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August 2017

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Self driving cars, drones, 3D printers, virtual reality, artificial intelligence. Not only have they been subjects of science fiction movies throughout the years, these technological advancements are now a part of our daily lives. We are surrounded by technology that manages our homes, schools and businesses. While technology has become an integral facet of our daily lives, it is also an ever-evolving area bringing with it new implications, new breakthroughs, and even the opportunity for new tax incentives.

While twenty years ago, few could have imagined the scale and scope of technology advancements that exist today, the District of Columbia recognized the potential in technology from an economic development perspective as a significant source of economic growth and job creation.

Background

In 2001, the District City Council enacted the "New E-Conomy Transformation Act of 2000."¹ The Committee on Finance and Revenue report stated that "the 'New E-Conomy Transformation Act of 2000' had its genesis with a local group of technology experts brought together . . . with the goal of identifying

barriers to entry and expansion of technology companies in the District of Columbia."² At its inception, the goal of the legislation was to attract and retain high technology companies in the District, thus creating technology-focused jobs. The legislation created a series of tax credits and exemptions available to a Qualified High Technology Company ("QHTC").

The tax benefits afforded to a company under the QHTC program have generally remained unchanged throughout the years, though the "how "and "what" that qualifies for tax benefits as "High Tech" under the QHTC program have evolved over the last five years. Therefore, it's worth looking at the QHTC program provisions with a fresh perspective.

QHTC eligibility

The QHTC program is unique in that a business may avail itself of the program benefits through a self-certification process. Unlike incentive programs in other jurisdictions that typically require pre-approval from a revenue agency or economic development group, the QHTC program benefits are generally claimed through company certification to the District of Columbia's Office of Tax and Revenue ("OTR") that the company meets the statutory requirements of the QHTC program.

Currently, a company must meet the following statutory criteria to be eligible for certification as a QHTC (emphasis added):

- be an individual or entity organized for profit and *leasing or owning* an office in the District;
- have 2 or more qualified employees *in the District*; and
- *derive* at least 51 percent of its gross revenues *earned in the District* from certain enumerated qualifying activities.³

A company must derive at least 51% of its gross revenues earned in the District from any of the 64 enumerated qualifying activities outlined in the statute. Generally, these activities are classified in five categories:

- Internet related services and sales;
- information and communication technologies, equipment and systems;
- advance material and processing technologies;
- engineering, production, biotechnology and defense technologies; and
- electronic and photonic devices and components.⁴

For tax years beginning after December 31, 2010, the District enacted a mandatory water's edge unitary combined franchise tax reporting requirement.⁵ Under the combined reporting method, a taxpayer subject

to tax and engaged in a unitary business with one or more other persons may need to file a combined District franchise tax return with the unitary members. However, a QHTC is not an "includable member" of the unitary combined franchise tax return.⁶ Therefore, a company claiming the franchise tax benefits afforded to a QHTC that is otherwise a member of a unitary group is excluded from a combined District filing and must file on a separate company basis.

QHTC tax benefits

The New E-Conomy Transformation Act of 2000 enacted a series of tax incentives to encourage high technology companies to locate in the District. The QHTC program tax incentives come in the form of tax credits and tax exemptions, discussed below.

Corporate franchise tax exemption and reduction: Based on a recent report issued by the District's Chief Financial Officer, the District's corporate franchise tax rate applicable to tax years beginning on or after January 1, 2018 is reduced to 8.25%.⁷ While this is a significant reduction to the historical rate of 9.975%, the rate continues to be among one of the highest state corporate income/franchise tax rates in the U.S.

The QHTC program provides a five-year exemption from the corporate franchise tax rate, or \$15 million exemption, whichever is lesser, for companies certifying as a QHTC on or after January 1, 2012.⁸ Once the five-year exemption period expires or the company receives \$15 million in exemptions before the five-year exemption expires, the company is then entitled to a reduced corporate franchise tax rate of 6.00% for each qualifying year thereafter.⁹

Corporate franchise tax credits: Other tax benefits afforded under the QHTC program are job-related credits against the corporate franchise tax. Among these are the tax credit for relocating a minimum of two employees to the District,¹⁰ a tax credit for hiring qualified employees in the District,¹¹ and a tax credit for hiring qualified disadvantaged employees in the District.¹² These credits are non-refundable credits and any unused amounts may be carried forward for up to 10 years.

