



# Discussion Draft of Detailed Outline of a White Paper on Sales Taxation of Digital Products

*Prepared by staff of the Multistate Tax Commission for discussion by the Uniformity Committee meeting, August 2, 2022 in Anchorage, Alaska.*

## Introduction

In response to a proposal to prepare a white paper on how states might best adapt their sales tax to include digital products, the MTC Uniformity Committee asked staff to talk to stakeholders, review the relevant research, and identify issues to be included in a detailed outline of that paper. This report provides a first discussion draft of that detailed outline, which is a working document that will change as the project continues.

In the last year, MTC staff conducted 43 separate interviews of individuals or groups representing particular taxpayers, states, or other organizations, as well as practitioners and academics. (See Appendix A). They surveyed other relevant research, including studies done by other groups, much of which also is cited throughout this outline. They also monitored work of the Streamlined Sales and Use Tax Governing Board ("Streamlined") and the New Jersey Division of Taxation's study on the taxation of the digital economy generally, which is being done in conjunction with Rutgers University. See the project page on the MTC website for additional information.

Among stakeholders, administrators, and experts, it appears there is widespread agreement on some issues. For example, there was almost unanimous agreement that the proposed white paper is a good idea. On other issues, as might be expected, viewpoints diverge. Nevertheless, there is no doubt as to the significance of particular issues and those issues have been incorporated into the detailed outline along with the related questions. Also, to aid in review of these issues and questions, this report provides a brief background section.

### Related Actions of the MTC Uniformity Committee:

April 28, 2021 –

Representatives from the Washington Department of Revenue gave a presentation to the MTC Uniformity Committee in which they described their state's experience with imposing sales tax on digital products as well as the alternatives considered. They also proposed that the Committee take up a project to help states develop a simpler and more adaptable approach. The Committee asked the Standing Subcommittee to review the project proposal.

July 28, 2021 –

The Standing Subcommittee recommended that a work group be formed to draft a white paper. The Uniformity Committee asked MTC staff to first solicit input from stakeholders and prepare a detailed outline of the white paper, identifying issues to be addressed.

The project page on the MTC website is here: <https://www.mtc.gov/Uniformity/Project-Teams/Sales-Tax-on-Digital-Products>.  
For questions or other information on this outline, please contact Helen Hecht, Uniformity Counsel, at [hhecht@mtc.gov](mailto:hhecht@mtc.gov).

## State Sales Tax – Background and Terminology

State sales taxes share a common history and there are many similarities across state sales taxes. But there are also important differences worth noting when reviewing the detailed outline.

NOTE on Terminology: The terms used to describe some types of taxes can be confusing. Therefore, this report uses the following terms in the following ways:

- Digital Products – We use this single term to mean digital goods, digital services, or other items.
- Sales Tax – Often referred to as the “retail sales tax,” and which will be referred to here simply as the “sales tax,” these taxes may vary somewhat in the way they are imposed and the breadth of their base. A few are called “gross receipts taxes,” but they should be distinguished from business activity or true gross receipts taxes, as will be further discussed.
- Business Activity or True Gross Receipts Taxes – We refer to taxes on gross receipts or gross income that are distinct from typical sales taxes as “business activity taxes” or “true gross receipts taxes.”
- Excise Tax - The sales tax can also be distinguished from other narrower excise taxes on specific goods and services which may be imposed by states or by local governments.
- “Seller” and “Sale” – The sales tax is typically imposed on customers but is collected by the person or business making the transaction. Various types of transactions may be subject to the tax. We will generally refer to the person or business collecting the tax as the “seller” and the transaction as the “sale.”

### Sales Tax – A Brief History

<b>NOTABLE EVENTS</b>
<p style="text-align: center;">1932 – Mississippi adopts the first “modern” retail sales tax.</p> <p style="text-align: center;">The Great Depression - Spurred other states to also adopt these and other new forms of taxation, including specific excise taxes.</p>

The history of the sales tax has influenced its development and particular events may have stifled the expansion of the tax base as the economy has changed.

