

Cite as Det. No. 04-0180E, 26 WTD 206 (2007)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Executive)	<u>F I N A L</u>
Level Review of)	<u>E X E C U T I V E L E V E L</u>
)	<u>D E T E R M I N A T I O N</u>
)	No. 04-0180E
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...)	Registration No. ...
)	Document No. ...
)	Audit No. ...
)	Document No. ...
)	Audit No. ...
)	Docket Nos. ... & ...

RULE 24003; RCW 82.04.4452: R & D B&O TAX CREDIT – COMPUTATION – PAYMENTS TO SUBCONTRACTORS. The R&D tax credit can be computed using either the expenditure or compensation method, not a combination of both methods. Taxpayers using the expenditure method must exclude payments to subcontractors.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

DIRECTOR’S DESIGNEE: Janis P. Bianchi, Policy and Operations Manager, Appeals Division

Lewis, ALJ, - Taxpayer, a large research and development (“R&D”) organization, requested an R&D business and occupation (“B&O”) tax refund on many of its research projects. Taxpayer computed the refund based on 80% of the compensation it received. . . . We . . . conclude that since there is no evidence that Taxpayer’s subcontractors assigned the tax credit to Taxpayer, the Audit Division correctly reduced the measure of the allowed credit by the amount it paid to its subcontractors that performed research.¹

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. Nonprecedential portions of this determination have been redacted.

ISSUE[]:

1. . . .
2. Did the Department err in disallowing the R&D B&O tax credit measured by the amounts paid to subcontractors for their research and development?

FINDING OF FACTS:

. . . Taxpayer conducts R&D in diverse areas Taxpayer's R&D has resulted in a diverse array of commercial products. In general, Taxpayer works throughout an R&D chain; from conceptual idea to basic research to applied research to product development to pilot product development to production.

On December 29, 1999, Taxpayer filed a request for refund with the Taxpayer Account Administration ("TAA") Division of the Department of Revenue ("Department"). Taxpayer requested the R&D business and occupation ("B&O") tax credit authorized by RCW 82.04.4452. . . .

TAA transferred the B&O tax credit request to the Audit Division for verification. The Audit Division reviewed . . . projects and allowed credit for all but . . . of the projects. . . .

Taxpayer . . . requested a credit based on 80% of the gross amount of compensation it received for conducting R&D. Taxpayer disagreed with the Audit Division's reduction of the credit by the amounts it paid to subcontractors. In reducing the amount of the credit, the Audit Division interpreted the B&O tax credit statute² to mean:

[A]mounts paid to subcontractors must be taken out of the amounts available for credit unless the subcontractor assigns the credit back to [Taxpayer]. . . . As such the amounts subject to the tax credit are the gross amounts received less work performed out-of-state, less amounts paid to subcontractors.

ANALYSIS

RCW 82.04.4452^[3] provides a B&O tax credit for qualified research and development projects:

(1) In computing the tax imposed under this chapter, a credit is allowed for each person whose research and development spending during the year in which the credit is claimed exceeds 0.92 percent of the person's taxable amount during the same calendar year.

² RCW 82.04.4452.

³ [RCW 82.04.4452 was amended effective June 10, 2004; the citations in this determination are to RCW 82.04.4452 as in effect prior to the amendment.]

(2) The credit is equal to the greater of the amount of qualified research and development expenditures of a person or eighty percent of amounts received by a person other than a public educational or research institution in compensation for the conduct of qualified research and development, multiplied by the rate provided in RCW 82.04.260(3) in the case of a nonprofit corporation or nonprofit association engaging within this state in research and development, and the rate provided in RCW 82.04.290(2) for every other person.

According to RCW 82.04.4452, “Qualified research and development” has the same meaning contained in RCW 82.63.010. RCW 82.63.010(14) defines “Qualified research and development” as:

"Qualified research and development" means research and development performed within this state in the fields of advanced computing, advanced materials, biotechnology, electronic device technology, and environmental technology.

Taxpayer. . . contends that it is eligible for the R&D B&O tax credit for amounts it paid to subcontractors. Taxpayer says its research and development spending meets the requirements of RCW 82.04.4452(9).