The QHTC program also provides a tax credit for retraining costs incurred as a result of hiring qualified disadvantaged employees in the District.¹³ The unused portion of this credit may either be taken as a refundable credit for up to 50% of the unused portion in the year generated or the unused amount may be carried forward for up to 10 years.¹⁴

Unincorporated business franchise tax exemption: The District generally subjects unincorporated businesses engaging in business in the District to an entity level tax referred to as the unincorporated business franchise tax.¹⁵ The unincorporated business franchise tax rate is the same as the corporate franchise tax. However, an unincorporated business that qualifies as a QHTC is exempt from the definition of an unincorporated business as long as it is a QHTC.¹⁶

Historically, the unincorporated business would file a Form D-30, SUB *Unincorporated Business Franchise Tax Return* and mark the box indicating the business was a "Certified QHTC" and thus was not subject to an entity level tax. However, the District changed its policy when it updated the tax year 2014 Form D-30 filing instructions and noted that an unincorporated business that is a QHTC shall no longer file Form D-30, but rather "must file a D-65 *Partnership Return*, or a D-40 *Individual Income Tax Return*."¹⁷ Historically, a partnership was instructed to file a Form D-30 to claim the QHTC program benefits.

Other QHTC program benefits

The QHTC program also provides for sales tax exemptions on certain purchases¹⁸ and sales,¹⁹ property tax exemptions and abatements,²⁰ commercial real property tax abatements,²¹ a deduction for certain depreciable business assets where a QHTC may deduct the lesser of \$40,000 or the actual cost of personal property described in I.R.C. Section 179(d)(1),²² and, for tax years beginning after December 31, 2017, there is a reduced corporate franchise tax rate applicable to the tax on capital gain from the sale or exchange of a QHTC investment.²³

Recent developments affecting the QHTC program

Recent legislative amendments, as well as court rulings, have implications for the "how" and "what" qualifications under the QHTC program

One substantive change to the QHTC criteria was enacted under the Technology Section Enhancement Act of 2012 ("Enhancement Act"), which was generally applicable to tax years beginning on or after January 1, 2012.²⁴ The legislation made two significant changes. The first was amending the definition of a QHTC by adding the phrase "in the District" to subsections (ii) and (iii) of section 47-1817.01(5)(A) of the District Code.

Prior to enactment of the Enhancement Act, a company would qualify as a QHTC if the company was deriving at least 51% of the entity's *total* gross revenues from the qualifying activities. Following the

enactment of the Enhancement Act, companies now evaluate only their gross revenues earned *in the District* for purposes of the 51% test. The legislation expanded potential eligibility for the QHTC to companies that derived at least 51% of their gross revenues from qualifying activities in the District even if their gross revenues outside of the District were primarily from non-qualifying activities. By contrast, the legislation served to disqualify companies whose District-only revenues would not be sufficient to meet the 51% test.

The Enhancement Act also removed the "high technology development zone" provisions from the statutory requirement such that a company was no longer required to be located within the high technology development zone to receive a five-year exemption from the franchise tax followed by a 6% reduced tax rate for each qualifying year thereafter. The Enhancement Act amended section 47-1817.06(2)(A) of the District Code to read as follows:

"A Qualified High Technology Company certified pursuant to § 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*."

The statute distinguished between companies certifying prior to January 1, 2012 versus on or after January 1, 2012. For the latter, a company's five-year exemption from the franchise tax commences as of the date it has taxable income rather than from when it commenced business in the District.

