

# Taxation of Digital Products

While discussing the specifics of the preference related to standard financial information at the August 10<sup>th</sup> Commission meeting, commissioners posed questions related to the broader issue of how digital products are taxed.

A brief history of legislative activity on this rapidly changing and complex issue follows, as well as information supplied by the Department of Revenue in response to more specific questions regarding the taxation of digital products.

## 2007: LEGISLATURE DIRECTS STUDY

In the 2007-09 Operating Budget, the Legislature directed DOR to conduct a study of the taxation of electronically delivered products, stating:

*The Legislature recognizes that (ESHB 1981, An Act relating to excise taxation of electronically delivered financial information) relates to specific types of electronically delivered products and does not address the taxation of numerous other types of electronically delivered products. Therefore, a policy question remains concerning the sales and use taxation of other electronically delivered products.*

Issues to be reviewed included:

- The provision of explicit statutory definitions for electronically delivered products.
- The current excise tax treatment of electronically delivered products in the state and other states.
- The tax treatment of the products under the streamlined sales and use tax agreement.
- Costs and potential recipients of the tax preferences in ESHB 1981.
- Alternatives to the excise taxation of electronically delivered products.

A committee of 16 was directed to develop the report, which included legislators, AWB, various companies (including Amazon, Microsoft, and Starbucks), OFM and DOR.

## 2008: REPORT TO THE LEGISLATURE

The [report's \(linked here\)](#) conclusion stated that legislation implementing tax policy on digital products was necessary in 2009 to:

- Protect the sales and use tax base.
- Establish certainty in the tax code.
- Maintain conformity with the Streamlined Sales and Use Tax Agreement (SSUTA).
- Encourage economic development.

The Committee was not able to reach consensus on a specific tax policy proposal. The Committee did agree that legislation adopting a broad, general imposition approach for digital products would be possible only if the legislation:

- Contained meaningful and easily administered broad-based exemptions for business inputs.
- Provided sales and use tax amnesty to taxpayers who failed to collect tax on digital products for prior periods.
- Maintained conformity with the SSUTA.
- Protected and promoted the location of server farms and data centers in Washington.

## 2009: LEGISLATURE PASSED ESHB 2075—“AN ACT RELATING TO THE EXCISE TAXATION OF CERTAIN PRODUCTS AND SERVICES PROVIDED OR FURNISHED ELECTRONICALLY”

In summarizing the 85-page bill, the [Bill Report\(linked here\)](#) stated:

- Conforms the sales and use taxation of downloaded digital goods to the streamlined sales and use tax agreement.
- Imposes sales and use taxes on certain streamed or remotely accessed digital services, goods, and prewritten computer software.
- Provides certain exemptions for electronically transferred digital goods and digital services.
- Applies the traditional retailing and wholesaling business and occupation tax rates to electronically transferred digital goods and digital services.
- Prohibits the state from extending its taxing authority to a business by considering a business’s use of Washington based servers to store digital goods.

## 2010: LEGISLATURE PASSED SHB 2620—“AN ACT RELATING TO THE EXCISE TAXATION OF CERTAIN PRODUCTS AND SERVICES PROVIDED OR FURNISHED ELECTRONICALLY”

Originally request legislation from the Department of Revenue, the bill included the following statements:

*ESHB 2075 (the 2009 bill related to digital goods) was a complex piece of legislation because of the intricate interrelationship between the sales tax and business and occupation tax and also because the bill affects the taxation of products and services that involve technologies that are changing rapidly.*

*Because of the complexity and length of ESHB 2075, it was the Legislature’s expectation that, in the course of implementing the bill, ambiguities and unintended consequences would be discovered, which, if not corrected will unsettle expectations.*

*Therefore, the purpose of this act is to clarify ambiguities, correct unintended consequences, restore expectations, and conform the law to the original intent of the legislature.*

In summarizing the bill, the [bill report\(linked here\)](#) included the following explanations:

- Definition of retail sale is clarified to include remotely accessing prewritten computer software to perform data processing.
- A person is not considered a final consumer if the purchase was to incorporate the product, code, or software into a new product.
- The definition of digital automated service is modified to specifically exclude live presentations, digital goods, the storage of digital products, and data processing services.
- To simplify administration, the sales and use tax exemption for standard digital information is broadened to include all digital goods used for business purposes.

