

# The Scope of Digital Sales Tax Reform

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In this installment of Academic Perspectives on SALT, Thimmesch provides initial thoughts on the Multistate Tax Commission's project on the sales taxation of digital products and on the possibilities that the project will help to facilitate fundamental state sales tax reform.

### The Multistate Tax Commission's Digital Sales Tax Project

The growth and evolution of the digital economy have undermined state tax systems in ways that are well recognized.<sup>1</sup> The inability of state tax systems to respond to market changes has resulted in tax bases that are underinclusive of the modern economy, inefficient tax differentials between "old" and "new" economy actors, and revenue losses for states. Taxpayers have also been faced with a lack of uniformity between states, uncertainty about their tax obligations, and the development of law through administrative rather than legislative action. We also see states pursuing new avenues for taxing digital revenue streams, like digital

services taxes or data mining taxes.<sup>2</sup> In light of these challenges, there is broad agreement that digital tax reform is needed and that uniformity between states in that reform would best serve national industry actors.

The Multistate Tax Commission is among the parties to recognize these needs, and in the summer of 2021, it authorized a project to study digital tax reform in the context of the state sales tax.<sup>3</sup> The MTC's uniformity committee spent the next year researching and conducting stakeholder interviews.<sup>4</sup> The MTC talked with a large group of stakeholders, including state revenue departments, taxpayers, practitioners, members of interested professional organizations, and academics,<sup>5</sup> and it ultimately issued a proposed outline of a white paper on August 2, 2022.<sup>6</sup> That outline impressively reflected the numerous issues involved with updating states' sales tax laws for the digital economy and provided a starting point for future work. The draft outline identified seven categories of issues that need to be addressed in this area:

1. the fact that digital products continue to evolve and change;
2. the lack of timely guidance from states;
3. concerns about parity between types of products;
4. the need for flexibility;
5. consideration of the mechanics of the sales tax;

<sup>1</sup>Orly Mazur and I have previously outlined the many ways in which the digital economy is challenging states' tax systems, and the work in this area of law is extensive. See Mazur and Adam Thimmesch, "Digital Tax Reform and the State Income Tax: Considerations," *Tax Notes State*, Jan. 3, 2022, p. 25; Mazur and Thimmesch, "Digital Taxation and the State Income Tax," *Tax Notes State*, Nov. 8, 2021, p. 635; Mazur and Thimmesch, "Closing the Digital Divide in State Taxation: A Consumption Tax Agenda," *Tax Notes State*, Nov. 30, 2020, p. 961.

<sup>2</sup>See Andrew Appleby, "Subnational Digital Services Taxation," 81 *Md. L. Rev.* 1, 6-7 (2021) (introducing state DST proposals).

<sup>3</sup>MTC, Sales Tax on Digital Products (last accessed Mar. 7, 2023).

<sup>4</sup>MTC, "Discussion Draft of Detailed Outline of a White Paper on Sales Taxation of Digital Products," at 13 (Aug. 2, 2022).

<sup>5</sup>*Id.* at 12-13.

<sup>6</sup>See *id.* That draft was updated: MTC, Draft Detailed Outline of White Paper (Sept. 1, 2022).

6. consideration of issues related to base expansion (such as *qui tam* lawsuits and the effects on marketplace facilitator laws); and
7. the need for implementation time.<sup>7</sup>

After the release of the draft white paper, concerns began to emerge from industry representatives that the MTC project might be overstepping. Written comments expressed apprehension with the scope of the MTC's project and whether its definition of digital products suggested that the project would lead to tax expansion.<sup>8</sup> During a December 8, 2022, meeting of the working group, there was significant discussion about working group member Ray Langenberg's proposed definition of the term "digital product."<sup>9</sup> His proposal — that a digital product be defined as an "item that is received by the consumer in a binary form" — raised conceptual questions about the definition itself and questions about the scope of the MTC project more generally. Commentators raised concerns that the proposed definition, although offered only as a way of defining the scope of the MTC's discussions, could upend states' tax systems if used to define taxability and might unduly interfere with tax policy discussions even if all understood the MTC's more limited purpose.

