

MINUTES
SENATE LOCAL GOVERNMENT & TAXATION COMMITTEE

DATE: Wednesday, March 19, 2014

TIME: 8:00 A.M.

PLACE: Room WW53

MEMBERS PRESENT: Chairman Siddoway, Vice Chairman Rice, Senators Hill, McKenzie, Johnson, Vick, Bayer, Werk and Lacey

ABSENT/ EXCUSED: None

NOTE: The sign-in sheet, testimonies and other related materials will be retained with the minutes in the committee's office until the end of the session and will then be located on file with the minutes in the Legislative Services Library.

CONVENED: **Chairman Siddoway** called the meeting of the Local Government and Taxation Committee (Committee) to order at 8:05 a.m. Without objection, the Chairman asked to reorder the agenda.

H 584 **Chairman Siddoway** welcomed Representative Christy Perry to the podium to present **H 584**, relating to homestead exemptions and provisions for active duty military service. **Representative Perry** shared that this issue was brought to her attention by Sgt. Martin Lopez from the United States Marine Corps. She said he and others like him are from Idaho and have homes here. She said current code says that active duty military personnel can keep their homeowner's exemption only when they are deployed in a combat zone specifically.

Representative Perry said often, military personnel will be in a combat zone intermittently, not necessarily all year long. She said there are also many military personnel who are actually deployed to a combat zone, but their orders will not necessarily reflect the combat zone because what they are doing and where they are is classified information. She said the specificity disallows some of our military members through no fault of their own.

Representative Perry said the legislation is very narrow in scope and allows an active duty military member to maintain his or her homeowner's exemption if they are deployed outside of the State, irrespective of whether they are in a combat zone specifically. She said the bill does call for personal responsibility on the part of the military member to reapply each year and prove their active duty status.

Representative Perry shared a letter with the Committee from Sgt. Lopez (see attachment 1). She quoted from the letter where Sgt. Lopez wrote, "upon further investigation, I discovered that again my homeowner's exemption had expired." She said this bill will make it easier on our military households to have some control, allows for a process for them to apply each year, and stops the constant changes to their household finances. **Representative Perry** said she would like to make the point that although these military families are moved around considerably, if they have a home in Idaho, they do pay their taxes, and this bill in no way changes that fact. She said what it does do is level the playing field for them and treats them like every other Idaho citizen. She noted that there is no impact to the state funds and the Division of Veterans Affairs, the Idaho Association of Counties and the Idaho Realtors Association are supportive of the bill. She also noted that Senator Guthrie had agreed to carry this bill on the floor.

- MOTION:** **Senator Lacey** moved, seconded by **Vice Chairman Rice**, to send **H 584** to the floor with a **do pass** recommendation. The motion carried by **voice vote**.
- MINUTES:** **Chairman Siddoway** called for the consideration of Minutes from previous meetings, noting that the Minutes of March 6, 2014 were not on the agenda but are ready for consideration as well.
- MOTION:** **Senator Lacey** moved, seconded by **Vice Chairman Rice**, to approve the Minutes of March 5, 2014. The motion carried by **voice vote**.
- MOTION:** **Senator Vick** moved, seconded by **Vice Chairman Rice**, to approve the Minutes of March 13, 2014. The motion carried by **voice vote**.
- MOTION:** **Senator Werk** moved, seconded by **Senator Hill**, to approve the Minutes of March 12, 2014. The motion carried by **voice vote**.
- MOTION:** **Vice Chairman Rice** moved, seconded by **Senator Hill**, to approve the Minutes of March 6, 2014. The motion carried by **voice vote**.
- H 441** **Chairman Siddoway** invited Seth Grigg of the Idaho Association of Counties to the podium to present **H 441**. **Mr. Grigg** shared that **H 441** is technical in nature. He offered some background to explain why this bill is before the Committee today. He said in 2008, the Legislature enacted the first personal property tax exemption, granting a \$100,000 exemption to businesses. He said the replacement money from that exemption was to be recalculated annually, and the assessors would continue to track and file declaration forms with the county each year. He said in 2013, H 315 changed that. He said it kept the \$100,000 exemption, but it triggered that exemption immediately, whereas the other one was contingent upon a state revenue amount being hit. He said it also fixed the replacement amount in time rather than a recomputation each year. He said that created problems that were not recognized until after the bill became law. **Mr. Grigg** explained the changes to the bill. His detailed points about the changes can be found in the attached document (see attachment 2). He noted that **H 383** did take care of some of the issues and this bill will follow those consistencies. He said **H 441** has two sections because one is the current law, and the other will go into effect in 2017 due to legislation that was enacted a couple years ago regarding a bankruptcy lawsuit in Boise County.
- Senator Vick** asked if people who own private homes on state land can apply for a homeowners exemption. **Mr. Grigg** said he assumes so, but he is not certain and would defer to the Commission, who from the audience nodded yes.
- Chairman Siddoway** thanked Mr. Grigg. He commented that much effort has been made during the session to do more work on the personal property tax exemption. He said there is a Rule that will affect legislation which deals with the three and a half factor, which relates to fixtures as defined in the rule book. He said it deals with equipment not required. Chairman Siddoway said **H 441** is in the position to be used for amendments to get that necessary legislation through. Because of that, Chairman Siddoway said, he will recommend this bill be sent to the 14th Order for amendment.
- MOTION:** **Vice Chairman Rice** moved, seconded by **Senator Hill**, to send **H 441** to the floor with a recommendation that it be placed in the Amending Order. The motion carried by **voice vote**.
- DOCKET NO.** **35-0103-1302** **Chairman Siddoway** invited Alan Dornfest of the Idaho State Tax Commission (Commission) to the podium to present the final rule in the docket that was previously before the Committee. **Chairman Siddoway** noted there is a handout for the Committee to reference as Rule 205 is discussed (see attachment 3).

