

The Committee approved the minutes from the August 12, 2008 meeting during the September 25, 2008 meeting. There were no amendments.

Study of the Taxation of Electronically Delivered Products
Committee Meeting Minutes
August 12, 2008

1. Welcome

- Chair Hunter opened the meeting.
 - Present: Chair Hunter, Vice-Chair Zarelli, Rep. Orcutt, Steve Collier, Bruce Reid, Ron Bueing, Rich Prem, Jim Justin, Cindi Holmstrom, and Victor Moore.
 - Absent: Rep. Kilmer, Julie Murray, Greg Silverman, Dr. Kim, Paula Borhauer, and Chuck Robinson
- Chair Hunter explained that the meeting was scheduled as a special meeting. The Open Public Meetings Act limits actions to those identified on the agenda.

2. Review and Approve May 29, 2008 Meeting Minutes

- Cindi Holmstrom relayed changes that were suggested by Paula Borhauer:
 - Page 11 – Under bullet discussing SSUTA, clarify that digital goods, *except prewritten software*, are not tangible personal property.
 - Footer date at the bottom of the page should read May 29, 2008.
- Motion to amend the May 29, 2008 meeting minutes approved.
- Motion to approve the May 29, 2008 meeting minutes as amended approved.

3. Proposal Presentation by Chair Hunter (04:08)

- Chair Hunter explained that his proposal tries to draw together all of the issues discussed by the Committee.
 - Although the Committee did not approve revenue neutrality (second bullet), he has added it as a starting point.
 - Chair Hunter briefly identified the Committee’s goals.¹
- Chair Hunter explained that his proposal establishes a new category or product for digital goods.
 - Calling these products “tangible personal property” strains the limits of logic.
 - Calling them “digital products” seems a reasonable way to move forward.
- Under Chair Hunter’s proposal, digital products would have a relatively broad tax application.
 - If you got it and paid for it, it’s a digital product. If you got it and enjoyed it, it’s a digital product.
 - Proposal expands the base beyond today’s and into the future as more products are converted to digital products.
 - Transition from CDs to digital has already happened.

¹ The November 30, 2007, Preliminary Report includes the Goals and Vision Statement agreed to by the Committee.

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- Buying downloaded music is the same as buying music on a physical disk.
- Chair Hunter recommended careful consideration of the treatment of application software.
 - There is no perceivable difference for the user for application software that is purchased via download versus application software operated on the seller's website.
- Chair Hunter explained that his goal was not to distinguish between business models by how products are delivered.
 - Broader implications, such as the business and occupation tax (B&O) tax that should be considered.
 - If services shift to being a retail sale, the B&O tax drops from 1.5 percent to 0.471 percent. Would be lowered for all business, not just business that occurs in Washington.
 - The lower B&O tax is a reasonable trade-off for businesses.
- Chair Hunter explained his proposal to provide a business inputs exemption.
 - Exempt digital products used to produce other digital products for sale.
 - Exempt digital products used to produce a product given away but funded via advertising.
 - Provide exemptions broader than those provided to the tangible world because the business is a little different.
 - For example, business model exists where digital products are acquired to build a web site where the product is given away but the revenue model is dependent on advertising.
 - Business inputs exemption avoids pyramiding and disadvantaging server farms.
- For purchases where the buyer's location is unknown, such as with PayPal, the proposal allows a default to the IP address before defaulting to the server location.
 - Need to look at the nexus rules as they relate to servers.
- Chair Hunter noted there are some problems that don't lend themselves to broad rules.
 - Businesses using large amounts of digital goods that are fundamental to their business may not have paid sales tax. There is a need to determine what will be done and specific exemptions may be necessary.
 - Chair Hunter explained that he's tried to come up with a proposal that provides the fewest set of exemptions, but the exemptions need work.
 - Current law limits standard financial information and there may be a need to discover other similar problems and provide exemptions.
 - Chair Hunter explained his proposal tries not to disadvantage businesses located in Washington.
- Chair Hunter recognized that it will take time to get the data and identify shifts.

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- There are two obvious shifts:
 - Some consumers would pay tax on products they've not previously paid sales tax on.
 - It's not clear how large this group is today.
 - While few consumer services are purchased, there's a need to identify those services.
 - There is probably a shift away from Washington businesses that produce digital products for businesses in Washington that, while they are consumers of digital products, are not digital producers.
 - These businesses will probably pay more but the goal is that they not pay a huge amount more.

