

The Digital Era: States to Expand Tax to Digital Goods and Services

by Tram Le



Tram Le

Tram Le is a member of the SALTovation team at TaxOps and an adjunct professor at the University of Texas at Arlington. She writes about hot topics in state and local tax affecting business operations and growth strategies and can be reached at tle@taxops.com.

In this inaugural installment of Spreading SALTovation, Le looks at how states are trying to generate revenue by imposing tax on various digital goods and services and the challenges they face in taxing the digital economy.

Copyright 2020 Tram Le.
All rights reserved.

As states are dealing with unprecedented budget deficits and shortfalls, there is considerable pressure to recover lost revenue caused in large part by the COVID-19 pandemic. State budget shortfalls are expected to total more than \$555 billion over fiscal 2020-2022.¹ The pandemic has substantially increased the popularity and usage of digital goods and services as people have been spending more time at home, shopping online, and working remotely. A recent study found that digital goods and services accounted for nearly three-quarters of online

purchases worldwide.² Examples of digital goods include electronically downloaded and remotely accessed software, music, movies, games, and books, as well as digital services such as streaming video, advertising, and cloud computing services.

More states are looking to generate revenue by expanding the tax base and imposing tax on various digital goods and services. Because of the nature and complexities of state tax issues, states face many challenges in taxing the digital economy.

Outdated Laws

State tax laws have not kept up with technological advancements to address how digital goods and services should be defined, much less how they are delivered, used, and accessed. State tax systems were originally designed to tax tangible personal property and have remained fundamentally unchanged.

States have reacted differently to capture revenue from digital goods and services. Some states have enacted new or amended legislation. In June Rhode Island passed H. 7532, expanding the sales tax base to computer software and streaming services. The law clarified that the tax applies only to the end-user of specified digital products on a permanent or less permanent basis. This is regardless of whether the purchaser is required to make continued payments for such right under S. 2650 Substitute A. North Carolina clarified under H.B. 1080 that the sale of a digital code is treated the same as the sale of digital property to which the digital code relates.

¹Elizabeth McNichol and Michael Leachman, "States Continue to Face Large Shortfalls Due to COVID-19 Effects," Center on Budget and Policy Priorities (July 7, 2020).

²First Data, "From Rideshare, Music Streaming, and Food Delivery: The Global Rise of Digital Goods and Services," Forrester Consulting white paper (July 2019).

Other states have tried to tax digital goods and services based on their interpretation of existing tax laws or other administrative actions. In May the Colorado Department of Revenue proposed changes to existing regulations and clarified that the definition of tangible personal property includes digital goods regardless of the method of delivery and application of the true object test. The purchase of a movie could be delivered on a compact disc, downloaded on the purchaser's computer through the internet, or accessed through an internet browser or streaming video via a monthly subscription.

When a purchase includes both tangible personal property and services or intangible property, the true object test is used to determine the nature of the transaction. If the true object of the purchase is a movie, regardless of delivery method, sales tax is due on the purchase price of that movie.³

The Tennessee DOR also issued a revenue ruling in May to clarify that on-hold messaging services, videocast programming services, and overhead music services are subject to sales tax as “the retail sale, lease, licensing or use of specified digital products transferred to or accessed by subscribers or consumers” in the state.⁴

No Universal Definitions or Standardized Tax Treatment

To further complicate matters, there is no universal definition, characterization, or tax treatment of digital goods and services among the states. In an effort to standardize the treatment of digital goods and services, the Streamlined Sales Tax Governing Board has defined digital products such as digital audiovisual works, digital audio works, and digital books, and adopted some sourcing rules in the Streamlined Sales and Use Tax Agreement; however, challenges still exist. Streamlined sales tax (SST) member states are not required to define digital products in their tax statutes or administrative rules or regulations and are free to exclude or exempt some or all digital products from taxation. Further diluting efforts at

universal adoption is the limited membership of SST, which includes only 24 member states.⁵ Notably missing from SST member rolls are the larger states — California, Florida, New York, and Texas — that have the influence to give universal adoption a greater chance.