#### Early Years

Most states adopted their sales tax in the 1930s and ‘40s. Mississippi was the first, converting its true gross receipts tax into a tax with features of a modern retail sales tax in 1932. West Virginia was next, enacting a freestanding retail sales tax in 1933 and also a pure gross receipts tax, the business and occupation tax.<sup>1</sup> The states with broad based sales taxes—Hawaii, New Mexico, South Dakota, and Washington—also enacted those taxes in the 1930s. The latest state to adopt a sales tax was Vermont in 1969.<sup>2</sup>

In general, the 20<sup>th</sup> Century saw a trend away from early forms of true gross receipts taxes and toward the sales tax. Most of these sales taxes defined their base to include only sales or transactions involving tangible personal property. To the extent taxes included other items, they typically did so by describing and defining, or “specifically enumerating,” those items. And, over the years, states have generally followed this same specific enumeration approach when expanding their sales tax base, with two exceptions. Florida and Massachusetts attempted to expand their tax to services broadly, but each soon repealed that expansion.<sup>3</sup>

<sup>1</sup> John L. Mikesell and Sharon N. Kioko, “The Retail Sales Tax in a New Economy,” presented at the Municipal Finance Conference, July 16-17, 2018, available here: <https://www.brookings.edu/wp-content/uploads/2018/04/Mikesell-Kioko1.pdf>, (hereafter “Mikesell”), p. 3.

<sup>2</sup> Liz Emanuel and Richard Borean, “When Did Your State Adopt Its Sales Tax?,” July 11, 2014, available here: <https://taxfoundation.org/when-did-your-state-adopt-its-sales-tax/#:~:text=The%20next%20decade%20brought%20twelve,with-out%20a%20statewide%20sales%20tax>, (hereafter “Emanuel”).

<sup>3</sup> Hellerstein, Hellerstein & Appleby, State Taxation, Thomson Reuters/Tax & Accounting, 3rd ed. 2001 & Supp. 2022-1, ¶12.05.

**NOTABLE EVENTS**

1960s – The Willis Committee expands its study to sales taxes and recommends federal law—states respond.

1967 – The U.S. Supreme Court ruled in *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967).

Also in the 1960s, states began to provide credits for sales taxes paid to other states and clarify acceptance of exemption certificates.

1992 – The U.S. Supreme Court ruled in *Quill Corp. v. North Dakota* (91-0194), 504 U.S. 298 (1992).

1998 – Congress enacted the Internet Tax Freedom Act – 47 U.S.C. § 151 note.

## Mid-20<sup>th</sup> Century - Federal Restrictions on Sales Taxes

State sales taxes long faced both real and potential federal limits, both from interpretations of the federal constitution and from federal statutory law. In the 1960s, the Willis Committee, best known for its study of multistate income taxes after the U.S. Supreme Court's Ruling in *Northwestern States Portland Cement*,<sup>4</sup> expanded its work to consider state sales taxes as well.

The Willis Committee proposed sweeping federal reforms and limits, which Congress declined to undertake.<sup>5</sup> But it also noted two specific issues that the states responded to—the lack of a uniform credit against sales tax imposed in one state for taxes already paid in another and the failure of states to accept certificates of other states to support exempt transactions. This led directly to the inclusion of provisions to address these issues in Article V of the Multistate Tax Compact,<sup>6</sup> and to widespread adoption by the states of similar and related provisions.

States may impose sales taxes on sellers although most impose them on the customers. But even these states depend on sellers to collect the tax. Therefore, the ability of states to assert taxing jurisdiction over out-of-state sellers, consistent with the U.S. Constitution, has always been a significant consideration for policy-makers in considering what to tax.

The U.S. Supreme Court, in its 1967 ruling in *National Bellas Hess*,<sup>7</sup> struck down a sales tax on an out-of-state seller. Then, in 1992, the Court upheld that decision in *Quill*,<sup>8</sup> setting out a physical presence standard for sales tax jurisdiction. This restriction of state tax jurisdiction likely influenced the breadth of the sales tax base.<sup>9</sup>

In addition to these constitutional limits, in 1998, Congress enacted the Internet Tax Freedom Act (ITFA).<sup>10</sup> ITFA had two critical provisions. One imposed a moratorium, now a permanent prohibition, on state taxation of internet access. The other provision, often referred to as the anti-discrimination clause, preempts multiple or discriminatory taxes (not including income taxes) that states might impose on “electronic commerce,” defined to include transactions over the Internet. States seeking to expand their sales tax base to digital products must consider the implications of ITFA, which are further detailed in the outline, below.

<sup>4</sup> 358 U.S. 450.

<sup>5</sup> See Jerome R. Hellerstein, “Federal Legislation on State Taxation of Interstate Commerce: Key Areas of Controversy,” William & Mary Annual Tax Conference, 626 (1966), available here: <https://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1630&context=tax>.

