Cite as Det. No. 00-125, 20 WTD 252 (2001)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of	)	D E T E R M I N A T I O N
	)	
	)	No. 00-125[1]
	)	
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

RCW 82.04.4452, RCW 82.63.010(16): SERVICE B&O TAX -- CREDIT -- RESEARCH AND DEVELOPMENT SPENDING -- COMPUTER SOFTWARE. Taxpayer is not entitled to a B&O tax credit for its research and development spending on computer software due to the taxpayer's internal use of the computer software.

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.

NATURE OF ACTION:

A corporation protests the denial of a business and occupation (B&O) tax credit for research and development costs provided to certain high technology fields.[2]

FACTS:

De Luca, A.L.J. -- The taxpayer is a corporation headquartered in the State of Washington. During the audit period, the taxpayer contracted with Internet-access providers to provide information content. At the time of the audit, the taxpayer operated only its ". . . Division" a.k.a. ". . . Services." The type of content the taxpayer provided included directory information, such as the white pages and the yellow pages, as well as maps, classified advertisements, marketplace guides, electronic commerce, and information services that provided detailed business information nationwide. The taxpayer contracted with third parties to supply it with the content it provided. The taxpayer also provided Web site design and creation services. During the audit period, the taxpayer primarily earned its revenues from advertising agreements with third parties.

[1] The reconsideration determination, Det. No. 00-125ER, is published at 21 WTD 245 (2002).
[2] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

The Audit Division of the Department of Revenue (the Department) reviewed the taxpayer's books and records for the period April 9, 1996 through December 31, 1997 and assessed $. . . in service business and occupation (B&O) tax, use tax, and interest. Document No. FY. . . . The Audit Division denied the taxpayer the B&O tax credit provided in RCW 82.04.4452 for businesses that perform research and development in Washington in any of five specified high technology fields and meet minimum expense requirements. The Audit Division found although the taxpayer continually improved its Web site during the audit period, the enhancements represented development of computer software for the taxpayer's own internal use per RCW 82.63.010(16), *infra*. The Audit also found the taxpayer was not developing computer hardware or other electronic device technology during the audit period.

TAXPAYER'S EXCEPTIONS:

The taxpayer protests the assessment of service B&O tax. The taxpayer contends the Audit Division erred in denying the taxpayer a B&O tax credit for research and development spending per RCW 82.04.4452, *infra*.

The taxpayer explains it originally began as a distributor of directory information to Internet users and businesses. . . . The taxpayer has contracted with many third parties to provide information to its customer base. The taxpayer has the difficult task of gathering the data from hundreds of sources. It then translates the information into formulas and processes for simpler and faster Internet and computer use. The information is stored on its technology platforms. Customers then contract and pay the taxpayer for access and use of the information encrypted and contained in the platforms rather than the customers themselves doing such work.

The taxpayer developed the technology it employs. The taxpayer explains its technology can be separated into three areas. The first area is the infrastructure, which is comprised of the raw data and raw programming of the information. The taxpayer claims it has conducted extensive research and development to provide more efficient storage and delivery of information and data. The second area is technology development where the taxpayer has developed computer formulas and processes that enable the user to accomplish more tasks more efficiently because the taxpayer's methods transfer information faster and easier. In the third area, the taxpayer has created a special method to present and deliver the data to the user. The taxpayer's technology enables it to add easily and rapidly new affiliates (Internet access providers such as . . . and . . ., for example) by employing a distributed and scalable architecture adapted specifically for its Internet-based content services. The taxpayer helps its affiliates build and maintain their brands by delivering content with the look and feel of navigational features specific to each affiliate. This service creates the impression to end users that they have not left the affiliate's Web site. The taxpayer has designed its technology to support affiliates across multiple platforms and formats, including the growing number of Internet access devices. Thus, instead of switching from one Web site to another to gather information through links, the taxpayer's technology enables the user to feel as if it is still within the original Web site it logged onto.

