

District of Columbia's Qualified High Technology Program An Often-Missed Opportunity That Deserves a Second Look



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Credits and Incentives

The District of Columbia's Qualified High Technology Company program was enacted more than 10 years ago to attract qualified high-tech companies to the district. The program's benefits have not changed in the last decade, but changes in the way companies do business means that some formerly unqualified taxpayers may now meet the program's definition of a "high-tech" company. In this article, authors Don Teichen, Scott Frishman, and Catherine Ford, of Deloitte Tax LLP, analyze the program's eligibility requirements and discuss its potential tax benefits, including corporate franchise tax rate reductions and exemptions, unincorporated business tax exemptions, job-related credits, and sales and use tax exemptions.

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INTRODUCTION

For years, as part of their economic policy, state and local governments have instituted programs to attract and retain businesses, including tax credits and other monetary incentives. The success of particular credit and incentive programs is often debated when compared to the direct and indirect cost of providing and administering these programs. The "return on investment" debate that often accompanies these programs has become even more focused in the current economic environment where governments are faced with high budget deficits and high unemployment rates.

Certain state and local governments are attempting to narrow their budget gaps by increasing taxes through the reduction of existing tax credits and by lim-

iting or eliminating amounts expended on tax incentive programs. Alternatively, there are those governments that believe certain incentive programs may provide a competitive advantage that can result in attracting and retaining businesses and long term benefits that may be derived from capital investment and job retention or growth in their jurisdictions. The district has chosen the latter approach.

BACKGROUND

In December 2000, in an effort to boost economic development, the District of Columbia City Council unanimously approved a bill called "The New E-conomy Transformation Act of 2000" to encourage technology-based businesses to locate in the district by granting certain tax benefits to Qualified High Technology Companies. The Qualified High Technology Company (QHTC) program included in the bill was approved by the mayor and became effective April 3, 2001, after re-

ceiving the required approval by the U.S. Congress.¹ Although a decade old, the QHTC program remains a competitive incentive intended to attract and retain business in the district.

The provisions and benefits of the QHTC program have remained relatively unchanged over the last decade, but during that time, technology has significantly transformed the way day-to-day business is conducted. Companies that may not have qualified for the benefits 10 years ago may qualify today—simply because they have changed the way they engage in business. A business should avoid a hasty conclusion that it is not a “technology company,” or run the risk of failing to obtain benefits otherwise available under the QHTC program.

Many taxpayers presume that they do not qualify due to the perceived restrictive meaning of the term ‘technology company.’

Unfortunately, the QHTC program appears not to have received the attention it deserves. Because the QHTC program has existed without much statutory or regulatory change, published guidance, or litigation, it has been the subject of little public discussion. This absence of discourse may have resulted in a lack of awareness by many qualifying businesses that may be missing an opportunity to avail themselves of QHTC program benefits, including the possibility of reducing their district corporate franchise tax, property tax, and sales and use tax liabilities.

Another reason for the QHTC program’s low profile may be that many taxpayers presume that they do not qualify due to the perceived restrictive meaning of the term “technology company.” The authors are aware of various companies across different industries that may not be perceived as “technology” companies, yet nevertheless appear to satisfy the requirements of the QHTC program. Some of the companies that may be entitled to such benefits are defense contractors, software companies, computer companies, pharmaceutical companies, and consulting firms. Also, there are those companies that, while aware that they qualify, only claim a portion of the benefits to which they are entitled. This may be particularly true regarding some large technology companies, since qualification seems clear but the totality of available benefits are sometimes overlooked or misunderstood.

QHTC ELIGIBILITY

To be eligible for the benefits of the QHTC program, a business has to qualify as a QHTC, which means it must:

- be an individual or entity organized for profit;
- maintain an office, headquarters, or base of operations in the district;
- have two or more employees;

¹ D.C. Law 13-256, §403(b), 48 D.C. Reg. 730, April 3, 2001.

- be registered to do business in the district and be current in all district filing requirements and payment obligations; and

- derive at least 51 percent of its gross revenues from qualifying activities.²

In this article we explore three elements of the QHTC classification:

- having an office, headquarters, or base of operations in the district;
- engaging in qualifying activities; and
- deriving at least 51 percent of gross revenues from qualifying activities.

