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To: MTC Sales Taxation of Digital Products Work Group Members

From: Jonathan White, MTC Counsel

RE: Reformatted Remarks from June 1, 2023 Work Group Meeting

This document is a modified and formalized version of my presentation during the June 1, 2023 meeting of the Sales Taxation of Digital Products work group. This writeup is intended to accompany the PowerPoint slides from that presentation. This writeup will refer to some slides by slide number. Those slides can be found on the project page on the MTC website here: <https://www.mtc.gov/uniformity/sales-tax-on-digital-products/>.

The June 1, 2023 presentation was partly a repeat of my presentation to the Uniformity Committee at the Spring 2023 MTC meetings, partly material left out of that presentation, and partly new and updated information. Additionally, the June 1, 2023 presentation was recorded. That video is available on the project page on the MTC website, linked above.

Introduction

Work group members asked MTC staff to research and provide information on what portions of the digital economy are subjected to states' sales taxes currently. To do that, I went through each of the 46 states that impose a sales and use tax (including the District of Columbia) and noted which digital products each state taxes. The results were organized into these categories: tangible personal property; software and digital products; services, including data processing services and information services; and cloud computing and digital subscription services. I also included various definitions of commonly taxed items. I also noted when a state does not tax certain common digital items. I requested that all 46 jurisdictions review and provide feedback on my research and that information was incorporated for the jurisdictions that responded. Overall, the research project was focused on what states do tax at this time.

The point of the project was to give the work group members a bottom line on which items states have determined to impose sales tax on and a partial set of definitions. The research is presented in Excel spreadsheet form and is available on the project page of the MTC website, linked above.

Next, I began mining the results for lessons and takeaways for the work group. This writeup is the result of that.

The Macro View

The states' tax bases were organized into categories based on the breadth of their taxation of digital products. Slide 2 presents a visual representation of this column of the spreadsheet. The lighter the color the narrower the sales tax base on digital items and the darker the color the broader the digital tax base.

Observing the map representing the states' digital tax bases, there are no obvious patterns or lessons. A few states—Texas, Washington, and South Dakota—have broad digital sales tax bases but no individual income taxes. That makes sense as a broad digital sales tax base might replace forgone revenue from lack of an individual income tax. But other states with narrow digital sales tax bases—Nevada and Florida—also have no individual income taxes. At this macro level, zoomed out this far, there is not much to see in terms of patterns.

This macro view of the states' digital tax bases was also compared to the digital tax bases of the Streamlined member states. And again, no real patterns emerged. Texas, New Mexico, and Arizona, being physically large states with broad digital sales tax bases, stand out. And they are not Streamlined member states. But there are many states with broad digital sales tax bases that are Streamlined members, including Washington and South Dakota. There are also Streamlined member states that have narrow digital sales tax bases, like Kansas and Michigan.

Again, zoomed out to this macro view there is not that much to find in terms of overall patterns. The states with a broad digital tax base just happen to be broad, and the states with a narrow digital base seem to just happen to be narrow.

The Streamlined Effect

Sticking with the Streamlined states briefly, my research highlighted the effectiveness of that project. The Streamlined states all either have the same definitions or no definitions at all. Within the Streamlined member states, there is uniformity. However, even among Streamlined states, things are not perfectly consistent. Four Streamlined member states—Kansas, Michigan, Oklahoma, and West Virginia—have not adopted the Streamlined suite of definitions of digital products, and do not tax those products. Similarly, Nevada and North Dakota, as Streamlined member states, adopt the definitions but do not tax the products.

To highlight the effectiveness of the Streamlined Agreement in a different way, consider that Connecticut, Mississippi, and the District of Columbia, none of which are Streamlined member states, have adopted definitions of digital products or digital goods that noticeably reflect the Streamlined suite of digital products. This demonstrates the influence of that project beyond its members.

About the Categories

The categorization is based on four metrics:

- taxation of prewritten software however delivered,
- taxation of digital products,
- breadth of the digital services tax base, and
- breadth of the cloud products tax base.

The first metric asks whether a state taxes prewritten software when there is no tangible medium. The taxation of digital products metric asks whether a state taxes at least the basic digital products, including what may be described as the digital equivalent of tangible personal property. The breadth of the services tax base metric considers how broadly a state taxes the types of services that capture portions of the digital economy. This can be either specific definitions of services or an imposition on services generally. The breadth of the cloud products tax base metric asks whether a state taxes a broad array of cloud products, more on this term below.

The four metrics were weighted differently. The prewritten software metric, however delivered, and services metrics were weighted the lightest and the digital product and cloud products metrics were weighted most heavily.

The Micro View

The macro view was just the starting point. Zooming in a bit reveals some interesting takeaways. Consider two states: South Carolina and Texas.

South Carolina interprets and applies its definition of tangible personal property to include nearly anything dealing with software. As a result, many software as a service-type products, a subset of cloud products, are taxable as prewritten software. Prewritten software is treated as tangible personal property.

