HOUSE BILL REPORT
ESHB 1462

As Passed Legislature

Title: An act relating to local government business and occupation tax on intellectual property.

Brief Description: Prohibiting local governments from imposing business and occupation tax on intellectual property.

Sponsors: By House Committee on Finance (originally sponsored by Representatives Morris, Cairnes, Gombosky, Ruderman, Nixon, Ericksen, Miloscia, Anderson, Wallace, Benson, Newhouse, Tom, Chandler, Orcutt, Woods, McMahan, Talcott and Campbell).

Brief History:
Committee Activity:
Finance: 3/10/03 [DPS].
Floor Activity:
Passed House: 3/19/03, 96-0.
Passed Senate: 4/9/03, 41-4.
Passed Legislature.

Brief Summary of Engrossed Substitute Bill

- Prohibits cities from imposing gross receipts taxes on intellectual property creating activity.

HOUSE COMMITTEE ON FINANCE

Majority Report: The substitute bill be substituted therefor and the substitute bill do pass. Signed by 7 members: Representatives Gombosky, Chair; Cairnes, Ranking Minority Member; Orcutt, Assistant Ranking Minority Member; Ahern, Morris, Roach and Santos.

Minority Report: Do not pass. Signed by 2 members: Representatives McIntire, Vice Chair; and Conway.

Staff: Mark Matteson (786-7145).

Background:

Thirty-seven cities impose Business and Occupation (B&O) taxes based on the gross receipts of the business. Municipal B&O taxes are imposed on gross receipts derived from activities conducted by businesses located within cities without any deduction for the costs of doing business. The Legislature has limited city B&O taxes on retail sales to a maximum of 0.2 percent, but higher rates are possible if voter-approved or in effect prior to January 1, 1982. Cities first imposing a B&O tax after April 22, 1983, and cities increasing tax rates must first receive voter approval.

Like a number of other municipalities with B&O taxes, the City of Seattle imposes its B&O tax on several classifications including manufacturing. As an aspect of its tax on manufacturing, the city also taxes software development; this imposition has been the subject of dispute. In 1999 the King County Superior Court, ruling in favor of Walker, Richer & Quinn, Inc., a software developer, found that the city's definitions of "manufacturing" and "manufacturer" were inconsistent and that software development was not taxable under the definition of manufacturing. In response, the city modified its definitions, and in 2001, the city council repealed its existing B&O ordinance entirely and adopted a revised version. The revised ordinance provides that manufacturing includes "persons engaged in the business of developing, or producing custom software or of customizing canned software." The revised ordinance also includes a partial credit against the tax for certain research and development expenditures conducted by high-technology industries, including software developers.

Intellectual property is a form of intangible property in which the product represents the manifestation of creative activity, such as in the case of software programs, music, and product designs. The activity of creating intellectual property may involve research, thought development, and other sorts of inventive processes. The use of intellectual property is typically allowed through license and the creator of such property may receive royalties or other compensation for licensing the product.

In the 2002 Legislative session, several bills were considered that would have prohibited the municipal taxation of "intellectual property creating activity", including software development.

Summary of Engrossed Substitute Bill:

Cities are prohibited from imposing a gross receipts tax on intellectual property creating activities, including research, development, authorship, creation, or other inventive activity, unless a city imposed such a tax as of January 1, 2002. In the latter case, a city is prohibited from imposing such a tax as of January 1, 2004.

Cities may impose gross receipts taxes on royalty income, except for income from casual or isolated sales, grants, capital contributions, donations, or endowments. The taxes may only be imposed on taxpayers whose principal business location is within the city

imposing the tax.

Cities are not prohibited from imposing gross receipts taxes on gross income derived from manufacturing, sales, or services, even if the processes might have involved intellectual property creating activity. Intellectual property creating activity may not be considered a manufacturing activity, however.

Appropriation: None.

Fiscal Note: Requested on March 20, 2003.

Effective Date: The bill takes effect 90 days after adjournment of session in which bill is passed.

Testimony For: (Testified on HB 1364, a similar bill) Seattle is considered a major technological center. The city also taxes intellectual property creation activity, and this is a disincentive to the growth of such activity. In the current economy, businesses could do without such a burden. Similarly situated taxpayers that create other forms of intangible property do not face such a tax. The reputation that Seattle has is an important reflection on the state. Taxing intangible property creates uncertainty for small and large businesses alike, and in the current economy businesses can do without that uncertainty.

In 1999 Seattle greatly expanded its manufacturing tax base by including software development within the definition of manufacturing. In 2001 they included a partial credit in their ordinance, but this simply reduced the 1999 increase. WSA opposed the original tax because it is discriminatory, since it treats software development differently than other similarly situated taxpayers who produce intangble property. Trying to place a value on intellectual property is difficult at best and could only lead to taxpayer confusion.

The definition of "intellectual property creating activity" does not embrace potential consultancy work, such as the services of a lawyer. If you read subsection 2 of the bill alone, one might conclude otherwise. However, subsection 3 of the bill provides clarification: fee-for-service work is not precluded from tax under this bill. A contract arrangement in which a person would be hired would still be taxable as a service. If a software company hires another company to do contract development work, that income would be subject to tax under the services classification.

What changes under this bill is a very odd tax that is difficult for taxpayers to comply with. The incidence of this tax is the development of intellectual property. But what is the value of that development? Software development may or may not yield a marketable product. It is very difficult to assign a value to development of software within that

context. You could look at sales, but there are no sales. You could look at cost, but then you would be essentially changing the tax base from gross receipts to a cost basis. So how to interpret Seattle's tax is difficult. You should not have a tax that only the tax administrator knows how to interpret.

WRQ is in the process of looking for new office space at the moment. One of the big factors in our considerations is local taxing structure. We would love to stay in Seattle; Seattle is the place to be. But we have to look at costs. In addition, I've spoken with tax managers at several other software companies, and none that I've spoken with understands how to comply with the tax. Everyone I've spoken with is calculating it in a different way.

In Washington in 2001, the state ranked seventh in the nation in terms of venture capital invested. Taxation of intellectual property creating activity will negatively affect venture capital. The taxation of intellectual property creating activity presents the taxpayer with a difficult situation, since it is very difficult to establish the value of such property. The tax system should be equitable.

Testimony Against: I'd like to establish a few facts with respect to this issue. First of all, if a business has no gross receipts, there will be no tax. Therefore, the argument that a software development business that has no gross receipts would be subject to tax is wrong. Second, the City of Seattle and the business community has been working over the last several years to get to a resolution on this issue. Third, Seattle did enact a research and development tax credit in 2001 that reduced the tax bill of these companies by 77 percent on average. Firms that are doing research and development pay relatively little or no tax. Fourth, high-technology firms have continued to move into the city, so it does not make sense to conclude that the tax is a disincentive to doing business within the city. Finally, I'd like to point out that the City of Seattle is not the only one that taxes software development. For example, Redmond taxes software development and other businesses based on the number of employees, while Bellevue taxes such activity in part based on the amount of square feet of office space utilized.

We also have concerns about the vagueness of the language. Other non-technical firms could argue that they are creating intellectual property. The City of Seattle may lose a lot of additional revenue, depending on how this is interpreted. The other concern is that this would create a distinction between the state approach and the city approach.

Testified: (Testified on HB 1364, a similar bill) Representative Morris, prime sponsor; Representative Anderson, sponsor; Lew McMurran, WSA; Laurie Amaral, WRQ; Robert Mahon, citizen; and Nancy Atwood, AeA.

(Opposed) Dwight Dively, City of Seattle.