

BEFORE THE APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition For Correction of	)	<u>D E T E R M I N A T I O N</u>
Assessment of	)	
	)	No. 98-027
	)	
...	)	Registration No. ...
	)	FY. . /Audit No. ...

[1] RCW 82.04.140: BUSINESS ACTIVITY DEFINED. The mere receipt of an intangible is an activity. When the receipt of an intangible is with object of gain, benefit, or advantage to someone, it is a business activity. Citing: Simpson Timber Co., v. State, Dept. of Rev., BTA Docket No. 30192A, B, C (1986).

[2] RCW 82.04.150: ENGAGING IN BUSINESS DEFINED. All persons who are engaged in business in Washington are subject to excise taxes. Engaging in business is defined as continuing in business. The mere receipt by a composer of royalty payments for compulsory and performance licenses, and of a percentage of receipts from a merchandising contract, is a business activity subject to excise taxes. Therefore, the continuation of the receipt of those payments by the estate of the composer is an activity subject to excise taxes.

[3] RCW 82.04.4281: INVESTMENTS. Only earnings from incidental investments of surplus funds by a qualifying business are eligible for the RCW 82.04.4281 deduction. Citing: O'Leary v. Department of Rev., 105 Wn.2d 679, 717 P.2d 273 (1986).

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:

The estate of a deceased composer protests the assessment of business and occupation (B&O) tax on its receipt of royalty income for the use of the decedent's compositions claiming that the estate is not engaged in any business activity.<sup>1</sup>

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FACTS:

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<sup>1</sup>Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

Coffman, A.L.J. -- During his life (“Composer”) wrote many pieces of music. The taxpayer is the estate of Composer. Before his death, Composer entered into contracts with three entities ([X], [Y], and [a merchandising firm]). The Department of Revenue’s (“Department’s”) Audit Division (Audit) reviewed Composer’s and the taxpayer’s records for the period January 1, 19 . . . through December 31, 19 . . . and issued the above-referenced tax assessment.<sup>2</sup>

Once a song is recorded, anyone can obtain a compulsory license under federal law to record that song for private use, subject to the payment of a royalty and certain other conditions<sup>3</sup>. 17 U.S.C. § 115. The holder of the copyright to a musical selection is entitled to this royalty for each record, tape, or compact disk sold containing that song. Here, Composer initially was the sole owner of the copyrights. In 19 . . . , Composer entered into a long term contract with [X]. [X] agreed to exploit and manage the copyrights, determine who recorded the songs, collect the appropriate royalties, and pay 50% of the receipts to Composer. In exchange, Composer granted to [X] a 50% ownership of the copyrights for the term of the contract. At the expiration of the contract term, all rights revert to Composer’s heirs.

By virtue of federal law, Composer also received royalty payments when the songs were performed on the radio, on juke boxes, in live performances, and for any other use in any other public place. A license fee was paid for the use of the Composer’s works.<sup>4</sup> In 19 . . . , Composer entered into a contract with [Y] which required [Y] to license the use of Composer’s work and collect the license fees. Composer received a percentage of the license fees collected and [Y] retained the balance. The initial contract term was two years with automatic renewals unless terminated by either party. The [Y] contract has not been terminated.

Composer also entered into a contract with a merchandising firm, whereby he gave the firm the right to use his name and likeness in connection with souvenir merchandise. In exchange for this right, Composer received a percentage of the wholesale receipts.

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<sup>2</sup> Composer died during the audit period. The Audit Division issued a single assessment under the Composer’s registration number prior to his death.

<sup>3</sup> CCH’s Copyright Law Reports states at ¶ 3100:

Certain conditions must be fulfilled to acquire and retain a license, including the existence of a previously authorized and distributed sound recording of the underlying musical composition, a notice of intention to use the compulsory license, monthly and annual statements of account of phonorecords made and distributed, and payment of statutory royalty fees shown to be due in the statements of account.

<sup>4</sup> CCH’s Copyright Law Reports states at ¶ 3400:

. . . and [Y] operate primarily through [[the sale of]] blanket licenses, which give [[their]] licensees the right to perform any of the compositions owned by the societies’ [[composing] ] members as often as the licensees wish for a stated term. Fees for blanket licenses are usually a percentage of [[the licensees’]] total revenues or a flat dollar amount, and they [[(the fees)]] do not depend directly on the amount or type of music used.

