

On the Taxation of Digital Goods and Services

Delivered Over the Internet

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The following are some provisional and tentative thoughts on the task before us. I offer them with the aim of facilitating discussion of issues that we must address in order to fulfill our legislative mandate.

In formulating our recommendation for the State Legislature, there are, in my opinion, at least four basic questions that must be addressed:

- (1) Does the State have the legal authority to tax digital goods and services?¹
- (2) Should the State impose taxes on any digital goods and services?

¹ Throughout this document I use the phrase “digital goods and services” rather than the more common “digitally delivered products.” I prefer the former to the latter because it does not prejudge the issue whether the downloaded digital files are the transfer of a product or the result of using a service. As shall become clear later in this document, I am inclined toward a service-oriented analysis and, therefore, prefer a nomenclature that is neutral on this issue. Moreover, I use the phrase “digital goods” to mean goods that are delivered without the transfer of title to a tangible medium. Digital files purchased on a tangible medium such as a DVD or CD are tangible goods, not digital goods. When I purchase a music CD, I take title to the CD on which the music files reside. Accordingly, this is the purchase of a tangible good. When I purchase a song from iTunes, I purchase the song without taking title to any tangible medium on which the music file resides. In this context, I am purchasing a digital good. While digital goods are typically delivered over the Internet, it is possible that such goods could be delivered using a tangible medium such as a USB drive that one already owns or has borrowed from another. Again, I leave for later discussion whether a digital good is in fact a service.

- (3) If so, which digital goods and services should be taxed by the State?, and
- (4) If the State decides to tax certain digital goods and services, how should those digital goods and services be taxed? Should such digital goods and services be taxed as tangible goods, intangible goods, services or in a manner *sui generis*?

I will briefly address each of these questions in turn.

With respect to the first question, it is clear that under the Constitution of the State of Washington, the State has the general legal authority to impose taxes on digital goods and services. The power to tax is an incident of sovereignty,² and as the State Constitution proclaims, it extends to “everything, tangible or intangible, subject to ownership.”³ “Exercised within constitutional limits,” the State Supreme Court has noted, “the power of a state to tax has been called plenary, and all subjects over which this sovereign power extends are objects of taxation.”⁴

The second question, whether the State should impose taxes on *any* digital goods and services, is somewhat more challenging. On the one hand, economists teach us that any taxation on goods and services leads to a dead weight loss of consumer surplus and, *a fortiori*, of social utility (i.e., social wealth). On the other hand, states need revenue to operate and provide for the public good. Ideally, therefore, one should only tax an item if the public benefit provided by the activities financed by that tax is greater than the dead weight loss of consumer surplus created by that tax. In other words, one should only tax a digital good or service if, *ceteris paribus*, that tax yields a net increase in social utility and wealth. Clearly, all other things being equal, as consumers and businesses substitute transactions in digital goods and services conducted over the Internet for traditional “brick and mortar” transactions that are subject to sales and use taxes, the

² M’Culloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819); Ward v. Maryland, 79 U.S. (12 Wall.) 418 (1870); State Tax Commission of Utah v. Aldrich, 316 U.S. 174 (1942).

³ WASH. CONST. art. 7, § 1.

⁴ Smith v. State, 64 Wash. 2d 323, 391 P.2d 718 (1964).

State will suffer a decline in revenue unless transactions in digital goods and services are also subject to taxation. Just as clearly, however, taxing digital goods and services will decrease the social utility in the form of consumer surplus that will be generated by these digital goods and services: fewer people will choose or be able to purchase these digital goods and services because of the additional cost created by the tax. The critical question is whether this dead weight loss in consumer surplus is greater than or less than the social utility of the public benefit achieved through this tax. If the dead weight loss is greater than the social benefit, then the State should not tax these digital goods and services. If the dead weight loss is less than the public benefit, then it should. As a practical matter, two points must be noted. First, the calculation of whether the tax is likely to yield a net public benefit should be based on empirical data. Typical sources of such data include reports, studies and testimony by economists and others who study the economy and particular markets within it. Second, to maximize overall social utility, this calculation should be made separately for each specific category or kind of digital good and service that might be taxed rather than lumping all digital goods and services together into an undifferentiated whole for this purpose. This brings us to the third question.

