



Study of The Taxation of Electronically Delivered Products

Preliminary Report

November 30, 2007

Why study the taxation of electronically delivered products?

ESHB 1981 (chapter 182, Laws of 2007) enacts a sales and use tax exemption for sales of electronically delivered standard financial information to investment management companies or financial institutions.

Because ESHB 1981 limits the sales and use tax exemption to a specific type of electronically delivered product, SHB 1128 (chapter 522, Laws of 2007, P.V.) recognizes that the taxation of other types of electronically delivered products, including standard financial information, remains a policy question. SHB 1128 directs the Department of Revenue, with the assistance of a committee, to study the taxation of electronically delivered products.

Preliminary Committee Report

SHB 1128 requires the committee to report its preliminary findings and recommendations to the House Finance Committee and the Senate Ways and Means Committee by November 30, 2007.

This preliminary report encompasses:

1. Legislative Background and Terminology;
2. Problem Statement;
3. Vision and Goals Statement;
4. Department of Revenue Interpretation of Current Law;
5. Association of Washington Business Interpretation of Current Law;
6. Tax Treatment by Other Jurisdictions of Electronically Delivered Products; and
7. Future Objectives and Work Plan.

Committee Members

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1 Legislative Background

SHB 1128 provides that a committee will assist the Department with the study of the taxation of electronically delivered products. The legislation provides that one member from the two largest caucuses of each chamber will serve on the committee. In addition, the Department is to appoint additional members representing government and industry.

Legislative committee members include Representative Ross Hunter (Chair), Senator Joseph Zarelli (Vice Chair), Senator Derek Kilmer, and Representative Ed Orcutt. Committee members representing state and local government include: Jim Justin (Association of Washington Cities); Julie Murray (Washington State Association of Counties); Victor Moore (Office of Financial Management); and Cindi Holmstrom (Department of Revenue). Academic members include Greg Silverman (Seattle University School of Law) and Ben Kim (Seattle University, Albers School of Business and Economics). Members representing industry include: Rich Prem (Amazon.com Inc.); Bruce Reid (Microsoft Corporation); Ron Bueing (Association of Washington Business); Chuck Robinson (Village Books in Bellingham); Paula Borhauer (Starbucks); and Steve Collier (Safeco).

SHB 1128 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;
- The administration, costs, and potential recipients of the tax exemptions provided in chapter ESHB 1981; and
- Alternatives to the excise taxation of electronically delivered products.

The committee's final requirement is to report its findings and recommendations to the Senate Ways and Means and House Finance Committees by September 1, 2008.

Terminology

SHB 1128 uses the term "electronically delivered products." For the purposes of this report, the terms "digital goods" and "digital products" are used interchangeably with "electronically delivered products." However, these terms may be determined to have different meanings in the future.

2 Problem Statement

With respect to the taxation of products delivered electronically and/or digital goods:

1. 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.
2. Application of current law may not be durable in the face of changing technology.
3. Developing a tax policy that treats conventional and digital goods equally in all instances will be difficult.
4. 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 and use tax base.
5. Many digital activities can be easily moved to other jurisdictions to avoid tax liability.
6. To continue to tax products delivered electronically while remaining in conformity with the Streamlined Sales and Use Tax Agreement, Washington must adopt a statute specifically authorizing the taxation of such items.

3 Vision and Goals Statement

The Committee envisions recommending to the Legislature options that promote the following goals:

1. Simplicity and fairness.
2. Conformity with the Streamlined Sales and Use Tax Agreement.
3. Neutrality regardless of industry, content, and delivery method while taking the purchaser's underlying property rights into account.
4. Consideration given to the revenue impact of potential changes to the tax base.
5. Consideration given to the impact caused by the pyramiding of business inputs.
6. Maintaining or enhancing the competitiveness of businesses located in Washington.
7. Maintaining certainty, consistency, durability, and equity despite changes in technology and business models.

4 Department of Revenue Interpretation of Current Law

Electronically delivered products, or “digital goods” for purposes of this report, include data (e.g. music, movies, books, and financial statistics), facts, knowledge, or procedures in electronic form and delivered by any means. The sale of digital goods is subject to either retail sales tax (RST) and retailing or wholesaling business and occupation (B&O) tax or service and other activities B&O tax. The *true object* of any transaction involving digital goods is either the sale of a service or the sale of a product (see WAC 458-20-155, the Department of Revenue’s rule on information and computer services). A service is generally the activity of customizing a digital good for sale to one specific customer, while a product is generally a digital good that is offered to multiple customers.

