



Tax Pyramiding and Business-to-Business Exemptions in the Context of State Taxation of Digital Products

Multistate Tax Commission

2024

This summary is prepared by the staff of the Multistate Tax Commission (MTC) as part of its uniformity project on state sales and use taxation of digital goods and is subject to revision. For more information contact MTC Deputy General Counsel Lila Disque at ldisque@mtc.gov.

This version of the summary is current as of January 30, 2024.

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Tax Pyramiding in General ¹

As a general practice, states try to reduce sales tax “pyramiding” on business-to-business (B2B) transactions by granting exemptions for purchases made for resale, purchases of manufacturing or processing inputs, or purchases of other business inputs that may address economic development goals in a state. These exemptions have proven challenging as applied to digital goods. A few states have explicitly implemented some form of business inputs exemption for the purchase of taxable digital products. As discussed in greater depth below, Iowa currently grants a broad exemption for digital business inputs; Maryland, New Jersey, and Washington allow partial exemptions via different methods; and Connecticut imposes a reduced tax rate.

MTC July 2023 Business Inputs Panel

At the MTC’s Uniformity Committee Meeting on July 25, 2023 in Austin, Texas, a panel of state tax experts discussed the taxation of business inputs from both the taxpayer and state perspectives. Karl Frieden of the Council On State Taxation, Jared Walczak of the Tax Foundation, and Michael Ettlinger of the Institute on Taxation and Economic Policy offered policy and implementation recommendations. Shannon Brandt of the Texas Comptroller's office and Gil Brewer of Washington discussed what their states have done to address the issue of tax pyramiding as applied to the sales of digital goods and associated revenue implications. A video of the presentation, including the slides used by the presenters, is available on the [project page on the MTC website under the “Research and Analysis” menu](#). Below is a list of key takeaways from their presentations and a summary of their perspectives. All speakers had an opportunity to review and approve the summaries of their remarks.

Key Takeaways:

- ✓ Some argue that pyramiding should always be avoided, while others point out that there are multiple policy considerations when considering the extent to which pyramiding exists in a sales and use tax base.
- ✓ The severity of pyramiding depends on the facts and circumstances, including whether the eventual retail sale will be exempt from tax and the incidence of the tax.

¹ Tax Foundation, TaxEDU Glossary, <https://taxfoundation.org/taxedu/glossary/tax-pyramiding/>; see also, Andrew Phillips & Muath Ibaid, EY, The Impact of Imposing Sales Taxes on Business Inputs, pg. 11 (2019), [1903-3073001_cost-ey-sales-tax-on-business-inputs-study_final-5-16.pdf](#) (prepared for the State Tax Research Institute and the Council on State Taxation).

- ✓ Taxing business inputs can impose tax on historically tax-favored industries, like agriculture.
- ✓ Exempting digital business inputs will be costly if done after the tax base is expanded to include digital business inputs.
- ✓ Exempting business inputs should be considered in tandem with any proposed expansion of the tax base to include digital products.
- ✓ Exempting business inputs can be complicated or simple. One simple option would rely on the identity of the purchaser as a commercial entity.
- ✓ Exempting business inputs, or any other anti-pyramiding effort, should be weighed against tax administration pros and cons, including the potential for fraud and the ability for exemptions to keep pace with the tax base.

Karl Frieden – Council On State Taxation

Mr. Frieden recommended that states limit pyramiding of tax on business inputs and focus sales tax as broadly as necessary on the final consumer. He said the problem with current sales taxes is that they are intended to tax just the retail level, but in reality they tax a large number of business inputs. Historically, state sales taxes provide business input exemptions for manufacturers, but not generally for service, retail, or the emerging digital industries. The economic distortions of sales tax pyramiding include: a bias in favor of integrated businesses (with fewer taxable stages); the unequal burden on different types of business (depending on the number of steps in the supply chain); the disincentive for capital investment (capital goods are included in the tax base); and the unfavorable treatment of exports (in the absence of border adjustments²).

Mr. Frieden recommends that the states emulate the anti-pyramiding model of European value-added taxes (VAT) that impose consumption taxes on a broad base of business-to-consumer (B2C) sales and a limited base of business-to-business (B2B) sales (essentially, only to the extent to which a B2C sale is not subject to tax). He conceded there is no “one size fits all” model that will suit all the states but recommends looking at Iowa and its broad exemption for digital products where the “purchaser is doing business as a commercial enterprise.”