The third question asks which digital goods and services should be taxed by the State. Based on the considerations described above, it is clear that the State should tax those and only those digital goods and services whose taxation would yield a net increase in social utility. As a general maxim or principle of efficient taxation, this response to the question is hardly controversial. But it provides little guidance to the more practical imperative of identifying the actual categories or kinds of digital goods and services that should in fact be taxed by the State. I have already stated that identification of those specific categories or kinds of digital goods and services should be based upon empirical data provided through reports, studies and testimony on the economy and particular markets within it. Even absent such data as would support more nuanced judgments about the effect of taxing particular categories of digital goods and services, however, one may discern on the basis of existing studies two general presumptions about which categories of digital goods and services should and should not be taxed.

In 2001, the State Legislature enacted legislation creating the Washington State Tax Structure Study Committee (“Committee”).⁵ Under its legislative mandate, the Committee undertook “a systematic analysis of Washington’s existing tax structure” and made “recommendations for alternatives to improve the tax system.”⁶ In its report to the State Legislature, the Committee stated that

while our tax structure, which was put in place in 1935, might have worked well for a mid-twentieth century manufacturing economy, it doesn’t work well in today’s economy with its greater dependence on the service sector. If this current trend continues, our tax structure will be even less adequate in the future. Furthermore, the rapidly expanding “Internet economy” is eroding our retail sales tax base. This impedes Washington’s ability to collect its fair share from economic activities occurring over the Internet.⁷

Among its recommendations intended to improve the State tax system, the Committee recommended streamlining the sales tax, stating that such “efforts will facilitate the possibility of subjecting remote sales (such as e-commerce) to state tax requirements” and that “[t]he ability to tax remote sales would [] help stem erosion of the retail sales base.”⁸ Remote sales include Internet transactions, “brick and mortar” transactions in Idaho and Oregon, and mail- and telephone-order purchases through catalogs. The Committee noted that

⁵ See Act of June 26, 2001, ch. 7, § 138, 2001 Wash. Sess. Laws xx (West).

⁶ Letter from William H. Gates, Sr., Chair, Washington State Tax Structure Study Committee, to the Honorable Lisa Brown, Chair, Washington State Senate Ways and Means Committee, and the Honorable Jeff Gombosky, Chair, Washington State House Finance Committee (Nov. 2, 2002), *available at* http://dor.wa.gov/content/aboutus/statisticsandreports/wataxstudy/Transmittal_letter.pdf.

⁷ Washington State Tax Structure Study Committee, Tax Alternatives for Washington State: A Report to the Legislature iv (2002), *available at* http://dor.wa.gov/content/aboutus/statisticsandreports/wataxstudy/Volume_1.pdf

⁸ *Id.* at vii.

State sales tax losses from remote sales are estimated to be \$138 million to \$148 million in CY 2001 and \$152 million to \$185 million in CY 2002. Growth rates in remote sales have been estimated to have been about 25 percent in each of the last couple of years. Such high growth rates could continue for the next several years.⁹

Given the 25% growth rate of remote sales in years that also saw dramatic growth in Internet commerce, it is reasonable to assume that at least in counties that do not border Oregon and Idaho, much of this leakage is due to remote Internet transactions involving tangible goods delivered by mail or parcel service as well as digital goods and services delivered over the Internet. While the Committee does not cite any studies or provide any data that might be used to determine how much of this sales tax leakage is attributable solely to the purchase of digital goods and services over the Internet, given the growth in Internet transactions involving “mass market” digital goods and services such as movies, music and e-books, it is reasonable to assume that the impact of such transactions on sales tax leakage is also growing. Accordingly, absent any empirical data or studies to the contrary, it appears that part of the solution to Washington’s problem of sales tax leakage would be to tax remote sales of “mass market” digital goods and services over the Internet. Thus, on the basis of the report of the Washington State Tax Structure Study Committee and reasonable inferences therefrom, we arrive at our first presumption regarding which categories or kinds of digital goods and services should be taxed: “mass market” digital goods and services.” Since only “mass market” digital goods and services may reasonably be presumed to have a significant impact on sales tax leakage, our presumption is limited to this category or kind of digital goods and services.

