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PROPOSED “DIGITAL GOODS AND SERVICES TAX FAIRNESS ACT” LIKELY TO DO MORE HARM THAN GOOD IN CURRENT FORM

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Summary

The Digital Goods and Services Tax Fairness Act of 2011 (S. 971/H.R. 1860) would regulate state and local taxation of downloaded music and movies and online services like photo storage and payroll processing. One section of the legislation — a set of so-called “sourcing rules” specifying which jurisdiction(s) can tax the interstate sale of a digital good or service — has the *potential* to benefit consumers and sellers of such items, as well as state and local governments, *if it is reworked*. As currently drafted, however, the sourcing rules and most other provisions of the bill would reduce state and local tax revenues even as states and localities struggle to fund critical services like education, health care, and public safety. The measure would also seriously disrupt fundamental features of state and local sales taxation of digital and non-digital goods and services alike. This is worrisome, because sales taxes supply nearly a quarter of all state and local tax receipts.

The principal goal of the legislation articulated by its congressional sponsors 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, this legislation is not needed to achieve it. As discussed in a companion report,¹ the Internet Tax Freedom Act enacted in 1998 already bans multiple and discriminatory taxation of “electronic commerce,” including all digital goods and services covered by this legislation.

Industry proponents of the Digital Goods and Services Tax Fairness Act (DGSTFA) have emphasized a different and much wider set of goals for the legislation:

- establishing a uniform, nationwide rule governing which state and locality may tax the sale of a digital good or service when the transaction crosses state borders;
- repealing existing taxes on digital goods and services that allegedly have been imposed by tax *administrators* declaring these items to be taxable without statutory authorization;
- barring states and localities from requiring third parties involved in the sales transaction, such as online brokers, from charging sales taxes that apply to the sale;

- preventing state and local governments from taxing the purchase of digital goods and services that are resold or used to provide other digital goods and services; and
- creating an exception to standard sales tax practice by allowing businesses that sell tax-exempt digital goods and services and other *taxable* services in a “bundle” for a single price to separate out the tax-exempt items.

Some of these goals may be reasonable, but the actual language in DGSTFA aimed at implementing them is problematic and could seriously harm the revenue-generating capacity of state and local sales taxes. The following are just some of DGSTFA’s adverse impacts on state and local revenues in the bill’s current form.

- **DGSTFA’s “sourcing rules” would allow many otherwise taxable business purchases of digital goods and services to escape taxation completely.** DGSTFA’s current sourcing rules would enable large corporations 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. As currently worded, DGSTFA explicitly permits businesses that make sales of digital goods and services to multiple locations of a purchaser to accept the purchaser’s assertion as to where the products will be used. (Digital goods and services that can be used at multiple locations of a business would include a particular type of specialized computer software used at all of a corporation’s customer service centers, or a service like online payroll processing that effectively is used by the entire enterprise.) Large multistate corporations could easily arrange to take online delivery of digital goods and services at existing facilities or new purchasing offices established in states that do not tax the specific items or levy sales taxes at all. The companies could then redistribute the digital goods/services to other corporate facilities where they would be used. Under the current 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.

A federally-imposed sourcing rule has the potential to benefit sellers and purchasers of digital goods and services by preventing 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. But to benefit state and local governments, such a rule must be written to minimize the ability of businesses to manipulate the location at which it receives such products. Any federally-mandated sourcing rule must also preserve the authority of all the states in which a business might use such a product to tax a fairly-apportioned share of the purchase price. The current vague language of DGSTFA’s sourcing rules fails to provide these protections and therefore needs to be significantly reworked.

- **Several provisions of DGSTFA would bar state and local governments from continuing to impose their sales taxes on the full retail price of a wide array of both physical and digital goods and services sold online by intermediaries.** The Internet has spawned a number of business models in which some type of online “intermediary” serves as a broker or facilitator of sales of goods and services that it does not actually produce or own. Examples of

such transactions include third-party retail sales of physical goods listed on the websites of Amazon and eBay, sales of smartphone “apps” by mobile phone service providers, online sales of event tickets by companies like Ticketmaster and Stubhub, and the brokering of hotel room rentals by companies like Expedia and Priceline. 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.