<sup>6</sup> Article V provides that purchasers liable for a use tax on tangible personal property are entitled to full credit for the combined amount or amounts of legally imposed sales or use taxes paid with respect to the same property to another state and any subdivision thereof. It further provides that whenever a vendor receives and accepts in good faith from a purchaser a resale or other exemption certificate of a state or subdivision taxing authority the seller will be relieved of liability for a sales or use tax with respect to that transaction. See the Compact, available here: [https://www.mtc.gov/The-Commission/Multistate-Tax-Compact#Article\\_V](https://www.mtc.gov/The-Commission/Multistate-Tax-Compact#Article_V).

<sup>7</sup> 386 U.S. 753.

<sup>8</sup> 504 U.S. 298.

<sup>9</sup> A number of experts have commented on the influence that the lack of tax jurisdiction over out-of-state sellers had on policy-makers decisions about whether or not to expand the tax base. See, for example, Mikesell, supra FN 1, .

<sup>10</sup> See 47 U.S.C. §151 note.

## Post-*Quill* Years – State and Federal Initiatives

After *Quill*, the states undertook a project to simplify state sales taxes, which led to the formation of the Streamlined Sales and Use Tax Agreement (“SSUTA”) in 2000. The MTC was an early and active proponent of the Streamlined effort.<sup>11</sup> Currently, SSUTA has 23 full and 1 associate members.

Also, in the years following *Quill*, states also began to consider expansion of their sales tax base to digital products. In addition, some states considered, and a handful of states adopted, general business activity taxes including Ohio, Nevada, and Oregon. In part, this may have been to avoid *Quill*'s physical-presence standard and to include in the tax base a much broader range of activities than the traditional sales tax.

Around this time there was another initiative to impose federal limits on states—the Digital Goods and Services Tax Fairness Act (“DGSTFA”). First introduced in Congress in 2010, it would preempt taxes on digital goods and services unless imposed on “similar” items and would require sales be sourced according to uniform rules—often to destination. The bill, however, failed to provide the destination state with jurisdiction over the seller. The Congressional Budget Office found the bill constituted an “unfunded mandate” and imposed costs on the states in the form of forgone revenues “totaling more than \$3 billion in the first full year and at least that amount in each subsequent year.”<sup>12</sup>

## Wayfair and Renewed Interest in Digital Products

In 2018, the Supreme Court in *Wayfair*<sup>13</sup> overturned *Quill* and *Bellas Hess*, allowing states to require that out-of-state sellers with no physical presence in the state collect and pay sales tax. In response, states have now adopted dollar-based thresholds and/or transaction thresholds into law, plus related rules for determining when out-of-state sellers must collect tax on sales into the state. States have also imposed tax collection requirements on intermediaries, including internet marketplaces, for sales made on their platforms.

Even before *Wayfair*, it was common for states to look at taxing software and certain digital products that are similar to traditional goods or services. Since *Wayfair*, interest has grown in taxing other digital products, as well. Two states are conducting studies on taxing the digital economy or digital products—New Jersey and Mississippi—reports to be issued this year. In the last few months, a number of states have considered legislation to expand their sales tax base to include digital products.<sup>14</sup> Also, in 2021, Maryland adopted a tax on digital advertising<sup>15</sup> that has received significant attention and is the subject of litigation. Other states have recently considered similar legislation.<sup>16</sup>

### NOTABLE EVENTS

**1990's – States, along with the MTC, began the process that would lead to the creation of Streamlined and the SSUTA in 2000.**

**Post-*Quill* – States began to revisit the idea of true gross receipts taxes.**

**2010 – the Digital Goods and Services Tax Fairness Act is first introduced in Congress.**

**2018 – The U.S. Supreme Court overturned *Bellas Hess* and *Quill* in *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 585 U.S. \_\_ (2018).**

**2021 – Maryland adopts a tax on digital advertising. Other states file bills on similar subjects in the 2021-22 sessions.**

<sup>11</sup> See MTC Resolution No. 02-01, Improving State Sales Taxes to Achieve Fairness and Simplicity; Resolution No. 01-10, Resolution Supporting the Proposals and Work of the Streamlined Sales Tax Project; and Resolution No. 00-2, and Resolution in Support of the Streamlined Sales Tax Project; available here: <https://www.mtc.gov/The-Commission/Policy-Statements-Resolutions>.