Sale of a Service

If the true object of the transaction involving a digital good is the sale of a service, then the digital good involved in the transaction is merely tangible evidence of the service activity rendered. Gross income from the sale of a service is usually subject to service and other activities B&O tax. However, if a service is statutorily defined as a retail sale, then the sale of the service is subject to RST and the retailing B&O tax classification applies to amounts derived from the sale. For example, credit bureau services are defined as a retail sale. Thus, a credit bureau’s sale of a customized credit report, whether the report is delivered to the customer electronically or otherwise, is a retail sale subject to RST and B&O tax under the retailing classification.

Sale of a Product

If the true object of the transaction involving a digital good is the sale of a product (for example, standard information), then the Department looks at whether the customer takes possession of the digital good to determine if the transaction is a retail sale. If the customer does not take possession of the digital good (e.g. streaming music), then the transaction is not a retail sale and the gross income from the transaction is subject to B&O tax under the default service and other activities classification. If the customer is entitled to take possession of the digital good (e.g. downloading music), then the Department treats the transaction as a retail sale of tangible personal property subject to RST and B&O tax under the retailing classification. However, some retail sales are statutorily exempt from RST.

A case in point involves a law recently enacted. Effective August 1, 2007, in accordance with chapter 182, Laws of 2007 (ESHB 1981), sales of electronically delivered standard financial information to an investment management company or a financial institution are exempt from retail sales and use tax. Such sales are subject to B&O tax under the retailing classification. Standard financial information is defined as “any collection of financial data or facts, not compiled for a specific consumer, including financial market data, bond ratings, credit ratings, and deposit, loan, or mortgage reports.”

It is important to note that “information services” (for example, statistical database access) are generally subject to B&O tax under the service and other activities classification. However, the term “information services” does not include standard information that is delivered or made available through any means, such as through a tangible storage medium or through electronic download. Currently, sales of standard information to consumers are retail sales subject to RST and the B&O tax under the retailing classification.

Other Interpretations of Current Law

The Department’s interpretation of current law as it pertains to digital goods is not universally accepted by taxpayers or tax practitioners. The Association of Washington Business’s (AWB) interpretation on current law, which follows, is one example of an interpretation that differs from the Department’s position. There may be other perspectives on current law from the business community not reflected in this interim report. Other perspectives from parties that have not provided input to the Committee may be aired during the coming year and appear in the Committee’s final report.

5 Association of Washington Business (AWB) Interpretation of Current Law: The Status of Taxation of Digital Goods – A Taxpayer Perspective

Only retail sales are subject to retail sales tax. The term “retail sale” is specifically defined in RCW 82.04.050. An item must be included within this definition to be treated as a retail sale. This definition includes all sales of tangible personal property and a number of other specifically enumerated services and other items that are not tangible personal property. If an item is not included in RCW 82.04.050; it is not a “retail sale.”

“Retail Sales” under RCW 82.04.050

1. Sales of Tangible Personal Property
2. Sales of Specifically Enumerated Services, such as
 - Installing, Repairing, Cleaning, Altering, Imprinting, or Improving of Tangible Personal Property for Consumers.
 - Constructing, Repairing, Decorating, Improving, Cleaning, Fumigating, Razing or Moving of Buildings or Other Structures.
 - Automobile Towing and Similar Automotive Transportation Services.
 - Furnishing of Lodging and All Other Services by a Hotel, Rooming House, Tourist Court, Motel or Trailer Camp.
 - Amusement and Recreation Services.
 - Abstract, Title Insurance, and Escrow Services.
 - Credit Bureau Services.
 - Automobile Parking and Storage Garage Services.
 - Landscape Maintenance and Horticultural Services.
 - Service Charges Associated With Tickets To Professional Sporting Events.
 - Physical Fitness Services, Tanning Salon Services, Tattoo Parlor Services, Steam Bath Services, Turkish Bath Services, Escort Services, and Dating Services.
 - Telephone Service.
3. Other Specifically Enumerated Items
 - Renting or Leasing of Tangible Personal Property With or Without an Operator.
 - Prewritten Computer Software Regardless of Method of Delivery.
 - Extended Warranties.

Digital goods are not tangible personal property. There is no test of digital equivalency in connection with retail sales. Certain digital goods, such as digital music downloads, digitally downloaded movies and digitally downloaded books may or may not be prewritten computer software. CDs, DVDs, books, tapes, etc. are tangible personal property.

Information is not tangible personal property. Information services are not specifically enumerated retail sales. Books, magazines, newspapers, and printed materials are tangible personal property. Sales of such items are retail sales; sales of information services are not retail sales.