# Digital Products: Questions posed to the Department of Revenue by JLARC staff and DOR's answers

**Note:** In responding to Question #1, DOR references "Rule 15503". Rule 15503 is WAC (Washington Administrative Code) 428-50-15503 ([linked here](#)). This 19 page WAC is where DOR provided taxpayers guidance on determining the tax liability for digital products.

## JLARC STAFF QUESTION:

- 1) How does DOR determine whether a digital product is a digital good or a digital automated service? The department's 2010 special notice concerning online searchable databases discusses this topic, but can you describe a practical example of the distinction between a digital good and a digital automated service?

## DOR Answer

RCW 82.04.192 and WAC 458-20-15503(203) describe the distinction between digital goods and digital automated services. It provides that a digital good is not a service involving one or more software applications.

- A digital good consists solely of images, sounds, data, facts, information or any combination thereof. Clear examples of digital goods are digital books, digital music, digital video files, and raw data.
- A digital automated service (DAS) is a service transferred electronically that uses one or more software applications. While a DAS may provide the customer with "data, facts, or information," the service received by the customer includes software applications (e.g., search and retrieval capabilities).

A good "rule of thumb" in distinguishing a digital good from a digital automated service is that a digital good is essentially a static file – it contains digitized information but it is incapable of doing anything or providing additional services other than providing the raw digital data contained therein. On the other hand, a digital automated service frequently includes raw data, but also employs software that enables the product to provide a functionality to the user beyond access to the mere data.

Rule 15503 also gives two practical examples distinguishing between a digital good and DAS (Examples 3 and 4).

- **Example 3.** XYZ provides an online service that uses one or more software applications to facilitate the use of news and information with features such as: Research history, natural and boolean searching, industry chat forums, chart creation, document and word flagging, and information organizing folders. In this example software features facilitate the search of the news or information. XYZ's service is a digital automated service the sale of which is subject to retail sales tax and retailing B&O tax.

- **Example 4.** Company sells digital music files (i.e., digital goods) on its web site. In order to locate specific digital music files customers may use a free software based search function that is integrated into Company's web site. Customers may also find the digital music file they are seeking by clicking on a series of links to get to the desired music file. Company's software based search function associated with the sale of the digital music file does not transform the sale of the digital music file into a digital automated service. Company is selling a digital good (i.e., music file) subject to retail sales tax and retailing B&O tax.

#### JLARC STAFF QUESTION:

- 2) What is the sales tax treatment of other information products purchased by professional service businesses, such as legal or medical information? Are you aware of any other tax preferences that exempt such purchases of information products by professional service businesses?

#### DOR Answer

The sales tax treatment is the same as across other businesses. That is, the exemption from retail sales and use tax for digital goods purchased or used for business purpose (RCW 82.08.02087; 82.12.02087; WAC 458-20-15503(505)) applies to legal, medical, and other professional service businesses. With respect to digital automated services, the only DAS "business purpose" retail sales and use tax exemption is that provided to qualifying international investment management companies for standard financial information. RCW 82.08.207.

#### JLARC STAFF QUESTION

- 3) When a business develops some kind of information product for its own internal use, what is the use tax treatment? If taxed, how does the business or DOR determine the taxable value of the developed product?

#### DOR Answer

There is no use tax liability associated with a digital information product produced by a business for its own use. Use tax applies to digital goods and digital automated services only if "transferred electronically," which is defined by statute as being electronically transferred to a purchaser. RCW 82.04.192. If a business produces a digital automated service for its own use, it is not a "purchaser" and cannot owe tax on its use of that service.

Because self-developed digital products are not subject to use tax, there is no need to determine the value of such a product.

## JLARC STAFF QUESTION

- 4) Does the Standard Financial Information tax preference exempt self-developed information from use tax?

### DOR Answer

As explained in 3, above, a qualifying international investment company self-developing information for its own business use does not incur a use tax liability.