



TECHNOLOGY
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High Technology Issues in Washington

The Tax Environment

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This document is intended to provide a framework for a discussion of the tax environment and some of its impacts on the high technology industry in Washington. It is not intended to be a comprehensive analysis of all of the tax issues that may have an impact on this industry.



I. OVERVIEW OF WASHINGTON'S TAX MAKEUP

Washington's tax base is composed of four major taxing systems:

Sales and use tax — This tax is imposed upon all retail purchases of tangible personal property and selected services within the State. The State rate is 6.5%. Local rates vary but can be as high as 2.1%. This produces a maximum combined state and local rate of 8.6%.¹ This tax is imposed upon the purchaser or user of qualifying property and services.

Business and occupation (B&O) tax — This tax is imposed upon all persons engaged in a business activity within the State. The tax rate varies by activity and is imposed upon the gross receipts of the business. The majority of the tax rates range from approximately 0.5% to 1.5%. A number of Washington cities also impose a B&O tax. The local tax rates, which vary by activity, range from approximately 0.1% to 0.5%.²

Real estate and other excise taxes — A real estate excise tax is imposed upon the sale of real property located in Washington. The tax is imposed on the seller of the property. The State tax rate is 1.28%. Local rates vary but can be as high as 1.5%. The combined tax rate in Seattle is 1.78%. Other excise taxes include taxes on hazardous materials, liquor, motor vehicles, utilities, carbonated beverages, and cigarettes.

Property tax — A property tax is imposed on real and personal property located in the State as of January 1.

¹ Maximum rate includes the Regional Transit Authority (RTA) Tax but does not include certain higher rates for rental cars or purchases of meals from restaurants in specially designated districts.

² Almost all sizable cities in Washington impose a local B&O tax. Notable exceptions include Redmond and Spokane.

II. COMPARISON OF WASHINGTON'S TAX MAKEUP WITH OTHER STATES

A. B&O Tax

The most obvious difference in Washington's tax system compared to other states' systems is that Washington does not impose an income tax on businesses or individuals. Forty-six states impose an income tax or income-tax equivalent on businesses. Washington, however, imposes a tax upon the gross receipts of persons engaging in a business activity within the State. A limited number of deductions and exemptions can be taken against total gross receipts to arrive at taxable gross receipts. Other differences between the two systems include the following:

	<u>B&O</u>	<u>Income</u> ³
1) Tax rate	varies by activity (0.138% to 1.5%)	9% ⁴
2) Starting point	total gross income	Federal taxable income
3) Partnerships, S-Corps.	taxable	not taxable
4) Nonprofit corps.	taxable	not taxable
5) Due date	monthly	annually
6) Apportionment	specific accounting	three factor
7) P.L. 86-272 protection ⁵	not available	available
8) Credits for other taxes paid	very limited	available

³ Income tax factors are generalizations.

⁴ 9% is intended to represent a top marginal rate in certain states. Selected states and their top rates are the following: CA - 8.84%, MA - 9.5%, NC - 7.0%, NY - 9.0%, OH - 8.9%, OR - 6.6%, PA - 9.99%.

⁵ P.L. 86-272 is a Federal law which prohibits states from imposing a tax based on net income on a company whose only activity within a state is the solicitation of sales of tangible personal property.

As a broad generalization, it is impossible to say if a specific company or industry would have a lower liability under one system or the other. To produce this answer, you would need to analyze the comparative tax rates, net income margin, and apportionment factors. The following table demonstrates the relationship between margin and tax impact under the B&O and income tax systems.

Sales	Profit	B&O at Services Rate ⁶	Income Tax ⁷	Effective B&O Rate ⁸
\$10,000,000	\$(2,000,000)	\$200,000	\$0	infinite %
10,000,000	0	200,000	0	infinite %
10,000,000	2,000,000	200,000	180,000	10.0%
10,000,000	4,000,000	200,000	360,000	5.0%

B. Sales and Use Taxes

In many ways, Washington’s sales and use tax system is similar to other states’. Washington, however, imposes the sales and use tax on a wide variety of service activities that have been statutorially defined to meet the definition of retail sale. These taxable services include the following:

- the installation, repair, modification, or alteration of tangible personal property;
- the construction, repairing, or improving of real property;
- the leasing of tangible personal property;
- certain computer consulting services; and
- telephone services.

