

Cite as Det. No. 00-125ER, 21 WTD 245 (2002)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| In the Matters of the Petition For Correction of |) | <u>F I N A L</u> |
| Assessment, For Credit, and Petition for |) | <u>E X E C U T I V E L E V E L</u> |
| Correction of Denial of Application for Tax |) | <u>D E T E R M I N A T I O N</u> |
| Deferral |) | |
| |) | No. 00-125ER ¹ |
| |) | |
| ... |) | Registration No. . . . |
| |) | FY . . . /Audit No. . . . |
| |) | Docket No. . . . |

RCW 82.04.4452, RCW 82.63.010, RCW 82.63.030: B&O TAX CREDIT – RETAIL SALES/USE TAX DEFERRALS – HIGH TECHNOLOGY BUSINESS -- COMPUTER SOFTWARE – R&D -- INTERNAL USE. A corporation engaged in research and development of computer software did not internally use its software because it made its software technology available to the public by granting licenses and other rights to its licensees to use the technology.

DIRECTOR'S DESIGNEE: Janis P. Bianchi, Policy and Operations Manager

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 denials of a business and occupation (B&O) tax credit and a retail sales and use tax deferral certificate for its research and development costs.²

PROCEDURAL BACKGROUND:

De Luca, A.L.J. -- This matter is an executive level reconsideration. We will not merely refer to the facts we discussed in Det. No. 00-125, 20 WTD 252 (2001) because the taxpayer provided a considerable amount of new information at the reconsideration hearing, including customer contracts that the Department of Revenue (the Department) had not previously reviewed.

¹ The original determination, Det. No. 00-125, is published at 20 WTD 252 (2001).

² Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

The taxpayer is a corporation headquartered in the State of Washington. The taxpayer originally began as a distributor of directory information to Internet businesses and users. . . . The taxpayer contracted with many third parties to enable it to provide the information to its customers, who are Internet-access providers. 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. Subsequently, the taxpayer's revenues have been from payments from its customers based on combinations of their advertising revenues, subscriber fees, set-up fees, monthly charges, and other types of fee arrangements.

The Audit Division of the Department reviewed books and records that the taxpayer made available to the Audit Division 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 qualified research and development. In support of its decision, 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. [According to the notes, the taxpayer] . . .

is a directory and content aggregator on the Internet. . . . [It provides] yellow pages, white pages, [and] a marketplace guide. . . . It also provides business information nationwide, company web sites, toll-free numbers, fax numbers, and e-mail addresses as well as local city information, including items such as weather [and] traffic. . . .

The Audit Division determined, based on the information available to it at the time, that the taxpayer did not develop its software for resale or licensing to others, but simply to provide content (information) to them. Although the taxpayer continually improved its web site during the audit period, the Audit Division found that such enhancements represented development of computer software³ for the taxpayer's internal use per RCW 82.63.010(16), *infra*, and therefore did not qualify for the credit. The Audit Division also found the taxpayer was not developing computer hardware or other electronic device technology during the audit period.

The Appeals Division of the Department sustained the tax assessment when it issued Det. No. 00-125. In short, the determination found the taxpayer was not selling, licensing, or otherwise marketing its software technology to make it available to the public during the audit period. The determination found the taxpayer, instead, had developed its software technology for the taxpayer's own use in order to gather and distribute directory information to its customers and other Internet users. The taxpayer seeks reconsideration of this determination.

Since the audit period and to the present the taxpayer has added more content services, such as financial data, sports scores, weather, news, etc. The taxpayer has also created technology for

³ "Software" is computer instructions or data that can be stored electronically. An organized list of instructions is a "program," which when executed causes a computer to behave in a predetermined manner. www.pcwebopaedia.com

users to have access to their personal calendars, address books, to-do lists, as well as instant messaging, alerts, web-based email, interactive games, etc. The taxpayer is seeking the B&O tax credit for this post-audit period as well.

After the Appeals Division issued that determination, the taxpayer also petitioned the Department's Special Programs Division for approval of its application for a retail sales tax/use tax deferral certificate for a high technology research and development facility it plans to build. *See* Chapter 82.63 RCW, *infra*. The Special Programs Division in a September 12, 2000 letter denied the application by writing:

Research and development for software that is sold or licensed to a customer and resides on a customer's computer may qualify for the deferral. Software that resides on your servers to be accessed by customers is considered internal use software and does not qualify.

The taxpayer appealed the denial of its application for the tax deferral certificate to the Appeals Division. Because the issue of "internal use" software is the same in the reconsideration petition, the claim for post-audit B&O tax credit, and the petition for the tax deferral, we have consolidated the actions.

FACTS:

The Department does not dispute the taxpayer developed the technology it employs. Approximately 40% of the taxpayer's employees are engaged in full time research and development pertaining to software technology. Since the audit period began, the taxpayer has applied for approximately sixty U.S. patents and several foreign patents. At least two U.S. patents have been granted and the taxpayer asserts several others will be issued soon. The patents and patent applications pertain to technical improvements in software technology for email and the Internet, including e-commerce.