Several DGSTFA provisions would interfere with the ability of state and local governments to include the commission or other compensation received by these intermediaries in the taxable sales price of the goods and services whose sales they are facilitating. The compensation would not be taxable despite the fact that analogous compensation received by a sales intermediary *not* operating online (such as a consignment shop or an auction house) under state law *is* included in the purchase price. Thus, these provisions reduce existing state and local sales tax revenues, and in some cases these changes would not be reversible. For example, DGSTFA includes a flat-out, 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.

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

DGSTFA proponents have not offered even the slightest justification or evidence for why the legislation needs to exempt online intermediaries from sales tax payment or collection responsibilities. In the absence of compelling evidence, these provisions should simply be dropped from the bill.

- **DGSTFA would force the vast majority of states currently taxing computer software sold and delivered online to enact new laws in order to continue taxing it.** The majority of states that tax pre-written or “canned” software sold and delivered online (such as a download of TurboTax) do so because their laws explicitly treat it as taxable “tangible personal property” like the same program sold on a disk, or because their laws have been interpreted that way. Indeed, the Streamlined Sales and Use Tax Agreement adopted by over 20 states (with the strong support of multistate businesses) was written deliberately to exclude downloaded software from the Agreement’s definition of a “digital good” in order to preserve the widespread current tax treatment. DGSTFA, however, treats downloaded software as a digital good and prohibits states from interpreting taxes on “tangible personal property” as encompassing it. This would force states to enact new laws to continue subjecting downloaded software to sales taxes, providing software merchants a new opportunity to block taxation. Reenacting such laws could be particularly difficult in the states that require legislative supermajority or citizen approval of all tax increases.
- **DGSTFA would reduce payments of gross receipts taxes and similar taxes by companies selling digital goods and services in such states as Ohio, Texas, and Washington, by requiring “sale-for-resale” exemptions that are not normal features of such taxes.** The legislation bars states from taxing digital goods and services that are used to produce other goods and services in order to prevent double taxation. For state and local general *sales* taxes, such “sale for resale” exemptions are appropriate features. However, Ohio,

Texas, and Washington (and several other jurisdictions) impose low-rate taxes on business gross receipts as a general business tax, and the lower rates compensate for the business expense deductions allowed under corporate income taxes. Nonetheless, DGSTFA would force these jurisdictions to allow expense deductions for business purchases of digital goods and services under their gross receipts taxes, reducing the revenue yield. There is no justification for this, and gross receipts taxes should be carved out of the bill's coverage, just as corporate income taxes have been.

In addition to these readily-identifiable potential adverse effects of the bill, it contains numerous undefined or inadequately-defined terms. These are likely to lead to uncertainty and to stimulate additional 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 email 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 encompasses Internet telephone services like Skype and Vonage that are not considered telecommunications for most federal regulatory purposes.

These are just some of the many flaws in DGSTFA discussed at greater length in the remainder of this report. Their prevalence suggests that if Congress is going to legislate in this area at all, it should proceed carefully with substantially more input from affected state and local governments. It would be preferable to allow business and government representatives to discuss these issues under the auspices of the Streamlined Sales and Use Tax Project, which has worked to simplify and harmonize state sales tax rules for more than a decade. Federal imposition of rules governing the issues covered in the DGSTFA would still be available as a remedy if a resolution could not be implemented through the Streamlined Agreement.

What Does the Proposed Legislation Do?

The bill addresses state and local taxation of "digital goods" and "digital services." Examples of digital goods are music, movies, and books that can be delivered online. Examples of digital services are online photo storage, payroll processing, and information databases. The measure proposes to regulate state and local taxation of these products in the following ways:

- Banning "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);
- Banning "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;
- Permitting taxation of a digital good or service only when purchased by the individual or business deemed to be the ultimate consumer of the product, in other words, banning taxation of a digital good/service that a business resells or incorporates into another digital good or digital service for sale;

