

Study of the Taxation of Electronically Delivered Products
Committee Meeting Minutes
October 22, 2007

1. Welcome

- Chair Hunter opened the meeting.
 - Present: Chair Ross Hunter, Vice-Chair Joseph Zarelli, Senator Derek Kilmer, Representative Ed Orcutt, Department of Revenue Director Cindi Holmstrom, Greg Silverman, Julie Murray, Rich Prem, Bruce Reid, Steve Collier, Jim Justin, Ron Bueing, Chuck Robinson, and Paula Borhauer.
 - Present via phone: Greg Silverman
 - Absent: Ben Kim
- Chair Hunter noted that the Committee just received the minutes and is not ready to vote on the minutes. Will vote on minutes at the next meeting. For future meetings, Chair Hunter requests detailed set of written minutes rather than a summary.

2. Panel Discussion: Future of Digital Products and Impacts of Change

- Rich Prem (03:39), Amazon, gave PowerPoint presentation (copies made available to members and audience) discussing the following key themes:
 - What is and is not a digital good
 - Downloaded items are
 - Streaming is not
 - Evolving technology
 - Mr. Prem used the example of concert to show how technology has evolved over time:
 - In-store purchase of DVD
 - Download DVD onto computer
 - Subscription of 20 concerts from a digital library for a flat fee
 - Concerts from the past
 - Stream live concert
 - Attend concert in person
 - Different bundles of content and different customer rights.
 - Telecommunications and cable companies business models.
 - Bundled content with Internet access and the impact of the Internet Tax Freedom Act.
 - Convergence
 - Bandwidth struggle - how to get content to people with different means of access (dial-up to T1-11 lines) will influence how business models evolve.
 - The infrastructure is like a straw and content is filling up the straw.
 - Engineers are trying to figure out how to get more content into the pipe.
 - Telecommunications and cable companies have the “fat pipes.”
 - Tax rules have developed around telecommunications and cable TV companies.
 - Amazon is very concerned about exemptions or special tax regimes applying to the same business model.
 - Globalization

- Digital products can be delivered anywhere in the world without customs, duties, and shipping.
- It's very easy to penetrate international markets.
- Limited payment information.
- Small transactions will be small (I-tunes, music services, 89 cents).
- To avoid costly charge card transactions, there will be block sales or gift certificates.
- Blind payment arrangements through the use of gift certificate and the customer's location will be unknown.
 - Chair Hunter, Vice-Chair Zarelli, and Rich Prem discussed what happens when a gift card is purchased and the tax status of the product is unknown. Possibilities include:
 - Do not tax gift cards and the downstream purchase is a non-taxable event, or
 - Incur the tax out of the gift card.
- Tax policy perspective
 - If the policy is to default to server and headquarters locations, companies will take this into account when making business decisions.
 - Easy to relocate digital companies.
- European Union (EU) experiences
 - Digital goods treated as services rather than as physical goods.
 - Sourcing taxes the market with an administrative advantage for EU companies:
 - Origin sourcing if the sale is by a European company.
 - Destination sourcing if the sale is by a non-European company.
 - Chair Hunter (17:14) asked if it is possible to determine the destination by the IP addresses are located. Rich Prem noted that the EU tried using IP addresses without much success. Chair Hunter would like more information about the EU's experiences with destination sourcing.
 - Rich Prem noted that when a "digital locker" is used, the digital goods will not be delivered to the purchaser's IP address. The digital locker on the company's server and the customer may access for use from any location. Chair Hunter suggested that the taxable event could occur when the seller downloads the digital good to the digital locker.
 - Rep. Orcutt (18:47) asked if Amazon sells gift certificates in stores or on line. Amazon does not sell in stores – only purchased on line. There was further discussion about the use of gift certificates and that the ultimate user may not be the purchaser.
- Bruce Reid, Microsoft (21:14)
 - Instead of looking at specific business models, he believes that Committee needs to determine what it wants the state's policy should be with respect to research and information activities conducted in this state.
 - Microsoft's, and other such as Intuit, Google, Yahoo, are concerned about the investments that they are making in the state.
 - Investments are being made in data centers and the digital products that will be housed in those centers.

