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POLICY NOTE

Digital Goods Taxation in Washington State

What it means to the business community

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During the 2009 Session the Legislature passed Engrossed Substitute House Bill 2075, which clarifies the definition of a "digital personal good" and sets some basic rules for taxation of intangible electronic products. An intangible electronic product means a digital good or service such as a digital book, digital audio and video files, ringtones, etc.

The bill Governor Gregoire signed will have a wide impact on businesses in Washington, particularly because our state has such a large high-tech industry.

Understanding the new rules will be important to businesses in Washington that are involved in the selling of digital goods or services. There are both benefits and some concerns with the new law.

Background

Government regulations often lag behind the real world. This is evident in the nature of electronic commerce. The Census Bureau reported that in 2007 the value of shipments, sales and revenue for electronic commerce nationwide was around $3 trillion, or 15% of the overall total of combined electronic and non-electronic shipments, sales and revenue.[1] This number will increase as businesses and policymakers move toward placing a higher emphasis on implementing an innovation economy.

In large part because of the shift towards more electronic commerce, in 2007, Washington signed onto the Streamlined Sales and Use Tax Agreement (SSUTA) – a cooperative agreement between 22 states, local governments, and businesses, to simplify and make more uniform sales and use tax collection and administration by retailers and states.[2] This was the major legislation that also changed Washington's sales and use tax to a destination-based system. Previously, taxes imposed on the shipment of goods depended upon where the seller's business was located, not on where the buyer made the purchase.

Under the SSUTA, electronic goods, such as music and movie downloads, ringtones, etc., are considered intangible personal property. The SSUTA requires that any taxation of these products has to be implemented by separate legislation. So, in Washington's case, if no separate legislation were to be passed in order to continue taxing intangible personal property purchases, on January 1, 2010, the Department of Revenue (DOR) would not be able to levy taxes on those purchases. Simply put: the Agreement stipulates that tangible and intangible property be taxed separately.

[1] See U.S. Census Bureau, "E-Stats, May 28, 2009": http://www.census.gov/eos/www/2007/2007reportfinal.pdf
[2] See SSB 5089: http://apps.leg.wa.gov/billinfo/summary.aspx?bill=5089&year=2007

This spawned action by legislators to craft, after several years of study, House Bill 2075, introduced and passed in 2009. The aim of the new law is to define an electronic good or service, so that Washington officials can continue to collect state sales tax on the sale of that good or service.

House Bill 2075

Currently (2009), a customer who lives in Washington state and purchases an MP3 album from Amazon.com has to pay the 6.5% state sales tax, plus the local sales taxes of where they live, even though they received no physical version of the album – no CD, vinyl record or cassette tape – hence it is a product that is intangible.

Under the HB 2075 law, little should change for the consumer. Purchasers of digital goods will continue to pay a sales tax on those goods, but now some digital automated services or streaming goods, such as games, could be taxed if the business providing the good or service is located outside of state borders.

There could be some changes on the provider's end as well, because sellers of digital goods and services that are located in Washington – or deemed to have sufficient business nexus – will have to calculate the sales tax based on the location of their customers in Washington state. Sellers will not have to charge sales tax to customers who are out of state.

The new law redefines what constitutes a digital good. The Department of Revenue will now define digital goods as

- downloaded digital goods (music, movies, and other standard information)
- streamed and accessed digital goods (e.g. rented movies streamed from Amazon.com)
- digital automated services (DAS)
- remote access software (RAS)

It is important to note that DOR stipulates that it does not matter if the purchaser obtains a permanent or nonpermanent right of use – so a 24-hour rental of a TV show streamed from Amazon.com is subject to the same sales tax as a downloaded movie that the consumer can add to his permanent library.

For businesses that provide digital goods and services the change is consistent with the SSUTA's destination-based sourcing. Therefore, a business selling a digital good uses the location where the purchaser receives the product when determining how to charge/collect applicable sales taxes.

One of the more confusing aspects of this law is the state's attempt to capture taxation of digital automated services (DAS). According to DOR, DAS are services that have been automated and are transferred electronically. DAS is not software, but includes software applications in providing the service. This also includes data processing services – a term that describes number crunching services such as payroll processing, data production and business accounts processing.

Collecting DAS tax revenue, however, caused concern among businesses that build, operate and maintain server (or data) farms. These facilities contain thousands of computer servers that function as the backbone of the Internet. Largely because of Washington's low energy costs (thanks to affordable hydro-power) our state contains several of these facilities. The concern was that out-of-state companies that host DAS on these server farms would be assessed a new business tax in the state, therefore increasing its potential tax liability. Lawmakers wisely exempted server farms from the taxation jurisdiction of HB 2075.

The law also states that Internet access, payment processing (such as PayPal) and telecommunications do not constitute DAS and are not subject to this tax.