Office, Headquarters, or Base of Operations In the District

The district code, related regulations, and other guidance do not clarify what is meant by an “office, headquarters, or base of operations” in the district. However, the meaning of these terms was recently addressed in *BAE Systems Enterprise Systems Inc. v. District of Columbia Office of Tax and Revenue*.³ In 2001 and following, BAE Systems Enterprise Systems Inc. (BAE), a Virginia-based company, began servicing federal contracts at government locations within the district. BAE did not own or lease any real property in the district, nor did it own any of the equipment used by its employees. Additionally, per a nonpublicity clause in the contracts with the federal government, BAE could not post signage advertising that BAE employees were present and working at these government facilities other than signs within the buildings on cubicles, offices, and hallway areas designated for BAE employees. Finally, BAE was not permitted to meet with other clients at these locations.

BAE filed its 2001 and 2002 district corporate tax returns as a QHTC. The District Office of Tax and Revenue (OTR) challenged BAE’s filing status as a QHTC, arguing that BAE did not meet the definition of a QHTC because it did not have an “office” or a “base of operations” in the district.⁴ The Office of Administrative Hearings (OAH) agreed with BAE’s assertion that having business transacted at a customer’s office met the “office” requirement. Further, the OAH determined that maintaining an “office” in the district did not require property ownership or the payment of rent. Employees reporting to work daily at locations in the district—where they conducted BAE’s business of providing services to federal government agencies—were facts highlighted by the OAH that appeared to weigh into its decision that BAE satisfied the qualification of maintaining an office in the district.

² D.C. Code §47-1817.01(5)(A); D.C. Mun. Regs. tit. 9, §1199. There are other scenarios under which an otherwise qualified business may not qualify, including:

- if the entity is included in a district consolidated return, or
 - if it is located in the district’s Ballpark TIF Area.
- D.C. Code §47-1817.01(5)(B); D.C. Mun. Regs. tit. 9, §109.1.

³ District of Columbia, Office of Administrative Hearings, Case No. TR-C-04-800012 (Aug. 4, 2010).

⁴ The parties stipulated that BAE did not have a “headquarters” in the district. *BAE*, No. TR-C-04-800012, at FN 3.

Additionally, the OAH determined that “base of operations” refers to locations where “employees perform their services on behalf of their employer, get their instructions, and obtain their supplies to perform their assignments.” The OAH found that BAE’s employees performed these tasks in the district and, therefore, BAE satisfied the alternative “base of operations” requirement for purposes of qualifying as a QHTC. The case has been appealed by the OTR to the District of Columbia Court of Appeals; a decision has not been issued as of the date of this publication.

Qualifying Activities

The QHTC program requires that a taxpayer derive 51 percent or more gross revenue from qualified activities. While it appears that a certain level of specificity is provided in the statutory definition of qualified activities, it remains difficult to determine whether the QHTC program applies to a particular taxpayer due to the complex interpretation of the type of activities that qualify. The only available published guidance interpreting the statutory and regulatory qualifying activities can be found in the OTR’s Publication FR-399, which is generally a reiteration of the language provided in the statute and regulations. The specified qualifying activities are any of the following:

(a) Internet-related services and sales, including website design, maintenance, hosting, or operation; Internet-related training, consulting, advertising, or promotion services; the development, rental, lease, or sale of Internet-related applications, connectivity, or digital content; or products and services that may be considered e-commerce.

(b) Information and communication technologies, equipment and systems that involve advanced computer software and hardware, data processing, visualization technologies, or human interface technologies, whether deployed on the Internet or other electronic or digital media. Such technologies shall include operating and applications software; Internet-related services, including design, strategic planning, deployment, and management services and artificial intelligence; computer modeling and simulation; high-level software languages; neural networks; processor architecture; animation and full-motion video; graphics hardware and software; speech and optical character recognition; high-volume information storage and retrieval; data compression; and multiplexing, digital signal processing, and spectrum technologies.