The taxpayer currently offers its services through three divisions: . . ., . . ., and . . . . The [first] division, as described above, provides a wide array of information, including maps, directories, etc., and since the audit period, real-time information, such as financial data, sports, weather, news and more. Again, the information is presented in a seamless manner to the end user, as if the data were generated from a single source. The user has the advantage of endless resources without having to leave the Web site.

As noted, the taxpayer originally began as a distributor of directory information to Internet users and businesses. Since the audit period, the taxpayer has created the two other divisions ([second division] and [third division]). The [second division] line offers merchants the ability to create, promote, sell, and distribute their products and services through the taxpayer's broad distribution network. The service line includes online delivery to any promotions device that can be used online or offline, and single click buying from any Web site directly from a wireless device. The service line also enables local merchants to create their own Web sites. It assists local merchants to build easily accessible online stores and create markets with distribution services to those markets.

In the [third division] division, the taxpayer has contracts with dozens of wireless carriers worldwide. The taxpayer's [third division] are comprised of an integrated set of wireless portal services that provide mobile users with relevant information services, such as real-time stock quotes and traffic reports as well as communication services such as "device-independent instant messaging," and email. The users also can quickly find and use real-time promotions on wireless devices and use location based directory services. Further, the [third division] allow the user to conduct secure commerce transactions from a wireless device. Users of these [third division] can press single keys to transact from nearly any Web site.

The taxpayer asserts its technology constitutes a "new or improved product, process, technique, formula, invention, or software" within the meaning of RCW 82.04.4452 and RCW 82.63.010(16) and qualifies for the B&O tax credit. The taxpayer describes its technology as a combination of computer software programs, hardware, Internet protocol methodologies, and electronic devices, including both Internet access devices and data and digital communication devices. The taxpayer states it constantly updates its services with new technology and new information. The taxpayer assists consumers and merchants by compressing many complex sites and resources into a single usable site. Therefore, the taxpayer explains, because it enables a series of actions and functions in accomplishing a complex task, its technology falls within the terms "processes" and "techniques" for storing and delivering data.

The taxpayer notes the terminology in RCW 82.04.4452 is nearly identical to a parallel federal research tax statute, IRC §41(d)(2)(B) (26 U.S.C. §41). Under the federal statute, the tax credit is limited to a new "product, process, computer software, technique, formula, or invention." The taxpayer asserts its technology falls within this definition for federal tax credit purposes and, therefore, it should qualify for the B&O tax credit. Accordingly, the taxpayer contends its technology does not constitute "computer software developed for internal use" within the meaning of the federal statute or RCW 82.04.4452, *infra*.

Similarly, the taxpayer notes the exclusions from the B&O tax credit listed in RCW 82.04.4452 and RCW 82.63.010(16) are the same as the exclusions from the federal tax credit listed in IRC §41(d)(4). In both the federal and state statutes, the same types of specified activities do not qualify for the respective tax credits, including developing computer software for internal use. The taxpayer notes that neither the Washington statutes nor the federal statute defines "computer software developed for internal use."

To help define what that term means, the taxpayer cited a portion of the Congressional Committee Reports for P.L. 99-514 pertaining to IRC §41(d)(4). A Committee Report stated the general rule that the costs of developing software are not eligible for the credit where the software is used internally for general and administrative functions - such as payroll, bookkeeping, or personnel management or in providing non-computer services, such as accounting, consulting, or banking services. However, the Committee Report added the internal use exclusion was not intended to apply to the development costs of a combined hardware-software product. Thus, under federal law, the taxpayer believes the technology it employs "is eligible for the federal credit even though internally developed software may be integral to that technology."

The taxpayer also submitted a copy of a proposed Internal Revenue Service regulation (Prop. Treas. Reg. §1.41-4) that pertains to the federal research credit. Like the Committee Report, the proposed federal regulation excludes from the credit the costs for developing internal-use computer software. The proposed rule also describes examples of software used internally, such as for general and administrative functions like payroll, bookkeeping, and personnel management, or in providing noncomputer services such as accounting, consulting, or banking services. But, under the proposed regulation, computer software and hardware that is developed as a single product is not excluded for the research credit as internal-use computer software.