- The products housed in those data centers could be software, consumer items, research products used to develop new products, lots of digital “stuff.”
- Mr. Reid believes the Committee needs to determine if they want to encourage investment in this state in research and information.
 - The Governor’s office and public officials say yes.
 - Last year’s legislation SHB 1981 is evidence that there’s uncertainty around how to tax digital property and goods.
- Mr. Reid identified a difference in the draft objectives statement from the legislation – difference between “Consider alternative taxation methods” and “Consider alternatives to the excise taxation.”
- Mr. Reid asked about the Committee’s scope:
- Is it to figure out how to tax electronic goods or to figure what the right policy should be and then to figure out what if anything should be taxed.
- Mr. Reid believes it makes sense to look at both consumer products and business inputs. He explained that Microsoft and others are sitting on information that could fall into either bucket.
 - There was a further Committee discussion about whether the Committee’s scope encompasses all taxation or simply excise taxes.
 - Mr. Reid’s concern is excise taxation because of the potential for unintended consequences.
 - The digital world is comparable to having warehouses full of millions of dollars of inventory.
 - The inventory in data centers may potentially subject to use tax or it could be considered a manufacturing activity.
 - Senator Zarelli (29:02) stated that his understanding of Mr. Reid’s concern is not whether software sold through one format or another, music, or movies sold taxable at a brick and mortar building. He believes that Mr. Reid is concerned if the Committee will venture into areas that have not previously been considered as taxable events. Senator Zarelli agrees that the Committee needs to first determine the policy and then look at the at the smaller questions.
 - Chair Hunter thinks that asking the smaller questions first is interesting and helps to illuminate the bigger policy decisions.
 - Steve Collier (30:24) said that Safeco’s interest is dynamic information – mostly financial information such as bond, credit, driving record, and investment information. The Department sees as being standard financial information and a taxable event. He sees this as more of a service.
 - Chuck Robinson, (32:32 & 34:00) owner of Village Books and past president of the PNW Booksellers, explains that booksellers are concerned equity and simplicity.
 - His business will be at a disadvantage if digital books and music are taxed differently.

- He believes that people buying books are buying the intellectual property (content) and not cardboard, cloth, ink and paper.
 - Booksellers are concerned about complicating the characterization of the products, sourcing, and nexus.
 - Main street merchants will not have the resources for destination sourcing unless it is provided.
 - Many main street merchants also make sales on line.
- Paula Borhauer (36:00) explained that Starbuck does business digitally –mostly on the buying side.
 - Ms. Borhauer believes that there will be many increases in gateways to digital goods.
 - Starbucks now sells I-Tunes cards in its stores. The customer purchases the card and later uses code to down load digital album and other content.
 - Many states tax the transaction of the time of sale, however, the down load can occur anywhere.
 - Redemption of the iTunes digital release card is limited to the a specific digital item and can be taxed as such when sold. Stored value cards are redeemable for any item offered by a seller. Tax is applied when the card is redeemed based on whether the item purchased is taxable or not.
 - The gateway is going to bring in many who’ve never been in the technology business they’ll have to figure out how to do it.
 - Multi-state businesses rely on systems/automation to find and identify taxable items.
 - There is a need to avoid uncertainty.
- Jim Justin of the Association of Washington Cities explained that cities are trying to keep up with technology. Sales tax is the primary revenue source for cities, but technology is quickly changing everything. Mr. Justin emphasized the need to try to find the balance.

3. **Decision Process: Taxability Interpretation Flow Chart**

- Dylan Waits (46:25), Tax Policy Specialist with the Department of Revenue’s Interpretations & Technical Advice Division, explained the Digital Goods Taxation Decision Tree. (Decision tree provided to members and available to audience as handout.) The decision tree was requested by the Committee during the October 2, 2007, meeting.
 - Determining how various digital goods is complicated, fact specific, and centered on the circumstances.
 - Question 1 for analysis is “Is it digital goods?” 1st box on the left. Area of digital goods is very broad.
 - Chair Hunter (52:40)asked if a credit report is a product or a service. Mr. Waits responded that the provision of a credit report is a service that the statute specifically defines as a retail sale.
 - Julie Murray (53:49) noted that discussion is about product but that the statute says we’re taxing tangible personal property. She explained that the definition of tangible personal property is pretty broad. It is personal property that can be seen,