(c) Advanced materials and processing technologies that involve the development, modification, or improvement of one or more materials or methods to produce devices and structures with improved performance characteristics or special functional attributes, or to activate, speed up, or otherwise alter chemical, biochemical, or medical processes. Such materials and technologies shall include metal alloys; metal matrix and ceramic composites; advanced polymers; thin films; membranes; superconductors; electronic and photonic materials; bioactive materials; bioprocessing; genetic engineering; catalysts; waste emissions reduction; pharmaceuticals; and waste processing technologies.

(d) Engineering, production, biotechnology and defense technologies that involve knowledge-based control systems and architectures; advanced fabrication and design processes, equipment, and tools; or propulsion, navigation, guidance, nautical, aeronautical and astronautical ground and airborne systems, instruments, and equipment. Such technologies shall include: computer-aided design and engineering; computer-integrated manufacturing; robotics and automated equipment; integrated circuit fabrication and test equipment; sensors; biosensors; signal and image processing; medical and scientific instruments; precision machining and forming; biological and genetic research equipment; environmental analysis, remediation, control, and prevention equipment; defense command and control equipment; avionics and controls; guided missile and space vehicle propulsion units; military aircraft; space vehicles; and surveillance, tracking, and defense warning systems.

(e) Electronic and photonic devices and components for use in producing electronic, optoelectronic, mechanical equipment and products of electronic distribution with interactive media content. Such technologies shall include microprocessors; logic chips; memory chips; lasers; printed circuit board technology; electroluminescent, liquid crystal, plasma, and vacuum fluorescent displays; optical fibers; magnetic and optical information storage; optical instruments, lenses, and filters; simplex and duplex data bases; and solar cells.⁵

The OTR concluded that the legislative intent of the 51 percent revenue requirement was not limited to district-sourced revenue.

51 Percent Gross Revenue From Qualified Activities

Although there is limited guidance in OTR’s Publication FR-399, one can look to the regulations for clarification regarding whether the 51 percent revenue test is limited to the activity in the district or is determined by taking into account the activity of the taxpayer as a whole. When final regulations related to the QHTC program were issued on March 8, 2002, by the OTR under its “Notice of Final Rulemaking,” the OTR specified that it had received comments that the 51 percent revenue test should relate only to district operations. However, the OTR concluded that the legislative intent of the 51 percent revenue requirement was not limited to district-sourced revenue, but rather, included entity revenue as a whole, even revenue earned outside of the district. Therefore, the district removed from the final regulations language that would have limited the calcu-

⁵ D.C. Code §47-1817.01(5)(A)(iii). See also D.C. Mun. Regs. tit. 9. §1199; District of Columbia Office of Tax Revenue, FR-399 *Qualified High Technology Companies* (April 2010), available at http://otr.cfo.dc.gov/otr/frames.asp?doc=/otr/lib/otr/2010_rpa_forms/2010_fr-399_qhtc.pdf.

lation to district-sourced revenue.⁶ Since some companies may have previously concluded that they were not a QHTC, having assumed that the revenue determination included only the company's district-sourced activities, such companies should reevaluate this requirement on an overall entity revenue basis.

However, if a company derives 51 percent or more of its gross revenues from the operation in the district of a retail store,⁷ an electronic equipment facility, or a professional athletic team, it does not qualify as a QHTC.⁸

QHTC PROGRAM BENEFITS

Once an entity qualifies as a QHTC, it is eligible for the benefits offered by the QHTC program. Some of these benefits are discussed below.

Corporate Franchise Tax Reduction

At 9.975 percent, the corporate income tax for the district is one of the highest rates of any U.S. jurisdiction. The QHTC program provides a reduced corporate franchise tax rate of 6 percent,⁹ making it more competitive with neighboring states. A QHTC would pay almost 40 percent less tax under this provision of the QHTC program.

Based on our experience, the corporate income tax rate reduction is the most commonly utilized benefit under the QHTC program.

Five-Year Elimination of Corporate Franchise Tax

The most significant benefit to qualifying taxpayers is a five-year exemption from the district franchise tax if the taxpayer is located in a specific geographic area within the district known as a "high technology development zone."¹⁰ After the five years, the taxpayer would still be eligible for the reduced tax rate as discussed above.

