

## Determining the Tax Base

Submitted for Consideration of the MTC Digital Products Work Group

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September 1, 2023

### A. General discussion.

1. In principle, a retail sales tax should be a broad-based single-stage levy on consumer expenditures. See Hellerstein & Hellerstein, *State Taxation*, at ¶ 12.01.
  - a. “If you tax some transactions and not their equivalents, then one distorts economic activity and hurts the segments of the economy subject to the tax. But there is also a different efficiency and fairness argument in favor of base broadening at the state level. This is because the broader the base, the more stable it will be, and stability in revenue is a particular virtue for governments bound by hard budget constraints, as state and local governments are bound.” Kim & Shanske, “[State Digital Services Taxes: A Good and Permissible Idea \(Despite What You Might Have Heard\)](#),” 98 *Notre Dame L. Rev.* 741, 766 (2022).
  - b. “Blanket exemptions are also blunt instruments for ameliorating regressivity, which as discussed previously is often overstated. Exempting all grocery items, while sold as a help to low-income taxpayers, benefits all consumers, regardless of their income level. Arguably, the exemption actually benefits higher-income individuals more than lower-income individuals as their total grocery spending will be higher. ... Additional research has found that broadening sales tax bases and using the new revenues to reduce rates is actually less regressive than the status quo.” Tax Foundation, “[Sales Tax Base Broadening: Right-Sizing a State Sales Tax](#)” (2007).
2. As a matter of economic theory, there is no reason to deviate from a broad-based levy, and tax goods while excluding services and intangibles. See Hellerstein at ¶12.05[1]. However, in practice, most states tax all retail sales of tangible personal property, unless explicitly exempted, but only tax explicitly enumerated services. See Hellerstein at ¶ 12.04.
3. Because the typical state sales tax is not truly a broad-based levy on all consumer expenditures, a major source of controversy has been the taxability disputes regarding products that have taxable and nontaxable elements. See Hellerstein at ¶ 12.04.
4. For example, although a product may be received by the consumer in a tangible form, arguments are often made that the true object or essence of the transaction is a nontaxable service. The true object or essence of the transaction test has been described as “folly” that tends to be determined by the “gut” reaction of the court, since the purchaser’s needs often cannot be satisfied without both elements of the product. Hellerstein at ¶ 12.08[2].
5. Furthermore, the vestigial distinction between TPP and services is not grounded on sound tax policy since both involve the consumption of a product.

6. Taxation based solely on whether a consumer receives the product in a digital form has the same potential policy flaws as taxation based solely on whether the consumer receives tangible personal property.
    - a. “the channel or form through which consumption is obtained should be irrelevant to taxability unless compliance or administrative costs are excessive for some channels.” Agrawal & Fox, [“Taxing Goods and Services in a Digital Era”](#) (2020).
  7. However, the digital format of a product may be one consideration, and in some cases an important, or even determinative consideration, in whether a product should or should not be taxed, particularly if the digital format makes the product unique or exceptionally distinctive.
- B. Determining the tax base using multiple considerations or factors.
1. The optimal tax base would be a broad-based single-stage levy on consumer expenditures. However, achieving the optimal tax base may be politically infeasible. The following factors may be considered, if the politically feasible option is to revise or expand the existing selective tax base in a piecemeal fashion.
  2. The overarching principle is that the taxation of digital products cannot be considered in isolation, but must be considered in the context of the entire tax structure.
  3. The prefatory language “extent to which” in describing a factor, is an acknowledgment that the relationship to be evaluated is likely to be on a continuum.
  4. The factors should be weighed collectively, and the relevance or relative weight of each factor may vary depending upon the circumstances.
- C. Factors
1. Clarity, ease of application for taxpayers and tax agencies.
  2. Uniformity with other states.
    - a. Synchronization with the Streamlined Sales Tax Agreement.
  3. Synchronization with other elements of the tax base.
    - a. The extent to which a digital product is like a non-digital counterpart that is taxed.
      - i. “It is a widely accepted principle of tax and economic policy that economic and functionally equivalent transactions should be treated similarly.” Hellerstein ¶ 12.08[3].
      - ii. “It is neither fair nor efficient to tax some but not all consumption. Why should the purchasers of physical books pay a tax that downloaders of e-books do not?” Kim & Shanske, “State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard),” 98 Notre Dame L. Rev. 741,763-64 (2022).
      - iii. Example of digital and nondigital products that may have strong similarities – a compact disc and a vinyl record. However, even in this

example, the products are not identical. The storage medium is different. The device that plays the recording is different. Even the content is not identical, since the playback fidelities of compact discs and vinyl records are different. See, <https://now.tufts.edu/2016/07/11/does-music-sound-better-vinyl-records-cds>.