RCW 82.04.4452(9) defines “Research and Development spending” as “qualified research expenditures plus eighty percent of amounts paid to a person to conduct qualified research and development.” While this definition describes the kinds of research and development spending that makes a person eligible to take the credit, it is not part of the computation of the credit. While we agree that taxpayer has research and development spending, we do not agree that amounts the taxpayer pays to its subcontractors may be included in the credit.

Taxpayer relies on *Cimlinc v. DOR*, BTA Docket No.54862 (2000), which maintained that because RCW 82.04.4452(9) included the word “plus,” the R&D B&O credit is available both for the compensation it receives and the compensation it pays to others to conduct research.

That interpretation, however, overlooks the plain language of RCW 82.04.4452(2).⁴ RCW 82.04.4452(2) explains how to compute the credit. RCW 82.04.4452(2) allows computation of the credit using either an expenditure or compensation method.

(2) The credit is equal to the greater of the amount of qualified research and development expenditures of a person or eighty percent of amounts received by a person other than a public educational or research institution in compensation for the conduct of qualified research and development, multiplied by the rate provided in RCW 82.04.260(6) in the case of a nonprofit corporation or nonprofit association engaging within this state in research and development, and the rate provided in RCW 82.04.290(2) for every other person.

⁴ [This section was amended effective June 10, 2004.]

The language of RCW 82.04.4452(2) is clear that the credit is computed based on using the greater of the expenditure method or the compensation method, not the combination of both the expenditure and compensation methods.

The measure of the credit calculated using the expenditure method is equal to the amount of the taxpayer's qualifying expenditures. Such expenditures, by definition, specifically exclude payments to subcontractors. RCW 82.04.4452(9)(a). The measure of the credit calculated using the compensation method is equal to eighty percent of amounts received by a person for the conduct of qualified research and development. The critical words are "received . . . for the conduct of qualified research." The credit rate applies to the amount a taxpayer receives for "conducting" research, not the amount a taxpayer receives to pay others to conduct qualified research. Had the legislature intended for a company to be able to include in the measure of the credit amounts it paid to other research companies, it would have said the measure of the credit is equal to eighty percent of the amounts received by a person "for qualified research." Instead the statute limited the measure of the credit to eighty percent of the amount received "for the conduct of" qualified research. The statute requires the taxpayer to conduct the research itself to be entitled to take the credit under the compensation method. To interpret the statute as Taxpayer and the *Cimlinc* decision have done is to treat those words as superfluous. We are required, when possible, to give effect to every word, clause, and sentence of a statute. No part should be deemed inoperative or superfluous unless the result of obvious mistake or error. *Cox v. Helenius*, 103 Wn.2d 383, 387-88, 693 P.2d 683 (1985).

We conclude that the definition of "qualified R&D spending" is only used to determine whether Taxpayer qualifies for the credit under RCW 82.04.4452(1) and is not used to compute the credit.

. . . [WAC 458-20-24003(5)(a)] Rule 24003(5)(a) explains that businesses are eligible for the credit if they have sufficient research and development spending:

Persons are eligible for the credit if their research and development spending in the calendar year for which credit is claimed exceeds 0.92 percent of the person's taxable amount for the same calendar year.

In contrast, Rule 24003(5)(b)(i) clarifies how the credit itself is computed. A taxpayer who receives funds for conducting research, who does not conduct the research itself, may not include in the calculation of the credit amounts paid out to others to perform the research:

Prior to July 1, 1998. The amount of the credit is equal to the greater of:

The person's qualified research and development expenditures or eighty percent of amounts received by a person other than a public educational or research institution as compensation for conducting qualified research and development multiplied by 0.00515 in the case of a nonprofit corporation or association, and multiplied by 0.025 in the case of all other persons.

Rule 24003(5)(b)(iii) further explains that:

Persons calculating the credit on the basis of amounts received for conducting qualified research and development must actually perform the research and development themselves. Amounts received for conducting qualified research and development that are paid to other persons who actually perform some or all of the qualified research and development contracted for may not be included in the calculation.

We further conclude that the assignment provisions of the statute would not be necessary if both the contractor and the subcontractor could take the credit at once. RCW 82.04.4452(3) allows a person who “conducts research under contract” to assign the credit back to the person contracting for the performance of the research. There would be no reason for the assignment provision if both the contractor and the subcontractor were always entitled to take the credit simultaneously.

