

September 2003

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DIGITAL EQUIVALENT OF TANGIBLE PERSONAL PROPERTY ISSUE PAPER

ISSUE

To define the term “digital equivalent of tangible personal property” to promote a uniform understanding by state administrators and vendors in the proper classification of these specific products.

BACKGROUND

Recent discussions regarding “Digital Equivalent of Tangible Personal Property”

Discussions during the July 2002 meeting resulted in the suggestion that the definition of “digital equivalent of tangible personal property” proposed in fall of 2001 be revisited. This approach is advantageous because it does not require a lengthy and comprehensive study of the categories of electronic commerce and it bypasses the need to determine if the various electronic commerce categories are tangible personal property or services.

The term “digital equivalent of tangible personal property” identifies products transmitted electronically that traditionally were only delivered through tangible means. The list of products within “digital equivalent of tangible personal property” includes, but is not limited to, books, booklets, flyers, videotapes, compact disks, laser discs, digital video discs, photographic prints and negatives, photocopies, works of art, printed or embossed advertising specialties, finished art, etc.

Example: A customer rents a videotape and the movie is provided on tangible storage media, which represents a taxable lease or rental of tangible personal property. The consumer can also access the same movie via satellite for home viewing. The movie accessed via satellite would not meet the definition of “tangible personal property” in most states because it was not delivered via a tangible storage media. Therefore, unless a state specifically imposed a sales or use tax on access to movies electronically (e.g., premium cable service or pay-per-view television service), the amount it collects in sales tax will decrease as more people access movies electronically rather than renting the tangible video tape.

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CURRENT RECOMMENDATION¹

1) Define digital equivalent of tangible personal property as follows:

Digital equivalent of tangible personal property means a product, except prewritten computer software², meeting all of the following conditions:

- 1) Is expressed in binary digits*
- 2) Is delivered, accessed, or subscribed to electronically and*
- 3) The sale³ of which would be treated as a retail sale⁴ of tangible personal property if transferred on tangible storage media.*

¹ The following definitions are no longer included in the Subgroup's recommendations:

“Digital property” means a product, other than prewritten computer software, or a service that is expressed in binary digits and is capable of being processed by a computer and delivered or accessed electronically.

Rationale for removal: “Digital property” was incorporated into the definition of “digital equivalent of tangible personal property” in response to concerns that states would adopt this all-encompassing term and impose taxes on all products expressed in binary digits.

“Digital equivalent of a service” means a digital property delivered or accessed electronically that would otherwise be considered a service.

Rationale for removal: There is no reason to have a definition of a “digital equivalent of a service.” Services are not defined by the manner in which they are delivered to the customer. (For example, if a state taxes data processing services today, it does so regardless of whether the data is sent via telecommunications lines or magnetic tape.)

² Prewritten computer software, regardless of the form in which it is transferred, falls within the meaning of “tangible personal property” included in the Streamlined Sales and Use Tax Agreement. The definition reads, “‘Tangible Personal Property’ means personal property that can be seen, weighed, measured, felt, or touched, or that is any other manner perceptible to the senses. ‘Tangible personal property’ includes electricity, water, gas, steam, and prewritten computer software.” Thus, digitally delivered forms of this software are tangible personal property even though they may also satisfy the elements of a “digital equivalent of tangible personal property.”

³ The term “sale” has not been defined in the Streamlined Sales and Use Tax Agreement. Until this term is defined by the Project and approved by the Implementing States, the application of the term “sale” will depend on the definition of “sale” provided in the laws of those jurisdictions adopting this term. Thus, there may be varying treatment of the application of “sale” (i.e., to include transfers of ownership, title, or possession, as well as enjoyment of tangible personal property — which could include leases and licenses of tangible personal property, for the duration of the lease or license).

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- 2) Amend Section 316, Subsection C⁵, to include “digital equivalent of tangible personal property” so that a state may create exemptions even though a defined term.

Explanation of Current Recommendation of “Digital Equivalent of Tangible Personal Property”

The recommended definition of digital equivalent has three elements, all of which must be satisfied in order for the definition to apply:

(1) *The product must be expressed in binary digits.* This first element specifies the type of good at issue, all products in patterns of binary digits of zeros and ones.

(2) *The manner in which the good is delivered must be electronically.* “Electronically” has been defined by the Project as “relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.” Thus, the item at issue must not only be in binary digital form, as provided in element one, but the manner in which it is transferred must also be in a binary digital form. Specifying the mode of delivery is necessary to exclude common items of digital goods that are transmitted on tangible storage media and that are considered tangible personal property, such as music or movie compact discs.

(3) *The sale of which would be treated as a retail sale of tangible personal property if transferred on tangible storage media.*⁶ This element seeks to capture the types of digital products that, if that product had been transferred on tangible storage media, would have been classified as tangible personal property if it had been delivered in that form.