<sup>12</sup> Congressional Budget Office Cost Estimate H.R. 1860, Digital Goods and Service Tax Fairness Act of 2012, Sept. 14, 2012, available here: <https://www.cbo.gov/system/files/112th-congress-2011-2012/costestimate/hr1860.pdf>.

<sup>13</sup> 138 S.Ct. 2080, 585 U.S. \_\_ (2018).

<sup>14</sup> See, for example, Georgia HB 594 and Kansas HB 2230.

<sup>15</sup> Md. Code, Tax-Gen. § 7.5-101 et. seq.

<sup>16</sup> See, for example, Indiana SB 372; Massachusetts bills H. 2894, H. 2928, H. 3081, H. 4042, New York A734, S1124, S302, S4959; and Washington HB 2107.

## Sales Taxes – Important Similarities and Differences

This section provides information about sales taxes that may be useful when reviewing the detailed outline.

### Revenue Generated from the Tax

All but five states—Alaska, Delaware, Montana, New Hampshire, and Oregon—have imposed a state-level sales tax. (In Alaska, the tax is imposed only by local governments.) Even these five states (and their local governments) impose narrower excise taxes on certain goods and services—e.g., fuel taxes, tobacco and alcohol taxes, lodging taxes, and utility taxes.

The share of tax revenue that each state derives from sales tax varies. A 2020 study found that sales taxes provided 32% of all state tax revenue, slightly less than the revenue provided by state personal income taxes, although, in 16 states, sales taxes are the largest source of tax revenues.<sup>17</sup> According to U.S. census data for more recent quarters, total state sales tax revenue for all states was about 30% of total state tax revenue.<sup>18</sup> This slightly lower percentage may be anomalous, or it may be consistent with the slight but steady relative decline in sales tax revenue that has occurred over the last few decades.<sup>19</sup>

### Tax Rates Imposed

Sales tax rates also vary between jurisdictions and depend on both the state rate imposed and any local rates that may be included. Today, the highest combined state and local rate is slightly less than 10%, and the lowest is around 5%. The overall trend in rates, however, is upward, with median state rates increasing about one percentage point over the last decade.<sup>20</sup>

### Tax Base

As noted above, while some states impose the sales tax on a broad base, others impose it only on sales or transactions involving tangible personal property (however defined) and certain other specifically enumerated items. Therefore, the relative breadth of the tax base (excluding specific excise taxes) varies from state to state and depending on whether it is measured relative to certain consumption data or personal income. One estimate based on personal income shows a variation ranging from 19% (California) to 94% (Hawaii).<sup>21</sup> Because of changes in the economy, one expert estimated that the breadth of the sales tax base across all states has narrowed by as much as 35% since 2000.<sup>22</sup>

### Common Exemptions

Most states have attempted to reduce what is sometimes called sales tax “pyramiding” or “cascading” on business-to-business (“B2B”) transactions by granting exemptions for purchases made for resale or purchases of manufacturing or processing inputs or other business inputs. In some cases, however, imposing tax on B2B transactions may be considered justified where there is no tax imposed on the ultimate consumption.<sup>23</sup> Most states have also attempted to reduce the regressivity of sales taxes.

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<sup>17</sup> “How States Raise Their Tax Dollars,” PEW, May 13, 2021, available here: <https://www.pewtrusts.org/en/research-and-analysis/data-visualizations/2021/how-states-raise-their-tax-dollars-fy2020>.

<sup>18</sup> See information available on the U.S. Census Data website, here: <https://www.census.gov/programs-surveys/stc.html>. All state excise taxes generate 13% of total state tax revenues. Common state excise taxes include fuel taxes at around 4% of total taxes and insurance premiums taxes at around 3%. Local governments also impose excise taxes, most notably hotel accommodations and related taxes.

<sup>19</sup> See Vivien Lee and David Wessel, “The history and future of the retail sales tax,” Brookings, July 16, 2018, available here: <https://www.brookings.edu/blog/up-front/2018/07/16/the-history-and-future-of-the-retail-sales-tax/#:~:text=The%20re-tail%20sales%20tax%20was,than%2032%20percent%20in%201970>, (hereafter, Brookings).

<sup>20</sup> See John L. Mikesell, “State Retail Sales Taxes in 2018,” Tax Notes State, Sept. 30, 2019, p. 1339.

