



Rhode Island Department of Revenue Division of Taxation

Declaratory Order 2017-01

Request for Ruling Regarding the Taxability of a Product Fee Either As a Paid Monthly or Annual Subscription or As a Free One-Month Trial

Request for Ruling

Taxpayer requested a declaratory ruling (“Ruling Request”) to determine whether its product (“Product”) is exempt from Rhode Island Sales and Use Tax as: (1) an annual or monthly paid subscription and (2) as a free one-month trial. R.I. Gen. Laws § 42-35-8 and Regulation DR 03-01 govern declaratory order requests.

Facts

The facts set forth below are taken from the statement of facts presented in the Ruling Request dated January 10, 2017.

Taxpayer offers its Product for which the public may sign up for a free one-month trial, monthly paid, or annual paid subscription. During the membership period, the purchaser obtains the right to access certain benefits associated with shopping on the Taxpayer’s website (“Website”). Product participants are referred to as Product Members or Members. Product Members are required to agree to the Product Terms & Conditions to activate their Product membership.

Product benefits currently provided to Product Members are as follows:

- 1.) Shipping Benefit – Product Members are entitled to receive free two-day shipping and other discounted shipping benefits on eligible purchases made on the Website. Products eligible for these shipping benefits are designated as such on the Website’s product pages. Also, certain products sold by third-party merchants participating in Taxpayer’s fulfillment program are eligible for Product’s shipping benefits.
- 2.) Streaming Video Benefit – Product Members may view designated movies and television shows an unlimited number of times at no additional cost during the course of their Product membership. Streaming Video Benefit can be viewed on the Member’s television, computer, video gaming system, electronic tablet, or other compatible device. All Product Members are permitted to access Streaming Video Benefit. Product Members with certain smartphones and electronic tablets can also download Streaming Video Benefit if their phone or tablet is registered to the same Website account as their Product membership. If a Product Member cancels his or her membership, or the membership expires after a movie or television show is downloaded, the Product Member will lose access to the downloaded movie or television show. There are restrictions on how much time Product Members are



permitted to access downloaded Streaming Video Benefit without an Internet connection.

- 3.) E-book Lending Benefit – The E-book Lending Benefit allows Product Members who own electronic book (“e-book”) readers to choose from thousands of electronic books to borrow for free, as frequently as one book a month, with no due dates. If a Product Member cancels his or her membership, or the membership expires after a book is borrowed, the Product Member will lose access to the borrow book.
- 4.) Free E-book Benefit – The Free E-book Benefit feature allows Product Members who own certain e-book readers to receive one (1) free e-book per month from four (4) e-books selected by Taxpayer’s editors. The selected e-book becomes a permanent part of the Product Member’s e-book reader library. To access this benefit, Product Members must own an e-book reader device that is registered to the same Website account as the Product membership.
- 5.) Bulk Item Benefit – This benefit allows Product Members to ship up to forty-five (45) pounds of heavy/bulky items for a flat shipping fee of \$5.99. The heavy/bulky items in the Bulk Item Benefit are only available for purchase by Product Members.
- 6.) Exclusive Access to Essential Items – Essential Items is a line of premium, everyday essential products (currently limited to baby wipes) only available for purchase by Product Members.
- 7.) Discount Pricing – Discount Pricing provides Product Members discounts on certain items of tangible personal property. For example, Product Members can purchase certain televisions and software at a discount. The suite of products offered to Product Members at a discount continues to expand.
- 8.) Advance Purchase Benefit – Product Members receive thirty-minute early access to select deals on the Website and sales events on a related website (“Related Website”). The deals and sales events are designated as such on the product detail page or on the respective websites.
- 9.) Music Benefit – Music Benefit provides Product Members with unlimited, ad-free access to more than a million songs and albums. Music Benefit may be played on the Product Member’s computer, electronic tablet, or other compatible device. Music Benefit may be streamed or downloaded for listening without an Internet connection. Similar to other benefits outlined herein, if a Product Member allows his or her Product membership to lapse or expire, he or she will lose access to the downloaded Music Benefit titles.
- 10.) Photo Benefit – Product Members receive unlimited storage for photos in Taxpayer’s Cloud Drive (“Cloud Drive”) and 5GB of storage for videos and files. Product Members must have a Cloud Drive account registered to the same Website account as their Product membership to activate this benefit. As long as the Product

membership is active, photos uploaded to the Product Member's Cloud Drive will not count against the Product Member's 5GB of fixed storage capacity in the Cloud Drive for files and videos.

