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CASE FOR REGULATING STATE AND LOCAL TAXATION OF DIGITAL GOODS AND SERVICES HAS LITTLE MERIT

By Michael Mazerov

A bill before Congress, the Digital Goods and Services Tax Fairness Act of 2011 or DGSTFA (S. 971/H.R. 1860), would regulate states' and localities' taxation of downloaded music, movies and online services like photo storage and payroll processing. Though proponents of the legislation claim that it is needed to protect consumers from multiple or discriminatory taxes on electronic commerce, existing law already prevents such taxation. Not only is the proposed legislation largely unnecessary, but also, as a companion paper¹ to this report explains, it threatens to:

- reduce state and local tax revenues even as states and localities struggle to fund critical services like education, health care, and public safety;
- seriously disrupt fundamental features of state and local sales taxation that extend far beyond the kinds of online goods and services covered by the bill; and
- open up major tax-avoidance opportunities for large multistate corporations selling *physical goods* online.

Proponents have focused their case for enacting DGSTFA primarily on three of its provisions:

- The bill bans “multiple taxation,” that is, taxation of a single purchase of a digital good or service by more than one state and more than one local government (unless the purchase occurs in overlapping local governments, such as a city and a county).
- The bill bans “discriminatory taxation” of digital goods and services, such as a higher tax rate on a digital book delivered online than on the purchase of a printed book.
- The bill voids any existing or future state and local taxes on digital goods and services that state or local tax administrators impose by interpreting existing taxes on tangible goods, telecommunications, Internet access, or audio/video services as also encompassing *digital goods* and services.

¹ See: 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/cms/index.cfm?fa=view&id=3562>.

DGSTFA proponents claim that state and local elected officials want to ease their current fiscal problems by imposing discriminatory taxes on digital goods and services. They also maintain that DGSTFA is needed to stop multiple states with only a tangential relationship to such transactions from taxing them. Finally, they argue that tax administrators, inappropriately and perhaps even illegally, interpret sales tax statutes to cover sales of digital goods and services. These justifications for the legislation are almost completely baseless.

No Concrete Examples of Discriminatory/Multiple Taxation of Digital Goods/Services

DGSTFA proponents have presented no concrete examples of multiple or discriminatory taxation of digital goods and services. Indeed, the website of the Download Fairness Coalition, a lobbying group pushing for DGSTFA's enactment, does not contain a single example of discriminatory or overlapping taxation.² Given that some forms of digital goods and services (e.g., computer software and information databases like Lexis/Nexis) have been sold online for decades, the absence of such examples is telling evidence that state taxation of these items has been responsible and fair.

In fact, the 1998 Internet Tax Freedom Act (ITFA) *already* bans “multiple or discriminatory taxes on electronic commerce.” ITFA, which is in force through October 2014, defines “electronic commerce” as “any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information. . .” That definition appears to encompass *all* “digital goods” and “digital services” covered by DGSTFA. If states and localities *already* imposed multiple and/or discriminatory taxes on digital goods and services, as some DGSTFA supporters suggest, litigation challenging such taxes would have been filed under ITFA, and the taxes would have been voided.

Yet not a single state or local tax has been invalidated based on this provision of ITFA. Taxpayers have cited the law in only a handful of pending or unsuccessful challenges to state and local taxes. In sum, since existing law already bans discriminatory and multiple taxation of digital goods and services, there is no justification for retaining this provision of DGSTFA even if the bill is ultimately enacted.³

No Realistic Danger of Multiple Taxation

DGSTFA proponents cite the imminent threat of multiple taxation of digital goods/services as a rationale for federal intervention. They argue that if a resident of State A, riding a train as it passes through State B, purchases a software program from a company based in State C, and downloads it to his or her laptop from a server in State D, there is a substantial risk that all four states would seek to tax the sale; indeed, some imply that multiple taxation already is occurring.

² See: www.downloadfairness.com.

³ The Internet Tax Freedom Act has been renewed three times since its initial enactment in 1998. It is likely to be renewed again in its entirety in 2014. Even if its controversial ban on taxation of Internet access services were not to be renewed, its prohibition on multiple and discriminatory taxation of electronic commerce very likely would be, since state and local government representatives have not had strong objections to that provision. In any case, there is no need for enactment of the comparable provision in the DGSTFA for at least three years.

Although Internet businesses have been presenting this scenario for more than a decade, they have provided no examples. There are good reasons for this. State policymakers understand that a law that attempted to tax software downloaded from the Internet while someone was passing through the state would be largely unenforceable; most website operators don't know the whereabouts of their customers when a purchase via download is made.⁴ State officials also understand that a law that made the sale of a digital good taxable in the state where the server delivering it is located would be ill-advised because servers could easily be moved to states without sales taxes. That is why sales taxes on interstate sales (technically, "use taxes") are imposed on a customer location or "destination" basis, not on a seller location or "origin" basis.