- felt, touched, and analyzed by the senses. She asked if the Department first asks if the product is personal property. Mr. Waits responded that the decision tree considers these issues. There was then a discussion about possession and downloading vs. streaming. Downloading is possession and taxable as a retail sale while streaming is not possession and is taxable as a service.
- Rep. Orcutt (57:07) asked if you specifically go to a movie rental business and rent a movie if that's subject to sales tax. Mr. Waits responded yes.
 - Ron Bueing (58:34) explained that he understands that some services are statutorily defined as retail sales.
 - Mr. Bueing noted that if a service isn't specifically a retail sale, then it must be a sale of tangible personal property. He noted that there's two things subject to sales tax:
 - Services that are specifically enumerated as retail sales; and
 - Tangible personal property.
 - Noting that the statute does not address "product," Mr. Bueing believes that when the Department uses the term Product," the Department really means tangible personal property.
 - Mr. Bueing asked Mr. Waits if standard information is specifically enumerated as a taxable sale or as tangible personal property because to be taxable it must be one or the other. Mr. Waits replied that it is subject to sales tax.
 - Director Holmstrom (01:00) explained that this is the disagreement, it's recognized, and that's why the committee is here. The rule that DOR relies on as well, which comes from the statute, lays out the service or product test illustrated by the decision tree.
 - Ron Bueing responded that from a pure taxpayer perspective, he sees no place in the statute that distinguishes between product or any other item and that tangible personal property is a very important concept.
 - Julie Murray noted that the definition of tangible personal property is very broad.
 - Tangible personal property is property that can be sensed, which is why the definition includes electricity and steam.
 - Before the adoption of streamlined, Washington relied on court cases for the definition of tangible personal property.
 - Mr. Bueing noted that under the history of streamlined, the definition of tangible personal property does not include digital goods.
 - Chair Hunter (01:01) paraphrased Mr. Bueing's concerns as that the statute says to be taxable, needs to either be a specifically enumerated service or be tangible personal property. Chair Hunter explained that instead of deconstructing what the current law is, the Committee is going to make a recommendation about what the law should be.
 - Chuck Robinson (01:03) believes that the distinction between a service or tangible good is blurred. Referring to his earlier book example, Mr. Robinson noted that it's not the book being purchased, it's the content.
 - Dylan Waits once again discussed possession and the issue of downloading vs. streaming.

- With respect to the I-Tunes card purchased from Starbucks, Chair Hunter asked if the taxable moment when the customer buys the plastic card or when it's downloaded. Mr. Waits responded ? Mr. Waits responded that the Department views it as one transaction – the purchase of the code to access the music and the sales tax applies at the store. If the digital code is not accessed, it becomes a service and is subject to service and other B&O tax and no sales tax. (01:07:02) Mr. Waits noted that if the transaction is a retail sale, then you have to determine if there is a specific sales tax exemption. As an example, Mr. Waits noted the exemption for standard financial information purchased by financial institutions.
- Chuck Robinson (01:07:47) asked standard financial information was not simply noted as exempt in box two. Mr. Waits responded that the sale of standard financial information is a retail sale and not a service.
 - Ron Bueing (01:08) explained that many in the business community believe that SHB 1981 was not necessary. Some in the business community believe that standardized information is not a sale of tangible personal property. Even though the Department disagrees with this position, Mr. Bueing believes it is a critical point.
- Dylan Waits (01:08:50) concluded his discussion of the decision tree by noting that if there is no exemption, then the transaction is subject to the retailing B&O tax and the retail sales tax.
- Bruce Reid (01:09:03) asked for clarification that software is not considered a digital good. Mr. Waits responded that software is defined as a retail sale. Mr. Reid asked if DOR was clear that software would never be considered a digital good – even though music or movies are still in electronic form 1 & 0's could still be considered to be software. Response is that software was specifically carved out as a retail sale.
- Chair Hunter (01:09:44) noted that Rule 155 was last revised in 1986, when we didn't think about downloading. Software still purchased in packages.
- Bruce Reid explained that until the adoption of streamlined, the statute never did define software as tangible personal property. It was intentionally simply defined as a retail sale subject to sales tax. Only through streamlined legislation was it defined as tangible personal property to support the way it was previously treated. Noting that office software and digital music are still 1 & 0s and operate the device, Mr. Reid (01:10:57) questioned if they should be considered differently.
 - Rich Prem (01:11:04) agreed with Mr. Reid's comments.
- Rich Prem believes it might be useful to understand how things would change if Washington is to stay compliant with Streamlined. Chair Hunter agreed that it would be useful and stated his understanding of how Washington law would have to change in the next two years. Discussion ensued about the changes between Chair Hunter, Mr. Prem, and Dylan Waits. Chair Hunter indicated that before or as legislation is crafted, it would be good to develop a flow chart to identify the two-step program for changes.
- BREAK

