

Multistate Tax
EXTERNAL ALERT

Changes to D.C. Qualified High Technology Company Incentive Enacted; *BAE* Decision Upheld

March 28, 2013

Overview

On November 1, 2012, District of Columbia Mayor (“Mayor”) Vincent Gray signed Bill 19-0747, the Technology Sector Enhancement Act of 2012 (“Act”). The Act introduced a number of changes to the treatment of Qualified High Technology Companies (“QHTCs”),¹ including an expansion of the five-year franchise tax² exemption to qualifying taxpayers *regardless of location in the District*. The Act was submitted to Congress on January 10, 2013, pursuant to the District of Columbia Home Rule Act.³ The Act became law on March 5, 2013 (Law #L19-0211). The provisions apply to tax years beginning on or after January 1, 2012, with certain changes potentially affecting tax periods prior to January 1, 2012.

In this External Tax Alert, we summarize certain provisions of the Act and discuss the District of Columbia Court of Appeals’ recent decision in *District of Columbia Office of Tax and Revenue v. BAE Systems Enterprise Systems Inc.*, which addressed the QHTC “base of operations” requirement.⁴

Overview of the QHTC Program

Incentives for QHTCs were enacted in 2000 by the District’s City Council to attract certain types of technology business to the District. Under these provisions, a business had to meet the following requirements to be eligible for the incentives:

1. Be an individual or entity organized for profit;
2. Maintain an office, headquarters, or base of operations in the District;
3. Have two or more employees;
4. Be registered to do business in the District and be current in all District filing requirements and payment obligations; and
5. Derive at least 51% of its gross revenues from qualifying activities.⁵

The various activities from which companies must generate revenue in order to qualify as a QHTC include: Internet-related services and sales, information and communication technologies, bioprocessing, engineering, and defense technologies.⁶

Qualified companies are entitled to various incentives, including but not limited to the following:

1. A reduced corporate income tax rate of 6%, instead of the District’s normal tax rate of 9.975%;⁷

¹ Note that in the final combined reporting regulations, adopted on September 14, 2012, QHTCs are not included in a combined report. D.C. Mun. Regs. tit. 9, §157.3.

² Note the District’s income tax is called a “franchise tax,” although imposed on a net income basis.

³ In the District, bills introduced by the City Council and/or at the request of the Mayor only become law after they are signed by the Mayor and approved by the United States Congress as provided in the District of Columbia Home Rule Act, D.C. Code §1-206.02(c)(1). Accordingly, legislation is submitted to Congress and District laws are “approved” by Congress if Congress does not enact a joint resolution to repeal the legislation within the 30-calendar-day period, which is defined in D.C. Code §1-206.02(c)(1).

⁴ *District of Columbia Office of Tax & Revenue v. BAE Systems Enterprise Systems, Inc.*, 56 A.3d 477 (D.C. Nov. 29, 2012). We previously issued a summary of the District’s QHTC Program, which included a discussion of the 2010 Office of Administrative Hearings decision in *BAE*, supporting the taxpayer’s interpretation of certain QHTC provisions. See Tax Management, Multistate Tax Report, Volume 18, No. 3, March 25, 2011, accessible at:

http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_Article_DCQHTC_040111.pdf.

⁵ D.C. Code §47-1817.01(5)(A).

⁶ D.C. Code §47-1817.01(5)(A)(iii)(I)-(V). The District of Columbia Office of Tax and Revenue (“OTR”) provides additional guidance on qualifying activities in OTR Publication FR-399, *Qualified High Technology Companies* (Rev. 3/2012).

⁷ D.C. Code §47-1817.06(a)(1).

2. A five-year exemption from payment of corporate franchise tax for qualified taxpayers in high technology development zones;⁸
3. Job-related franchise tax credits;⁹
4. Sales tax exemptions on certain purchases and sales;¹⁰ and
5. Property tax abatements.¹¹

Qualifying companies must self-certify to claim the benefits by submitting Form QHTC-CERT and other required forms with any tax return in which the benefits are claimed.

How the Act Impacts QHTC Incentives

The Addition of the Phrase “in the District”

The Act amends the D.C. Code §47-1817.01(5)(A) definition of a QHTC by adding the phrase “in the District” to subsections (ii) and (iii). As a result of this change, the revised sections now read (emphasis added) as follows:

D.C. Code §47-1817.01(5)(A) “Qualified High Technology Company” means:

- (i) An individual or entity organized for profit and maintaining an office, headquarters, or base of operations in the District of Columbia;
- (ii) Having 2 or more employees *in the District*; and
- (iii) Deriving at least 51% of its gross revenues *earned in the District* from qualifying activities.

