Government of the District of Columbia
Office of the Chief Financial Officer

Natwar M. Gandhi
Chief Financial Officer

MEMORANDUM

TO:	**The Honorable Philip H. Mendelson** **Chair, Council of the District of Columbia**
FROM:	**Natwar M. Gandhi** **Chief Financial Officer**
DATE:	**June 29, 2012**
SUBJECT:	**Fiscal Impact Statement – "Technology Sector Enhancement Act of 2012"**
REFERENCE:	**Bill Number 19-747– Draft bill shared with the Office of Revenue Analysis on June 27, 2012**

Conclusion

Funds are sufficient in the proposed FY 2013 through FY 2016 budget and financial plan to implement the bill.

The bill limits the scope of companies that can take advantage of tax credits offered to Qualified High Technology Companies (QHTCs) by requiring employee presence and economic activity in the District, and thus reduces tax expenditures during the financial plan period. However, the bill is expected to have a negative impact in the years outside of the financial plan. This is because the bill also allows QHTCs to shift their use of tax credits from the first five years of their establishment to the five years after they become profitable. They also qualify for a lower tax rate on capital gains from the sale of their shares. These changes are expected to reduce both corporate franchise and capital gains tax collections in years outside of the financial plan period. This future negative impact cannot be reliably estimated at this time, but it could be substantial.

Background

The bill exempts[1] a Qualified High Technology Company from business franchise taxes for *5 years after the date that the Qualified High Technology Company has taxable inco*me. It also establishes a tax exemption limit of $15 million for each company. Under current law, in lieu of the business franchise tax levied at 9.975 percent of taxable income, Qualified High Technology Companies (QHTC) pay a tax that is equivalent of 6 percent of their taxable income. Again, under current law,

[1] The bill amends subsection (a)(2) of D.C. Official Code § 47-1817.06, Tax on Qualified High Technology Companies.

QHTCs located in a priority development area[2] are exempt from business franchise taxes for *5 years after the date they locate in such an area*. For both types of companies, currently there is no limit to the exemption amount.

The bill limits[3] eligibility for QHTC status to companies that have two or more employees *in the District*, and derives at least half of its *District gross revenues* from high technology activities. Eligibility requirements under current law do not impose such local presence and activity requirements. Companies with two or more employees regardless of employment location, with high technology activities generating half of their gross revenues in any location—in the District or elsewhere—can qualify.

The bill also eliminates the requirement that a company locate in the priority development area to receive the tax benefits outlined in the bill, opening the program to all QHTC's located in the District.

Finally, the bill limits the tax in capital gains from the sale of an investment in a District of Columbia QHTC to 3 percent for tax years beginning January 1, 2013, provided that such investment is entirely in the stock of such a company, and was held by the investor for at least twenty-four continuous months. Under current law, capital gains from the sale or exchange of a QHTC is excluded from gross income if held for more than five years.

Financial Plan Impact

Funds are sufficient in the FY 2012 budget and the proposed FY 2013 through FY 2016 budget and financial plan to implement the bill. The bill is expected to result in a positive net impact of $61,000 in FY 2013 and $1.6 million over the FY 2013 through FY 2016 budget and financial plan.

Estimated Fiscal Impact of Bill 19-747, Technology Sector Enhancement Act of 2012 FY 2013 through FY 2016					
	FY 2013	**FY 2014**	**FY 2015**	**FY 2016**	**Total**
Impact on corporate income tax revenue[1]					
Modify eligibility requirements[2]	$531,000	$540,000	$565,000	$590,000	**$2,224,000**
Repeal Redevelopment Zones	($470,000)	($141,000)	0	0	**($611,000)**
Net Fiscal Impact	$61,000	$399,000	$565,000	$590,000	**$1,613,000**

Table Notes
[1] Estimate based on the most recent tax expenditure analysis included in the FY 2013 budget submission.
[2] Assumes geographical limitations would result in a 10 percent reduction in estimated value of tax credits.

Modification of eligibility requirements that require employee presence and economic activity in the District will result in fewer companies qualifying for QHTC credits, and therefore reduce the value of QHTC tax credits by an estimated 10 percent. As a result, the District is expected to save $531,000 in tax revenue in FY 2013 and $2.2 million over the four-year financial period.

[2] Priority development areas are listed in D.C. Official Code § 2-1219.20.
[3] The bill amends subsections (5)(A) (ii) and (5)(A) (iii) of D.C. Official Code § 47-1817.01.

Repealing the requirement that QHTCs be located in certain redevelopment zones will offer some immediate benefit to existing QHTCs that are currently outside of the zone but will not be applied retroactively and will not result in refunds. Expanding the QHTC tax benefits to all QHTCs regardless of location is expected to reduce tax revenue by $470,000 in FY 2013 and FY 2014 $141,000.

Impact outside of the financial plan

Two sections of the bill are likely to result in revenue losses in years outside of the financial plan.

First, new QHTCs will be able to become certified for the non-income tax related items immediately but have the five year window for a zero percent tax rate start when they have taxable income. This will shift the impact of tax credits to out years, but also to years when the credits could be much larger. It is not possible to estimate this amount but given the growth in QHTC activity, the impact could be substantial.

Second, the lower rate for capital gains from sales of shares in QHTCs headquartered in the District is not estimated to have a significant benefit to this provision in the financial plan because of the lag time between investment in a technology company and the realization of capital gains. But if such a company were to have an IPO, depending on the IPO price and the subsequent trading, the revenue losses could be significant. There are mitigating factors to this risk: the investor has to be a District resident to take advantage of the capital gains tax break, and most venture capital investments in technology companies are made by firms that are outside of the District and so the preferential tax rate does not help them if the income is partnership income that is not taxable in the District. Office of Revenue Analysis (ORA) will be able to monitor companies through Securities and Exchange Commission filings to determine if a sizeable IPO is on the horizon.[4] If a significant IPO is approaching, ORA can determine at that time the impact on the regular quarterly estimate.

[4] The SEC requires companies planning to offer securities to the public to file an S-1 report outlining the details of the offering. Facebook, for example, filed the S-1 in February, three months before shares were put up for sale to the public. http://www.sec.gov/edgar/searchedgar/webusers.htm