preserved, frozen, processed, or dehydrated by the seller and sold to purchasers who transport in the ordinary course of business the goods out of this state.

By December 2011, the Department is required to study and report on the effect of the exemption to the Legislature. The Department must study the effect on job creation, job retention, company growth, the movement of firms or the consolidation of firms' operations into the state, and such other factors as the Department selects.

B&O tax jobs credit. A B&O tax credit is authorized for manufacturing, research and development, and computer service businesses located in rural counties or community empowerment zones if they create jobs such that their employment is at least 15 percent above the prior year. Businesses may claim $2,000 as a credit against the tax for each new job created, except the credit is $4,000 if the wages and benefits exceed $40,000 per year. If the business is in a community empowerment zone, the persons filling the new jobs must be residents of the zone. No more than $7.5 million may be taken in any fiscal year by all businesses.

To receive the credit, a business must apply to the Department before filling the new positions. The application is required to contain information pertaining to the location of the business facility, employment, wages, costs, operational time schedules, and other information. The Department must rule on the application within 60 days.

A business that receives a credit for new employment must submit an annual report to the Department. The report must contain information that shows whether the recipient's business is meeting the eligibility requirements of the credit program. If the Department finds that the business is ineligible, an amount of tax is due equal to the amount of credit taken. If the reason for ineligibility is failure to meet the employment requirements, interest is also due on the foregone taxes.

Sales and use tax exemption on machinery and equipment (M&E) acquisitions by manufacturers. In1995, the Legislature exempted new or replacement manufacturing machinery and equipment from retail sales and use taxes if used in a manufacturing operation. Both materials and installation labor are included for machinery, equipment, pollution control equipment and the internal use portion of cogeneration equipment. Repair parts and labor, R&D equipment, testing devices and certain logging and rockcrushing equipment are also covered by the exemption. Excluded from the exemption are short-lived tools, hand tools, and consumable supplies.

Tax incentives accountability. In the 2003, 2004 and 2005 sessions, the Legislature enacted, extended, or reauthorized a number of business tax incentives for the purposes of economic development and/or tax relief to struggling industries. The incentives ("recent economic development/relief incentives") include the following:

- high-tech business and occupation (B&O) tax credit for research and development (R&D) spending;
- semiconductor manufacturing program;
- aerospace incentive program;
- aluminum smelter program;
- electrolytic processor public utility tax (PUT) tax incentive;
- fruit and vegetable processing B&O tax exemption; and
- solar energy manufacturing preferential B&O tax rate.

With the passage of the incentives, the Legislature has included a number of reporting requirements relating to accountability. Most of the incentive reports are due by March 31st of the year after that in which the incentives were claimed. Except for the high tech R&D, B&O tax credit, no allowance is provided for late surveys under any circumstance, and reports may be transmitted in electronic or hard copy format.

Interest and penalties. The Department is prohibited from assessing additional taxes, penalties, and interest more than four years after the tax year, except under certain circumstances. One circumstance that is an exception is where a taxpayer has executed a written waiver of this limitation.

The Department is also authorized to waive or cancel penalties under certain circumstances if the failure to pay any excise tax was the result of circumstances beyond the control of the taxpayer. Pursuant to departmental rule, a number of such circumstances would justify waiver. Examples include delinquency resulting from erroneous information provided to the taxpayer by a department employee, or from the death of the taxpayer or a member of the taxpayer's family.

Disclosure of taxpayer information. Excise tax information received from taxpayers by the Department is generally protected by confidentiality requirements. The information may not be disclosed to the public, except as part of statistical reports that do not reveal the identity of a particular taxpayer or transaction. Certain other express exceptions are provided under law, such as disclosure for official purposes to the United States Department of Justice, Department of Defense, Customs Service, Coast Guard, and Department of Transportation.

The reporting and study requirements under the recent economic development/relief incentives in some cases are not possible without disclosing taxpayer information, since several of the programs concern very few taxpayers.

Summary of Bill:

Sales and use tax deferral programs. The high-technology R&D tax deferral, rural county/ distressed area tax deferral, and the fruit and vegetable processor tax deferral programs are combined under one umbrella program for administrative purposes. Substantively, the programs remain largely unchanged.

Uniform definitions are provided with respect to qualified buildings, qualified machinery and equipment, and the dates for initiation of construction and operational completion. The respective qualifying activities under each of the three programs (high-tech R&D; rural county/distressed area manufacturing, R&D, and computer programming; and fruit and vegetable processing and cold storage) are brought under a single definition of qualifying activities.

