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"DIGITAL GOODS AND SERVICES TAX FAIRNESS ACT" WOULD IMPAIR FUNDING FOR EDUCATION, HEALTH CARE AND OTHER STATE AND LOCAL SERVICES

By Michael Mazerov

The proposed Digital Goods and Services Tax Fairness Act of 2011 would immediately and significantly reduce state and local tax collections, and these revenue losses would accelerate in the future. The Act (DGSTFA, S. 971/H.R. 1860) would restrict sharply the ability of state and local governments to levy sales and gross receipts taxes on fast-growing categories of consumer and business purchases like downloaded music and movies, online photo storage, and payroll processing. Accordingly, the National Governors Association and the National Conference of State Legislatures have expressed deep concern about the bill's enactment in its current form. The Federation of Tax Administrators, the 24-state Streamlined Sales Tax Governing Board, and all of the major organizations representing cities and other local governments oppose this legislation because it preempts their taxing authority with little if any policy rationale. (See text box on page 2.)

The revenue losses from DGSTFA would grow over time as more types of entertainment, information, and business-to-business services shift to online technologies. Sales taxes represent roughly one-fourth of all state and local tax receipts, and even more in some states. Already, recession-induced revenue losses in the last few years have led states, cities, counties, and school districts to eliminate over 600,000 jobs, lay off teachers, close fire stations, reduce library hours, scale back medical care, hike community college and state university tuitions, and delay road and bridge maintenance. Enactment of this legislation would further undermine state and local governments' already shaky finances.

Why and How DGSTFA Would Reduce State and Local Revenues

While numerous provisions of DGSTFA would adversely affect state and local tax collections,[1] the major damage would flow from four provisions:

- **DGSTFA would immediately repeal existing sales taxes imposed on computer software sold and delivered online.** Some 30 states impose their sales taxes on pre-written or "canned" software sold and delivered online (such as a download of TurboTax). Many of these states explicitly include downloaded software in their definition of taxable "tangible personal

[1] All major provisions of DGSTFA are analyzed in detail in Michael Mazerov, "Proposed 'Digital Goods and Services Tax Fairness Act' Likely to Do More Harm Than Good in Current Form," Center on Budget and Policy Priorities, August 11, 2011; http://www.cbpp.org/files/8-11-11sfp2.pdf .

Organizations Representing State and Local Officials Oppose the DGSTFA

Contrary to the claims of some DGSTFA proponents, all of the major organizations representing state and local officials have expressed serious reservations about or opposition to its enactment in its current form:

National Governors Association:

> Bills such as S. 971, the Digital Goods and Services Tax Fairness Act claim to establish clear rules for sourcing transactions of digital goods, but they fail to adequately define the types of taxation subject to the bill and could have unintended consequences for states. This is the type of bill where Congress should insist that industry and states work together to find common ground and craft workable legislation that has the support of industry, states and consumers. (Written testimony submitted to an April 25, 2012, hearing of the Senate Finance Committee)

National Conference of State Legislatures:

> It is our understanding that the Committee will also hear testimony on other state tax issues such as . . . the Digital Goods and Services Tax Fairness Act. We believe the issues raised in these bills are worthy for discussion and NCSL has been working with the various industry representatives who support these bills to craft state solutions to the concerns these pieces of legislation seek to address. . . . However, as these bills will affect state revenues and in some cases actually preempt state tax statutes, we respectfully request that any decisions on these state tax bills be held until the Marketplace Fairness Act [empowering states to tax Internet sales] has been enacted. (Written testimony submitted to the same hearing)

Federation of Tax Administrators:

> We regret to inform you that our efforts over the last nine months to address what we believe are fatal flaws in the Digital Goods and Services Tax Fairness Act (HR 1860) have failed to make any progress. We have no recourse but to encourage all Members of the House of Representatives to oppose HR 1860 because it will significantly and unnecessarily impede the collection of legitimately owed state revenues. (April 26, 2012 letter to House Judiciary Chairman Lamar Smith and Ranking Member John Conyers)

Streamlined Sales Tax Governing Board:

> The states that are members of the Streamlined Sales Tax Governing Board (SSTGB) strongly oppose the Digital Goods and Services Tax Fairness Act of 2011 (S. 971 and H.R. 1860) in their current form. (May 1, 2012 letter to Senate Finance Committee Chairman Max Baucus and Ranking Member Orrin Hatch)

National League of Cities, U.S. Conference of Mayors, Government Finance Officers Association, National Association of Counties, and International City/County Managements Association:

> The state and local government community strongly opposes any federal preemption of its taxing authority. . . . Some examples of proposals that have been introduced that would preempt state and local taxes are as follows. . . *The Digital Goods and Services Tax Fairness Act of 2011.* (Joint written statement submitted to the April 25, 2012, Senate Finance Committee hearing)

property," a category that also includes the identical program sold on a physical disk. Indeed, the Streamlined Sales and Use Tax Agreement adopted by 24 states (with the strong support of several corporations now supporting DGSTFA) was written deliberately to *preserve* the widespread current tax treatment of downloaded software as tangible property.