The high technology development zones are referenced in the district code and regulations and are summarized in the OTR's Publication FR-399 as follows:

- Downtown East;
- Capital City Business and Industrial;
- Capital City Market;
- Georgia Avenue;
- Southeast Federal Center/Naval Yard;
- any district-designated Foreign Trade or Free Trade Zone;
- any federally-approved enterprise or empowerment zone;¹¹
- any federally approved enterprise community;

⁶ 49 D.C. Reg. 2142 (March 8, 2002).

⁷ However, the district provides similar incentives for grocery stores, restaurants, and similar retailers through a "super-market credit." See D.C. Code § 47-3801.

⁸ D.C. Code §§ 47-1817.01(5)(B)(i)-(ii).

⁹ D.C. Code § 47-1817.06(a)(1).

¹⁰ D.C. Code § 47-1817.06(a)(2)(C).

¹¹ In addition to the district benefits available under the QHTC program, companies who are within a high technology development zone may also be within the District of Columbia Federal Empowerment Zone and should consider federal credits that may be available under that federal program.

- any designated development zone (D.C. Code, tit. 5, Ch. 14);
- any designated housing or development opportunity area or new or upgraded commercial center;
- transit impact area; and
- Minnesota Avenue.

The brief description provided in the OTR's publication of the eligible areas makes it difficult to determine if a corporation has an operation located in a designated high technology development zone. Regulations provide a more thorough description of the geographic territories that make up the various zones.¹² In addition, the district mayor's website provides an interactive map whereby a user can determine if a specific address falls within a designated area.

Unincorporated Business Franchise Tax

The district generally subjects business entities that are not incorporated to an unincorporated business franchise tax (UBT), with the same rate as the corporate franchise tax rate of 9.975 percent. Entities that are otherwise subject to the UBT and that are also QHTCs are exempt from the UBT.¹³

Job-Related Credits

A QHTC is eligible for job-related credits that are triggered by hiring new employees in the district, transferring jobs from outside the district into the district, or hiring or training disadvantaged employees. The credits are summarized below:

■ **Wages Paid to Qualified Employees.** A QHTC may claim a corporate franchise tax credit equal to 10 percent of a new hire's wages during the first 24 months of employment at a qualified technology activity, not to exceed \$5,000 per new hire per tax year.¹⁴ Credits in excess of a corporation's franchise tax due may be carried forward for 10 years.¹⁵

■ **Wages Paid to Disadvantaged Qualified Employees.** If the new hire is considered a "disadvantaged employee," as defined below, the credit is increased to 50 percent of the new hire's wages for the first 24 months of employment, not to exceed \$15,000 per new hire per tax year.¹⁶ Credits in excess of a corporation's franchise tax due may be carried forward for 10 years.¹⁷ A "disadvantaged employee" is a district resident that is also:¹⁸

- ◆ a recipient of Temporary Assistance for Needy Families (TANF); or
- ◆ a recipient of TANF in the period immediately preceding employment; or

¹² D.C. Mun. Regs. tit. 9, § 1199.

¹³ D.C. Code § 47-1808.01(5) excludes a QHTC from the definition of an unincorporated business.

¹⁴ D.C. Code § 47-1817.03. The credit will not be allowed if the employee is employed as a result of: a reduction of the regular wages, benefits, or rights of other employees in similar positions; the displacement of another worker; a strike or lock-out; or a layoff where other employees are awaiting to be recalled. *Id.*

¹⁵ D.C. Code § 47-1817.03(c).

¹⁶ D.C. Code § 47-1817.05.

¹⁷ D.C. Code § 47-1817.05(c).

¹⁸ D.C. Code § 47-1817.04(a)(1).

◆ a person released from incarceration within 24 months before the date of employment by a QHTC; or

◆ an employee hired, or relocated to district, after Dec. 31, 2000, and for whom a QHTC is eligible to claim the welfare-to-work tax credit or the work opportunity tax credit under I.R.C. §51.

