



MULTISTATE TAX COMMISSION

To: Uniformity Committee
Tommy Hoyt, Chair

From: Standing Subcommittee
Maria Sanders, Chair

Subject: **DRAFT** - Recommendation on Proposed Project –
White Paper on Sales Taxation of Digital Products

Date: June 17, 2021

The Uniformity Committee has asked the Standing Subcommittee to consider a project to prepare a white paper on sales taxation of digital products, identifying potential best practices and areas for increased uniformity.

This memo provides information and a recommendation to the committee using the subcommittee's general criteria for evaluating proposed projects. The memo also sets out a general scope of the potential white paper.

NOTE: In this memo, the term “digital products” is intended to encompass the entire category of products made possible by digital or electronic technologies that are not, primarily, tangible or physical property or traditional services. The term may include what some would consider digital “services.”

GENERAL CRITERIA FOR A UNIFORMITY COMMITTEE PROJECT

- **Does the project fall within the Commission's general expertise and mission, that is, state taxes on multistate businesses and related issues?**
- **Would it build on existing models or work done previously?**
- **Is it a pervasive issue affecting a number of states or taxpayers?**
- **Would the project produce a model law to address an emerging issue?**
- **Would the project produce a uniform law, and if so, how difficult it would be for states to change any existing laws?**
- **Would the goals of the project require legislation or could they be accomplished by agency action?**
- **Would there likely be political support or opposition?**

PROPOSED PROJECT & THE WASHINGTON APPROACH

As Washington state discussed in its presentation to the Uniformity Committee on April 28, 2021,¹ the approach to taxing digital products that it has taken includes the following significant features:

- Sourcing using the streamline model law (destination)
- Broad imposition on digitally-supplied services
- Many specialized exclusions and exemptions
- Broad taxation of digital goods (broader than SSUTA), and
- Addressing of prewritten software remotely accessed (i.e. not delivered)

What generally distinguishes Washington’s approach from the approach taken by many other states is that Washington imposed the tax on broad categories of products and then provided for a number of specific exclusions. In this respect, Washington’s approach is like the traditional imposition of the sales tax on tangible or physical property. Washington recommends its approach, in part, because the alternative—specifically identifying particular products for inclusion in the tax base—creates a system that becomes outdated quickly as technology changes and requires continual updating, which can also create compliance and enforcement difficulties. Washington’s broad-inclusion, specific-exemption approach also allows policy choices to be made as to what items to exempt, following the traditional approach to sales taxes on physical goods.

EVALUATION OF PROPOSED PROJECT

The Standing Subcommittee has discussed the project and requested that staff conduct a preliminary review of relevant information—including conferring with the Executive Director of the Streamlined Sales and Use Tax organization (Streamlined), Craig Johnson. The Standing Subcommittee also considered whether the project might address cryptocurrency (e.g. Bitcoin) or related digital technologies.

MTC staff would especially like to thank Arizona and Louisiana for providing their research and analysis on methods used by states, currently, to tax digital products.

This section summarizes information from the preliminary evaluation of the project. Some of the information and source materials used in this process are posted on the Standing Subcommittee web page, here: <https://www.mtc.gov/Uniformity/Standing-Subcommittee>.

IMPORTANT SALES TAX HISTORY

The following history is useful background for evaluating the proposed project.

¹ Available on the MTC website, Standing Subcommittee webpage, both as a recording and a copy of the slides, here: <https://www.mtc.gov/Uniformity/Standing-Subcommittee>.

General Sales Tax – Early Foundations

According to some sources, the general sales tax is a century old this year.² Other sources date the first “retail” sales taxes to the 1930’s. During that same period, states and the federal government were also beginning to impose excise taxes—including, most importantly, on fuel.³ Obviously, the world was very different nearly a century ago. Nevertheless, certain foundational elements of the sales tax system were established at that time, and have persisted, including:

- Imposition of two separate but related taxes—a retail sales tax and a separate compensating use tax;⁴
- Variations in the legal imposition of the retail sales tax with some states imposing the tax on the seller,⁵ or on the buyer (as collected by the seller),⁶ or both;⁷
- Recognition of the need for credits for taxes paid to another state on the same items to avoid multiple taxation;⁸ and
- With notable exceptions,⁹ inclusion in the tax base of only specified intangible property or services, while generally including *all tangible property*, with specified exemptions.

As discussed briefly below, these foundational elements have had important, but not always obvious, implications for how states approach the taxation of digital products. Further, while there are significant similarities in these elements from state to state, the variations may make the adoption of a uniform approach to taxing digital products more challenging.