C. Real Estate and Other Excise Taxes

Most states do not impose an excise tax upon the sale of real property.⁹ Washington’s tax is far-reaching and includes transactions that involve a change in the controlling interest in an entity which owns real property in the State. The imposition of excise taxes on liquor, cigarettes and other select goods is a common practice among states.

⁶ Based on approximate combined state and city rate.

⁷ Based on average state net income tax rate of 9%.

⁸ Rate calculated as a percentage of net income.

⁹ Many localities do, however, tax real estate transfers.

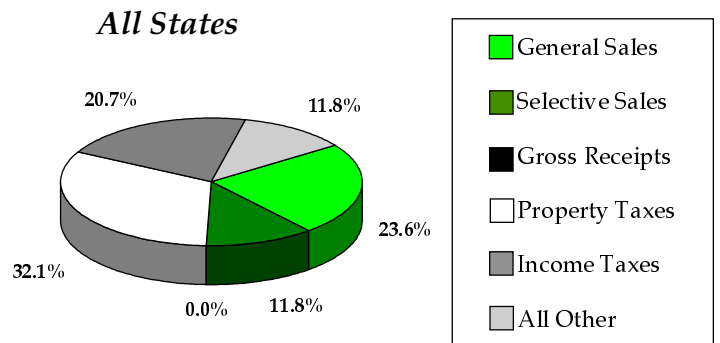
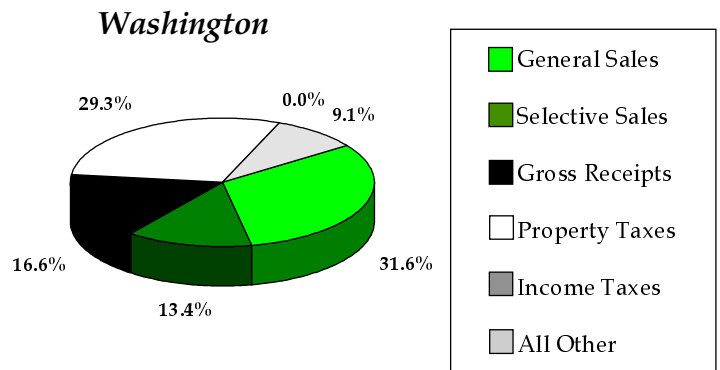
D. Property Taxes

Washington's property tax system and tax burden are fairly typical compared to other states. Currently, the property tax is not imposed on intangibles that are located or utilized within the State.

E. Fiscal Impact

For comparative purposes, the following table compares Washington's reliance on certain taxes as a percentage of total taxes collected with other states.¹⁰

Tax Source	Washington	All States
General Sales Tax ¹¹	31.6%	23.6%
Selective Sales Tax ¹²	13.4%	11.8%
Gross Receipts Taxes ¹³	16.6%	0.0%
Property Taxes	29.3%	32.1%
Income Taxes	0.0%	20.7%
All Other Taxes	9.1%	11.8%



¹⁰ Revenue Research Report, *Tax Reference Manual*, Washington Department of Revenue, January 1996.

¹¹ Includes retail sales and use taxes.

¹² Includes specific taxes on cigarettes, wine, beer, etc.

¹³ Other states have gross receipts taxes, but these are more correctly categorized as general sales taxes.

III. GENERAL BUSINESS INCENTIVES

Washington State law provides for 412 tax exemptions for a variety of reasons. There are 122 different exemptions that are intended to promote economic development. These exemptions range from preferential B&O rates for certain industries to a B&O credit for job creation in the State. These exemptions occur in most of the taxes that are imposed on Washington businesses.