Mr. Dornfest stated that Rule 205 clarifies statutory definitions of real and personal property to assist assessors and the Commission in determining what property qualifies for the \$100,000 personal property exemption enacted by the legislature with H 315 in 2013.

Mr. Dornfest said the amendments found in Section 04 of Rule 205 are intended to clarify the definition of personal property to provide guidance to assessors and taxpayers as well as to allow for more uniform application of the exemption. He went on to describe the three clarifications:

(1) He noted first that Section 04 restates the statutory definition of "improvement." He said items considered structures or buildings are improvements, and as improvements, must be defined as real property which is ineligible for the personal property exemption. He said this was based on analysis of Idaho Code § 63-201, in which Subsection 11 defines "improvements" as meaning "all buildings, structures, erected upon or affixed to land." He said in the same code section, Subsection 23 defines "improvements" as real property.

(2) **Mr. Dornfest** said Section 03 of the rule reiterates the three factor test, under which once movable items become part of improvements to real property, they become real property, by being physically incorporated into the real property improvements, integral to the use of the real property, and intended during their useful life to be permanent additions to the real property.

Mr. Dornfest gave the example of a window. He said a window was once movable inventory, but then it became part of a business building or house, at which point it is a fixture, and therefore real property. He said because there is a section of statute that excludes articles affixed to real property to enable proper utilization of the articles, making such articles personal property, there is confusion between the three factor test and this extra provision.

(3) He said Section 04(a) of the rule helps resolve this by advising that when this extra provision conflicts with the traditional, well established and nationally recognized three factor test, the three factor test prevails. He said, then in the window example, once installed, it is a fixture which is part of the building, and it is an improvement to real property that is no longer personal property.

Mr. Dornfest then explained that Section 04(b) of Rule 205 provides examples of improvements considered ineligible by reason of being structures, such as cell towers, underground storage tanks, poles and towers, signposts, pipelines, and railroad track. He said an underground storage tank is a good example because it has to be affixed, even though at one time it was personal property, but he would argue it is not personal property under the three factor test.

Mr. Dornfest said most of the time there is no conflict, but he said if there is a conflict, Rule 205 takes the position that the "predominant determinant" as to determining whether a fixture is real property would be the three factor test, and not the extra half factor.

Chairman Siddoway stated if this Committee decides to reject this rule, it will give the Commission the opportunity to go back to the three factor test of annexation, adaptation and intention.

Senator Hill asked if the bill that was just sent to the 14th Order for possible amendment would have the amendments being considered to take care of the provisions in Rule 205 and would supersede Rule 205 anyway. **Chairman Siddoway** answered that is correct. He said the proposed amendments to **H 441** would directly affect this rule and would supersede it and would put in statute what has been dealt with in rule, which would make it legislative authority rather than just rule.

MOTION: **Senator Hill** moved, seconded by **Vice Chairman Rice**, to approve **Docket No. 35-0103-1302**, with the rejection of Rule 205.