Many states now tax some digital products and services, the treatment of which varies widely. Some states broadly tax digital goods and services as tangible personal property without specifying or defining digital goods and services. In Texas, a digital good is taxable if the item is sold in a tangible form and is also taxable.⁶ Other states may define and impose the tax on specific digital products like books, music, and streaming services. Sales tax applies to all digital products in Washington regardless of how they are accessed. Digital products include downloaded or streamed music and movies, digital automated services, and remotely accessed software.⁷ Still other states, such as California, exclude digital goods and services altogether from tax if transmitted over the internet and not sold in a tangible form.⁸

Also, sourcing rules for digital goods and services create an additional layer of complexity. In a state where a digital good is characterized as tangible personal property, destination-based sourcing rules may apply. If characterized as a service, the transaction might be sourced based on where the benefit of the service is received or where a buyer takes possession or makes first use. As digital goods and services are generally sold online and can be downloaded or accessed anywhere, determining where to tax the sale may be problematic, and the risk of multiple taxation arises. An order for the sale of a digital good or service may be received in one state, have a “bill to” address of a buyer in another state, and users located in several different states. Depending on the tax treatment and sourcing rules in each state, the sale could be subject to sales tax in all states involved.

⁵ Streamlined Sales Tax Governing Board, State Information.

⁶ Tex. Tax Code sections 151.009 and 151.010.

⁷ Washington DOR, Digital Products Including Digital Goods.

⁸ California Department of Tax and Fee Administration, Publication 109, “Internet Sales.”

³ Colorado Secretary of State Jena Griswold, Code of Colorado Regulations eDocket, Details of Tracking Number 2020-00369.

⁴ Tennessee Department of Revenue, Rev. Rul. 20-03.

A Look at Cloud Computing

As digital goods and services may be defined very broadly, many states include cloud computing services — software as a service (SaaS), infrastructure as a service (IaaS), and platform as a service (PaaS) — with varying tax treatment of such services.

SaaS is generally defined as software that is not transferred or downloaded to the user. In general, states follow the taxation of SaaS in a similar manner as electronically delivered software. Nuances exist, such as in Texas where electronically downloaded software is fully taxable but SaaS is taxable at the 80 percent level.⁹ New Jersey exempts both downloaded software and SaaS if the product or service is for business purposes.¹⁰ In Colorado, local tax jurisdictions such as the city and county of Denver impose tax on downloaded software and SaaS even though it is exempt at the state level.¹¹

When it comes to IaaS, most states have exempted hardware supplied by a third party as a service, such as Amazon Web Services. PaaS is an ill-defined combination of SaaS and IaaS, in which customer access and ownership are contractually defined. States generally have not addressed the tax treatment of PaaS. New Jersey is one of the few states to take a stand and has come down on the side of not taxable.¹²

A Future Tax on Digital Advertising Services

Another avenue for states to generate revenue is to impose tax on digital advertising services, a highly dynamic and emerging industry. Digital advertising may include the placement of ads through various online and digital channels as banners or ad slots.¹³ Digital advertising services are exempt from state tax in most states. A handful, such as Maryland, Nebraska, and New York as well as the District of Columbia, have

proposed legislation this year to impose tax on digital advertising.

Maryland's H.B. 732 tried to impose a tax with rates ranging from 2.5 to 10 percent on gross annual revenue in excess of \$1 million from specific digital advertising services in the state. The bill was passed in the legislature but was vetoed by the governor in May. Although the legislature could override the veto in the upcoming session, there are several anticipated legal challenges. First, there were no provisions to tax non-digital advertising services. As such, the proposed digital advertising tax would likely be a discriminatory tax on e-commerce under the equal protection clause and run afoul of the permanent Internet Tax Freedom Act, which prohibits a state from imposing multiple or discriminatory taxes on electronic commerce.

Other constitutional challenges may arise under the First Amendment because of the implications of regulating speech in the form of advertising. Under the foreign commerce clause, imposing a digital advertising tax would likely undermine federal foreign policy in regulating foreign trade. Countries within the European Union have recently proposed similar taxes on digital advertising services with great opposition from the United States. Maryland's proposed digital advertising tax would also raise tax policy concerns such as the potential for double taxation on entities that pay tax on their in-state revenue.

