HOUSE BILL REPORT
HB 1894

As Reported by House Committee On:
Technology & Economic Development

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

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

Sponsors: Representatives Sullivan, Wilcox, Slatter, Stokesbary, Buys, Tarleton, Senn, Haler, Goodman and Stanford; by request of Office of Financial Management.

Brief History:
Committee Activity:
Technology & Economic Development: 2/8/17, 3/9/17 [DPS].

Brief Summary of Substitute Bill

- Establishes a business and occupation tax credit for qualified research and development (R&D) expenditures, expiring January 1, 2027.
- Establishes a state and local sales tax deferral program for high-technology R&D, pilot-scale manufacturing facilities, and purchases on certain machinery and equipment, expiring January 1, 2027.
- Establishes performance metrics to measure success of the tax preferences.

HOUSE COMMITTEE ON TECHNOLOGY & ECONOMIC DEVELOPMENT

Majority Report: The substitute bill be substituted therefor and the substitute bill do pass. Signed by 17 members: Representatives Morris, Chair; Kloba, Vice Chair; Tarleton, Vice Chair; Smith, Ranking Minority Member; DeBolt, Assistant Ranking Minority Member; Doglio, Fey, Harmsworth, Hudgins, Manweller, McDonald, Nealey, Santos, Slatter, Steele, Wylie and Young.

Staff: Kirsten Lee (786-7133).

Background:

This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.

In 1994 legislation was enacted to create a program of business and occupation (B&O) tax credits for qualified research and development (R&D) expenditures, and a sales 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.
Until January 1, 2015, a B&O tax credit was available to a person whose qualified R&D spending during the year in which the credit was claimed exceeded 0.92 percent of the person's taxable amount. "Taxable amount" meant the amount subject to the B&O tax, as must be reported on combined excise tax returns, less any credit that may be claimed by a person engaged in an activity that is subject to more than one B&O tax rate. "Qualified research and development" meant R&D performed within Washington 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) 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 defined to include, among other categories, individuals, companies, political subdivisions, nonprofits, and federal agencies. No person could take more than $2 million a year in credit.

Sales and Use Tax Deferral for Certain Construction-Related Expenses.
Until January 1, 2015, application for deferral of sales taxes could be made before initiation, construction, or acquisition of equipment or machinery for an investment project. "Investment project" was defined as an investment in qualified buildings or machinery and equipment, including labor and services rendered in the planning, installation, and construction or improvement of the 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.

Annual Survey.
Taxpayers claiming either R&D tax preference were required to submit an annual survey to the 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.

Tax Preference Performance Statement and Expiration Date.
All new tax preference legislation must include a tax preference performance statement. Tax preferences include deductions, exemptions, preferential tax rates, and tax credits. The performance statement must clearly specify the public policy objectives of the tax preference,

and the specific metrics and data that will be used by the Joint Legislative Audit and Review Committee to evaluate the efficacy of the tax preference.

New tax preferences expire 10 years after the effective date of the tax preference, unless otherwise provided.

Summary of Substitute Bill:

A research and development (R&D) business and occupation (B&O) tax credit and sales and use tax deferral program are created, effective January 1, 2018, and expiring January 1, 2027. Persons may only claim either the B&O tax credit or sales and use tax deferral under the program. Persons claiming a tax credit or deferral for advanced spacecraft-related activities must have an active registration with the Department of Revenue (DOR) and be actively engaged in advanced spacecraft manufacturing.

<u>Business and Occupation Tax Credit for Research and Development</u>.
A business whose qualified R&D spending during the same calendar year in which the credit is claimed exceeds 0.92 percent of the business's taxable amount is eligible to receive a B&O tax credit for qualified R&D expenditures. "Qualified R&D" means R&D performed within Washington in the fields of advanced spacecraft manufacturing, life science, and environmental technology. Qualified R&D expenditures that may be claimed include those directly incurred as operating expenses, partner or owner compensation, benefits, supplies, and computer expenses. Excluded as claimable expenses are amounts paid to a person other than a public educational or R&D institution to conduct R&D, and capital costs and overhead, which include expenses for land and structures.

The B&O tax credit is calculated by multiplying 1.5 percent times the greater of: (1) qualified R&D expenditures that exceed 0.92 percent of the business's taxable amount; or (2) 80 percent of the compensation received for conducting qualified R&D under contract. The total tax credit that may be claimed by a person is capped at the lesser of $750,000 or the amount of total B&O tax due for the calendar year. Before a person may claim a B&O tax credit, they must provide certain employment information to the DOR and must update the DOR when there is any change to the information provided.

Additionally, persons claiming a B&O tax credit for advanced spacecraft-related activities must disclose the payload of any spacecraft launched by that person, unless the payload is already subject to payload review by a federal agency. If the payload includes a satellite, additional disclosure requirements apply.

<u>Sales and Use Tax Deferral for Certain Construction-Related Expenses</u>.
The High-Technology Sales and Use Tax Deferral provides a sales and use tax deferral and ultimate waiver on the construction or expansion of an eligible R&D facility or pilot scale manufacturing facility, and certain machinery and equipment purchases related to qualifying R&D.