4. Discussion of Chair Hunter's Proposal (17:53)

- Ron Bueing commented about the difficulty of understanding the proposal without having a real understanding of what digital goods are vs. services. An example includes sending a tax return digitally for someone to sign or sending the whole file electronically. What factors determine a taxable digital good from a service from a communication?
 - Chair Hunter acknowledged that the Committee won't be able to tell what's what until there is actual legislation before the Committee.
 - Chair Hunter explained that his intent is that sales tax is due if a person uses tax preparation software on line vs. buying and using the disk. There's no intent to impose sales tax on an accountant doing tax returns or other human beings providing services that aren't currently being taxed.
- Vice-Chair Zarelli explained that it comes down to defining "digital retail sales." He further explained that the discussion is about the end product of work that has been accomplished vs. the actual retail sale that would otherwise occur in a brick and mortar environment. He agreed with Chair Hunter that the Committee doesn't really know what that looks like until they start working on something.
- Chair Hunter asked Committee members to provide suggestions for defining digital products – how to draw the line to avoid capturing what they don't want to capture.
- Chair Hunter and Mr. Bueing discussed not capturing transactions that they don't intend to capture.
- Mr. Bueing asked about the taxation of access to a database stored in Washington if access is provided to persons in and out of state and the multi-state company doesn't know who and where the employees are that will access the database.
 - Mr. Bueing further explained his concerns as:
 - What constitutes additional goods subject to sales tax and how do you tell that from a service; and
 - How to determine where the good is sold, used, etc., by a business that has multi-state locations that it uses information from a web-based application.

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- Vice-Chair Zarelli asked Mr. Bueing how his company treats software that is accessed via the company's Intranet site.
 - Mr. Bueing responded that software is not accessed via the Intranet. They acquire site licenses based on who in the company needs to use what software. Sales tax is paid based on the number of site licenses acquired for Washington personnel.
 - Vice-Chair Zarelli asked about using the same approach for digital goods.
 - Mr. Bueing responded that they know who is going to use software when they acquire site licenses. They don't know who or from where people will access information. Some web-based software applications that reside on a server in another state are accessed, but to his understanding, such use currently isn't taxable.
 - Chair Hunter paraphrased Mr. Bueing's comments as questioning whether use tax should be paid or apportioned to Washington based on the number of Washington employees for a narrow-use product that might only be used in specific locations but available companywide even though a Washington office might never use the information.
 - Mr. Bueing responded that this is one question. There might be some broader-based information databases that it would be difficult to tell ahead of time who would use the information
 - Chair Hunter suggested that there could be apportionment rules for narrow-use products and different apportionment rules for broad-based personal productivity software. Mr. Bueing agreed.
 - Chair Hunter noted that statute typically doesn't go this far and asked if the idea would be an issue to be worked through administratively.
 - Vice-Chair Zarelli wondered if this represents a large enough tax increase that some businesses would relocate certain aspects of worker activities to other states. He asked if this could impact the potential growth and work force of certain industries. He is concerned about the trickle-down effect on the State's economy. Chair Hunter agreed with Vice-Chair Zarelli.
 - Mr. Bueing noted that service businesses that used large amounts of information would simply never locate in Washington because of the additional cost that wouldn't occur anywhere else. Chair Hunter explained that the goal is to avoid that situation.
- Chair Hunter noted that "deep" clarification is needed:
 - How and where to draw the line between what would be a digital product for sale vs. a service.
 - What specific exemptions should there be for information purchased as part of a service business rather than for inclusion in a retail sale.
 - Mr. Bueing explained that many in the business community believe information has never been and shouldn't have been subject to tax. He

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further explained that doing so would shift a larger tax burden on to business – which has an already significant burden.