² Mr. Frieden says that a “border adjustment” refers to the “credit” in the case of a VAT and the “exemption” in the case of a sales tax of business inputs provided in conjunction with exported goods or services. Under both a VAT and a sales tax the final good or service is not taxed because of the “destination” principle. However, without the “border adjustment”, the business input is taxed in the exporting country and the consumer good or service is taxed in the importing (destination) country – thus pyramiding the tax.

Jared Walczak – Tax Foundation

Mr. Walczak pointed out that the digital realm is very large, and it encompasses things that are potentially already exempted by policy or are subject to special tax regimes and rules. Agriculture, for instance, is largely exempted, but there are a huge number of digital business inputs in agriculture. These include:

- artificial intelligence tools used for assessing soil quality, plant yield, and plant deficiencies data to improve farming operations and reduce food waste
- cloud computing and data storage
- digital pasture management
- digital seed technology
- digital tools and equipment
- weather forecasting
- drones
- farm management software
- GPS guidance systems like the ones in combines
- machine learning to improve crops and identify pests
- monitoring technology for crops
- robotic harvesting sensors
- smart irrigation and variable rate applications for water, pesticides, and fertilizers

These things have historically been exempted because, for the most part, states have viewed all of these things as inputs and the states tend to care about agriculture-related exemptions in particular. But if states elect to tax "digital" items in general, the items on the above list are included in the sales tax base. Therefore, states should consider a truly broad definition of business inputs so as not to accidentally capture items that are not digital. Mr. Walczak agreed with Mr. Frieden that the Iowa model, which emphasizes the identity of the purchaser as a commercial entity, is consistent with his view of this issue.

Michael Ettlinger – Institute on Taxation and Economic Policy

Mr. Ettlinger posited that an ideal consumption tax would not tax business inputs, but taxation of business inputs is not as bad in practice as it is in theory, it's an important part of the state revenue picture, it's preferable to some alternatives and it's in a context whether other forms of business taxation are insufficient. Adding more business inputs can decrease economic distortion. Uniformity among states is probably as important as whether inputs are taxed; there's not much that's more inefficient than companies arbitraging different states for tax advantages. He provided a list of issues and questions to consider when imposing the sales tax, including:

- Does taxing the specific input more likely come out of corporate profits or is more likely to hit consumers?

- For the particular input, is there a genuine issue of cascading?
- Does taxing a business input increase or decrease volatility?
- To what degree are the inputs taxed if the ultimate good or service is exempt from tax?
- Does taxing a particular input level the playing field between sellers of the same items?
- What is the potential for fraud under this structure – for example, people who use business exemptions but are clearly buying for individual purposes.

Shannon Brandt – Texas Comptroller of Public Accounts

Ms. Brandt works for the state of Texas, which does not have a specific exemption for business inputs as part of its sales and use tax. To minimize tax pyramiding, the state has a sale for resale exemption and a manufacturing exemption (although this exemption requires a physical or chemical change). Computer programs and things that have a tangible analogue are taxed as tangible personal property, while data storage and manipulation is taxed as a data processing service at a discounted tax rate. “Data storage and manipulation” includes things like web development, the service between a marketplace provider and a marketplace seller, data conversion, data storage, but specifically excludes medical transcription and payment processing.

Ms. Brandt’s presentation indicates that in fiscal year 2022, Texas sales tax revenue attributable to B2B software purchases was \$1.294 billion, compared to \$1.369 billion in 2023. She also noted that revenue collections on data processing services, which are generally B2B transactions, accounted for \$360 million in fiscal year 2022, compared to \$392 million in 2023. Moreover, based on the fiscal note to HB 5070, a bill introduced in the 2023 legislative session that would exempt certain data processing services purchased by marketplace providers, Texas would lose \$47.7 million during the 2024-25 biennium.

Gil Brewer – Washington State Department of Revenue

Mr. Brewer stated that Washington, a member of the Streamlined Sales and Use Tax Agreement, has a complete business inputs exemption for digital goods (the books, music, and video defined by Streamlined, plus any static data file), but no similar exemption for digital automated services (any automated service that uses software). The digital goods exemption currently stands to cost the state around \$1.4 million in the next biennium and around \$1.6 million in the ’28-’29 biennium. Digital automated services exemptions would currently cost around \$182 million, going up to almost \$300 million by the ’28-’29 biennium.

Washington made a very deliberate decision to go with a broad imposition approach to taxing digital products because legislators decided they did not want to reassess their tax code year after year when the digital market created a new product that did not fit a prior definition – however, they failed to anticipate that exemptions can become dated just as quickly. Mr. Brewer emphasized that there can be a limited opportunity window for exempting digital business inputs from the state’s sales tax base, and if states choose to implement the exemption, sooner is better, because the loss will be significant if it is done after the tax base is expanded to include digital business inputs, and the states will need to make up the revenue elsewhere.