Common Trends Over Time

In addition to the foundational elements noted above, a few common trends also affected the evolution of those taxes over time. And, similar to the elements above, these trends demonstrate that state sales taxes may have both uniform and non-uniform features.

- Universal adoption of a credit for taxes paid (at least against the use tax);¹⁰
- Universal treatment of traditional leases as included in the sales tax base;¹¹

² Those sources cite to West Virginia’s occupation tax as the first proto-sales type tax. See, for example, “State and Local Sales Taxes,” Tax Foundation, 1970, p. 8, available here: <https://files.taxfoundation.org/legacy/docs/rp23-1.pdf>. (Hereafter, Tax Foundation.)

³ “A brief history of Oregon vehicle fees and fuel taxes”. The Oregonian/Oregon Live. December 12, 2010.

⁴ See *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937)(Washington state).

⁵ See *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938)(New Mexico).

⁶ See *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359 (1941)(Iowa).

⁷ See *City of New York v. Feiring*, 313 U.S. 283 (1941).

⁸ *Id.*

⁹ See *Western Live Stock* (New Mexico).

¹⁰ See, for example, the Multistate Tax Compact, Art. V. Elements of Sales and Use Tax Laws, Sec. 1. Tax Credit, a copy of which is available here: <https://www.mtc.gov/getattachment/The-Commission/Multistate-Tax-Compact/Original-Model-Multistate-Tax-Compact.pdf.aspx>.

¹¹ Based on a general search of various sources.



- Widespread adoption of exemption certificates as a means to shift the onus of paying the tax from the seller to the buyer;¹²
- Various forms of credits or exclusions to alleviate the regressivity of the tax;¹³
- Various forms of exclusions or exemptions for items used in the production process in order to alleviate tax-pyramiding or cascading;¹⁴ and
- Local impositions generally, but not always, based on the state tax base.¹⁵

As sales taxes developed, the area in which states tended to diverge significantly was in the definition of specific intangible property and services included in the tax base as well as specific tangible property exempted from the base. These differences, in particular, created a complex system that made it difficult for multistate taxpayers to comply.

Finally, a later development in federal law has also affected states inclusion of digital products in its tax base—the enactment of the Internet Tax Freedom Act, initially a temporary act passed in 1998, which has recently become a permanent restraint on all states.¹⁶

Commerce Clause Challenges

The sales tax was the target of constitutional challenges throughout the 20th Century, most typically under the Commerce Clause. Those challenges often focused on states' taxing jurisdiction over out-of-state sellers. States won many of the early cases.¹⁷ But then, in 1954, the U.S. Supreme Court held Maryland could not impose a tax collection obligation on an out-of-state seller that had no retail outlets or sales solicitors in that state.¹⁸ The Court re-affirmed that general position in 1967 and again in 1992.¹⁹ The Court's 1992 decision in *Quill*²⁰ cited the burdens imposed on multistate sellers as the primary reason that states' jurisdiction was restricted under the dormant commerce clause doctrine.

After 1992, a number of states, as well as the MTC and other organizations, supported a state-level effort to address the burdens on multistate sellers identified by the U.S. Supreme Court. This effort ultimately resulted in the Streamlined Sales and Use Tax Agreement. States also participated in the development of technological solutions.

A few states also attempted to create a workable system for collecting use taxes directly from consumers within their states. The MTC Uniformity Committee was involved in this effort, which resulted in a proposal to require remote sellers to provide notice and information

¹² Id. Sec. 2. Exemption Certificates. Vendors May Rely.

¹³ Tax Foundation, p. 7.

¹⁴ Id.

¹⁵ Id.

¹⁶ 47 USC 151 note.

¹⁷ See, for example: *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62 (1939); *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359 (1941); and *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).

¹⁸ *Miller Bros. v. Maryland*, 347 U.S. 340 (1954).

¹⁹ *Natl. Bellas Hess, Inc. v. Dept. of Revenue of Illinois*, 386 U.S. 753 (1967) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

²⁰ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).



reports so that customers could report the use tax owed, and so that states would be able to verify taxes paid. That approach was subject to immediate challenge and was never widely adopted.²¹

It was not until 2018, in *South Dakota v. Wayfair, Inc.*,²² that the Supreme Court overturned its earlier decisions and allowed states to impose sales tax obligations on remote sellers. By that time, it was clear that these remote sellers had the ability to exploit in-state markets, particularly to sell physical goods over the Internet and also to sell other types of digital products.