- Jim Justin noted that Julie Murray and he see some pieces of what they proposed and other pieces that they expected to see added. They are very interested in the apportionment issue. He commented that there is a lot to be determined, but the counties and cities can support this proposal as a first step.
- Steve Collier asked if the intent is to tax standard information unless a particular industry or service is exempted.
 - Chair Hunter explained that he doesn't have a way to describe standard information – he couldn't come up with a broad definition that met the other goals. He explained his belief that you have to exempt specific categories and that he's open to doing so. He questions how to define what's exempt and what's not. If done wrong, insurance companies are driven out of the state, which isn't what he wants to do. Or, people "trivially" evade the tax by customizing the information feed. Chair Hunter explained that he doesn't want to impose a law that can't be enforced. All information will become custom if the law is based on standard or custom information.
 - Chair Hunter explained that his preference would be not care about the form that information is presented in. He used the example of CCH books that have been taxed for generations. Chair Hunter explained that he wouldn't create new, big, tax liabilities for companies located in the state that they don't think are being taxed today.
 - Chair Hunter noted that he doesn't know how to do it in a broad way without exempting all business inputs. It seems that an all business inputs exemption would violate his goal of remaining relatively revenue neutral. He's looking for suggestions.
- Bruce Reid commented that Chair Hunter's proposal goes beyond the streamlined definitions of specified digital products to include remote access software, and some vague web-based products or services. He asked what's driving the proposal to tax all web-based or digital products.
 - Chair Hunter explained:
 - His goal not to discriminate against the form that the product gets delivered in. Using tax preparation software as an example, he noted that some ways in which the software is purchased are taxable and some are not.
 - An incentive has been created to shift from one business model to another – from the tangible personal property to an ASP model.
 - The choice of a business model should be neutral. A business should choose to deliver a product based on how the customer wishes to receive it – not based upon how the product is taxed.

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- His tax policy goal to have a tax with broad application with a lower tax rate than you'd have with a narrow base and his preference to avoid a narrow base if the base is narrowing over time with a shift of essentially the same products.
- The lines are blurred even with products we believe are tangible personal property today. An example is software help that comes from the Internet rather than the hard drive. Is this a web-based product or is it a local product?
- Chair Hunter asked how to have similar tax treatment for all. We have to choose to not tax them or to tax them. Taxing is cleaner and broadens the base, is revenue neutral, and businesses are not disadvantaged if work is done on the business taxation side to make it more neutral.
- Sales tax is paid if you buy a CD or DVD. Sales tax is paid if you rent from a brick and mortar video store. Sales tax is paid if it is bought on line while sales tax is not paid if you stream the video. It's the same movie.
- Chair Hunter acknowledged that like any proposal, his proposal has problems. He also acknowledged that Mr. Collier's concern is a real one – does it create large, new, tax liabilities for businesses in Washington.
- Bruce Reid commented that the SSUTA agreement addresses the user rights issue. There are different rights associated with music in tangible form vs. downloaded music. He explained that if this is the path, he expects to see legislation that clearly defines the expectations around other web-based products so that the uncertainty is not left to the Department's interpretation. If it's not clearly defined in the legislation, then he expects that it's out of the base.
- Mr. Reid also explained that streaming and getting music from the store are not the same. Chair Hunter and Mr. Reid discussed the differences in rights. Mr. Reid offered that there may be no difference from a consumer perspective, but that there are differences from an industry perspective.
- Vice-Chair Zarelli offered that under the use and enjoyment theory, the sales tax is less when there are fewer rights because the cost is less. He noted that if the issue isn't resolved, everything will move that direction and then they'll have to find something else to tax. He'd rather see tax under a use or enjoyment criteria rather than to find another mechanism for tax when the current base has dissolved.
- Chair Hunter noted that this has been a struggle and that there's a lot of detailed work to do around the questions, particularly around the issue of business inputs.
 - Mr. Collier explained that it's necessary to start with dynamic information. With the exception of CCH and REA type access, most of the time access

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to dynamic information has not been taxed. He believes the term can be defined. He further explained that the insurance underwriting industry accesses databases for various types of information. The information is not taxed in any state that he's aware of. Under this proposal, tax would apply.