The aggregate state and local tax impact of these 412 exemptions amount to an estimated savings for taxpayers of approximately \$40.5 billion for the 1997-1999 biennium.¹⁴ The amount of savings to taxpayers via exemptions exceeds one-half (53.4%) of the total potential tax base.¹⁵

¹⁴ Revenue Research Report, *Tax Exemptions 1998*, Washington Department of Revenue.

¹⁵ *Ibid.*

A. B&O Tax

Certain aspects of the B&O tax have a significant impact upon the high tech industry in the State. These factors include:

Tax on royalties — The B&O tax is imposed upon royalties at the rate of 0.484%. A royalty can be any payment for the right to use or derive the benefits from an intangible asset. For example, if a company is granted the right to make 100 copies of software, the payment for this right could be characterized as a royalty payment.

Generally, royalty receipts are sourced to this state if the taxpayer's commercial domicile is Washington. A software company with royalty receipts of \$10 million would pay \$48,400 of B&O tax.

Tax on manufacturing — The B&O tax is imposed upon manufacturing activities which are conducted within the State. The State has a very broad definition of what constitutes a manufacturing activity. If a company produces a heart monitor and sells all of the product to out-of-state customers, the company will pay B&O tax and possibly income tax to other states on the same revenue stream. A manufacturing company with \$10 million of manufacturing activity in the State would pay \$48,400 of B&O tax.

Tax on grants — The B&O tax may be imposed on grants if the recipient is required to perform services or produce a report as a condition of receiving the money. This is a significant issue in the biotech industry.¹⁶

No net operating loss provisions — The B&O tax does not allow a deduction for net operating losses. Entities experiencing losses are normally not subject to any income taxes but will still be required to pay B&O tax.¹⁷

¹⁶ The impact of the B&O tax on grants is substantially offset by a research and development B&O tax credit available to certain high technology companies. See Section V.

¹⁷ A B&O tax credit up to \$420 per year is available for annual filers to minimize the impact of the tax on small or new businesses. However, the credit is phased out for companies if the gross receipts exceed certain amounts.

B. Sales and Use Tax Issues

Software — New 1998 legislation clarifies the taxation of computer software under the B&O tax and the retail sales tax. This legislation became effective July 1, 1998.

The new legislation adds definitions of the following terms to an existing Washington statute: (1) Canned software (2) Custom software (3) Customizing of canned software (4) Master copies (5) Retained rights (6) Software.

“Canned software” and “custom software” were already defined under Washington statutes. However, the new legislation redefines these two terms. Canned software now means software that is created for sale to more than one person. Custom software is now defined to mean software created for a single person.

Sales of canned software to consumers (end users) are subject to the B&O tax under the retailing classification. In addition, a seller of canned software must collect retail sales tax on the selling price. The sale, lease, or licensing of canned software is treated in the same manner as the sale or lease of a product, even though produced through a computer system or process.

One important addition to Washington statutes by virtue of the new legislation is that sales of canned software will be considered retail sales regardless of the method of delivery to the end user. Thus, canned software purchased and delivered to an end user through electronic means (e.g., Internet, modem) would be considered a retail sale requiring the collection of sales or use tax.

Another important addition to Washington statutes is that canned software provided free of charge or provided for temporary use in viewing information, or both, will not be subject to use tax.

Sales of canned software to businesses that will resell the software (without intervening use) are wholesale sales subject to the B&O tax under the wholesaling classification. The seller in this situation is required to obtain a resale certificate from the purchaser to document such sales.

Creating and distributing custom software and customizing canned software are taxable as professional services. Customizing canned software is no longer regarded as a retailing activity subject to the retailing B&O tax and the retail sales tax, but is now a professional service subject to the B&O tax under the services and other activities classification. Retail sales tax need not be collected on such professional services. Duplication of custom software for the same person, or by the same person for their own use, does not change the custom software to canned software.

The following table illustrates the combined tax impact on each transaction:

Activity	B&O Rate	Sales Tax Rate	Combined Tax Rate
Sale of Canned Software	.471% ¹⁸	8.6% ¹⁹	9.071%
Custom Software Services	1.5% ²⁰	0.0%	1.5%

Use tax on prototypes and self-manufactures assets —The sales tax extends beyond items purchased at retail. If a taxpayer builds a prototype machine, the taxpayer will be subject to use tax on this asset.

