

Washington State Issues Proposed Rules on Sales and Use and Business and Occupation Taxation of Computer Hardware, Software, and Digital Products

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Overview

The Washington Department of Revenue (“Department”) recently published a notice of proposed rulemaking containing draft regulations for public comment.¹ The proposed rules are intended to clarify the effect of legislation passed in 2009 and 2010 that: (1) expanded the Washington sales and use tax base to include digital products and remote access software, and (2) changed the treatment of these items for Washington Business and Occupation (“B&O”) tax purposes.² The proposed rules also address other tax issues related to computer hardware and software. Specifically, the proposed rules discuss the following:

- Amendment of existing WAC 458-20-15501 (“Rule 15501”) - Taxation of Computer Systems and Hardware
- Adoption of WAC 458-20-15502 (“Rule 15502”) - Taxation of Computer Software
- Adoption of WAC 458-20-15503 (“Rule 15503”) - Digital Products
- Repeal of existing Rule 155 - Information and Computer Services

This Tax Alert summarizes the proposed rules and highlights some of the more complex issues.

Summary of the 2009 and 2010 Law Changes and the Related Proposed Rules and Amendments

Chapter 535, Laws of 2009 (ESHB 2075) made significant changes to the taxation of certain products and services provided or furnished electronically (commonly referred to as “digital products”). Effective July 26, 2009, the 2009 law specifically imposed sales and use tax on “digital products,” which include: (1) “digital goods,” such as digital audio works, digital audio-visual works, and digital books; and (2) “digital automated services,” defined to include any service transferred electronically using one or more software applications. Digital products acquired through the use of “digital codes” are also subject to sales and use tax. In addition, the 2009 law imposed sales and use tax on remote access software, while adding a number of targeted sales and use tax exemptions and definitional exclusions. Also, under the 2009 law change, gross proceeds derived from Washington-sourced sales of these items were made subject to the retailing or wholesaling B&O tax. Chapter 111, Laws of 2010 (SHB 2620) clarified ambiguities and corrected unintended consequences related to the 2009 law changes.

The rule changes proposed by the Department in response to these law changes include the following:

Proposed Amendment to Rule 15501 – Taxation of Computer Systems and Hardware: The current version of Rule 15501 (which addresses sales and use and B&O taxation of computer hardware, computer software, information services, and computer services) is outdated due to the 2009 and 2010 law changes. Proposed amended Rule 15501 has a reduced scope and only addresses the taxation of computer systems and hardware. The proposed amendment distinguishes what constitutes computer systems versus hardware and discusses considerations for wholesalers, retailers, and manufacturers of both items.³

Proposed Rule 15502 – Taxation of Computer Software: Proposed Rule 15502 addresses a variety of sales and use and B&O tax issues relating to computer software, including distinguishing between prewritten computer software, custom software, and software that has both prewritten and custom

¹ The Department’s proposed rulemaking activities were published on August 22, 2012.

² The B&O tax is a transaction-based, business privilege tax levied on gross receipts.

³ Proposed WAC 458-20-15501.

components. The proposed rule also discusses taxability considerations for manufacturers, wholesalers, and software licensors, including the treatment of site licenses, the multiple points of use exemption, and the distinction between wholesale sales of prewritten computer software and royalties received for the licensing of such software. Finally, Proposed Rule 15502 outlines the differences between traditional prewritten software and remote access software, which became subject to sales and use tax under the 2009 law change effective July 26, 2009.⁴

Proposed Rule 15503 – Digital Products: Proposed Rule 15503 outlines the differences among a “digital good,” “digital automated service,” and “digital code.” Certain products and services, which generally meet the definition of a digital good or digital automated service, are deemed excluded from that definition. Exclusions from the definition of a digital good include: (1) telecommunications and ancillary services; (2) computer software; (3) the Internet and Internet access; and (4) professional or personal services represented in electronic form. Exclusions from the definition of a digital automated service include: (1) services that require primarily human effort by the seller where the human effort originated after the customer requested the service; (2) loaning or transferring money or the purchase, sale, or transfer of financial instruments; (3) dispensing cash or other physical items from a machine; (4) payment processing services; (5) pari-mutuel wagering and handicapping contests; (6) telecommunications and ancillary services; (7) Internet and Internet access; (8) remote access software; (9) online education programs; (10) live presentations where participants are connected over the Internet or other network; (11) travel agent services, including online travel services and automated systems used by travel agents to book reservations; (12) online marketplace related activities; (13) advertising services; (14) storage, hosting and back-up; and (15) data processing services.⁵