- Chair Hunter acknowledged that this is so, but also said greater discussion is necessary. He asked how to figure out how to exempt the items.
- Mr. Collier noted that information is not part of the base today. In theory it might be. He further explained that it would be one thing if it was being done nationally, but Washington is carving new ground. A business that's looking at where to structure its presence will likely do so in a state that doesn't tax information.
- Chair Hunter explained that in drafting legislation, there's a need to look at definitions to avoid simple changes in business structures to alter taxation. He also explained that he has not found a way to structurally exempt these things, while still capturing movie rentals. His goal is to have a structure that produces the fewest exemptions. He doesn't want a structure that's so complicated it can't be administered.
- Mr. Collier commented that you could define dynamic information and except videos from the definition – videos typically don't change.
- Chair Hunter, Mr. Collier, and Mr. Bueing discussed the Encyclopedia Britannica in the context of dynamic information. Mr. Collier noted that much of the information he's talking about changes constantly.
- Chair Hunter suggested that rather than trying to define the product, it might be more useful to look at it from a business input model.
 - Ms. Holmstrom agreed there is an importance to defining “digital goods” and then the definition of the “business inputs” exemption. She explained that the proposal can be changed as legislation is drafted. She agreed that some of the language will be difficult to draft and will require a lot of thought and work to capture it just right without unintended consequences.
- Chair Hunter asked Mr. Collier if it would be better to provide a broad exemption for dynamic information or to use a business input exemption. He explained that he's more nervous to try and exempt the product because products are subject to change over time.
 - Vice-Chair Zarelli recommended that pen be put to paper.
 - Mr. Bueing noted that from a business perspective, it's important to note how broad-based some of the things are. He thinks few people are paying tax on standard information and that there's little to give up

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with an exemption for that type of information. He explained that most businesses won't resell the information because it's simply used in the context of providing a service. Mr. Bueing noted that support of the proposal depends on whether a significant amount of information is out rather than trying to find something that draws a line in the sand. From a business perspective, he doesn't think there's much to get behind. He explained that it's hard to support something without knowing the details. He further commented that any significant user of information that sells services would never place another research facility in the state. He explained that he hasn't heard anything from a policy perspective that assures him that businesses wouldn't be subject to a significant increase in taxation.

- Chair Hunter explained that he's not hearing a lot of concern about the structure of his proposal, but that he is hearing significant concern about the taxation of standard information, particularly for service businesses. He commented that this goes back to the beginning and the Department's position that information is taxable and others' position that it's not. He noted a need for numbers before there can be a resolve.
 - Ms. Holmstrom noted that there are some numbers to work with from previous legislation and that Steve Smith (Department of Revenue staff) has done some further work. She explained that the Department can provide the best information it has. She acknowledged that the information is limited.
 - Chair Hunter noted on the need to fit it into the current and long-term budget.
 - Vice-Chair Zarelli asked if there was a comfort level for moving ahead with the current proposal outside of the business inputs issue.
 - Mr. Reid responded that it's clear the business community opposes expanding the base to include digital goods, even the base digital goods. He expressed appreciation for looking at the pyramiding and business inputs issues. Mr. Reid also:
 - Sought clarification that the three bullet points identified in the proposal under "Dealing with Pyramiding of Retail Sales Tax" are intended as concepts rather than limitations to the parenthetical examples;
 - Suggested that nexus (with respect to server farms) continue to be discussed; and
 - Urged, for rules implementation, caution with respect to default sourcing and audit proof for sales to out-of-state customers.

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- There was further discussion about IP addresses, determining where an IP address is located, fraud with respect to persons who set up fraudulent IP addresses to avoid sales tax, and sourcing issues.
- Victor Moore commented that with every concept, the discussion “drills down” to specific words. He recommended drafting specific language.
- Mr. Reid commented that he’d like to see the Committee reach out for more public comment.

5. Remaining discussion of May 29 Proposals (02:04:55)

- Chair Hunter summarized the proposals heard during the May 29th meeting.
 - Steve Collier’s proposal – Points include:
 - Standard/financial/dynamic information
 - Exempting such purchases by all taxpayers, not just financial institutions.
 - There was discussion about exempting all purchases of information that changes versus exempting such purchases as a business input.
 - Bruce Reid’s proposal – Points include:
 - Rights to reproduce and redistribute digital goods are distinct from end-user rights.
 - Chair Hunter believes his proposal addresses this concern.
 - Use tax concerns for server farms.
 - Chair Hunter believes this has been dealt with, although needs to be addressed in the details.
 - Business inputs for web products.
 - Chair Hunter believes this is addressed with a broader business inputs exemption.
 - AWB’s proposal (presented by Ron Bueing) – Points include:
 - Presumption that most digital are not taxable.
 - Chair Hunter noted that his proposal does not address this point.
 - Tax only defined digital goods, music, books, and videos.
 - Chair Hunter noted that his proposal does not limit digital goods to only music, books, and videos.
 - Amnesty for past periods.
 - Chair Hunter commented that this point is a real issue and needs to be worked out.
 - Avoid policies that drive away Washington business.
 - Chair Hunter noted that this is a common concern and that there is a need to handle in a reasonable way business that are not in a digital product business but who consume digital products.
 - Paula Borhauer’s proposal – Points include:
 - Working within the existing excise tax structure