Tax Break for Retailers

The Department of Revenue says that the new law allows businesses that sell digital products, including certain services, to pay the lower B&O tax retailing rate (0.471%) instead of the higher services rate (1.5%) for selling products not subject to sales tax. The goal is to reduce the rate but expand the tax base to offset some of the revenue loss to the state.

Another key component to any taxation system – whether it targets tangible or intangible property – is that business inputs be largely exempt from taxation. Otherwise, taxing business inputs will result in tax pyramiding. Tax pyramiding is one of the major problems of a gross receipts tax – like the business and occupation tax – because at each step of production a new tax is levied. By the end of the production process the final cost to the consumer is artificially high because it reflects the added cost of production as businesses pass the taxation cost down the line.[3] This violates the sound tax principle of transparency.

Financial Impact on the Business Community and the State

Because there will be new goods and services taxed that previously were not, and even though tax rates for some service providers will be reduced, this legislation is not revenue-neutral. However, the financial impact (particularly in light of the state's $9 billion shortfall) is minimal.

The state actually stands to lose money due to this legislation, at least initially. According to the Office of Financial Management (OFM), the fiscal note prepared for HB 2075 shows that the state's General Fund will lose approximately $2.6 million during the 2009-11 biennium and $2.8 million in the 2011-13 biennium.

Issues/Concerns

HB 2075 is the result of years of work by policymakers, agency personnel and business stakeholders. Most of the larger issues were cleared up in the final bill that passed, and that the Governor signed, but it was not a perfect bill and some lingering issues remain.

Businesses that are determined to have nexus in Washington state that sell digital goods to consumers also based within state borders will have to begin collecting the sales and use tax associated with the sale of their products or service. This could cause the seller of these products quite a hassle as they adapt to becoming a tax collector for the state – particularly if they were not required to collect these taxes before. However, the only businesses that will have to charge sales tax that previously did not will be businesses that provide streaming content or digital or remote access services. Businesses that previously sold MP3 albums or digital movies should have already been charging sales tax. The law does include an amnesty clause for businesses that were not charging sales tax in years past for digital goods.

[3] For more on the negative aspects of tax pyramiding, see "Reforming Washington's B&O Tax," parts II and IV, at http://www.washingtonpolicy.org.

The Department of Revenue should recognize that, similar to when the SSUTA passed in 2007, expansion of a tax base brings complication – time and outreach will be needed to ensure a smooth transition before the rule goes into effect on July 26, 2009. This is particularly true when considering Washington state has over 350 sales and use tax districts just for cities and counties.[4]

A future concern, based upon discussion of the bill during committee testimony, is that some policymakers are exploring options to capture sales and use tax revenue from out-of-state customers. So far, this is not constitutionally possible, and the U.S. Supreme Court has ruled in the past that governments may only collect taxes from businesses with a physical presence in their state. However, efforts to enable cross-border tax remittance and collection are underway, though passage of any type of legislation to this effect is doubtful any time soon.

Because of the current economic climate and to increase state tax revenue, policymakers throughout the nation are looking at changing the definition of what constitutes a business nexus.[5] A more liberally construed definition of business nexus – for instance, a website that only has a digital advertisement in a state as opposed to actual commercial activity – would shift more businesses into the tax base and could curtail economic activity because of the extra cost to those same businesses. Again, some in Congress are looking to apply a national standard throughout the states in order to avoid creating a comparative disadvantage for businesses in an ecommerce sales tax state.

Because the law is very broad and incorporates many different industries under the digital goods, digital automated services and digital codes definitions, clarification will most likely be needed when the Department of Revenue finalizes the rule. This is particularly true in the area of digital automated services, in large part because of the complexity of the definition – e.g. one exception to DAS is "Any service that primarily involves the application of human effort, and the human effort originated after the customer requested the service."[6]

Conclusion

Legislation often lags behind innovation, particularly in technological growth. Taxation policy in regards to electronic commerce also takes time to analyze in order to avoid unintended consequences. Policymakers run the risk of further complicating the tax code, which simply raises the compliance costs to small businesses.

As the technology industry sector incorporates strategies that deal with increasing amounts of data – like Cloud Computing – policymakers must recognize that increasing taxes on data sharing would inhibit economic growth. The new law on digital personal goods in Washington does not do that, but it does give rise to concerns that future legislatures will be tempted to close budget gaps by raising taxes on new and more efficient ways to conduct commerce.

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[4] See Department of Revenue's downloadable excel workbook for calculating city and county sales and use tax rates: http://dor.wa.gov/Docs/Pubs/Misc/Streamline/SST_Q32009.xls
[5] For more information see: http://publicola.net/?p=8745
[6] Department of Revenue, Draft Rule 15503 – Taxation of Digital Products, page 6. http://www.dor.wa.gov/Docs/Rules/wac/DRAFT458_20_15503.pdf