SOURCING OF DIGITAL GOODS AND SERVICES FOR SALES TAX –
THE EVOLUTION OF A FEDERAL LEGISLATIVE PROPOSAL
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INTRODUCTION

This paper discusses a proposed federal law that purports to create a mandatory interstate sourcing regime for sales of digital goods and services—that is, a method by which transactions may be assigned to a particular state for tax purposes. It is commonly believed that the nature of digital goods and services, and the fact that there is no transfer of a physical product, creates a particular need for sourcing methods that give purchasers and sellers the assurance that items sold are being properly treated for tax purposes. Development of an interstate sourcing regime may be important if state policymakers hope to subject such transactions to sales and use taxes in the same manner as other consumer sales. However, when analyzed closely, the proposed federal legislation presents as many problems as it does opportunities.

Summary of Approach to Analyzing Proposed Federal Sourcing Rules

As context for examining the proposed federal legislation, called the Digital Goods and Services Tax Fairness Act (“the DGSTFA,” see Appendix A), this paper first outlines the important characteristics of the existing sales and use tax system within which any sourcing regime must fit. It also briefly addresses the critical issue of jurisdiction—the authority that states must have to be able to enforce tax collection—and the impact of this issue on the development of an acceptable sourcing regime. It then briefly reviews one state’s long experience taxing sales of services and intangibles generally and what that experience teaches about the factors that make for a workable sourcing regime. Finally, it analyzes the provisions of the proposed DGSTFA. This paper concludes that although the DGSTFA contains elements of a workable sourcing regime, it ultimately creates more problems than it solves.

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**Terminology**

This paper uses certain terms that may have particular meanings when used in other contexts, but as used in this paper will mean the following:

- **“Sales tax”** - a tax levied on the purchaser for the purchase of a taxable item where an obligation to collect the tax is also imposed on the seller;

- **“Use tax”** - a tax levied on the purchaser for use (or consumption) of a taxable item, which may be collected by the seller or paid directly to the state by the purchaser, and against which the purchaser can take a credit for sales or use tax already paid;

- **“Consumer” or “consumer sale”** – generally, the final purchaser or transaction before the good or service transferred is use for its intended purpose rather than resold in some form (encompassing some business-to-business transactions);

- **“Use” or “consumption”** – when referring to the use tax” these terms generally refer to any use by the purchaser of the item purchased for the intended purpose, rather than to the resale of the item in some form;

- **“Instate seller”** - a seller with one or more sales operations (including sales representatives, with or without an office or other property) in the taxing state;

- **“Out-of-state seller”** - a seller with no sales operations in the taxing state but with other physical presence sufficient to be subject to tax-collection jurisdiction\(^2\) under Supreme Court precedents;

- **“Remote seller”** - a seller with insufficient physical presence in the taxing state to be subject to that state’s tax-collection jurisdiction;

- **“Sourcing”** refers to the assigning of a sale or use of an item to a particular state for sales and use tax purposes. This paper divides the bases upon which sourcing may be determined into four general classes, set out here in the order in time in which they occur:

  - **“Performance-based sourcing”** – a sourcing method that assigns a sale to the location where the activity to perform a service or create an intangible is done;

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\(^2\) As will be discussed in a later section, the particular jurisdictional limitation this paper is primarily concerned with under U.S. Supreme Court precedents is the authority states have over out-of-state sellers to subject those sellers to an obligation to collect and pay over the sales and use tax.
oSourcing methods that assign a sale to the location of the seller when the sale is made, or the place where the seller offers the item for sale to the purchaser;

• “Destination sourcing” - a sourcing method that assigns a sale to the location of the purchaser when the sale is made, or the place where the purchaser receives or takes delivery of the item;

• “Use-based sourcing” - sourcing methods that assign a sale (or the place of use for use tax) based on use or employment by the purchaser—which may include first use or primary use; and

The terms “digital goods” and “digital services” are also defined in detail in the DGSTFS.)

RELEVANT HISTORY AND CHARACTERISTICS OF SALES AND USE TAXES

General consumption taxes were widely adopted by the states during the Great Depression. The economic pressure during that period, led states to look for a broad, stable tax base to fund needed governmental services. The sales and use tax, which is imposed in some form in 44 states (not counting Alaska, which has only local sales and use taxes), has six important characteristics that create a framework into which any possible sourcing method for sales of digital goods and services must fit. (Note that while there is overwhelming consistency among the states in terms of these characteristics, there are rare exceptions.)
A General Policy to Tax Consumption: First, the overarching policy behind the sales and use tax is to impose a levy on consumption. Therefore, the relevant policy choices with respect to the tax are properly the domain of lawmakers in the state where the consumer resides or the consumption takes place.\(^7\) (Of course, whether the economic incidence of the tax is actually borne by the consumer is a much more difficult question.\(^8\))

**Tax Applied on a Transactional Basis:** Second, the tax is imposed on a transactional basis. This is in contrast with a gross receipts tax, which is imposed on total revenue from a broad range of business activities with few if any deductions for related expenses,\(^9\) as well as the determination of the numerator of the sales factor used in most state’s corporate income tax apportionment methods.\(^10\) The fact that sales and use taxes are imposed on individual transactions is reflected in virtually every aspect of the tax including imposition, exemption, administration, collection and the application of credits (in particular the credit tax previously paid to another jurisdiction).\(^11\)

**Application of a Use Tax as a “Backstop”:** Third, the tax is often referred to, here and elsewhere, as the “sales and use tax.” In reality, of course, these are separate although interrelated taxes. The typical sales tax is legally imposed on the purchaser for the purchase of items in the first instance, but is also required to be collected by the seller (and where the seller fails to properly collect the tax or pay it over, the seller may become legally liable for it).\(^12\) The use tax is typically imposed on the use (or consumption) of the purchased item by the purchaser in the state and paid by the purchaser directly to the state, but may be collected by an out-of-state seller. The use tax is sometimes referred to as a “compensatory tax” or “compensating use tax” because its purpose is to act as a “backstop” against any tendency of purchasers to avoid sales tax by purchasing items for use from outside the state.\(^13\)

**“Downstream” Credit for Tax Paid:** Fourth, while the use tax works to eliminate “nowhere” taxed purchases and create a backstop for the sales tax, a separate element of the sales and use tax system helps avoid the possibility of multiple taxation. All states allow some form of credit against the imposition of use tax for sales or use taxes already paid on the item or

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9 See, for example, Ohio’s Commercial Activity Tax, which is imposed on “gross receipts” defined as: “the total amount realized by a person, without deduction for the cost of goods sold or other expenses incurred, that contributes to the production of gross income of the person, including the fair market value of any property and any services received, and any debt transferred or forgiven as consideration.” Ohio Rev. Code Ann. §5751.01(F).
10 See the revisions to the Uniform Division of Income for Tax Purposes Act as embodied in the Multistate Tax Compact, Article IV, adopted by the Multistate Tax Commission July 30, 2014, and available on the website of the Multistate Tax Commission at: http://www.mtc.gov/Uniformity/.
11 Hellerstein & Hellerstein, ¶12.02.
12 Hellerstein & Hellerstein, ¶12.01.
13 Id. ¶ 16.01.
event in another jurisdiction.\textsuperscript{14} Note that most states allow the credit to be taken only against the use tax, although at least one state (discussed below) allows a credit in certain situations against the sales tax.\textsuperscript{15}

**Use of a Seller-Collection and Record-Keeping Mechanism:** Fifth, the role of the seller in collecting the sales and use tax is critical. No jurisdiction that imposes any kind of general consumption tax has found an effective way to dispense with this seller-collection mechanism.\textsuperscript{16} This is self-evident when one considers the difficulty most consumers would have keeping records of their day-to-day purchases, calculating and paying over the tax periodically, and correctly interpreting and applying the jurisdiction’s tax imposition and exemption provisions. The role of the seller in collecting the tax includes not only the function of charging the tax to the customer and paying it over to the state, but also maintaining records sufficient to show that the proper tax was collected and paid and reporting information to the state to allow enforcement and verification of taxes due.