This definition does account for items that in the future will only exist in digital form. Because the definition states that the good **would be** treated as tangible personal property, there is no requirement that the digital item exist in a tangible form today. The question that must be answered is whether the transfer of the digital product, if it were transferred on a tangible storage medium, would be considered the retail sale of tangible personal property.

⁴ The term “retail sale” has been defined in the Streamlined Sales and Use Tax Agreement as, “any sale, lease, or rental for any purpose other than for resale, sublease, or subrent.”

⁵ This subsection reads: “For purposes of complying with the requirements of this section, the inclusion of a product within the definition of tangible personal property is disregarded.”

⁶ A previous version of the definition included a subdivision that stated, “is capable of being processed by a computer.” The subgroup recommends that this language be removed because, ‘is expressed in binary digits’ assures that it can be processed by a binary circuit on a chip in a computer.

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It is important to note that if a transfer of a digital equivalent of tangible personal property involves a product, the transfer of which would not have been classified as a retail sale of tangible personal property, then all three elements of the definition are not met. One major area where this would apply would be if a digital equivalent of tangible personal property is for resale, sublease, or subrent. To clarify this point, the word “retail” has been added to the phrase “sale of tangible personal property” in this September 2003 draft to clarify that the definition applies only to sales transactions to the final, end consumer.

Application of the term “digital equivalent of tangible personal property”

The defining of this term is an effort to accurately describe a type of product in a way that legislatures can make policy decisions regarding this type of product with uniformity and equity so that digital equivalent of tangible personal property will mean the same in all states regardless of how a particular state wishes to treat the category for sales and use tax purposes. This term would not automatically become an imposition nor would it be included within the already-defined “tangible personal property.” By making this type of item a distinct category, legislatures will need to affirmatively impose sales and use taxes on these transactions, similar to the treatment of the taxable services, upon which the sales or use tax is specifically imposed in state law.

The defining of this category of digital equivalents does not supplant existing statutory, regulatory, or jurisprudential structures governing the sales or use taxability of services. For example, states currently have statutes, regulations, or case law that govern whether or not the providing of cable services are subject to sales or use tax. The adoption of this definition would not override that state’s current treatment of the providing of video or audio content services by a cable operator or cable network over a cable system. Similarly, the providing of telecommunications service will remain subject to the state’s sales or use tax definitions or case law regarding that specific service.

Objective of the Transaction

Similar to tangible personal property furnished with a service, whether a person is selling a “digital equivalent of tangible personal property” or furnishing a service will be determined by the essence of the transaction. For example, a state does not tax the preparation of a will on paper as a sale of tangible personal property because the customer’s objective was to receive the legal services and not the tangible personal property representing the will. Therefore, a state could not consider the preparation of a will transferred in an electronic form to be a digital equivalent of tangible personal property because the transfer of the will on paper is not considered a sale of tangible personal property. Similarly, if a company processes transactions for a financial company and transfers statements detailing the transactions processed

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electronically, although the data or text transferred via computer is in a digital form, if the data processed was transferred on a tangible storage medium (paper, diskette, etc.) it would not be a sale of tangible personal property and, therefore, cannot be a digital equivalent of tangible personal property.

Conversely, if a state treats the sale of an advertisement on audio or video tape (commercial) to an end consumer as tangible personal property, the transfer of the advertisement in an electronic form (MP3 file e-mailed to the end consumer), the electronic form of the advertisement would be a digital equivalent of tangible personal property.

Exemptions

The definition recommended is neutral as to whether a digital product is taxable or exempt. If a state chooses to impose a sales tax on sales of “digital equivalents of tangible personal property,” it may enact product-based, entity-based, or use-based exemptions without restriction if the Agreement does not have a definition for the product. Therefore, it follows logically that if a state exempts some item of tangible personal property, the state would use this definition of “digital equivalent of tangible personal property” to extend the exemption to the electronic version.

A state that chooses to impose tax on the digital equivalent of tangible personal property could preface all exemptions to say that all exemptions that apply to tangible personal property also apply to digital equivalents of tangible personal property. As a result, the state that exempts all sales of tangible personal property by a school would also exempt all sales of digital equivalents of tangible personal property by a school. A state that exempts newspapers in print form would extend their exemption to electronic versions whether initially in a tangible form and converted to electronic form or created in an electronic form with no tangible counterpart.

Rather than providing a blanket extension of exemptions to digital equivalents of tangible personal property, a state could choose to amend only certain exemptions to extend to digital equivalents of tangible personal property. A state could also create unique exemptions for certain categories of digital equivalents of tangible personal property that do not apply to tangible personal property, such as subscriptions to access databases of information, movies and books delivered electronically, etc. However, if a state wishes to create an exemption for a product category for which the Project has already adopted a uniform definition, that definition must be used in crafting an exemption for the electronic version of that product category.