- 11.) Audio Channel Benefit – Product Members receive access to a selection of original programs, comedy, lectures, and audio editions of articles from newspapers and other periodicals. Audio Channel Benefit also showcases twenty (20) hand-selected playlists on a range of topics. The Audio Channel Benefit is free exclusively for Product Members.
- 12.) Product Reading Benefit – In addition to E-book Lending Benefit and Free E-book Benefit, Product Members receive access to unlimited reading from a rotating selection of books, magazines, comics, and more on their computers and devices.
- 13.) Video Game Benefit – Product Members receive greater access to Video Game Benefit, a platform for video game players to broadcast streaming video of themselves playing video games and to interact with their viewers, recently integrated with Product. Product Members receive free Video Game Benefit channel subscriptions, discounts on game purchases, exclusive access to games and in-game content, and other perks. Some video games and video game content may be downloaded while others may be streamed or otherwise accessed.
- 14.) Electronic Button – Product Members may also purchase an Electronic Button, which allows customers to press a button to reorder a product. Upon pressing the button, an order is placed through the customer's Website account for the specific item. Each button works for a single product. Currently, only Product Members are eligible to purchase Electronic Buttons. However, it will likely be offered to all customers. When the Electronic Button is sold, tax is calculated and collected where Taxpayer is required to collect sales and use tax.

While Taxpayer does not directly provide the membership benefits, it is contractually obligated to ensure the benefits are provided to Product Members. To meet its contractual obligations, Taxpayer pays its affiliates to provide the underlying service related to each benefit. For example, one of Taxpayer's affiliates provides the expedited shipping service while another affiliate provides the e-book benefits.

Ruling Requested

Based on the facts provided, Taxpayer's sale of Product to Rhode Island customers is subject to sales and use tax because it is a bundled transaction whose real object is ready access to both taxable and nontaxable goods and services. However, Taxpayer's provision of a free, one-month trial Product to Rhode Island customers is exempt from sales and use tax because no consideration is paid for the trial.

Pertinent Local Statutory and Regulatory Law

I. Tangible Personal Property and Services

R.I. Gen. Laws § 44-18-18 imposes a sales tax on all “sales at retail” in Rhode Island. If the sales tax does not apply, the state imposes a use tax under R.I. Gen. Laws § 44-18-20 “on the storage, use, or other consumption in this state of tangible personal property; prewritten computer software delivered electronically or by load and leave; or services as defined in § 44-18-7.3.” R.I. Gen. Laws § 44-18-8 defines “retail sales” or “sale at retail” as “any sale, lease or rentals of tangible personal property, prewritten computer software delivered electronically or by load and leave, or services as defined in R.I. Gen. Laws § 44-18-7.3 for any purpose other than resale, sublease or subrent in the regular course of business.” Unlike tangible personal property, services are generally nontaxable unless they are specifically enumerated by statute. Rule 7(2) of Regulation SU 11-25 reinforces the taxability of prewritten computer software, including application software, that is delivered electronically or by load and leave.

Under R.I. Gen. Laws § 44-18-7(1), the term “sales” means and includes “any transfer of title or possession, exchange, barter, lease, or rental, conditional or otherwise, in any manner or by any means of tangible personal property for a consideration. ‘Transfer of possession’, ‘lease’, or ‘rental’ includes transactions found by the tax administrator to be in lieu of a transfer of title, exchange, or barter.” “Sales” also includes “the sale, storage, use or other consumption of prewritten computer software delivered electronically or by load and leave as defined in paragraph 44-18-7.1(v),”¹ and “the furnishing of services in this state as defined in § 44-18-7.3.”²