The presumption that “mass market” digital goods and services delivered over the Internet should be taxed may be paired with a second presumption that digital goods and services that target a more specialized group of users should not. Internet commerce arose in 1994 when

⁹ *Id.* at 143.

commercial use of the Internet was permitted by the National Science Foundation. Before this time, the Internet was used principally as a research network. Realizing the potential of this new online marketplace, the federal government took steps to encourage its growth. In particular, recognizing that burdensome transaction costs such as taxes could kill this new form of commerce in its infancy, the U.S. Congress enacted the Internet Tax Freedom Act which prohibited states from imposing new taxes on “Internet access” as well as “multiple or discriminatory taxes on electronic commerce.”¹⁰ This federal moratorium has been extended three times.¹¹ During this moratorium, Internet commerce has grown from a fragile seedling that needed protection and cultivation to a sturdy and robust if still young oak tree. No longer does one have to worry that transaction costs such as state taxation of Internet access might undermine the Internet as a platform for commerce. Nonetheless, the U.S. Congress continues to encourage the growth of Internet commerce by prohibiting the states from imposing taxes on Internet access. By extending the tax moratorium to the year 2014,¹² the U.S. Congress recently demonstrated its continuing commitment to the principle that young and evolving markets which one desires to encourage and cultivate should be shielded from transaction costs such as state taxation to the greatest extent feasible. This same principle applies to markets in digital goods and services. While markets in “mass market” digital goods and services delivered over the Internet such as music and movies may not require protection and cultivation, markets in digital goods and services that cater to more specialized needs and interests are more fragile. Evolving markets in such “specialized” digital goods and services do require protection and cultivation. Moreover, since the markets in “specialized” digital goods and services are small and these goods and services are generally not marketed to the general public, it is unlikely that remote sales of

¹⁰ Internet Tax Freedom Act, Pub. L. No. 105-277, §§ 1100-1109, 112 Stat. 2681-719 (1998).

¹¹ The Internet Tax Nondiscrimination Act, Pub. L. No. 107-75, 115 Stat 703 (2001), extended the moratorium until November 1, 2003; an act bearing the same name, Internet Tax Nondiscrimination Act, Pub. L. No. 108-435, 118 Stat 2615 (2004), extended the moratorium until November 1, 2007; and the Internet Tax Freedom Act Amendments Act of 2007, Pub. L. No. 110-108, 121 Stat 1024, extended it yet again until November 14, 2014.

¹² Internet Tax Freedom Act Amendments Act of 2007, Pub. L. No. 110-108, 121 Stat 1024.

“specialized” digital goods and services contribute significantly to sales tax leakage. Accordingly, absent empirical data demonstrating that the taxation of such digital goods and services would yield a net social benefit, one ought to presume that “specialized” or “non-mass market” digital goods and services delivered over the Internet should not be taxed.

Guided by these two presumptions—that “mass market” digital goods and services should be taxed and that “specialized” digital goods and services should not be taxed—we are now in a position to answer the question of which digital goods and services should be taxed by the State: *all and only “mass market” digital goods and services*. Intuitively, this answer makes sense since only “mass market” digital goods and services contribute significantly to sales tax leakage. But without a practicable definition of the phrase “mass market’ digital goods and services” that can give us more specific and concrete guidance in identifying which digital goods and services fall into this category, this answer will not be very helpful. Of course, some types of digital goods and services are clearly “mass market” digital goods and services. These include music downloads, as well as electronically delivered movies, TV shows, ringtones, and video games. But the status of other items is less clear. What about digital sheet music, digital house plans and architectural blueprints, or items purchased in Second Life? To determine whether these digital goods and services are in fact “mass market” digital goods and services, we need a working definition of the latter phrase.

To assist us in delineating the class of “mass market” digital goods and services, I offer the following tentative definition:

- D1.** A digital good or service is a “mass market” digital good or service if and only if it meets the following two conditions:
- (1) the digital good or service is marketed to the general public;
and
 - (2) the digital good or service is an economic substitute for some type of tangible personal property.

While the first condition is relatively straightforward, the second condition requires two brief comments. First, to say that item A is an *economic substitute* for item B implies that the purchase of item A obviates the need for item B. This relationship can also be described by saying that item A is a *substitute good* for item B. Thus, we could reformulate the second condition by stating that “the digital good or service is a substitute good for some type of tangible personal property.”¹³ Employing the concept of a substitute good in our definition allows us to use and build upon a rich and well developed economic literature as we apply this definition to determine which categories of digital goods and services should be subject to the sales tax. Second, by “tangible personal property,” I mean ordinary physical goods that one can touch or hold in one’s hands. Examples include books, magazines, music CDs, DVDs, telephones, automobiles, airplanes and pretty much any other physical thing that you can think of.