DGSTFA, however, defines downloaded software as a digital good rather than as a tangible product and *prohibits* states from interpreting taxes on "tangible personal property" as including downloaded software. This would force states to enact new laws to continue subjecting downloaded software to sales taxes — laws that software publishers would likely fiercely oppose. Enacting such laws could be particularly difficult in the states that require legislative supermajority or citizen approval of all tax increases.

- **DGSTFA's proposed "sourcing rule" for digital goods and services would promote corporate tax avoidance by allowing many otherwise taxable *business* purchases of these products to escape taxation completely**. This new rule would facilitate tax avoidance by large corporations because they would be allowed to assign their purchases of digital goods and services for tax purposes solely to states that do not tax them, even if they were being used (in whole or in part) in states that *do* tax them.

  Here's how that would work: The bill permits the seller of a digital good or service to accept the *purchaser's* assertion as to where the products will be used. Many purchasers of digital goods and services are large corporations with locations in multiple states that are buying, say, a service like online payroll processing. Such a corporation could arrange to take online delivery of digital goods and services at a facility in a state that does not tax those specific items, or that does not levy sales taxes at all. It could even open a purchasing office in such a state for just that reason. The corporation could then redistribute the digital goods and services to other facilities where they would be used. Under the current DGSTFA language, the states and localities in which those facilities are located would be unable to tax even a share of the original purchase price because they are not the jurisdiction in which the good or service was originally received.

- **DGSTFA would create a large, unwarranted new tax break for many online purchases by preventing state and local governments from continuing to impose sales taxes on the full retail price of items sold by online "intermediaries."** The Internet has spawned many online "intermediaries" that serve as brokers or facilitators of sales of goods and services they do not actually produce or own. Amazon and eBay, for example, act as intermediaries for millions of small, independent merchants that list *physical* goods for sale on their websites. Apple's App Store, ticket sellers like Ticketmaster and StubHub, and hotel brokers like Expedia and Priceline are other well-known online intermediaries.

  The product listing, brokerage, customer billing, and payment collection functions performed by these intermediaries all qualify as "digital services" under DGSTFA because they are performed online. Normally, charges for those costs are considered part of the retail price and are therefore taxable. But DGSTFA would block state and local governments from including those intermediaries' commissions or other compensation in the taxable sales price of those goods and services. This compensation would not be taxable despite the fact that the compensation received by a sales intermediary *not* operating online (such as a consignment shop or an auction house) *is* included in the purchase price under existing state tax law. Thus, these

provisions reduce existing state and local sales tax revenues, and in some cases these changes would be irreversible. For example, DGSTFA includes a complete, permanent ban on taxing the compensation received by online intermediaries when the product whose sale is being brokered is a digital good or a digital service. Apple, for example, reportedly receives a 30 percent commission on all sales of iPhone "apps," meaning that close to one-third of the value of this type of computer software could be permanently tax-exempt if DGSTFA were enacted.[2]

Even more worrisome is the possibility that companies like Amazon, selling their *own* inventories of *physical goods,* could separate their legal structures into a nominal retailing arm and a nominal "intermediary" arm. This would reduce states' sales tax bases by the amount of compensation received by the online "intermediary."

- **DGSTFA would reduce revenue from gross receipts taxes and similar taxes in such states as Ohio, Texas, and Washington, by requiring "sale-for-resale" exemptions for digital goods and services that are not normal features of such taxes**. The legislation bars states from taxing digital goods and services that are used to produce *other* digital goods and services. Such "sale-for-resale" exemptions are common features of state and local *sales* taxes.

  Ohio, Texas, Washington, and several other jurisdictions, however, impose low-rate taxes on business gross receipts (i.e., total sales, including sales for resale) as a general business tax. The low rates compensate for the breadth of the tax base. Nonetheless, DGSTFA would force those states to grant sale for resale exemptions for business purchases of digital goods and services under gross receipts taxes, reducing the revenue yield of these taxes. DGSTFA's enactment would inflict its greatest damage on the revenues of Texas and Washington; both of those states rely very heavily on sales and gross receipts taxes to fund schools, health care and other services and would be particularly harmed.