**General Use of Destination-Sourcing:** Sixth, the sales tax, imposed as it is on the purchase of the taxable item by the purchaser, is generally imposed on a destination-sourcing basis on interstate transactions—so, the method for sourcing transactions looks primarily to the location of the purchaser when she takes delivery of the item.\textsuperscript{17} (Some states impose the tax on an origin-sourcing basis when it comes to the determination of interstate rates and application of local taxes.)\textsuperscript{18} This, combined with providing a credit against the use tax that may be imposed on the use of an item for sales tax previously imposed on the sale of that item, means that a single event (sale plus consumption) is taxed only once.\textsuperscript{19}

There appears to be little controversy about whether inclusion of digital goods and services into the sales and use tax system should be done consistently with the first five elements of that system summarized above. The one question that is sometimes raised has to do with destination sourcing and whether it would be better to use an origin-sourcing regime, or some other principle, for these products. The use of a performance-based or origin system could virtually eliminate the jurisdictional issue discussed in the following section. Also, digital goods and services (and services and intangible property in general) often, although not always, produce no physical manifestation the transfer of which can literally be traced. So an alternative basis may produce clearer results. The alternative methods of sourcing—origin, performance, and use—have other implications, as well:

\textsuperscript{14} Hellerstein & Hellerstein, ¶ 18.08.
\textsuperscript{15} See also the Streamlined Sales and Use Tax Agreement, adopted November 12, 2002 and amended through October 8, 2014, (hereinafter the SSUTA), Best Practice Number 2, p. 167 (describing in detail the rules for providing a credit against the use tax or, alternatively, against the sales and the use tax imposed in a “downstream” jurisdiction).
\textsuperscript{17} Hellerstein & Hellerstein, ¶¶ 12.02 and 18.02.
\textsuperscript{18} See also the SSUTA, Sec. 310, p. 19.
\textsuperscript{19} A subsequent transaction in which a good or other item is sold is a separate event, so that
• Origin sourcing – probably faces the same kind of difficulties posed by the lack of a physical product as would be faced under a destination sourcing regime. But in addition, origin sourcing does not conform to the principle that the tax, as a consumption tax, should be subject to the policy choices of lawmakers in the jurisdiction where consumption occurs. This means that it will be impossible to achieve any reduction of the inefficiencies caused by taxing tangible personal property differently than digital goods and services, since the destination jurisdiction will control policy choices as to how to tax the former (including rates and exemptions), while the origin jurisdiction will control policy choices as to how to tax the latter, even when these goods are similar in nature (books versus e-books, for example). This disconnect between sourcing regimes is also likely to create other conflicts and administrative complications, as for example, where traditional goods are sold in combination with digital goods and services—so that items in the same sale would often be subject to the taxes of differing states. One benefit of origin sourcing is that the jurisdictional issue (discussed further below) would not pose a problem to tax enforcement.

• Performance-based sourcing – would perhaps avoid some of the difficulties in pinpointing the location of sale or delivery of a digital good or service, although it would present other problems—including determining which activities should be used to identify the location of performance (e.g. direct or indirect activities, activities of the seller or also its contractors, etc.). Otherwise, it would be similar to origin sourcing in terms of drawbacks and possible benefits. Performance-based sourcing is essentially the method used by jurisdictions (mostly local) that impose an activity-based tax, like a business and occupations, or business licensing tax, measured by receipts. It is also the method that was used under the Uniform Division of Income for Tax Purposes Act promulgated in 1957 by the Uniform Law Commission for sourcing sales other than sales of tangible personal property (i.e. services and intangibles).

• Use-based sourcing – rather than looking at the seller’s activities of performance, use-based sourcing looks to the purchaser’s activities of use. In that sense, it is also likely to avoid some of the difficulty in pinpointing the location of sale or delivery of transactions that lack a physical product. It also would be more consistent with the goal of a consumption tax. One major draw-back to use-based sourcing, however, is that the seller often (but not always) lacks information about where use will take place, especially where use is defined as something other than first use. Use-based sourcing may be a viable alternative in two general types of transactions, however. The first involves periodic payments in exchange for ongoing use. Often, sellers who engage in these kinds of transactions will have information on the location of use. The second involves business-to-business transactions where the customer can be made to register, report and pay the applicable tax directly to the state, and maintain appropriate records sufficient for audit, without the necessity for the seller to fulfill these roles.
Given that destination sourcing is the method upon which the current sales and use tax system is founded, this paper takes the position that destination sourcing for digital goods and services is preferable, when possible. Origin and performance-based sourcing would likely create too many conflicts and complications. Use-based sourcing, however, may make sense, especially in the context of business-to-business purchases, where destination sourcing is particularly difficult and the activities evidencing use of the item are likely to be easier to identify and locate.

In sum, a successful sales and use tax sourcing regime for digital goods and services must comport with the essential characteristics of the existing state sales and use tax system. This means that it must:

1) Generally provide the state of consumption the power to set tax policy with respect to the digital good or service;
2) Allow for assignment of individual transactions;
3) Not disrupt the ability of states to impose use tax on the use of digital goods and services, as well as sales tax, to maintain a backstop against purchasing those items from outside the state;
4) Not disrupt the administrability of the credit for taxes paid against the use tax;
5) Provide for an effective seller-collection and record-keeping mechanism—so that the tax imposed is enforceable; and
6) Use a destination sourcing regime rather than some alternative sourcing method for imposing sales tax, except where use-based sourcing provides a better alternative, particularly in licensing and business-to-business transactions.

This paper will evaluate the DGSTFA in light of whether it fits this six-part framework generally. It is necessary, however, to add one additional factor to the analysis and that is the limitation on state jurisdiction to impose a tax collection duty. As suggested above and discussed further in the following section, this limitation has implications for whether there will be an effective seller-collection and record-keeping system under any sourcing rules adopted, and in particular, whether destination sourcing should be used. But the limitation on state jurisdiction also has implications for whether the consumption state will be able to effectively make policy choices governing taxation of digital goods and services.

**Importance of State Tax Jurisdictional Limitations**

It is not necessary for purposes of this paper to delve deeply into the U.S. Supreme Court’s thinking about due process and dormant commerce clause limits on state taxing jurisdiction in the Twentieth Century. Suffice it to say, that under the Court’s precedent, as established in *Quill*\(^20\) and *National Bellas Hess*,\(^21\) two cases involving sales by mail-order

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sellers, the dormant commerce clause creates a higher threshold for requiring collection of the sales tax by out-of-state sellers than the due process clause creates for personal jurisdiction in general.\textsuperscript{22} For purposes of this paper, it is assumed that sellers who lack physical presence in a state cannot be made to collect tax on sales of digital goods and services into the state, regardless of the amount of sales made or whether the seller might be subject to personal jurisdiction in the state.