A few examples will further clarify how this definition may be applied and extended to determine whether particular kinds of digital goods and services are “mass market” digital goods and services that can be taxed by the State. The digital goods and services used for these examples are Kindle Edition e-books, digital newspapers, and electronically delivered standard financial information.

Kindle Edition E-Books. Since Amazon.com introduced its new, wireless, portable reading device, the Kindle, it has been selling e-books that can be downloaded from its website and read on a Kindle. To determine whether sales of these e-books should be taxed, under the approach adopted here we need only apply the definition for “mass market” digital goods and services. To apply this definition, we need only answer two questions: (1) are the Kindle edition e-books being marketed to the general public? and (2) is a Kindle edition e-book an economic substitute for some type of tangible personal property? Clearly, the answer to both of these questions is yes: the Kindle edition e-books are being promoted on the Amazon.com website which is a model

¹³ A more detailed introduction to the concept of substitute goods from the perspective of neoclassical economics may be found at <http://www.economicwebinstitute.org/glossary/substitute.htm>.

for using the Internet to market to the general public, and a Kindle edition e-book is an economic substitute for a type of tangible personal property, namely a physical book—if I want to read the latest Nelson DeMille novel and I download the Kindle edition of WILD FIRE to my Kindle, I have no need to purchase either the hardcover or paperback editions of this novel.

Digital Newspapers. Imagine that a local newspaper publisher begins selling digital editions of its daily newspaper. Assume further that the newspaper publisher promotes the digital edition of the newspaper on the newspaper’s website and in advertisements in the paper edition of the newspaper. Is the digital edition of the newspaper a “mass market” digital good or service? Clearly, the digital edition of the newspaper is being marketed to the general public. Moreover, the digital edition of the newspaper is an economic substitute for a type of tangible personal property, namely the paper edition of the newspaper of the same date. Accordingly, the digital edition of the newspaper is a “mass market” digital good or service.

The determination that the digital edition of the newspaper is a “mass market” digital good or service, however, does not mean that the State can impose a sales tax on this digital good or service. Under Washington State law, the paper edition of a newspaper is exempt from sales tax,¹⁴ and the federal Internet Tax Freedom Act prohibits states from imposing “discriminatory taxes on electronic commerce.”¹⁵ In that Act, a discriminatory tax is defined, in relevant part, as “any tax imposed by a State or political subdivision thereof on electronic commerce that . . . is not generally imposed and legally collectible by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means.”¹⁶ Accordingly, imposing a sales tax on the digital edition of a newspaper when the

¹⁴ WASH. REV. CODE ANN. § 82.08.0253 (West, Westlaw through 2008 Legislation effective through June 11, 2008).

¹⁵ Internet Tax Freedom Act, Pub. L. No. 105-277, § 1100(a)(2), 112 Stat. 2681-719 (1998), *amended by* Internet Tax Nondiscrimination Act, Pub. L. No. 107-75, 115 Stat 703 (2001), *amended by* Internet Tax Nondiscrimination Act, Pub. L. No. 108-435, 118 Stat 2615 (2004), *amended by* Internet Tax Freedom Act Amendments Act of 2007, Pub. L. No. 110-108, 121 Stat 1024.

¹⁶ *Id.* at § 1105(2)(A).

State does not impose a sales tax on the paper edition of the newspaper would be a violation of federal law.

To ensure compliance with federal law as well as tax neutrality, one can simply add a third condition to the definition of “mass market’ digital goods and services” requiring that the type of tangible personal property for which the digital good or service is an economic substitute be taxed by the State. Indeed, one could simplify matters still further and use these three conditions as the definition of a “taxable digital good or service.” Revised in this fashion, the definition becomes:

- D2.** A digital good or service is subject to sales tax if and only if it meets the following three conditions:
- (1) the digital good or service is marketed to the general public;
 - (2) the digital good or service is an economic substitute for some type of tangible personal property; and
 - (3) the type of tangible personal property for which the digital good or service is an economic substitute is subject to sales tax in the State.