The Enhancement Act also imposed a new limitation to the five-year exemption from franchise tax. The limitation provides that "the total amount that each Qualified High Technology Company may receive in exemptions under this paragraph shall not exceed \$15 million."²⁵ Therefore, if a qualifying company's franchise tax benefits exceed \$15 million before the five-year exemption period expires, it appears the company is then entitled to the reduced rate of 6% for each qualifying year thereafter but may not receive the full five-year exemption amount.

The second significant change to the QHTC criteria was enacted under the Fiscal Year 2015 Budget Support Act of 2014 ("FY15 Budget Act"), with the QHTC change being generally applicable to tax years beginning on or after January 1, 2015.²⁶ The FY15 Budget Act replaced the phrase "maintaining an office, headquarters, or base of operations" with "leasing or owning an office."²⁷

This statutory change appears to legislatively reverse the District of Columbia Court of Appeals decision in *District of Columbia Office of Tax and Revenue v. BAE Systems Enterprise Systems, Inc.*,²⁸ which had affirmed the 2010 Office of Administrative Hearings decision²⁹ that a taxpayer with employees working in the District on a regular basis was maintaining a "base of operations" within the District, even if the taxpayer did not actually own or lease a location within the District. Companies that previously qualified for the QHTC program but did not have a leased or owned location in the District no longer qualified as a result of this 2015 legislative amendment.

On January 17, 2014, the District Office of Administrative Hearings ("OAH") issued its *Final Order* in *NBC Subsidiary WRC-TV, LLC v. District of Columbia Office of Tax and Revenue*.³⁰ The central issue revolved around the definition of "derive," in the context of a QHTC deriving more than 51% of its gross revenues from one or more of the 64 enumerated high technology activities set forth in the Code.³¹ NBC is a commercial broadcast television station that owns and operates television stations in the District, including WRC-TV.

The *Final Order* affirmed OTR's position that WRC-TV did not meet the requirements to avail itself of the QHTC benefits because it derived its gross revenue mainly from the sale of program time or television air time for advertising and, therefore, did not derive at least 51% of its gross revenues from a qualified high technology activity.³² The OTR's interpretation of the term "derive" required that one look to the "specified source of the taxpayer's income," and in this case it was determined that the specified source was advertising revenue, which is not one of the 64 enumerated high technology activities. On October 22, 2015, the District of Columbia Court of Appeals affirmed the *Final Order*.³³

Considering the narrower OAH interpretation of "derive," a company must now be able to demonstrate a nexus between its revenues and one of the 64 enumerated high technology activities, not merely that it is "investing in and using technology to earn" its revenues.³⁴

QHTC certification and additional considerations

As previously noted, the process for claiming the QHTC program benefits is through a self-certification process. A company must analyze its activities on a separate legal entity basis as well as on an annual basis to determine its eligibility. To claim the QHTC benefits reported on the corporate franchise tax return such as the tax rate exemption, reduced franchise tax rate or the job related credits, a company must submit the Schedule UB Business Credits, QHTC-CERT, QHTC Gross Revenue Worksheet, and D-20CR

QHTC Corporate Business Tax Credits along with its original or amended Form D-20. If the company is an unincorporated business, then it must submit the QHTC-CERT and QHTC Gross Revenue Worksheet along with its Form D-65. To claim the personal property tax, a company must submit the QHTC-CERT along with its Form FP-31, *Personal Property Tax Return*. In addition to the required schedules, the company is required to indicate its QHTC status by checking the appropriate box on each of these respective returns.

In addition to the statutory requirements, the District regulations also require that a company "is appropriately registered as a business with a District agency that requires registration, such as the Department of Consumer and Regulatory Affairs and Office of Tax and Revenue, and is current in all District filing requirements and payment obligations."³⁵

Conclusion

Despite support in the legislative history that a comprehensive credits and incentives package such as the QHTC program was intended to attract and retain high technology companies in the District, eligibility for the QHTC program has been the subject of close legal and legislative attention recently. Notwithstanding developments that have potentially narrowed its scope, the QHTC program continues to make the District an important participant in the high technology economy. Companies are encouraged to review their District footprint and consider whether their activities fall within the required high technology qualifying activities such that they may take advantage of the broad array of QHTC program benefits.

