SENATE BILL REPORT
SB 5665

As of March 26, 2015

Title: An act relating to reinstating tax preferences for high-technology research and development.

Brief Description: Reinstating tax preferences for high-technology research and development.

Sponsors: Senators Hill, Liias, Fain, Brown and Benton; by request of Office of Financial Management.

Brief History:
Committee Activity: Ways & Means: 3/25/15.

SENATE COMMITTEE ON WAYS & MEANS

Staff: Juliana Roe (786-7438)

Background: In 1994 the Legislature created a program of business and occupation (B&O) tax credits for qualified research and development (R&D) expenditures, and a sales and use tax deferral program for high-technology R&D and pilot-scale manufacturing facilities. The R&D tax preferences expired January 1, 2015.

Business and Occupation Tax. The 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. Revenues are deposited in the state general fund. A business may have more than one B&O tax rate, depending on the types of activities conducted. Major B&O tax rates include 0.471 percent for retailing; 0.484 percent for manufacturing, wholesaling, and extracting; and 1.5 percent for professional and personal services, and activities not classified elsewhere.

Business and Occupation Tax Credit for High Technology Research and Development. Under the program that expired January 1, 2015, qualified research and development meant R&D performed within this state in the fields of advanced computing, advanced materials, biotechnology, electronic device technology, and environmental technology. In 2014 the B&O tax credit available was 1.5 percent of the greater of (1) qualified R&D expenditures that exceed 0.92 percent of the person's taxable income; or (2) 80 percent of the compensation received for conducting qualified R&D under contract. Person was broadly defined to include, among other categories, individuals, companies, political subdivisions, nonprofits, and federal agencies. No person could take more than $2 million per year in

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credit. Qualified R&D expenditures that were claimable included those directly incurred as operating expenses, partner or owner compensation, benefits, supplies, and computer expenses. Excluded as claimable expenses were amounts paid to a person other than a public educational or R&D institution to conduct R&D, and capital costs and overhead, including expenses for land and structures. Any credit overclaimed or claimed by an ineligible person must be repaid, with interest but not penalties.

<u>Sales and Use Tax Deferral for Certain Construction-Related Expenses.</u> Until January 1, 2015, application for deferral of sales and use taxes could be made before initiation of, construction of, or acquisition of, equipment or machinery for an investment project. The Department of Revenue (DOR) was required to issue a sales and use tax deferral certificate for taxes due on each eligible investment project.

- Investment project was defined as an investment in qualified buildings or qualified machinery and equipment, including labor and services rendered in the planning, installation, and construction or improvement of the project.
- Eligible investment project was defined as an investment project that either initiates a new operation or expands or diversifies a current operation by expanding, renovating, or equipping an existing facility. In the case of an investment project involving multiple qualified buildings, applications must be made for, and before the initiation of construction of, each qualified building.
- Qualified building was defined as construction of new structures and expansion or renovation of existing structures for the purpose of increasing floor space or production capacity used for pilot-scale manufacturing or qualified R&D.
- Qualified research and development was defined as R&D performed within this state in the fields of advanced computing, advanced materials, biotechnology, electronic device technology, and environmental technology.
- Qualified machinery and equipment was defined as fixtures, equipment, and support facilities integral and necessary to a pilot-scale manufacturing or qualified R&D development operation.

The lessor or owner of a qualified building may be eligible for the deferral, only if the lessor by written contract agrees to pass the economic benefit, in an amount no less than the tax deferred, to the lessee, and the lessee agrees in writing with DOR to complete the required annual survey.

<u>Annual Survey.</u> Taxpayers claiming tax preferences aimed at creating jobs or increasing industry competitiveness were required to file an annual survey with DOR. The annual survey included a report of the tax preference amounts claimed each calendar year and information related to employment positions and wages in Washington. In addition if the annual survey or other information caused DOR to find that an investment project, within seven years of being certified as operationally complete, was used for a purpose other than qualified R&D or pilot-scale manufacturing, a percentage of the deferred taxes were immediately due. The sales tax deferral became a waiver of the tax if the business maintained qualified activities for eight years once the facility was operationally complete.

Summary of Bill: The high technology B&O tax credit and sales and use tax deferral, with certain modifications, are reinstated. The new tax preferences go into effect July 1, 2015, and expire January 1, 2025.

Business and Occupation Tax Credit for High Technology Research and Development. The total B&O tax credit that may be claimed by a person is reduced from the original $2 million cap to the lesser of $500,000 or the total amount of B&O tax due for the calendar year.

Sales and Use Tax Deferral for Certain Construction-Related Expenses. DOR must issue a sales and use tax deferral certificate upon receipt of an application from a person for an eligible investment project, if the application indicates that meaningful construction will occur within five years of the application date. Qualified machinery and equipment are no longer included in the definitions for the sales and use tax deferrals and, therefore, are no longer tax deferrable.

Meaningful Construction. A new term is defined. Meaningful construction means an active construction site, where excavation of a building site, laying of a building foundation, or other tangible signs of construction are taking place and that clearly shows a progression in the construction process, at the location designated by the taxpayer in the application for deferral. Planning, permitting, or land clearing before excavation of the building site, without more, does not constitute meaningful construction. If meaningful construction of a project does not begin within five years of the application date, or a project is not operationally complete within ten years of the application date, the full amount of deferred tax is immediately due.

