



MULTISTATE TAX COMMISSION

REPORT  
SOURCING DIGITAL GOODS AND SERVICES

Uniformity Committee Meeting

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For several reasons the Uniformity Committee may wish to initiate a project (i) to study the various approaches used by states to source digital goods and services for purposes of sales/use taxation and then (ii) to develop a model sourcing statute that would incorporate best practices. This Report provides some background.

**What is a digital good or service?**

Any discussion of digital goods and services must begin with a definition of the terms, but there is no single governing legal definition. Statutory definitions typically describe those goods or services that are delivered, transferred or accessed via electronic means.

The Digital Goods and Services Tax Fairness Act of 2019 (S. 765/H.R. 1725), which recently was introduced in both houses of Congress and which closely mirrors prior iterations of the bill, contains the following definitions:

- (a) “The term ‘digital good’ means any software or other good that is delivered or transferred electronically, including sounds, images, data facts, or combinations thereof, maintained in digital format, where such software or other good is the true object of the transaction . . . .”
- (b) “The term ‘digital service’ means any service that is provided electronically, including the provision of remote access to or use of a digital good . . . .”
- (c) “The term ‘delivered or transferred electronically’ means the delivery or transfer of a digital good by means other than tangible storage media, and the term ‘provided electronically’ means the provision of a digital service, audio or video programming service, or VoIP service remotely via electronic means.”

The rules adopted by the Streamlined Sales Tax Governing Board contain the following terms and definitions, which are utilized by the 16 Board members that tax digital products:

(a) “Digital Audio Visual Works--Products within the definition of the term ‘digital audio visual works’ include movies, motion pictures, musical videos, news and entertainment programs and live events. ‘Digital Audio Visual Works’ shall not include video greeting cards or video or electronic games.”

(b) “Digital Audio Works--Products within the definition of the term ‘digital audio works’ include recorded or live songs, music, readings of books or other written materials, speeches or ringtones or other sound recordings . . . ‘Digital Audio Works’ shall not include audio greeting cards sent by electronic mail.”

(c) “Digital Books--Products within the definition of the term “digital books” include any literary work other than ‘digital audio visual works’ or ‘digital audio works,’ expressed in words, numbers, or other verbal or numerical symbols or indicia so long as the product is generally recognized in the ordinary and usual sense as a ‘book.’ The term includes works of fiction and nonfiction and short stories. The term does not include periodicals, magazines, newspapers or other news or information products, chat rooms or weblogs.

(d) “Transferred electronically--means obtained by the purchaser by means other than tangible storage media. It is not necessary that a copy of the product be physically transferred to the purchaser. So long as the purchaser may access the product, it will be considered to have been electronically transferred to the purchaser. The term ‘transferred electronically’ has a broader meaning than the term ‘delivered electronically’ used in the computer related definitions.

(e) “‘Delivered electronically’ means delivered to the purchaser by means other than tangible storage media.”

For purposes of this Report, digital goods and services include the following: music, video, books and games that are either streamed or downloaded by users; electronically-delivered or -transferred computer software; and cloud computing services.

### **Size of the Digital Economy**

Digital goods and services, although recent innovations, have become nearly ubiquitous. The following figures illustrate the size and rapid growth of this part of the economy:

- According to the Bureau of Economic Analysis, the digital economy has grown in real terms by 9.9% per year since 1997 and accounted for 6.9% (\$1.351.3 billion) of gross domestic product in 2017.<sup>1</sup>

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<sup>1</sup> The BEA’s definition of the digital economy is broad, including the entire information and communications technologies sector and the digital-enabling infrastructure needed for a computer network to exist and operate, the digital transactions that take place using that system, and the content that digital economy users create and access. The purpose of citing the BEA figures is to indicate the rapid growth of this part of the U.S. economy.

- The Recording Industry Association of America reported that retail sales of streaming music and music downloads amounted to \$2.4 billion and \$760 million, respectively, in 2017, while sales of physical music media amounted to only \$620 million.
- Netflix’s most recent annual report states that the company had 139.26 million streaming paid memberships worldwide in the fourth quarter of 2018 compared to 110.64 million memberships in the fourth quarter of 2017.
- Gartner predicts that the market for cloud computing services will grow from \$153.5 billion in 2017 to \$302.5 billion in 2021.<sup>2</sup>

### **Trend Toward Taxing Digital Goods and Services**

In response to the growth of the market for digital goods and services (and the corresponding decline of comparable tangible goods), many states either have amended their tax laws to cover digital products or have interpreted current laws to apply to them. A preliminary survey indicates that 30 states and the District of Columbia tax digital music, video and books, 22 of which tax streaming, at least 17 states and the District of Columbia tax cloud computing either as a result of legislation or administrative action,<sup>3</sup> and 34 states tax prewritten software that is electronically delivered.<sup>4</sup>

States that tax digital products, however, have not all adopted similar sourcing rules. Moreover, some of these states appear not to have adopted sourcing rules with respect to at least some digital goods or services. Other states may utilize sourcing rules that are not obvious to taxpayers or their representatives.