<sup>21</sup> See Jared Walczak, State Sales Tax Breadth and Reliance, Fiscal Year 2021, May 4, 2022, Tax Foundation, available here: <https://tax-foundation.org/state-sales-tax-base-reliance/>.

<sup>22</sup> Id.

<sup>23</sup> See William F. Fox and Leann Luna, “How Broad Should State Sales Tax Bases Be? A Review of the Empirical Literature,” State Tax Notes, Sept. 4, 2006, P. 639.

Methods include exempting certain essential purchases, such as food, tax “holidays,” providing credits tied to income, or expanding the tax base to include certain services purchased by higher-income households.<sup>24</sup>

### Adaptability (or Lack of It)

The inability of the state sales taxes to adapt to changes in the economy—reflected in rising tax rates imposed on a narrowing base relative to consumption—is often cited as critical to the tax’s future.<sup>25</sup> Experts have, for decades, noted the failure of sales taxes to keep up with the digital economy, to the point where one noted expert has opined:

“. . .the tax, as it currently functions, is an anachronism that reflects its origins in the Industrial Age nearly 70 years ago; since the [retail sales tax or RST] was created without a firm conceptual basis and “just grewed,” it is not surprising that it is defective—or that e-commerce magnifies its defects. But the problem may be deeper than this; even if reformed, the RST may simply not be suitable to serve as the most important source of tax revenue of state and local governments in the twenty-first century.”<sup>26</sup>

### Structure and Common Elements

Sales taxes have a certain structure and common elements, but also some deviations that may affect efforts to develop an approach to taxing digital products.

- Legal Imposition of Sales Tax – In most states, the tax is imposed on the customer but must be collected by the seller (or certain intermediaries). A seller who fails to properly collect the tax typically becomes legally obligated to pay it. A minority of states legally impose tax on the seller.
- Imposition of Use Tax – The sales tax is invariably imposed with a complementary tax called the “compensating use tax,” or “use tax.” This tax is imposed on the customer and may be collected by the seller, or paid directly by the customer. The use tax, which is imposed only on purchases from out-of-state sellers, does not violate the Constitution if it is imposed with an “identifiable and substantially similar tax on intrastate commerce.”<sup>27</sup>
- Tax Rates – Most but not all state sales taxes are imposed by both state and local governments. The tax rate on a particular transaction will be a combination of the state and any local rates applicable.
- State Tax Base - Most sales tax laws provide for general imposition of the tax on all sales or transactions involving tangible personal property, but may also include other specifically enumerated items and specific services. A handful of states impose tax on gross receipts or broad categories of transactions.

#### MAJORITY RULES

**Legal Imposition of the Sales Tax – on the customer unless the seller fails to properly collect.**

**Imposition of Compensating Use Tax – all states**

**Tax Rates – combination of state and local rates.**

**State Tax Base – tangible personal property and specifically enumerated services.**

<sup>24</sup> See, for example, “Who Pays? 6th Edition,” Institute for Taxation and Economic Policy, 2018, available here: <https://itep.sfo2.digital-oceanspaces.com/whopays-ITEP-2018.pdf>; and Michael Mazerov, “Expanding Sales Taxation of Services: Options and Issues,” Aug. 10, 2009; available here: <https://www.cbpp.org/research/state-budget-and-tax/expanding-sales-taxation-of-services-options-and-issues>.

<sup>25</sup> See, for example, Brookings, supra FN 17; and Mikesell, supra FN 1.

<sup>26</sup> Charles E. McLure, Jr., “Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the Sales Tax or Discard It?,” 2000 BYU Law Rev. 1, Art. 11, Mar. 1, 2000, available here: <https://digitalcommons.law.byu.edu/cgi/viewcontent.cgi?article=2052&context=lawreview>, (hereafter, McClure).

<sup>27</sup> See *Associated Industries of Mo. v. Lohman*, 511 U.S. 641 (1994).

