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

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**TAX ABATEMENT FINANCIAL ANALYSIS**

**TO:** **The Honorable Vincent C. Gray**
**Mayor, District of Columbia**

**The Honorable Kwame R. Brown**
**Chairman, Council of the District of Columbia**

**FROM:** **Natwar M. Gandhi**
**Chief Financial Officer**

**DATE:** **May 29, 2012**

**SUBJECT:** **"Technology Sector Enhancement Act of 2012"**

**REFERENCE:** **Bill 19-747**

## Findings

The proposed legislation makes amendments to the New E-Conomy Transformation Act of 2000, effective April 3, 2001 (DC Law 13-256, DC Official Code § 47-1817). These amendments provide additional benefits to Qualified High Technology Companies (QHTCs) and QHTC investors through the District's corporate franchise and capital gains tax codes.

The Office of the Chief Financial Officer (OCFO) cannot determine whether the proposed corporate franchise tax subsidies are necessary to induce QHTCs to locate in the District and, therefore, entice new residents and create new jobs for District residents. The proposed changes to the QHTC capital gains tax are not expected to have an effect on a QHTC's decision to locate in the District. Research indicates that tax incentives are generally not a critical factor in corporate locational decisions. However, without fully understanding the locational criteria for each company, the OCFO cannot fully assess the effectiveness of the additional subsidies.

## Background

The revised corporate franchise tax exemptions in the proposed bill provide that any QHTC, (regardless of location in the District) is exempt from business franchise taxes for 5 years after the date that the company has taxable income. These exemptions are limited to $15 million per QHTC. The proposed changes to the franchise tax exemption could have some effect on locational decisions, but the effect is not expected to be significant.

The proposed legislation also revises the capital gains provisions in the District Code so that investors in QHTCs would pay a 3 percent capital gains rate on QHTC investments, beginning in tax year 2013, provided the investment was held for at least 24 consecutive months, entirely in common or preferred stock of the QHTC. The proposed changes to the capital gains tax rate for QHTC investors will benefit investors residing in the District, but are unlikely to have any impact on a company's decision to locate in the District.

Notwithstanding the findings presented in this analysis, the proposed legislation may have an effect on the District's FY 2012 budget and the proposed FY 2013 through FY 2016 budget and financial plan. A separate Fiscal Impact Statement will be issued.

## Financial Analysis

The Exemptions and Abatements Information Requirements Act of 2011 requires the analysis provided by the OCFO to contain certain information. The required information is included below.

<u>Terms of the Exemption or Abatement</u>

1. Under current law, in lieu of the corporate franchise tax levied at 9.975 percent of taxable income, QHTCs pay a tax rate of 6 percent on their taxable income, except in high technology development zones, where the company pays no corporate franchise tax for the first five years after the QHTC commences business in the area. In FY 2010, there were 127 certified QHTCs in the District. Of these, 82 claimed a QHTC corporate franchise tax benefit – 45 within high technology development zones and 37 outside those zones. The total value of the benefit claimed in FY 2010 was $13.8 million.

   The proposed legislation eliminates the high technology development zones, making <u>any</u> QHTC eligible for an exemption from business franchise taxes for five years. Further, to acknowledge that some start-up tech companies can take several years before making a profit, the proposed legislation begins the five-year exemption in the first year the QHTC generates taxable income rather than in the first year of commencing business. After the five-year exemption, a QHTC would revert to paying a 6 percent corporate franchise tax rate.

2. Current law imposes no limit on the total dollar amount of exemptions that a QHTC can claim.

   The proposed legislation establishes a limit of $15 million for each company for the income tax exemption described in (1), above. To date, no QHTC has reached this $15 million threshold.

3. Under current law, capital gains from the sale of QHTC assets are excluded from a QHTC's income if the assets are held for at least five years. However, individual investors' capital gains realized from their investments in QHTCs are taxed as regular income (8 percent for incomes between $40,000 and $350,000 and 8.95 percent for incomes $350,000 and above). As of 2010, no company had taken advantage of the current capital gains provision.

The proposed legislation would set a rate on capital gains realized from all QHTC stockholder investments at 3 percent for tax years beginning January 1, 2013, provided that the investor held these investments for at least two consecutive years.

Annual Proposed Value of the Exemption or Abatement

The type of programmatic exemptions provided in the legislation are difficult to value, as it is not easy to predict 1) the number of qualifying companies to set up an office, headquarters, or base of operations in the District, 2) how much profit they will make and when they will make it, and 3) what kind of capital gains they will generate for investors who reside in the District.

