Cite as Det No. 13-0006, 32 WTD 272 (2013)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of Assessment of	)	D E T E R M I N A T I O N
	)	
	)	No. 13-0006
. . .	)	Registration No. . . .
	)	
	)	Document Nos. . . .
	)	Audit Nos. . . .
	)	Docket No. . . .
	)	

RCW 82.04.4452: HIGH TECHNOLOGY R&D CREDIT – PROFESSIONAL EMPLOYER ORGANIZATIONS. A Special Notice entitled "Professional Employer Organizations – Deduction" does not provide a blanket prohibition against all PEOs from qualifying for a tax credit or incentive.

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.

Sohng, A.L.J. – Professional employer organization ("PEO") protests denial of high technology research and development credit on the grounds that it isn't disqualified from the credit solely by virtue of being a PEO. We remand the petition. [1]

ISSUE

Is a PEO that may meet the substantive requirements of the high technology research and development credit under RCW 82.04.4452 potentially eligible for the credit for its activity involving software development when its only reported income is from acting as a PEO?

FINDINGS OF FACT

[Taxpayer] is a Washington corporation engaged in business as a PEO.[2] In addition, Taxpayer developed software . . . (the "Software") . . . . Under a License Agreement . . . (the "License Agreement"), Taxpayer licenses the Software to [Software Company], a corporation headquartered [out of state]. Taxpayer grants [Software Company] the right to use and distribute

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[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

[2] Whether Taxpayer qualifies as a PEO under RCW 82.04.540 is not at issue in this appeal.

the Software under the names [Name 1] and [Name 2]. [Software Company] markets the licensed software to its own customers. In exchange for the grant of the license, [Software Company] pays Taxpayer [a percentage] of the total gross revenue related to sublicensing the software and [a percentage] of the revenue earned from certain set-up and implementation fees related to the Software.[3] During the course of the appeal, Taxpayer provided financial statements for the audit period that show that it earned income from the licensing of the Software, as well as cancelled checks paid by [Software Company] under the License Agreement.

The Audit Division examined Taxpayer's books and records for the period January 1, 2007, through September 30, 2012. The review was a partial audit and was limited in scope to a review of the research and development high technology credit that Taxpayer claimed under RCW 82.04.4452 (the "R&D credit"). On December 23, 2011, the Audit Division disallowed the R&D credit and issued Assessment No. . . . in the amount of $. . . , including $. . . in taxes and $. . . in interest. The Taxpayer Account Administration Division ("TAA") performed a desk examination of Taxpayer's excise tax returns for the period October 1, 2010, through December 31, 2011, and also disallowed the R&D credit. On February 29, 2012, TAA issued Assessment No. . . . in the amount of $. . . , including $. . . in taxes and $. . . in interest. Taxpayer appeals both assessments.

ANALYSIS

RCW 82.04.4452 provides a B&O tax credit to persons engaged in research and development activities in Washington in one or more of the following high technology fields: (1) advanced computing, (2) advanced materials, (3) biotechnology, (4) electronic device technology, and (5) environmental technology. To be eligible for the credit, the claimant's "research and development spending" in the calendar year for which the credit is claimed must exceed 0.92 percent of its taxable amount for the same calendar year. RCW 82.04.4452(1). "Research and development spending" is defined as "qualified research and development expenditures plus eighty percent of amounts paid to a person other than a public educational or research institution to conduct qualified research and development." RCW 82.04.4452(7)(d).

The Audit Division disallowed the R&D credit on the grounds that "[a] review of the taxpayer's records showed no indication of software sales."[4] During the appeals process, Taxpayer provided documentation, including a licensing agreement, financial statements, and cancelled checks that substantiate that it earned income from the licensing of the Software to [Software Company] during the audit period.[5]

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[3] *See* License Agreement, ¶8.

[4] Auditor's Detail of Differences and Instructions to Taxpayer, at 5.

[5] Whether Taxpayer should have reported under the royalties classification or the wholesaling classification of the B&O tax is not at issue in this appeal. *See* WAC 458-20-15501(303)(a), which provides:

> (i) **Distinction between wholesale sales of prewritten computer software and royalties received for the licensing of prewritten computer software.** Sales of prewritten computer software constitute wholesale sales if the reseller, who has no right to reproduce the software for further sales, sells the same software to

TAA disallowed the R&D credit on the grounds that PEOs are disqualified from claiming the high tech credit:

> The first requirement for the eligibility of the High Technology B&O Tax Credit is the person is engaged in the business of a qualifying field. It has been determined that your business is a professional employer organization; therefore you do not qualify for the High Technology B&O Tax Credit.[6]

TAA relies on a Special Notice entitled "Professional Employer Organizations – Deduction" (the "Special Notice") issued by the Department of Revenue (the "Department") on June 2, 2006. The Special Notice generally provides guidance on the requirements of qualifying as a PEO under RCW 82.04.540. The specific language in the Special Notice upon which TAA relies provides:

> **Eligibility for Tax Incentives**
> The Client (not the PEO) is eligible for any tax credit, exemption, or other tax incentive <u>as the result of the employment of covered employees</u>."[7]

(Emphasis added.)

We conclude that . . . this language merely mandates that the client, not the PEO, is entitled to take a tax credit or incentive that arises from its employment of covered employees. It does not provide a blanket prohibition against all PEO's from ever qualifying for any tax credit or incentive.[8] . . . [To the extent the R&D credit] . . . arises from Taxpayer's [non-covered employees'] activities in the field of advanced computing, as required by RCW 82.04.4452, [Taxpayer may qualify for the credit]. We remand this case to the Audit and TAA Divisions (the

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> its customers. The true object of the sale to the reseller is the sale of the software. On the other hand, income received for granting an intangible right to reproduce and distribute copies of prewritten computer software for sale constitutes royalties. The true object of the transaction that generates royalty income is the right to reproduce and relicense the software. See subsection (308) of this section for more information on royalties.

If taxpayer is unclear how to report, it can seek a ruling from the Department's Taxpayer Information and Education section. *See* WAC 458-20-100.

[6] Examiner's Detail of Differences and Instructions to Taxpayer, at 1.

[7] The Special Notice defines a "covered employee" as:

> [I]ndividuals who are co-employed by a PEO and the PEO's client. An employee is a covered employee when:
> - The individual has received written notice of co-employment with the PEO, and
> - The individual's co-employment relationship is pursuant to a professional employer agreement between the PEO and its client.

[8] [PEOs may qualify for a tax credit, exemption, or other tax incentive as a result of work performed by employees of the PEO only, i.e. employees that are not covered by the co-employment agreement, if the substantive requirements of the tax incentive are met.]

"Operating Divisions") to determine whether Taxpayer has met the substantive requirements of the R&D credit under RCW 82.04.4452 and WAC 458-20-24003.

DECISION AND DISPOSITION

We remand this case to the Operating Divisions for possible recalculation of the assessments in accordance with this determination.

Dated this 8th day of January 2013