This has important implications for the establishment of a sales tax sourcing regime. While this paper maintains that sourcing of digital goods and services should be done in most cases using a destination approach, it is likely that some sellers will lack the requisite nexus with the destination state to be required to collect tax (sellers that this paper refers to as “remote sellers”), while at the same time making significant sales of digital goods and services into the state as measured under a destination sourcing method.\textsuperscript{23}

Because of this jurisdictional limitation, therefore, care must be taken in implementing any uniform sourcing method based on a destination approach. Otherwise, that sourcing method may effectively prevent the imposition of tax. One characteristic of mandatory sourcing rules is that they act as a prohibition against taxes imposed by every state except the one state to which the sale is sourced pursuant to the specific rules. If the seller must have a physical presence in that one state in order for it to impose a tax collection duty, then the seller need only structure its activities to avoid physical presence in that one state. This allows the seller not only to avoid the collection obligation, but any tax burden on its sales. On the other hand, if states are free to choose whether to adopt uniform destination-based sourcing rules, or alternatively, to impose tax on sales of digital goods and services using other rules or on an alternative sourcing basis, (assuming credits are in place to avoid multiple taxation), then arguably each state would retain a greater ability to collect the tax on these products to some extent.\textsuperscript{24}

It is likely no surprise, therefore, that the states’ first and most critical objection to the DGSTFA, as discussed further below, is that it would limit the authority of every state to impose tax on the sale of digital goods and services except for the one state to which the sale is assigned, without granting to that state the authority to collect the tax from remote sellers.\textsuperscript{25} There is no doubt that Congress possesses the authority to overturn \textit{Quill}’s higher dormant commerce clause threshold using its own affirmative Commerce Clause

\textsuperscript{22} See Helen Hecht, “Is There a Due Process Cloud on the Sales and Use Tax Horizon,” 24 JMT 5, August 2014 (hereinafter Hecht).

\textsuperscript{23} Note: This paper assumes that whether a sale is sourced on an origin, destination or use basis, the state to which it is assigned will always have a sufficient connection to the transaction to subject it to tax.

\textsuperscript{24} For example, the state of origin might employ a “throwback” rule so that sales of digital goods and services made to a state that lacks jurisdiction to tax are, instead, sourced back to the state of origin for taxation.

authority. So one solution to the jurisdictional problem might simply be for Congress to grant the ability to impose tax to the state to which the digital good or service is sourced.

But what about the limitations on states’ authority or jurisdiction under the Due Process Clause of the Fourteenth Amendment? Does Congress have the authority to impose a state-law tax collection duty on remote sellers who may not have sufficient connection with the state to give rise to personal jurisdiction under due process principles? As it happens, in recent years, the federal circuit courts have heard similar questions involving the federal Prevent All Cigarette Trafficking Act, which imposes federal requirements meant to aid in the enforcement of state cigarette taxes on cross-border shipments of cigarettes. The results in these cases are conflicting, but may suggest that the answer turns on whether Congress merely authorizes states to impose tax, or instead imposes a federal duty to collect tax levied under state law. This paper assumes that even if Congress’s power does not extend to removing due process constraints on state authority to impose a tax collection duty on remote sellers, these constraints would not be a serious limitation to imposing tax on sales of digital goods and services.

In sum, then, because of the limitations on state jurisdiction to require sellers to collect tax, no mandatory sourcing rules should be imposed without, at least, granting corresponding authority to require tax collection to the state where the sale is sourced. If Congress declines to provide this authority, an alternative to mandatory sourcing will be needed. (It should be noted here that mandatory rules must be even more carefully crafted to avoid possible manipulation, a problem with the rules in the DGSTFA which are evaluated below.)

**A Real Life Example of a Sales and Use Tax Applied to Services and Intangibles**

New Mexico has long had a consumption tax imposed generally not only on the sales of tangible personal property, but also on services and intangible property—and because the law does not limit the imposition to non-digital goods, the tax would apply when services or intangibles are delivered electronically. Called the “gross receipts tax” (with a corresponding “compensating” or use type tax), this tax is not a true gross receipts tax but is imposed on a transactional basis and takes the place of a more traditional sales tax. The primary difference between New Mexico’s tax and the typical sales tax is that New Mexico’s tax is not legally imposed on the purchaser, but only on the seller, for the privilege of engaging in the activity of selling in the state. Nevertheless, sellers may and typically do include the tax as a separate charge on sales documents when possible.

26 Quill, supra note 15.
28 See Hecht, supra at note 15.
29 New Mexico Taxation And Revenue Dept. Ruling, Nos. 401-13-2 and 401-13-3
New Mexico’s tax base has had a broad scope since its inception. One accepted explanation for this is the role the federal government has played in the state’s economy and the belief of policymakers that some part of that sector of the economy should support state governmental infrastructure.31 While the sale of tangible personal property to the federal government is not subject to tax, the lease of tangible property, sale and lease of intangible property, and the sale of services to the federal government are generally taxable unless another general exemption or deduction applies.32 And since the tax is imposed on the seller, not the purchaser, there is no intergovernmental immunity that would bar the tax on these transactions.33

To understand New Mexico’s sourcing regime for services, it is necessary to combine the effects of its general imposition with two general exemptions from tax. New Mexico’s tax is imposed on gross receipts “from selling services performed outside New Mexico, the product of which is initially used in New Mexico, or from performing services in New Mexico.”34 Most imported services, other than some research and development services, are exempted.35 Exported services are also not taxable. A non-taxable exported service is one where the sale “is made to an out-of-state buyer . . . unless the buyer of the service or any of the buyer’s employees or agents makes initial use of the product of the service in New Mexico or takes delivery of the product of the service in New Mexico.”36 While the state provides the same sort of credit against the compensating tax as all states provide for taxes previously paid, it also provides a credit against the gross receipts tax if a service performed outside the state for importation has already been taxed.37 Thus, taxation of services turns on the application of these critical terms: “performed,” “delivery,” “initial use,” and “product of a service.”

An example of a particularly difficult case applying these terms was the TPL, Inc. case, decided by the New Mexico Supreme Court in 2002.38 The case involved competing theories over where the service of “demilitarizing” surplus munitions (rendering the components of military weapons safe for disposal in different ways) should be sourced. There was no doubt that the munitions were present in New Mexico, owned for a time by the buyer of the service—a federal agency which had no employees or agents in the state—and that the work done to decommission those munitions was done within the state, although the buyer took no possession of the components of the weapons once the service was complete.

The court in TPL held that because the “product of the service” is the basis for determining whether a service is taxable in the state or not, every service must be presumed to have a product, which may be tangible or intangible. It further held that since both the

31 Id.
32 NMSA 1978 § 7-9-47.
34 NMSA 1978 § 7-9-3.5.
36 NMSA 1978 § 7-9-57.
38 TPL, INC. v. New Mexico Taxation and Rev. Dep’t, 133 NM 447 64 P3d 474 (2002).
performance of the service and the product of the service are operative terms under the state's taxing statutes, the product of the service must be identified as something distinct from the performance of the service itself. The court concluded, therefore, that the product of the demilitarization service was not the activity of taking the weapons apart and rendering their components inert; rather, this was the performance activity. The product, instead, was the “freedom from responsibility for dangerous munitions.”

