



April 23, 2008

TO: Members of the Committee on the Study of Electronically Delivered Products (“Committee”)

FROM: Washington Technology Industry Association (“WTIA”)
AeA (formerly American Electronics Association) – Washington Council

RE: Study of The Taxation of Electronically Delivered Products: Preliminary Report (November 30, 2007) (“Preliminary Report”)

The WTIA and AeA are pleased to comment on the Preliminary Report issued by the Department of Revenue and the Committee with respect to the taxability of electronically delivered products (“digital goods”) in Washington. The WTIA and AeA are the principal trade associations representing well over 1,000 member companies, which are a part of Washington’s substantial high technology industry and are among the leading businesses impacting the technology and business models of electronic commerce. Many, if not most, of the WTIA and AeA members market products that would fall within the scope of the digital goods being contemplated by the Committee.

We commend the members of the Committee for serving and bringing each of your unique talents and perspectives to bear on this important public policy goal of determining and articulating the appropriate state tax policy for digital goods. The members of AeA and the WTIA understand that the development and widespread adoption of software and information technology have changed the paradigm under which state tax policy is conceived and implemented.

The technology industry realizes that states and taxpayers need to rely on laws and rules that are understandable, can be readily complied with and can adapt to economic and technological changes. That is why your efforts are so critical. Since the path of technology development and adoption is inherently unpredictable, we have to rely on some underlying principles that are designed to attract the kind of business activity that yields the best return to the state.

The high technology industry has historically and currently supported the Streamlined Sales Tax Project (“SSTP”) in its undertaking to simplify the collection and remittance of sales and use taxes. The industry has supported SSTP related legislation in the state of Washington since 2003, as it recognizes the importance of Washington’s participation in SSTP. The industry also supports a thoughtful and critical examination of the appropriate tax policy for the state of Washington with respect to the application of sales and use tax to certain digital goods defined by SSTP, such as digital books, digital music and digital video.

Discussion of Taxability of Digital Goods in Washington

As reflected in Section 5 of the Preliminary Report¹, items that are clearly tangible personal property such as CDs, DVDs, tapes, and similar media; and prewritten computer software as a specifically enumerated category of “retail sale,” are subject to sales or use tax. Unlike some other types of digital goods, information is not by itself tangible personal property. Moreover, information services are not specifically enumerated retail sales. However, books, magazines, newspapers and printed materials are all tangible personal property. Consequently, sales of such physical items such as books are retail sales, but sales of information services are not retail sales. Beyond that, however, Washington has provided little direct guidance on the taxation of digital goods that are related to, or the equivalent of, these items.

Technological advances change how taxpayers interact with or access information such as written materials, music, and pictures or movies. Certainly, digital equivalents of tangible personal property, such as digital books, music, and pictures are not taxable solely because their

¹ “Study of the Taxation of Electronically Delivered Products: Preliminary Report.” Pg. 6-7 (November 30, 2007) http://dor.wa.gov/Docs/Reports/DigitalGoods/Preliminary%20report_jd.pdf

tangible personal property counterparts are taxable. No authority currently supports such a conclusion. For example, a digital download of music, while ultimately providing a song to the consumer, differs in a myriad of ways from a CD or record in its characteristics, such as: The underlying technology used to reproduce the music, the use of the music by the consumer, the usage rights obtained by the consumer and the method or medium of storage. The mere fact that a technologically advanced 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, which considers the characteristics of the good itself and the ultimate nature of the service or product exchanged.

In evaluating Washington’s tax treatment of digital goods, we also consider the pertinent authority under the Streamlined Sales and Use Tax Agreement (“SSUTA”) and related guidance from the Governing Board of the Streamlined Sales and Use Tax Project (“Governing Board”), as Washington has now become a full member of the Governing Board. The SSUTA legislation adopted in Washington as well as the actions of the Governing Board in drafting new proposed legislation are particularly helpful in ascertaining how Washington’s laws may be interpreted. As a full member of the Governing Board, Washington’s tax policy with respect to digital goods will be guided in significant part by the related provisions of the SSUTA.

Washington has adopted the streamlined sales tax definition of tangible personal property, which does not specifically include “digital goods” in its definition:

For the purposes of the taxes imposed under this chapter and under chapter 82.12 RCW, "tangible personal property" means personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses. Tangible personal property includes electricity, water, gas, steam, and prewritten computer software.²

In addition to the definition of tangible personal property, Washington has also enacted the streamlined sales tax sourcing provisions. The sourcing provisions, which illustrate how retail sales should be sourced to each jurisdiction, specifically contain rules for allocating sales of “digital goods” even though the legislation is silent on the definition of such goods.

² RCW 82.08.010(7).

The December 12, 2007 amendment to the SSUTA includes new sections pertaining to “specified digital products” (§ 332) and to “use of specified digital products” (§ 333). These provisions serve to elucidate what we believe to be the Governing Board’s intention with respect to how the states could likely tax digital goods.

The provisions of § 332 identify different categories of specified digital products, such as “digital audio-visual works”, “digital audio works”, and “digital books,” and provides definitions of which are included for such terms in the SSUTA Library of Definitions. Section 332 also defines the underlying components of the specified digital products as “digital codes”. A “digital code” means a code, which provides a purchaser with a right to obtain one or more specified digital products from within one or more specified digital product categories having the same tax treatment. Under the current § 332, the tax treatment of “digital codes” would be the same as the tax treatment of the “specified digital product” to which the code relates.