Applying the revised definition to digital newspapers, we immediately see that it fails to satisfy the third condition and, therefore, is not a taxable digital good or service.

Electronically Delivered Standard Financial Information. Imagine an entrepreneur who decides to sell standard financial information to financial institutions and investment management companies.¹⁷ The standard financial information will be delivered in digital form over the

¹⁷ For purposes of this hypothetical, we shall define “standard financial information” as that phrase is defined in section 82.08.705(2)(c) of the Revised Code of Washington. *See*. WASH. REV. CODE ANN. § 82.08.705(2)(c) (West. Westlaw through 2008 Legislation effective through June 11, 2008) (“Standard financial information’ means any collection of financial data or facts, not generated or compiled for a specific customer including, but not limited to, financial market data, bond ratings, credit ratings, and deposit, loan, or mortgage reports. . . . ‘financial market data’ means market pricing information, such as for securities, commodities, and derivatives; corporate actions for publicly and privately traded companies, such as dividend schedules and

Internet. Is delivering standard financial information over the Internet to companies in the financial services sector of the State's economy a taxable digital good or service? To answer this question, we shall apply the three conditions contained in our revised definition. If a digital good or service fails to satisfy just one of these conditions, then that digital good or service is not taxable.

Insofar as the standard financial information is being marketed only to companies in the financial services sector of the State's economy, it is clearly not being marketed to the general public. Accordingly, the first condition is not satisfied, and under the approach proposed, this digital good or service would not be subject to the State sales tax. Note that the first condition—that the digital good or service be marketed to the general public—requires that the *marketing efforts* of the seller be *directed at* the general public. While members of the general public might be able to purchase the digital good or service, if the marketing efforts of the seller target a more specialized user base—such as companies in the financial services sector of the economy, then the digital good or service will still fail to satisfy this condition.

While failing the first condition is sufficient to rule out the taxability of electronically delivered standard financial information under this approach, let us consider whether the second and third conditions are satisfied. The second condition requires that a taxable digital good or service be an economic substitute for some type of personal tangible property. Thus, in applying this condition, we must seek to identify some type of personal tangible property for which delivering standard financial information over the Internet is a substitute good. The business of compiling standard financial information, combining it in some convenient form, and then selling it to companies that can benefit from the use of that information in their daily business is hardly a new business model. Historically, the most convenient form in which to package such information was a paper report, and for some, this still continues to be the most convenient

reorganizations; corporate attributes, such as domicile, currencies used, and exchange where shares are traded; and currency information.”).

form. For many more today, however, the most convenient form in which to receive such information is a digital data stream or electronic report—in other words, as a digital good or service. For those who prefer to purchase their information in this latter form, electronically delivered standard financial information is clearly an economic substitute for some type of tangible personal property, namely paper reports containing the same information. Accordingly, the second condition is satisfied.

The only remaining question, required by the third condition, is whether the type of tangible personal property for which electronically delivered standard financial information is an economic substitute is taxed in the State? As it turns out, the answer to this question is no. The type of tangible personal property for which electronically delivered standard financial information is an economic substitute is a paper report. In the State of Washington, paper reports provided as part of an information service are not subject to sales tax. Section 458-20-155 of the Washington Administrative Code states that

Liability for sales tax or use tax depends upon whether the subject of the sale is a product or a service. If information services, computer services or data processing services are performed, such that the only tangible personal property in the transaction is the paper or medium on which the information is printed or carried, the activity constitutes the rendering of professional services, similar to those rendered by a public accountant, architect, lawyer, etc., and the retail sales tax or use tax is not applicable to such charges.¹⁸

For purposes of this section, the term “information services” is defined as “every business activity, process, or function by which a person transfers, transmits, or conveys data, facts, knowledge, procedures, and the like to any user of such information through any tangible or intangible

¹⁸ Wash. Admin. Code 458-20-155 (2008), WA ADC 458-20-155 (Westlaw through April 2, 2008).

medium.”¹⁹ Clearly, a person who provides standard financial information in the form of paper reports is an information services provider within the meaning of section 458-20-155. Accordingly, paper reports used to convey standard financial information are not subject to sales tax in the State of Washington, and, *a fortiori*, the third condition is not satisfied.