As for delivery and initial use, the court found that the application of these terms in distinguishing taxable from exported-nontaxable services meant that the focus must be on the activities of the buyer's employees or agents, or perhaps on some real property interest of the buyer, where the benefit from the delivery of the product of the service or the use of that service might be evident. The court also noted that state statutes defined initial use as the “first employment for the intended purpose.” So, the court reasoned, the focus was on the activities of the buyer—or its employees or agents—in determining whether the buyer made initial use or took delivery of the seller's services in New Mexico or elsewhere. The court rejected arguments by the state Taxation and Revenue Department that the buyer's physical presence within the state was not necessary for the buyer to make initial use or take delivery in the state, finding that adoption of this principle would provide little guidance and was contrary to the language of the statutes.

The court also noted that the legislature's concern in exempting exported services was to protect in-state businesses against competition from out-of-state firms that might not have to pay any sales and use tax. Therefore, the court concluded that, when determining where delivery had taken place, it was insufficient that a buyer's mobile tangible personal property might be in the state and might somehow benefit from the service. In a case where the buyer had no employees or agents in the state and, itself, conducted no activities within the state, there was nothing that could constitute use or acceptance of delivery, and the product of the service must be deemed exported.

While the TPL case illustrates how using the “product of the service” may work as a proxy for a tangible product, even where the product is intangible, the interaction between delivery and initial use is probably what makes the rule useful in practice. Neither delivery nor initial use of the product of the service can be in the state if the sale of the service is to be deemed exported. While it may be a simple matter in some cases to contractually define “delivery,” and provide for “deliverables” that are sent outside the state, if those deliverables are initially used in the state (for their intended purpose), then the sale will not be deemed exported.

As for taxation of intangibles, from the beginning New Mexico’s law contemplated that the gross receipts tax would be imposed on “property” generally, including tangible and some kinds of intangible property. Transactions involving intangible property often took the general form of a lease—having periodic payments in exchange for use—and were taxed

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39 Id.
40 Id.
based on where the property was employed. A change in the definition of “leasing” in 2001, however, threw a wrench into the works by providing that a lease was “an arrangement whereby, for a consideration, property is employed for or by any person other than the owner of the property, except that the granting of a license to use property is the sale of a license and not a lease.” The state supreme court subsequently held that under this definition, licenses would be considered “sold” where the license contract (in this case a royalty agreement for the use of trademarks) was entered into. In another case, the state supreme court explicitly rejected the holding of the court of appeals that the legislature could not have intended to base the rule for where a license might be taxed solely on where the contract was entered into, since avoidance of the tax in that case would be a simple matter.

In response to this holding, the legislature amended the definition of lease to provide that “the granting of a license to use property is licensing and is not a lease.” At the same time, the definition of “property” was amended and now includes only two types of intangibles: 1) licenses other than the licenses of copyrights, trademarks or patents, and 2) franchises, and the tax is now imposed on gross receipts “from selling property in New Mexico, from leasing or licensing property employed in New Mexico, and from granting a right to use a franchise employed in New Mexico . . .”. The state continues to impose tax on licenses and franchises employed in the state.

New Mexico’s experience applying a sales and use tax to services and intangibles sheds some light on what may be necessary to make sourcing of such items, particularly digital goods and services, feasible. Sourcing rules for services and intangibles, generally, should:

1) **Distinguish performance from delivery.** - First, when it comes to services, it may be useful to distinguish the performance of the service from the product of the service, especially where it is not the intent to use performance-based sourcing. This, in turn, appears to allow a proper focus on the location of the customer—or the market for the service. Otherwise, it is possible that the tax will fall, not where the consumption of the service takes place, but where the performance occurs.

2) **Focus on activities of the purchaser.** - Second, it may be useful to focus on the customer’s action with respect to the product of the service, or even the customer’s potential action with respect to the product of the service—that is, where the customer either responds to or benefits from delivery or initial use of that product, or where the customer might be reasonably expected to do so.

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43 *Kmart Corporation v. Taxation and Revenue Dep’t*, 131 P3d 22 139 NM 172 (2005).
45 NMSA 1978 7-9-3(E).
46 NMSA 1978 § 7-9-3(J).
47 NMSA 1978 § 7-9-3.5.
3) If useful, incorporate a credit for sales tax paid “upstream” against sales tax imposed. - Third, when taxing imported services, it may be necessary to provide a credit for taxes previously paid against both the sales tax and the use tax imposed by the state to ensure that there is no risk of multiple taxation, since the service might also be taxed in the state of performance (“upstream” from the state where delivery takes place). As will be discussed further below, allowing such a credit can be problematic, however, and care is necessary to make sure it is administrable, primarily by limiting the credit to sales tax paid taken against sales tax imposed.

4) Employ use-based sourcing for licensing arrangements. - Fourth, the licensing of intangible property is probably more analogous to the lease of tangible property than to the sale of tangible property, which would presuppose a focus on the use or employment of the licensed property as a basis for sourcing in these cases.

5) Balance ease of administrability with avoidance of manipulation. - Fifth, when it comes to sourcing, ease and administrability have to be balanced against the potential of the rule to be manipulated in order to avoid tax. This is especially important where other states may not impose a tax on the same items. So while sourcing rules may be well established and less given to manipulation where consumer sales of goods are involved, states should not assume that just having a clear sourcing regime for digital goods and services will necessarily make taxation of those products possible. Given that the states first venturing to expand their tax bases to digital goods and services will be, for some period, in the minority, they must be cognizant of the pressure this inevitably puts on the sourcing regime. It is especially important that the existing mechanisms for ensuring taxes are properly paid are not disrupted, in particular, the duty of sellers and business purchasers to obtain information and maintain records.

6) When possible, assign transactions consistently regardless of the category of transaction. - Sixth, New Mexico’s experience in this area reveals at least one other important factor that bears on the application of tax to services and intangibles generally, as well as to the issue of sourcing. As the experience of most other states has also shown, where there is a difference in how tangible personal property and services or intangibles are taxed, there will be substantial litigation and controversy over how the line between the categories of items is drawn.49 In New Mexico, this difference is largely confined to sales to the federal government since, in those circumstances, services and intangibles are taxed while tangible property is not. As with classifications that may determine taxability or exemption, any distinction in sourcing that affects how a transaction is classified (whether as a digital or non-digital good or service) is likely to give rise to controversy over the classification. If all products—tangible,

49 Hellerstein & Hellerstein, ¶12.06[2].
intangible or service, whether digital or non-digital in nature—can be sourced so they are generally going to be subject to tax in the same state, regardless of their characterization, then this will put less pressure on the sourcing rules, and create greater consistency and ease in tax administration and enforcement.

**Proposed Federal Legislation: Digital Goods and Services Tax Fairness Act**

This section of the paper summarizes the sourcing rules and related provisions in the Digital Goods and Services Tax Fairness Act of 2013 (the DGSTFA). It then analyzes the provisions of the DGSTFA based on the following principles, extracted from the previous sections:

1) Whether the sourcing rules are mandatory, and thus give rise to the potential for tax avoidance discussed above.

