The MTC's Digital Products Work Group Should Adopt Our Three Guiding Principles

The MTC's Sales Tax on Digital Products Work Group should adopt three guiding principles as the project moves forward. As noted in a memorandum by the Standing Subcommittee recommending that the MTC's Uniformity Committee take on this project:

> [T]he term "digital products" is intended to encompass the entire category of products made possible by digital or electronic technologies that are not, primarily, tangible or physical property or traditional services. The term may include what some would consider digital "services."[1]

The above definition demonstrates that the stakes are high. The potential expansion of sales and use taxation to include never-before-taxed digital goods and services may lead to dramatic tax increases, and also pose substantial policy and legal hurdles. Recent attempts by states to expand sales taxation in an inconsistent manner can lead to confusion and compliance challenges. Hopefully, the Work Group will produce definitions of digital products that will encourage thoughtful consideration by the states as to whether, and how, to tax digital products.

To facilitate continued efforts by the Work Group, it should adopt principles that provide stakeholders with a collective understanding of the Project's goals, scope, and ultimate work product. We propose only three principles and expect that more will be contributed by other interested parties.
Our proposed principles are:

1. The Work Group should adopt clear and specific definitions of digital products, and reject broad and ambiguous ones;

2. Sourcing of digital products should reflect where products are used. Use by consumer purchasers should reflect the place of sale, which is typically customers' billing addresses; use by business purchasers should reflect a reasonable approximation of actual use; and

3. Sellers of taxable digital products should be provided exemptions applicable to purchases of their business inputs.

The Need for Clear and Specific Definitions

Pursuing the adoption of clear and specific definitions should be a cornerstone principle of the Work Group's pursuit of defining digital products. Providing clear and specific definitions will allow policymakers to consider the effect of their decisions. And, it will allow the Work Group to avoid the consequence of creating definitions that may trigger a violation of the federal Permanent Internet Tax Freedom Act.[2] For instance, a definition of digital products that includes every product and service that is electronically delivered (i.e., a definition of digital products that we believe to be broad and

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[1] *See* Multistate Tax Commission Memorandum from Maria Sanders, Chair, Standing Subcommittee, to Tommy Hoyt, Chair, Uniformity Committee, "Draft – Recommendation on Proposed Project – White Paper on Sales Taxation of Digital Products" (June 17, 2021), *available at* https://www.mtc.gov/wp-content/uploads/2023/02/Subcommittee-Recommendation-Proposed-Digital-Goods-Project-FINAL.pdf.

[2] Pub. L. No. 105-277, tit. XI, 112 Stat. 2681 (1998), as amended, available at 47 U.S.C. § 151, note ("ITFA").

ambiguous) will inevitably run head long into the federal law's ban on "taxes on Internet access" or the law's prohibition on "multiple or discriminatory taxes on electronic commerce."[3]

For example, some have argued that Washington's use of the term "digital automated services" is a serviceable broad definition of digital products. We disagree. Washington's definition of "digital automated services," a sub-definition of "digital products," means "any service transferred electronically that uses one or more software applications."[4] This broad base definition goes on to exclude no less than *sixteen* products and services.[5] As one would expect, applying these exclusions has been difficult for both businesses and the Washington Department of Revenue's auditors. In particular, the ambiguity in the "human effort" exclusion from digital automated services has created controversy and has resulted in the expenditure of significant private and public resources attempting to parse its meaning.[6] The "digital automated services" definition exemplifies the type of approach that we ask the Work Group to avoid – a definition so broad that carve-outs are needed to reflect what is "really" subject to tax.

Our "clear and specific" principle is intended to produce definitions that an ordinary person will be able to understand and to anticipate whether sales tax applies to the product or service they are selling or purchasing. For example, the Streamlined Sales and Use Tax Agreement's (SSUTA) "specified digital products" definitions are "clear and specific," while providing member states the ability to impose sales tax on a wide array of those products.[7]

Further, general and ambiguous statutes invariably delegate a legislature's policymaking prerogative to tax administrators, leaving potential taxpayers in the dark about what is subject to tax – and potentially straddling them with millions in unexpected audit assessments or class action liabilities when unintentionally over-collecting. Unfortunately, there are several examples of state laws that reflect general and ambiguous tax base definitions that leave excessive room for interpretation by tax administrators or the courts, e.g., taxing digital services as "tangible personal property" because they may be "perceptible" to the senses, or attempting to tax remote access software, SaaS, or a digital service as a "communications service," "information service," or "data processing service." Adhering to our principles will help mitigate these uncertainties.

For these reasons, we urge the Work Group to embrace "clear and specific" as a cornerstone principle as it moves forward.

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[3] ITFA §§ 1101(a), 1105.

[4] *See generally*, R.C.W. §§ 82.04.192 (defining "digital products" to include "digital goods" and "digital automated services"), 82.04.192(3)(a) (defining "digital automated services").

[5] R.C.W. § 82.04.192(3)(b).