The adoption of chapter 182, Laws of 2007 (ESHB 1981), providing an exemption for sales of electronically delivered "standard financial information," was meant to provide resolution to a specific dispute between the Department of Revenue and a taxpayer. ESHB 1981 was not intended to decide the broader issue of whether "standard financial information" or any information services are subject to retail sales tax.

Technological advances change how information is used and change the universe of questions applicable to taxation. A digital download of music can be different in myriad of ways from a CD or record. The mere fact that a technological alternative replaces or displaces a piece of tangible personal property should not be determinative of its taxation. The taxation of such items should be the result of a thoughtful approach taking into account the characteristics and uses of that item. Thoughtful decisions with respect to appropriate methods and approaches to taxation will not bankrupt government, but will result in consistent and fair taxation of new technology.

6 Tax Treatment by Other Jurisdictions of Electronically Delivered Products

For a view of the taxation of electronically delivered products by other jurisdictions, the tax structures of the European Union (EU), Canada, and the United States (including the Streamlined Sales & Use Tax Agreement (SSUTA)) were reviewed. This review sought the answers to two key questions:

1. What are the jurisdictions' equivalent of electronically delivered products; and
2. What are the jurisdictions' tax treatments of such equivalent electronically delivered products?

European Union (EU)

The EU member countries apply their value-added tax (VAT), a consumption tax, to electronically delivered products. For consumption purposes, all sales of supplies (goods or services) provided via the Internet are characterized as "supplies of service."

Examples of "electronically supplied services" include:

- Website supply, web-hosting, distance maintenance of programs and equipment.
- Software and software updates.
- Database Access.
- Music, films and games (including games of chance and gambling games), and political, cultural, artistic, sporting, scientific and entertainment broadcasts and events.
- On-line access to education.
- On-line access to banking and brokerage service, and advertising services.

The EU's conclusion that electronically delivered products are services does not impact the taxability of electronically delivered products because both goods and services are generally subject to the VAT.

Canada

Canada does not consider electronically delivered products to be tangible personal property. Canada characterizes a "supply made by electronic means" as either a supply of intangible personal property or a supply of service. The Canada Customs and Revenue Agency (CCRA) uses multiple factor tests to make this distinction.

A sale of intangible personal property occurs when there is the sale of:

- A right in a product or a right to use a product for personal or commercial purposes, such as:
 - Intellectual property or a right to use intellectual property (e.g., a copyright); or
 - Rights of a temporary nature (e.g., a right to view, access or use a product while on-line);
- A product that has already been created or developed;
- A product created or developed for a specific customer and the supplier retains ownership of the product; and
- A right to copy a digitized product.

The sale of the supply of a service occurs when:

- The supply does not include the provision of rights (e.g., technical know-how), or if there is a provision of rights, the rights are incidental to the supply;
- The supply involves specific work that is performed by a person for a specific customer; and
- There is human involvement in making the supply.

Canada imposes the GST/HST¹ consumption tax on both types of electronically delivered products (intangible personal property and services), as well as on tangible personal property, intangible personal property and services not delivered electronically. The distinction merely determines whether the seller collects and remits GST/HST (goods) or the buyer self-assesses GST/HST (service/IPP), not whether the electronically delivered product is subject to tax in Canada.

United States (and SSUTA)

The fifty states have taken different approaches to defining and taxing digital goods. This was shown in a survey of the fifty states with respect to cell phone downloads of ring tones, games, music, pictures, and other information.² Twenty-one states impose sales and use tax on the charges for these downloads. Five states do not impose sales and use tax. Four states have sales and use tax, but do not impose sales and use tax on these cell phone related transactions. The remaining twenty states do not impose sales and use tax on the charges for these downloads.

The following four states exemplify the spectrum of approaches. These two states treat electronically delivered products as intangible personal property:

- New York defines prewritten computer software as tangible personal property for sales tax purposes, but “charges for music, audio recordings, or artwork delivered electronically for download on customers’ computers or other devices are not sales of tangible personal property and are thus not subject to sales tax.”³
- Tennessee holds that “digital transmissions of anything other than software are not tangible personal property and are not subject to tax since they are not taxable services. This position essentially exempts solely based on the mode of transmission, as transmissions of electronic files contained on discs, tapes, or other tangible media are taxable.”⁴

¹ The goods and services tax (GST) applies to the supply of most goods and services in Canada. The GST rate is 6%, and the HST rate is 14%. Three provinces (Nova Scotia, New Brunswick, and Newfoundland and Labrador) harmonized their provincial sales tax with the GST to create the harmonized sales tax (HST). The HST applies to the same base of taxable goods and services as the GST. Other provincial sales taxes were not reviewed.