In discussion, **Senator Bayer** asked a procedural question. He asked if the potential amendments on a House bill would not be subject to further hearings and/or testimony in the legislative process. **Chairman Siddoway** answered that is correct in that there would not be any further Committee meetings. He said bills sent to the Amending Order will have discussion on the Senate floor.

The motion carried by **voice vote**.

H 598

Chairman Siddoway invited Jay Larsen, CEO and President of the Idaho Technology Council (Council), to the podium to present **H 598**, relating to sales and use tax and remotely accessed computer software. **Chairman Siddoway** pointed out to the Committee that there is a handout provided by the Commission that may help during the presentation (see attachment 4).

Mr. Larsen said his Council represents about 50,000 employees and companies that operate in the technology industry, which has grown significantly over the past five to ten years. He said just in the Boise Valley, there are about a thousand more software developers that have a salary range of \$60,000 to \$120,000. He said the Council focuses on helping technology jobs start and thrive in Idaho.

Mr. Larsen thanked the Committee members for their support offered when he was before this Committee last year. He said he came here for two reason: 1) to gain alignment for the modernization of cloud services or electronically delivered software for services like accounting and legal services, and to provide that these software services are not subject to sales tax; and 2) to discuss the hyper growth of this industry now and in the next several years, and how the industry helps manage and optimize the operations in agriculture, manufacturing, food processing, forestry, mining, financial management, social networking, analytics, security, and much more. He said this legislation will help grow the future of this industry that has a five times multiplier as one of the highest paid industries in the world.

Mr. Larsen defined cloud services by saying they basically enable a customer who pays a license or leases or subscribes to a service for computing, storage, control, robotics, processing and analytics. He said last year the business community ran legislation that basically excluded cloud services from taxation in Idaho as H 186. He said the Commission asked for clarification of the Council's intent. He said the bill was reintroduced as H 243 with language from the Commission, and it passed the Legislature overwhelmingly and was signed into law by Governor Otter.

Mr. Larsen said during the rulemaking process, it became clear that the Commission and the industry came to an impasse in their ability to determine what the language really meant. He said it was decided to bring new legislation to remove ambiguity, which is what **H 598** is about. He said it is not a new tax exemption, but rather an update to definitions to reflect modernization of the industry, while repealing language from the last year's bill and clarifying the intent of the Legislature.

Mr. Larsen said he put together a broader consortium for discussion because it affects so many people and companies. He said Simplot, Micron, Internet Truck Stop, Clearwater Analytics, IACI, Farm Bureau, Boise Metro Chamber, Idaho Association of Realtors, Idaho Automobile Dealers Association, Idaho Restaurant and Lodging Association, Idaho Food Producers, SuperValue, Centurylink, Verizon, and the Pocatello Chamber of Commerce are just some of the companies and organizations who support this bill.

Mr. Larsen offered an example of how the Commission interpreted the intent. He said if a customer pays a subscription service for something on the cloud and puts it on his computer and downloads or prints something from it, that action would be a taxable event based on last year's bill. He said that was not the intent. He said the Council's intent was that a customer pays for a service and can go in and manipulate information as needed. **Mr. Larsen** said the new legislation is a little broader to allow industry to grow and to remove ambiguity.

Mr. Larsen shared four points about the fiscal impact. He said he felt it was important to keep the growing entertainment segment of the industry out of the exemption, which would include videos, books, games and music. He said doing so will provide great revenue for the State. He said the second point is the bill removes the retroactive clause at the request of the Commission, which said making it retroactive made a significant financial impact. Thirdly, he said because of the language of the last year's legislation that said "cloud services are remotely accessed software not subject to the sales tax," he thinks the Commission still is populating some figures in the impact. He said the Commission has supplied him with information regarding several disputes about cloud services, which may contribute to the fiscal impact. He said the last impact is that the business of downloading software is decreasing and cloud services remotely accessed software is increasing more into the future.

Mr. Larsen asked for the Committee's support in sending **H 598** to the floor with a do pass recommendation.

Senator Werk thanked Mr. Larsen for the explanation and asked for more detail with specific examples of where the conflicts were on specific types of products. He said he'd like a more tangible handle on what is being discussed. **Mr. Larsen** gave an example of using a GPS on a tractor. He said the GPS goes through cloud services through the internet and the farmer sits in the tractor while the tractor does its work. He said that would not be a taxable event. He said if he downloaded TurboTax, which could be purchased off a shelf at an electronics store, he would pay tax on that. However, he said if he had an opportunity to pay for a TurboTax subscription service, that would not be a taxable event, and he would have the ability to have other consolidated services, such as information storage.