Thus, under the approach adopted here, electronically delivered standard financial information should not be taxed. It should not be taxed because it fails to satisfy the first and third conditions of the proposed definition of a taxable digital good or service. This example is especially interesting for present purposes because the current law of the State of Washington actually exempts electronically delivered standard financial information from sales tax when it is sold to a financial institution or an investment management company.²⁰ Thus, in the one case in which the State legislature has already addressed the taxability of a particular type of digital good or service, it resolved that issue in the manner required by the definition of “taxable digital good or service” proposed here, demonstrating that, at least in this one case, the proposed definition reflects current State policy.²¹

Adopting the proposed revised definition of a taxable digital good or service as an answer to the third question—which digital goods and services should be taxed by the State?—not only reflects existing State policy regarding electronically delivered standard financial information, but also helps to create a good tax system by promoting an approach to the taxation of digital goods and services that conforms to commonly-accepted tax principles. The first condition addresses the problem of sales tax leakage by targeting those digital goods and services that are likely to be

¹⁹ *Id.* Section 458-20-155 of the Washington Administrative Code defines the term “computer services” as “every business activity, process, or function by which a person transfers, transmits, or conveys data, facts, knowledge, procedures, and the like to any user of such information through any tangible or intangible medium.” *Id.*

²⁰ WASH. REV. CODE ANN. § 82.08.705 (West, Westlaw through 2008 Legislation effective through June 11, 2008).

²¹ It is worth noting that extending the sales tax exemption to vendee insurance companies would not alter the analysis of the taxability of electronically delivered standard financial information marketed to companies in the financial services sector of the State’s economy, suggesting that section 82.08.705 of the Revised Code of Washington may have been drafted too narrowly when it excluded insurance companies.

significant sources of sales tax loss as Internet commerce continues to grow and thereby advances the principles of adequacy²² and stability.²³ Moreover, by exempting digital goods and services that do not market to the general public, the first condition protects and promotes emerging and innovative online businesses serving particular sectors of the State's economy, thereby fostering the economic vitality of the State.²⁴ The second condition promotes fairness²⁵ as well as the perception of fairness²⁶ by ensuring that "brick and mortar" vendors and online vendors are treated the same when selling goods competing for the same buyers. By ensuring that substitute goods are taxed the same whether they are purchased online or through more traditional marketing channels, the third condition advances the principles of economic neutrality and efficiency.²⁷ Finally, the definition as a whole, using well understood economic concepts and being easy to apply, promotes transparency and administrative simplicity.²⁸

²² "Adequacy is the ability of the tax system to provide for growth in revenue adequate to fund normal growth in public services as the state's population and economy expand." Washington State Tax Structure Study Committee, *supra* note 7, at 3. (emphasis in original).

²³ "Stability is the ability of the tax system to provide the revenue necessary to maintain public services notwithstanding fluctuations in economic activity over the business cycle." *Id.* (emphasis in original).

²⁴ "The state tax system should support a stable economic infrastructure conducive to a vital and growing economy." *Id.* at 5. Moreover, "the tax system should minimize the opportunities for selective tax avoidance that would allow some firms to shift their taxable activity out of the state and thereby raise the tax burdens on other firms within the state." *Id.* at 4.

²⁵ "A good tax system should distribute the tax burden across taxpayers in a manner that is consistent with the accepted norms of fairness and equity." *Id.* at 3.

²⁶ "While taxpayer perceptions should not take priority over the accepted principles of good tax system design, it is wise to take note of them when evaluating the existing tax system and any potential alternatives." *Id.* at 7.

²⁷ "Different production and consumption activities should be subject to the same effective rate of tax. Such a *neutral* tax system is efficient when taxpayers make decisions based on economic advantages rather than tax advantages." *Id.* at 5. (emphasis in original).

²⁸ "A good tax system is designed to ensure that the tax burdens on residents are clear and evident. The rules, record-keeping and computation requirements should be simple enough that the tax system can be administered at low cost by the tax collection agency without imposing an undue compliance burden on the taxpayer." *Id.*

Having suggested an approach for determining which digital goods and services should be subject to sales tax by the State, I will now briefly consider how such digital goods and services should be handled within the Revised Code of Washington. Should digital goods and services be taxed as tangible property, intangible property, services, or in a manner *sui generis*?