Qualified building construction includes:

- construction of new buildings used for the qualifying activities;
- expansion or renovation of existing buildings to increase floor space or production capacity for the qualifying activities;
- construction or expansion of warehouses to support qualifying activities;
- construction of new offices exclusively occupied by the employees of a deferral recipient whose job responsibilities exclusively support the qualifying activities or other employees performing qualifying activities; and
- parking lot construction, if the lot is next to or under the building used for the qualifying activities.

Qualified machinery and equipment includes:

- all industrial fixtures, equipment, and support facilities, if not otherwise eligible for the M&E sales and use tax exemption, and if used in qualifying activities; and
- computers, software, data processing equipment, laboratory equipment, manufacturing components, tools, operating structures, and other equipment used to control or operate the machinery and that are used primarily in qualifying activities.

The application and eligibility processes are aligned. Applications are due before qualified equipment acquisition or the initiation of construction on qualified buildings, defined as the date on which the building permit is issued. Projects are considered to be operationally complete with respect to eligibility requirements if the project is capable of being used for its intended purpose. For any project found to be used for an ineligible purpose, the person receiving the benefit of the deferral must pay one-eighth of the deferred taxes, multiplied by the remaining number of years that the qualified use is required.

The annual survey due date is moved to April 30th for all deferral projects. Persons receiving deferral certificates for fruit and vegetable processing projects must now include information about numbers of new products, trademarks, patents, and copyrights associated with the activities of the project. For the purposes of public disclosure, the Department may disclose the amount actually deferred if the amount reported as deferred on the survey is different. Failure to complete the survey by the due date or an extension results in the requirement to repay the portion of deferred taxes that need not be repaid for the previous calendar year according to the repayment schedule. For rural county/distressed area deferrals, failure to complete the survey also now means that interest, but not penalties, is due retroactively to the date of deferral. Persons who must repay deferred taxes are relieved from filing annual surveys. A person who has received a deferral certificate and who files a timely annual report for either the semiconductor manufacturing incentive, aerospace incentive, aluminum smelter incentive, or electrolytic processor incentive program is relieved of the survey requirement.

With respect to deferrals for high-tech R&D qualifying activities, no new certificates may be issued after July 1, 2015.

The use of a deferral certificate is deemed a waiver with respect to the statute of limitations on the Department's authority to assess additional taxes, penalties, and interest.

The existing high-technology R&D tax deferral, rural county/distressed area tax deferral, and the fruit and vegetable processor tax deferral programs are each repealed. Persons having received deferral certificates under those programs are subject to the new requirements.

B&O tax jobs credit. Applications for tax credits under the B&O jobs tax credit program may be made within 90 days of the hiring for the qualified employment position.

Tax incentives accountability. The recent economic development/relief incentives provisions concerning surveys or reports are modified. The due date for reports is changed to April 30 annually. In addition to the high-tech B&O credit program, persons filing reports or surveys for other programs must do so electronically and may receive an extension to file if failure to file is beyond their control. The de minimus cumulative tax relief requirement for electronic filing under the high-tech B&O credit program is eliminated. For all recent economic development/relief incentive programs, the Department may waive the electronic filing requirement for good cause shown. For the purposes of the sales and use tax deferral programs, and for the high-tech R&D B&O tax credit, a survey is considered to be complete if submitted by the due date with responses substantial enough to allow the Department to provide summary statistics and report on the effectiveness of the program.

Some of the Department's requirements with respect to studying the effect of the high-tech R&D B&O tax credit and the B&O tax exemption for fruit and vegetable processor programs are changed and made consistent. The requirements to study the number of jobs created for Washington residents, the introduction of new products, the growth in R&D investment, and the movement of firms operations into the state are eliminated. Requirements to study job retention, net jobs for Washington residents, diversification of the state's economy, and cluster dynamics are kept or added.

Disclosure of taxpayer information. The Department is authorized to disclose the minimum of taxpayer information necessary for the purposes of the reports and studies on the effectiveness of tax incentive programs, in situations when the number of taxpayers participating in the programs is such that taxpayer data could not be combined for reporting purposes to prevent the identification of taxpayers or certain tax information.

Modifications are made to update agency name references within the exception to the disclosure protection law with respect to certain United States agencies.

Appropriation: None.

Fiscal Note: Requested on January 12, 2006.

Effective Date: The provisions concerning the sales and use tax deferral programs, and the B&O jobs credit program, are effective January 1, 2007. The bill contains an emergency clause with respect to the sections concerning changes to tax incentives accountability and reporting and so these sections are effective immediately.