Taxpayer counters this conclusion by suggesting that the purpose of the assignment provision was to allow a taxpayer, who couldn’t use the credit because its R&D spending exceeded the \$2,000,000 annual limit, to be able to assign the credit to someone who could use it. We note, however, that the statute permits assignment only to the entity that actually paid for the research. Under Taxpayer’s reasoning, such assignment would not be necessary if the credit pyramided, because the contractor would already be able to take the credit even if the subcontractor couldn’t. Further, if the credit pyramided there would be no reason for the last sentence in RCW 82.04.4452(5) that authorizes the assignor to take the credit if the credit is subsequently disallowed to the assignee. Again, if the credit pyramided, the eligibility of both the assignee and assignor would be judged separately, and it would not take the disallowance of the credit to one for it to be allowed to the other.

Taxpayer also maintains that the assignment provisions were inserted to allow the original contractor to take the credit twice – once on its own and a second time as an assignment of the credit the subcontractor was entitled to take. Nothing in the language of the statute suggests that any person is ever entitled to a double credit for the same work. The statute allows a contractor to add to any credit it is otherwise eligible to take for other R&D, the credit assigned to it by a subcontractor. It does not say the credit is available to one Taxpayer twice for the same work.

Despite the new rule, Taxpayer continues to contend that the Department must follow the *Cimlinc* decision of the BTA. . . . To the contrary, the Department issued Excise Tax Advisory 2009 (August 20, 2002) explaining that it disagrees with and will not follow the decision. Nothing in the statute authorizing review of Department of Revenue actions by the Board of Tax Appeals states that its decisions are binding on the Department except with regard to the specific parties before the Board. See RCW 82.03, *et seq.* Further, it would be particularly egregious to hold that the Department is obligated to follow as precedent an informally heard BTA appeal where the Department has no opportunity to appeal the BTA’s decision. RCW 82.03.180; *Pettit v. Board of Tax Appeals*, 85 Wn.2d 646, 538 P.2d 501 (1975).

Taxpayer's belief that the Department's policy of nonacquiescence is unsupportable is misplaced. Filing "Notices of Nonacquiescence" is not unique to the Department. Administrative departments of both the Federal Government and other states routinely file "Notices of Nonacquiescence."⁵

Finally, Taxpayer maintains that the failure of the Department to follow the BTA's decision in *Cimlinc* was an impairment of contract under Wash. Const. Art. I, Sec 23.⁶ Taxpayer explained:

The legislature's enactment of this B&O tax credit constituted a contract under Article 1, section 23 of the state's Constitution. As a contract, The Department of Revenue is not free to alter unilaterally the terms of the contract because it deems the terms unacceptable. The Board of Tax Appeals has defined the terms of the contract in *Cimlinc* and that decision has become a vested right in all similarly situated taxpayers.

RCW 82.63.005 declares:

The legislature further declares its intent to create a contract within the meaning of Article I, section 23 of the state Constitution as to those businesses that make capital investments in consideration of the tax deferral program established in this chapter.

(Emphasis added).

This legislative directive applies by its terms to the high technology tax deferral program, codified at RCW 82.63, *et seq.*, not the tax credit program, codified at RCW 82.04.4452. It was the latter program that the BTA construed in *Cimlinc*. Further, Taxpayer misinterprets what the legislature meant when it said it intended to create a contract that could not be impaired. We believe that what the legislature intended was that a future legislature could not withdraw the . . . retail sales tax deferral program and require the deferred taxes to become immediately due, if a taxpayer qualifying for the deferrals made the capital investments in return for the promise of the deferral. Without this provision, a future legislature could simply repeal the deferral program even though the taxpayer invested . . . in anticipation of it. This Article I, section 23 argument has nothing to do with whether the Department is bound by BTA decisions regarding the [B&O] tax credit program.

We conclude that, absent assignment by the subcontractor, RCW 82.04.4452 does not authorize a taxpayer that subcontracts R&D to a subcontractor to take as a credit the amounts it pays to a subcontractor. Taxpayer's petition for refund is denied.

Dated this 2nd day of August, 2004.

⁵ See, 2 Am. Jur.2d Administrative Law § 73 (Requirement that Agency Follow Courts; Nonacquiescence).

⁶ Taxpayer quotes the portion of RCW 82.63.005, which states:

The legislature further declares its intent to create a contract within the meaning of Article I, section 23 of the state Constitution as to those businesses that make capital investments in consideration of the tax deferral program established in this chapter.