

HOUSE BILL REPORT

HB 1678

As Reported by House Committee On: Finance

Title: An act relating to improving tax fairness for businesses engaged in electronic commerce by eliminating inconsistent tax treatment of digital business inputs, ensuring that prewritten computer software developers remain eligible for the manufacturing machinery and equipment sales and use tax exemption, and providing greater clarity for out-of-state sellers concerning their tax obligations.

Brief Description: Improving tax fairness for businesses engaged in electronic commerce by eliminating inconsistent tax treatment of digital business inputs, ensuring that prewritten computer software developers remain eligible for the manufacturing machinery and equipment sales and use tax exemption, and providing greater clarity for out-of-state sellers concerning their tax obligations.

Sponsors: Representatives Carlyle and Nealey; by request of Department of Revenue.

Brief History:

Committee Activity:

Finance: 2/6/15, 2/23/15 [DPS].

Brief Summary of Substitute Bill

- Expands the sales and use tax exemption for digital goods to include digital automated services.
- Expands the sales and use tax exemption for manufacturing machinery and equipment to include prewritten software that is delivered electronically.
- Establishes a nexus standard for out-of-state sellers that derive income from making retail sales into the state through agreements with Washington residents.

HOUSE COMMITTEE ON FINANCE

Majority Report: The substitute bill be substituted therefor and the substitute bill do pass. Signed by 13 members: Representatives Carlyle, Chair; Tharinger, Vice Chair; Nealey,

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Ranking Minority Member; Condotta, Fitzgibbon, Manweller, Reykdal, Robinson, Ryu, Springer, Stokesbary, Wilcox and Wylie.

Minority Report: Do not pass. Signed by 2 members: Representatives Orcutt, Assistant Ranking Minority Member; Vick.

Minority Report: Without recommendation. Signed by 1 member: Representative Pollet.

Staff: Dominique Meyers (786-7150).

Background:

Sales and Use Tax.

Retail sales taxes are imposed on retail sales of most articles of tangible personal property, digital products, and some services. A retail sale is a sale to the final consumer or end user of the property, digital product or service. If retail sales taxes were not collected when the user acquired the property, digital products, or services, then use taxes apply to the value of property, digital product, or service when used in this state. The state, most cities and all counties levy retail sales and use taxes. The state sales and use tax rate is 6.5 percent; local sales and use tax rates vary from 0.5 percent to 3.1 percent, depending on the location.

Business and Occupation Tax.

Washington's major business tax is the business and occupation (B&O) tax. The B&O tax is imposed on the gross receipts of business activities conducted within the state, without any deduction for the costs of doing business. Businesses must pay B&O tax even though they may not have any profits or may be operating at a loss. A business may have more than one B&O tax rate, depending on the types of activities conducted. Major tax rates are 0.471 percent for retailing; 0.484 percent for manufacturing, wholesaling, and extracting; and 1.5 percent for services, and activities not classified elsewhere. Several lower rates also apply to specific business activities.

Digital Automated Service.

In 2009 the Legislature made numerous amendments to the retail sales and use taxes statutes to define the terms digital good, digital automated service, and digital code. In 2010 the Legislature provided sales and use tax exemptions for purchases of standard digital information used solely for business purposes. Standard digital information is defined as a digital good consisting primarily of data, facts, or information that is not generated for a specific client or customer. Since then, the business use of digital automated services, such as online research applications, has increased without a comparable exemption for retail sales and use tax.

Prewritten Computer Software.

The production of prewritten computer software contained on a disc or other tangible storage media provided to the buyer is a manufacturing activity. Prewritten computer-software

developers have historically qualified for the retail sales and use tax exemptions for manufacturing machinery and equipment (M&E). Today, the software industry delivers most prewritten software to buyers electronically rather than by tangible storage media. This change has called into question whether software developers continue to be eligible for the M&E exemptions.

Out of State Sellers.