2) Whether the sourcing rules themselves appear calculated to achieve destination sourcing as appropriate and administrable under the circumstances, or use-based sourcing, as a viable alternative—and whether they:
   a. Allow for assignment of individual transactions;
   b. Properly avoid using origin or performance-based sourcing by clearly defining how delivery/receipt or use are to be determined; or
   c. Properly focus on the activities of the purchaser, to the extent known; and
   d. When possible, assign transactions consistently regardless of the applicable category of transaction.

3) Whether the sourcing rules are potentially subject to manipulation, allowing sellers to take advantage of the fact that a number of states currently do not tax most digital goods and services (and so potentially undermine states’ ability to make policy choices).

4) Whether provisions of the bill otherwise fit well within the existing sales and use tax system or interfere with or disrupt that system.

**History of the Legislation and of Industry and State Involvement**

In July 2011, congressional staff asked the Federation of Tax Administrators (FTA) to comment on a previous version of the DGSTFA legislation. FTA member representatives and staff met with congressional staff and the proponents of the bill and provided a list of specific comments and criticisms, which were extensive, and had to do largely with provisions of the bill that were not aimed at sourcing of transactions but would otherwise limit state taxing authority. At its 2012 Annual Meeting, the FTA membership approved a resolution opposing the bill.\(^{50}\)

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\(^{50}\) See FTA resolution available at http://www.taxadmin.org/fta/meet/13am/Resolutions_2013.pdf.
In June 2012, the previous version of the bill passed out of the House Judiciary Committee without any substantial amendments despite opposition by FTA, the National Governor’s Association (NGA), the National Conference of State Legislatures (NCSL) and local government groups. After the committee’s vote, the CBO estimated that the bill’s provisions would cost states $3 billion annually, primarily because of the bill’s failure to grant authority to collect tax from remote sellers coupled with mandatory sourcing rules and other restrictions, creating a means for sellers of digital goods and services to challenge currently applicable taxes or avoid having to collect them. At that same time, the NGA convened a working group made up of representatives from the states, the NGA, and industry to consider revisions to the proposed bill. That effort resulted in a revised bill introduced July 25, 2013 in the Senate, S. 1364. The NCSL has endorsed this 2013 bill generally, while suggesting that it should be part of a package granting states authority to require remote sellers to collect tax. The NGA has not yet committed to supporting the bill.

In addition to objecting to the bill for failing to address Quill and the limitations on state authority to impose a tax collection duty on remote sellers, the states also objected to provisions in the bill that, like the 2011 version, had little if anything to do with establishing a workable sourcing regime. In particular, as briefly noted below, the bill would grant special tax status to digital goods and services by providing certain protections not provided to other types of goods, it would disrupt existing state rules on bundled transactions, and it would impact the obligations of sellers of digital goods and services with respect to the normal recordkeeping requirements imposed on all other taxpayers. In short, it would grant those goods and services “most-favored” taxpayer privileges vis-à-vis other goods and services. The special tax status granted to digital goods and services would effectively remove from state lawmakers the ability to vary the taxation of digital and similar non-digital goods and services for any reason. Since making distinctions between classes of goods and services for sales tax purposes is fundamental to

51 See statement of the FTA available at http://www.taxexchange.org/member/leg/fed_leg.html
54 See the report of the Congressional Budget Office available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/hr1860.pdf
56 The Digital Goods and Services Tax Fairness Act of 2013, S. 1364 (hereinafter S. 1364), Sec. 2: The bill prohibits “discriminatory and multiple” taxes but the proponents have given no state-specific examples of state tax being systematically imposed in such a way that digital goods and services have to pay more or additional taxes.
57 The IRS and state taxing authorities are authorized to require taxpayers to obtain information and maintain records to establish that the correct amount of tax has been paid and, if taxpayers fail to do so, may resort to other methods to ensure that the correct amount of tax has been paid. As discussed below, the bill here relieves taxpayers from obtaining certain information and also prevents states from correcting erroneous information used by taxpayers to source sales until notice has been given to the customer in question.
the taxing authority of states, this is a significant interference in state tax policy by the federal government.

The following section outlines the specific provisions of the federal bill.

**Summary of the Bill's Provisions**

**Observation About the Effects of Federal Statutory Rules**

**Preemption legislation** -

At the outset, it must be noted that the embodiment of uniform sourcing rules in federal legislation, in general, raises two important issues that would not be created if the same rules were incorporated into state law, and that bear upon this analysis. First, the bill as written must be interpreted as federal preemption legislation—meaning that it may explicitly or implicitly negate existing state law that conflicts with or is seen as an obstacle to the policy embodied in the bill.\(^{58}\) Therefore, it is likely that provisions as broad as those incorporated into the bill would generate unintended consequences when imposed on top of existing state tax systems. Nor will state lawmakers be able to remedy this conflict by adjusting, however minimally, the provisions in the federal law. The intersection of existing state law and the overriding federal provisions may also create uncertainty, even if no preemption is ultimately deemed to exist.

**Limitation on regulatory authority** -

Second, the bill delegates no authority to state tax agencies to interpret its provisions. Unlike state statutes, any agency interpretations will therefore not be entitled to deference.\(^{59}\) This is critical when evaluating certain ambiguous terms and avoiding conflicts over how provisions should be applied. In essence, the bill consigns to the courts the duty to mediate all potential controversies over anything in the bill that is open to interpretation. It is unclear how this will contribute to uniformity in how the bill's provisions are interpreted.\(^{60}\)

\(^{58}\) See *AT&T Mobility LLC v. Concepcion*, 131 S.Ct. 1740 (2011).

\(^{59}\) In other words, taxpayers may be able to successfully challenge any administrative interpretation given to the provisions in the bill, without having to show that the interpretation is unreasonable or exceeds the statutory authority. See *Ramey v. Reinertson*, 268 F.3d 955 (10th Cir., 2001); *Reames v. Oklahoma*, 411 F.3d 1164 (10th Cir., 2005); *Turner v. Perales*, 869 F.2d 140 (2d Cir., 1989); *Perry v. Dowling*, 95 F.3d 231 (2nd Cir., 1996); *Building Trades Employers' Educational Ass'n v. McGowan*, 311 F.3d 501, (2nd Cir., 2002); *Carroll v. DeBuono*, 998 F.Supp. 190 (N.D. N.Y.,1998).

\(^{60}\) The 2011 version of the DGSTFA would have waived the jurisdictional bar under the federal Tax Injunction Act, but states strongly objected to this provision and it was removed in the version reviewed in this paper. Having such a provision would not have created uniformity, in any case, since there are eleven federal circuits courts of appeal that would have had the final say over most questions here and the circuit courts regularly disagree about the meaning of federal statutes. For example, the federal “4-R Act” which limits how state
The bill does the following (discussed further below):

- It sets out mandatory sourcing rules for “digital goods” and “digital services”;
- It does not grant authority over remote sellers;
- It preserves some authority to impose use tax collected from the customer;
- It prohibits taxing digital and similar non-digital goods and services differently (by prohibiting “discriminatory” taxes);
- It requires that states grant a credit against any type of transaction tax imposed by that state for any type of transaction tax paid by the seller or the customer to another state (by prohibiting ”multiple” taxes);
- It limits the ability of states to require a seller change a customer’s incorrect sourcing information only after permitting the customer is given an opportunity to dispute the change;
- It requires states to allow customers to pay tax directly on digital goods or services that are “available for use” in multiple locations simultaneously; and
- It contains a “bundling” rule that preempts any state rules governing the treatment of mixed (taxable and nontaxable) transactions where the transaction contains a digital good or digital service (whether taxable or not).