Mr. Larsen said another issue with the Commission was how to delineate items for customers, because last year's legislation said "like services" would be taxable, meaning if the same item could be downloaded or purchased off the shelf. He said that is why this bill makes it so that anything downloaded off the cloud or having access off the cloud would not be a taxable event. He said other examples of non taxable events would be financial services accessed through the cloud or storage of pictures on the cloud. He said the most important thing to realize is that these examples were not taxable before either. He said until such time that the Commission interpreted portions of this tax code, people and other businesses were not paying taxes on these situations because they are services that are not taxable events. He said it did not come on their registers until audits started taking place a couple years ago.

Mr. Larsen shared examples of 1) a local security company that is one of the top in the world that has grown to half a billion dollar company in the past eight to ten years and 2) a financial institution that manages Fortune 500 companies that is in the top in the world. He said they both use cloud services to deploy their products to their customers. He said customers manage "time accounting" in cloud services, and Micron and HP manage services they provide to their customer base via the cloud. **Mr. Larsen** said this is a space that will continue to grow and excel in Idaho as it is optimized.

Senator Werk said he assumes a company providing services in the cloud is not "what we're dealing with here." He said, "We're dealing with people who are accessing these services from the cloud." He said if there is an Idaho company that provides cloud services all over the world, it is not feeling the heat from this issue. He said it is the user who is feeling the heat as to whether or not they pay tax. **Mr. Larsen** said, "You're right, that is a big issue." He said if he has a company in Idaho and that company's customer is in Idaho, that company is subject to collecting the 6 percent tax from that customer, and that customer has to pay that 6 percent tax (and he said he doesn't know if they are or not), so it is affecting both sides, the company and the customer, especially if the company's operations are in Idaho.

Senator Werk commented that Idaho doesn't collect internet taxes unless there is a nexus in the State. He referred to the tractor example of the tractor guiding itself along the field, stating that he is trying to figure out how a tax would be collected on that service. He asked if that would be a use tax and people would be expected to report that on their returns because it wasn't collected as part of the interaction.

Mr. Larsen said one of the people who helped craft this legislation was one of the top tax attorneys in the State, Rick Smith with Hawley Troxell, and he would defer the question to him. **Chairman Siddoway** cautioned the Committee about time constraints and that one person scheduled to testify is from the Commission. **Senator Werk** withdrew his question.

Senator Vick directed attention to the handout, noting that some parts of the taxable status matrix were still written in as "uncertain." He asked who will decide and how will it be decided whether those events are taxed or not. **Mr. Larsen** answered that he has not seen the document, so he cannot comment on it, but he hopes **H 598** will provide more clarity and clear up ambiguity. He said there were at least nine times in last year's legislation where discussions got hung up on language and definitions, but this bill removes those words. He said he would work with the Commission in rulemaking to clarify any issues and remove obstacles.

Senator Bayer asked for clarification on the origin of this document. **Chairman Siddoway** said he requested the information from the Commission and it was provided by McLean Russell.

TESTIMONY:

Chairman Siddoway welcomed Michael Chakarun, Tax Policy Manager with the Commission, to the podium to testify. **Mr. Chakarun** said the Commission is not here to support or oppose the legislation. He said he's here because the Commission believes it has understated the Fiscal Note. He said the Commission feels it is more along the lines of \$8 million "minimum" per year and will likely grow as more of the services move toward the cloud. He said the Commission appreciates Mr. Larsen and his group's decision to remove the retroactive provision of the bill, because that could have caused the Commission to have to pay refunds.

Mr. Chakarun offered some background. He said it was in 1986 that software was first incorporated into the sales tax code and was defined as taxable tangible personal property. He said the fact that software came on a disk or other media did not matter for sales tax purposes. He said the software itself, the 1's and 0's was tangible personal property. He said in 1993 all information stored in an electronic medium became tangible personal property as well. He emphasized that it was the information itself, not the medium on which it came, that was taxable.

Mr. Chakarun said last legislative session, the Commission was asked to provide a fiscal impact for H 243, and it did so based on publicly available data for software sales. He said they took global industry data and tried to scale back to what the Idaho impact might be. He said in the end, the sponsors calculated their own much lower fiscal impact for the bill. He said over the course of the summer's rulemaking activity, the Commission discussed the issue on several occasions with individuals from the public participating in the rulemaking. He said they believed that tax had not been collected on most sales of cloud-based software, and consequently they alleged the data used by the Commission in calculating the fiscal impact was poor.