Proponents of legislation like ITFA and DGSTFA suggest that the Internet is so unique that federal intervention to impose rules on states' and local governments' taxation of Internet transactions is urgently needed because state and local officials cannot adapt their laws fast enough to prevent stifling this new technology.⁵ That argument overlooks the fact that Internet commerce has been growing explosively for 15 years despite these supposedly unresolved tax issues. There is virtually nothing unique about these issues in the Internet context that justifies federal involvement. Long before the Internet existed, a person on a business trip in State A, who permanently resided in State B, could call the 1-800 number of a mail-order catalog company in State C to request the delivery of a gift in State D (which the company sometimes didn't have in stock and so directed its supplier in State E to ship directly). States have worked out tax priority and cross-crediting rules to try to ensure that there is no double-taxation in such transactions, and those rules achieve that result in the overwhelming number of cases.

Leaving aside the fact that ITFA already prohibits it, there is no more reason to expect widespread, multiple taxation of sales of *digital* goods and services than there is with respect to non-Internet-based, multistate sales just described. Until DGSTFA proponents can present evidence of actual, widespread multiple taxation of digital goods and services, this rationalization for such a far-reaching law deserves to be dismissed.

No Evidence of — and Adequate Remedies for — Egregious Action by Tax Administrators

Similarly, claims that tax administrators have improperly extended sales taxes to digital goods and services without sufficient legislative authority are dubious — if not completely false.

DGSTFA contains two closely related provisions voiding taxes on digital goods and services

⁴ In theory, if the seller of the software were the mobile telephone service provider itself, a state could try to compel the company to collect tax on a mobile purchase by matching records to identify which cell tower was being accessed at the time of the purchase. Whether such matching could be done with sufficient accuracy to survive an inevitable legal challenge seems questionable. In any case, phone companies could rather easily thwart such a requirement in a number of ways, including separately incorporating the seller of the software from the part of the company that owns the communications network itself.

⁵ For example, a "questions and answers" document on the Download Fairness Coalition's website states: "State laws governing sales and use and other transaction taxes are outdated and not able to address the complexities that arise in today's e-commerce economy. This can only be resolved through a national framework passed by Congress. . ." www.downloadfairness.com/tax-facts/.

(including existing taxes) if they are imposed as a result of tax administrators' interpretations of their laws rather than what the bill's sponsors deem to be sufficiently explicit statutory or judicial authority to tax digital items. In other words, it creates new federal rules that override existing state tax law to dictate how a state's tax administrator may interpret his or her own state's tax law. It does so with no evidence that any actual tax administrators are misinterpreting state tax law or that any such misinterpretation is likely to occur in the near future.

The website of the Download Fairness Coalition contains a map identifying ten states (AL, AZ, CO, CT, HI, ID, LA, ME, NM, TX) plus the District of Columbia as jurisdictions where such laws supposedly exist, but it provides no supporting information beyond the claim that "The [Colorado] Department of Revenue is using 40 year-old law to justify unfair taxes on cutting edge digital goods and services."

Until DGSTFA proponents provide information about the specific state tax policies at which this provision is aimed, it is difficult to know whether there is any legitimacy to their claims — or any justification for federal legislation addressing this issue.

There are good reasons to be skeptical that the states identified by DGSTFA proponents as practicing unauthorized taxation of digital goods and services are in fact doing so. In the case of Texas, for example, the sales tax *statute* states, "The sale or use of a taxable item in electronic form instead of on physical media does not alter the item's tax status."⁶ Furthermore, Texas's *statutory* definition of a taxable "data processing service" says that it "includes the use of a computer or computer time for data processing whether the processing is performed by the provider of the computer or computer time or by the purchaser or other beneficiary of the service."⁷ Such a sweeping definition clearly supports the Texas Comptroller's administrative determination that it covers many forms of what is now called "cloud computing" — using the Internet to access and manipulate data and/or software stored on computer servers owned by third parties.⁸ The fact that the definition was developed at a time when remote data processing was done with a direct telephone line and a modem, rather than over the Internet, does not negate its ongoing relevance.

Given that elected and accountable state legislatures can easily clarify state laws to override any perceived *administrative* overreaching, DGSTFA proponents bear a heavy burden to demonstrate that the problem is so widespread and the behavior of state and local tax administrators so egregious that this particular provision of the legislation is justified. That burden of proof has not yet been satisfied.

And if a state tax administrator were to overreach his or her statutory authority and the legislature passively acquiesce, there is an additional established mechanism for taxpayer redress: the state court system. Serious questions must be raised about the wisdom of adding disputes over a state tax agency's interpretation of its sales tax statute to the already-burdened federal court system.

⁶ Section 151.010 of the Texas Tax Code.

⁷ Section 151.0035 of the Texas Tax Code.

⁸ See, for example, memorandum dated May 28, 2008 from Nancy Prosser, Tax Policy Division, Texas Comptroller of Public Accounts, to Lia Edwards, same office, re: "Data processing services provided by an application service provider," STAR Accession number 200805095L.

DGSTFA empowers taxpayers to challenge in *federal* court state and local tax practices they believe are illegal. State courts are perfectly capable of adjudicating such claims.