There is some ambiguity in the definitions of “digital goods” and “digital services,” however, the main distinguishing factor for “digital goods” and the separately defined category of “digital services” is whether they are delivered or provided electronically. It appears that the following major categories of items would be included in the terms as further defined:61

- Software delivered electronically (downloaded, rather than on physical media)
- Applications or “apps” downloaded for use on portable electronic devices
- I-tunes, e-books, e-subscriptions and other types of data files delivered electronically
- Most services provided electronically (except telecommunications and some other specifically excluded services) where contemporaneous human effort, skill or expertise is not the predominant component
- Streaming video services
- Data and information services provided electronically

**Evaluation of the Bill**

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61 S. 1364 §§ 7(5) and (6).
1) Whether the sourcing rules are mandatory, and thus give rise to the potential for tax avoidance –

As noted, the bill’s rules are mandatory. They would preempt every state but the one to which the sale is sourced from taxing the sale of a digital good or service. The bill does this by restricting the ability of every state to tax the sale of digital goods and services except the one determined by the seller to contain the “customer tax address” (CTA).62 Nor does the bill grant any authority to states to impose a tax-collection duty on remote sellers. Therefore, with the exception of business-to-business sales where the use tax can be collected directly from the seller, a tax on digital goods and services would be largely unenforceable.

2) Whether the sourcing rules themselves appear calculated to achieve destination sourcing as appropriate and administrable under the circumstances, or use-based sourcing, as a viable alternative –

The DGSTFA requires sellers to “obtain and maintain in the ordinary course of business” the “customer’s tax address.”63 The bill does not impose a single sourcing rule, but rather, a set of rules, a hierarchy, based on the definition of the term “customer tax address.”64 Under this definition, the sale would generally be sourced as follows:

1. If the sale of a digital good or digital service that is received by the customer at a business location of the seller, then the sale is sourced to that business location;65
2. If 1 does not apply and the “primary use location” (that is the location where the customer will primarily use the digital good or service66) is known by the seller, then the sale is sourced to that location;67
3. If neither 1 nor 2 applies, and if the location where the digital good or digital service is received by the customer, or by a donee of the customer that is identified by such customer, is known to the seller and maintained in the ordinary course of the seller’s business, then the sale is sourced to that location;
4. If 1, 2 and 3 do not apply, the sale is sourced to the location indicated by an address for the customer that is available from the business records of the seller that are maintained in the ordinary course of the seller’s business, when use of the address does not constitute bad faith;
5. If 1-4 do not apply, the sale is sourced to the location indicated by an address for the customer obtained during the consummation of the sale, including the

62 S. 1364, Sec. 3.
63 S. 1364, § 4(a)(1).
64 S. 1364, § 7(2).
65 S. 1364, § 7(2)(a)(i).
66 S. 1364, § 7(9).
67 S. 1364, § 7(2)(a)(ii).
address of a customer’s payment instrument, when use of this address does not constitute bad faith; or

6. If 1-5 do not apply, including the circumstance in which the seller is without sufficient information to apply these rules, the location from which the digital good was first available for transmission by the seller (disregarding for these purposes any location that merely provides for the digital transfer of the product sold), or from which the digital services was provided by the seller.

The first rule would presumably apply in the fairly limited instance that an electronic good is delivered electronically to a customer while in the business location of the seller. (This happens, for example in retail stores that provide software or mobile applications.) This is undoubtedly a rule based on destination principles.

The second rule would by-pass the destination of the sale and look, instead, to where the purchaser makes primary use of the digital good or service. One problem with this rule is that it is possible the seller would not only lack the presence in the state of primary use necessary for that state to impose a collection duty, the seller might lack even due process nexus in that state, assuming the purchaser takes the product from where it is purchased into another state for primary use. This could prevent the state in which the sale is sourced from even obtaining records or other information from the seller for purposes of enforcing the tax. As already discussed, for business-to-business transactions, this is less of a concern, since the use tax could be collected directly. The rule is also not limited to sales of intangibles that take the form of a license and so have some ongoing payment in exchange for use, which would often make it more likely that the seller would have information about the place of use (e.g. subscriptions to use Internet based research applications). No doubt, the drafters of this rule would point out that it is to be used only where the seller has information. But drafting the rule in this fashion potentially subjects it to manipulation. In cases where the primary use location is in a state that taxes the digital good or service, but the sale would otherwise be sourced to another state (under rules 3, 4, 5 o4 6) that does not tax the good or service, the seller might simply not obtain that information and so would have no obligation to source the sale to that state. (This is a problem with the rules generally and is discussed further below.)

The third rule is a basic codification of the destination principle, assuming the word “received” is generally interpreted as the place where the purchaser first obtains the benefit or control over the digital good or the product of the service. Rules four and five are meant to approximate the destination assuming that the address available corresponds with the place of receipt or delivery. Rule six is based on origin-sourcing principles.

With the exception of the issue created by rule two discussed above, as a general matter, the locations to which the sales would be sourced, in and of themselves, do not appear to depart substantially from the system for sourcing sales of other goods and services for sales tax purposes. However, embedded in these rules are presumptions that, taken with

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68 Unilateral acts of the purchaser will not give rise to personal jurisdiction over the seller. See *World-Wide Volkswagen Corp v. Woodson*, 444 U.S. 286, 100 S.Ct. 559 (1980).
other provisions in the bill, are likely to create significant issues and could undermine the very purpose in establishing sourcing rules—which is to make taxation of consumer sales of digital goods and services possible.

The rules leave undefined critical terms that will likely give rise to disputes over interpretation and application.

The main purpose of the bill is to establish clear sourcing rules. So it is remarkable that critical terms, essential to those rules, have been left entirely undefined. Those terms include “received,” “location” and “first available for transmission.” It is not unusual for lawmakers to leave to regulatory agencies the responsibility to further define such terms and promulgate rules for their application to specific circumstances. But as noted, because this is a federal law, rules adopted by state revenue agencies will not be entitled to any deference. Some may see this as creating a beneficial advantage for sellers of digital goods and services. But a lack of any kind of binding rules will also result in uncertainty and possibly even litigation which will impact those sellers, including suits by consumers challenging the collection of the tax, and disputes over taxes deemed to be due upon audit, where the seller may have failed to collect the tax.

What New Mexico’s experience in particular has shown is that even with a long history of explicit sourcing rules, backed up by regulations, rulings and case law, there will be difficult circumstances in which the application of the rules is uncertain. It is, therefore, unfortunate that the DGSTFA does not take greater pains to ensure that the sourcing rules themselves are clearer, although it may simply not be possible to have the level of specificity needed in a statute.

The rules would unnecessarily disrupt the existing sales and use tax system to a degree in most states.