¹⁸ Does not include impact of city business license taxes.

¹⁹ Maximum rate includes the Regional Transit Authority (RTA) Tax but does not include certain higher rates for rental cars or purchases of meals from restaurants in specially designated districts.

²⁰ Does not include impact of city business license taxes.



A. B&O credits

- Washington provides a credit against the B&O tax for research and development activities conducted in the State. The credit is equal to 1.5% of all qualifying expenditures. *The maximum amount of the credit which can be claimed in any year is limited to \$2 million.* Qualified research and development expenditures include operating expenses such as wages, supplies and computer expenses.

Fiscal impact – \$29.6 million (for 1997-1999 biennium).²¹

- There is a job creation credit available to new enterprises in certain distressed areas of the State. The credit is available to businesses which create new jobs in manufacturing or research and development activities. The credit is equal to \$2,000 per new qualifying job created for wages and benefits less than \$40,000 per year or \$4,000 for wages and benefits greater than \$40,000 per year. The maximum credit per company is unlimited. The maximum credit pool available to all companies is \$5.5 million for FY1998 and FY1999 each (\$7 million for years thereafter).

Fiscal impact – \$11 million (for 1997-1999 biennium).²²

- New 1998 legislation created a \$3,000 credit against state B&O tax for each new employee of eligible firms that are engaged in providing international services. The credit for each position may be taken annually for up to five years. The firm must be located in a community empowerment zone (CEZ) or in contiguous census tracts in individual cities with at least an 80,000 population which are located in a county which does not have a CEZ.

²¹ Revenue Research Report, *Tax Exemptions 1998*, Washington Department of Revenue.

²² *Ibid.*

International services are defined as services relating directly to the delivery of the services outside the United States in the following areas: computer, data processing, information, legal, accounting, tax preparation, design, engineering, architectural, business management and consulting, public relations, advertising, surveying, geological consulting, real estate appraisal, and financial services.

In order to qualify for the B&O tax credit for international services, the employment position must be new for the firm after the effective date of July 1, 1998 and must be retained by the firm for at least four subsequent years.

The amount of B&O tax credit may not exceed the firm's B&O tax liability, but unused credits may be carried forward to future years. For firms located in non-CEZ areas, the city must adopt an ordinance designating the appropriate census tract which will be eligible for the program before the end of 1998.

Fiscal impact – \$9.1 million (for 1999-2001 biennium).

B. Sales and Use tax exemptions and deferrals

- Washington provides a sales/use tax exemption for manufacturing equipment that is utilized in the State. The exemption extends to any equipment that comes in direct contact with materials in the manufacturing process, and includes certain repair and replacement parts. A sales/use tax exemption for the machinery and equipment used in research and development activities is also available.

Fiscal impact – \$452.2 million (for 1997-1999 biennium).²³

- A sales tax exemption is available for new or expanded research and development and pilot-scale manufacturing facilities.²⁴ The exemption is dependent upon the taxpayer receiving approval from the Department of Revenue before the facility is built. The exemption extends to all purchases which would normally be subject to sales tax.

Fiscal impact – \$84.6 million (for 1997-1999 biennium).²⁵

²³ Ibid.

²⁴ Repayment of the tax may be required in certain circumstances.

²⁵ Revenue Research Report, *Tax Exemptions 1998*, Washington Department of Revenue.

- A sales tax exemption is available for manufacturers in certain distressed areas of the State.²⁶ The exemption specifically includes computer software, computer-related services, research and development laboratories and commercial testing laboratories. The exemption extends to all purchases of qualified machinery and equipment and new building construction or expansion costs, including labor and services rendered in construction or installation.

Fiscal Impact – \$78.3 million (for 1997-1999 biennium).²⁷

C. Other

- The current exclusion of intangibles from assets subject to property tax is a significant advantage for many high tech businesses. *This statutory exclusion was signed into law in 1997.* The current treatment benefits many Washington-based companies that have significant intangible assets on their books: patents, golden master software, copyrights, etc.

