

Taxation of Digital Products in the States

Presentation to the New Mexico Legislature
Revenue Stabilization and Tax Policy Committee
By Helen Hecht, Uniformity Counsel, Multistate Tax Commission
November 3, 2022

**Helen Hecht
Uniformity Counsel
Multistate Tax Commission**

Bio

Work:

- 2020 – Current - Uniformity Counsel for the Multistate Tax Commission
- 2014 – 2020 - General Counsel for the Multistate Tax Commission (Washington, D.C.)
- 2009 – 2014 - Tax Counsel for the Federation of Tax Administrators (Albuquerque, NM)
- 2003 – 2009 - Of Counsel – Sutin, Thayer & Browne law firm (Albuquerque, NM)
- 1995 - 2003 - Senior Manager (and various) - KPMG accounting firm (Albuquerque, NM)
- 1984 – 1995 – Bureau Chief (and various) - New Mexico Taxation and Revenue Department (Las Cruces, Santa Fe, and Albuquerque, NM)

Education:

- Juris Doctor, University of New Mexico
- Masters in Accountancy, New Mexico State University
- Bachelors in Accountancy, New Mexico State University

Other:

- Member of the New Mexico and U.S. Supreme Court Bar
- New Mexico Licensed CPA
- Founding member of the New Mexico Tax Research Institute

Multistate Tax Commission

The Multistate Tax Commission (MTC) is an intergovernmental state tax agency formed in 1967. New Mexico is a founding member of the MTC, enacting the Multistate Tax Compact in June of that year. In addition to compact members, states can also participate in the Commission as “sovereignty” or “associate” members. The overarching goal of the MTC is to facilitate states working together. The MTC’s uniformity committee drafts model state tax regulations and statutes. The joint audit and nexus programs provide services to participating states. (New Mexico participates in these programs.) The MTC also provides training, research, litigation support, and other services, as requested. See the MTC’s website at www.MTC.gov.

Unless indicated, the views expressed in this testimony are my own and not the official positions of the Multistate Tax Commission or any of its member states.

The story begins in the distant past

...

Analysis of ancient writing, including the famous Rosetta Stone, shows that the subject of that writing was often . . . taxation.

“Indeed, early recorded history is largely the history of tax. Sumerian clay tablets from 2500 BCE include receipts for tax payments.”

Rebellion, Rascals, and Revenue, Michael Keen and Joel Slemrod,
Princeton University Press, 2021, p. 3.

Tax law is based on language—hundreds or thousands of pages—much of which is created just for that purpose.

In order for the tax law to adapt to change, we have to come up with the particular language to describe or categorize new things and activities and to address how they are treated.

But if you define things too specifically, then these precise terms will have to be redefined and updated constantly.

So, the faster things change, the more out-of-date our tax systems can become.

Brief history of sales & use taxes

- Enacted by states beginning in the 1930's and 40's
- The structure of the tax –
 - Levied on certain general categories of items
 - Specific items are then excluded based on the nature of the buyer, the buyer's use, or other factors
- Two styles of tax base –
 - On tangible personal property transactions
 - On gross receipts
- Two styles of imposition –
 - On the buyer (collected by the seller)
 - On the seller
- Most states opted for a tax levied on tangible personal property and imposed on the buyer.
- New Mexico adopted a tax levied on the gross receipts of the seller.
- All sales-type taxes have a separate “use tax” or “compensating tax” imposed on the buyer.
- For states that traditionally included only tangible personal property—there has been a struggle to expand the tax base.

Problems with expanding the tax base

- Jurisdiction to tax interstate commerce –
 - 1967 and 1992 - Just as the service economy was expanding and again when the Internet took off, the U.S. Supreme Court issued two decisions holding that states could not require a seller to collect tax on sales unless the seller had a physical presence in the state. See *Nat'l Bellas Hess* and *Quill*.
 - That physical presence standard was overruled in 2018 with the Court's *Wayfair* decision.
 - Before *Wayfair*, states would have had difficulties collecting tax on sales by “remote” sellers—including sellers of services and intangibles, like digital products.
- Continuing issues –
 - Collection of tax from foreign sellers
 - Potential dormant commerce clause limitations – including restrictions on placing undue burdens on interstate commerce

Problems with expanding the tax base

- The federal Internet Tax Freedom Act
 - A 25-year-old federal statute that restricts state taxation.
 - It prohibits tax on Internet access, as defined, and it also prohibits “multiple” or “discriminatory” taxes on “electronic commerce.”
 - Electronic commerce = “any transaction conducted over the Internet or through Internet access.”
 - Discrimination = taxing electronic commerce more than “transactions involving **similar property, goods, services, or information** accomplished through other means”
 - What does “similar” mean?
 - This question can only be answered by litigation in state courts, with the final authority being the U.S. Supreme Court.

Problems with expanding the tax base

- Policies against taxing business inputs –
 - A significant amount of sales of services and intangibles, including digital goods, are sales to businesses.
 - Taxing business inputs leads to “pyramiding” of the tax (tax on tax).
 - This often increases the costs of small businesses, which tend to contract for business services, making them less competitive.
 - The tax can also affect certain industries more.
 - Exception – when the final consumption is not taxed.
- Policies against taxing certain consumption –
 - Educational services or products
 - Healthcare services or products
 - Childcare services

Problems with expanding the tax base

- The traditional structure of the tax raises sourcing problems –
 - “Sourcing” refers to determining which state or local government gets to tax the transaction or income.
 - Because most states impose the tax on the buyer, collected by the seller, they require the tax to be separately stated and charged by the seller on the seller’s bill.
 - Most states allow local governments to enact tax increments on top of the state sales tax.
 - This means that the seller must know which tax rate (including local rates) applies at the time of the transaction. There is no ability to use estimates when reporting each month, as there is with a gross receipts tax.
 - Sourcing issues can be particularly difficult for services and intangibles.
 - Currently, the Streamlined governing board is working to address sourcing of digital products.