² “Sales/Use Tax Treatment of Cell Phone Related Transactions (Part 2),” Healey, John C. and Michael S. Schadewald, 2007 Multistate Corporate Tax Guide Volume II, Sales/Use Tax (CCH 2006) II-486.

³ Advisory Opinion S060313A, TSB-A-07(16)S, 2007 WL 2026396 (N.Y. Dept. Tax. Fin.).

⁴ Tennessee Department of Revenue Sales and Use Tax Guide, February 2007 at page 10.

These two states treat electronically delivered products as tangible personal property:

- Alabama held that digital photographs constitute tangible personal property and that gross proceeds from the retail sale of those electronically transmitted photographs thus are subject to the Alabama sales tax.⁵
- Utah holds music to be tangible personal property in the form of prewritten computer software or computer generated output.⁶ However, the Utah Tax Commission has ruled that a charge to simply access a database is not taxable if items are not downloaded onto the customer's computer.

SSUTA

In 2001, Streamlined Sales Tax Project began an initial survey⁷ of participating states on the tax treatment of digital goods. At the time, nine states taxed digitized goods. Six of these states appeared to tax them on the theory that digitized goods are tangible personal property. Fourteen states did not tax digitized goods. Nine of these states appeared to exempt them from tax on the theory that digitized goods are not tangible personal property.

On September 20, 2007, and effective January 1, 2008, SSUTA was amended to define three specified digital goods (digital audio-visual, digital audio, and digital books) as not being tangible personal property. All other electronically delivered products will not be tangible personal property under the SSUTA definition effective of January 1, 2010. Each member state will have up to two years from each effective date to come into compliance with the new agreement terms. Until the member states do so, their current law remains in effect.

Therefore, under SSUTA, member states cannot and will not be able to impose RST on electronically delivered products on the basis that electronically delivered products are tangible personal property.

Member states may impose RST on electronically delivered products separate from its imposition tax on electronically transferred products, but the state must specifically impose and enumerate whether the tax is only on end-users or rebroadcasters, permanent right users or terminable right users, and subscribers or non-subscribers.

⁵ *Robert Smith d/b/a FlipFlopFoto v. State Department of Revenue*, Admin. L. Div. Dkt. No. S05-1240.

⁶ See *South Cent. Utah Telephone Ass'n, Inc., v. Auditing Div. of Utah State Tax Comm.*, 951 P.2d 218 (1997). See also Utah Administrative Rule R865-195-92.

⁷ The initial survey was not completed. It is suggested that the responses received may not have accurately reflected the taxing agencies' official positions with regard to the taxation of electronically delivered products.

7 Future Objectives and Work Plan

Following the 2008 Legislative Session, the Committee will resume meetings in April 2008, and meet monthly or as needed thereafter until the conclusion of the study by September 1, 2008.