Qualified Buildings and Partial Use for Other Purposes. The definition for qualified buildings is modified in that it excludes areas for amusement and recreational activities, physical fitness activities, parking, the selling or furnishing of meals or other food and beverages, or similar commercial and noncommercial activities as not essential or integral to pilot-scale manufacturing or qualified R&D. If a building or buildings are used partly for pilot-scale manufacturing or qualified R&D, and partly for other purposes, the applicable tax deferral will be determined by apportionment of the costs of construction under rules adopted by DOR.

Sales and Use Tax Deferral Limits. The total amount of sales and use tax deferred is limited to $1 million per eligible project, per person, and only one eligible project per person may qualify for a deferral under this chapter per calendar year. Applicants may be a person or company, broadly defined to include entities such as municipal corporations, a state university, or an affiliate of any such entity. Projects for which an application for deferral was denied prior to January 1, 2015, are not allowed to re-apply for deferral.

Tax Preference Performance Statement. The Legislature states that the tax preferences are intended to improve industry competitiveness and create or retain jobs. The tax preference should be extended beyond the 2025 expiration date if a review finds that, as compared to the effective date of the act: (1) the number of businesses participating in the tax preference programs increased; and (2) the overall number of jobs for businesses participating in the tax preference programs increased.

Appropriation: None.

Fiscal Note: Available.

Committee/Commission/Task Force Created: No.

Effective Date: The bill contains an emergency clause and takes effect on July 1, 2015.

Staff Summary of Public Testimony: PRO: This bill addresses two critical parts of our economy – bio technology and high technology – that create incredible investments in our state and create jobs that are very high wage with great employment multipliers.

We live in a competitive global economy. States and countries are stepping up their game to attract high-skill, high-wage jobs. History shows that investment in R&D plants the seeds of future economic prosperity and those that don't, slowly fade. We don't have to have an incredibly rich tax credit. These preferences are virtually impossible without additional revenue. Yet these are critical investments in our future economic success.

One of our companies, while small, is growing rapidly. The company had a choice to use some of its money to either pay its taxes or employ new people. And, because they took advantage of the credit and employed new people, they have new technology that is going worldwide.

The incentives are part of the state's investment portfolio and they are working. They have paid great dividends. More multi-national companies are coming to Washington. Startups are at an all-time high and we're seeing more manufacturing in this sector. There are 70 companies in life sciences manufacturing in the state today. States that did not have these incentives did not grow jobs. States with incentives had at least 2 percent job growth and Washington had 12 percent. Texas, which ended its incentives in 2005, lost over $3 billion in economic activity and lost over 24,000 jobs. They have since reinstated these incentives.

We hope Washington will learn from Texas and our own experience. When the incentives expired here, we had over 100 applicants rush into DOR to ensure that they kept their spot for constructing projects under the deferral program. Both incentives have built-in metrics. With regard to the credit, if you're not doing R&D, you're not getting the credit. The dollar that you save goes right back into reinvestment. With regard to the construction deferral, if you don't build something, you don't get a deferral, and if you're not using the building for what's required you have to pay back the deferral.

Physio-Control has been developing defibrillators in Washington for over six years and has a significant footprint here. It employs over 800 people in Redmond and has vendors in approximately 20 counties and 128 cities. It spends over $60 million per year in R&D. The incentives help it stay competitive. The continuation of the credit will allow the company to hire an additional five engineers to allow it to pursue additional technologies. Companies need long term commitments so they can make long term investments in this industry.

There are over 8500 tech firms in Washington, big and small, all interested in attracting talented individuals. We compete with other states and internationally for this talent. These incentives provide jobs that attract talented individuals who produce inventions and innovations that produce more jobs.

Novo Nordisk requests that you reinstate the machinery and equipment deferral. Novo Nordisk, unlike other companies, spends a lot of time and money on equipping its buildings with expensive equipment like microscopes, etc.

CON: We shouldn't be creating any new tax preferences, digging our budget hole deeper, before meeting the state's basic obligations. Some proposals may create jobs and metrics for successful economic development, but not all. We caution you to balance the potential benefits against the opportunity costs of funding essential services and staff. Other elements to consider are whether these contribute to or mitigate our already regressive tax structure and whether the tax break is actually needed by the recipient. Is the economic activity you hope to promote actually caused by the tax preference or would it happen anyway without the incentive?

Persons Testifying: PRO: Senator Hill, prime sponsor; Amber Carter, Assn. of WA Business; Michael Transue, Novo Nordisk; Chris Rivera, WA Biotechnology and Biomedical Assn.; Tracy Day, Physio-Control Inc; Tom Ranken, Clean Tech Alliance; Kelly Ogilvie, Governor's Office; Jim Justin, WA Technology Industry Assn., Clark Co High Tech Council.

CON: Nick Federici, WA United for Fair Revenue.

Persons Signed in to Testify But Not Testifying: CON: Shawn Lewis, WA Education Assn.