State Exemption Statutes, Rules, and Forms for Business Inputs

As discussed above, the few states that expressly exempt digital business inputs do so in very different ways. Accordingly, we have compiled below the forms, exemption certificates, rules, and statutory language each state uses.

Washington

- *Washington, a member of the Streamlined Sales and Use Tax Agreement, has a complete business inputs exemption for digital goods, but no similar exemption for digital automated services.*
 - Exemption certificate
 - Digital products including digital goods (discussion of definitions)
 - WAC 458-20-15503 provides a detailed analysis and extensive examples for determining tax liability for digital products and digital codes
 - RCW 82.04.192 Digital products definitions.
 - (1) "Digital audio works" means works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones.
 - (2) "Digital audiovisual works" means a series of related images which, when shown in succession, impart an impression of motion, together with accompanying sounds, if any.
 - (3)
 - (a) "Digital automated service," except as provided in (b) of this subsection (3), means any service transferred electronically that uses one or more software applications.
 - (b) "Digital automated service" does not include:
 - (i) Any service that primarily involves the application of human effort by the seller, and the human effort originated after the customer requested the service;

- (ii) The loaning or transferring of money or the purchase, sale, or transfer of financial instruments. For purposes of this subsection (3)(b)(ii), "financial instruments" include cash, accounts receivable and payable, loans and notes receivable and payable, debt securities, equity securities, as well as derivative contracts such as forward contracts, swap contracts, and options;
- (iii) Dispensing cash or other physical items from a machine;
- (iv) Payment processing services;
- (v) Parimutuel wagering and handicapping contests as authorized by chapter 67.16 RCW;
- (vi) Telecommunications services and ancillary services as those terms are defined in RCW 82.04.065;
- (vii) The internet and internet access as those terms are defined in RCW 82.04.297;
- (viii) The service described in RCW 82.04.050(6)(c);
- (ix) Online educational programs provided by a:
 - (A) Public or private elementary or secondary school; or
 - (B) An institution of higher education as defined in sections 1001 or 1002 of the federal higher education act of 1965 (Title 20 U.S.C. Secs. 1001 and 1002), as existing on July 1, 2009. For purposes of this subsection (3)(b)(ix)(B), an online educational program must be encompassed within the institution's accreditation;
- (x) Live presentations, such as lectures, seminars, workshops, or courses, where participants are connected to other participants via the internet or telecommunications equipment, which allows audience members and the presenter or instructor to give, receive, and discuss information with each other in real time;
- (xi) Travel agent services, including online travel services, and automated systems used by travel agents to book reservations;
- (xii)

(A) A service that allows the person receiving the service to make online sales of products or services, digital or otherwise, using either:

- (I) The service provider's website; or
- (II) the service recipient's website, but only when the service provider's technology is used in creating or hosting the service recipient's website or is used in processing orders from customers using the service recipient's website.

(B) The service described in this subsection (3)(b)(xii) does not include the underlying sale of the products or services, digital or otherwise, by the person receiving the service;

(xiii) Advertising services. For purposes of this subsection (3)(b)(xiii), "advertising services" means all services directly related to the creation, preparation, production, or the dissemination of advertisements. Advertising services include layout, art direction, graphic design, mechanical preparation, production supervision, placement, and rendering advice to a client concerning the best methods of advertising that client's products or services. Advertising services also include online referrals, search engine marketing and lead generation optimization, web campaign planning, the acquisition of advertising space in the internet media, and the monitoring and evaluation of website traffic for purposes of determining the effectiveness of an advertising campaign.

Advertising services do not include web hosting services and domain name registration;

(xiv) The mere storage of digital products, digital codes, computer software, or master copies of software. This exclusion from the definition of digital automated services includes providing space on a server for web hosting or the backing up of data or other information;

(xv) Data processing services. For purposes of this subsection (3)(b)(xv), "data processing service" means a primarily automated service provided to a

business or other organization where the primary object of the service is the systematic performance of operations by the service provider on data supplied in whole or in part by the customer to extract the required information in an appropriate form or to convert the data to usable information. Data processing services include check processing, image processing, form processing, survey processing, payroll processing, claim processing, and similar activities. Data processing does not include the service described in RCW 82.04.050(6)(c); and
(xvi) Digital goods.

(4) "Digital books" means works that are generally recognized in the ordinary and usual sense as books.