Section 82.08.020 of the Revised Code of Washington states, in relevant part, that “[t]here is levied and there shall be collected a tax on each retail sale in this state”²⁹ A retail sale is defined as a “sale of tangible personal property.”³⁰ Tangible personal property, in turn, “means personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses,” including “electricity, water, gas, steam, and prewritten computer software.”³¹ Insofar as digital goods and services cannot be “seen, weighed, measured, felt, or touched” and, at least from the perspective of the ordinary person, is not “in any other manner perceptible to the senses,” it would appear hard to conclude that digital goods and services are tangible personal property and, *a fortiori*, that the sale of a digital good or service is a retail sale. If this were not the case, then much of the preceding discussion would be irrelevant because all digital goods and services, whether marketed to the general public or not, would be taxable as personal tangible property. While lawyers are expert at semantic contortions imbuing words with a technical legal significance that common sense cannot bear, it strains even the credulity of a lawyer to suggest that a retail sale of tangible personal property can be completed without the transfer from seller to buyer of anything tangible.

Now I know that the Washington Department of Revenue has taken the position that digital goods and services are tangible personal property for purposes of the retail sales tax, but I

²⁹ WASH. REV. CODE ANN. § 82.08.020(1) (West, Westlaw through 2008 Legislation effective through June 11, 2008).

³⁰ WASH. REV. CODE ANN. § 82.04.050(1) (West, Westlaw through 2008 Legislation effective through June 11, 2008)

³¹ WASH. REV. CODE ANN. § 82.08.010(7) (West, Westlaw through 2008 Legislation effective through June 11, 2008)

cannot help but believe that the Department has taken this position out of a necessity that this committee is meant to obviate. The only thing transferred from a seller's server to a buyer's computer is information, and I cannot close my eyes to this reality no matter how noble the cause.

Nor does the inclusion of prewritten computer software within the meaning of tangible personal property save the Department's interpretation. When the phrase "prewritten computer software" was added to the definition of tangible personal property in 2002, the first section of the Act which made this addition declared that it was "the intent of the legislature that Washington join as a member state in the streamlined sales and use tax agreement" and that the purpose of the Act was "to bring Washington's sales and use tax system into compliance with the agreement so that Washington may join as a member state and have a voice in the development and administration of the system, and to substantially reduce the burden of tax compliance on sellers."³² Moreover, this same section also announced that it was "the intent of the legislature that the provisions of chapters 82.08 and 82.12 RCW be interpreted and applied consistently with the agreement."³³ In other words, the State legislature declared its intent that the Streamlined Sales Tax Project's interpretation of the phrases "prewritten computer software" and "tangible personal property" would be controlling for the meaning of these phrases in chapters 82.08 and 82.12 of the Revised Code of Washington. Thus, we must look to the Streamlined Sales Tax Project's interpretation of these phrases to determine whether digital goods and services are comprehended within their meanings. The Streamlined Sales Tax Project's statement on this question is set forth in an issue paper entitled, appropriately enough, the Tangible Personal Property Issue Paper.³⁴ So there can be no confusion on this issue about the intended meaning of the phrase "tangible personal property," the Streamlined Sales Tax Project expressly

³² Act of May 9, 2003, ch. 168, § 1, 2003 Wash. Sess. Laws xx (West).

³³ *Id.*

³⁴ Streamlined Sales Tax Project, Tangible Personal Property Issue Paper (2002), available at [http://www.streamlinedsalestax.org/issue_papers/TPP%20issue%20paper%204-15-02%20\(3\).pdf](http://www.streamlinedsalestax.org/issue_papers/TPP%20issue%20paper%204-15-02%20(3).pdf).

states that “[d]igital property will not be addressed in the definition of tangible personal property.”³⁵ Moreover, the Streamlined Sales Tax Project continues, “[i]f a state wishes to impose tax on the sale, lease, or rental of digital property, it must specifically impose such tax separate from imposition of tax on tangible personal property.”³⁶ In other words, while tangible personal property includes prewritten computer software, it does not include digital goods and services. To the extent that this interpretation is controlling, it follows that digital goods and services are not tangible personal property for purposes of sections 82.08.010 and 82.08.020 of the Revised Code of Washington

Insofar as the State legislature has expressed its intent that “the provisions of chapters 82.08 and 82.12 RCW be interpreted and applied consistently with the [streamlined sales and use tax] agreement” and insofar as the Streamlined Sales Tax Project has declared that for purposes of that agreement the phrase “tangible personal property” does not include digital goods and services, it follows that in carrying out our legislative mandate from the State legislature that we must treat digital goods and services as something other than tangible personal property for purposes of taxation. In other words, we must treat digital goods and services as either intangible property, services, or in a manner *sui generis*.

