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2021-2022

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November 2, 2021

Nancy L. Prosser  
General Counsel  
Multistate Tax Commission  
444 North Capitol Street, NW Suite 425  
Washington, DC 20001

Re: Comments on the Taxation of Digital Products

Dear Ms. Prosser:

Enclosed please find comments for consideration by the Multistate Tax Commission on tax issues surrounding the application of sales and use taxes to digital goods and services. These comments are submitted on behalf of the Section of Taxation and have not been reviewed or approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Julie A. Divola  
Chair, Section of Taxation

Enclosure

**AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION**

**Comments on Issues to Address  
Regarding the Taxation of Digital Products**

These comments (“**Comments**”) are submitted on behalf of the American Bar Association Section of Taxation (the “**Section**”) and have not been reviewed or approved by the House of Delegates or Board of Governors of the American Bar Association. These Comments should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Edward J. Bernert. The following individuals provided substantial assistance in the drafting of these Comments: Gregg D. Barton, Edward J. Bernert, Hayes R. Holderness, R. Bruce Johnson, Lindsay M. LaCava, Mathew P. Schaefer, and Shirley K. Sicilian. These Comments were reviewed by Edward Tanenbaum, of the Committee on Governmental Submissions and Kurt Lawson, Vice Chair for Government Relations.

Although members of the Section may have clients who might be affected by the tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a submission with respect to, or otherwise to influence the development or outcome of, one or more specific issues addressed by these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: November 2, 2021

## Executive Summary

The Section appreciates the opportunity to submit comments in conjunction with the consideration by the Multistate Tax Commission (“MTC”) of tax issues surrounding the application of sales and use taxes (“SUT”) to digital goods and services (collectively “**Digital Products**”). The Section takes no position on whether individual states should expand their tax bases to encompass additional types of Digital Products. These Comments are intended to outline important tax policy issues arising when a state considers legislation to enact or amend its current SUT statutes and regulations for Digital Products, and to propose ways in which the MTC might address such issues in preparing a white paper on the SUT treatment of Digital Products. The Section anticipates offering additional comments as the MTC Digital Products Project moves forward.

These Comments focus on U.S. subnational SUT, in contrast to gross receipts taxes or specialized enactments that do not closely resemble the SUT and that normally would not be classified as SUT.<sup>1</sup> For the same reasons they do not focus on the application of value added taxes to Digital Products, although there has been a great deal of activity in that area outside of the United States.<sup>2</sup> The discussion focuses on state-level statutes because most jurisdictions conform their local tax bases to that of the state.

In light of the foregoing, and as explained more fully below, we make the following recommendations:

- Common definitions and other means to achieve uniformity are vital elements in any discussion of the proper SUT treatment of Digital Products.
- The application of SUT to Digital Products should reflect not only the benefit enjoyed by the consumer but also the manner in which the product is provided and delivered.
- Digital Products should be separately identified as taxable and not deemed to be “tangible personal property” (or “software”) merely to fit within the current structure of the SUT.
- Appropriate exemptions, including business input exemptions, should be provided to avoid pyramiding of the tax. They should not be limited to the terms of traditional exemptions for tangible personal property and should not require a seller or purchaser to prepare burdensome transaction-level documentation to claim them.

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<sup>1</sup> For the distinction between sales and use taxes and gross receipts taxes, *see generally Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995).

<sup>2</sup> For a comparison of value added taxes to sales and corporate income taxes, *see Trinova Corp. v. Michigan Dep’t of Treasury*, 498 U.S. 358 (1991). Much of the discussion relating to value added taxes also has focused on the taxation of digital services rather than digital products.

- Sourcing for Digital Products presents difficult issues. The sourcing statutes must provide meaningful guidance in their application.
- The regulatory process and informal guidance by taxing authorities should be expanded for Digital Products to address issues as they arise.
- Clear rules are needed for the application of SUT to bundled transactions that include both taxable and exempt elements.
- Implementing the expansion of a SUT to Digital Products is likely to introduce administrative and compliance difficulties. Appropriate provisions to address those difficulties should be provided.

### Discussion

1. **Uniformity is important.** Variations among the states in classifying taxable Digital Products will challenge service providers' ordering, payment processing, accounting, and tax reporting systems. The many variations in the types of Digital Products that are provided today and that will be provided in the future further increase those challenges and, thus, the need for uniformity. We recommend that uniformity be part of the original architecture of the taxes rather than an after-thought strived for after they're adopted. Thus, in outlining and later drafting a potential white paper, we recommend that the MTC give attention not only to those definitions that already are part of SUT statutes, but also to taxpayer input regarding which definitions are most workable and that should be advanced for widespread adoption among states.
2. **The design of a tax on Digital Products should reflect the behind-the-scenes technology required to provide the Products.** Unlike a consumer, who can benefit from a Digital Product without needing to understand how it's produced or provided, the drafter of a SUT statute must understand how a Digital Product is produced, generated, and distributed in order to apply SUT principles sensibly to it. The process of creating and providing the product might not easily be seen or understood.

For example, typically an extensive network of separate parties is needed to produce, display, and pay for a digital advertisement. These intricacies are irrelevant to a consumer, but without thoroughly understanding them SUT cannot be administered properly and might create multiple taxes on a single transaction. Such intricacies are not unique to Digital Products, but are more common in the digital sector than others. As a result, tax administrators cannot simply rely on input from taxpayers after SUT language is proposed or adopted; rather, we recommend that states engage subject matter technology experts to assist in the initial design of the taxes.