The taxpayer has submitted a copy of a regulation, WAC 458-20-24003, that the Department proposed in 1994, but never adopted, for the High Technology Tax Credit and Deferral Programs. The proposed rule excluded from the B&O tax credit the costs for "development of computer software for internal use, including accounting, cost accounting, inventory, control, payroll, quality control, spreadsheet and word processing." Thus, the proposed regulation, like the Congressional Committee Report and the proposed federal regulation, addressed "internal use" in terms of general and administrative functions such as payroll, bookkeeping, accounting, etc.

The taxpayer suggests the draftsperson of the Washington statutes relied heavily on the federal tax credit provisions because the language in RCW 82.04.4452 and RCW 82.63.010 is in many areas nearly identical to IRC §41. As a result, the taxpayer contends the Department should treat the federal tax treatment of software developed for internal use as persuasive authority for applying the B&O tax credits. The taxpayer asserts because its technology does not perform tasks that are general and administrative in nature and is not used for accounting, inventory

control, payroll, spreadsheet work, word processing, etc., its technology is not software developed for internal use.

The taxpayer continues by arguing that if its software serves its clients and is delivered outside of general and administrative functions, it is not internal use. Specifically, in this case, the taxpayer explains its "technology is indirectly sold to [its] clients as they use the resources." The taxpayer sells it services based upon its technology and its ability to process and deliver information to an external customer. The taxpayer does not believe such activity is internal use, and none of the technology is used for an internal function.

Furthermore, the taxpayer argues it has not developed software for internal use because it does not operate a Web site as its business. The taxpayer states, unlike Internet companies, it did not develop its technology to support its Web site to capture and maintain a client base. An Internet retailer, for example, develops its computer technology to improve its Web site to increase business efficiencies and market share. The taxpayer believes the Internet retailer's research and development efforts to improve the retailer's Web site is not performed with the intent to use the technology externally. The taxpayer distinguishes itself from other Internet businesses because the taxpayer does not use its technology to operate its Web site. Instead, the taxpayer focuses its technology on gathering, encoding, and delivering data and information to its customers and users. The taxpayer adds its Web site is not used for retail purposes, but only to showcase its technology.

ISSUE:

Is the taxpayer entitled to the B&O tax credit for research and development of computer software, or is it excluded from receiving the credit due to internal use of the software it developed?

DISCUSSION:

RCW 82.04.4452(1) allows a credit against B&O taxes for research and development spending that exceeds 0.92 percent of the person's taxable amount during the same calendar year. RCW 82.04.4452(9)(b) provides that "qualified research and development" shall have the same meaning as in RCW 82.63.010." RCW 82.63.010(14) provides:

> "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.

Additionally, RCW 82.63.010(16) provides:

> "Research and development" means activities performed to discover technological information, and technical and nonroutine activities concerned with translating technological information into new or improved products, processes, techniques, formulas,

> inventions, or software. The term includes exploration of a new use for an existing drug, device, or biological product if the new use requires separate licensing by the federal food and drug administration under chapter 21, C.F.R., as amended. The term does not include adaptation or duplication of existing products where the products are not substantially improved by application of the technology, nor does the term include surveys and studies, social science and humanities research, market research or testing, quality control, sale promotion and service, computer software developed for internal use, and research in areas such as improved style, taste, and seasonal design. (Underlining added).