(5) "Digital code" means a code that provides a purchaser with the right to obtain one or more digital products, if all of the digital products to be obtained through the use of the code have the same sales and use tax treatment. "Digital code" does not include a code that represents a stored monetary value that is deducted from a total as it is used by the purchaser. "Digital code" also does not include a code that represents a redeemable card, gift card, or gift certificate that entitles the holder to select digital products of an indicated cash value. A digital code may be obtained by any means, including email or by tangible means regardless of its designation as song code, video code, book code, or some other term.

(6)

(a) "Digital goods," except as provided in (b) of this subsection (6), means sounds, images, data, facts, or information, or any combination thereof, transferred electronically, including, but not limited to, specified digital products and other products transferred electronically not included within the definition of specified digital products.

(b) The term "digital goods" does not include:

(i) Telecommunications services and ancillary services as those terms are defined in RCW 82.04.065;

(ii) Computer software as defined in RCW 82.04.215;

(iii) The internet and internet access as those terms are defined in RCW 82.04.297;

(iv)

(A) Except as provided in (b)(iv)(B) of this subsection (6), 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.

(B) The exclusion in (b)(iv)(A) of this subsection (6) does not apply to photographers in respect to amounts received for the taking of photographs that are transferred electronically to the customer, but only if the customer is an end user, as defined in RCW 82.04.190(11), of the photographs. Such amounts are considered to be for the sale of digital goods; and

(v) Services and activities excluded from the definition of digital automated services in subsection (3)(b)(i) through (xv) of this section and not otherwise described in (b)(i) through (iv) of this subsection (6).

(7) "Digital products" means digital goods and digital automated services.

(8) "Electronically transferred" or "transferred electronically" means obtained by the purchaser by means other than tangible storage media. It is not necessary that a copy of the product be physically transferred to the purchaser. So long as the purchaser may access the product, it will be considered to have been electronically transferred to the purchaser.

(9) "Specified digital products" means electronically transferred digital audiovisual works, digital audio works, and digital books.

(10) "Subscription radio services" means the sale of audio programming by a radio broadcaster as defined in RCW 82.08.0208, except as otherwise provided in this subsection.

"Subscription radio services" does not include audio programming that is sold on a pay-per-program basis or that allows the buyer to access a library of programs at any time for a specific charge for that service.

(11) "Subscription television services" means the sale of video programming by a television broadcaster as defined in RCW

82.08.0208, except as otherwise provided in this subsection. "Subscription television services" does not include video programming that is sold on a pay-per-program basis or that allows the buyer to access a library of programs at any time for a specific charge for that service, but only if the seller is not subject to a franchise fee in this state under the authority of Title 47 U.S.C. Sec. 542(a) on the gross revenue derived from the sale.

- RCW 82.08.0208 (3)

(a) The tax imposed by RCW **82.08.020** does not apply to the sale to a business of digital goods, and services rendered in respect to digital goods, if the digital goods and services rendered in respect to digital goods are purchased solely for business purposes. The exemption provided by this subsection (3) also applies to the sale to a business of a digital code if all of the digital goods to be obtained through the use of the code will be used solely for business purposes.

(b) For purposes of this subsection (3), the following definitions apply:

(i) "Business purposes" means any purpose relevant to the business needs of the taxpayer claiming an exemption under this subsection (3). Business purposes do not include any personal, family, or household purpose. The term also does not include any activity conducted by a government entity as that term is defined in RCW **7.25.005**; and

(ii) "Services rendered in respect to digital goods" means those services defined as a retail sale in RCW **82.04.050**(2)(g).

Iowa

- *Iowa, a member of the Streamlined Sales and Use Tax Agreement, exempts sales of specified digital products when sold to a "commercial enterprise" for use exclusively by the commercial enterprise, and has also added specified digital products to existing exemptions (for instance, the exemption for sales to legal aid organizations).*

- See Iowa DOR, Taxation of Specified Digital Products, Software, and Related Services

STREAMLINED SALES AND USE TAX ACT, §423.3 Exemptions. There is exempted from the provisions of this subchapter and from the computation of the amount of tax imposed by it the following:

...

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)³, or section 423.2, subsection 6, paragraphs “bq”, “br”, “bs”, and “bu”⁴ 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)⁵, 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.

105. The sales price of specified digital products sold to a non-end user. For purposes of this subsection, “non-end user” means a person who receives by contract a specified digital product for further commercial broadcast, rebroadcast, transmission, retransmission, licensing, relicensing, distribution, redistribution, or exhibition of the product, in whole or in part, to another person.