Mr. Chakarun said arriving now in 2014, calculating the fiscal impact of **H 598**, the Commission considered those discussions from last year and chose to approach the fiscal impact from a different angle. He said the Commission reviewed sales tax returns, information obtained in the course of sales tax audits, and publicly available financial statements of approximately 100 taxpayers which they were able to identify in the short time frame available. He noted that significant additional time would be required to review even a small portion of the remaining 55,000 sales and use tax permit holders.

Mr. Chakarun said only transactions on which tax has been consistently collected for many years were included in the fiscal effect number. He said taxes that could be collected under interpretations of existing law, but were under audit or appeals and were not collected are not included in these numbers. He said of the 100 taxpayers, 28 were identified that the Commission could confidently say pay tax on these types of transactions. He said those taxpayers' information is confidential data and could not be disclosed to industry groups. He said that would mean collecting \$5 million in taxes to Idaho on an annual basis, and he said the Commission is very confident and comfortable with that number.

Mr. Chakarun said the Commission looked at 100 out of 55,000 tax returns, and those 55,000 are not the whole tax base, because companies don't have to have a sales and use tax permit to do business in Idaho, so there may still be these types of transactions on which taxes would be paid on a corporate return. He said the Commission's \$3 million estimate would be a conservative estimate of what that untapped population might contribute to the Fiscal Note. He said if they couldn't find evidence that a taxpayer didn't pay sales and use tax, the Commission didn't include that taxpayer.

Mr. Chakarun said the broad overview is that this bill moves far beyond what H 243 did last year. He said it is going to exempt smartphone and tablet apps, downloaded software, online software of which there is a downloadable or boxed version, enterprise software, and software maintenance contracts. He said pure help desk software is never held taxable, but software in which the customer receives help desk functionality plus software updates would be taxed at 50 percent, half taxable, half not taxable. He said some maintenance contracts are such that a customer cannot buy the software unless they also purchase the maintenance contracts, and that is taxable. Mr. Chakarun's comments were provided in writing (see attachment 5).

Mr. Chakarun said he would like to yield his time to Mr. Russell to walk the Committee through the matrix. **Chairman Siddoway** granted the request to yield. McLean Russell of the Commission approached the podium.

Mr. Russell said he tried to keep the matrix as close to prior versions as possible with updates of exemptions under **H 598**. He said page one addresses the traditional types of software loaded onto the computer, but with various delivery methods. He said essentially this bill exempts any delivery method besides a disk. He said this is where the primary fiscal impact is because it would exempt very large software packages that large companies use which cost millions up front and millions to keep up each year. He said item 1C of the matrix is in response to the bill, which addresses computer software that is delivered by the load and leave method. He said this line item does not affect individuals but only the big companies. He said this stuff doesn't come on a disk and so is exempted. He said this is a major difference from the current climate to what will the climate will be like under this bill.

Mr. Russell said the next section is about cloud type services. He said during discussions last year, everyone agreed that software that is delivered electronically was taxable, as was software delivered by the load and leave method. This is where this year's bill is more expansive than last year's. He said the fiscal impact of \$8 million that Mr. Chakarun shared does not include cloud based software. He said it includes only tax being paid on traditional types of software that have been taxable for many years. He said he personally vetted every single taxpayer that came across his desk, and every single one was selling kinds of software that has been used for years. The discussion now is just about differences in delivery methods.

Mr. Russell addressed Senator Vick's question about the line items marked "uncertain." He said this bill will not address all of them, and he said, "Frankly, I don't know if they can be addressed in rule or not. I don't know if we need a statute. That is always the best way to settle some of these issues so taxpayers and the Commission have guidance."

Mr. Russell said page three of the matrix is about digital products. He said most of them do remain taxable. He said the only change on this is where it used to say "movie, book, song or article" it now says "game" instead of "article" because he is uncertain if a digital article will be taxable under the new bill. He said the others are tangible personal property regardless of what the new law says. He said page four has a lot of uncertainty, because it includes things like video streaming, Netflix, Hulu and digital subscriptions to newspapers. He said, "We don't know what to do with it now and I don't think we'll know what to do with it under **H 598**."