In Nebraska, L.B. 989 was introduced in January to expand the sales tax base to digital advertisements. These were defined as "an advertising message delivered over the internet that markets or promotes a particular good, service, or political candidate or message." Similar to the provisions in the Maryland bill, Nebraska's measure would tax digital advertising but not non-digital advertising and would face the same constitutional scrutiny.

Several bills were introduced in New York to impose tax on digital advertising services. The latest bill, A.B. 10706, was introduced in July to impose a tax with rates ranging from 2.5 to 10 percent on the annual gross revenue derived from digital ads. The bill broadly defined digital advertising services to include:

advertisement services on a digital interface, including advertisements in the

⁹Tex. Tax Code Ann. sections 151.051, 151.009, and 151.010; and Tex. Tax Code sections 151.0035 and 151.351.

¹⁰N.J. Stat. Ann. section 54:32B-8.56; and N.J. Technical Bull. No. TB-51(R) (Div. of Tax'n July 5, 2011).

¹¹City and County of Denver, Tax Guide, Topic No. 18, Software (June 2019); and Colorado DOR, Sales Tax Topics: Computer Software (July 2019).

¹²N.J. Technical Bull. No. TB-72 (Div. of Tax'n July 3, 2013).

¹³Indrajett Deshpande, "What Is Digital Advertising and Getting Started as a Digital Advertiser," Martech Advisor (Jan. 31, 2019).

form of banner advertising, search engine advertising, interstitial advertising, and other comparable advertising services, that use personal information about the people the ads are being served to.

S. 8166 was introduced earlier in New York and is similar to Nebraska's proposed digital advertising tax as it would expand the sales tax base to include advertising that "markets or promotes a particular good, service, or political candidate or message."

In the District of Columbia, B23-0760 was introduced in May to impose a 3 percent tax on advertising services, including digital advertising services and personal information. Notably distinguishing the tax proposal from other states, the District would impose tax on all advertising services and defined it as:

the planning, creating, placing, or display of advertising in newspapers, magazines, billboards, broadcasting, and other media, including, without limitation, the providing of concept, writing, graphic design, mechanical art, photography, and production supervision.

The bill further defined digital advertisements to mean:

advertising services related to advertisements displayed on a digital interface, including advertisements in the form of banner advertising, search engine advertising, interstitial advertising, or other comparable advertising.

Taxes on digital advertising are particularly challenging and controversial internationally as well as at the state and local level. Other states are likely to follow suit in enacting taxes on digital advertising but will have to overcome constitutional obstacles and tax policy concerns. Aside from these concerns, there will be other tax complications regarding the characterization and sourcing of digital advertising services. Each jurisdiction trying to tax digital advertising will need to determine what is included in the tax base. Leads or email distribution lists gathered from digital advertising could be characterized as a taxable information service. Also, who ultimately will carry the responsibility of

collecting and remitting these taxes may be difficult to track.

Layering in *Wayfair* Nexus

*Wayfair*¹⁴ was decided over two years ago and overturned physical presence as the minimum nexus standard under *Quill*.¹⁵ Under *Wayfair*, substantial nexus can be established with an economic presence (for example, \$100,000 of sales and or 200 transactions annually) in the state. Because nearly all states have economic nexus rules in place, there will be significant nexus implications on the sale of digital goods and services as states change laws to broaden the tax base, address sourcing issues, and revise interpretations of existing laws to tax and keep up with technological advances in the digital economy.

States will continue to expand and have differing approaches to taxing digital goods and services. Taxpayers and practitioners need to monitor these changes and understand the various legal, policy, and administrative issues arising in the digital era. Understanding what businesses are selling and how and where they are delivering digital goods and services will help taxpayers to navigate the complexities of this evolving area as new laws, rules, regulations, and pressure points unfold across the United States. ■

¹⁴ *South Dakota v. Wayfair Inc.*, 585 U.S. ___ (2018).

¹⁵ *Quill v. North Dakota*, 504 U.S. 298 (1992).