CHAPTER 1

DESCRIPTION AND ADMINISTRATION

In 1993 the Department of Revenue was asked to study high technology incentives, determine which technologies have the greatest potential for improving high wage R&D jobs, and make recommendations for targeted tax incentives with the goal of increasing the number of these types of jobs. This effort culminated in a report, "Incentives for High Technology," issued by the Research and Legislation and Policy Divisions of the Department on January 10, 1994.

In 1994 the Legislature created the B&O tax credit and sales and use tax deferral/exemption programs for R&D covered by this report. Both programs established tax incentives for five technologies. These five were based on a list of national critical technologies and recommendations from Washington industries.

HIGH TECHNOLOGY BUSINESS AND OCCUPATION TAX CREDIT

The 1994 Legislature established a B&O tax credit for qualified R&D expenditures other than for capital improvement purposes (RCW 82.04.4452). The program became effective on January 1, 1995, and, as of the date of this report, is scheduled to expire on December 31, 2004. An annual credit of up to $2 million is allowed for businesses that perform R&D in Washington in five specified high technology categories:

- Advanced computing
- Advanced materials
- Biotechnology
- Electronic device technology
- Environmental technology

Definitions of the above categories can be found in RCW 82.63.010. These definitions are as follows:

Statutory Definitions

(1) "Advanced computing" means technologies used in the designing and developing of computing hardware and software, including innovations in designing the full spectrum of hardware from hand-held calculators to super computers, and peripheral equipment.

(2) "Advanced materials" means materials with engineered properties created through the development of specialized processing and synthesis technology, including ceramics, high value-added metals, electronic materials, composites, polymers, and biomaterials.

(3) "Biotechnology" means the application of technologies, such as recombinant DNA techniques, biochemistry, molecular and cellular biology, genetics and genetic engineering,

cell fusion techniques, and new bioprocesses, using living organisms, or parts of organisms, to produce or modify products, to improve plants or animals, to develop microorganisms for specific uses, to identify targets for small molecule pharmaceutical development, or to transform biological systems into useful processes and products or to develop microorganisms for specific uses.

(4) "Electronic device technology" means technologies involving microelectronics; semiconductors; electronic equipment and instrumentation; radio frequency, microwave, and millimeter electronics; optical and optic-electrical devices; and data and digital communications and imaging devices.

(5) "Environmental technology" means assessment and prevention of threats or damage to human health or the environment, environmental cleanup, and the development of alternative energy sources.

The tax credit cannot exceed the amount of the B&O tax due for the same calendar year. The credit is required to be taken against taxes due for the calendar year in which the expenditures occur.

Any business claiming the credit is required to file an affidavit form prescribed by the Department of Revenue. The form includes the amount of credit claimed, an estimate of anticipated qualified R&D expenditures, an estimate of the taxable amount, the type of R&D being performed, and other information.

In order to qualify, a business must spend at least 0.92 percent (0.0092) of its taxable income (adjusted for the multiple activities credit) upon qualified R&D within Washington. The 0.92 percent threshold was determined as the estimated average percentage of R&D spending for all industries in the state.

The rate for calculating the credit is currently:

Nonprofit corporations/associations	0.484 percent (0.00484) of qualified expenses
Proprietary businesses	1.5 percent (0.015) of qualified expenses

(Initially, the tax credit rates were 0.515 percent for nonprofit corporations and 2.5 percent for proprietary businesses, but the rates were changed to the current levels in 1997.) These rates relate generally to the B&O tax rate for R&D activities.

HIGH TECHNOLOGY SALES AND USE TAX DEFERRAL

The high technology sales and use tax deferral program was enacted in 1994. The program became effective on January 1, 1995, and is codified in Chapter 82.63 RCW. As of the date of this report, the program is scheduled to expire on July 1, 2004.

Businesses operating in the following R&D technology categories may be eligible for both the sales and use tax deferral and the B&O tax credit:

- Advanced computing
- Advanced materials
- Biotechnology
- Electronic device technology
- Environmental technology

The detailed definitions of each of the five categories are the same as listed above under the discussion of the B&O tax credit.