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- Chair Hunter noted his proposal does this.
- Conform to the SSUTA.
 - Chair Hunter noted his proposal does this.
- Avoid tax pyramiding.
 - Chair Hunter commented he believes the proposal does to the same extent as under the current tax structure if not a little bit better.
- Julie Murray’s proposal – Points include:
 - Presume that digital goods are taxable as a retail sale when used or enjoyed in Washington.
 - Chair Hunter noted his proposal does this.
 - Sale for resale exemption applies to products delivered electronically.
 - Chair Hunter noted his proposal does this.
 - Use tax exemption for data storage within the state when right of permanent use of data resides with a third party.
 - Chair Hunter noted his proposal does this.
- Greg Silverman’s proposal – Points include:
 - Establish new classification of tax for digital goods and services (sui generis).
 - Chair Hunter noted his proposal does this by trying to create a new category to define digital goods and services instead of misusing an existing category.
 - Establish a specific test based on marketing and economic substitution to determine if the product is subject to retail sales tax.
 - Chair Hunter noted his proposal does not incorporate this point.
- Mr. Bueing explained that clarity is why AWB’s proposal starts with the presumption that digital goods are not subject to sales tax instead of all digital goods are taxable unless exempt. He commented that any draft must have specificity otherwise it will be gray and there will be further debate.
- Rich Prem noted his assumption that it appears the intent for the new category should specifically address and define the taxation of what he referred to as “digital code.” He recommended keeping the incidence of taxation to where the money is changing hands.

6. Discuss Possible Final Report (02:16:18)

- Chair Hunter noted that based on everyone’s discussion, the way to move forward is to actually propose language:
 - Clearly define digital goods to provide clarity.
 - He explained his nervousness about doing so without knowing the incidence – it’s hard to do the analysis without knowing what you’re trying to measure. He went on to explain that it’s a chicken and the egg situation, but he’s willing to work on language if that’s the next step. A draft will be necessary before session starts.

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- Mr. Bueing noted the difficulty of commenting on proposals and that there is something to be had from working with a draft. A concern is that the draft is in the context of somebody's proposal, not necessarily what they've agreed to.
 - Mr. Bueing and Chair Hunter agreed that nothing has been agreed to.
- Vice-Chair Zarelli commented that a draft is for moving the group forward and is the next logical step. He also explained that the Committee's focus is to generate recommendations – not necessarily to create a bill. A draft can be used as a tool to move forward. If there isn't a level of agreement on what the draft should become in terms of a bill to the legislature, it should not be presented as coming from the Committee. Vice-Chair Zarelli explained that he does not want to bind members of the Committee to supporting whatever comes out of the Committee.
- Chair Hunter paraphrased the discussion as that it would be useful to do a draft, use it as a structure to generate a rough fiscal note and to bring out more public comment. He noted that public comment to date has been "narrow."
- Chair Hunter commented that the Committee must also present a report by September 1st. He acknowledged the low likelihood of having a bill by then. The Committee does need to have a report to present to the House Finance and Senate Ways and Means Committees. He explained that a report could be done at any level of specificity.
 - Vice-Chair Zarelli stated that a good report might be a statement of fact – an informational report that lays out the issues coming in, the discussion the Committee has had, what the outstanding issues are, and maybe a statement that the Committee has agreed to initiate discussion of a piece of draft legislation. A report might contain the facts and knowledge gained rather than a set of recommendations. At this point, the Committee does not know what the recommendations will be that half or all of the Committee could agree to.
 - Jim Justin agreed with Vice-Chair Zarelli. He asked that the final report include the principles that the group has been working with.
- Chair Hunter presented a possible outline for a final report. He noted that it includes everything discussed by the committee and two bullet points on which there is no agreement – "Recommendations" and "Issues Needing Further Exploration." Chair Hunter explained that there is no recommendation with which everyone agrees to be voted on.
- There was much discussion about what work is necessary to complete the work, that there is no final recommendation, the need for additional work beyond September 1st, the need for a draft before members can agree or disagree on a specific proposal, the need for revenue estimates, and whether a report could be ready for the members to vote on at the scheduled August 28th meeting.
 - Chair Hunter noted his discomfort with asking the committee members to vote on a long document that they receive at the meeting or the night before the meeting.