A January meeting took up this concern, with some expressing the need to start with a broad conception and others suggesting that the business community would be fearful of that project because it could be viewed as a Trojan horse for tax expansion.<sup>10</sup> Despite MTC participants' continued openness to clarifying that a broad scope for the project would not

mean that it would become a broad tax-expansion project, industry participants suggested that a narrow approach would be preferable to avoid those concerns. Work on the project is ongoing and can be followed on the MTC's website.<sup>11</sup>

### A New Look at Old Challenges

The MTC's early work and meetings evidence the difficulty of the task before the working group. The challenges of digital tax reform are complicated. Managing those challenges along with the unique considerations and challenges of attempting reform in nearly 50 states can start to seem impossible. Those who have been involved with state tax reform efforts over multiple decades know this clearly. The MTC project is just another in a long line of digital tax projects within the United States. Attention to the impact of the digital economy on the states accompanied the growth of personal computing and the internet in the late 1990s.<sup>12</sup> The National Tax Association started a project to evaluate the impact of electronic commerce on state tax systems in the late 1990s with a Conference on Taxation of Telecommunications and Electronic Commerce leading to the NTA Communications and Electronic Commerce Tax Project (the NTA project).<sup>13</sup> Nearly simultaneously, Congress commissioned a temporary Advisory Commission on Electronic Commerce (ACEC) to study these issues as well. Walter Hellerstein described a concurrent "flurry of 'white papers' addressed to state taxation of electronic commerce."<sup>14</sup> There is also significant academic scholarship, which is just as old, evaluating the need for and

<sup>7</sup> *Id.*

<sup>8</sup> Letter from Jeffrey Friedman and Charlie Kearns (Sept. 21, 2022); MTC Working Group, Sales Taxation of Digital Products, Notes of Meeting — Draft (Sept. 22, 2022); and MTC Working Group, Sales Taxation of Digital Products, Discussion Draft of Detailed Outline of a White Paper on Sales Taxation of Digital Products (Oct. 17, 2022). Other issues have been discussed in the MTC meetings and in comment letters, but the overarching question of the scope of the MTC project is the subject of this article. See, e.g., American Bar Association Section of Taxation, Comments on Issues to Address Regarding the Taxation of Digital Products (Nov. 2, 2021); and MTC Working Group, Sales Taxation of Digital Products, Notes of Meeting — Draft (Oct. 27, 2022).

<sup>9</sup> MTC Working Group, Sales Taxation of Digital Products, Notes of Meeting — Draft (Dec. 8, 2022).

<sup>10</sup> MTC Working Group, Sales Taxation of Digital Products, Notes of Meeting — Draft (Jan. 5, 2023).

<sup>11</sup> See MTC, *supra* note 3.

<sup>12</sup> See, e.g., Kendall L. Houghton and Walter Hellerstein, "State Taxation of Electronic Commerce: Perspectives on Proposals for Change and Their Constitutionality," 2000 *B.Y.U. L. Rev.* 9 (2000) (discussing the attention paid to state digital tax reform in the 1990s).

<sup>13</sup> A detailed account of this project can be found in Houghton and Gary C. Cornia, "The National Tax Association's Project on Electronic Commerce and Telecommunication Taxes," 53 *Nat'l Tax J.* 1351 (2000). See also Houghton and Hellerstein, *supra* note 12.

<sup>14</sup> Hellerstein, "Taxing Electronic Commerce: Preliminary Thoughts on Model Uniform Legislation," *Tax Notes*, May 12, 1997, p. 819.

impediments to digital tax reform.<sup>15</sup> Overall, these discussions indicate what has long been a broad consensus that states need to reform their tax systems to respond to the digital economy and that they should do so in ways that are uniform among them.<sup>16</sup> Yet, we are still talking about many of the same foundational issues in 2023.