Before his death, Composer reported and paid B&O tax on 100% of income from all three contracts. All three contracts continue in effect and the payments are now being made to the taxpayer. The taxpayer has not paid any B&O tax on the income received under these contracts. The taxpayer has taken no action to modify or otherwise change the rights specified in the three contracts.

#### ISSUES:

1. Does the receipt of royalty payments by the estate of a composer constitute “engaging in business” as defined in RCW 82.04.140 and .150?
2. If so, is the income considered deductible investment income for the purposes of RCW 82.04.4281?

#### DISCUSSION:

This determination does not address the taxability of any person who acquires the rights to a copyright by purchase, contribution to capital, donation, community property, or any other manner other than as the estate of a deceased composer.

##### 1. Engaging in Business.

The term “business” is defined in RCW 82.04.140 as:

. . . all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly.

Thus, “[u]nder the statute, tax liability attaches when a ‘person’ engages in an activity with the object of gain.” Impecoven v. Department of Rev., 120 Wn.2d 357, 361, 841 P.2d 752 (1992).

The taxpayer argues it has not engaged in any business activities. Rather, the taxpayer is merely collecting revenues generated by the activities of Composer and protecting those receipts for benefit of Composer’s heirs. Further, the taxpayer argues that it is impossible to perform any activities relative to the works of Composer because the rights to those works have been sold.

The Department, on the other hand, argues that the receipt of royalties is an activity subject to the B&O tax because the definition of “gross income of the business” specifically includes royalties. RCW 82.04.080. The taxpayer agrees that the receipt of royalty income prior to the Composer’s death was subject to the B&O tax because Composer was engaged in the activities that generated the royalty income.

[1] The term “activity” is not defined in Title 82 of the RCW. When a term is not defined, commonly understood definitions will apply. King County v. City of Seattle, 70 Wn.2d 988, 425 P.2d 887 (1967). Webster’s II New Riverside University Dictionary, 76, (1988) defines “activity” as: “The state of being active.” “Active” is defined as: “In action.” “Action” is defined as: “The

process of acting or doing.”<sup>5</sup> Thus, a business activity is something that is done by a person with the object of gain, benefit, or advantage.

In Simpson Timber Co., v. State of Washington, Dept. of Rev., BTA Docket No. 30192A, B, C (1986), the Board of Tax Appeals (BTA) found that a subsidiary of Simpson Timber Company was engaged in business and taxable on its income (interest received on real estate contracts) despite the fact that its subsidiary had no employees and no offices. The BTA found:

that the activity at issue is the interest income generated by the extension of the privilege of paying for real estate over a period of time and that the Contracts of Sale are intangible property.

(Emphasis added.) Thus, the mere collection of an intangible is a business activity. We hold, therefore, that the taxpayer is engaged in the activity of collecting for the royalties earned under the contracts with [X], [Y], and the merchandising firm. Further, we note this business activity is necessary to insure that the beneficiaries of the Composer’s estate receive the full benefit of the royalties.

[2] The B&O tax is imposed on the “act or privilege of engaging in business activities”. RCW 82.04.220. “Engaging in business” is defined in RCW 82.04.150 as:

. . . commencing, conducting, or continuing in business and also the exercise of corporate or franchise powers as well as liquidating a business when the liquidators thereof hold themselves out to the public as conducting such business.

(Emphasis added.)

We must read all related statutes in harmony. See, e.g. Clifford v. State of Washington, 78 Wn.2d 4, 469 P.2d 549 (1970).

In this case, the B&O tax is imposed on the privilege of “engaging in business”. The taxpayer does not dispute that during the Composer’s life, his receipt of royalty income was subject to the B&O tax. The taxpayer has continued to perform exactly the same activities as the Composer did relating to his compositions. RCW 82.04.140 does not state that a minimum level of activity is required, rather it requires only that there be some activity. Therefore, the taxpayer has merely continued the business activities of the Composer, and under RCW 82.04.150, the taxpayer is engaging in business.