4. Review Draft Problem Statement and Draft Goals

- Gil Brewer (01:31) lead discussion about the draft Problem Statement, Vision and Goals Statement, Future Objectives and Work Plan.

Problem Statement

- Rep. Orcutt (01:32:27) recommended changing problem statement 3 to read “Developing a taxation policy . . . “
- Another member recommended distinguishing between the movement of existing tangible goods to digital and new digital goods. The member also recommended identifying the loss as potential.
- Julie Murray(01:34:35) asked if problem statement #5 was in regard to retail sales tax along or both sales tax and B&O tax. Mr. Brewer responded both, depending on the Committee’s recommendation. Ms. Murray noted that there may not be a collection responsibility, but there would be a use tax liability.
- Chair Hunter (01:35:20) mentioned that Quincy has server farms and questioned how we treat e-mail services. Is it a service subject to the service B&O tax rate or is it a product.
- Gil Brewer (01:35:52) explained that a company with a server located in Washington could be making sales to Washington consumers and the digital goods are downloaded in Washington. The company could move the servers outside the state and the state could lose both the B&O tax and the retail sales tax if the company no longer has nexus.
- (01:36:58) There was discussion about problem statement #6 and whether conformance with the Streamlined Sales and Use Tax Agreement means that the Department would need to change its interpretation or whether it would require a law change. Both Chair Hunter and Vice Chair Zarelli believe the law must be changed so that the Department has something on which to base the WAC.
- There was further discussion about problem statement #1 and current law.
 - Rich Prem (01:39:00) is not so much concerned with disputes with the Department over audit assessments. Mr. Prem’s concerned about disputes with his customers. He explained that class action law suits over the collection of sales tax are becoming frequent because the law lacks certainty and clarity. Clarity and transparency are necessary so that retailers are not sued and consumers know what is and is not taxable. Mr. Prem asked that the problem statement reflect this concern.
 - Ron Bueing (01:40:27) believes that the current statute is adequate with respect to digital goods. The statute addresses digital goods because the statutes taxes only tangible personal property and specifically enumerated services. He explained a theory held by some in the business community that tax applies only to those things that are specifically enumerated. Items that are not specifically enumerated are not subject to tax.
 - Vice Chair Zarelli (01:41:50) suggested changing the statement to read “current law should be clarified to expressly address the digital environment.” He explained that current law should be clarified because there is dispute.
 - Chair Hunter (01:42:38) left to attend a meeting of the Education Funding Taskforce. Vice Chair Zarelli lead the conversation.
 - Bruce Reid (01:43:42) believes that SHB 1981 means that everything is subject to tax except for sales of standard financial data. By inference, there

was no need for the legislation absent how confusion over the taxability of digital “stuff.” There was further discussion between Mr. Reid and Mr. Bueing (01:44:04) as to the intent of ESHB 1981 and the budget proviso. Mr. Reid believes that the carve out for the financial services industry gave inference that there might be credibility to the Department’s taxation of standardized data.

