STATE OF WASHINGTON
DEPARTMENT OF REVENUE
OFFICE OF THE DIRECTOR
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August 28, 2008

The Honorable Margarita Prentice
Chair, Senate Ways and Means Committee
303 John A. Cherberg Building
Olympia, Washington 98504-0411

The Honorable Ross Hunter
Chair, House Finance Committee
333 John L. O'Brien Building
Olympia, Washington 98504-0600

Dear Senator Prentice and Representative Hunter:

Substitute House Bill 1128 (chapter 522, Laws of 2007, P.V.) requires the Department of Revenue (Department) to study the taxation of electronically delivered products. The legislation also provides for the appointment of a committee, including four legislative members, to assist the Department with the study.

Since the Committee's first meeting on October 2, 2007, Committee members have worked diligently on the study and last November, your committees received the preliminary report, as required under SHB 1128. Although scheduled to present a final report next week, the Committee finds additional work is necessary in order to conclude its findings and recommendations. For this reason, I request an extension of time for the Committee's final report to you.

SHB 1128 establishes an ambitious agenda for the Committee. Specifically, the legislation directs the Committee to review:

- The provision of explicit statutory definitions for electronically delivered products;
- The current excise tax treatment of electronically delivered products in the state of Washington and other states as well as the tax treatment of these products under the Streamlined Sales and Use Tax Agreement (SSUTA);
- The administration, costs, and potential recipients of the tax exemptions provided in ESHB 1981 (relating to electronically delivered standard financial information); and
- Alternatives to the excise taxation of electronically delivered products.

In its preliminary report to the Legislature, the Committee concluded the following concerning the taxation of electronically delivered products:

- Current excise tax law lacks specificity, which leads to a lack of transparency and certainty, and results in disagreements between the Department of Revenue, taxpayers, and those charged with the collection and remittance of the tax. This could result in class action lawsuits being filed by customers of those charged with collecting and remitting the tax;
- Application of current law may not be durable in the face of changing technology;
- Developing a tax policy that treats conventional and digital goods equally in all instances will be difficult;
- As new digital goods and existing conventional goods are digitized, Washington and local governments may face a reduction of the retail sales and use tax base if digital goods are removed from the retail sales tax base;
- Many digital activities can be easily moved to other jurisdictions to avoid tax liability; and
- To continue to tax products delivered electronically while remaining in conformity with the SSUTA, Washington must adopt a statute specifically authorizing the taxation of such items.

The Committee has engaged in robust conversations about the taxation of electronically delivered products. The Committee has:

- Discussed current law taxation of electronically delivered products and areas of disagreement between the business community and the Department;
- Examined the treatment of digital goods by other states, Canada and its provinces, and the European Union;
- Considered the requirements of the SSUTA with respect to the tax treatment of digital goods;
- Identified and discussed several key areas of concern held by stakeholders; and
- Discussed alternative approaches to taxing digital goods proposed by committee members.

The Committee has agreed on the following principles that will guide its recommendations to the Legislature; any Committee recommendation should promote the following goals:

- Simplicity and fairness;
- Conformity with the SSUTA;
- Neutrality regardless of industry, content, and delivery method while taking the purchaser's underlying property rights into account;
- Consideration given to the revenue impact of potential changes to the tax base;
- Consideration given to the impact caused by the pyramiding of business inputs;
- Maintaining or enhancing the competitiveness of businesses located in Washington; and

- Maintaining certainty, consistency, durability, and equity despite changes in technology and business models.

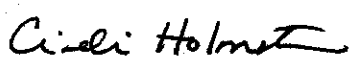
The Committee has identified several key issues to be addressed before the Committee can make recommendations consistent with the above goals. These issues include:

- Defining "digital goods" or "digital products;"
- Whether a transaction is a "digital good" or a professional service;
- Whether a retail sales tax on digital goods should be imposed on a general or a specific basis;
- How to source the sale of digital products in the absence of the purchaser's address without resorting to server location and while remaining compliant with SSUTA requirements; and
- Determining the need for and appropriate level of business input exemptions.

To address the above issues and to provide substantive recommendations to the legislature, the Committee will attempt to develop specific statutory language. This will help Committee members better understand the ramifications associated with any specific proposal. It will also allow the Department to perform the financial analysis necessary to understand the potential impacts to the retail sales tax and business and occupation tax.

As noted above, SHB 1128 directs the Department to deliver a final report to your committees by September 1, 2008. With your approval, the report will be submitted later this fall. The Committee is confident that by continuing its work, it will produce a report that will provide the knowledge and background the Legislature needs to make an informed decision on the taxation of these products. To that end, the Committee has scheduled meetings for September 25th, October 30th, and November 18th. In any event, the final report will be submitted to you before the end of the year.

Sincerely,



Cindi L. Holmstrom
Director

cc: Digital Goods Study Committee Members