R.I. Gen. Laws § 44-18-16 defines “tangible personal property” as “personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses. ‘Tangible personal property’ includes electricity, water, gas, steam, and prewritten computer software.” “Prewritten computer software” refers to “‘computer software,’ including prewritten upgrades, which is not designed and developed by the author or other creator to the specifications of a specific purchaser.”³ “‘Computer software’ means a set of coded instructions designed to cause a ‘computer’ or automatic data processing equipment to perform a task.”⁴ These same definitions of “prewritten computer software” and “computer software” are in Rule 5 of Regulation SU 11-25 and the Streamlined Sales and Use Tax Agreement (“SSUTA”), which Rhode Island must comply with pursuant to R.I. Gen. Laws § 44-18.1-1 *et seq.* and Regulation SST 13-01.⁵

¹ R.I. Gen. Laws § 44-18-7(14).

² R.I. Gen. Laws § 44-18-7(16).

³ R.I. Gen. Laws § 44-18-7.1(g)(vi).

⁴ R.I. Gen. Laws § 44-18-7.1(g)(ii).

⁵ Streamlined Sales and Use Tax Agreement, STREAMLINED SALES TAX GOVERNING BD., INC. (Dec. 16, 2016), <http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA%20As%20Amended%2012-16-16.pdf>, at 104.

R.I. Gen. Laws § 44-18-12(a)(iv) states that “‘sales price’ applies to the measure subject to sales tax and means the total amount of consideration, including cash, credit, property, and services, for which personal property or services are sold, leased, or rented, valued in money, whether received in money or otherwise, without any deduction for... delivery charges, as defined in § 44-18-7.1(i)...” “‘Delivery charges’ means charges by the seller of personal property or services for preparation and delivery to a location designated by the purchaser of personal property or services including, but not limited to, transportation, shipping, postage, handling, crating, and packing.”⁶ Regulation SU 07-33 explains that delivery charges are subject to sales tax if the property sold is taxable. On the other hand, if the property sold is tax-exempt, the delivery charges are not subject to tax.

Under R.I. Gen. Laws § 44-18-25, all gross receipts are presumed to be taxable until the taxpayer proves otherwise to the Tax Administrator. The burden of proving to the contrary is on the person who makes the sale and the purchaser, unless the person who makes the sale takes from the purchaser a certificate indicating that the purchase was for resale. The certificate must be in the form that the Tax Administrator requires. R.I. Gen. Laws § 44-18-30 provides a list of specific exemptions to the Sales and Use Tax in Rhode Island. If a good falls outside of this list, it is generally taxable.

II. Digital Products

The SSUTA defines electronically transferred products as distinct from tangible personal property and computer software.⁷ However, it is up to each state to decide whether to tax electronically transferred products. Under R.I. Gen. Laws § 44-18-7.1(g)(vi), “delivered electronically” means “delivered to the purchaser by means other than tangible storage media.” Rule 7(6) of Regulation SU 11-25 states that “specified digital products such as digital audio visual works, digital audio works, digital books, movies, music downloads, and ringtones which are delivered electronically, are not subject to tax, as they are not considered to be prewritten computer software.”

Per Rule 5 of Regulation SU 11-25, “specified digital products” refers to electronically transferred:

- (a) “Digital Audio-Visual Works” which means a series of related images which, when shown in succession, impart an impression of motion, together with accompanying sounds, if any:
- (b) “Digital Audio Works” which means works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones. For purposes of the definition of “digital audio works”, “ringtones” means digitized sound files that are

⁶ R.I. Gen. Laws § 44-18-7.1(i).

⁷ Streamlined Sales and Use Tax Agreement, STREAMLINED SALES TAX GOVERNING BD., INC. (Dec. 16, 2016), <http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA%20As%20Amended%2012-16-16.pdf>, at 59.

downloaded onto a device and that may be used to alert the customer with respect to a communication.

- (c) “Digital Books” which means works that are generally recognized in the ordinary and usual sense as “books”.