Vision and Goals Statement (01:46:30)

- Rep. Orcutt suggested eliminating “Recognize the need for” because the goal is not to recognize the need. The goal is to have simplicity and fairness.
- (01:47:33) There was no discussion about vision and goal statement #2 – conforming to the Streamlined Sales and Use Tax Agreement.
- Ron Bueing (01:47:55), in respect to vision and goal statement #3, doesn’t disagree with neutrality in the method sent. He noted importance of recognizing difference between a physical book and a digital book. He explained that it is difficult to reproduce the physical book while it is easy to reproduce a digital book over and over. Mr. Bueing used the example of standard information as illustration. Due to the cost, he would have to think about mailing flyers to 100,000 to potential clients, whereas he might not think twice about sending out 100,000 e-mails. If both methods were to be taxed the same, e-mailing could result in a large liability for use tax.
- Another member (01:49:00) agreed in large part with Mr. Bueing’s statement, although he was concerned with the word “technology.”
- Vice Chair Zareil (01:50:05) believes that the goal is stay neutral to changes in the market place so that tax policy doesn’t have to be redefined every year. He questioned why the sale of a book in a store should be taxed but the sale of a book over the Internet shouldn’t be taxed.
- Rich Prem synthesized the points he heard as delivery channel and underlying rights – e.g., streaming vs. downloading. Another member suggested incorporating neutrality with respect to industry.
- Vice Chair Zarelli wants to define the taxable event.
- Rich Prem (01:55:??) suggested incorporating in #4 or #5, the pyramiding of business inputs and unintended consequences.
- (01:58:11) With respect to problem statement #5, there was a discussion between Rich Prem, Vice Chair Zarelli, and Rep. Orcutt about maintaining and improving the state’s competitiveness and considering a policy that encourages new business in the industry to come to the state.
- Ron Bueing (02:00:03), as concerns #6 and maintaining consistency, durability, and equity despite future changes, questions whether it can ever be achieved because of the lack of a crystal ball. He believes determining the taxation now for the future is a futile effort because:
 - 1) It won’t be right; and
 - 2) It takes away from working on it when there is an understanding and the ability to promote a correct tax policy.

- Vice Chair Zarelli (02:01:17) believes there is value to looking towards the future. He believes you can name every item subject to tax in the code or; determine the taxable events. Vice Chair Zarelli prefers the latter.
- Director Holmstrom (02:02:20) believes that there are challenges to meeting goal statement #6, but believes it is an important goal from a tax administrative perspective.
- Ron Bueing (02:02:38) disagrees with the concept taxing everything except for what is specifically exempt. Mr. Bueing believes it possible to have a system that provides consistency and reliability. It may not start with the premise of taxation, but it provides consistency and reliability until there's an opportunity to determine if something should be taxable.
- Rich Prem (02:04:04) believes that the word "technology" might be too narrow. Technology is an enabler to changes in business models and processes. He explained that Amazon is a good example because it had to have the technology, but a whole business model grew up around the technology. Mr. Prem recommends broadening the statement to include certainty.
- Julie Murray (02:05:16) doesn't believe that goal statement #6 presupposes either way of taxing. Ms. Murray believes goal statement #6 means that whatever policy the Committee recommends will have life beyond the Committee and beyond two years.
- (02:06:09) There was a discussion about if there is a need for another bullet distinguishing as a goal for taxing digital services vs. retail sales. There was the conclusion that it's inferred by the overall task.
- Chair Hunter (02:09:08) returned and Vice Chair Zarelli provided brief recap as to final statement. No further changes.

Future Objectives and Work Plan

- Gil Brewer (02:09:30), Department of Revenue, explained that the future objectives and work plan primarily came from the legislation establishing the Committee. DOR also added a few that seemed obvious based on comments from the previous committee meeting. The Committee will resume meeting in April, after the Legislative Session, and will meet monthly thereafter or as often as necessary through September 1, 2008.
- Member (02:10:27) questioned if "digital products is the right word or whether it should be "digital goods" for objective #1 – researching how other jurisdictions treat digital goods. Response that the specific words in the budget proviso are "electronically delivered products," and that the Department has shortened it to digital products.
- Chuck Robinson (02:11:14) asked if the Oklahoma amendment for the Streamlined Sales and Use Tax Agreement used electronically delivered rather than digital products or goods. Discussion between Chair Hunter, Vice Chair Zarelli, Director Holmstrom, and Gil Brewer about the proper term to use and intention is to have broadest term possible.
- Steve Collier (02:12:43) asked if in looking at Canada and the E.U. if that means the Committee's task or goal includes throwing out the current model. Canada