## 2. Character of royalty income.

The taxpayer claims that if its receipt of royalty payments is a business activity, the income is deductible under RCW 82.04.4281, which states:

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<sup>5</sup> There are additional definitions of each term, but they are not relevant to our inquiry.

In computing tax there may be deducted from the measure of tax amounts derived by persons, other than those engaging in banking, loan, security, or other financial businesses, from investments or the use of money as such, . . . .

We note, that exemptions and deductions are narrowly construed. Budget Rent-A-Car, Inc. v. Department of Rev., 81 Wn.2d 171, 500 P.2d 764 (1972). Taxation is the rule; exemption is the exception. Spokane County v. City of Spokane, 169 Wash. 355, 13 P.2d 1084 (1932). Exemptions are not to be extended by judicial construction. Pacific Northwest Conference of the Free Methodist Church v. Barlow, 77 Wn.2d 487, 463 P.2d 626 (1969).

The taxpayer argues it is not required to have actually invested anything to be entitled to the deduction. Rather, the taxpayer argues that “[Composer] invested his personal skill and effort in his compositions, but because he was engaged in his music business, the income was business income to him.” The taxpayer misconstrues the term investment as it is used in RCW 82.04.4281.

We find the proper application of RCW 82.04.4281 is determined by reference to O’Leary v. Department of Rev., 105 Wn.2d 679, 717 P.2d 273 (1986). Paraphrasing the decision, the court said:

For the [taxpayer] to qualify for the deduction, [it] must show both (1) the . . . contracts from which [it] received [royalties] constituted investments, and (2) [the taxpayer] is not engaged in a financial business.

[1] To decide if the [taxpayer] meet[s] the first requirement, we must define investment and then determine if the . . . contracts meet that definition. Exemptions to the tax laws are to be construed narrowly. Budget Rent-A-Car of Wash. Or., Inc. v. Department of Rev., 81 Wn.2d 171, 500 P.2d 764 (1972). “Taxation is the rule and exemption is the exception.” Budget Rent-A-Car, at 174.

[2] As we stated in John H. Sellen Constr. Co. v. Department of Rev., 87 Wn.2d 878, 883, 558 P.2d 1342 (1976), an interpretation of an “investment” should be limited to the plain and ordinary meaning of the word. In Sellen we allowed a deduction for income from a business’ “incidental investments” of surplus funds Sellen, at 883. Whether an investment is “incidental” to the main purpose of a business is an appropriate means of distinguishing those investments whose income should be exempted from the B & O tax of RCW 82.04.4281. Here the . . . contracts held by [the taxpayer] were neither incidental investments nor were they made from surplus income of the [taxpayer].

(Bracketed material added.) O’Leary, at 681-82.

[3] Thus, only earnings from incidental investments of surplus funds by a qualifying business are eligible for the RCW 82.04.4281 deduction.<sup>6</sup>

<sup>6</sup> In Detlefsen v. Department of Rev., BTA Docket No. 84-38 (1985), the BTA referred to dictionary definitions of an “investment”. The BTA quoted Webster’s Third International Dictionary (1971) for its definition as follows:

1a. An expenditure of money for income or profit or to purchase something of intrinsic value: Outlay  
b. The sum invested or the property purchased

The taxpayer did not invest anything, nor are surplus funds involved in its receipt of royalty income. The royalty income is not incidental to the taxpayer. The fact that Composer used his skill to create the compositions does not create an investment by his estate. Therefore, we find the taxpayer is not entitled to the RCW 82.04.4281 deduction.

In summary, we find: (1) the receipt of royalty income from an intangible by the estate of a decedent is a business activity which is subject to the B&O tax; (2) when the decedent was engaged in business, the estate's activity of receiving the royalty income is a continuation of the business of the decedent and therefore engaging in business; and, (3) the RCW 82.04.4291 deduction is not available to the estate.

#### DECISION AND DISPOSITION:

The taxpayer's petition is denied.

DATED this 27th day of February, 1998.

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2. The commitment of funds with the view to minimizing risk and safeguarding capital while earning a return -- contrasted with speculation.
  3. The commitment of something other than money to a Long-term interest or projects.