Rhode Island’s definitions of specified digital products match those provided by the SSUTA.⁸

III. Membership Fees

Membership fees and dues are generally nontaxable in Rhode Island. Regulation 87-54 states that “charges by the club for other than the sales of tangible personal property such as membership dues assessments, are not charges for tangible personalty and, as such, are not taxable.” However, “sales of tangible personal property, including food and beverages and rentals of golf carts and other equipment, by golf and country clubs, whether made to members or other persons are taxable and such clubs must obtain a sales tax permit.” Likewise, Declaratory Ruling 2011-01 holds that a taxpayer’s renewable subscription fee for its website authentication service is nontaxable because the service is not statutorily enumerated as a taxable service and did not involve the transfer of software, tangible personal property, or other materials.

In *Potowomut Golf Club v. Norberg*, the Rhode Island Supreme Court decided that a \$15 minimum charge for golf club members was a nontaxable membership fee⁹. The golf club imposed the \$15 fee because its members were not buying enough food and beverages to make the club’s restaurant profitable. The charge was applied only against food purchases, so if a member bought at least \$15 worth of food one month, he or she would not incur any additional charge. If the customer bought less than \$15 worth of food, he or she would be assessed the difference of the \$15 and the amount of food actually bought. The Division of Taxation assessed sales tax on this difference, but the court held that this amount was nontaxable. The court reasoned that the \$15 minimum food charge was due regardless of whether the member made purchases at the club restaurant. Where all members must pay the same fee and that fee is not charged in direct proportion to any benefit received, that amount is a nontaxable membership fee or due.¹⁰

IV. Bundled Transactions

R.I. Gen. Laws § 44-18-7.1(c) defines a bundled transaction as “the retail sale of two or more products, except real property and services to real property, where (1) the products are otherwise distinct and identifiable, and (2) the products are sold for one non-itemized price. A

⁸ *Id.* at 106.

⁹ 337 A.2d 226, 229 (R.I. 1975).

¹⁰ *Id.*

‘bundled transaction’ does not include the sale of any products in which the ‘sales price’ varies, or is negotiable, based on the selection by the purchaser of the products included in the transaction.” If even one of the products in the bundle is taxable, the entire bundled transaction is taxable unless the real object of the transaction is nontaxable.

Rhode Island determines whether bundled transactions are taxable based on the real object test. *New England Telephone and Telegraph Co. v. Clark* spells out three (3) categories into which property and services are typically organized.¹¹ If the real object of the transaction is tangible personal property, the transaction is taxable. If the real object instead is a nontaxable service, the transaction is not taxable. When the property and service aspects of the transaction are readily separable, but each is consequential, then the property and service elements must be analyzed as separate transactions for tax purposes. Rhode Island’s past cases on the real object test have primarily dealt with the taxability of real estate listing booklets (taxable)¹², mechanical layouts and color overlays for toy packaging (taxable personal property exempted as a manufacturing component)¹³, telecommunications equipment and engineering services to update a switching office (personal property and services separable)¹⁴, and videotaped depositions (case remanded on an evidentiary issue)¹⁵.

Discussion

Taxpayer claims that the sale of Product is not subject to sales and use tax because it is not a retail sale. More specifically, Taxpayer states that the sale of Product is not (1) taxable tangible personal property, (2) a taxable digital product, (3) a retail taxable service, or (4) a bundled transaction. Instead, Taxpayer asserts that Product’s fee is for a nontaxable transfer of an intangible right to access certain benefits, the use of which is unknown to Taxpayer and the customer at the time of purchase. Taxpayer states that it does not know whether a given Product Member will use any benefit or none at all during Product’s term, which is either monthly or annual. The key categories of tangible personal property and services, digital products, membership fees, and bundled transactions will each be discussed in turn.

I. Tangible Personal Property and Services

Taxpayer states that its Product is not tangible personal property, including prewritten computer software, because it cannot be physically perceived by the senses. Taxpayer also states that Product is not a taxable service under R.I. Gen. Laws § 44-18-7.3. Product in and of itself is not taxable tangible personal property or services. Although Product is not a taxable service

¹¹ 624 A.2d 298, 300-01 (R.I. 1993).

¹² *Statewide Multiple Listing Serv. v. Norberg*, 392 A.2d 371, 372 (R.I. 1978).