This lack of progress is not surprising. The issues presented by digital tax reform include complicated conceptual issues, economic issues, and political considerations that can often be insurmountable. Reflective of these difficulties, the NTA project took over three years and yet “reached very few concrete conclusions and raised more questions than were answered.”<sup>17</sup> In addition, it was observed that “precious little ground was broken.”<sup>18</sup> The ACEC proceeded similarly.<sup>19</sup> The standard for achieving consensus recommendations — a two-thirds majority — along with concerns about federal overreach into state tax systems led to very little by way of reform proposals. The ACEC suggested that the National Conference on Uniform State Laws (the ULC) consider drafting a uniform law on key components of states’ sales tax systems. That suggestion made sense given the ULC’s general experience and history with state uniformity projects, but the ULC did not take on that project. It was also asked, and declined, to engage in a project to update the Uniform

Division of Income for Tax Purposes Act in the early 2000s.<sup>20</sup> Most recently, the ULC studied whether to engage in a uniformity project related to online sales tax and again declined. It considers the likelihood that a project will result in a statute that will be broadly adopted in determining what projects to undertake.<sup>21</sup> The challenges of broad tax reform projects have led the ULC not to have confidence that such a result would occur.

This history suggests that it is no surprise that the MTC has received early resistance to a potentially broad scope for its project or that it might have an interest in narrowing its focus. Large projects are difficult and time consuming, and projects involving large stakeholder participation increase those challenges. A narrow project might seem to involve fewer complications and therefore have a higher likelihood of resulting in much-needed reform. And reform is certainly needed. It is also useful to remember, though, that the work (and failure) of the NTA project significantly affected the project that led to the Streamlined Sales and Use Tax Agreement, which brought about much-needed tax reform, simplification, and uniformity.<sup>22</sup> The SSUTA is an example of a broad reform project that *did* work, and that success was built on earlier broad reform efforts. Of course, the SSUTA did not address digital tax reform specifically, but the governing board ultimately adopted uniform definitions for “specified digital products,” including digital audiovisual works, digital audio works, and digital books. Those definitions have naturally lagged the economy and are due for modernization, which is where the MTC project may be able to provide guidance. Although leveraging and tweaking the SSUTA might seem to be a quicker path to reform than broad

<sup>15</sup> See, e.g., Charles E. McClure Jr., “Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws,” 52 *Tax L. Rev.* 269 (1997); J. Clifton Fleming Jr., “Electronic Commerce and the State and Federal Tax Base,” 2000 *B.Y.U. L. Rev.* 1 (2000); McClure, “Radical Reform of the State Sales and Use Tax: Achieving Simplicity, Economic Neutrality, and Fairness,” 13 *Harv. J.L. & Tech.* 567 (2000).

<sup>16</sup> See, e.g., Advisory Commission on Electronic Commerce, Report to Congress, at 19 (Apr. 2000) (suggesting that “state and local governments work with and through NCCUSL in drafting a uniform sales and use tax act”); Hellerstein, *supra* note 14 (“Virtually all concerned parties agree that state taxes on electronic commerce should be uniform”); McClure, “Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws,” *supra* note 15, at 409-411, 416 (discussing the benefits of uniformity in both the sales and income tax areas).

<sup>17</sup> Houghton and Cornia, *supra* note 13, at 1366.

<sup>18</sup> *Id.*

<sup>19</sup> McClure notes that while the ACEC also had participation from a wide range of stakeholders, “in fact the membership was packed with members who opposed taxation of e-commerce.” McClure, “Thinking Straight About the Taxation of Electronic Commerce: Tax Principles, Compliance Problems,” 16 *Tax Pol’y & the Economy* 115, 131 (2002).

<sup>20</sup> See John Buhl, “ULC Committee Recommends Halting UDITPA Revision Study,” *State Tax Notes*, July 6, 2009, p. 7.

<sup>21</sup> Uniform Law Commission, New Project Criteria (last accessed Mar. 3, 2023) (listing as a criterion “whether there is a reasonable probability that an act, when approved, either will be accepted and enacted into law by a substantial number of states or, if not, will promote uniformity indirectly”).