In addition to these readily identifiable adverse effects of DGSTFA, the bill contains numerous undefined or inadequately defined terms. These are likely to lead to uncertainty and considerable litigation. For example, the term "digital good" is so broadly defined that it appears to cover an architect's blueprint and a contract drafted by a lawyer, merely because they are transmitted as an e-mail attachment. Similarly, the definitions of "digital good" and "digital service" do not clarify which of these mutually exclusive categories audio and video streaming services fall into. Further, the bill's definition of telecommunications services (which are excluded from its coverage) fails to state clearly whether it includes Internet telephone services like Skype and Vonage that are not considered telecommunications for most federal regulatory purposes. It therefore is not surprising that leading state tax law expert Walter Hellerstein of the University of Georgia School of Law recently told the Senate Finance Committee that enactment of the bill in its current form would create "a field day for lawyers given the uncertainties of some of the definitions and the scope. . ."[3]

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[2] Igor Faletski, "Apple's App Store: An Economy for 1 Percent of Developers," CNET News.com, March 8, 2012. http://news.cnet.com/8301-32973_3-57392575-296/apples-app-store-an-economy-for-1-percent-of-developers/ .

[3] Professor Hellerstein's comment came in response to a question from DGSTFA co-sponsor Senator John Thune at the April 25, 2012 Senate Finance Committee hearing. The feed of the hearing is archived at http://www.finance.senate.gov/hearings/watch/?id=2fceb5af-5056-a032-52b8-d8d88b7ee9d5 ; the comment comes approximately 81 minutes and 38 seconds into the hearing.

One Provision of the Bill Is Worth Saving – *If* It is Changed

One provision of DGSTFA arguably is worth preserving — *if* it is reworked to prevent the location of sales of digital goods and services from being manipulated in order to avoid legitimate sales taxation.

As noted above, the bill contains a sourcing rule that specifies which state and locality has the right to tax digital goods and services. A federally established sourcing rule has the potential to benefit sellers and purchasers of digital goods and services by helping avoid multiple taxation of the sale, creating nationwide uniformity and certainty about which state and locality can tax it, and forestalling lawsuits against sellers by purchasers who might claim that the state in which they are located had no authority to tax the sale. Such a rule also could benefit states and localities by clearly establishing the authority of a particular state and locality to tax a specific sale of a digital good or service.

At present, there is a compelling need for a clearer sourcing rule for the variety of services falling into the category of "cloud computing" — individuals' and businesses' use on an as-needed basis of data storage, data processing capacity, software, and hardware owned by third parties and accessed over the Internet. But to benefit state and local governments, a sourcing rule for cloud computing services must be written to minimize the ability of businesses to manipulate the location at which they receive such services. It must also preserve the authority of all the states in which a business might use such a service to tax a fairly apportioned share of the user charge. The current vague language of DGSTFA's sourcing rule fails to provide these protections and therefore needs to be significantly reworked.

Rather than enact a congressionally drafted sourcing rule now, it would be preferable to encourage business and government representatives to negotiate the development of such a rule under the auspices of the Streamlined Sales and Use Tax Agreement, which has worked to simplify and harmonize state sales tax rules for more than a decade. As it did with the sourcing rule for mobile phone calls enshrined in the Mobile Telecommunications Sourcing Act (2000, P.L. 106-252), Congress could then enact the product of these negotiations. Should the parties fail to reach agreement, the federal government could still opt to impose its own sourcing rule for digital goods and services.

DGSTFA Proponents Are Selling the Bill Under False Pretenses

Unfortunately, DGSTFA proponents have engaged in considerable "false advertising" related to both the aims of and the controversy surrounding this legislation. The goal of the bill emphasized by its congressional sponsors and its industry supporters is to prevent "multiple and discriminatory taxation" of digital goods and services. (Taxation of a single purchase of a downloaded movie by more than one state would be an example of multiple taxation of a digital good; taxing a downloaded movie at a higher rate than would apply to a purchase of the movie on a DVD would be an example of discriminatory taxation.) While this goal is commendable, proponents are well aware that this legislation is not needed to achieve it. As discussed in a companion report,[4] the

[4] Michael Mazerov, "Case for Regulating State and Local Taxation of Digital Goods and Services Has Little Merit," Center on Budget and Policy Priorities, August 11, 2011, http://www.cbpp.org/cms/index.cfm?fa=view&id=3561.

Internet Tax Freedom Act enacted in 1998 already bans multiple and discriminatory taxation of "electronic commerce," including all digital goods and services covered by DGSTFA.

Perhaps even more unfortunate, some industry proponents have told congressional offices that the legislation is essentially benign, uncontroversial, and unopposed. This report has made clear, however, that the enactment of DGSTFA would have far-reaching, adverse effects on state and local sales and gross receipts tax collections — and therefore, would curtail these governments' ability to provide critical services like education and health care. It has also documented the opposition to the enactment of the bill in its current form by essentially all of the major organizations representing state and local governments.

Congress can play a useful role in encouraging industry and government to constructively address some very real problems that have emerged in the taxation of digital goods and services, but, as is usually the case, negotiation and dialogue is likely to lead to a better long-term result than unilateral action. The legislation should not move forward without significant changes.