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He acknowledged there is no significant penalty for not hitting one of the dates, but that they do need make a presentation to the fiscal committees.

- Ms. Holmstrom commented that a presentation could still be made to the committees about the work of the Committee. She explained that there is enough information to present to the committees – particularly about the types of issues that are being considered and about the next steps.
- Bruce Reid commented that there’s still work to be done and that the issue is important enough not to “jam something together” to meet a September 1st date. He also suggested adding a section to the appendices for public submissions.
- Rep. Orcutt asked whether the members’ proposals should be included in the report because Bruce Reid’s proposal indicated that it was not for publication or attribution and that it was for discussion purposes only. Mr. Reid commented that it was fine with him to be included because the proposals were presented and are part of the public record. Rep. Orcutt then recommended that the proposals be included for people to see what some of the differences are.
- Chair Hunter commented that he is also concerned about quality. Chair Hunter called a five minute recess for Department of Revenue staff to confer.
- Mr. Reid asked if in addition to the final report, there would be the parallel exercise of creating draft legislation.
- After the recess, it was agreed to:
 - Send a communication to the chairs of the House Finance and Senate Ways & Means committees advising the fiscal committees of the Committee’s work to date, explain the need for further work, and ask for permission to continue with the Committee’s work, and to delay the final report.
 - Make a presentation, as scheduled, to the two fiscal committees during Assembly Days in September ;
 - Complete parallel work on potential draft legislation and fiscal note;
 - Cancel the August 28th meeting and schedule meetings during September, October, and November.

7. Discussion about Public Comment

- Chair Hunter approached the Committee about soliciting public feedback on proposed legislation. He explained that there are two choices to present potential legislation:
 - Use scheduled hearings in the House Finance and Senate Ways & Means committees this fall; or
 - Use the Committee’s venue. It would not be a public hearing such as is done with bill drafts, but the Committee could receive public feedback.
- Mr. Reid responded that it would be a productive way of fleshing everything out before it gets before the Legislature. He also noted that the draft legislation is a working document to see if the Committee members agree or disagree.

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- Vice-Chair Zarelli commented that the Committee, as a working group with the greatest amount of experience with the subject, should first do some vetting of the legislation itself. He suggested that the changes may be narrowed down if the Committee works on the draft first before seeking public input.
- Chair Hunter suggested one meeting as a work session, one meeting for feedback from Committee members and feedback from the public. He also suggested quickly lining up potential meeting dates so that the members can calendar those dates. Chair Hunter commented that a third meeting would also probably be necessary for the Committee to vote on a final report.
- Mr. Reid commented that the Committee would likely receive public comment because the draft will be publicly posted. Mr. Reid proposed providing time for public comment during the Committee's next meeting, the work session.

8. Public Comment²

- There were no public comments.

9. Final Comments

- Steve Collier asked if, when looking at taxes that would go away, if the financial analysis could look actual taxes paid.
- Chair Hunter noted that the analysis wouldn't a formal fiscal note. He thought the information could be presented both ways.
- Ms. Holmstrom explained that this is part of the debate over fiscal notes. She further explained that the Department is required to take a current law approach to fiscal note estimates. For example, the Department has to take a current law approach for the estimate even if a tax wasn't actually paid. She noted that the Department has limited data available for the areas under discussion. Ms. Holmstrom, Chair Hunter, and Mr. Collier agreed that the current law requirement didn't mean that the impact of reality couldn't be discussed.

10. Meeting Adjourned

² Although Chair Hunter typically identifies who signs the attendance sheets at committee meetings, he did not do so for this meeting. For the record, the following persons signed the attendance roster: Bob Longman (Russell Investments), Mike Kelly (K & L Gates), Mark Johnson (Washington Retail Association), Michael Transue (Intelius, Inc.), Tom McBride (McBride Public Affairs), Reid Okimoto (KPMG LLP), Lew McMurrin (Washington Technology Industry Association), and Amber Carter (Association of Washington Business).

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