Sales of digital products are sourced under the proposed rule in a manner similar to that applicable to other retail sales. Finally, the proposed rule outlines applicable exemptions and the classifications of digital products to which those exemptions apply. The relevant exemptions include: sales for resale, sales involving a component of a new product, certain items made available for free to the general public, and certain items purchased solely for a business purpose. The proposed rule also provides a partial exemption for multiple points of use.⁶

Repeal of Rule 155 – Information and Computer Services: The proposed rules provide for the repeal of existing Rule 155, which addresses taxation of information and computer services⁷ and is no longer applicable because of the 2009 and 2010 law changes. Going forward, Rules 15502 and 15503, if adopted, would generally govern the taxability of products and services transferred electronically.

Proper Classification of Information Technology Products and Services is Important for Sales and Use and B&O Tax Purposes

The new law adopted in 2009 and 2010 and the proposed rules outlined above (coupled with new Washington B&O tax economic nexus and market-based, single factor receipts apportionment provisions that became effective June 1, 2010⁸) have introduced an unprecedented level of complexity into the Washington sales and use and B&O tax compliance process for companies selling software and information technology consumer services. With the new economic nexus standard, a business has Washington nexus if it has any of the following in the state:

- Commercial domicile,
- Property – average value exceeding \$50,000,
- Payroll exceeding \$50,000 (including certain third party costs),
- Sales exceeding \$250,000 in a calendar year, or
- At least 25% of its worldwide property, payroll, or sales.

In determining whether the \$250,000 Washington sales threshold has been exceeded, businesses are required to utilize new market-based, single factor receipts apportionment rules. The new economic nexus and market apportionment provisions apply only to certain “apportionable income” derived from “apportionable activities,” including those activities taxed under the “service and other activities” and

⁴ Proposed WAC 458-20-15502.

⁵ For a full list of exclusions, see Proposed WAC 458-20-15503(301)-(303).

⁶ Proposed WAC 458-20-15502.

⁷ WAC 458-20-155.

⁸ Chapter 23, Laws of 2010 (2ESSB 6143).

“royalties” B&O tax classifications, among others. The existing physical presence nexus standard still applies to retailing and wholesaling activities, among others. Accordingly, there are now two separate Washington nexus standards, with the determination of the applicable standard based upon the proper classification of the business’ activities for B&O tax purposes. In addition, establishing nexus under one standard does not automatically create nexus under the other standard. Therefore, if a business has a physical presence in Washington and thereby establishes nexus for sales and use tax and retailing B&O tax purposes, this will not automatically create nexus with respect to that same business’ other activities that are potentially taxable under the “service and other activities” B&O tax classification. Finally, different sourcing rules will apply depending upon the proper classification of the revenue-generating activity for B&O tax purposes.

The following examples highlight how the different nexus standards would be applied in practice. The sale of prewritten computer software, including remote access software, as well as the provision of digital automated services, are classified as retail or wholesale activities. An out-of-state business with a physical presence in Washington will be required to collect and remit Washington sales or use tax on Washington-sourced sales of these items to consumers unless an applicable exemption applies, and the business will be subject to B&O tax at the lower retailing or wholesaling B&O tax rates. Other information technology services, such as data processing, the creation of custom software, or the customization of prewritten computer software after installation, are not subject to sales or use tax when separately itemized. If the same business also derives gross receipts from these activities, such receipts will potentially be taxable under the “service and other activities” classification of the B&O tax only if the business has established nexus with Washington under the new economic nexus standard.

In addition to dual nexus standards, the 2009 and 2010 legislation also introduced a myriad of potentially applicable sales and use tax exemptions that are based on the characterization of the product or service that is provided. For example, digital goods purchased solely for a business purpose are exempt from sales and use tax. However, this exemption does not apply to the purchase of digital automated services.

As these examples highlight, it is important that businesses accurately define and classify each separate revenue-generating activity in order to determine if they are properly reporting Washington B&O tax and properly collecting and remitting Washington sales and use tax. It is hoped that the new proposed rules will be helpful in performing this task.

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