Texas, on the other hand, taxes many cloud products as data processing services or information services. In Texas, data processing services are a category of specifically enumerated and defined services that capture many cloud products. To paraphrase, that term includes, among other things, computerized data and information storage or manipulation as well as the use of a computer or computer time for data processing.¹

South Carolina and Texas tax similar cloud products but in different ways. South Carolina has interpreted and applied tangible personal property broadly while Texas has used data processing services. Neither state is unique, and this led to the first formal takeaway:

It's not just the tax bases that differ; the entire characterization of single items can be wildly different based on statute writing from decades ago.

Characterization of digital items affects more than just the tax base. It will affect sourcing as well as Internet Tax Freedom Act and tax exemption analyses. If a single product, as sold by a vendor and bought by a customer, is considered tangible personal property in one state and a service in another, the sourcing may not reflect the product itself. Instead, it might reflect the category chosen, tangible personal property, services, or intangibles. The potential for uniformity is limited by this amount of variation just at the threshold question of taxability.

Expanding the analysis to include Washington reveals another variation. Washington taxes many of the same cloud computing products as South Carolina and Texas but as digital automated services rather than as tangible personal property or as data processing services, which are

About Cloud Computing

Cloud computing and cloud products are an important category. These products represent the newer edge of what the work group has studied so far. This category also has the least comprehensive guidance of any other category. For this category, I used the most general definition possible. Cloud computing is the practice of using a network of remote servers hosted on the Internet to store, manage, and process data, rather than a local server or a personal computer.

Cloud products are also the most difficult to categorize, as some states tax these products as tangible personal property—prewritten software—and some tax it as services.

¹ Tex. Tax Code Ann. § 151.0035.

services exempt from the tax base. Digital automated services are services transferred electronically that use one or more software applications and do not require more than 50% human effort after the customer requests the service.²

South Carolina and Texas both tax the same products, but in two different ways. Washington taxes the same cloud products as digital automated services, a purposefully defined term. Remember that South Carolina taxes these products as tangible personal property and Texas as data processing services.

This demonstrates the importance of the “how” in sales tax over the “what.” The structure of the sales tax in general, the—“how”—while related to whether a state has a broad or a narrow base, is much more than just the base. Multiple states may tax the same products but get there in very different ways.

For income tax, the characterization question, whether between business and nonbusiness income, capital gain and ordinary income, or some other distinction, more often determines sourcing or the tax rate that is applied. With sales tax, a character choice must be made each time just to determine taxability. And that character choice is for that purpose specifically. However, that characterization then follows that item around to affect sourcing and other determinations even though the characterization was not made for those purposes, and this is the second formal takeaway:

Sales tax characterization determinations are always made with an eye toward determining whether an item is taxable. This characterization follows through to all remaining sales tax considerations.

Is such a characterization good enough for sourcing? Is it good enough for application of the state’s existing business-to-business exemptions? Is it good enough for Internet Tax Freedom Act analysis?

Services and the Prewritten Software Experience

Now let’s focus on the services category of digital products and on Tennessee. Tennessee’s treatment of services reflects a national trend, further explained below, in that many states have added services dealing with software to the list of taxable services. In Tennessee, computer programming and code writing services, software implementation, consulting and professional services relating to software, and standalone installation of software are all taxable. Tennessee’s language is paraphrased on slide 10. Another example, this time from the Streamlined agreement, is software maintenance contracts. This is a Streamlined defined and treated term. But even in non-Streamlined states, software maintenance contracts are usually defined and taxed, most often taxed only if they are contracts for prewritten software.

² Wash. Rev. Code § 82.04.192(3)(a).

Both examples reflect a national trend of taxing prewritten software. In the 1980s, states began to tax software as tangible personal property. At that time software came packaged inside a tangible medium, and tangible personal property is the original base of all state sales taxes. The tangible element to software gradually disappeared, but the treatment as tangible personal property remained. Then, slowly, many services accessory to and surrounding prewritten software were added to the tax base. This includes the services Tennessee taxes, discussed above, including installation, implementation, or modification of prewritten software, software maintenance contracts, and other services.

The prewritten software experience is being repeated as new digital products are added to the marketplace. Most states tax some digital products and now the surrounding and supporting services and similar products are gradually being identified and added to the tax base. This observation led to the third formal takeaway:

The prewritten software experience is repeating itself. What are the lessons from that experience?

This leads to a series of questions:

- Has the prewritten software experience been satisfactory? Why or why not?
- What, if anything, should be different and why?
- Is the current situation with the digital world so much more dynamic and complicated than with prewritten software?
- Should that approach be repeated for digital products, for the digital economy?
- Is the current situation so much more heavily business-to-business than it was with prewritten software?
- Given the uniformity of sales taxation of prewritten software, is the issue with the timing and that it was such a gradual process to get to the current point?

The prewritten software experience is one where the results can be observed. It is a natural experiment. The experience with prewritten software, whether you like that experience or not, is a set of results that can be studied and used. The Excel spreadsheet containing the results of this research gives you a partial view of how that happened and what that looks like.