Effects of Sales Tax History on the Sales Tax Base

Recently, some have commented on the failure of the general sales tax base to evolve—and in particular, to include digital products, especially as these new products have replaced more traditional consumer goods.²³ But there seems little doubt that, for 50 years, this evolution was stymied because states could not be certain that any tax imposed on these items, when sold by remote sellers, would be enforceable. So expansion of the tax base would simply favor some sellers over others.

But there are other aspects of the traditional sales tax that may also be barriers to its adaptation to the new economy, including:

- Transaction-based taxation and the need for transaction-by-transaction sourcing, which creates additional difficulty (as opposed to sourcing for a gross receipts tax or for apportionment formula purposes);²⁴

²¹ See the project page for the Use Tax Information Reporting Work Group, here: <https://www.mtc.gov/Uniformity/Project-Teams/Model-SU-Notice-and-Reporting-Statute>. Challenges to this approach led, indirectly, to the *Wayfair* case. See Justice Kennedy’s concurring opinion in the 2015 case of *Direct Marketing Assn. v. Brohl*, where he said: “Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court’s holding in *Quill*. . . . The instant case does not raise this issue in a manner appropriate for the Court to address it. It does provide, however, the means to note the importance of reconsidering doubtful authority. The legal system should find an appropriate case for this Court to reexamine *Quill* and *Bellas Hess*.” 575 U.S. 1 (2015) .

²² 138 S. Ct. 2080.

²³ See, for example: Orly Mazur and Adam Thimmesh, “Closing the Digital Divide in State Taxation: A Consumption Tax Agenda,” 98 Tax Notes State 961 (NOV. 30, 2020); Annette Nellen, “Now is a Good Time to Start Fixing the Sales Tax Base,” 97 Tax Notes State 987 (SEPT. 7, 2020);

²⁴ Not all state sales-type taxes impose a requirement to charge or collect the amount of tax on a transaction-by-transaction basis, and this requirement may add to the burden of the sales tax. See Helen Hecht, Sourcing of Digital Goods and Services for Sales Tax—the Evolution of a Federal Legislative Proposal, National Tax Association, Proceedings of the Annual Conference on Taxation, 2014, available here: <https://www.mtc.gov/MTC/media/Standing-Subcommittee/NTA-2014-Digital-Goods.pdf>.



- Concern that a lack of uniformity in sourcing might lead to nowhere sales or to sales subject to multiple taxation, and belief by some that a federal solution to the sourcing of digital products and services²⁵ is preferable;²⁶
- Concern that expansion of the sales tax base may exacerbate systemic problems such as the regressivity of the tax or its tendency to create cascading tax burdens on business inputs; and
- An expectation that digital products may be too difficult to consistently define, which will only increase the overall complexity of the tax system.

HOW MIGHT THE PROPOSED PROJECT FIT THE GENERAL PROJECT CRITERIA?

An evaluation of the general criteria used by the Standing Subcommittee to evaluate potential projects shows that the proposed project, while potentially challenging, is one that the MTC is well suited to address.

The MTC’s General Expertise and Mission

The purposes of the Multistate Tax Compact are to facilitate proper tax determinations for multistate taxpayers, promote uniformity or compatibility in significant components of state tax systems, facilitate taxpayer convenience and compliance, and avoid duplicative taxation.²⁷ In addition to the role the MTC has played in the sales and use tax area as noted above, the MTC recently concluded a project drafting detailed regulations on market-based sourcing of receipts from intangible property and services for purposes of the corporate income tax apportionment factor—an exercise that raised issues similar to those faced by states wishing to apply their sales tax to digital products.

Building on Existing Models or Prior Work

In its initial discussion of the potential project, the Uniformity Committee noted the work done previously by the Wayfair Implementation and Marketplace Facilitator Work Group (headed up by Tommy Hoyt, Texas, and staffed by Richard Cram, MTC National Nexus Director) as a possible exemplar for the committee’s process in addressing this potential project. In addition, the MTC has worked on several other sales and use tax projects over the years. Nevertheless, the issues to be addressed here are difficult and complex and will undoubtedly pose a challenge unless there is widespread support for, and participation in, the project by states as well as taxpayers, practitioners, and others. (See Conclusion below.)

²⁵ See the Digital Goods and Services Tax Fairness Act of 2019, available here: <https://www.congress.gov/bill/116th-congress/senate-bill/765>.

²⁶ This federal bill was proposed for a number of years but met with general opposition from the states. See Michael Mazerov, “Digital Goods and Services Tax Fairness Act Would Impair Funding for Education, Health Care and Other State and Local Services,” (2012), available here: <https://www.cbpp.org/research/digital-goods-and-services-tax-fairness-act-would-impair-funding-for-education-health-care>.