Section 332 very clearly provides that a member state shall not include these specific types of digital goods within its definition of “ancillary services”, “computer software”, “telecommunications services”, or “tangible personal property.” Clearly, the Streamlined Sales Tax Governing Board contemplates that digital goods should be treated separately rather than included as part of a broader category of taxable goods or services, to the extent a state chooses to include digital goods in its tax base. Section 332, however, specifies that “until January 1, 2010, the exclusion of ‘specified digital products’ from the definition of ‘tangible personal property’ shall have no implication on the classification of products ‘transferred electronically’ which are not included within the definition of ‘specified digital products as being included in, or excluded from, the definition of ‘tangible personal property’.”

Section 333 elaborates on the treatment of “products transferred electronically”, providing that such products will not be included in the definition of “tangible personal property” effective January 1, 2010. Products “transferred electronically” means products “obtained by the purchaser by means other than tangible storage media.”

Thus, it appears that, while other “specified digital products” are immediately separated from tangible personal property and must be enumerated separately as a taxable product, products “transferred electronically” may be still be included as “tangible personal property”

until 2010. In either case, it appears fairly clear that the SSUTA contemplates taxing these items in some capacity.

The reference to “digital goods” in the sourcing provisions, as well as in the current SSUTA, illustrates that the Governing Board contemplates that if digital goods are to be subject to sales tax, they could only be included in the tax base as a specifically enumerated category of taxable property (for most specified digital products immediately and for products “transferred electronically” after 2009). Moreover, the adoption of the sourcing provisions referencing digital goods by the Washington legislature may imply that Washington intends on subjecting these digital goods to retail sales tax in the near future given that Washington must now comport its statute and rules with § 332 and § 333 of the SSUTA.

Under current Washington authority, it is unclear whether or to what extent digital goods are subject to tax. The Legislature has never specifically considered the issue. While recent amendments to the SSUTA lay out some possible ground rules for how digital goods might be taxed, the ultimate decision whether and how to tax them rests with the Legislature. The question before the Committee, however, must be whether that is a desirable or correct result, and whether it might be inconsistent with existing Washington tax policy of encouraging the development and growth of a robust, high-technology industry in the state.

Conclusion

The Washington Legislature has made the health, safety, and welfare of the people of the state of Washington and supporting the state government its top priorities. As such, it has long recognized that success in addressing these priorities is heavily dependent upon the continued encouragement, development, and expansion of opportunities for family wage employment in Washington’s private sector. Furthermore, Washington’s opportunities for increased economic dealings with other states and nations of the world are dependent on supporting and attracting a diverse, stable, and competitive economic base of private sector employers. In furtherance of these goals, the state’s private sector must be encouraged to commit to continuous improvement of process, products, and services and to deliver high-quality, high-value products through technological innovations and high-performance work organizations. We believe that exempting digital goods from sales and use taxes in Washington would place our state’s private sector at a

significant competitive advantage as compared to other states and will serve as a significant incentive for continuous improvement of products, technology, and modernization necessary for the preservation, stabilization, and expansion of employment and to ensure a stable economy.

One segment of Washington's private sector, the software and information technology industry, has benefited from tax policies that have promoted and encouraged job creation and economic growth. In fact, the information technology companies alone employ over 100,000 people at average salaries of approximately \$ 90,000 annually. One factor instrumental to this success has been incentivizing research and development in the state. On top of encouraging the addition of high technology jobs in the state, the tax incentives for research and development have also helped create jobs across a number of other supporting industries, which has resulted in a healthy diversification of the state's economy. Such a healthy regional economy, bolstered by high-wage technology positions, has helped soften the blows of the recent economic downturn and contributed to stabilizing the local economy, which has been weakening in other parts of the country. Clearly, the welfare of the people of the state of Washington has been positively impacted through the encouragement and expansion of family wage employment in the state's software and technology industries through the use of tax incentives. The benefits of creating a high-wage, educated workforce cannot be ignored.

Targeting tax policy to focus on key industry clusters has been an important and effective business climate strategy. Washington has continuously recognized the software and technology industries as one of the state's existing key industry clusters. Businesses in this cluster in the state of Washington are facing increasing pressure to expand or move operations elsewhere. The existing tax incentives for the software and information technology industries have enabled Washington to compete with other states for investment, and an exclusion from the sales and use tax for digital products will improve Washington's ability to compete with other states and countries for technology investment. Therefore, we encourage the Committee to consider the activities of the software and information technology industry as well as its suppliers and its customers when establishing a competitive sales and use tax policy for digital goods. An exclusion from sales and use tax will help in both retention and expansion of existing businesses and attraction of new businesses, all of which will strengthen the software and information technology cluster in Washington.

The same underlying principles of creating high-wage employment and economic stability and improving the state's competitive position through appropriate tax incentives should also guide tax policy for digital goods. In short, we believe that such policy must continue to be geared toward rewarding intellectual property creation. The high technology industry hopes that you will consider as a critical part of your charge as Committee members, and a key outcome of this process, the support and encouragement of business formation and growth of the technology and business models fueling the digital economy, and the avoidance of tax policies that would expand the tax base in a way that discourages high technology investment in the state of Washington.

A starting point would be to specifically exclude digital goods as "business inputs" from the sales and use tax base. Such exclusion could take the form of an outright exemption targeting digital goods or it could classify digital goods as "intangible property" exempt from sales and use tax. Either type of exclusion would reflect the true characteristics of digital goods: A bundle of rights to use an intangible product or item for a fee. We believe such property does not belong within the sales and use tax regime and that the state of Washington would significantly benefit from such exclusion through economic advantages that will strengthen the state economy for the benefit of all Washington citizens.