Other Options

The spreadsheet shows other ways to approach the taxation of digital products as well. Focusing on Washington, we see that Washington's digital tax base is broad, but what really distinguishes Washington is the formulation of one of its definitions, that of digital automated services. As discussed above, digital automated services are services transferred electronically that use one or more software applications that do not require more than 50% human effort after the customer requests the service. This definition is not just a purpose-built modern definition, this definition

is designed to capture many other things as yet unknown. In other words, the definition appears intended to be somewhat future proof.

The other end of this spectrum would be software maintenance contracts, also discussed earlier. “Software maintenance contract” is a specific item in the Streamlined Agreement, related to software and defined very specifically. Software maintenance contract is defined so specifically the definition will never fail to capture a software maintenance contract. However, the definition will also never capture anything other than the exact software maintenance contract the drafters targeted. There is no room for anything else in the definition. These are two different, valid, approaches to taxing digital products with two different intentions and different outcomes.

Another example is Texas. In Texas many of the same cloud products may be taxed as data processing services, also discussed earlier. The taxation of data processing services was added to the Texas sales tax law in the late 1980s. Though likely not written to capture the cloud products of today or other products as yet unknown, the definition is nonetheless capturing many cloud products. Though not written to be as future proof as possible, it is less specifically drafted than other definitions, like that of software maintenance contracts.

Washington’s and Texas’s approaches are similar but with a different intention and outlook at the drafting stage. These two examples show that either of two broader approaches to definitions can be flexible and adaptable to differing degrees.

Three Possible Structures

There are many different tax bases among the states, and several different ways to structure those tax bases. The structure drives the tax base to a certain extent; a state with a broad approach will typically have a broad digital tax base, and a state with a narrow approach will typically have a narrow digital tax base.

On slide 14 I present a fictional 3-state country. Each state is a different color and has one of three approaches to sales tax structure. The colors on this map, in contrast to the earlier map, represent a different way each state structures to its sales tax, not its sales tax base. The three fictional states are each a conglomeration of multiple real states and their approaches to structuring their sales taxes.

The broad approach state in this fictional country would likely have a tax imposition on tangible personal property and on services generally. The state’s definitions of tangible personal property and services would be broad. The broad state might impose tax on income rather than on

Back to TPP

Two states with narrow digital tax bases, South Carolina and Missouri, can show another potential difference in approach. Each of these states has a narrow tax base according to the metrics discussed above primarily due to neither taxing any digital products. However, South Carolina taxes many cloud products, whereas Missouri taxes practically no cloud products.

The difference is in the structure of their sales taxes. Neither has defined and taxed cloud products, as such. South Carolina has a broad interpretation of tangible personal property, bringing in many cloud products. Missouri’s interpretation of tangible personal property is narrow, leaving no room for cloud products in the tax base as tangible personal property.

transactions. The broad state might also have some purpose-driven definitions that are formulated to be as future proof as possible.

The state with the broad approach would also grapple with the pyramiding of the tax to a greater extent than the states with narrow or in-between approaches. As a result, the business-to-business exemption or exemptions in that state would need to be broader and possibly more complicated. Additionally, the broad state may have the ability to holistically categorize products for purposes of all aspects of the sales tax rather than categorizing products solely for purposes of determining whether they fit into the tax base.

The state with the narrow approach would almost certainly have a narrow sales tax base to match its approach. Such a state would have an imposition statute based on “sales” of tangible personal property and probably insist that a physical attribute be present, meaning that the interpretation of tangible personal property would remain narrow.

Such a state might also impose tax on a few other enumerated and tightly defined services. A narrow approach would likely see specific definitions for any taxable enumerated services. Specific definitions would provide the maximum amount of clarity while limiting the adaptability of the tax base. Definitions as specific as this would always capture the item being targeted but would leave no room for any other item to be included in the tax base.

When it comes to business-to-business transactions, the narrow approach would present fewer overall issues. With a narrower approach likely comes a narrower base, leaving fewer taxable items to contribute to pyramiding. Given this, a state with a narrow approach could use a simpler business-to-business exemption than a state with a broad approach.

The state with the middle approach would still have a tax imposed on sales of tangible personal property and a limited set of services but would probably have broader definitions and interpretations of both tangible personal property and taxable services. Those definitions may be flexible and adaptable to some extent but would not be born of the intent to future proof the tax base.

These characteristics are not meant to be complete descriptions of these different approaches. Nor are these the only approaches. There could be more, or fewer, different approaches depending on how granularly the approaches are categorized. Additionally, the approaches could be described in completely different terms. For example, one approach could be the ‘broad interpretation of tangible personal property approach.’

Conclusion

To illustrate my findings after researching the 46 jurisdictions that impose a sales and use tax and their current treatment of digital items, I have compared and contrasted the laws of South Carolina, Texas, Washington, and Tennessee. I also discussed a fictional three-state country that illustrates how all states generally approach the taxation of digital products. I further provided a comparison between interpretations of tangible personal property in Missouri and South Carolina. My findings help to highlight the difference between looking at what digital items

comprise the states sales tax bases and looking at why the states' reach that taxability determination. The bases are the surface level, showing what the states are taxing. The approaches are the next, more analytical level, showing what causes a state to have the tax base that it has.

I welcome feedback from the work group members and the public on this research and my takeaways.