²⁷ Multistate Tax Compact, *supra* note 10, Art. I.



Pervasiveness of the Issue

A total of 45 states, plus the District of Columbia, have sales taxes. The majority impose tax on at least some types of digital products. As these digital goods and services become more prevalent, and evolve, they may reduce or replace the sales of other, more traditional, taxable products and services. Therefore, the issue affects all states (regardless of whether they do or do not tax some digital products currently) and also the vast majority of taxpayers who may buy or sell these products.

Opportunity to Produce a Model Law or Uniform Law

While the majority of states impose tax on at least some types of digital products, they have taken very different approaches. As an important article on the subject succinctly puts it:

“How do the states define, tax, and exempt from taxation digital goods and services? Each and every way. The end.”²⁸

And as Washington’s presentation highlighted, after the *Wayfair* decision, it is clear that states have renewed interest in how to best tax digital products where, prior to *Wayfair*, it might have been difficult to collect that tax. But few states will be writing on a clean slate. The MTC’s past experience suggests that it is particularly difficult to bring about uniformity where individual states have already committed to diverse approaches.

Need for Legislative Versus Regulatory Action

Implementing any recommendation resulting from this project would likely be accomplished through legislation rather than regulation. Nevertheless, creating a workable system or approach—which is administrable by both tax agencies and taxpayers—requires the involvement of administrative professionals, in addition to legislators and policymakers.

Political Support or Opposition

There are also likely to be political hurdles in many states and resistance to tax increases resulting from expansion of the tax base. But there is also increasing pressure created by the realization that certain products and services have traditionally been excluded entirely from the state tax base. That pressure can be seen in both the interest in broader gross receipts type taxes (which have been considered by a number of states and adopted, in recent years, by Nevada and Oregon), as well as similar taxes on certain types of digital goods or services (including on digital advertising, also considered by multiple states and adopted recently by Maryland).

Despite any political opposition, as Washington’s presentation makes clear, there are sound policy reasons to expand the sales tax base to include digital products. And, assuming that some states will undertake that task, there are also critical decisions to be made about how to frame

²⁸ That article, “Digital Goods and Services: How States Define, Tax, and Exempt These Items,” by Natalia Garrett, Deputy Assistant Director, Audit District and Grant Nülle, Deputy Director of the Arizona Department of Revenue (hereafter “Digital Goods Article”) is reproduced with permission on the MTC website, here: <https://www.mtc.gov/MTC/media/Standing-Subcommittee/Digital-Goods-Paper-N-Garrett.pdf>.



the imposition of the tax, how to describe the particular characteristics of items to be exempted from tax, and how to consistently source items so as to reduce, as much as possible, uncertainty and controversy. And because this is an area of constant change, there is also a need provide a structure that can respond to that change.

Finally, because interests of state tax organizations overlap, including interests of the MTC, Streamlined, and the Federation of Tax Administrators, it will be beneficial to coordinate efforts with these organizations.

CONCLUSION

This project presents obvious challenges. While it may be difficult, the MTC and its member states have the experience and expertise to identify or develop one or more best practices in taxing digital products that will also serve to reduce complexity, create more consistency, and be flexible enough to allow variation in policy choices and adaptation to changes in products over time. But it also seems likely that such best practices will not match the approach currently taken by many states. Moreover, as noted, we expect some political opposition to any expansion of the tax base. Therefore, the Standing Subcommittee recommends that the Uniformity Committee initiate a limited scope project, as described below. Based on the results of this project, the scope of any follow-on projects or initiatives may be better assessed.

RECOMMENDATION & SCOPE OF PROJECT

The Standing Subcommittee recommends that the Uniformity Committee establish a work group to advise on the drafting of a white paper to address:

- A general survey and description of the kinds of digital products currently offered in the marketplace and the nature of the transactions through which those digital products may be provided to customers;
- A general survey of academic research or other analysis on policy reasons for including digital products in (or excluding them from) the sales tax base;
- A review and summary of general information on the specific types of digital products that states currently tax (which information is available from different sources, including Streamlined);
- Analysis of the extent to which mixed or bundled products (including nondigital services and intangibles) may create issues for taxing digital products;
- A summary of sourcing issues and common approaches to sourcing digital products, including multiple points of use, and
- Analysis of the ways that digital products might be defined, categorized, exempted and sourced.



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Sales Taxation of Digital Products – June 17, 2021

Note on cryptocurrency and related issues—we also recommend that staff provide the Uniformity Committee with information and a possible presentation on cryptocurrency and related issues for the committee’s consideration as a project at a later date, but that this issue not be included within the scope of this project.