[6] R.C.W. § 82.04.192(3)(b)(i) (providing "digital automated service" does not include "[a]ny service that primarily involves the application of human effort by the seller, and the human effort originated after the customer requested the service"); Gartner, Inc. v. Dep't of Revenue, 455 P.3d 1179, 1191 (Wash. App. 2020); *see also* R.C.W. §82.04.192(6)(b)(iv) (providing "digital goods" does not include "the representation of a personal or professional service in electronic form, such as an electronic copy of an engineering report prepared by an engineer, where the service primarily involves the application of human effort by the service provider, and the human effort originated after the customer requested the service").

[7] SSUTA §§ 332 ("Specified Digital Products"), 333 ("Use of Specified Digital Products"), and App. C, Part II, Product Definitions ("Digital Products Definitions").

Use-Based Sourcing

We believe that sourcing sales of digital products should reflect the location of the purchaser's use. In the context of consumer-type transactions, sales should be sourced based on customer location – typically reflected by a purchaser's billing address. However, business-to-business transactions pose greater situsing challenges as a purchased item may be used in more than one location, which justifies consideration of apportionment.

This principle is reflected in Section 310 of the SSUTA and accompanying rules,[8] as well as the now-repealed Section 312 that established the short-lived "multiple points of use" (MPU) exemption. We recognize the apprehension with applying apportionment to sales tax that led to the repeal of the MPU provision. This apprehension has been mitigated by the application of apportionment by states that formally or informally adopted apportionment rules for business purchases of digital products, digital services, and/or prewritten computer software.[9] Massachusetts, Minnesota, Ohio, and Washington apply some version of the MPU rules.[10] Texas and New York provide rules for apportioning taxable sales of certain services. Still other states allow such apportionment informally during the course of an audit, subject to reliable data provided by the seller or purchaser.[11] The concept of MPU and apportioning the sales price when software or digital services are used by businesses in multiple states is no longer novel, and should be clarified and broadly applied.

Sellers of Taxable Digital Products Should be Provided with Business Input Exemptions

The retail sales tax should not be imposed on taxable "inputs" that a business purchases to produce, manufacture, create, or provide other taxable products and services. This principle stands on solid ground.[12] Sales and use tax regimes contain various exemptions aimed at avoiding the taxation of business inputs, including manufacturing exemptions, ingredient and component part exemptions, and resale exemptions. The Work Group's undertaking to define digital products afford the states an opportunity to either create a new exemption, revising existing ones, or some combination of both.

A few states have sought to adhere to this principle by exempting business inputs during the legislative process while expanding their respective tax bases to digital transactions. By way of example:

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[8] *See* SSUTA Rule 309.2: "When prewritten computer software is not received by the purchaser at a business location of the seller, the retail sale is sourced to the location(s) where receipt by the purchaser occurs. Receipt may occur at multiple locations if the seller delivers the software to multiple locations. The transaction is sourced to those locations if the seller receives delivery information from the purchaser by the time of the invoice."

[9] *See*, *e.g.*, *Oracle USA, Inc. v. Comm'r of Revenue*, 168 N.E.3d 349 (Mass. 2021), where the taxpayer successfully sought to apportion the sales tax base.

[10] 830 C.M.R. 64H.1.3(15); Minn. Stat. § 297A.668, subd. 6A; O.R.C. § 5739.033(D); R.C.W. § 82.08.0208(4).

[11] Tex. Admin. Code §§ 3.342(g) (multistate service benefit rule for information services), 3.330(f) (multistate service benefit rule for data processing services); New York Dep't of Taxation and Finance Advisory Op. TSB-A-03(5)S, Jan. 31, 2003 (user-based allocation for information services).

[12] *See* State Tax Research Institute, "Total State and Local Business Taxes: State-by-State Estimates for FY21" (Dec. 2022), *available at* https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/2209-4097478_50-state-tax-2022-final-e-file.pdf.

- Iowa exempts purchases of "specified digital products and of prewritten computer software sold, and of enumerated services ... to a commercial enterprise for use exclusively by the commercial enterprise."[13]
- New Jersey exempts prewritten computer software delivered electronically when "used directly and exclusively in the conduct of the purchaser's business, trade or occupation" and exempts specified digital goods "purchased for use or consumption directly and exclusively in research and development ..."[14]
- Washington adopts a more narrow "business purpose" exemption for digital goods.[15]
- Other states, in particular Connecticut, adopt resale and component part exemptions specific to prewritten software and digital goods.[16]

Unfortunately, the above examples are the exceptions; most states have not tackled the best way to exempt business inputs related to taxable digital products.

Concluding Thoughts

The principles of "clear and specific definitions," "business input exemptions," and "use-based sourcing" were not pulled out of thin air (or anywhere else). A number of states adopt them to varying degrees. Defining digital products is a daunting task. One that can easily be misconstrued or misdirected. Our proposed three principles will allow the Work Group to advance its work while also ensuring various stakeholders that the Work Group will not venture off to overhaul sales taxation. The Work Group – led by its co-chairs – has been open to industry and practitioner views and concerns. We appreciate the opportunity to provide ours.

[13] Iowa Code §§ 423.3(104)(a), -(47)(d)(1), -(104)(b)(1).

[14] N.J.S.A. §§ 54:32B-8.56, 54:32B-8.14.

[15] R.C.W. §§ 82.08.0208(3), 82.12.0208(6).

[16] C.G.S. §§ 12-410(e)(1), -(3), -(4), -(5), 12-407(a)(13).