### **Sourcing Concerns**

This in turn has caused some tax practitioners to express concerns either about the risk of multiple taxation (since states with different sourcing rules conceivably could seek to tax the same transactions) or the lack of guidance from states. Whether these concerns are overstated, or are being satisfactorily addressed via formal or informal interactions between taxpayers and state tax department, requires further investigation.

The Streamlined Sales Tax Governing Board (which currently consists of 24 member states) has adopted some sourcing rules. Section 309 of the Streamlined Sales and Use Tax Agreement provides that the Agreement’s general sourcing provision applies to all sales “regardless of the characterization of a product as tangible personal property, a digital good, or a service.” The general sourcing provision (Section 310) in turn sources sales to the location where the product is received by the purchaser, if known by the seller.<sup>5</sup> Section 311 of the

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<sup>2</sup> <https://www.geekwire.com/2018/plenty-growth-store-cloud-computing-according-gartner-will-hit-186b-2018/>.

<sup>3</sup> Seven states appear not to have not provided explicit guidance on whether or not their tax laws apply to cloud computing.

<sup>4</sup> Every state that imposes a general sales tax now taxes the transfer of at least some prewritten software, but 12 of those states exempt software that is electronically delivered.

<sup>5</sup> The seller is typically the party which is responsible for remitting applicable tax to the state.

Agreement states that receipt means “[t]aking possession or making first use of digital goods, whichever comes first,” a rule that would appear to be problematic in cases where purchasers have employees in multiple jurisdictions.<sup>6</sup>

It is noteworthy that the Agreement once contained a “Multiple Points of Use” provision. This provision required business purchasers of digital goods or electronically-delivered computer software to present to the seller an exemption certificate if the product were to be used in more than one taxing jurisdiction. The purchaser then was required to pay applicable tax directly to the various states where the goods or software would be used, based on any reasonable apportionment methodology. This provision was repealed by the member states effective December 14, 2006, although at least four member states continue to mandate the use of MPU exemption certificates.

Of perhaps particular concern is the Digital Goods and Services Tax Fairness Act. This bill, which has both Democratic and Republican sponsors, would (a) impose uniform sourcing rules on the sale of electronic goods and services and also (b) ban multiple taxes on the sale or use of electronic products and (c) ban discriminatory taxes on the sale or use of digital products. It closely tracks the language of sourcing bills introduced in prior Congresses.

As was the case with prior iterations of the bill, the proposed Act, like other federal legislative preemptions, raises a number of concerns. For example, complex matters of state and local taxation inevitably require revisions over time, but history demonstrates that federal preemptions are never revised.<sup>7</sup> Moreover, unlike state tax laws, federal tax preemption statutes are not subject to interpretation by an expert administrative agency, thereby ensuring that ambiguities will linger and that litigation will arise.

These risks apply in particular to the proposed Act’s provision banning discriminatory taxes. Prior federal statutes seeking to ban discriminatory taxes have triggered substantial litigation because the meaning of “discriminatory” is complex and is never adequately addressed by a short statutory provision.<sup>8</sup>

Most broadly, state tax administrators in the past have identified various drafting issues and ambiguities in the bill. At least at the present time, there is no indication that these issues

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<sup>6</sup> The “Rules and Procedures” issued by the Governing Board address the subject of receipt in multiple jurisdictions in the case of pre-written software and computer-related services. *See* Rule 309.2 and Rule 309.3.

<sup>7</sup> *See, e.g.*, Public Law 86-272 which remains in its original form. This statute was enacted in 1959 to limit state taxation of businesses engaged in interstate commerce. Ironically, legislative supporters of the bill indicated that it was intended to be temporary; the economy of course has changed dramatically over the past 60 years.

<sup>8</sup> *See, e.g.*, the Railroad Revitalization and Regulatory Reform Act of 1976 which is now before the U.S. Supreme Court for the fourth time and has been the subject of substantial litigation over the years.

will be addressed, particularly because they have reappeared in successive versions of the legislation.<sup>9</sup>

By initiating a project to study state sourcing regimes, the MTC and states could identify any issues with respect to the current state of the law. Given the substantial growth of the digital economy in recent years, this would be a particularly propitious time to undertake such a study. A study also could identify best practices among the states and potentially be the basis for developing a model sourcing statute. A model statute developed by state tax administrators would be a superior alternative to a federal preemption statute and might well serve as the best way to discourage preemption efforts in the future.<sup>10</sup>

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<sup>9</sup> It is important to note that the bill's ban on discriminatory taxes appears to prevent a local jurisdiction from imposing a tax on digital products that is not generally imposed on similar property, goods or services, even if the local jurisdiction imposes some other tax on the similar property, goods or services.

<sup>10</sup> It should be noted that issues relating to the sourcing and taxation of digital goods and services are not unique to the United States. For example, policy makers in Europe are engaged in similar debates. *See, e.g.*, The Irish Times, "European Commission proposes 3% turnover tax for digital companies," March 21, 2018, posted at <https://www.irishtimes.com/business/economy/european-commission-proposes-3-turnover-tax-for-digital-companies-1.3434928>.