



## Legislative Fiscal Bureau

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June 8, 2007

Joint Committee on Finance

Paper #331

### **Sales and Use Tax Exemptions for Biotechnology (General Fund Taxes -- General Sales and Use Tax)**

#### *Bill Agency*

[LFB 2007-09 Budget Summary: Page 173, #2]

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#### **CURRENT LAW**

Wisconsin imposes a 5% general sales and use tax on the gross receipts from the sale and rental of tangible personal property and selected services. Currently, there are no sales and use tax exemptions specific to biotechnology.

#### **GOVERNOR**

Create five sales and use tax exemptions related to biotechnology. Three of the exemptions would apply directly to biotechnology businesses, while the other two would apply with respect to businesses raising laboratory animals to be sold primarily to biotechnology businesses or higher education institutions or governmental units for use in qualified research or manufacturing.

#### **Description of Provisions**

Under the proposal, the gross receipts from the sale of and the storage, use, or other consumption of the following would be exempted from the sales and use tax:

a. Machines and specific processing equipment, including accessories, attachments, and parts for the machines or equipment, that are used exclusively and directly in raising animals that are sold primarily to a biotechnology business, a public or private institution of higher

education, or a governmental unit for exclusive and direct use by any such entity in qualified research or manufacturing;

b. The following tangible personal property used exclusively and directly in raising animals that are sold primarily to a biotechnology business, a public or private institution of higher education, or a governmental unit for exclusive and direct use by any such entity in qualified research or manufacturing: (i) certain tangible personal property, the sales of which are currently exempt when used in the business of farming [including seeds for planting; plants; feed; fertilizer; soil conditioners; animal bedding; sprays, pesticides, and fungicides; breeding and other livestock; poultry; farm work stock, baling twine and baling wire; containers for fruits vegetables, grain, hay silage, and animal wastes; plastic bags, plastic sleeves, and plastic sheeting used to store or cover hay or silage]; (ii) medicines; (iii) semen for artificial insemination; (iv) fuel; and (v) electricity;

c. Machines and specific processing equipment, including accessories, attachments, and parts for the machines or equipment, that are sold to a biotechnology business and used exclusively and directly in qualified research in biotechnology;

d. Tangible personal property that is sold to a biotechnology business, if the property is consumed or destroyed or loses its identity while being used exclusively and directly in qualified research in biotechnology; and

e. Animals that are sold to a biotechnology business and used exclusively and directly in qualified research in biotechnology.

A person claiming an exemption under "a" or "b" above would be required to obtain written documentation from the person's customers related to each customer's use of animals, including the percentage of animals sold to the customer that are used exclusively and directly in qualified research.

For purposes of these provisions, "biotechnologies" would be defined to include recombinant deoxyribonucleic acid (DNA) techniques, biochemistry, molecular and cellular biology, genetics, genetic engineering, biological cell fusion, and other bioprocesses. "Biotechnology business" would be defined as a business primarily engaged in the application of biotechnologies that use a living organism, or parts of an organism, for one of the following purposes: (a) to produce or modify products to improve plants or animals; (b) to develop microorganisms for specific uses; (c) to identify targets for small molecule pharmaceutical development; or (d) to transform biological systems into useful processes or products. To qualify as a biotechnology business, a business would also have to be certified by the Department of Revenue (DOR) in a manner prescribed by the Department.

The following definitions would also apply with respect to the proposed sales and use tax exemptions:

a. "Animals" would include bacteria, viruses, and other microorganisms;

b. "Manufacturing" would have the same meaning as under the current sales and use tax exemptions related to manufacturing, for which "manufacturing" is defined as the production by machinery of a new article with a different form, use, and name from existing materials by a process popularly regarded as manufacturing.

c. "Qualified research" would mean qualified research as defined under section 41(d)(1) of the Internal Revenue Code (IRC), which pertains to the federal credit for increasing research activities. Under the IRC definition, qualified research includes: (i) research with respect to which expenditures may be treated as research and experimental expenditures for purposes of federal itemized deductions for individuals and corporations; (ii) research that is undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and (iii) research for which substantially all of the associated activities constitute elements of a process of experimentation for the purpose of a new or improved function, performance, reliability, or quality. Under the proposal, research conducted by a public or private institution of higher education or by a governmental unit would also be "qualified research" if the research was intended to be useful in developing a new or improved product or service, was undertaken for the purpose of discovering information that is technological in nature, and satisfied condition "iii," above. The result of this provision would be that certain conditions that would apply to business entities would not apply in the case of a public or private institution or a governmental unit.