Preventing Tax Base Erosion, Not Seeking a “Quick Buck”

In seeking to tax digital goods and services, states and localities are not looking to exploit a “windfall” or “make a quick buck.” They are seeking to prevent erosion of their sales tax base that occurs when consumers shift from purchasing items that are subject to sales tax to items that are not. General sales taxes are a critical source of revenue for state and local governments.⁹ In FY08, they supplied \$304 billion in revenue, representing 23 percent of all state and local tax collections.¹⁰

Consider, for example, a hypothetical state or locality where sales taxes on physical books, computer software disks, DVDs, and cable television service raise \$10 million annually and thereby finance 200 teachers’ salaries. If half of those purchases shift to tax-exempt online equivalents, then it is reasonable to update the sales tax law to cover those items. Failure to do so would result in the elimination of half of those teaching jobs — 100 teachers — or in the reduction of other services or increase of other taxes.

Given this straightforward arithmetic and the urgency of keeping sales tax bases in sync with changing household purchasing patterns, it is understandable that state and local officials are dismayed by the argument that the DGSTFA is needed to stop them from taxing digital goods and services at all. Senator Ron Wyden (D-OR) recently made that argument:

The need for this bill is especially critical right now, because what you have is a lot of states and localities in a climate like this being short-sighted. They’re saying, “Hey, we can go there and milk this digital world — all these new services, these apps — and we can raise a whole bunch of revenue and no one will ever see the consequences.”¹¹

States and localities have every right to tax “all these new services, these apps,” if state and local elected officials deem it appropriate and do so in a non-discriminatory way. Indeed, their ability to finance critical public services depends on their doing so. Moreover, as the next section shows, there is no evidence that states and localities are seeking to “milk” the existence of new services with new hidden taxes; in fact, new digital goods and services are typically beneficiaries, not victims, of unevenness in state tax systems.

Tax Code Actually Discriminates in Favor of Digital Goods/Services

Far from being discriminated against, digital goods and services often start out with an unfair 5 percent to 10 percent price advantage over their physical counterparts because they are exempt from sales taxes. Almost every state with a sales tax imposes it on books, music, movies, software, and games delivered on physical media. Many states also tax newspapers and magazines, cable and

⁹ As discussed in the next section, state and local policymakers also seek to extend their sales taxes to digital goods and services in order to create a level playing field and eliminate an unfair competitive disadvantage for local companies that sell comparable goods and services sold offline.

¹⁰ Governments Division, U.S. Census Bureau.

¹¹ Jennifer Martinez, “Wyden: Keep E-Commerce Tax-Free,” *Politico*, May 12, 2011.

satellite TV service, pay-per-view movies, and satellite radio subscriptions. Yet only a minority of states tax these same goods and services when they are sold in the form of a digital download or as a service delivered over the Internet.

The most widely taxed digital good is downloaded computer software. Yet only 33 of 45 states with sales taxes tax it.¹² About 25 states tax downloaded books, music, movies, or games.¹³ And taxation of digital services like the Hulu Plus video streaming service or the Rhapsody music streaming service is less common still.

Of course, states' failure to update their sales tax laws to cover digital goods and services is not the federal government's responsibility. The federal government has, however, *contributed* to the problem. One reason many states have not broadened their sales taxes to cover digital goods and services is that state officials understand that it is not currently possible to collect a significant portion of the potential revenue. The Supreme Court has ruled that an out-of-state retailer cannot be compelled to collect a state's sales tax if it lacks a physical presence in the state. Sellers of digital goods and services can often provide them from a single state, and almost always from no more than a handful of states. So, in order for most states to collect sales taxes on many digital goods and services, the federal government would have to enact legislation reversing the relevant Supreme Court decisions and authorizing states to impose sales taxes on non-physically-present sellers.

State and local governments are partners with the federal government in providing many critical public services, including transportation, health care, education, and homeland security. Their inability to collect sales taxes on many Internet transactions is estimated to cost as much as \$11 billion annually and impairs their ability to provide these services.¹⁴ Since the mid-1980s, states and localities have repeatedly petitioned Congress to enact legislation empowering them to tax remote sales, but to no avail.¹⁵ Rejecting those entreaties is Congress's prerogative, of course. Nonetheless, it would be ironic and unfortunate if Congress gave greater priority to enacting legislation aimed at stopping discrimination that may not even exist than to legislation that can eliminate actual discrimination *in favor* of Internet transactions.

Conclusion

The Digital Goods and Services Tax Fairness Act is largely a solution in search of problem. It is substantially superfluous in that the 1998 Internet Tax Freedom Act already prohibits multiple and discriminatory taxes on these products. Given this reality, and the risk of significant unintended consequences that are laid out in the Center's companion report, DGSTFA should not be enacted in its current form.

¹² CCH, Inc. *State Tax Guide*.

¹³ 2011 *CCH Multistate Corporate Tax Guide on CD-ROM*, "Digital Products" category.

¹⁴ Donald Bruce, William F. Fox, and LeAnn Luna, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce," April 13, 2009, p. 26; <http://cber.utk.edu/ecom/ecom0409.pdf>.

¹⁵ Such legislation was recently reintroduced in the 112th Congress as "The Main Street Fairness Act" (S. 1452/H.R. 2701).