As I mentioned in the first footnote to this document, I am inclined to treat digital goods and services as services. In my somewhat tentative opinion, it seems to me that a seller of digital goods and services is really an information services provider. When I purchase an e-book from Amazon.com, information in the form of bytes is sent to my Kindle from one of the Amazon.com servers. A program running on my Kindle then uses that information to create a physical file that my Kindle interprets as the text of an e-book. My point is that the physical e-book file was not physically transferred from an Amazon.com server to my Kindle but was created *ab initio* on my Kindle using the information sent to it. No doubt that the information

³⁵ *Id.* at 2.

³⁶ *Id.*

sent to my Kindle was derived from a physical e-book file residing on one of the Amazon.com servers, but that does not change the fact that the physical e-book file residing on my Kindle was created by a program on my Kindle and was not physically transferred to it. The same is true for music files “downloaded” to my computer: all that is “downloaded” is information that is then used to create the physical music file. Accordingly, what I am really purchasing when I purchase a digital good or service is the information that I need to create certain kinds of physical files on my computer or other electronic device, and, *a fortiori*, a vendor of digital goods and services is really just offering a service of providing certain kinds of information.³⁷ If this is correct, then digital goods and services should be treated as services for purposes of taxation. In Washington, a service is not taxed unless the State legislature enacts legislation to tax it. Accordingly, under this approach to the taxation of digital goods and services, the State legislature would enact a rule using the revised definition to define a general category of digital goods and services the sale of which is a service subject to sales tax in the State.

A second approach, closely related to the first, is to treat digital goods and services in a manner *sui generis* for purposes of taxation. Under this approach, the State legislature would enact a rule creating a new category of taxable activity in the State: the retail sale of digital goods and services. The State legislature could use the revised definition to define this new category of digital goods and services that are taxable. As a practical matter, given the way in which services are taxed in the State, I am not sure there is any real difference between this approach and the first.

Finally, one could treat digital goods and services as intangible property for purposes of taxation. Under this approach, it might appear that we are taxing the sale of information—the information transferred from the seller’s server to the buyer’s computer—but since information cannot be owned what we would really be taxing is the assignment or licensing of some form of

³⁷ An analogous point can be made concerning streaming media and data, though streaming media and data does not involve the creation of a physical file on a computer that can be accessed at a later time.

intellectual property, presumably a copyright.³⁸ Under this approach, if a digital good or service was not protected by a copyright, then the tax would not apply since no assignment or licensing of a copyright would have occurred. For example, while the sale of an authorized recording of a musical performance would be taxable, the sale of an unauthorized (bootlegged) recording of a musical performance at which no authorized recording was made would not be taxable. For the same reason, under the United States Supreme Court's ruling in *Feist Publications v. Rural Telephone Service*,³⁹ a comprehensive commercial database of factual information might not be taxable. To avoid challenges to the taxation of digital goods and services based on the scope of intellectual property protection, it seems to me simpler just to treat digital goods and services as services or in a *sui generis* manner for purposes of taxation—though I should emphasize that I have not fully thought through the issue of treating digital goods and services as intangible property for purposes of taxation and could possibly be convinced otherwise.

In light of the foregoing and in a provisional and tentative manner, I offer the following proposal to facilitate discussion as we work to fulfill our legislative mandate:

Proposal for the Taxation of Digital Goods and Services

I propose

- (1) that the revised definition D2 be used to identify those digital goods and services that are taxable in the State of Washington; and
- (2) that digital goods and services be treated as services or in a manner *sui generis* for purposes of taxation.

³⁸ A patent holder owns the right to exclude others from “practicing” the invention. A copyright holder owns the right to exclude others from “copying” the protected expression. Contrary to popular belief, in neither case is there ownership of the underlying idea or information “behind” the invention or expression.

³⁹ 499 U.S. 340 (1990).