States have different rules for when a “mixed” or “bundled” transaction (a transaction containing taxable and non-taxable components) can be treated separately for tax purposes. The DGSTFA would displace those rules whenever the transaction contains a “distinct and identifiable” digital good or service. The bundling rule under the DGSTFA provides that a state may not subject a transaction to tax as an “entire aggregation” if:

- “A charge for a distinct and identifiable digital good or digital services is aggregated with and not separately stated”
- The aggregation also contains “one or more charges for other distinct and identifiable [digital or non-digital] goods or services”
- “Any part of the aggregation is subject to tax” or

\[69\text{S. 1364, § 5.}\]
“The seller can identify, by reasonable and verifiable standards, one or more charges for the nontaxable goods or services [whether digital or non-digital] from its books and records kept in the ordinary course of business.”

The following transactions will be subject to the bundling rule in the DGSTFA:

1. A transaction with a taxable digital good/service and a non-taxable digital good/service.
2. A transaction with a taxable digital good/service and a non-taxable non-digital good/service.
3. A transaction with a non-taxable digital good/service and a taxable non-digital good/service.
4. A transaction with a taxable digital good/service, a taxable non-digital good/service and a non-taxable non-digital good/service.
5. A transaction with a digital good/service that is taxable in state X (where the “customer tax location” may be located) and a non-digital good/service non-taxable in state Y (where that component would be sourced under different rules).
6. A transaction with a digital good/service that is non-taxable in state X (where the “customer tax location” may be located) and a non-digital good/service taxable in state Y (where that component would be sourced under different rules).

Note that under 4, even though the component to be separated is a non-taxable non-digital good or service, the bundling rule in the DGSTFA still applies and would preempt the state’s existing rule.

The bundled transaction rule in the DGSTFA will apply rather than the state law rule when one part of the transaction is taxable and another part is not—but this might be determined under different states’ laws. The determination of whether the digital good or service component is taxable would have to be determined based on the law to which the digital good or service is sourced, which in turn would be based on the “customer tax address” as determined under the DGSTFA’s sourcing rules even if the non-digital component(s) were subject to tax in a different jurisdiction (delivery). So before determining if a sale must be unbundled, it will likely be necessary to first determine in what jurisdiction the customer tax address is located. Moreover, the bill does not make an allowance for when the “distinct and identifiable” digital good or service is a minor or even incidental part of a bundled transaction. Therefore, it is possible that the bill would have a much broader effect than it would appear on the surface.
The DGSTFA also contains a multiple location rule, which provides for sourcing of digital goods or services “available for use” in multiple locations simultaneously. But the rule does not provide for apportionment where the charge is not separately billed by location, nor does it specify that the “multiple locations” must be locations in some way directly connected to the customer. So not only might this rule displace existing state rules on the treatment of sales to multiple locations, it would do so without providing a workable substitute.

3. Whether the sourcing rules are potentially subject to manipulation, allowing sellers to take advantage of the fact that a number of states currently do not tax most digital goods and services (and so potentially undermine states’ ability to make policy choices) -

The rules do not achieve the right balance between ease of use and prevention of manipulation.

What is notable about these rules is that a single sale may be sourced to different states, depending on what information the seller obtains about where the customer is located, where the customer takes delivery of the good or service, or where the customer makes use of the good or service. The rules presume that sellers may not always have some or all of this information. What is a little less clear is whether the seller must obtain and keep the information when possible. Assuming that the DGSTFA allows the seller to, in effect, choose whether to obtain information (which it appears to do), and assuming that the seller may also use intermediaries to facilitate sales, so that the information may not be in the seller’s own records (which is clear the seller may do), the rules could potentially be manipulated to source sales to no-tax jurisdictions or jurisdictions where the seller cannot be made to collect the tax. States may also be prevented from imposing record keeping requirements as a consequence of the preemptive effect of the bill’s language, so that sourcing will be subject to manipulation.

In particular, while the DGSTFA requires the seller to use “reasonable” efforts to “obtain” the “customer tax address” (as opposed to obtaining the information on which that address is determined), that requirement is limited to the efforts specifically described in the sourcing rules contained in the definition of the customer tax address itself. The sourcing rules that define the customer tax address, however, do not actually describe any particular efforts. Rather, they specify the information to be used to the extent that it is “known,” “known” and “maintained in the ordinary course of the seller’s business,” “available from the business records of the seller that are maintained in the ordinary course of the seller’s business,” or “obtained during the consummation of the sale.” Otherwise, if the seller does not obtain the information or, is “without information,” then the ultimate default rule

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70 S. 1364, § 4(e)
71 See Sec. 4 (a)(2)(A) and (B)—“as such efforts are described in clauses (iii), (iv), and (v) of section 7 (2)(A). . .” etc.
72 Sec. 7 (2)(A)(ii).
73 Sec. 7 (2)(A)(iii).
74 Sec. 7 (2)(A)(iv).
75 Sec. 7 (2)(A)(v).
(origin of transmission) will apply.\textsuperscript{76} (Note that an alternative sourcing rule under the DGSTFA for items used by the customer in multiple locations relies on the customer’s determination of those locations of use.\textsuperscript{77} Another alternative, sourcing to the “primary place of use” under the Mobile Telecommunications Sourcing Act, is not discussed in this analysis.\textsuperscript{78})

It appears that there are some situations in which information relevant to sourcing a sale simply cannot be obtained under the circumstances of that sale. The flexibility in the application of the DGSTFA’s sourcing rules, however, would presumably apply both to sellers who \textit{cannot} obtain information (due to limitations inherent in the nature of the transaction) and to sellers who \textit{choose not} to obtain the information as part of the normal course of their business. Also note that while the seller is allowed to use certain information only if it does not constitute bad faith (for instance, an address from the seller’s business records\textsuperscript{79} or the address of the customer’s payment instrument\textsuperscript{80}), the seller is also generally protected from any additional liability if it relies in good faith on information provided by the customer.\textsuperscript{81} (The DGSTFA does grant some authority for states to provide information to a seller so as to change determination of the CTA for a customer, provided the customer is given an opportunity to dispute that change first, in accordance with applicable state administrative procedures.\textsuperscript{82})

The bill requires the sellers to “obtain and maintain in the ordinary course of business” the “customer tax address.” While the word “obtain” is used in conjunction with the CTA (singular), the CTA is not a single place, but is a defined term under the bill which includes different possible locations—determined based on information obtained by the seller. The jurisdiction which may impose tax will be determined by the seller under the bill’s sourcing rules set out as part of the definition of the CTA\textsuperscript{83} and in other provisions.\textsuperscript{84}

\textbf{3) Whether provisions of the bill fit well within the existing sales and use tax system or interfere with or disrupt that system—}

In addition to sourcing rules, the bill creates additional issues by including provisions that are largely unrelated to sourcing, but create unnecessary preferences, each of which is briefly analyzed further below. Note that not all of the provisions of the bill apply to both a tax on the sale and a tax on the use of digital goods and services, but the preferences that

\begin{itemize}
\item \textsuperscript{76} Sec. 7 (2)(A)(vi).
\item \textsuperscript{77} Sec. 4 (e).
\item \textsuperscript{78} Also, while the bill’s language speaks of “obtaining” the “customer tax address,” this is really something that is \textit{determined based on information} that the seller may choose to obtain or the customer may choose to give. See Sec. 4 (b) and (e).
\item \textsuperscript{79} Sec. 7 (2)(A)(iv).
\item \textsuperscript{80} Sec. 7 (2)(A)(v).
\item \textsuperscript{81} Sec. 4 (b).
\item \textsuperscript{82} See Sec. 4 (b) and (c).
\item \textsuperscript{83} Sec. 7 (2).
\item \textsuperscript{84} See further discussion of the bundled-transaction provision and the multiple-location provision discussed further below.
\end{itemize}
prohibit imposing “multiple or discriminatory taxes,” as defined, is one provision that does apply to both sales and use taxes.\textsuperscript{85}