Mr. Russell moved on to page five, which he said is where a large source of the fiscal impact lies. He said this is large companies who purchase data and the rights to use proprietary consumer data so companies can know what's going on in their industry. He said this bill would exempt all of that because it never comes on a disk.

Mr. Russell discussed page 6 of the matrix, and said 6B currently says taxable, but in reviewing the bill again today, he said events or shows that can be viewed at anytime through video on demand would fall in the category of uncertain, probably exempt. He then spoke about the items on page 7, and commented that while the bill does specifically say that digital games will remain taxable as tangible personal property, there is much uncertainty about it because of the various delivery methods and the current language in the statute that goes back 20 to 30 years.

Mr. Russell said he wanted to run through this information with the Committee so the members "understand what they are exempting, what they're excluding from taxation." He said he uses the word exempt and realizes this is a change in the definition. He's using the word exemption in the colloquial.

Vice Chairman Rice expressed concern that it appears to him that the Commission was interpreting printing off a report as being a separate a taxable event, even though the software wasn't taxable. He said he has a problem with that, because he doesn't see anywhere in tax code that that would be a taxable event. He said that would mean all sorts of services would be taxable, and he said it reminds him of the Stamp Act that led to the American Revolution. He asked Mr. Russell to explain the rationale on "why we suddenly have a Stamp Act that has never been passed by the Legislature."

Mr. Russell answered that "I can't speak to the Stamp Act" but he can say that during last summer's discussions, there was a lot of talk about documents. He said the problem they had was software that had online components loaded on computers. He said the particular cases Mr. Larsen referenced were research databases that are primarily in the cloud now, which 20 years ago were a set of books on a shelf, as for a lawyer or accountant. He said this information is now in the cloud and allows someone the ability to pull anything they want out of the database and load it onto their computer. He said that was one of the key issues that created an impasse and could not agree on how that should be treated. He said it was never the Commission's intention to put into rule or tax remotely accessed software from which reports can be printed.

Senator Werk said, "This is just so muddy." He said instead of having a wall full of legal books, he has a service that provides him with information that he needs. He asked under the current policy, would it be the Commission's duty to treat every per-transaction-basis each time he downloads a chunk of case law as a taxable event, so that he is taxed when he downloads case A on one day, and then gets taxed again the next day when he needs to download case B. **Mr. Russell** answered that the line item being discussed is 4D on the matrix. He said if someone were to pay for a chunk of content and just get that chunk of content, he believes that would be taxable under current law. He said information stored in an electronic medium in Idaho is tangible personal property and has been for 20 years. He said the problem is with online libraries where someone has access to everything and downloads only what is needed, like a court case or tax law or whatever. He gave an example of how everything "LexisNexis Westlaw" sold 20 years ago was taxable and now a lot of their sales are not, or it is uncertain whether they are.

Senator Werk asked if this doesn't pass and everything remains the same, how on earth does the Commission propose to collect tax on these types of ethereal transactions. **Mr. Russell** asked Senator Werk what he means by ethereal transactions, and if that means the difficulty in administering and enforcing tax collection. **Senator Werk** replied yes, based on the types of transactions being discussed. **Mr. Russell** answered that in general, these companies and providers are often very large and if they have a presence and nexus in Idaho, they generally know when they should or shouldn't be collecting tax. He said they collect it on the items they think they should be and don't on the things they don't. He said when talking about very small companies, it is always a problem in tax enforcement in every industry. He said the Commission does good work in auditing and informing and helping nonfilers get permitted if they need to be. He said in many of these areas tax is being collected. He said it is particularly large companies that are paying the use tax, and that is why this is such a big fiscal impact in actual dollars, not just what the Commission thinks should be collected.

Senator Werk said he is hearing discrepancies in the claims about the Fiscal Note. He said under Joint Rule 18, he would challenge the sufficiency of the Fiscal Note on **H 598**.

Senator Hill thanked Mr. Russell because members were struggling with what this bill actually does, and even though there are many things still uncertain, this matrix is helpful. He said it is "our fault, not yours" because it is the statutes that the Legislature passes that makes things uncertain. He said he appreciates the help.

Senator Vick had a question about line 4A in relation to online digital library of movies or music, with examples of Netflix and Hulu. He said there is a specific exclusion for music, movies, and books. He asked Mr. Russell to explain how he came to the determination that it is uncertain if these items are taxable or not. **Mr. Russell** said during discussions last summer, they could not agree on whether access to an online library with "information stored in electronic medium" that could have items downloaded made it "tangible personal property" or not. He said without something in the code that says something like "a subscription to a library of digital movies" making it very clear, there is uncertainty. He said he could make an argument that it is taxable and he could make an argument that it is not taxable.