- iv. Maine is explicit. Products transferred electronically are included in the definition of tangible personal property. 36 Me. Rev. Stat. § 1752. Product transferred electronically means digital products transferred to a purchaser electronically the sale of which in nondigital physical form would be taxable as TPP. 36 Me. Rev. Stat. § 1752(9-E); Me. Instructional Bulletin No. 3; Me Reference Guide to the Sales and Use Tax Law (October 2019).
  - v. Utah is also explicit, but taxes products transferred electronically in addition to TPP. See Utah Code Ann. § 59-12-103 & § 59-12-102(103)(a): “Except as provided in Subsection (103)(b), ‘product transferred electronically’ means a product transferred electronically that would be subject to a tax under this chapter if that product was transferred in a manner other than electronically.”
  - vi. If the products are sufficiently similar, equity could be achieved by taxing or excluding both products.
- b. The extent to which a digital product is like a non-digital counterpart that is not taxed.
    - i. “It is a widely accepted principle of tax and economic policy that economic and functionally equivalent transactions should be treated similarly.” Hellerstein ¶ 12.08[3].
    - ii. Example of digital and nondigital products that may have strong similarities – an opinion letter received in Portable Document Format (PDF) and an opinion letter received on type-written paper.
    - iii. Assuming that the products are sufficiently similar, equity could be achieved by taxing or excluding both products.
  - c. The extent to which a digital product is like other digital products that are taxed or untaxed.
    - i. Example of digital products that may have strong similarities – compact discs and digital music downloads.
  - d. The extent to which a digital product has no similar or only remotely similar non-digital counterparts.
    - i. Example – software.
    - ii. Some digital products will have only remotely similar non-digital counterparts because the superior quality of the digital products make the non-digital counterparts noncompetitive.
      - (1) Superior analytic abilities of computer-generated digital products.
      - (2) Superior speed and methods of delivery of digital products.

- e. Some considerations in determining similarity.
  - i. An important consideration is the extent to which products compete in the economy.
    - (1) Because total consumer demand exceeds total consumer resources, all products compete to some extent. The competition becomes more or less direct with additional levels of detail. For example, a consumer may spend finite resources on either food or entertainment. So, to an extent, food and entertainment compete. Dollars spent on entertainment may be spent on live performances or recorded performances. The competition is more direct. Dollars spent on recorded performances may be spent on streaming services or permanent access. The competition is even more direct. Dollars spent on permanent access may be spent on downloads, compact discs, or vinyl. With each level of detail that the products share, the competition becomes more direct.
    - (2) The more direct the competition, the more reason to apply the same tax treatment. Kim & Shanske call it the “touchstone of competitive harm.” Kim & Shanske, “State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard),” 98 Notre Dame L. Rev. 741, 781 (2022).
  - ii. Price may be a factor in determining similarity. A dissimilarity in the price of a digital product and a nondigital counterpart may indicate that the products themselves are dissimilar or that there is no significant competition between them.
    - (1) Income tax software and accountants may both produce tax returns, and to that extent, they are in competition. It seems plausible that the proliferation of tax software has lessened the demand for accounting services. However, the dissimilarity in price indicates that there are differences in the products. One would not pay high fees to an accountant if a relatively inexpensive computer program could produce the same product.
  - iii. Content may be an important criterium, and in some instances, it may be the decisive criterium for similarity. But not always.
    - (1) For example, the content of a digital book, a hardback book, and a paperback book may be essentially the same. However, a consumer may prefer one media over the other due to features other than content. Nevertheless, in this instance, similar content may be decisive in determining that digital books, hardback books, and paperback books should be taxed the same.
  - iv. If real time or near-real time receipt of the product is a critical part of the product such that a computer-to-computer communication is required, there may not be a sufficiently similar nondigital counterpart, even if the same content could be delivered nondigitally. For example, the real time or near-real time approval of credit card transactions is so critical to the product that there is no sufficiently similar nondigital product.

4. The extent to which taxation of the digital product will result in the pyramiding of taxes.
  - a. In principle, a retail sales tax should exclude business inputs to the extent that the taxation of the business inputs would result in the pyramiding of the tax. See Hellerstein at ¶¶ 12.01.
  - b. In practice, a substantial portion of state sales taxes are attributable to business purchases. See Hellerstein at ¶¶ 12.01.
  - c. If pyramiding of taxes exists for nondigital products, equity might require taxation of digital counterparts. Equity might also be achieved by excluding both products.
  - d. When the price of a taxable product is reduced or eliminated because delivery of the product is subsidized by advertising revenue or other revenue received by the vendor, equity might be achieved by taxing the advertising service or other service for which the vendor receives consideration.
    - i. An example would be a website that is monetized through advertising rather than consumer subscriptions. See Agrawal & Fox, “Taxing Goods and Services in a Digital Era” (2020) at 27 (“the consumption value is not monetized to the consumer though considerable value appears to exist for the consumer”).
    - ii. Agrawal and Fox propose to tax the platform for the implicit value of non-monetized consumer service, or to levy a sales tax on the non-consumer side of the platform (advertising). Agrawal & Fox, “Taxing Goods and Services in a Digital Era” (2020) at 30-34.
    - iii. “Thus, if DSTs are reaching either un-taxed consumption or untaxed supranormal returns, they are, in effect, properly expanding the sales tax base.” Kim & Shanske, “State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard),” 98 Notre Dame L. Rev. 741, 768 at n. 139 (2022).
    - iv. Kim and Shanske, in support of a digital services tax on advertising revenue, argue that the pyramid has only two steps: “To be sure, digital ads are a business input and so there would be some pyramiding if the costs are shifted back to the advertising businesses. But our point is that as a tax only on one later stage of production, it should not cause great pyramiding and it is unfair to compare its economic effects to broad-based turnover taxes.” Kim & Shanske, “State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard),” 98 Notre Dame L. Rev. 741, 801 (2022).
  - e. If a business does not produce a taxable product, taxing the business inputs will not result in the pyramiding of taxes.
    - i. Example – an investment firm that produces nontaxable intangible investment returns.
    - ii. Example – a company that provides a nontaxable service.