¹ A13-0543 (B13-0752) (effective Apr. 3, 2001).

² The Committee on Finance and Revenue Report on Bill 13-752, "New E-Conomy Transaction Act of 2000" (Oct. 19, 2000).

³ D.C. Code § 47-1817.01(5)(A).

⁴ *Id.*; See also FR-399 Qualified High Technology Companies (last revised Feb. 2016).

⁵ D.C. Code § 47-1805.02a.

⁶ The term "person" for purposes of combined reporting specifically excludes a QHTC as defined in section 47-1817.01(5)(A). D.C. Code § 47-1801.04(39); D.C. Code Mun. Regs. tit. 9, § 157.3.

⁷ D.C. Code §§ 47-181(16); 47-1807.02(a)(6); District of Columbia Chief Financial Officer—February 2017 Revenue Estimate Report FY2017-2021 (Feb 28, 2017).

⁸ D.C. Code § 47-1817.06(a).

⁹ *Id.*

¹⁰ D.C. Code § 47-1817.02.

¹¹ D.C. Code § 47-1817.03.

¹² D.C. Code § 47-1817.05.

¹³ D.C. Code § 47-1817.04.

¹⁴ *Id.*

¹⁵ D.C. Code § 47-1808.01.

¹⁶ *Id.*

¹⁷ 2014 Form D-30 Filing Instructions (last revised Dec. 2014). The OTR also updated its 2015 Form D-65 Partnership Return of Income to reflect an oval for "Certified QHTC" (last revised Dec. 2015).

¹⁸ D.C. Code § 47-2005(31).

¹⁹ D.C. Code § 47-2001(n)(2)(G). This exemption does not apply to telecommunication service providers.

²⁰ D.C. Code §§ 47-1508(a)(10); 47-1523.

²¹ D.C. Code § 47-811.03(b).

²² D.C. Code § 47-1803.03(a)(18).

²³ D.C. Code § 47-1817.07a.

²⁴ A19-0513 (B19-0747) (effective Mar. 5, 2013).

²⁵ D.C. Code § 47-1817.06(2)(B).

²⁶ A20-0424 (B20-0750) (effective Feb. 26, 2015). The Fiscal Year 2015 Budget Support Act of 2014 also made the following changes: In D.C. Code § 47-1817.01(5)(A)(ii), the word "employees" was replaced with "qualified employees." A "qualified employee" is defined as a person who is employed in the District by a QHTC. D.C. Code § 47-1817.01(4). Also, D.C. Code § 47-1817.01(5)(B) was amended to exclude "an on-line or brick and mortar retail store" and "a building or construction company" from the definition of a QHTC. Previously, a QHTC excluded "An individual or entity that derives 51% or more of its gross revenues from the operation in the District of: an electronic equipment facility that is primarily occupied, or intended to be occupied, by electronic and computer equipment that provides electronic data switching, transmission, or telecommunications functions between computers, both inside and outside of the facility; or a professional athletic team, as defined in § 47-2002.05(a)(3); or a business entity located in the DC Ballpark TIF Area, as defined in § 2-1217.12a(a)."

²⁷ B20-0750 *amending* D.C. Code § 47-1817.01(5)(A)(ii).

²⁸ *District of Columbia Office of Tax and Revenue v. BAE Systems Enterprise Systems, Inc.*, 56 A.3d 477 (2012).

²⁹ *District of Columbia, Office of Administrative Hearings*, Case No. TR-C-040002 (Aug. 4, 2010).

³⁰ *District of Columbia, Office of Administrative Hearings*, Case No. 2013-OTR-00017 (Jan 17, 2014).

³¹ D.C. Code § 47-1817.01(5)(A).

³² *Id.*

³³ *NBC Subsidiary WRC-TV, LLC v. Office of Tax and Revenue*, No. 14-AA-174 (D.C. Oct. 22, 2015).

³⁴ *Id.*

³⁵ D.C. Mun Regs. tit. 9, § 1199.