- **Local Tax Base** - In most states that have tax imposed by local governments, the local tax base is identical to the state tax base. But in a handful of states, local government tax bases may not be identical.
- **Separate Statement of the Tax** – In most but not all states, the seller must separately state the tax being charged to the customer. In part, this facilitates the customer’s determination of whether use tax is due.
- **Exemptions** – As noted above, states typically provide a number of exemptions. Many of these exemptions address B2B transactions to reduce tax pyramiding or address the inherent regressivity of the tax. Others may single out particular industries or activities for tax benefit. There is a wide variation in the types of exemption states offer and even similar exemptions may rely on slightly different defined terms or requirements.
- **Sourcing** – Since rates vary by state or local jurisdiction, it is necessary for transactions to be sourced to particular jurisdictions. In the past, sourcing rules varied considerably. Most states today use destination-based sourcing, although there are some exceptions, and sourcing of certain items, like services and digital products, is more complicated than sourcing transactions involving tangible personal property. States that are members of the SSUTA must conform to uniform sourcing rules.
- **Credit for Tax Paid** – Customers who may owe use tax in a particular state for items acquired outside the state can claim a credit against that tax for sales or use tax properly collected or paid to another state. State credits, however, may not completely eliminate double-taxation. A particular transaction may be subject to two (or more) simultaneous sales tax impositions. In some states, the credit for tax paid may not apply in such cases.
- **Documentation** – Sellers and customers must keep proper documentation to show that any exemptions claimed are valid or that tax paid is computed at the proper rate. States typically provide a standard form or certificate for customers to give to sellers, asserting the transaction would meet the exemption criteria, on which the seller can then rely. If the customer fails to qualify, then the use tax may be imposed.
- **Streamlined States** – The members of the SSUTA must conform their laws to that agreement. SSUTA imposes requirements involving definitions, imposition, and sourcing. It contains definitions of certain “specified digital products,” “digital audio-visual works,” “digital audio works,” “digital books,” and “computer software.” SSUTA also provides: “Nothing in this section or the definition of “specified digital products” shall limit a state’s right to impose a sales or use tax or exempt from sales or use tax any products or services that are outside the definition of “specified digital products.” See Section 332 of the SSUTA.

## MAJORITY RULES

**Local Tax Base** – same as for the state.

**Separate Statement of Tax** – required to be properly made to customer.

**Exemptions** – generally provided to reduce pyramiding, regressivity, and provide other tax benefits.

**Sourcing** – destination-based and SSUTA.

**Credit for Tax Paid** – may apply except in certain circumstance.

**Documentation** – typically includes forms of certificates given by customers to sellers

**SSUTA** – provides definitions of certain digital products but does not limit taxation of others.

The detailed outline below relies primarily on the majority rules governing states' sales taxes but will also note when additional consideration might need to be given to how minority-rule states could be affected.

## Detailed Outline

### I. General Purpose or Goal of the White Paper –

In this section we would develop the general principles and criteria that will be used to evaluate the information gathered and to compare potential alternatives. The purpose or goals may include:

- A. Determine the best approach to making existing state sales taxes adaptable and responsive to changes in the digital economy as opposed to creating a new tax or looking at gross receipts taxes.
  - (1) Based on pros and cons of different approaches as determined from the analysis of the issues outlined here.
  - (2) Based on survey of state experience with different approaches.
- B. Determine the approach that is most responsive to issues identified by stakeholders.
  - (1) Addressing the important issues identified by stakeholders and summarized in the outline here.
  - (2) Reducing the compliance and enforcement costs based on best available information.
- C. Determine the approach that will lead to the greatest uniformity.
  - (1) Does the method provide for the ability of states to adopt and apply common definitions?
  - (2) Does the method provide for the ability of states to adopt and apply common requirements for certain exemptions?
- D. Other [may want to note the common criteria used to evaluate taxes – economic equity, revenue reliability, etc.]

### II. Describe the Categories and Sub-Categories of Digital Products and Transactions Generally –

In this section we would use both existing tax definitions and industry information to help categorize and describe the types of products that we are focusing on.

- A. SSUTA definitions of digital products.
- B. Other common state tax definitions
  - (1) Interpretations of “tangible personal property”
  - (2) Goods versus services distinction
    - (a) Traditionally – true object or other tests
    - (b) As applied to certain digital products
  - (3) Examples
    - (a) Advertising
    - (b) Artificial intelligence
    - (c) Data processing services
    - (d) Information services
    - (e) Software as a Service
- C. Typical forms of digital product transactions
  - (1) Sales (meaning the customer owns the rights to the item after the transaction)
  - (2) Licenses or leases
  - (3) Subscriptions



(4) Exchange of user data for certain products

D. Common and emerging products

(1) Most common consumer products

(2) Common B2B products

(3) Non-Fungible Tokens (“NFTs”) (e.g., PA DOR REV-717, p.12 (05-22) adds NFTs to the list of taxable digital products without definition; WADOR issues “Interim Statement Regarding the Taxability of Non-Fungible Tokens (NFTs) 7/1/22)

(4) Digital currency

III. Important Limitations Facing States that Must be Considered –

In this section we would focus on certain practical realities of making an adaptable tax on digital products work including enforcement and ITFA limits.