The MTC can help to ensure that, when states adopt SUT statutes, those statutes reflect the underlying technologies by which Digital Products are produced and distributed by

emphasizing the importance of understanding such technologies in outlining and preparing the MTC white paper on Digital Products.

3. **Classes of Digital Products should be identified separately and not deemed to be “tangible personal property” (or “software”) for tax purposes.** In some circumstances, existing taxes on tangible personal property (or software) have been expanded legislatively and administratively to incorporate new forms of Digital Products. But Digital Products often bear little resemblance to tangible personal property (or software) as traditionally understood. Thus, it helps affected parties avoid confusion and understand and implement the tax to expressly describe and classify the Digital Products as taxable services and not simply deem them to be tangible personal property (or software) when describing the taxable transaction. The MTC Digital Products Project presents an opportunity to establish a strong foundation for applying SUT laws efficiently to new kinds of product offerings.
4. **The exemptions for Digital Products should be structured to be applied to the nature of the products being taxed.** Sound tax policy requires that tax pyramiding be limited by the enactment of exemptions.<sup>3</sup> Yet using exemptions designed for purchases of tangible property can create confusion and uncertainty for the same reasons that simply deeming Digital Products to be tangible personal property when describing the taxable transaction can do so. This problem is magnified by the fact that taxpayers often bear the burden of proof for establishing their entitlement to exemptions. Thus, we recommend that business input exemptions, including purchases for resale and purchases for use in producing a Digital Product, should be separately addressed legislatively to ensure that the exemption can be applied administratively.

We also recommend against demanding detailed transaction-level records to support the exemptions. Washington State’s exemption for the application of human effort<sup>4</sup> to a Digital Product is a good example. As explained in the earlier presentation to the MTC by the Washington Department of Revenue,<sup>5</sup> it requires detailed record-keeping on the part of the provider of the service, including information that businesses typically do not maintain in the ordinary course. The difficulty in documenting the exemption hinders the ability of taxpayers to use the intended exemption.

5. **Sourcing issues will be crucial but challenging.** Determining which state (and locality) is authorized to tax Digital Products transactions, including those provided in the Cloud, is daunting. Expanding the types of products to be taxed will raise new sourcing

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<sup>3</sup> E.g., 1 Richard S. Pomp, *State and Local Taxation*, 6-35 & 6-36-6-40 (9th ed. 2019).

<sup>4</sup> Wash. Rev. Code § 82.04.192(3)(b)(i).

<sup>5</sup> Washington State Department of Revenue, *Taxing Digital Products & Services* (April 28, 2021), available at <https://www.mtc.gov/Uniformity/Standing-Subcommittee> (last visited Nov. 1, 2021).

considerations. Even with crediting provisions for tax imposed by another state, sourcing rules are essential to prevent multiple taxation or nowhere taxation.

When the sourcing is attributed to the market state, the provider might not know the location of the customer. The sourcing methods in use, *e.g.*, Internet Protocol or “IP” addresses, have well-known limitations, including the use of devices away from the assigned “home” location, and might present excessive real-time tax processing burdens. Absent an ascertainable fixed location like that for a delivery of tangible personal property, states use alternative “proxies,” *e.g.*, “delivery location,” location where the “benefit is received,” billing address, the location of the customer’s customer, and even market state population data, to establish the sourced-to state. In practice, the use of alternative and inconsistent proxies has been very difficult to apply. We believe that a thoughtful consideration of the best practices for sourcing Digital Products will be essential for the success of the overall MTC Project. Specifically, we believe that a white paper should do more than merely canvass existing sourcing regimes for Digital Products, and instead should evaluate which sourcing principles are most workable in light of Digital Product technologies.

6. **Digital Product statutes will require regulations and other forms of guidance.** A broad legislative statement that certain types of Digital Products are subject to SUT will be difficult for consumers, providers and tax department personnel to apply. Even though state departments of revenue face resource challenges, we believe the broadening of the base and the novelty of the issues implicated by including Digital Products calls for regulations or other forms of administrative guidance to avoid confusion and ensure that taxpayers have time to develop compliance systems.
7. **Bundled transactions require careful attention.** We believe that bundled transactions—where the seller provides both taxable and otherwise non-taxable elements as part of a single transaction—should not necessarily cause the entire transaction to be taxable. Personal services not provided “digitally” typically are not taxable. Economic efficiency and the non-discrimination provisions of the Internet Tax Freedom Act,<sup>6</sup> if nothing else, argue against subjecting an entire transaction to tax merely because computers are used to provide personal services. Therefore, we believe that guidelines for separating the taxable from non-taxable elements of sales transactions should be provided by statute.
8. **Administrative and compliance difficulties should be addressed.** Extending a SUT to Digital Products is likely to result in administrative difficulties for state revenue departments as they develop the resources and expertise to apply the law equitably and

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<sup>6</sup> The Internet Tax Freedom Act, 47 U.S.C. § 151, note, Title XI of the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999, Pub. L. No. 105-277, 112 Stat. 2681, 2681-719, imposed a three-year moratorium preventing state and local governments from imposing multiple or discriminatory taxes on electronic commerce. Section 922 of the Trade Facilitation and Trade Enforcement Act of 2015, Pub. L. No. 114-125, 130 Stat. 122, 281, made the moratorium permanent.

efficiently. The same will be true for taxpayers, who will need time to analyze their operations, determine their own SUT obligations, and develop appropriate compliance procedures. They are likely to experience many inadvertent failures as they do that. The application of existing SUT penalty provisions to taxpayers making good faith efforts to comply with new laws in the face of such difficulties should be carefully considered, and potentially phased in over time.