<sup>22</sup> John A. Swain and Hellerstein, “The Political Economy of the Streamlined Sales and Use Tax Agreement,” 58 *Nat’l Tax J.* 605, 606 (2005).

digital-tax discussions, the MTC project would benefit from thinking beyond that approach.

### **The Insufficiency of Thinking Narrow**

The MTC project is a step in the right direction regardless of its ultimate scope. States' sales taxes need updating in many ways, and a narrow scope could help states and taxpayers adjust to the changing economy in ways that are beneficial. But narrowly focusing on known deficiencies in states' laws without a fuller understanding of the digital economy would lead to incomplete and potentially problematic reforms. A narrow focus could fail to leverage the lessons learned in other projects related to the digital economy, fail to help states fully understand the technological backdrop against which new rules need to be drafted, and miss the opportunity to provide reform that is more able to handle future market changes.

The reality is that state digital tax reforms are needed not because of some limited shifts from traditional to digital products but because of how the digital economy has fundamentally changed many traditional market dynamics and structures. Advancements in technology also keep occurring, and the rate of change is only increasing. Under these conditions, legal reform that follows an incremental approach is certain to continue to lag the economy and to result in the same tax base erosion, economic distortions, and opportunities for abuse that now necessitate reform.

Also, the digital economy is not the root cause of the weaknesses in the state sales tax. The need for digital tax reform is a symptom of deeper issues. The state sales tax is an instrument of the 1930s that has been patched up and upgraded over the intervening decades. A tax base that was originally focused on sales of tangible personal property has been expanded through piecemeal reforms to add definitions of additional transactions included in the base. Similarly, business input exemptions have not been updated to capture all business consumption, and states have become heavily reliant on the revenue provided by that overbreadth in the tax base. Narrow tax reform efforts will likely fail to address those issues.

None of this is to say that there is no room for narrow work to be done. To the contrary, work on how to best modify tax bases to better reflect and describe digital transactions is needed. Work on how to best modify sales tax exclusions to better capture business inputs is needed. Work on sourcing rules is needed. These types of narrow reforms would not only be valuable, but also likely raise fewer issues for stakeholders to discuss or disagree upon. The result might seem to be a higher likelihood for progress. But narrow reforms now are unlikely to address the root causes of states' issues, leaving states in an endless cycle of legislative catch-up that benefits only companies and tax advisers that can leverage gaps in state law for economic gain. Reform that leaves these fundamental issues with the state sales tax may also prove to be especially problematic as states and taxpayers put more pressure on the sales tax by reducing their reliance on income taxes.

### **Thinking Broad and Narrow**

That some have proposed a broad scope for the MTC digital tax project is no surprise given the many issues that states are facing in the digital space. Having a broad understanding of the digital economy and its scope and trajectory will be important if states are ever to keep up with the economy and provide taxpayers with a tax system that makes sense. The importance of a broad approach is true even if the MTC ultimately proposes narrow statutory fixes through model uniform definitions. It will be difficult for the MTC to address individual issues without a broad understanding of the digital economy, digital technologies, and the different approaches that have been taken within the United States and globally.

Ideally, the MTC project would also provide states with longer-lasting assistance by grappling with the systemic weaknesses that have brought states to where they are today. The digital tax projects of the 1990s provide great roadmaps for what is needed to reform states' systems, and the broad principles that should guide the "ideal" sales tax are largely agreed upon. All sales at retail should be taxable by default, all sales to business purchasers should be exempt by default, and destination sourcing is preferable to origin

sourcing.<sup>23</sup> The challenges that stand in the way of that system are multiple and include conceptual issues related to the digital economy, political challenges that would accompany expansions of the tax base and increases to tax rates,<sup>24</sup> and issues related to transitioning between the current system and a more conceptually pure system that can more easily handle future market evolutions.