- and the EU have value added taxes (VAT) There was a discussion that even though this state wouldn't use a VAT, it's worthwhile to see what they're doing.
- Chair Hunter (02:15:34) wants to make sure that the EU research includes Iceland. Iceland has a lot of hosting businesses.
 - Rich Prem (02:15:50) based on his experiences, believes it will be very interesting looking at the EU from the competitive aspects of power, policy, and choices.
 - Chair Hunter (02:16:22) asked why the Department is going to research the Far East and would like to do so if it makes sense. He asked Committee to delegate to him to look at in a brief overview and he'll make a recommendation to the Committee via e-mail after talking with staff.
 - Rep. Orcutt (02:17:35) has concerns about using a term other than that used in the budget proviso.
 - Vice Chair Zarelli (02:19:20) with respect to objective #3, the Committee decided to include a discussion of current law, how others interpret the law, and revenue estimates for both interpretations in the preliminary report
 - (02:22:00) There was a discussion about the report process. It was explained that a preliminary report goes to the Legislature this year based on what the Committee reviewed. There will be another draft at the next meeting and the Committee will be able to make final word-smithing changes before voting on the report.
 - (02:22:42) There was a discussion about the revenue estimates.
 - Gil Brewer (02:24:24) in presenting objective #6, explained that the statement will be altered to parrot the budget proviso.
 - Rich Prem (02:27:34) asked if it within the Committee's scope address "digital bundling" due to the Internet Tax Freedom Act and changes coming along from Streamlined. Chair Hunter responded affirmatively, but that they'll also have to see what Congress actually does.
 - Chair Hunter (02:29:06) hopes that at the next meeting the Department will report on other jurisdictions tax treatments.
 - Rep. Orcutt (02:29:33) referring back to object #1, noted his concern about using terms that are different than the term used in the budget proviso. The discussion about terms was tabled until the November 15th meeting after the Department gives its report on other jurisdictions.
 - Gil Brewer, (02:32:23) Department of Revenue, committed to getting an updated draft back to the Committee members as soon as possible before the next meeting. Will send to Committee members and interested parties. Asked members to send back comments. Next meeting will be finalizing the document, hearing the report on other jurisdictions, and may be have analysis of current treatment and numbers. Coming out of the meeting will have a closed report to the Legislature.

5. Future Meetings/Schedule/Agenda

The next meeting will be November 15, 2007.

6. Public Comment

- Kim Risenmay, (02:34:54) Risenmay Law Firm. There are three issues to the taxation of digital goods:

- B&O tax,
- Sales taxes, and
- Potentially use taxes.

- Mr. Risenmay explained his interpretation that sales of digital goods are neither retail sales nor sales of services. He believes the income is subject to the B&O tax as royalties for revenue derived from the use of intangible property under RCW 82.04.2907.
- As a citizen and a resident of Washington and, he suggests that it is in the state's best interest to have clarity.
- He believes that whether or not digital goods are tangible personal property is a red herring.
- He discussed nexus and the need for large business to correctly know whether they have nexus.
- He discussed the problems with determining where a sale of tangible personal property occurs and explained that there's even more complexity with intangibles.
- If digital goods are subject to sales tax, the unintended consequence may be a use tax liability when business documents are digitally viewed.
- Taxpayers need clarity because the Department has been changing its position through the accretion method.
- Mr. Risenmay urged the Committee to bring together a comprehensive package to eliminate as many areas of uncertainty as possible.

- Chair Hunter (02:44:21) noted that Kim Risenmay shares a goal as everyone else. Chair Hunter identified those who signed in for the meeting – Greg Pierce from Microsoft, Christine Lane from Moss Adams, Ralph Ammon from Boeing, Amber Carter from AWB, and Bob Longman from Russel Investment Co.
- The meeting adjourned.

Minutes of the October 22, 2007 meeting were amended and approved during the November 15, 2007 meeting. An additional amendment to the October 22, 2007 meeting was made and approved during the April 24, 2008 meeting.