Based on the reference to the IRC, research related to style, taste, cosmetic, or seasonal design factors could not be considered qualified research. The IRC reference would further exclude research after commercial production has begun and research involving adaptation of existing business components, duplication of existing business components, certain surveys, certain computer software, foreign research, and research funded by another source.

Under the proposal, DOR would be required to publish on the Department's Internet site a list of all biotechnology businesses certified by the Department.

These provisions would take effect on the first day of the second month beginning after publication of the budget bill.

### **Fiscal Effect**

The administration estimates that the provisions would reduce state sales and use tax revenues by \$2.5 million in each year of the 2007-09 biennium.

## **DISCUSSION POINTS**

1. As an industry, "biotechnology" encompasses a range of activities that is difficult to precisely describe. The North American Industry Classification System (NAICS), which is the industry classification system used by the federal government, does not specify a "biotechnology

industry" for classification purposes. According to a definition provided by the University of Wisconsin Biotechnology Center, biotechnology, viewed broadly, is the use of a living organism to make a product or run a process. Initially, the term was generally used to refer to DNA technology. As used currently, biotechnology can encompass a wide range of fields, including activities in areas such as agriculture, biochemistry, molecular biology, and genetics.

2. Biotechnology has had a presence in the state on the University of Wisconsin-Madison campus at least since July, 1984, when the Biotechnology Center was founded. That presence has since increased dramatically, in part through the Biostar Initiative, a multiyear program started in the early 2000s that provided for construction of additional bioscience facilities at state university campuses. This initiative, funded through a combination of state funding and private gifts and grants, was undertaken with the goal of helping the University maintain a national leadership role in the biosciences, including biotechnology.

3. It was also anticipated that the investment would enhance the development of biotechnology businesses in general, based on the expectation that biotechnology businesses would locate in the same area as a university at which initial research was performed. According to the Wisconsin Biotechnology and Medical Device Association, there were about 250 companies in the business of biotechnology in 2005, and the biotechnology industry generated approximately \$3.2 billion in revenues in the state.

4. Biotechnology businesses do not typically generate profits in the start-up years. Therefore, the administration has indicated that sales and use tax exemptions, as the most immediate method of providing tax benefits to support the industry, are preferable to income and franchise tax deductions or credits. The administration has provided the following examples of the types of research and associated activities that the proposed sales and use tax exemptions are intended to benefit:

a. Pharmaceutical biotechnology, including activities performed in identifying a biological target molecule and a chemical compound or protein molecule that interacts with the target to elicit the desired pharmacological effect, and then testing the compound or protein on animals and humans. This field also includes activities performed in designing and developing drug delivery systems that are necessary for the drug to achieve its therapeutic effect.

b. Biosensor biotechnology, including activities performed in developing a system or device (a biosensor) that measures or detects a chemical or organic molecule with the use of a biological material or tissue. This field also includes such activities as engineering bioluminescent reporter genes to test for the presence of a specific chemical or organic molecule; attaching enzymes, nucleic acids or antibodies to a solid surface to test for the presence of a specific chemical or organic molecule; DNA fingerprinting techniques; and techniques to detect the presence of disease using polymerase chain reaction processes.

c. Agricultural biotechnology, including activities performed to improve plants or animals, such as to make them more disease or pest resistant or faster maturing. This field includes

aquacultural biotechnology, which includes activities performed to develop seafood products or to produce models for medical research.

5. Under the bill, one of the conditions under which a business could qualify as a biotechnology business would be for the business to be primarily engaged in the application of biotechnologies that use a living organism, or parts of an organism, to produce or modify products to improve plants or animals. The administration has requested a modification to this provision to refer to such activities "...to produce or modify products to improve plants or animals or to improve animal or human health." The proposed modification would clarify the administration's intent that research to improve animal or human health would be among the business activities that would satisfy the conditions under which a business could qualify as a biotechnology business. As the modification would reflect the original intention of the proposal, the administration does not expect that the modification would affect the estimated fiscal effect (discussed below).