We further describe the taxpayer's software to help explain what it does. The taxpayer's computer software technology gathers the data and information the taxpayer provides its customers from hundreds of sources and then translates the information into formulas and processes for simpler and faster Internet and computer use. The information is stored on the taxpayer's technology platforms.⁴ Customers then contract with and pay the taxpayer for access to and use of both the taxpayer's technology and its information encrypted and contained in the platforms. The taxpayer provides its technology and information services to . . . web sites, including . . . wireless subscribers. The taxpayer's platforms can deliver narrowband and broadband services to all manner of Internet devices, including cellular telephones, pagers, screen telephones, television, set-top boxes, on-line kiosks, personal digital assistants, and

⁴ A "platform" is the underlying hardware or software for a computer system. The platform defines the standard around which a computer system can be developed. The term is often used as a synonym of "operating system," which is the most important program that runs on a computer. Operating systems perform basic tasks, such as recognizing input from keyboards, sending output to display screens, keeping track of files and directories on the disk and controlling devices such as disk drives and printers. www.pcwebopaedia.com

personal computers. The taxpayer's technology allows its customers to enable their subscribers to conduct commerce and manage their personal affairs from wherever they are by using any Internet device.

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 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 quickly new customers (Internet access-providers such as . . . , for example), who supply their subscribers with information and technology obtained from the taxpayer.

Essentially, the taxpayer's technology helps its customers build and maintain their brands by rapidly delivering content with navigational features that appear to be specific to each customer. This service creates the impression to end users that they have not left the customer's web site. 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 sample contracts the taxpayer provided for review for the first time at the reconsideration hearing revealed the taxpayer, during and since the audit period, has entered into agreements with customers to grant the customers the right to use the taxpayer's [software] "Technology" in return for licensing fee[s] "Technology" [includes such things as] . . . the taxpayer's patents, copyrights, trademarks, trade secrets, and other proprietary and intellectual rights.

Finally the testimony at the hearing established that the taxpayer's technology can be installed by the taxpayer's customers on their own servers and adapted to the customers' ends, and that even their subscribers download portions of the taxpayer's technology onto their own computers.

ISSUE:

Is the taxpayer entitled to both the B&O tax credit for its research and development expenditures for computer software, and a sales tax/use tax deferral certificate for research and development facilities it plans to build? Or is the taxpayer excluded from receiving the credit and tax deferral due to internal use of the software it developed?

DISCUSSION:

To obtain the B&O tax credit and sales tax deferral, a person must conduct qualified research and development within this state in one of five listed fields, one of which is advanced computing. Such "research and development" requires "activities performed to discover technological information, and technical and non-routine activities concerned with new or

improved products, processes, techniques, formulas, inventions, or software.” RCW 82.63.010(16), *infra*. However, research and development activities do not include computer software developed for internal use. *Id.* We acknowledge that the taxpayer’s activities meet the technical requirements of research and development for the reasons stated above. The issuance of the patents are further evidence that the Department does not question that the taxpayer’s research and development activities are performed to discover technological information that is intended to be translated into new or improved products, processes, techniques, formulas, inventions, or software as defined in RCW 82.63.010(16). The issue before us, as noted, is whether the taxpayer’s research and development activities are not eligible for the credit and deferral because they result in computer software developed for the taxpayer’s internal use.

The statutes granting the B&O tax credit and the sales tax deferral, RCW 82.04.4452 and RCW 82.63.010,030, respectively, do not define internal use software. The Audit Division contends that the test of whether software qualifies for the deferral or the credit is whether its use is licensed or sold to the public. The Special Programs Division contends that the test of whether software qualifies is whether the software is removed from the taxpayer’s servers and loaded onto the customers’ servers and the public’s computers. Both rationales apparently flow from those Divisions’ understanding of the plain meaning of the words, “internal use.” The testimony at the hearing, however, established that the taxpayer does grant and license its technology . . . to its customers who use that technology on their own servers to interface (exchange information) with the taxpayer’s servers. The testimony also shows that customers can and, at times, do install the taxpayer’s technology on their own servers and adapt it for use on their web sites for their subscribers’ use. The subscribers also can and do download, at least some of the taxpayer’s software onto their computers in order to access the information they seek through those web sites.

In sum, through contracts, the taxpayer has made its software technology available to the public by granting licenses and other rights to its customers to use the “Technology” it developed. By making the computer software technology available to the public, the taxpayer is not internally using the software. Det. No. 00-125 denied the taxpayer’s petition for correction of the tax assessment because the Department found the taxpayer had not sold, licensed or otherwise marketed its software technology to make it available to the public. We have since discovered that finding is not accurate.

Thus, we hold the taxpayer’s software technology is not excluded from the B&O tax credit and the sales/use tax deferral as software intended for internal use by the taxpayer. As we have demonstrated above, the opposite is true. Because the taxpayer has met the criteria set by the Audit Division and the Special Programs Division, respectively, we find the taxpayer is entitled to the B&O tax credits and the sales/use tax deferral it seeks. However, we are not, at this time, declaring that taxpayers may qualify for those tax benefits only if they can meet both of these same specific criteria. There may be other reasons why computer software is not deemed internal use software, but we need not reach them in this matter because the taxpayer did license its computer software to others. We expect the Department will announce in the future by rule what the requirements are for taxpayers to qualify for the B&O tax credits and sales/use tax deferrals in RCW 82.04.4452 and Chapter 82.63 RCW.

DECISION AND DISPOSITION:

The taxpayer's petition is granted. Det. No. 00-125 is reversed.

Dated this 25th day of April 2002.