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Joint Committee on Finance

Paper #295

Sales and Use Tax Exemption for Qualified Research in Biotechnology and Advanced Manufacturing (General Fund Taxes -- Sales and Excise Taxes)

[LFB 2013-15 Budget Summary: Page 182, #2]

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. Pursuant to 2009 Wisconsin Act 28, certain exemptions are provided for property used in qualified research in biotechnology and manufacturing. The exemptions from the sales and use tax took effect on January 1, 2012, for the types of purchases listed below.

Machinery and Equipment Used in Manufacturing and Biotechnology Research

A. Machinery and equipment, including attachments, parts, and accessories, that are sold to persons who are engaged primarily in manufacturing or biotechnology in this state and are used exclusively and directly in qualified research.

B. Tangible personal property that is sold to persons who are engaged primarily in manufacturing or biotechnology in this state, if the property is consumed, destroyed, or loses its identity while being used exclusively and directly in manufacturing or biotechnology qualified research.

Machinery and Equipment Used in Raising Animals

C. 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.

D. Tangible personal property used exclusively and directly in raising animals that are sold 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 that is primarily engaged in qualified research in biotechnology and manufacturing; including: (i) sales of certain tangible personal property, the sales of which are exempt when used in the business of farming (seeds for planting, plants, feed, fertilizer, soil conditioners, animal bedding, sprays, pesticides, fungicides, breeding other livestock, poultry, farm work stock, baling twine and bailing wire, containers for fruits, vegetables, grain, hay silage, animal wastes, and plastic bags, sleeves, and sheeting used to store or cover hay or silage); (ii) medicines; (iii) semen for artificial insemination; (iv) fuel; and (v) electricity.

Definitions

Specific to these four exemptions, the following definitions apply.

- a. "Animals" include bacteria, viruses, and other microorganisms.
- b. "Biotechnology" means the application of biotechnologies, including recombinant deoxyribonucleic acid techniques, biochemistry, molecular and cellular biology, genetics, genetic engineering, biological cell fusion, and other bioprocesses, that use living organisms or parts of an organism to produce or modify products to improve plants or animals or improve animal health, develop microorganisms for specific uses, identify targets for small molecule pharmaceutical development, or transform biological systems into useful processes and products.
- c. "Biotechnology business" means a business, as certified by DOR in the manner prescribed by the Department, that is 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, develop microorganisms for specific uses, identify targets for small molecule pharmaceutical development, or transform biological systems into useful processes and products.
- d. "Machinery" means a structure or assemblage of parts that transmits forces, motion, or energy from one part to another in a predetermined way by electrical, mechanical, or chemical means, but "machinery" does not include a building.
- e. "Primarily" means more than 50%.
- f. "Qualified research" means research undertaken for the purpose of discovering information which is technological in nature, and the application of which was intended to be useful in the development of a new or improved business component of the taxpayer.
- g. "Used exclusively" means used to the exclusion of all other uses except for other use not exceeding 5% of total use.

GOVERNOR

Make the following changes to the current law exemptions from the state sales and use tax.

General Applicability of Definitions

The definitions listed above for "biotechnology," "biotechnology business," and "primarily," as defined above, would apply generally throughout the sales and use tax statutes, rather than apply to the current law exemptions listed above.

Machinery and Equipment Used in Manufacturing and Biotechnology Research

The bill would delete the two current law exemptions described under "A" and "B" related to machinery, equipment, and property used exclusively in qualified research by a person primarily engaged in manufacturing or biotechnology. Instead, one new exemption would be provided for the sales price from the sale of machinery and equipment, including attachments, parts, and accessories, and other property that is sold to any of the following and that is consumed or destroyed or loses its identity while being used exclusively and directly in qualified research: (1) a person engaged in manufacturing in this state at a building that is assessed under laws governing the state assessment of manufacturing property; (2) a person engaged primarily in biotechnology in this state; and (3) a combined group member who is conducting qualified research for another combined group member provided that the other combined group member is a person described in "1" and "2."

The following definitions would apply for purposes of the newly-created exemption described above.

- a. "Building" and "machinery" would have the same meaning as defined in the property tax statutes under current law.
- b. "Combined group" would have the same meaning as defined in the combined reporting provisions under current law governing corporate income and franchise taxes.
- d. "Qualified research" would retain its meaning as described previously under current law. In addition, "qualified research" would also include qualified research that is funded by a member of a combined group for another member of a combined group under the bill.
- e. "Used exclusively" would retain its meaning as described previously under current law.

Machinery and Equipment Used in Raising Animals

The current law exemptions described under "C" and "D" related to purchases of machines, equipment, and 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 use in qualified research or manufacturing would not be changed. However, the bill would delete the definition of "qualified research" under these two exemptions and would not provide a new definition. The administration indicated that the repeal of this definition was unintentional.

These provisions would apply retroactively to sales made on January 1, 2012. The administration indicates that these changes would have a minimal impact on sales and use tax

revenues.

DISCUSSION POINTS

1. According to DOR, the AB 40 provisions are intended to make two changes to current law. First, a member of a combined group would be eligible to receive the exemption for purchases of machinery and equipment used, or items that are consumed or destroyed while being used, exclusively and directly in qualified research provided at least one member of the combined group is either engaged in manufacturing at a building assessed as manufacturing property under Wisconsin's property tax statutes or is engaged primarily in biotechnology. Second, the bill would specify that, for a person to be considered engaged in manufacturing under the exemption, the person must be engaged in manufacturing at a building assessed as manufacturing property under Wisconsin's property tax statutes instead of being engaged primarily in manufacturing.