Research and development activities that are eligible for the B&O tax credit do not include computer software developed for internal use. As noted, the Audit Division disallowed the credit for the taxpayer's [first] Division because the Audit Division found the taxpayer internally used the software it had developed. In support of this finding, the Audit Division relied in part on a description of the taxpayer's business located in the notes accompanying the taxpayer's financial statements for the period March 1, 1996 through December 31, 1997, which covered almost exactly the same time as the audit period. The business description declared in part that the taxpayer:

> is a directory and content aggregator on the Internet. The Company's business objectives include replacing the traditional phone book with technology that integrates directories with the interactivity of the Internet. Service offerings include yellow pages, white pages, a marketplace guide and information services that provide detailed business information nationwide, company web sites, toll-free numbers fax numbers, e-mail addresses and local city information including items such as weather, traffic, and apartments.

This statement is consistent with the taxpayer's statement in its memorandum that it began as a distributor of directory information to Internet users and businesses.[3]

Moreover, the Audit Division determined the fact the taxpayer did not develop its software for resale or licensing to others further supported the Audit Division's finding that the taxpayer developed the software for internal use. Additionally, the Audit Division found the taxpayer was not developing computer hardware or other electronic device technology during the audit period.

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[3] We are limiting our discussion to the taxpayer's activities during the audit period (April 9, 1996 through December 31, 1997). As noted above, since the audit period the taxpayer has created two new divisions, [second division] and [third division], along with rapid technological changes. Because the Audit Division did not review the activities of those divisions or the new services provided by the taxpayer's [first] Division, any issues arising from them pertaining to B&O tax credits for research and development since the audit period are not properly before us. The Appeals Division can only rule upon final actions taken by other divisions within the Department. The taxpayer can seek a written ruling on these new activities from the Department's Taxpayer Information and Education Section with the right to appeal any unfavorable decision to the Appeals Division.

We have found no Washington court cases or determinations that address the issue of "computer software developed for internal use." We agree with the taxpayer that neither RCW 82.04.4452 nor RCW 82.63.010(16) defines the term. The legislative history connected to these Washington statutes is silent about the meaning of the term. *See* Senate Bill Report to SB 6347. As discussed above, the Department never adopted proposed WAC 458-20-24003. Therefore, neither the Department nor taxpayers can rely on it as a valid law to interpret the term.

We agree with the taxpayer that the wording in the federal statute IRC §41 is similar in many ways to the Washington statutes. Like RCW 82.04.4452 and RCW 82.63.010(16), IRC §41 does not define the term computer software developed "primarily for internal use by the taxpayer." *See* 26 U.S.C. §41(d)(4)(E). Granted, the Congressional Conference Report and the proposed Treasury Regulation §1.41-4, like proposed WAC 458-20-24003, gave examples of what is internal use software for general and administrative functions – activities such as payroll, bookkeeping, or personnel management, or in providing noncomputer services such as accounting, consulting, or banking services. However, we do not find that we can simply assume the intent of the Washington Legislature was the same as Congress' legislative intent on the matter of internal use and general and administrative functions when the Legislature passed a similarly worded statute. For instance, the Senate Bill Report for SB 6347 makes no reference to the Congressional Conference Report, internal use of software, or general and administrative functions like bookkeeping, etc. Moreover, there is a significant difference in the wording of the federal and state statutes pertaining to internal use of software, which indicates some difference of intent between Congress and the Washington Legislature.[4] Finally, we cannot rely on proposed Treasury regulation § 1.41-4 to be controlling for our purposes. The Department is not bound by a proposed federal regulation and, for reasons discussed immediately below, the Department does not find the proposed federal regulation persuasive on the matter of defining internal use solely by general and administrative functions. [5]

Federal courts have construed the exclusion in IRC §41(d)(4)(e) that pertains to the internal use of software. The courts have rejected arguments similar to the taxpayer's that the definition of software developed "primarily for internal use" is limited to general and administrative functions, such as payroll, bookkeeping, accounting consulting, etc. *See United Stationers, Inc.*

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[4] The federal statute excludes from the qualified research credit any computer software developed "primarily for internal use by the taxpayer." 26 U.S.C. §41(d)(4)(E). (Underlining added.) By comparison, Washington law excludes "computer software developed for internal use." RCW 82.63.010(16). Thus, internal use of computer software is not excluded for federal research credit purposes unless it is "primarily" used internally. Under Washington law, computer software developed for any internal use is excluded from the B&O tax credit. Although the federal statute does not apply in this case, the taxpayer does not qualify for the credit under either standard. *Infra*.