Senator Vick said, "The exclusion then for music doesn't apply, in your mind." **Mr. Russell** said he thinks it makes it clear that if someone gets a digital movie and pays for it, and gets a digital song and pays for it, that one movie or song is subject to tax. He said it's when there are other types of transactions that it becomes less clear.

Chairman Siddoway invited Jim Lowe to the podium to testify. **Mr. Lowe** said he is here to represent Food Producers of Idaho, which has voted to support and track **H 598**. He said agriculture has become a very technology-intense industry and farmers rely heavily on online and cloud based services. Mr. Lowe's testimony is in writing and is available in the attached document (see attachment 6).

Chairman Siddoway invited Jonathan Parker with the firm Holland and Hart, representing Internet Truck Stop, to the podium to testify. **Mr. Parker** said Internet Truck stop is only eight miles from the Oregon border, but the owner is from Idaho and wants to stay in Idaho, despite Oregon throwing millions of dollars of incentives toward them to relocate to Oregon. He said he believes **H 598** is a good bill that will keep Idaho based businesses in Idaho and attract new ones. Mr. Parker's testimony is in writing and is available in the attached document (see attachment 7).

Chairman Siddoway invited Rick Smith of Hawley Troxell Law Firm, representing the Idaho Technology Council, to the podium to testify. **Mr. Smith** said there have been many issues raised about uncertainties remaining in this bill, about the fiscal impact, and about why this bill is even here after last year's bill. He said he thinks this bill does remove many uncertainties that were present in last year's bill. He said "we're not going to get them all." He said software applications and cloud technology will change over time, and there's no way to clarify everything in one bill at one time. He said he thinks they will probably come back in a few years and look at it again.

Mr. Smith said there is clarification for sure if software is in tangible form it will be taxable. If it is not in tangible form and is electronically delivered or accessed over the cloud, it will not be taxable. He said the bill establishes a bright line with respect to that. He said for clarification of the fiscal impact, this bill makes clear that digital products, music, books, games and videos would be taxable. He said that has been in doubt for a long time. He said these products, which will be coming into use more and more, are going to be taxable and are going to generate sales tax revenue for the State of Idaho. He said he thinks that is an offsetting factor to the fiscal impact that has been estimated by the State.

Mr. Smith addressed some of Senator Werk's questions about the problems encountered last year with the Commission. He said last year's bill excluded from tax remotely accessed software; software that is out on the cloud. He said every time an Idaho user accessed software from the cloud, whether from an Idaho or out of state software developer, there will always be some kind of "output" that will result from that access. He said it would be like printing a report or printing out a case, or some other instance of electronic download of the product. He said the Council and the Commission couldn't come to terms over the intent of the legislation.

Mr. Smith said if it is remotely accessed, it should still be excluded even if there is some downloaded product that everyone knows one would have with any software application. He said the clarification they tried to make with this bill is that if electronic download of remotely accessed software is that big of a problem, then "let's make a better bright line and include electronically downloaded software as part of the software that is excluded from tax." He said that should remove a lot of uncertainty that has been present for a long time, including with last year's bill. He said there is an additional fiscal impact from that.

Mr. Smith said he would dispute the amount the Commission has expressed. He said he thinks the Commission has conceded that the method they used to determine fiscal impact is something they don't do in measuring other fiscal impacts. He said they reviewed 29 (sic) tax returns and looked at them to estimate what taxes were paid by those taxpayers for software products. He said he doesn't know how they could tell from those returns what kind of software those companies were buying, whether it was remotely accessed software, electronically downloaded software, or software delivered in tangible form. He said it could be that those software packages were packages that would continue to be taxed even after this bill is enacted. He said he thinks there are fundamental problems with the method the Commission used to determine the fiscal impact.

Mr. Smith said everything he has heard and read is that the movement of software applications is going to be toward the cloud. He said more and more is going toward the cloud and less and less will be electronically downloaded. He said to the extent that there is a fiscal impact from this additional electronic download feature, revenues from that would be diminishing over time anyway. He said from his view, even before last year's bill, Idaho did not have the statutory authority to tax transactions on the cloud in the first place. He said whatever the fiscal impact might be from this bill which comes from the migration toward the cloud is foregone revenue to begin with, because it's not something that Idaho had the right to tax at all.