2. As noted, the administration had indicated that the repeal of the definition for "qualified research" under the current law exemptions for machinery and equipment used in raising animals was unintentional. The administration has requested that the definition for "qualified research," as amended under the bill, also apply to these two exemptions.

3. As described above, 2009 Act 28 created certain exemptions related for machinery, equipment, and property sold to persons that are primarily engaged in manufacturing or biotechnology in this state and for similar items used in raising animals are used exclusively and directly in qualified research. As enacted, the exemption does not apply to a person who is primarily engaged in some other sort of activity, such as primarily engaged in qualified research, if that person performs qualified research on behalf of a member of a combined group who is primarily engaged in manufacturing or biotechnology. Therefore, if two businesses are members of a combined group under the same owner, the owner could own one business that is primarily engaged in research and a separate business that is a primarily engaged in manufacturing under the same combined group. If the research company purchased machinery, equipment, or property to engage in qualified research on behalf of the manufacturing company in the same combined group, those purchases would be subject to tax under current law. Conversely, if a person primarily engaged in manufacturing were to purchase machinery, equipment, and property to themselves engage in qualified research, that person would not be subject to tax. The Governor's proposal would treat these two types of research related purchases the same regardless of what business structure the owner chose to organize his or her manufacturing or biotechnology business.

4. It could also be argued that the proposal continues a long-term trend of reducing the sales tax base with specific exemptions for certain industries or business activities. Sales and use tax theory generally recommends imposing the tax on a broad base at a low rate. Exemptions from the sales and use tax narrow the tax base, which puts a greater burden on the purchasers of goods and services which remain taxable and can impede economic efficiency, create inequities between types of businesses, and complicate administration and compliance of the tax. On the other hand, qualified research can be considered a business input, which tax theory suggests should not be subject to the retail sales tax.

5. Under current law, exemptions from the tax are generally provided in three ways. In

some cases, exemptions apply generally to purchases of specific items that are considered necessities, such as food for home consumption, water delivered through mains, prescription drugs, and purchases of gasoline, which help lessen the regressivity of the tax. In other cases, exemptions are provided for purchases or sales made by specific entities, such as governmental, educational, and charitable organizations. Entity-based exemptions can be used to provide a tax advantage to organizations that further a societal goal, such as exemptions for trucks purchased by volunteer fire departments or sales of admissions to elementary or secondary school activities. Exemptions are also provided if items are used in a specific manner, which are referred to as use-based exemptions. Several use-based exemptions under current law are provided to reduce the tax burden of items used in the course of business, such as business inputs for manufacturing, farming, printing services, and maple syrup production.

6. As noted, the Governor's proposal would provide a use-based exemption for a business if another member of its combined group was engaged in a specific type of business activity. One could argue that a use-based exemption for qualified research provided to an entity that is related to a manufacturer or a biotechnology business creates additional complexities and inequities in the tax code. Current law does not provide similar types of sales and use tax exemptions for other purchases made by a company for a specific use provided that the company is related to a specific type of business. It is unclear why a member of a combined group that has a manufacturer or a biotechnology business should be permitted an exemption for machinery, equipment, and property that is used exclusively and directly in qualified research, while companies that are not members of a combined group with a manufacturer or a biotechnology business remain ineligible for the exemption even if those companies perform the same type of research.

7. This provision has been reestimated, based on available data for research and expenditure credits claimed on state corporate income and franchise tax returns for member of combined groups, to reduce sales and use tax revenues by \$900,000, annually, beginning in 2013-14. As noted, the Governor's proposal would be retroactive to cover an additional year and a half worth of sales and, as a result, two and a half years' worth of sales and use tax revenues could be foregone or refunded in 2013-14. Based on previously claimed research expenditure credits claimed on state corporate income and franchise tax returns, it is estimated that up to \$1,200,000 in additional refunds could be claimed in 2013-14 for purchases since January 1, 2012. As a result, sales and use tax revenues are estimated to be reduced by \$2,100,000 in 2013-14 and \$900,000 in 2014-15 under the Governor's proposal.

8. Use-based sales tax exemptions, and other tax benefits related to economic development, are often provided to encourage certain types of business activity. The modifications proposed by the Governor would be retroactive to January 1, 2012, for business activity that has already occurred. Members of a combined group who have made purchases of property that would become exempt under the proposal could receive a refund for taxes paid on those purchases, provided that the purchases occurred between January 1, 2012, and the effective date of the bill. Since it is not possible for an expanded tax exemption to induce business activity that has already occurred, the Committee may wish to eliminate the retroactive effective date for these provisions.

ALTERNATIVES

1. Approve the Governor's proposal with a modification to apply the proposed definition for "qualified research" to the two current law exemptions for property used in raising animals. Reestimate the fiscal impact to be a decrease in sales and use tax revenues of \$2,100,000 in 2013-14 and \$900,000 in 2014-15.

ALT 1	Change to Bill
	Revenue
GPR-Tax	- \$3,000,000

2. Approve the Governor's proposal with a modification to apply the proposed definition for "qualified research" to the two current law exemptions for property used in raising animals; however, specify that the changes would first apply to sales made on the day following publication of the budget bill. Reestimate the fiscal impact to be a decrease in sales and use tax revenues of \$900,000 in 2013-14 and 2014-15.

ALT 2	Change to Bill
	Funding
GPR-Tax	- \$1,800,000

3. Delete the bill's provisions regarding combined group members. Retain the other provisions recommended by Governor with a modification to apply the proposed definition for "qualified research" to the two current law exemptions for property used in raising animals.

4. Delete provision.

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