6. The proposed sales and use tax exemptions related to biotechnology are intended to resemble current exemptions for farming and manufacturing (the types of businesses for which current law provides the most comprehensive sales and use tax exemptions). The current law exemptions for farming include the following: (a) farm tractors and machines, including parts (effective July 1, 2007, lubricants, nonpowered equipment, and other tangible personal property used exclusively and directly in or consumed in the business of farming as well); (b) seeds, plants, feed, fertilizer, pesticides and related chemicals, fuel, livestock, wire and twine, animal bedding, milkhouse supplies, plastic sheeting, and certain containers used in farming; (c) medicine used on farm livestock, not including workstock; (d) animal tags and standard milk samples sold by the Department of Agriculture, Trade and Consumer Protection; (e) livestock semen used for artificial insemination; and (f) fuel and electricity sold for farm use. For manufacturing, sales and use tax exemptions are currently provided for: (a) property that becomes an ingredient or component or that is consumed or destroyed in the process of manufacturing tangible personal property that is subsequently sold; (b) fuel and electricity consumed in manufacturing tangible personal property in Wisconsin; and (c) manufacturing machinery and equipment, including safety attachments. In both cases, machinery, equipment, and other significant business inputs, including fuel and electricity, are exempt for the sales and use tax. The same would be true under the proposed exemptions related to biotechnology.

7. However, unlike the exemptions for farming and manufacturing, the proposed exemptions would be directed at two types of businesses, biotechnology businesses and businesses that supply animals to biotechnology businesses and certain research institutions. A person belonging to the second type of business would have to obtain written documentation from the person's customers related to each customer's use of animals. To be eligible to claim exemptions, such a person's sales of animals would have to be primarily to the first type of business or to a qualified research institution.

8. The administration has estimated that the proposal would reduce state sales and use tax revenue by \$2.5 million per year. The estimate represents the midpoint of an upper-bound estimate, based on a report by the U.S. Department of Commerce that estimated spending on

machinery and equipment by biotechnology firms in 2001, and a lower bound based on a sales and use tax refund available in Colorado for expenditures on research and development in biotechnology. However, based on more current state-specific information from representatives of the biotechnology industry in Wisconsin, it is estimated that the proposed exemptions would reduce state sales and use tax collections by \$4.0 million in 2007-08 (on an annualized basis) and \$4.5 million in 2008-09. As the provisions would take effect on the first day of the second month beginning after publication of the budget bill, and assuming a July, 2007, publication date, the estimated reduction to the general fund in the first year would be \$3.3 million. Compared to the estimates under the bill, the revised estimates would reduce general fund tax revenues by an additional \$800,000 in 2007-08 and \$2.0 million in 2008-09.

9. The administration has requested a technical correction in the bill's provision that would exempt from the sales tax fuel and electricity used exclusively and directly in raising animals to sell to biotechnology businesses or for qualified research or manufacturing. As it is likely that the fuel and electricity sold to a business raising such animals would be partially exempt and partially taxable, a cross reference should be included to a current law provision providing direction to retailers with respect to sales of fuel or electricity that are partially exempt and partially taxable. A similar cross reference should be included in the proposed exemption for tangible personal property sold to a biotechnology business that is consumed or destroyed or loses its identity while being used exclusively and directly in qualified research in biotechnology (which could include fuel and electricity).

**ALTERNATIVES TO BILL**

1. Approve the Governor's proposal, with the technical corrections described above. However, reestimate the fiscal effect as a reduction in sales and use tax revenues of \$3.3 million in 2007-08 and \$4.5 million in 2008-09. Compared to the bill, reduce estimated sales and use tax revenues by \$800,000 in 2007-08 and \$2.0 million in 2008-09.

<b>ALT 1</b>	<b>Change to Bill Revenue</b>	<b>Change to Base Revenue</b>
GPR	-\$2,800,000	-\$7,800,000

2. Delete provision.

<b>ALT 2</b>	<b>Change to Bill Revenue</b>	<b>Change to Base Revenue</b>
GPR	\$5,000,000	\$0

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