The DOR must issue a sales and use tax deferral certificate upon receipt of an application for an eligible investment project if the application indicates that meaningful construction will occur within five years of the application date.

- "Investment project" means an investment in qualified buildings, including labor and services rendered in the planning, installation, and construction or improvement of the project.
- "Eligible investment project" means 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 each qualified building before the initiation of construction.
- "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.
- "Pilot-scale manufacturing" means design, construction, and testing of preproduction prototypes and models in the fields of advanced spacecraft manufacturing, life science, and environmental technology for purposes other than commercial sale.
- "Qualified buildings" means 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 machinery and equipment" means fixtures, equipment, and support facilities that are an integral and necessary part of a pilot-scale manufacturing or qualified R&D operation.
- "Qualified research and development" means R&D performed within Washington in the fields of advanced spacecraft manufacturing, life science, and environmental technology.

Approved deferral applications may be amended to update the completion date, estimated expenses, and square footage of the project. However, requests to amend previously approved applications for projects for which meaningful construction has not commenced within five years of the application date must be denied. The DOR may require additional information, such as project milestones, indicating that meaningful construction will not occur within two years of the application date. If meaningful construction of a project does not begin within five years of the application date, or a project is not operationally complete within 10 years of the application date, the full amount of deferred tax is due immediately.

Sales and Use Tax Deferral Limits.
The total amount of sales and use tax deferred is limited to $750,000 per eligible project, per person, and only one eligible project per person may qualify for a deferral under this chapter per calendar year. The DOR may not issue a deferral certificate for investment projects that have already received certain other deferrals for Investment Projects in Rural Counties or High-Technology Businesses. However, qualified R&D projects that are being adapted for use in pilot-scale manufacturing are eligible, even if they have previously received a deferral.

<u>Annual Survey</u>.

A person claiming either tax preference must file a complete annual survey with the DOR.

Tax Preference Performance Statement.
A tax preference performance statement provides that the goal of the tax preferences is to improve industry competitiveness and create or retain jobs. To measure the effectiveness of the tax preferences, the Joint Legislative Audit and Review Committee (JLARC) must evaluate whether the number of businesses participating in the credit and deferral programs, and the overall number of jobs participating in the credit and deferral programs performing R&D, have increased by a minimum of 125 direct jobs and 315 indirect jobs. If so, the Legislature intends to extend the expiration date of the tax preferences. The JLARC may refer to data available from the Employment Security Department and the DOR to perform the review.

The tax preferences are effective January 1, 2018, and expire on January 1, 2027.

Substitute Bill Compared to Original Bill:

The substitute:
- includes a new performance metric, requiring the creation of 125 direct jobs and 315 indirect jobs to extend the tax preferences in the future;
- restricts tax preference participants to receipt of either the business and occupation (B&O) tax credit or the sales and use tax deferral;
- requires participants electing to claim a B&O tax credit under the program to provide certain employment information to the Department of Revenue (DOR) prior to claiming the credit, and to update the DOR with any changes to the employment information;
- changes the definition of "research and development" to include clinical trials and organization of clinical trial participants;
- changes the maximum amount of B&O tax credit or sales and use tax deferral amounts to $750,000, from $500,000 and $1 million respectively;
- requires any person claiming a B&O tax credit for research and development for advanced spacecraft manufacturing to disclose the payload of any spacecraft launched by that person, unless the payload is already subject to a payload review by a federal agency and the person is able to provide confirmation of the review to the DOR;
- creates additional payload disclosure requirements for any person claiming a B&O tax credit for research and development for advanced spacecraft manufacturing if the payload includes a satellite;
- defines "payload" and "satellite;"
- changes the terms "unmanned commercial spacecraft" and "commercial spacecraft" to "spacecraft;" and
- changes the definition of "spacecraft" to exclude certain restrictions of intended use.

Appropriation: None.

Fiscal Note: Available.

Effective Date of Substitute Bill: The bill takes effect 90 days after adjournment of the session in which the bill is passed.

Staff Summary of Public Testimony:

(In support) The tax preferences support research and development in Washington, including support of the life sciences and space industries. The tax preferences: allow Washington-based research firms to invest more in technology development, commercialization of technologies, and infrastructure; provide additional support for firms to expand laboratories; and help create educational opportunities. In addition, the tax preferences incentivize research and development companies to establish in or relocate to Washington. Without the tax preferences, Washington is at a disadvantage. The tax preferences have clear goals and metrics and will have a positive impact on job creation, innovation, support for a statewide network of suppliers, continued success of existing qualifying fields, and development of nascent sectors within the state.

(Opposed) None.

Persons Testifying: Marc Cummings, Life Science Washington; Margaret McCormick, Matrix Genetics; Kathy Scanlon, Institute for Systems Biology; Myles Phipps, Hyprotek, Incorporated; Mila Lobanova, Blaze Bioscience, Incorporated; Ian Goodhew, University of Washington Medicine; Michael Transue, Oregon Biosciences Association and Novo Nordisk; Jean Leonard, Washington Space Partnership; Erika Wagner, Blue Origin; Eric Lohnes, Association of Washington Business; and Scott Merriman, Office of Financial Management.

Persons Signed In To Testify But Not Testifying: None.