A. Enforcement generally

(1) International sellers

(2) Other enforcement issues

B. ITFA’s non-discrimination provision and its interpretation and application [which would include survey of litigation and case law as well as other information]

(1) “Electronic commerce”

(2) “Similar property, goods, services, or information”

(3) “Internet access”

IV. Important Issues Raised by Stakeholders –

In this section we would focus primarily on the biggest issues cited by stakeholders that are creating challenges or problems—describing the issues and potential solutions generally.

A. Continually changing products

(1) Description of the problem

(2) Possible solutions

B. Lack of certainty and areas needing more guidance generally and process for obtaining specific, timely guidance

(1) Description of the problem

(2) Possible solutions

C. Concern for equity/parity between digital products and other items

(1) Description of the problem.

(2) Possible solutions.

D. Need for some flexibility

(1) Description of the problem

(2) Possible solutions

E. General mechanics of the sales tax – especially exemptions and sourcing

(1) Application of B2B exemptions to digital products

- (a) Description of the problem
- (b) Possible solutions
- (2) Application of other exemptions
  - (a) Description of the problem
  - (b) Possible solutions
- (3) Treatment of bundled or mixed transactions
  - (a) Description of the problem
  - (b) Possible solutions
- (4) SSUTA sourcing rules and gaps in the rules
  - (a) Description of the problem
  - (b) Possible solutions
- (5) Multiple points of use
  - (a) Description of the problem
  - (b) Possible solutions
- (6) Consideration of federal DGSTFA sourcing provisions
- (7) Consideration of direct pay by customers
- F. Related issues
  - (1) Threat of qui tam and class action suits [see the MTC resolution on this subject]
  - (2) Expansion of the tax base through administrative interpretation
  - (3) Effect on existing marketplace facilitator laws
- G. Provide time for taxpayers to implement changes and for agency to issue necessary guidance
- V. Survey of the Main Approaches to Including Digital Products in the Tax Base
  - A. States with broad tax bases – generally
    - (1) Duration of the taxes
    - (2) How the taxes have adapted generally
    - (3) Challenges faced – including exemptions, sourcing, etc.
  - B. States that have specifically enumerated certain digital products – survey
    - (1) Different products included [see the work done by Arizona and Louisiana, as well as others]
    - (2) How the taxes have adapted generally
    - (3) Challenges faced – including exemptions, sourcing, etc.
  - C. States that have interpreted “tangible personal property” to include digital products – survey
    - (1) Examples of states using definition of TPP [again, see the work done by Arizona and Louisiana.]
    - (2) How the taxes have adapted generally
    - (3) Challenges faced – including exemptions, sourcing, etc.
  - D. Example – contrasting approaches – taxation of software [Lila's presentation to the auditors]

## VI. Pros and Cons of Applying an Alternative Tax

### A. True gross receipts taxes [see research done by various groups.]

- (1) Possible Pros – May be simpler.
- (2) Possible Cons – Pyramiding and need for different rates.
- (3) Other

### B. Digital advertising taxes [summarizing the discussion of Maryland's tax.]

- (1) Possible Pros – Can be tailored to the industry.
- (2) Possible Cons – ITFA limitations and failure to address other products; OECD Pillar 1 discussions to eliminate digital taxes at the international level.
- (3) Other

### C. “Data mining” taxes [summarizing Plattner's proposal and discussion.]

- (1) Possible Pros – Recognizes value in “free” services provided in exchange for data.
- (2) Possible Cons – Untested.
- (3) Other

### D. Alteration of sales tax mechanics – simplifying the sales tax

- (1) Ability to vary the typical mechanics including separate statement of the tax so as to allow estimated amounts sourced to particular jurisdictions.
- (2) Elective use of a single state tax rate (i.e., the Texas approach).

## VII. Conclusions

## APPENDIX A

This is a list of the stakeholders that MTC staff talked to, the questions we asked, and a summary of the responses we received.