As currently interpreted by the United States Supreme Court (Court), the commerce clause of the United States Constitution prohibits states from imposing sales or use tax collection obligations on out-of-state businesses unless the business has a substantial nexus with the taxing state. Under the Court's decision in *Quill Corp. v. North Dakota*, a substantial nexus for sales and use tax collection purposes requires that the taxpayer have a physical presence in the taxing state. Physical presence can be established through a taxpayer's own activities in the taxing state, or indirectly, through independent contractors, agents, or other representatives that act on behalf of the taxpayer in the taxing state. Businesses that have established nexus with Washington and collect and remit retail sales tax are also required to pay B&O taxes for income derived from sales in the state.

Summary of Substitute Bill:

Digital Automated Service.

The sales and use tax exemption for business purchases of digital goods is expanded to include business purchases of digital automated services. The bill includes a tax preference performance statement for this sales tax exemption and expires the tax preference for business purchases of digital automated services July 1, 2025.

Prewritten Computer Software.

The definition of manufacturing is expanded to include prewritten software delivered electronically so businesses engaged in this activity will continue to qualify for the M&E sales and use tax exemption.

Out of State Sellers.

Nexus standards are modified to include remote sellers who: (1) enter into agreements with Washington residents who, for a commission or other consideration, refer potential customers to the remote seller such as by a link on a website, and; (2) generate more than \$10,000 in gross receipts during the prior calendar year under such agreements from sales into this state. This type of nexus is referred to as "click-through" nexus.

This change in nexus standards will require these remote sellers to collect and remit Washington sales tax for sales made into the state. Remote sellers that collect and remit retail sales tax will also be required to pay B&O tax on their Washington sales. Remote sellers have the ability to rebut a determination by the Department of Revenue that they have

established click-through nexus with the state. Any provision of the click-through nexus standards that conflict with any future change in federal law will expire. The provisions establishing click-through nexus standards expire on July 1, 2025, thereby eliminating the requirement that a remote seller must collect and remit sales tax if nexus was established through an agreement with a Washington resident.

Substitute Bill Compared to Original Bill:

The substitute bill:

- includes intent language and a tax preference performance statement for the sales and use tax exemption for digital automated services purchased for business purposes;
- includes an expiration date for the sales and use tax exemption for digital automated services;
- provides a safe-harbor provision for remote sellers to rebut the presumption that they have established click-through nexus with the state; and
- expires the click-through nexus provisions July 1, 2025.

Appropriation: None.

Fiscal Note: Available.

Effective Date of Substitute Bill: The bill takes effect 90 days after adjournment of the session in which the bill is passed.

Staff Summary of Public Testimony:

(In support) The intent is to level the playing field within the confines of the Constitution regarding sales tax collections from out-of-state retailers. This bill was drafted to address three areas of confusion with respect to digital commerce. Currently there is an exemption for a business input of digital goods, but not one for digital automated services. This causes confusion for taxpayers and the Department of Revenue when trying to determine the taxability of such similar products; therefore, the goal is to simplify and create tax parity with the similar products. The third piece will allow businesses that qualify for a sales tax exemption for their machinery and equipment that produces prewritten software to maintain that exemption when the prewritten software is delivered electronically verses delivered on a tangible storage medium. This bill creates tax parity for like products, it creates tax fairness, and it simplifies the application of tax policy in the realm of the digital world. This bill is trying to align tax policy with the digital economy. The three primary policy reasons to support this legislation is to uphold the digital goods legislative intent to exempt these business inputs from sales tax. This bill is a small start towards the collection of sales tax revenues from remote sellers that sell into Washington. Lastly, this bill treats like products similarly by providing like tax treatment. This bill might not be a full reach but it does provide tax fairness for in-state sellers with out-of-state business; it is a step in the right direction.

(Opposed) None.

Persons Testifying: Representative Carlyle, prime sponsor; Drew Shirk, Department of Revenue; Amber Carter, Association of Washington Business; and Joanie Deutsch, Washington Retail Association.

Persons Signed In To Testify But Not Testifying: None.