¹³ *Hasbro Indus. v. Norberg*, 487 A.2d 124,125, 127 (R.I. 1985).

¹⁴ 624 A.2d at 301-02.

¹⁵ *White v. Clark*, 823 A.2d 1125, 1126, 1128 (R.I. 2003).

under Rhode Island law, it does provide customers with direct access to taxable video games and in-game content through the Video Game Benefit. Video games are considered taxable prewritten computer software under R.I. Gen. Laws §§ 44-18-8, 44-18-18, 44-18-20, and Rule 7(2) of Regulation SU 11-25. As will be discussed shortly, Product is more accurately described as a bundled transaction.

II. Digital Products

Product itself is not a specified digital product under Regulation SU 11-25 such as an electronically transferred movie, book, or song. However, Product provides customers with direct access to a wide array of digital products and essentially acts as a transaction for these digital products. Customers do not have to pay any extra consideration to access these digital benefits. Nevertheless, despite this broad access to specified digital products at no additional cost, such products are currently nontaxable under Regulation SU 11-25.

III. Membership Fees

Membership fees are generally nontaxable in Rhode Island.¹⁶ Regulation 87-54 exempts membership dues for golf and country clubs. The Division of Taxation has also applied this exemption to memberships to retail stores where goods can be bought in bulk at discount prices. Ruling 2011-01 exempts the membership fee for a website certification service. Product appears to be similar to a membership whose fee is nontaxable. When a customer purchases Product, the customer has access to a wide variety of goods and services: free two-day shipping, streaming or downloadable digital products and video games, discounts on future purchases, etc.

As with the \$15 membership fee in *Potowomut Golf Club*, the monthly or annual Product fee is also equally charged to all of Taxpayer's customers regardless of the benefits they may or may not use. A golf club customer in *Potowomut Golf Club* would have been charged \$15 even if he never stepped foot in the club restaurant. Likewise, a customer who purchases a retail store discount club membership must pay the membership fee even if she never avails herself of a single product discount. All customers must pay the same monthly or annual fee for Product as the charge is not proportional to the benefits used. However, although Product's fee could be characterized as a nontaxable membership fee, it is more accurately described as a bundled transaction, as discussed in the next section.

IV. Bundled Transactions

A. Statutory Definition

Product is ultimately a bundled transaction whose real object is ready access to one or more enumerated benefits, some of which are taxable, for no additional consideration. Product fits the definition of a bundled transaction under R.I. Gen. Laws § 44-18-7.1(c). As noted earlier,

¹⁶ *Potowomut Golf Club*, 337 A.2d 226 at 229 (\$15.00 minimum food fee was a nontaxable service where it was "shared equally by all members and not levied as a charge in direct proportion to any benefit received...")

the statute defines a bundled transaction as “the retail sale of two or more products, except real property and services to real property, where (1) the products are otherwise distinct and identifiable, and (2) the products are sold for one non-itemized price.”

Here, Product is a bundle of goods, services, and other benefits that Taxpayer’s Ruling Request indicates are distinct and identifiable and sold for one non-itemized price. As stated earlier under “Discussion” Section 1, video games and in-game content are the only readily identifiable prewritten computer software being sold through Product that are subject to sales and use tax. Under R.I. Gen. Laws § 44-18-7(1), the term “sales” means and includes “any transfer of title or possession, exchange, barter, lease, or rental, conditional or otherwise, in any manner or by any means of tangible personal property for a consideration.” Prewritten computer software is considered tangible personal property under R.I. Gen. Laws § 44-18-16 and is taxable whether delivered electronically or by load and leave per R.I. Gen. Laws §§ 44-18-8, 44-18-18, and 44-18-20. Even if some of Taxpayer’s customers do not access a single video game or in-game content, they are paying for the unconditional right to access those items along with all of Product’s other benefits for not additional cost.