[5] We add the Washington statutes differ from the proposed federal regulation in another way. The statutes do not provide that a taxpayer is not internally using software by developing computer hardware and software as a single product. Anyway, we have no evidence that the taxpayer was developing such a combined product during the audit period.

v. United States, 163 F.3d 440, 447 (7th Cir. 1998), *US cert den* 527 U.S. 1023 (1999). In *United Stationers*, the Court of Appeals wrote

> Congress intended the original credit to reward taxpayers for a significant contribution to the store of public technological knowledge. See S. Rep. No. 97-144 (1981); H. Rep. No. 97-201 (1981). To avoid this exclusion, then, a taxpayer claiming a credit for developing software must to an appropriate extent make the program available to the public. Something more than a speculative or attenuated impact on the economy is required.
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> USI also pins its hope on the 1986 Conference Report which explicitly states that software development projects would constitute internal use software where they are "used internally, for example, in general and administrative functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services)." H.R. Conf. Rep. No. 99-841, at II-73 (1986). USI relies on this language to urge us to draw elusive distinctions between the provision of general and administrative services and a taxpayer's core revenue-generating activities. Core business activities have an external impact and should not be subject to the internal use exclusion, USI asserts. It maintains that the projects at issue here--inventory controls and the like--are integral to its core revenue activities as a wholesale distributor. USI therefore concludes that its eight projects cannot be internal use software.
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> We cannot accept this analysis. USI seems to be asking us to view cost accounting methodology (specifically, the difference between general overheads and directly assigned costs) as a determinative principle in identifying internal use. In effect, USI appears to be arguing that, if the programs involve activities that directly impact parties outside the taxpayer, they are not for internal use. As we stated before, however, this formulation does not fully capture the idea of contributing to the store of public technological knowledge. In any event, we agree with the district court that all the relevant facts—the totality of the circumstances--must be taken into account. See United Stationers II, 982 F. Supp. at 1286-87; see also Prop. Treas. Reg. @ 1.41-4(e)(4), 62 Fed. Reg. 81, 83 (Jan. 2, 1997) (Credit for Increasing Research Activities). And, on the record before us, the district court's conclusion that the software development projects were for internal use is not clearly erroneous. USI developed all of the software to help it track its huge inventory. Even the two programs to which customers have limited access, DRRS and Unilink, were developed primarily for use by USI in streamlining its operations. The services these software programs expedite--marketing, ordering, invoicing, shipping, receiving, pricing, etc.--even though they may have a direct impact on customers, suppliers and other third parties do not rescue the programs from the internal use exclusion. (Underlining added.)

We find the Court's reasoning in *United Stationer's* more persuasive than proposed regulations and Conference Reports. Accordingly, we find the taxpayer developed its software technology for internal use during the audit period. The taxpayer was not, selling, licensing, or otherwise

marketing its software technology to make it available to the public during the audit period. Instead, the taxpayer was developing its software technology to gather and distribute directory information to Internet users and businesses. The taxpayer was distributing information by internally using its software technology. The taxpayer was not distributing its software technology. The taxpayer states as much in its June 14, 2000 memorandum at p. 5 where it wrote:

> In this case, the technology is indirectly sold to [the taxpayer's] clients as they use the resources. [The taxpayer's] services are sold based upon its technology and its ability to process and deliver information to an external customer.

In order to process and deliver the information to its external customers the taxpayer had to internally use the software technology it developed. Therefore, the taxpayer does not meet the definition of "research and development" in RCW 82.04.4452 and RCW 82.63.010(14) and (16).

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

Dated this 28th day of June, 2000.