Fiscal impact – \$14.5 billion (for 1997-1999 biennium).²⁸

(This is the amount of forgone property tax revenue that results from county assessors' current treatment of intangibles as being exempt from property tax. The fiscal impact includes taxation of intangibles held by individuals.)

²⁶ Repayment of the tax may be required in certain circumstances.

²⁷ Revenue Research Report, *Tax Exemptions 1998*, Washington Department of Revenue.

²⁸ Ibid.



VI. TAX DISINCENTIVES FOR THE HIGH TECHNOLOGY INDUSTRY IN WASHINGTON

For some companies, the most significant disadvantage to doing business in Washington is that the B&O tax puts a tax burden on companies in the development stage. Depending upon their revenue stream, companies with large book losses could still be faced with a material B&O tax liability. Additionally, those companies subject to the B&O tax are unable to use any net operating loss carryover provision as they can for income tax purposes. Low margin, developing companies effectively pay a very high income tax rate equivalent on their activities.

Effective July 1, 1998, the B&O tax rate on royalty receipts has been reduced to 0.484% from 1.83%. The previously higher rate on royalty receipts had been a big disadvantage to locating high-tech companies in the Washington. Lowering of the rate has lessened the impact on high technology businesses.

Washington's taxation of construction activities could be considered to be a disincentive for new or expanding high technology businesses. Washington, unlike most other states, subjects the entire construction cost of a new building or plant to sales tax. Most other states tax only the materials that are incorporated into the real property being constructed. In essence, Washington is taxing the labor component of a real property construction project. Finally, the real estate excise tax and the sales tax on real estate construction activities are disincentives to expanding operations in the State.



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VII. CONCLUSION

The high technology industry is composed of many different industry segments. Some of Washington's tax incentives help certain segments of the high technology industry more than others. Appendix A attempts to rate the impact of selected incentives and disincentives on different segments of the high technology industry in the State.

It is important to compare state tax incentives with those of "competing" states. If taxes are viewed as a cost of doing business in a state it is crucial to understand how one state ranks against other major technology states. It is also important to look at an incentive's economic impact. State legislators often view incentives with an eye toward the direct amount of lost revenues. This is only part of the picture. The real question is the following: how many jobs and new businesses did the incentive foster and what is the fiscal impact from the multiplier effect of the incentive dollars?

Finally, a tax incentive needs to be viewed in its proper context. Very few businesses base relocation decisions on tax impact alone. Quality of life, educated work force, efficient infrastructure, cost of resources and the quality of local educational institutions are all factors which equal or outweigh taxes in making these important business decisions.

General Measures of Washington Tax Incentives and Disincentives by Industry

High Technology Industry	Hardware	Software	Biotech	Service Providers ⁽¹⁾	Telecom Providers
Incentive Impact					
B&O tax credit for R&D	Low	High	High	Low	Low
B&O tax credit for new jobs in distressed areas	Low	Low	Low	Low	Low
Sales tax exemption for manufacturing equip.	High	Low	Low	Low	Low
Sales tax exemption for R&D facilities	Low	High	High	Low	Low
Property tax exemption for intangibles	Low	High	High	Low	High
B&O tax credit for International Services	Unknown	Unknown	Unknown	Unknown	Unknown
Disincentive Impact					
B&O tax on royalty income	Low	High	High	Low	Low
B&O tax on manufacturing activities	High	Low	Low	Low	Low
B&O tax on grants	Low	Low	High ⁽²⁾	Low	Low
No net operating loss provisions	Unknown	Unknown	High	Unknown	Unknown
B&O taxes on "normal" business activities	Unknown	Unknown	Unknown	Unknown	Unknown

The above schedule is a broad generalization of the impact of Washington State taxes as applied to specific industries. In fact, the impact of Washington State taxes can vary greatly between companies in a single industry segment.

¹ Includes custom software programmers, digital media service providers, and other high-technology consulting firms.

² As previously noted, the research and development B&O tax credit, in many cases, substantially mitigates the impact of the B&O tax on biotech companies.