Iowa Admin Code r. Rule 701-225.8 - Exemption for commercial enterprises

(1) Commercial enterprise as purchaser. A purchaser seeking this exemption must be a commercial enterprise as defined in Iowa Code section 423.3(104)"b"(1). For purposes of Iowa Code section 423.3(104)"b"(1), the terms "profession" and "occupation" mean the same as defined in 701-paragraph 230.18(3)"c"

(2) Exclusive use by a commercial enterprise. A commercial enterprise must be the exclusive user of the product. Use in the ordinary course of a commercial enterprise's business constitutes exclusive use by a commercial enterprise. Uses by all other users, including entities other

³ (5) Sales of optional service or warranty contracts for computer software maintenance or support services. (a) If a service or warranty contract does not specify a fee amount for nontaxable services or taxable personal property, the tax imposed pursuant to this section shall be imposed upon an amount equal to the sales price of the contract. (b) If a service or warranty contract provides only for technical support services, no tax shall be imposed pursuant to this section.

⁴ bq. Storage of tangible or electronic files, documents, or other records. br. Information services. bs. Services arising from or related to installing, maintaining, servicing, repairing, operating, upgrading, or enhancing either specified digital products or software sold as tangible personal property. bu. Software as a service.

⁵ “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.

than commercial enterprises, do not constitute uses by a commercial enterprise.

a. Examples of exclusive uses. The following are examples of exclusive uses by a commercial enterprise in the normal course of business:

(1) Word processing software loaded onto employees' work computers.

(2) Software that displays a menu on a tablet used by customers at a restaurant.

(3) Information services used by temporary employees of a commercial enterprise in the ordinary course of business.

b. Examples of disqualifying nonexclusive uses. The following are examples of uses that are not exclusive uses by a commercial enterprise or uses in the ordinary course of business:

(1) Software shared by a commercial enterprise with an entity that is not a commercial enterprise.

(2) Video games that customers may purchase on a tablet that is provided at a restaurant for customers to use while waiting for service.

(3) Noncommercial purposes. "Noncommercial purposes" means purposes that are outside of carrying out the business purpose of a commercial enterprise or purposes outside of the ordinary course of business of a commercial enterprise. The following are examples of uses for noncommercial purposes:

a. Personal and recreational use.

b. Holding a product for future use for a noncommercial purpose.

(4) De minimis. "De minimis" means an amount of use of a product for noncommercial purposes that, when considering the product's value and the frequency with which the use for noncommercial purposes occurs during the product's total use time, is so small as to make accounting for that use unreasonable or impractical. Whether a use is de minimis is a fact-based determination that shall be made on a case-by-case basis.

This rule is intended to implement Iowa Code section 423.3(104).

Maryland

○ *Maryland sales and use tax only applies to the sale or use of digital product by an end user; certain other digital products, such as those used in agriculture, are specifically excluded.*

- See Business Tax Tip #29: Sales of Digital Products and Digital Codes
Md. Code, Tax-Gen. § 11-101

(c-4)

- (1) "Digital product" means a product that is obtained electronically by the buyer or delivered by means other than tangible storage media through the use of technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.
- (2) "Digital product" includes:
- (i) a work that results from the fixation of a series of sounds that are transferred electronically, including:
 - 1. prerecorded or live music or performances, readings of books or other written materials, and speeches; and
 - 2. audio greeting cards sent by e-mail;
 - (ii) a digitized sound file, such as a ring tone, that is downloaded onto a device and may be used to alert the user of the device with respect to a communication;
 - (iii) a series of related images that, when shown in succession, impart an impression of motion, together with any accompanying sounds that are transferred electronically, including motion pictures, musical videos, news and entertainment programs, live events, video greeting cards sent by e-mail, and video or electronic games;
 - (iv) a book, generally known as an "e-book", that is transferred electronically; and
 - (v) a newspaper, magazine, periodical, chat room discussion, weblog, or any other similar product that is transferred electronically.
- (3) "Digital product" does not include:
- (i) prerecorded or live instruction by a public, private, or parochial elementary or secondary school or a public or private institution of higher education;
 - (ii) instruction in a skill or profession in a buyer's current or prospective business, occupation, or trade if the instruction:
 - 1. is not prerecorded; and
 - 2. features an interactive element between the buyer and the instructor or other buyers contemporaneous with the instruction;
 - (iii) a seminar, discussion, or similar event hosted by a nonprofit organization or business association, if the seminar, discussion, or event:
 - 1. is not prerecorded; and
 - 2. features an interactive element between the buyer and host or other buyers contemporaneous with the seminar, discussion, or event;
 - (iv) a professional service obtained electronically or delivered through the use of technology having electrical, digital,

magnetic, wireless, optical, electromagnetic, or similar capabilities;

(v) a product having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities where the purchaser holds a copyright or other intellectual property interest in the product, in whole or in part, if the purchaser uses the product solely for commercial purposes, including advertising or other marketing activities; or

(vi) computer software or software as a service purchased or licensed solely for commercial purposes in an enterprise computer system, including operating programs or application software for the exclusive use of the enterprise software system, that is housed or maintained by the purchaser or on a cloud server, whether hosted by the purchaser, the software vendor, or a third party.