Objectives and Work Plan

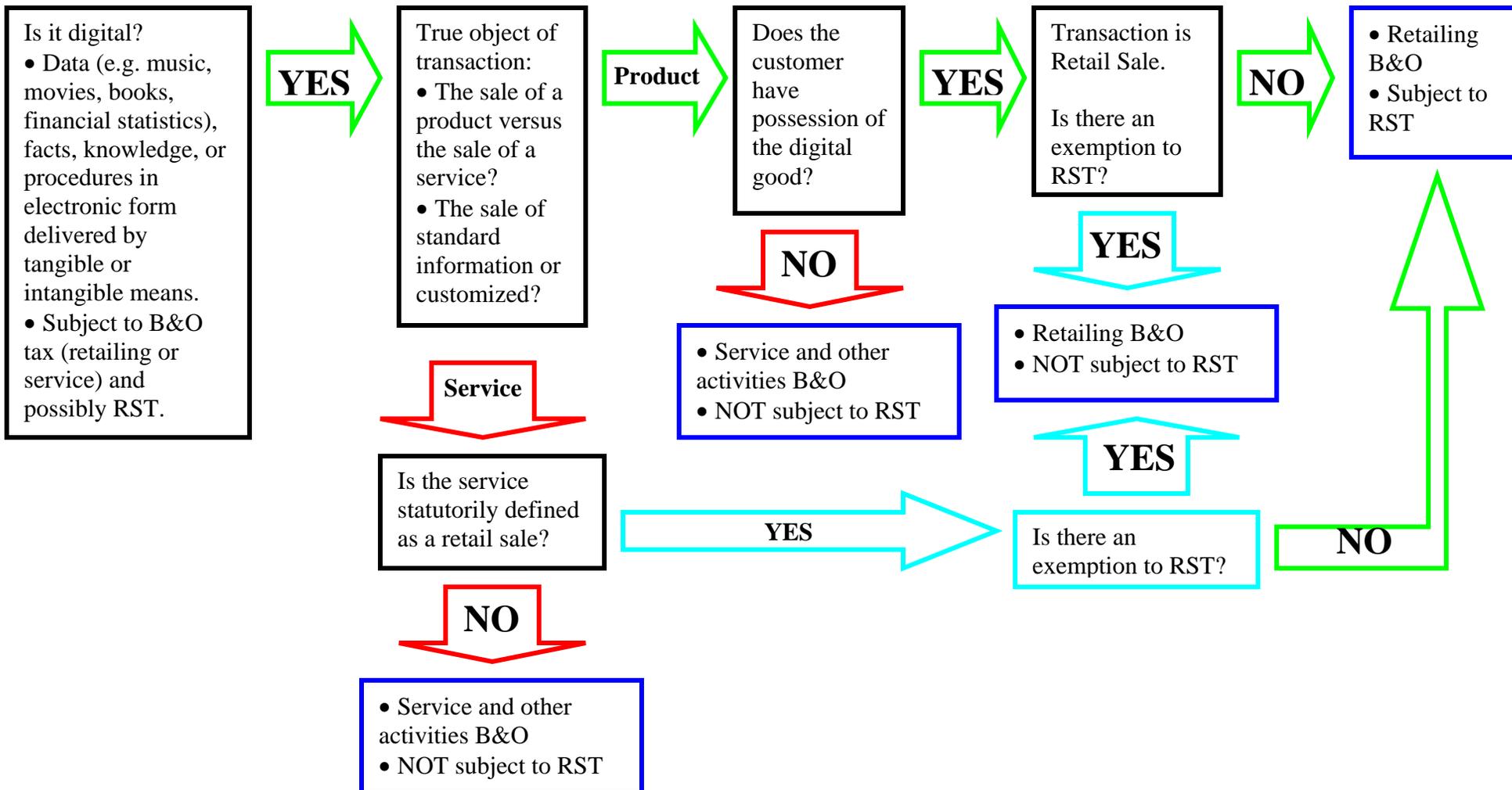
1. Research other jurisdictions' tax treatment of any product delivered electronically, however described, that fall within the scope of electronically delivered products. Other jurisdictions include the United States, Canada, European Union, Iceland, and the Far East.
2. Review the administration, costs, and potential recipients of the tax exemptions provided in chapter 182, Laws of 2007 (SHB1981 - standard financial data exemption).
3. Prepare a report that describes the Department's and others' interpretation of the taxability of products delivered electronically under current law, provides revenue estimates for both interpretations, and establishes long-term trend analysis.
4. Identify and evaluate means for maintaining conformity with the Streamlined Sales and Use Tax Agreement with regard to products delivered electronically.
5. Identify current and likely future products delivered electronically.
6. Consider alternatives to the excise taxation of electronically delivered products, including the provision of explicit statutory definitions for electronically delivered products.
7. Determine current electronically delivered products issues and investigate impacts and remedies.
8. Consider the effect of recent amendments to the federal Internet Tax Freedom Act on the taxation of digital bundles that contain electronically delivered products.
9. Prepare and approve final report to the Legislature by September 1, 2008.

Future Meetings

Future committee meetings will occur as follows:

Date	Time	Location
Thursday April 24, 2008	10 a.m. – 3 p.m.	John O'Brien Building - Hearing Room D Capital Campus, Olympia, WA
Thursday May 22, 2008	10 a.m. – 3 p.m.	John O'Brien Building - Hearing Room D Capital Campus, Olympia, WA
Thursday June 19, 2008	11 a.m. – 3 p.m.	John O'Brien Building - Hearing Room D Capital Campus, Olympia, WA
Thursday July 24, 2008	10 a.m. – 3 p.m.	John O'Brien Building - Hearing Room D Capital Campus, Olympia, WA
Thursday August 28, 2008	10 a.m. – 3 p.m.	John O'Brien Building - Hearing Room D Capital Campus, Olympia, WA

DIGITAL GOODS TAXATION DECISION TREE (DOR Version)



DIGITAL GOODS TAXATION DECISION TREE (AWB Version)