\textbf{Prohibition Against “Discriminatory Taxes”}

The bill prohibits the imposition of a “discriminatory tax” defined under the bill's provisions, in relevant part, as a tax that is “not generally imposed and legally collectible,” or “not imposed and legally collectible at the same or higher rate,” or “imposes an obligation . . . on a person, other than the seller,” or “establishes a classification . . . establishing a higher tax rate on providers,” or “does not provide a resale and component part exemption . . .” as compared to “transactions involving similar property, goods, or services accomplished through other means.”\textsuperscript{86}

There is some similarity between the discriminatory tax provision under the bill and the one incorporated into the federal Internet Tax Freedom Act. There is a critical difference, however. Under ITFA, the protection under the prohibition against discriminatory taxes applies to transactions conducted by “electronic commerce” as compared to traditional commerce. In essence, the discriminatory tax provision in ITFA protects transactions made over the Internet from being taxed differently than the same transaction would be if sold through other means.\textsuperscript{87} Since states do not generally tax the same item differently based solely on how the transaction occurs, this generally has not been an issue.\textsuperscript{88}

In this bill, unlike ITFA, the protection applies to a “digital good” and “digital service” as compared to “similar” goods and services. These classes of products are defined both in how they are delivered (electronically or not) as well as in other ways.\textsuperscript{89} So while the protection here is also based on how other “similar” goods and services are taxed when delivered by other means, “similar” is not limited to other similar \textit{digital goods or services}. (Not only does the language itself not provide this limitation, but digital goods and services generally \textit{cannot} be delivered by other means.)

In short, what ITFA protects is the \textit{manner} in which the sale happens whereas what this bill protects is the \textit{good or service itself}. Since states tax items differently for a whole host of reasons, the provision in the bill is likely to cause many more issues than ITFA’s provision.

\textsuperscript{85} S. 1364, Sec. 2.
\textsuperscript{86} S. 1364, Sec 7(7).
\textsuperscript{87} 47 U.S.C. 1105(2).
\textsuperscript{88} That said, the “discriminatory tax” provision in the Internet Tax Freedom Act could be interpreted to sweep more broadly. The provision was called the "poster child for horizontal federal-state tax coordination at its worst" by Prof. Walter Hellerstein, the leading authority on state taxation in testimony before the Senate last year. According to the professor, "... ITFA's definition of [discriminatory tax and other terms] sweeps so much more broadly than their common understanding that ITFA's bar on such taxes basically raises the question as to whether electronic commerce should be taxed at all." Available at http://www.finance.senate.gov/imo/media/doc/Testimony\%20of\%20Hellerstein.pdf
\textsuperscript{89} Sec. 7 (4), (5) and (6).
Moreover, the terms “generally imposed and legally collectible,” “transactions involving,” and “similar” are critical to the application of the “discriminatory tax” definition. Each of these terms is ambiguous in that it can mean different things and those meanings could have significantly different impacts. In addition, the definition requires that resale and component part exemptions be extended to digital goods and services “in a manner consistent with” the way such exemptions are applied now to non-digital goods and services, but this raises issues in application.

For example, the term “similar” (property, goods, or services accomplished through other means—or is “non-digital”) may refer to:

- Goods or services that fall into the same general class as the digital good or service.
- Goods or services that have a similar use or function to the digital good or service.
- Goods or services that compete directly with the digital good or service.
- Goods or services that could be substituted for the digital good or service.

Prohibition Against Multiple Taxes

The bill also prohibits “multiple taxes.”\(^9^0\) The definition of “multiple tax”, especially in conjunction with other provisions of the bill, appears to create a credit for taxes paid that is possibly unworkable. More importantly, the credit is unnecessary, given that, under the bill’s sourcing rules, only one state can tax the sale of the digital good or service. As with the definition of “discriminatory tax,” the provision defining “multiple tax” here is similar to language in ITFA, but in this bill creates additional issues.\(^9^1\)

One difficulty with the credit for taxes paid created under the definition of multiple tax is that it would apply based on either a sales or use tax paid and against both sales taxes and use taxes owed. Currently, while all states that impose sales and use tax allow a credit against use tax for sales and use tax already paid on the good or service, states generally do not allow credits against the sales tax. There are a number of reasons for this. First, the liability for sales tax typically arises before the liability for use tax. Therefore, granting a credit for use tax paid against sales tax owed appears unnecessary. But under the bill, the credit may be required even though the liability for sales tax arises before the liability for use tax, so long as the use tax is paid first. This is unworkable. It would impose additional enforcement and compliance difficulties on both states and sellers, since it would be necessary to verify whether any purchaser paid the tax and paid it properly—for example, whenever the seller is determined to owe a sales tax upon audit. That said, a properly designed credit against a state’s sales tax for another state’s sales tax paid might go a long way toward creating a sourcing method that would not only be workable but would not require absolute uniformity among states.

While the idea of treating similar digital and non-digital goods alike and guarding against multiple taxes may make sense from a general policy standpoint, the provisions

\(^9^0\) S. 1363, § 2.
\(^9^1\) S. 1364, § 7(8).
incorporated into DGSTFA would not only usurp the proper role of state lawmakers in addressing these policy issues, but would greatly complicate the application of the sourcing rules and would put unnecessary pressure on those rules. For example, there will undoubtedly be many circumstances where the characterization of an item as a digital or non-digital product will have no effect on where the sale is determined to be sourced, but may make a difference as to whether the tax imposed is a “discriminatory tax” or whether a credit must be given against the sales tax for use taxes paid. So the definitions of “digital good” and “digital service” not only have to appropriately categorize items for purposes of the special sourcing rules but also for purposes of these preferences. In turn, this may affect whether the bill’s so-called “bundling rule” or the state’s existing rule applies, which can affect whether the sale is taxable in whole or in part. In other words, the goal of the bill to provide sourcing rules is overshadowed by attaching to those rules other provisions that have nothing to do with sourcing but may ultimately drive how sourcing rules are interpreted and applied.

**Conclusion**

There appears to be a need for special sourcing methods for digital goods and services if states are going to expand their sales tax bases to include those types of products. The sourcing regime adopted, however, should fit within the existing state sales and use tax system generally, including adherence to a destination sourcing principle. The sourcing regime should not be mandatory unless the state to which the product is sourced has authority to require the seller to collect the tax. Care should be taken so that sourcing rules are both administrable and so that the possibility of manipulation is minimized, especially since there will likely be a number of states that do not tax digital goods and services for some time to come, creating an incentive to source transactions to non-taxing jurisdictions. The rules should serve the purpose of reducing uncertainty and litigation. Nor should the rules disturb existing state rules that are only indirectly related to the issue of sourcing, unless there is a clear need to do so and the substituted rule is adequate to the purpose. Moreover, to ensure the success of a sourcing regime, preferences or other provisions that unnecessarily complicate the taxation of digital goods and services should not be attached to those rules, especially given the likelihood that this will create unintended consequences. On these measures, the proposed Digital Goods and Services Tax Fairness Act falls short.