(c-5)

(1) "End user" means any person who receives or accesses a digital code or digital product code for use.

(2) "End user" does not include any person who receives a digital code or digital product for further commercial broadcast, rebroadcast, transmission, retransmission, licensing, relicensing, distribution, redistribution, or exhibition of the digital product.

Maryland Tax-General Article § 11-101(n)(3): "Use" does not include:

...

(ii)(1): an exercise of a right or power over tangible personal property, a digital code, or a digital product acquired by a sale for use if the buyer intends to:

1. resell the tangible personal property, digital code, or digital product in the form that the buyer receives or is to receive the property, digital code, or digital product;
2. use or incorporate the tangible personal property or digital product in a production activity as a material or part of other tangible personal property or another digital product to be produced for sale; or

3. transfer the tangible personal property, digital code, or digital product as part of a taxable service transaction

Maryland Tax-General Article § 11-101(h)(3)(ii)(3): “Retail sale” does not include:

...

- (ii) a sale of tangible personal property, a digital code, or a digital product if the buyer intends to:

...

2. use or incorporate the tangible personal property, digital code, or digital product in a production activity as a material or part of other tangible personal property or another digital product to be produced for sale; or
3. transfer the tangible personal property, digital code, or digital product as a part of a taxable service transaction

New Jersey

- *New Jersey has a sales tax exemption for business-to-business sales of prewritten software (but not load-and-leave)*

54:32B-8.56 Certain prewritten software, exemption from tax; definitions.

15. Receipts from sales of prewritten software delivered electronically and used directly and exclusively in the conduct of the purchaser's business, trade or occupation are exempt from the tax imposed under the "Sales and Use Tax Act", P.L.1966, c.30 (C.54:32B-1 et seq.). The exemption provided by this section shall not apply to receipts from sales of prewritten software delivered by a load and leave method.

"Computer" means an electronic device that accepts information in digital or similar form and manipulates it for a result based on a sequence of instructions.

"Computer software" means a set of coded instruction designed to cause a computer or automatic data processing equipment to perform a task.

"Delivered electronically" means delivered to the purchaser by means other than tangible storage media.

"Electronic" means relating to technology having electrical, digital magnetic, wireless, optical, electromagnetic, or similar capabilities.

"Load and leave" means delivery to the purchaser by the use of a tangible storage medium where the tangible storage medium is not physically transferred to the purchaser.

"Prewritten computer software" means computer software, including prewritten upgrades, which is not designed and developed by the author or other creator to the specifications of a specific purchaser. The combining of two or more prewritten computer software programs or prewritten portions thereof shall not cause the combination to be other than prewritten computer software. "Prewritten computer software" includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than such purchaser. If a person modifies or enhances computer software of which that person is not the author or creator, the person shall be deemed to be the author or creator only of such person's modifications or enhancements. Prewritten software or a prewritten portion thereof that is modified or enhanced to any degree, where such modification or enhancement is designed and developed to the specifications of a specific purchaser, shall remain prewritten software; provided, however, that if there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification or enhancement, such modification or enhancement shall not constitute pre-written computer software.

Connecticut

- *In Connecticut, electronically accessed or transferred canned or prewritten software (without any tangible aspect), and any additional content related to such software, that is sold to a business for use by the business remains taxable at the 1% rate (as opposed to the 6.35% rate implemented in 2019)*
 - Special Notice 2019(8), Sales and Use Taxes on Digital Goods and Canned or Prewritten Software

New Mexico

- *New Mexico includes digital products in their gross receipts tax base but provides a deduction for those products that are purchased by businesses for resale or license to others.*

NMSA § 7-9-3 defines certain terms including property:

P. "property" means:

- (1) real property;
- (2) tangible personal property, including electricity and manufactured homes;
- (3) licenses, including licenses of digital goods, but not including the licenses of copyrights, trademarks or patents; and
- (4) franchises;

Deductions are then provided as follows:

Section 7-9-47. Deduction; gross receipts tax; governmental gross receipts tax; sale of tangible personal property or licenses for resale

Receipts from selling tangible personal property or licenses may be deducted from gross receipts or from governmental gross receipts if the sale is made to a person who delivers a nontaxable transaction certificate to the seller or provides alternative evidence pursuant to Section 7-9-43 NMSA 1978. The buyer must resell the tangible personal property or license either by itself or in combination with other tangible personal property or licenses in the ordinary course of business.

