

CHAPTER 4

ADMINISTRATION OF THE PROGRAMS AND DATA LIMITATIONS

High Technology Business and Occupation Tax Credit

REQUIREMENTS

Expenditures by qualified firms for research and development purposes are eligible for a credit against B&O tax liability incurred during the same year. Such expenditures must exceed 0.92 percent (0.0092) of the firm's taxable amount during that same year. Spending for research and development includes operating expenses, wages and benefits, supplies, and computer expenses directly incurred while conducting the research and development. For example, a business reports a taxable amount of \$1 million on its Combined Excise Tax Return during a calendar year. This company must spend at least \$9,200 ($\$1,000,000 \times .0092 = \$9,200$) on qualified research and development during that same calendar year to claim the credit.

Businesses may estimate their annual spending on research and development for the year and thus take the credit throughout the year. If a firm's spending does not reach the threshold, it is required to pay the underpaid taxes, with interest, to the Department of Revenue.

The rate by which the amount of credit is determined is tied to B&O tax rates. Nonprofit corporations and associations calculate the credit by applying the B&O rate for R&D income, per RCW 82.04.260(6); this rate is currently 0.484 percent. All other firms utilize a rate equivalent to the B&O tax rate for general services, per RCW 82.04.290(2); this rate is currently 1.5 percent. A person performing research under contract has the option of using the greater of either its qualified research and development expenditures or 80 percent of the amounts received as compensation for conducting the qualified research and development.

Example A: a for-profit business performs its own research and development and has research and development expenses of \$10,000. To determine if the amount of expenses qualifies the business for a credit, the taxable income must be determined. To do this:

Divide \$10,000 by .92 percent ($\$10,000 / .0092 = \$1,086,957$). If the taxable amount is \$1,086,957 or greater, the expenses qualify.

To determine the amount of credit:

Multiply the expenses (\$10,000) times the rate (1.5%). The amount of credit is determined to be \$150. ($\$10,000 \times 0.015 = \150).

To use the credit:

If the business is a manufacturer, the B&O tax on the taxable amount is \$5,261

$(\$1,086,957 \times .00484 = \$5,261)$. The credit of \$150 should be subtracted from \$5,261, leaving a B&O tax due of \$5,110.

Example B: a for-profit business performs its own research and development. It has a gross taxable income of \$2,000,000. To determine if the business is eligible for the credit:

It must have expenses that total \$18,400 ($\$2,000,000 \times .0092 = \$18,400$). If the expenses are \$18,400 or more, the credit may be used.

To calculate the amount of credit:

Multiply the expenses (\$18,400) times the rate (1.5%). The amount of credit is \$276 ($\$18,400 \times 0.015 = \276).

To use the credit:

The manufacturing B&O tax on \$2,000,000 is \$9,680 ($\$2,000,000 \times .00484 = \$9,680$). The credit of \$276 should be subtracted from \$9,680, leaving B&O tax due of \$9,404.

Example C: a nonprofit business performs its own research and development. It has a gross taxable amount of \$1,000,000 and \$8,000 in expenses. To be eligible for the credit, this business must have \$9,200 of expenses ($\$1,000,000 \times .0092 = \$9,200$). In this example the firm would not qualify, and no credit can be used.

A person performing qualified research and development under contract for another MAY ASSIGN all or a portion of the credit to the person paying for the research and development. Both businesses must meet the eligibility requirements. Assigned credits may not exceed the smaller of the business and occupation tax of the research business or \$2 million.

When credit is used, a copy of the "Declaration - Research and Development Credit" must be attached to the Combined Excise Tax Return. The credit should be entered on page one of the Combined Excise Tax Return, under the TOTALS section. The amount of the credit should also be entered on page two of the Combined Excise Tax Return under the CREDITS section, credit ID number 810.

APPLICATION

No pre-approval from the Department of Revenue is required to use this credit.

The first time a business uses the high tech B&O tax credit, it must complete an initial survey and mail it to the address shown on the bottom of the form. In addition, the business must

complete the “Declaration - Research and Development Credit” and attach it to the Combined Excise Tax Return each time the credit is used.

The forms may be requested by calling the Department of Revenue’s Telephone Information Center at 1-800-647-7706 (TTY 1-800-451-7985) or on our web site at <http://dor.wa.gov>.

High Technology Sales/Use Tax Exemption

REQUIREMENTS

Applications must be filed with the Department of Revenue before construction begins or machinery or equipment is acquired. The investment project must be devoted to research and development or pilot scale manufacturing in order to qualify for the deferral/exemption. The investment must consist of machinery and equipment, new structures (including materials and labor), and/or expansion or renovation to increase floor space or production capacity. The machinery and equipment may be used but must be new to the state or to the business.

Qualified machinery and equipment means fixtures, equipment and support facilities that are an integral and a necessary part of pilot scale manufacturing or qualified research and development operation. Included are computers, software, data processing equipment, laboratory equipment, instrumentation, and other devices used in the process of experimentation to develop a new or improved pilot model, plant process, product, formula, invention or similar property.

If a building, machinery, or equipment is used partly for pilot scale manufacturing or qualified research and partly for other purposes, the tax deferral will be apportioned on the basis of the cost of the area used for the qualified purposes.

REPAYMENT

No repayment of the taxes deferred under this program is required if the business uses the investment project for qualified research and development or pilot scale manufacturing.

If the investment project is used for any other reason at any time during the calendar year in which the investment is certified as operationally complete, or during the next seven calendar years, the deferred taxes must be repaid immediately according to a prorated schedule. Interest will be assessed on the payments.