- iii. Michael Ettlinger discussed this principle at the MTC Annual Meeting in Austin in July 2023. His PowerPoint presentation included some basic statements: “Pyramids and Cascading: Not everything is taxed at the consumer level • Will a tax on a business input be taxed at a final consumer? • Is the taxed business purchase actually an input or is it final personal?”
- f. Credit on sales tax return rather than exemption and resale certificates?
  - i. “A further simplification would be to charge sales tax to all customers, with business customers obtaining the sales tax refund from the tax agency on their own — such as with a line on the sales tax forms used to report and remit what they collect. This would also put the verification of business status on the party with the relevant information: the buyer rather than the seller. Moreover, the approach avoids the challenges a vendor can face if required to determine if a self-employed person is making a personal or business purchase.” Nellen, “Now Is a Good Time to Start Fixing the Sales Tax Base,” *Tax Notes State* (September 7, 2020) at 999.
  - ii. If the business purchaser is not reporting sales tax collected, there will be no pyramiding of taxes if the business purchaser pays sales tax on the purchase.
- g. Iowa has a broad exemption that might be examined – entity based - Iowa Code section 423.3(104):
  - a. The sales price of specified digital products and of prewritten computer software sold, and of enumerated services described in section 423.2, subsection 1, paragraph “a”, subparagraph (5), or section 423.2, subsection 6, paragraphs “bq”, “br”, “bs”, and “bu” furnished, to a commercial enterprise for use exclusively by the commercial enterprise. The use of prewritten computer software, a specified digital product, or service fails to qualify as a use exclusively by the commercial enterprise if its use for noncommercial purposes is more than de minimis.
  - b. For purposes of this subsection:
    - (1) “Commercial enterprise” means the same as defined in section 423.3, subsection 47, paragraph “d”, subparagraph (1), but also includes professions and occupations, and includes public utilities as defined in section 476.1, subsection 3.
    - (2) “De minimis” and “noncommercial purposes” shall be defined by the director by rule.
  - ...
  - (47)(d)(1) “Commercial enterprise” means businesses and manufacturers conducted for profit, for-profit and nonprofit insurance companies, and for-profit and nonprofit financial institutions, but excludes other nonprofits and professions and occupations.

5. The extent to which taxation of the digital product may violate the Internet Tax Freedom Act.
  - a. Although the scope of the Internet Tax Freedom Act is still being determined and litigated, the likelihood of preemption increases to the extent that a tax is perceived to single out the Internet for taxation.
  - b. The report should state that a broad application of the Internet Tax Freedom Act may lead to economic distortion and impair sound tax policy.
    - i. The discrimination provision “arguably has outlived its originally intended purpose” of fostering the growth of electronic commerce. Hellerstein & Appleby, “[The Internet Tax Freedom Act at 25](#),” 107 State Tax Notes 7, 20 (Jan. 2, 2023).
    - ii. A fact-intensive analysis of whether activities are sufficiently similar invited endless litigation. *Id.* at 21-22.
  - c. Arguably, even if the tax singles out the Internet, the tax does not discriminate if there is no other comparable service.
6. The extent to which the taxing authority may wish to promote or discourage economic activity or tax segments of the economy.
  - a. The traditional discretionary province of the Legislature.
  - b. “We have long held that “[w]here taxation is concerned and no specific federal right, apart from equal protection, is imperiled, the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation.” *Kahn v. Shevin*, 416 U.S. 351, 355 (1974) quoting *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356, 359 (1973).
  - c. In a sense, a state has some discretion to exercise intentional economic distortion.
  - d. In general, the digital products market appears to be sufficiently robust that taxation will not discourage this activity.
  - e. Kim & Shanske make an argument for singling out digital platforms that earn “supranormal returns.” Kim & Shanske, “State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard),” 98 *Notre Dame L. Rev.* 741, 768 (2022).
7. Revenue generation and preventing erosion of the tax base.
  - a. “Unless the structure evolves with the economy, the sales tax will continue eroding and burdening traditional consumption relative to new alternatives.” Agrawal & Fox, “Taxing Goods and Services in a Digital Era” (2020).
  - b. “a large and growing gap in the sales (consumption) tax.” Kim & Shanske, “State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard),” 98 *Notre Dame L. Rev.* 741,746 (2022).
  - c. The National Conference of State Legislatures has stated that the erosion of the sales tax base is due in part due to the shift to the digital economy. <https://www.ncsl.org/fiscal/examining-state-sales-taxes>.