Section 7-9-49. Deduction; gross receipts tax; sale of tangible personal property and licenses for leasing

A. Except as otherwise provided by Subsection B of this section, receipts from selling tangible personal property and licenses may be deducted from gross receipts if the sale is made to a person who delivers a nontaxable transaction certificate to the seller or provides alternative evidence pursuant to Section 7-9-43 NMSA 1978. The buyer shall be engaged in a business that derives a substantial portion of its receipts from leasing or selling tangible personal property or licenses of the type sold. The buyer may not utilize the tangible personal property or license in any manner other than holding it for lease or sale or leasing or selling it either by itself or in combination with other tangible personal property or licenses in the ordinary course of business.

B. The deduction provided by this section shall not apply to receipts from selling:

- (1) furniture or appliances, the receipts from the rental or lease of which are deductible under Subsection C of Section 7-9-53 NMSA 1978;

- (2) coin-operated machines; or
- (3) manufactured homes.

State Tax Agency Experiences with Digital Business Input Exemptions and Recommendations

MTC staff met with state tax agency staff who administer these exemptions in order to get insight on administrative, compliance, and audit issues they have encountered with their various approaches. Below is a summary of what we learned.

For an exemption of this type, the statute can be keyed either to the taxable event (sale of the product) or the object of taxation (identity of the purchaser). A statute that is keyed to the taxable event can be made as narrow or broad as the state desires by statutorily defining the product. Washington, for example, noted that their statute has been easily administrable because only sales of “digital goods” are subject to the exemption. The Washington definition of “digital goods” includes only digitally-transferred audio works and audiovisual works; with certain specified exceptions, everything else is considered a “digital automated service” (DAS) and sales for business purposes are not exempt. When the Washington Department of Revenue conducted its study on the taxation of electronically delivered products for purposes of drafting its 2009 bill,⁶ it considered a number of approaches to the exemption, including exemptions for:

- digital products and services given away or made available for free
- the general use of certain types of information or to certain users of standard information (like the existing standard financial information exemption)
- digital products or services used directly in generating business income
- all business inputs.

Although exempting all business inputs would be simplest from a taxpayer and administrator perspective, it would be a much broader exemption than currently exists in Washington’s sales tax structure. As currently structured, state staff noted that some taxpayers have claimed alternative exemptions—such as those for component parts—for items considered DAS. Staff from states with similar statutes said that taxpayers maintaining purchase documentation is essential, as is experienced audit staff, since they must be able to assess whether products fall within the state’s definition.

⁶ <https://apps.leg.wa.gov/billssummary/?BillNumber=2075&Year=2009&Initiative=false>

By contrast, a state exemption that is keyed to the identity of the purchaser will be significantly broader than one keyed to the sale of the product, so states must consider whether they want to exempt a part of the tax base that continues to broaden. Iowa's statute was passed in 2018 as part of Senate File 2417 at the same time taxes were imposed on digital goods.⁷ Curiously, the file was introduced and placed on the ways and means calendar on May 2, 2018, and the committee report was written on the same day. The fiscal note addressed the projected general fund revenue change as a result of "digital goods," but did not separately discuss the effect of the digital business inputs exemption. The final vote was 28 legislators in favor and 20 against, so presumably something about the file was contentious, but there is no indication what caused the disagreement. In 2022, the Iowa legislature considered narrowing its exemption for digital products purchased by a commercial enterprise with H.F. 2583, which would have stricken "professions and occupations" from the definition of "commercial enterprise" in Code section 423.3(104), making sales to professions and occupations related to prewritten software, specified digital services, and other services subject to the sales tax. "Professions and occupations," as defined in Iowa Administrative Code rule 701-215.18(3)(c), include medical offices, law firms, and farming operations. It is unclear why the bill was introduced, and it did not pass.

State auditors we interviewed told us that regardless of the statutory approach, states will need to draft their statutes carefully to avoid conflicts with other statutes, particularly where definitions are concerned. They also recommended straightforward exemption forms. As of this date, most states have limited experience with sales tax audits of digital business inputs exemptions because the laws have not been in place long enough for them to find any major issues. In general, taxpayers whose exemptions have been denied were described by some as filing a "throw everything at the wall" refund request, so they did not appeal when they were denied by the tax agency. Agency tax staff in Washington is also aware that certain types of taxpayers, including financial institutions, are asking the legislature to add new exemptions for their purchases of business inputs.