The sales or use taxes on machinery or equipment used in pilot scale manufacturing that could have qualified for the sales/use tax exemption for manufacturers at the time of sale or first use do not have to be repaid.

APPLICATION

A project that has received any sales/use tax deferral under this or any other deferral program is not eligible for further deferral under this program. A research and development facility may get

additional deferral certificates to upgrade to pilot scale manufacturing. Businesses may have more than one project that may qualify for deferral/exemptions under any of these programs.

Applications may be requested by calling the Department of Revenue's Telephone Information Center at 1-800-647-7706 (TTY 1-800-451-7985) or on our web site at <http://dor.wa.gov>.

The Department of Revenue must approve or deny applications within 60 days. If denied, the business may appeal the decision to the Department's Division of Appeals.

Businesses approved for a deferral program receive a Tax Deferral Certificate from the Department to present to their contractors and vendors. This certificate allows the contractors and vendors to sell to approved businesses without charging retail sales tax (the seller must keep a copy of the certificate in its records).

REASONS FOR DENIAL OF THE DEFERRAL

As of October 2000, 49 deferral applications had been denied. The most frequent (20) reason was that the project had started construction prior to applying for the deferral, and 13 others were denied for not performing R&D activity. The remaining denials were related to incomplete information being provided by the applicant.

Data Limitations

During any study there are constraints to performing analysis due to the availability of information and incomplete, missing or incorrect data. This section summarizes some of the difficulties in doing analysis in this study. If improvements are to be made in the data for study purposes, it would be critical to complete them before the last study is due in September 2003.

The two programs differ in some significant ways which impact the information that is available to do analysis and the extent that information is subject to disclosure. The R&D B&O credit program does not have a statutory proviso that allows information to be disclosed to outside parties but does provide in statute that participants need to supply necessary information to the Department of Revenue for analysis of the program. The R&D sales/use tax deferral program does have a statutory provision allowing disclosure but limits the types of information that need to be provided to nonproprietary information. These provisions and limitations impact the extent to which the Department can survey participants and then publish the information.

A frequent problem with analysis of the credit program was caused by missing information. In some cases the taxpayer improperly filled out the declaration or omitted information and in others, the document could not be located. This problem, however, appears to be subsiding over time as taxpayers become familiar with the program. In 1995 information is missing for 32 percent of credits taken compared to 13 percent by 1999. Taxpayers also seem to be learning about what types of research qualifies as well, because the number of credits removed in audit has declined from 22 percent in 1995 to 6 percent in 1999. Some additional taxpayer education

may still be helpful, though. The credit confuses taxpayers who are allowed to accumulate the credit over a calendar year but may claim the credit only to the extent of their B&O liability for a reporting period. Additionally, firms attempt to apply the credit to other types of taxes and others attempt to carry the credit forward to subsequent years.

One area of difficulty in analysis of geographic impact of the B&O credit program as opposed to the sales tax deferral/exemption program is that the location of the research activity is not provided. Since an application form is not required only the mailing address of the taxpayer is known, and this must be assumed to be the location of the investment activity.

Evaluating credits taken over time is also difficult. Firms don't always take credits continuously (a research project stops and starts) and in some cases only take the credits when auditors discover they are entitled to them. This sometimes provides a confusing result relative to other economic data and makes the data look inconsistent over time.

Participants are required to file an application to be included in the R&D sales/use tax deferral program. Most applications are completed in full; however, some of the applications are missing information. The most frequently missing information is the amount of anticipated employment. Although an improvement from the 1997 study, both current employment and expected future employment are missing from approximately 25 percent of applications processed to date.

In conclusion, a major difficulty in analysis of these programs is that the information that is the basis of the analysis is not always provided by the firm and is not readily available from other sources. The taxpayer is required to report proprietary information in some circumstances, but may exclude proprietary information in other circumstances. For this reason, doing a survey such as the one included in Chapter 5 helps to fill in the information gaps. The use of matched data from other agency administrative records is also necessary for analysis of these programs.

Data Limitations Related to the Survey

Surveys are a means of providing additional information needed for analysis. Statistical reliability of survey data depends upon the response rate of the survey. The higher the response rate, the more likely a survey sample is representative of the population. The larger the number of missing respondents, the more likely that an entire type of respondent will be missing from the responses. A response rate of at least 50 percent is usually desired because then the surveyor is confident that the data represent at least a simple majority.

For purposes of increased reliability, surveys are normally confidential. The Department of Revenue is aware that data collected in surveys are often sensitive. Scientific studies have shown that response rates are more likely to increase as steps are taken to assure confidentiality. The organization that constructed the survey advised the Department that not promising confidentiality would have a devastating impact on the response rate.

As indicated above, the R&D deferral program has a permissive statutory disclosure provision so data collected through a survey of those specific participants might have become disclosable if they were surveyed. The R&D credit program does not have such a statutory provision. Therefore, to maintain confidentiality for both types of participants, it was decided that only the credit participants would be surveyed.

Although numerous steps were taken to achieve a high response rate (see Chapter 5 for a description), the survey of the firms taking the R&D credit had a response rate of 51.6 percent. Although there is a statutory requirement for firms taking the credit to supply the Department with data, including survey data, many firms did not respond.

Recommendations

The Legislature should consider making the two programs not subject to disclosure. This would make data gathering and monitoring easier because firms would be more likely to provide the necessary information. This would allow information for both programs to be treated equally. The Legislature should also consider penalties for firms that do not provide information as required by the statute.