Prior to the Act, with respect to the gross revenues requirement under D.C. Code § 47-1817.01(5)(A)(iii), it would appear that at least 51% of the entity’s *total* gross revenues must come from qualifying activities.¹² Under the Act, taxpayers claiming QHTC status will now evaluate only *District sourced gross revenues* for purposes of the 51% test. The change to the statute may disqualify companies that generate at least 51% of their gross revenues from qualifying activities as a whole, but generate less than 51% of their District gross revenues from qualifying activities in the District. However, other companies that generate at least 51% of their total District gross revenues from qualifying activities may now qualify as a QHTC even if their gross revenues outside of the District are primarily from non-qualifying activities.

Franchise Tax Exemption Expansion and Franchise Tax Cap

Under D.C. Code §47-1817.06 (a)(2) prior to amendment, a QHTC in a “high technology development zone” was entitled to a franchise tax exemption for a period of five years after the date that the QHTC commenced business in the high technology development zone. After the five-year period, the QHTC continued to be entitled to the 6% reduced rate. Under the Act, D.C. Code §47-1817.06 (a)(2)(A) was amended so that taxpayers no longer have to be located in a *high technology development zone* to receive the five-year franchise tax exemption.¹³ The statute states that for QHTCs certified prior to January 1, 2012, the five-year franchise tax exemption begins as of the date the QHTC commences business *in the District*. Taxpayers should consider whether as a result of this amendment there may be a potential opportunity for a QHTC operating outside of a high technology development zone to amend prior year returns open under the statute of limitations if the QHTC commenced business in the District within the prior five years. The amended statute also states that for QHTCs certified on or after January 1, 2012, the five-year exemption begins as of the date that the QHTC has taxable income.

In addition, amended D.C. Code §47-1817.06(a)(2)(B) imposes a new limitation on a QHTC that claims the five-year exemption. This limitation imposes a cap of \$15 million on the total amount of District franchise taxes that each

⁸ D.C. Code §47-1817.06(a)(2)(C).

⁹ D.C. Code §§47-1817.02, 47-1817.03, 47-1817.04, and 47-1817.05.

¹⁰ D.C. Mun. Regs. tit. 9, §1111.

¹¹ D.C. Mun. Regs. tit. 9, §§1112 and 1115.

¹² When final regulations related to the QHTC program were issued on March 8, 2002 by the OTR, the OTR noted that the legislative intent of “The New E-conomy Transformation Act of 2000” (D.C. Law 13–256, D.C. Code § 47–1817.01 et seq. (2001)) was to consider the entity’s total gross revenues for purposes of the 51% requirement, not solely gross revenues generated in the District. Further evidence of this position is that language that would have limited the calculation to District-sourced revenue was not included in the final regulations.

¹³ The amended statute includes the following new provisions (emphasis added) to effect this change:

A Qualified High Technology Company certified pursuant to D.C. Code §47-1805.05:

- i. Before January 1, 2012, shall not be subject to the tax imposed by this chapter for 5 years after the date that the Qualified High Technology Company commences business *in the District*; and
- ii. On or after January 1, 2012, shall not be subject to the tax imposed by this chapter for 5 years after the date that the Qualified High Technology Company has taxable income.

QHTC may claim under the five-year exemption. Once the cap is met, a QHTC will no longer be eligible for the full franchise tax exemption. However, the QHTC would presumably still be entitled to the reduced 6% tax rate.

Proposal to Tax Capital Gains from the Sale of Stock in a QHTC at 3%

An earlier version of the Act contained a provision that would have reduced the District's capital gain tax from the regular rate to 3% for investors who sell shares of stock in a QHTC held continuously for more than 24 months if the QHTC was headquartered in the District as of the date of the sale. The proposed provision had an effective date of January 1, 2013. However, it appears that the City Council determined that additional time was needed to understand the impact of the provision. Thus, the final Act did not include this provision and instead included a provision authorizing a study of the matter.

OTR vs. BAE Systems

In light of the Act's changes to the QHTC program, the November 2012 decision in the *BAE* court case is particularly relevant. On November 29, 2012, the District of Columbia Court of Appeals affirmed the 2010 Office of Administrative Hearings ("OAH") decision in favor of the taxpayer, BAE Systems.¹⁴ BAE had claimed QHTC income tax incentives in 2001 and 2002 using customer locations in the District as the company's "base of operations," as the taxpayer had hundreds of employees who reported to these locations on a regular, 40-hours-per-week basis. The OTR denied the benefits, claiming that these locations did not qualify as a base of operations. Although both the OAH and the Court of Appeals generally defer to an agency's interpretation of its own regulations, both found that the OTR was reinterpreting the statute and regulation without concrete guidance. The Court identified examples where the OTR's interpretation of the term "base of operations" for purposes of the QHTC program contradicted with other guidance and interpretations. Accordingly, the Court upheld the OAH decision. Based on this case, a taxpayer with employees working in the District on a regular basis should consider whether QHTC status may be applicable, even if the taxpayer does not own or lease real property in the District.

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¹⁴ *District of Columbia Office of Tax & Revenue v. BAE Systems Enterprise Systems, Inc.*, 56 A.3d 477 (D.C. Nov. 29, 2012).