R.I. Gen. Laws § 44-18-7.1(c) additionally states that “a ‘bundled transaction’ does not include the sale of any products in which the ‘sales price’ varies, or is negotiable, based on the selection by the purchaser of the products included in the transaction.” Here, the benefits available under a Product subscription are being sold for one non-itemized price as a monthly or annual fee. Product’s monthly or annual price is not dependent on each customer’s selection of benefits to consume. One customer who uses only free two-day shipping will be charged the same monthly or annual Product fee as another customer who uses free two-day shipping, watches videos, listens to music, borrows e-books, uploads photos for storage, and plays video games through Product. Therefore, Product meets the statutory definition of a bundled transaction. Whether a bundled transaction is taxable depends on whether it satisfies the real object test.

B. Real Object Test

Whether a bundled transaction is taxable depends on the real object of the transaction.¹⁷ The real object of any transaction to purchase Product is access to one or more readily-accessible benefits, some of which are taxable, for no additional consideration. The real object of a Product transaction is not predominantly a taxable good, a nontaxable service, or both that can be separately analyzed as in *New England Telephone* or Rhode Island’s other case law. Product’s business model is novel and does not fit neatly into the conventional archetype of tangible personal property being taxable and services being nontaxable.

In its Ruling Request, Taxpayer states that “at the time of purchase, it is impossible to reasonably allocate the [Product] fee given the uncertain frequency with which an individual [Product Member] will utilize a given benefit.” However, when each customer purchases Product, a fixed number of goods and services are available for the customer to access. Those

¹⁷ See *New Eng. Tel. & Tel. Co.*, 624 A.2d at 300-01.

goods and services are “distinct and identifiable”, as Taxpayer indicated in its list of benefits in the Ruling Request. The customer must then pick and choose which of the benefits he or she wants to use as a Product Member. The Product fee covers all of the available goods and services that Product offers without additional charge.

R.I. Gen. Laws § 44-18-25 presumes that all gross receipts are subject to sales tax and all use of tangible personal property is subject to the use tax until the contrary is proven to the Tax Administrator’s satisfaction. Tangible personal property that is not exempted by R.I. Gen. Laws § 44-19-30 and services that are enumerated in R.I. Gen. Laws § 44-19-7.3 are subject to sales and use tax. Where there is some ambiguity in how much of a transaction is taxable, and the taxable portion of the transaction is not inconsequential, the transaction is presumed to be taxable. When a customer purchases Product, he or she has unconditional access to all of the benefits in the bundle, including the taxable ones. Some customers may purchase Product only to access taxable video games while others may never see a single game. Either way, each customer is paying for full access to that benefit.

Today’s increasingly digital landscape blends the tangible with the intangible, resulting in shifting boundaries for taxation. Even if Taxpayer could prove that most of its customers’ Product transactions were nontaxable, such a showing would not detract from the fact that its customers have access to taxable prewritten computer software at no additional charge. There is no evidence that video games and in-game content are inconsequential as a Product benefit. To exempt Product from sales and use tax would create an inequity in state tax administration where tax is collected on those items for some retailers but not for others. For these reasons, Product is most appropriately considered a bundled transaction that is subject to Rhode Island sales and use tax.

V. Free Trial

The free one-month trial subscription of Product is not subject to sales and use tax because no consideration is paid for that transaction. R.I. Gen. Laws § 44-18-7(1) defines “sales” as “any transfer of title or possession, exchange, barter, lease, or rental, conditional or otherwise, in any manner or by any means of tangible personal property for a consideration.” (Emphasis added.) Since customers do not pay Taxpayer for the free one-month Product trial subscription, no sales and use tax is owed.

Ruling

Based on the facts provided, Taxpayer’s sale of Product to Rhode Island customers is subject to sales and use tax because it is a bundled transaction whose real object is ready access to numerous benefits, some of which are taxable, for no additional consideration. However, Taxpayer’s provision of a free, one-month trial Product to Rhode Island customers is exempt from sales and use tax because no consideration is paid for the trial.

This ruling is limited to the facts stated herein and may be relied upon by the Taxpayer and shall be valid unless expressly revoked because (1) the applicable statutory provisions of law are amended in a manner that requires a different result; (2) the underlying facts described herein

materially change; or (3) a decision on point has been issued by the Rhode Island or Federal courts.

Neena S. Savage
Tax Administrator
March 31, 2017

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