Value of the changes to the Franchise Tax

Based on FY 2007 through FY2010 data on current QHTCs, the OCFO estimates the differential between the tax benefits claimed by QHTCs currently in the high technology development zones and those residing elsewhere in the District to be approximately $47,000 annually. Therefore, assuming no change in the profitability of QHTCs, by eliminating the high technology development zone incentive, current and future QHTCs not otherwise residing in a high technology development zone would expect to see an increased tax benefit of approximately $47,000 per year.

The value of the proposed change to delay the start of the five-year corporate franchise tax exemption will depend on the success of the QHTC, but could be extremely valuable to a QHTC that takes a few years to ramp up operations.

Based on current data, it would be reasonable to expect that the elimination of the high technology development zones and the revision to the start of the five year full franchise tax exemption together would result in some QHTCs reaching the $15 million cap on this exemption.

The OCFO expects the revised corporate franchise tax provisions of the proposed legislation to have the following impacts:

- QHTCs would receive a financial benefit from establishing a business operation at any location within the District.
- A QHTC's landlord could benefit from a portion of the increase in subsidy to QHTCs through increased rent payments.
- More companies could be incentivized to certify themselves as QHTCs.

Value of the changes to the Capital Gains Tax

There is no direct value to the QHTC itself of the preferential rate on capital gains because this benefit generally accrues to individual investors. A company can certify itself as a QHTC if it has an office or base of operation in the District, has at least two employees (irrespective of whether they work in the District), and derives at least 51 percent of gross revenue from high tech activities (regardless of where that revenue is generated).[1] The OCFO expects the capital gains provision of the proposed legislation to have the following impacts:

[1] See DC Law 13-256, DC Official Code § 47-1817.1(5)(A).

- Because the change impacts investors, not the company itself, it should have virtually no impact on the locational decision of the company.
- The provision is unlikely to cause an investor to move to the District because all of the investor's other income (wages, capital gains from non-QHTCs, interest and dividends) would become taxable in the District.
- Residents of the District will have an incentive to invest in certified QHTC's.
- As a result, the value of the QHTC stock could be positively impacted.
- Many current District residents who already invest or plan to invest in QHTCs, will receive an unexpected tax benefit.
- Under certain circumstances, this incentive could result in a significant subsidy to an individual investor or group of investors. For example, if an investor has held a QHTC stock for two years or more, and subsequently realizes a substantial one-time gain as a result of an IPO or other corporate action, the value of the QHTC capital gain tax break could be considerable.

Summary of the Proposed Community Benefits

As no recipient of the proposed tax abatement subsidy is identified in the legislation, no specific community benefits have been identified. Attachment 1, submitted by the Office of the Deputy Mayor for Planning and Economic Development, provides a general discussion of Community Benefits.

Financial Analysis for Development Projects

This portion of the TAFA requires a financial analysis of existing buildings and development projects. As the QHTC program is not specific to any particular building or development project, no such analysis can be completed.

Attachment 1

**Community Benefits Discussion**
**Submitted by the Office of the Deputy Mayor for Planning and Economic Development**

Technology is an area of growth—

- Technology has a strong underpinning in DC. The District is currently home to 2,131 businesses and 22,771 employees.
- Beyond having a strong technology sector base, we anticipate the sector to grow in the next decade, while other core regional industries are shrinking.
- Technology comprises 4 of 8 growth sectors identified by US Department Of Labor where DC possesses a strategic advantage.
- The District has already enjoyed growth from the technology sector, where jobs have grown 50% in the last 10 years.

The District of Columbia has already invested in technology—

- This bill is just one of many investments the District has made in technology as a part of the District's future.
- Last year, the Mayor cut the ribbon on HD Woodson Technology High School, and the McKinley K-12 STEM campus in Ward 5.
- Culminating a decade of work, the high speed DC NET fiber optic network was lit in Wards 7 and 8 and is now beginning to serve essential community anchors like health clinics and schools.

Technology can address a part of our unemployment issue—

- Attracting an early stage funding community is an investment in countless startups and small tech businesses that will create a pipeline of jobs for graduates of CCDC, UDC, and McKinley and Woodson Technology High Schools.
- Because barriers to technology job entry are shrinking, technology can provide jobs to applicants with as little as a two-year certificate.