New Mexico Legislative Hearings

The New Mexico Revenue Stabilization and Tax Policy Committee conducted hearings on October 19-20, 2023, regarding its gross receipts tax. A significant amount of the discussion concerned tax pyramiding, which has been an ongoing concern⁸ due to the gross receipts tax's broad base.

⁷ <https://www.legis.iowa.gov/legislation/BillBook?ba=SF2417&ga=87>

⁸ See *Pyramiding in the New Mexico Gross Receipts Tax*, presented to the Legislative Finance Committee July 22, 2010, by Richard L. Anklam, President & Executive Director of the New Mexico Tax Research Institute,

Clinton Turner, Fiscal Policy Analyst, gave a presentation⁹ urging the committee to “consider more complex models of policy outcomes.” He explained that the simplified tax models that show preventing tax pyramiding is “ideal” assume the following:

- Final consumption is taxed
- A closed economy (where businesses operate all within the same taxing jurisdiction)
- Equity between large and small businesses and “economic” efficiency are primary goals
- Equity between different types of businesses and simplicity/ease of compliance & administration may be secondary

He further explained that if the stages of production and/or consumption cross national or state borders, the model must become more complex or it can become misleading. In New Mexico, the simplified model begins to break down when final consumption or intermediate steps are not actually taxed in the New Mexico tax system. As a result, economic models need to become complex and policy makers need to decide what to prioritize amid a host of considerations, including:

- Equity
- Economic “efficiency”
- Tax exporting (for example, shifting tax burden to New York consumers/workers and off New Mexico consumers/workers)
- Simplicity
- Cost of administration & compliance
- Adequacy
- Transparency
- Who bears the greater burden

Andre Barbe, Ph.D., presented at the same hearing.¹⁰ Mr. Barbe defined a “textbook” gross receipts tax as a tax on sales of goods and services to both consumers and firms, and a “textbook” sales tax as a sale of goods and services only

https://www.nmlegis.gov/entity/lfc/Documents/Revenue_Reports/Tax_Policy_Expert_Testimony/2010/R%20Anklam%20on%20GRT%20Pyramiding%20-%20July%202010.pdf and *Pyramiding in New Mexico’s Gross Receipts Tax* Presented to the Legislative Finance Committee July 2012, by Thomas Clifford, Ph.D., Chief Economist New Mexico Legislative Finance Committee, https://www.nmlegis.gov/entity/lfc/Documents/Revenue_Reports/Tax_Policy_Staff_Briefs/2010/Pyramiding%20in%20the%20Gross%20Receipts%20Tax%20July%202010.pdf.

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<https://www.nmlegis.gov/handouts/RSTP%20101923%20Item%206%20Overview%20of%20econ%20studies%20of%20GRT.pdf>

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<https://www.nmlegis.gov/handouts/RSTP%20101923%20Item%204%20Barbe%20GRTs%20vs%20RS Ts%20Tradeoffs%20for%20NM.pdf>

to the consumer. Gross receipts taxes have historically been viewed as less economically efficient, particularly because they tax intermediate sales. But real-world gross receipts taxes and sales taxes diverge significantly from the textbook examples used for economic modeling. Mr. Barbe built an economic model to compare a real-world sales tax with a textbook gross receipts tax and found that the real-world sales tax resulted in *more* taxation of business-to-business sales than the textbook gross receipts tax. This is because the base broadening that occurs under the gross receipts tax falls less heavily on intermediate goods than the original sales tax base did.

Table 1: Tax Rate Assumption for Different Goods and Services in GRT vs Sales Tax (Percent)

Type of Purchase	Sales Tax	GRT
Business purchases of education, health care, etc.	0.00	0.41
Business purchases of other goods and services	0.64	0.41
Consumer purchases of education, health care, etc.	0.00	0.41
Consumer purchases of other goods and services	1.00	0.41

Source: Barbe and Zodrow (2014) page 13.

In essence, the fewer things a state taxes, the higher the tax needs to be, and this results in less economic efficiency. States therefore need to account for the fact that exemption of digital business inputs will likely mean that they will be making up for lost revenue elsewhere. This ties back to Gil Brewer's comments at the MTC/s Business Inputs Panel, that if exemptions are created *after* the tax base is expanded to include digital business inputs, the state may find itself trying to make up for a revenue shortfall.