Businesses are eligible for the sales/use tax deferral if they (1) start a new R&D or pilot scale manufacturing facility and acquire equipment; or (2) expand, renovate, or equip an existing facility anywhere in Washington. The deferral does not apply to the repair or replacement of high technology equipment. Firms using this program must apply for the deferral prior to starting construction or acquiring machinery and equipment.

The statute defines as pilot scale manufacturing "the design, construction, and testing of preproduction prototypes and models in the fields of biotechnology, advanced computing, electronic device technology, advanced materials, and environmental technology other than for commercial sale. As used in this subsection, 'commercial sale' excludes sales of prototypes or sales for market testing, if the total gross receipts from such sales of the product, service, or process do not exceed $1 million."

In 1995 the Legislature waived the repayment requirement for firms that continue to use the high tech facility for eight years. For each year that these use requirements are met, 12.5 percent of the deferred tax is waived, thus waiving all tax if the facility is in use for eight years.

ADMINISTRATION OF THE B&O TAX CREDIT

Requirements

Expenditures by qualified firms for R&D 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 R&D includes operating expenses, wages and benefits, supplies, and computer expenses directly incurred while conducting the R&D. 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 x 0.0092 = $9,200) on qualified R&D during that same calendar year to claim the credit.

Businesses may estimate their annual spending on R&D 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 taxes equal to the credit taken throughout the year, 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 R&D expenditures or 80 percent of the amounts received as compensation for conducting the qualified R&D.

Example A: A for-profit business performs its own R&D and has R&D 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 0.92 percent ($10,000 / 0.0092 = $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 x 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 x 0.00484 = $5,261). The credit of $150 should be subtracted from $5,261, leaving a B&O tax due of $5,111.

Example B: A for-profit business performs its own R&D. 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 x 0.0092 = $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 x 0.015 = $276).

To use the credit:

> The manufacturing B&O tax on $2,000,000 is $9,680 ($2,000,000 x 0.00484 = $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 R&D. 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 x 0.0092 = $9,200). In this example the firm would not qualify, and no credit can be used.

A person performing qualified R&D under contract for another may assign all or a portion of the credit to the person paying for the R&D. 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 a 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 the 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 Department. In addition, each time the credit is used the business must complete the “Declaration - Research and Development Credit” and attach it to the Combined Excise Tax Return.

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 they may be found on the Department's web site at http://dor.wa.gov.

ADMINISTRATION OF THE SALES/USE TAX DEFERRAL

Applications must be filed with the Department of Revenue before construction begins or before machinery or equipment is acquired, in order to be eligible for the sales/use tax deferral/ exemption. The investment project must be devoted to (1) R&D or (2) pilot scale manufacturing. The investment may consist of machinery and equipment, new structures, and/or expansion or renovations to increase floor space or production capacity. The machinery and equipment may be used property but must be new to the state or to the business.

- *Qualified buildings* means the construction of new structures, or the 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, including plant offices and other facilities that are an essential or an integral part of a structure used for pilot scale manufacturing or qualified R&D.

  If a building is used partly for pilot scale manufacturing or qualified research and partly for other purposes, only that portion of the building used for a qualifying purpose is eligible for the deferral.

- *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. 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.

  Qualified machinery and equipment must be used exclusively for pilot scale manufacturing or qualified R&D to qualify for the deferral. Unlike buildings, if machinery and equipment are used for both qualifying and nonqualifying purposes, the costs may not be apportioned. Sales or use tax may not be deferred on the purchase or use of machinery and equipment used for both qualifying and nonqualifying purposes.

Repayment of Deferred Taxes

Deferred taxes must be repaid if an investment project is used for purposes other than qualified R&D or pilot scale manufacturing during the calendar year for which the Department certifies the investment project as operationally complete or at any time during any of the succeeding seven calendar years.

Taxes are immediately due according to the prorated schedule shown below. Interest on the taxes, but not penalties, must be paid retroactively to the date tax was deferred.

Deferred taxes do not need to be repaid on particular items if the purchase or use of the item would have qualified for the machinery and equipment sales and use tax exemptions at the time of purchase or first use.

Year in Which Non-Qualifying Use Occurs	Percent of Deferred Taxes Due
1	100.0%
2	87.5%
3	75.0%
4	62.5%
5	50.0%
6	37.5%
7	25.0%
8	12.5%

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. An R&D 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.

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

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

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 his records).