If the stakeholders are interested in real reform, a broad project that focuses not only on understanding the digital economy but also on addressing those structural issues would be warranted and ultimately needed. Like the SSUTA project, the MTC could use subcommittees to focus on different issues — understanding the digital economy broadly, developing proposals for uniform state approaches within their current systems (including focusing on tax base issues, business input issues, and sourcing issues), and understanding whether and how digital tax modernization might help states to make more fundamental reforms that might obviate the need for those types of incremental reforms in the future. The latter would involve consideration of the ideal sales tax base, including business input exemptions, and how to manage the political, economic, and practical challenges of transitioning to a system built on that ideal.

A project with this breadth would surely be different from one that focuses just on how to capture streaming services in the tax base, how to handle non-fungible tokens, or similar tax base challenges. Conceptually, however, states and taxpayers need to start thinking broader and consider whether digital tax reform can provide an avenue for much-needed structural reform. Whether the current MTC project is the right vehicle for that work is unclear and depends on the interests of the MTC and the project participants. But unless the MTC takes a broad look at the digital economy in the scope of its

project, it will not be able to even consider these more fundamental issues or provide work that might help future projects.

### A Broad Project and Broad Concerns

No proposal is without critique, and it makes sense to address some of the core concerns about a broad MTC project before concluding. Some participants have already raised the possibility that a broad project would cause some to lose faith in the MTC or that a broad project would serve to provide states with a roadmap for increased taxation. Those concerns should be considered and respected. However, some stakeholders may harbor those thoughts regardless of what the MTC does. Those who are wary of the states or the MTC hold those opinions for a variety of reasons, and states that want to raise taxes can still do so, but without the benefit of a reasoned white paper generated after participation by multiple stakeholders.

Participants in the working group have already made it clear that a broad project would be focused on summarizing the field and getting input from all stakeholders on the broad topic of the digital economy and not on proposing a tax base. Those who are not interested in this process or reform or those who just distrust the MTC for whatever reason will always be able to ignore that explanation and claim an ulterior motivation, and they can also do so if the MTC engages in a more limited project. The MTC should continue to explain its motivations and approach and adopt a scope that it believes is proper given its desires and available resources.

A broad project might also be critiqued as requiring too many resources of all participants. The history of digital tax projects shows that meaningfully discussing these issues is not a quick endeavor. For those who want reform, simplification, or uniformity now, a broad project might seem to reduce the likelihood of the desired fast action. Certainly, no one wants to get bogged down in a project that takes years and fails to advance the ball. At the same time, unless someone undertakes to more fundamentally fix the state sales tax, these types of projects will continue to be needed, some taxpayers and business methods will face higher taxes than others, and state revenues will be more volatile

<sup>23</sup> McClure, "Rethinking State and Local Reliance on Retail Sales Tax: Should We Fix the Sales Tax or Discard It?" 2000 *B.Y.U. L. Rev.* 77 (2000); Jerome R. Hellerstein, Walter Hellerstein, and John A. Swain, *State Taxation*, para. 19A.01[1] (2018).

<sup>24</sup> States rely on tax revenues from the imposition of tax on business inputs to such a degree that even base expansion is unlikely to be revenue-neutral absent increases to tax rates. Of course, taxpayers are already paying higher actual rates because of tax pyramiding, but those costs are hidden in the prices of goods and services.

than necessary. In this vein, there is a broad recognition that uniformity among states is important for interstate actors and that neutral tax systems are preferable to tax systems that preference certain types of market actors or transactions. Those goals seem more achievable through a broad project rather than continued reliance on incrementalism, even if it takes more time to get to that point.

In sum, there is considerable merit to the MTC taking a broad look at the digital economy and at the types of reforms that might move states closer to an ideal consumption tax system. There are certainly concerns that should be addressed if the MTC is to go that route, but those concerns seem manageable and insufficient to settle for a project that is more narrow than otherwise desired. It might ultimately be that a project with multiple stages or a project undertaken in coordination with another group, like the Streamlined Sales Tax Governing Board or the NTA, is warranted. Again, though, only by undertaking a broad approach will the project be able to advance the ball in that way. ■

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