■ **Retraining Expenses for Disadvantaged Employees.** A QHTC may claim a credit for expenses paid for retraining a “disadvantaged employee”, (as defined above), limited to \$20,000 for the first 18 months of employment. To the extent this credit cannot be used to offset the franchise tax liability in the year generated, 50 percent of the excess credit may be refunded, the other 50 percent can be carried forward as a franchise tax credit for up to 10 years.¹⁹

■ **Relocation Credit.** A QHTC may claim a credit for employees relocating to the district. A credit is available for up to \$7,500 per employee measured by the moving costs associated with relocating that employee to the district when the employee also moves his or her principal residence to the district. The credit is \$5,000 per employee for employees who only relocate their job to the district. The maximum annual credit is \$1,000,000 for employees who relocate their jobs and principal residence to the district and \$250,000 for employees who only relocate their jobs to the district.²⁰

Sales Tax Exemptions

The QHTC program provides a sales tax exemption on both the purchase of certain equipment and the sale of certain products or services by the QHTC. A QHTC may purchase computer software or hardware free of sales tax.²¹ The sale by a QHTC of intangible property or services and internet related products are not subject to sales tax.²² The OTR has issued an exemption certificate (Qualified High Technology Company Exempt Purchase Certificates, Form FP-337) that QHTCs can provide to vendors to obtain this exemption. The good-faith acceptance and maintenance of such certificates by a vendor may absolve it from having to collect the tax on an otherwise taxable transaction. However, the administration of exempt sales made by a QHTC may be more difficult and impractical, as there are no forms or procedures to document such transactions.

Property Tax Benefits

QHTCs may potentially benefit from property tax exemptions and abatements. Personal property purchased by a QHTC is exempt from personal property tax for 10

years.²³ After 10 years, the property is reported at 25 percent of its cost or value (10 percent if the property is qualified technological equipment).²⁴ Also, QHTCs may receive real property tax abatements for five years on certain improvements and renovations.²⁵

Other QHTC Program Benefits

While the benefits discussed above are more significant, the QHTC program also includes several other additional benefits. A QHTC may deduct from its district income and franchise tax the lesser of \$40,000 or the actual cost of the personal property described in I.R.C. §179(d)(1).²⁶ The program also excludes from taxable income gain from the sale or exchange of a QHTC’s capital assets held for more than five years.²⁷ However, gain recognized prior to Jan. 1, 2001, or after Dec. 31, 2007, is not excludable. Also, an individual who owns stock in a QHTC may qualify to defer (*i.e.*, “roll over”) gain on the sale of such stock if the proceeds are used to buy the stock of another QHTC.²⁸

Procedures for Claiming Benefits

A company that determines it is QHTC-eligible may self-certify itself for the applicable tax year on an original or amended D-20, Corporate Franchise Tax Return; D-30, Unincorporated Franchise Tax Return; or FP-31, Personal Property Tax Return. The district requires that the eligible company complete and attach a QHTC-CERT form to the applicable district tax return. It is important to note that all of the district tax forms (D-20, D-30, or FP-31) require the company to indicate its QHTC status by checking the appropriate “box” on the return in addition to attaching the QHTC-CERT form. Additional forms, schedules and/or worksheets may be required as provided in FR-399. Determination of QHTC eligibility is made on a year-by-year basis, thus requiring a company that desires to claim QHTC benefits to self-certify itself (as described above) annually.

CONCLUSION

The district offers significant potential tax benefits that should be explored by any company with business operations within the district. A company may initially conclude that it is ineligible for the QHTC program due to a belief that it is not engaged in qualified activities. However, what constitutes “high technology” for purposes of the QHTC program may be more expansive than what is commonly understood as “high technology.” Companies should investigate whether their activities may be considered “high technology” under the definitions provided by district law and take advantage of the many potential tax benefits afforded by the program.

¹⁹ D.C. Code §47-1817.04(e)(2).

²⁰ D.C. Code §47-1817.02(c)(1).

²¹ D.C. Code §47-2005(31) and D.C. Mun. Regs. tit. 9, §1111.3.

²² D.C. Code §47-2001(n)(2)(G) and D.C. Mun. Regs. tit. 9, §1111.1. This exemption does not apply to telecommunication service providers.

²³ D.C. Code §47-1508(a)(10).

²⁴ D.C. Code §47-1523.

²⁵ D.C. Code §47-811.03(b).

²⁶ D.C. Code §47-1803.03(a)(18).

²⁷ D.C. Code §47-1803.02(a)(2)(Q).

²⁸ D.C. Code §47-1817.07.