Biggest problem

- The approach used by most states to expand their tax base has been to do so incrementally—either reinterpreting the term “tangible property” or coming up with specific terms and categories of particular items. But both approaches are flawed:
 - Software – first was “tangible property,” then purely digital, and now is often provided in a way that more closely resembles a service—even though it serves the same purpose.
 - Books were first tangible, then digital, and now audible.
 - Artificial intelligence can now substitute for services that were once delivered by humans.
 - Data has become a “product” – but what kind of product?
 - Transactions have also changed – from sale, to lease, to license, to subscription, to “access . . .”

Problems with broad expansion

- Florida case study –
 - 1987 - State “sun-setted” the general exemption for professional and personal services. This legislation was repealed six months later due to controversies over the tax—especially its application to out-of-state service providers.
 - Complaints and controversy centered around when should a service not be taxed on the grounds that it is resold as well as the sourcing of services and the cost of compliance for small service providers.
 - The events have been studied extensively over the years – with varying conclusions. See, for example, “The Florida Sales Tax on Services: What Really Happened,” James Francis, available here: <https://ljfo.vermont.gov/assets/docs/Tax-Commission/247b9ad3d1/FL-Sales-Tax-on-Services.pdf>.
- Massachusetts case study –
 - 1990 – State expanded sales tax to a number of services including professional services. As with Florida, the state struggled to determine how to handle sale-for-resale exemptions and sourcing.
 - The tax on professional services was repealed six months later.

Work of the Streamlined states

- The Streamlined organization has engaged drafting definitions of certain terms, including some limited types of digital products.
- But that work has stalled. In large part, this is because industry representatives make no secret of their view that if the Streamlined agreement defines something—states will start taxing it.
- But Streamlined states may tax things that aren't defined by the agreement—so long as their definitions don't conflict with the agreement.
- So states are left to come up with their own definitions of a number of items.

The MTC's Digital Products Project

- Washington is a Streamlined state and a member of the MTC. It expanded its tax base to include digital products, including certain services, more generally—also granting certain general exemptions.
- Washington approached the MTC Uniformity Committee in 2021 to talk about its experiences compared to the more incremental approach most other states have taken, enumerating specific items to include in the tax base.
- As a result, the MTC began a project to study what is a better approach to taxing digital products from an administrative and compliance standpoint.

Two Approaches

Specific Enumeration:

- Each new item to be included in the tax base has to be specifically defined.
- Then that item has to be incorporated into existing exemptions or new exemptions for some items need to be created.
- So any change is likely to raise issues and unintended consequences.

General Inclusion:

- The tax base is expanded to apply to very broad general categories (“services”).
- Exemptions are granted on a general policy basis – to exclude business inputs or essential consumer items, for example.
- This expansion is more substantial.

**Even general
inclusion states
may face issues.**

- Sourcing – again – knowing where to report sales of services and intangibles.
- Questions as to how general exemptions or deductions apply –
 - Are digital products “manufactured”?
 - Can services be resold tax-free?
 - Are digital products licensed by their creator to another business which then grants access to those products to a consumer subject to the “resale” deduction?
- Note: The ITFA anti-discrimination provision may require states to provide exemptions and deductions to “similar” items—but it is not clear if property can only be similar to other property, or services can only be similar to other services, etc.
- How should “bundled” transactions be taxed—that is—if a transaction consists of both non-taxable and taxable items, how is it treated?

Two other ideas being debated.

- Digital advertising taxes –
 - Internet browsers and other businesses gain access to data, often by providing users access to content and monitoring what those users access or search for.
 - These companies, and others, can then sell this data to advertisers or use it to provide advertising services.
 - This has become a very profitable business.
 - Maryland enacted a special tax on digital advertising which is currently being litigated on a number of grounds.
 - Similar taxes are being imposed in certain foreign countries.
- Data mining taxes –
 - An alternative to the tax on the digital advertising service is to tax the exchange of data for access.
 - While this does take the form of an “exchange,” it is difficult to value until the data is sold.
 - So some have argued that a resource excise tax might be imposed assuming that the data gathered has a basic value that can be taxed.

Early thoughts on the issues

- General deductions/exemptions for business inputs are easier to administer and often more equitable, but they also exclude a significant portion of the service and intangible segment.
- Care has to be taken to make sure that the structure of inclusion and exclusion doesn't miss something.
- If there are to be specific consumer products that are excluded from tax (food, medical, educational, etc.) then those exclusions should apply based on the favored use—not the nature of the product or the transaction –
 - Example: There are certain medical devices today that do what doctors and nurses used to do.
- Transactions (sale, lease, license, etc.) are also hard to define and may change—and there may be little reason to distinguish types of transactions.
- Sourcing issues need to be addressed and may require different approaches than those used for tangible property.

Resources

- You can find information on the MTC project on Sales Taxation of Digital Products on the project page which is located on the MTC website here: <https://www.mtc.gov/Uniformity/Project-Teams/Sales-Tax-on-Digital-Products> - The project page contains information on the work on the project as well as other research and what other states are doing.
- You can also find numerous articles and analysis of the digital advertising taxes and the proposed data mining tax online.

Questions

Helen Hecht

hhecht@mtc.gov