### Digital Products Stakeholder Discussions as of July 1, 2022

- Departments of Revenue (12)
  - Arizona
  - New Jersey
  - Hawaii
  - Colorado
  - Maryland
  - New Jersey
  - New Mexico
  - Texas
  - South Dakota
  - California Department of Tax and Fee Administration
  - Utah
  - Iowa
- Taxpayers (7)
  - Amazon
  - AT&T
  - Meta
  - Verizon
  - Microsoft
  - Charter Communications
  - Apple
- Practitioners (8)
  - Kranz & Associates
  - Eversheds Sutherland
  - BakerHostetler
  - EY
  - KPMG
  - Deloitte
  - McDermott Will & Emery
  - MultiState Associates
- Industry (2)
  - Avalara
  - Tax Cloud
- Organizations (10)
  - Council On State Taxation
  - Electronic Transactions Association

- Center on Budget Policy and Priorities
  - American Bar Association – written comments submitted
  - Tax Foundation
  - Motion Picture Association
  - Streamlined Sales Tax Governing Board (staff)
  - AICPA – State & Local Tax TRP
  - National Taxpayers Union Foundation
  - National Conference of State Legislatures (informal)
- Academics (4)
    - Bill Fox, Univ. of Tennessee
    - Orly Mazur, Southern Methodist University Dedman School of Law
    - Adam Thimmesch, Nebraska College of Law
    - Hayes Holderness, University of Richmond School of Law

### Stakeholder Questions

These are the basic questions we asked all stakeholders, with some modifications for states and the “Big Four” accounting firms that agreed to talk with MTC staff.

1. Which states have the best / worst approach to taxation of digital items and why?
2. Which states have the best guidance for taxpayers/CSPs?
3. Which states have the best systems for taxation of digital products?
4. How much of a problem is the fear of qui tam or other suits for sourcing/charging the wrong rate?
5. Would it make things simpler if states would allow taxpayers to “build in” the cost of the tax, rather than charging it on the bill or invoice, so that the tax would work more like a gross receipts tax?
6. In addition to the concerns that states’ taxation of digital products lacks uniformity (definitions, sourcing, etc.) and likely may be over-reliant on “B to B” transactions, please identify any other major concerns states’ taxation of digital products and be as specific as possible.
7. How would you approach the taxation of digital products irrespective of what states are currently doing? What are your specific suggestions on how such taxes should be structured, imposed, and administered?
8. What issues relating to the taxation of digital products should the MTC be focusing on and in what priority?
9. How should the MTC approach this uniformity project in order to get maximum positive input from interested parties (in particular private sector/industry participants) to produce the best possible end result that states can use for sound policy guidance?
10. What would you like to see as the end result for this project?
11. Any other thoughts for us / the Uniformity Committee?
12. Who else should we be talking to?

### Summary of Stakeholder Responses

As reported at the April 20, 2022 Uniformity Committee meeting, here are some general takeaways from the interviews in no particular order.

1. There is general support for the project: The majority of people are supportive of this project and can see value from the MTC proceeding to help provide information and guidance to policymakers, taxpayers, and tax administrators. In only one interview were we told not to move forward.
2. Be mindful of the Streamlined states: We are mindful of what the Streamlined states are doing with respect to taxation of digital products, particularly their current project on sourcing. Richard Cram is monitoring their activities.
3. B to B transactions: Attention is needed to bundling, multiple points of use, and related issues; eliminating "B to B" transactions could simplify taxation issues. Iowa has statutory language.
4. Definitions needed: Some are concerned that clear definitions will lead to more taxation of digital goods and services, but many people said clear definitions were important.
5. Broad versus piecemeal approach: Washington state is a good model among the states as to how to tax digital items given the broad definitions and clear guidance. In contrast, and for example, trying to navigate how to tax software depending on how it is sold (TPP vs. SaaS vs. downloaded) is a burden and leads to greater risk of getting it wrong.
6. Sales and use versus other tax type: Taxing digital goods and services through a sales and use tax is the best way to proceed; creating a new or separate tax, such as a gross receipts tax, adds complexity to the overall tax system and has its own problems / doesn't solve other problems, such as not allowing for exemptions based on purchaser status and requiring sellers to still determine proper tax rates.
7. Legislation versus administrative guidance: There is a preference for state legislatures to address taxation of digital items rather than through administrative guidance.
8. Whitepaper versus model statute: Most people liked the idea of developing a whitepaper / best practices for policymakers to use as guidance. Fewer people asked for model statutory language.
9. Focus on today versus the future: Stakeholders recommended focusing on the digital goods that exist now (instead of trying to look ahead) and making rules that are broad enough to cover future innovation.