Senator Hill said he understood from Mr. Chakarun's testimony that the Commission had already taken into account that this bill had been changed to remove the entertainment parts. He said it sounds to him like Mr. Smith is saying they are overstating it because they haven't taken that out. He said Mr. Smith noted he has a problem with their method of calculating the fiscal impact, and he asked what method did the Council use. He said this is setting quite an interesting precedent, because he has had tax bills he's carried himself in which the fiscal note from the Commission "didn't feel right" but they are the only ones who have the actual data to go back and reference, as limited as it may be at times. **Senator Hill** asked what empirical data or evidence is Mr. Smith using to challenge the fiscal note.

Mr. Smith said he understands that the Commission's fiscal note does not include any additional impact or mitigation from the fact that entertainment is now taxable and was taxable as a result of last year's bill. He said his point is that he thinks the increasing clarity provided by both last year's and this year's bills will clarify that these types of entertainment products are taxable and have an offsetting impact that should make this whole clarification process more palatable to the Legislature.

Mr. Smith said he thinks in the future digital products are going to increase in use, and he does not think they have been consistently reported or taxed, so he thinks this will be an additional source of revenue that the Commission didn't try to quantify because it was not part of their charge. He said he thinks it is something fair to consider.

Mr. Smith said yes, he has problems with the Commission's method. He said to answer the question about what he'd do differently, he pointed out that the problem is the Commission has all the information. He said he'd like to be able to audit what they did, but "they won't give it to us because it's private confidential taxpayer information." He said he can't get in there and dissect it any better than he is now. He said he thinks it is fair to say that they've conceded it is a pretty unscientific method they used. **Mr. Smith** said they just looked at returns, which are not very detailed as to what types of software is being purchased or what methods of delivery were used for that software, in order to know whether or not that software would have been taxable under this bill. He said if it would have been taxable under this bill, it is not fair to consider it as part of the overall fiscal impact. He said the way the Council did it is to take the Commission's number and "just discount it a little bit." He said the Council thinks it's overstated. He said it is a guess because this is a very difficult area, and it is hard for the Commission, too. He said it's hard to know what is taxable in the first place, how that is impact estimated, and how it's going to be counted in the future because it will all be in the cloud and Idaho wouldn't be able to tax that anyway.

Chairman Siddoway invited Mr. Larsen to the podium to close the testimony. **Mr. Larsen** said the reason people like cloud services is because it allows them to get a custom product that would have cost them millions and millions of dollars for only \$30 because that cost has been spread out. He said, "Do not be deceived on this issue; it is much clearer than this." He said the ambiguity comes from the Commission. He said the Council clearly defines that entertainment is excluded from the exemption, and the Commission tries to tell you that Netflix is a service where you buy movies and it could be argued either way. Mr. Larsen said it cannot be, because in their method, it is supposed to be taxed. He said the Committee can now see the difficulty they had last summer during discussions, because the Commission brought in the ambiguity. He said "It doesn't need to be that way." He said this bill clarifies it. He said there will be some things that need to be discussed, but he believes there will be really good rules out of this. He said this is good legislation that will really help the State of Idaho. He said the Council will come back to the Legislature, because this is all about modernization. He said what will happen with the hyper growth of this industry will be phenomenal, and they'll need to come back multiple times in the next two to five to ten years. He said they don't know what the next cloud service will be. **Mr. Larsen** asked for the Committee's support.

MOTION:

Vice Chairman Rice moved, seconded by **Senator Bayer**, to send **H 598** to the floor with a **do pass** recommendation.

During discussion, **Senator Werk** said he doesn't know which way to go on this because the Fiscal Note is disturbing. He said, "Any additional monies that go into any kind of not taxing something or taking money away impacts our ability to fund education. I don't know which way to go on this, but I don't like the idea of money not being able to be put into education."

Vice Chairman Rice said in regard to the Fiscal Note, the Commission did a study, but the statistical information collected and compiled was not as good as he would like, and that adds to the uncertainty. He said he understands the Commission is addressing that and hopefully there will be better numbers in the future. He said he is comfortable with what it is.

The motion carried by **voice vote**.

ADJOURNED: There being no further business, **Chairman Siddoway** adjourned the meeting at 9:30 a.m.

Senator Siddoway
Chair

Christy Stansell
Secretary