- Limiting the imposition of taxes on digital goods and services to the purchaser or the seller and barring the imposition of taxes on an intermediary involved in the transaction, such as a business that delivers the product or bills the purchaser on behalf of the seller;
- Setting up a series of mandatory, uniform “sourcing rules” that establish which state and locality can tax a particular transaction, such as the purchase and delivery of a smartphone “app” over a mobile phone network;
- Voiding state and local taxes on digital goods and services imposed when state or local government tax administrators decide that taxes on tangible goods, telecommunications, Internet access, or audio/video services should extend to digital goods and services;
- Voiding state and local taxes on digital *services* imposed when state or local government tax administrators decide that taxes on digital *goods* also encompass digital services;
- Authorizing retailers that sell digital goods and services in combination with other goods and services for a single price to treat them as separate sales if they can “reasonably identify the charges for the digital goods or digital services.”

Like most federal legislation preempting state/local taxes, the bill would not vest administrative or regulatory authority in any federal or state agency to interpret its terms. Consequently, courts would end up interpreting the law. DGSTFA empowers businesses to challenge state and local tax practices they believe are illegal in *federal* court and to seek an injunction against the payment of taxes while the litigation is pending.

Potential Adverse Impacts of DGSTFA on State and Local Revenues

Most provisions of DGSTFA have substantial potential to seriously disrupt state and local revenues, including, in some cases, sales tax revenues from sales of *non-digital* goods and services. Such a loss of revenue comes as state and local governments already face a prolonged period of tight finances during the slow economic recovery. They already have made deep cuts in critical investments in education and infrastructure and cannot afford new restrictions on sales taxes that DGSTFA would impose. General sales taxes are a major source of revenue for states and localities, supplying 23 percent of their tax receipts.

Many of the potential impacts of DGSTFA discussed in this section of the report may well be unintended. If that is the case, it should generally be possible to prevent them with relatively minor amendments to the legislation (such as an across-the-board carve-out for particular types of goods and services). In other cases, such as the Act’s “sourcing” provisions discussed immediately below, it is clear that a somewhat more protracted language development process requiring input from industry and government representatives will be necessary.

“Sourcing” Provisions Allow Businesses to Avoid Taxation by Manipulating Location at Which Purchases of Digital Services Are Deemed to Be Received

A major objective of the bill is to establish clear “sourcing rules” that identify which state and locality may tax the sale of a digital good or service.² But as currently drafted, these rules do the opposite: they allow businesses purchasing digital goods and services for use in states that tax those items to assign them, for tax purposes, to states that specifically exempt them from sales tax or that don’t have a sales tax at all – an open invitation for massive tax avoidance.

The problem arises primarily with respect to digital goods and services purchased by a business and used either at multiple discrete locations of the business or by the entire enterprise. (Examples of the latter would be hosting a corporation’s main public website or outsourced “cloud computing” services, such as remote backup of the corporation’s customer database and processing its company-wide payroll.) Normally, under state sales tax law, the taxing jurisdiction is the one where the product is used. If a service purchased by a business is used in multiple locations, some states will seek to tax a share of the purchase price based on some type of reasonable apportionment formula.³ The current sourcing rule in DGSTFA effectively precludes apportionment of the purchase price if that is not in the interest of the purchaser.

The Act says that “if the sale of digital goods or digital services is made to multiple locations of a customer . . . the seller may determine the customer’s tax address or addresses using the address or addresses of use *as provided by the customer*” (emphasis added), so long as the address is relied upon in “good faith.” It gives no guidance as to what is meant by a “sale . . . made to multiple locations of a customer.” It further provides that the tax address shall be considered to be the business location where the “digital good or digital service is received by the customer,” if that location “is known to the seller.”⁴ It gives no guidance as to what is meant by the location at which a digital good or service is “received” by a customer.

These provisions mean that if a business purchasing digital goods and services tells the seller that it is “receiving” or accessing the service at a single location, and the seller has the slightest evidence that the good/service *could* be accessed or used at that location, then the seller can charge the sales or use tax⁵ there, ignoring all the other locations at which the good/service is also being used. That is a virtual guarantee that digital goods and services purchased by businesses would not be taxed anywhere. Any large business purchasing significant amounts of digital goods or services subject to sales/use taxes in any state(s) in which it does business could easily form a small subsidiary corporation in any state that does not tax those goods or services, including the four states that do not have any sales or use taxes at all.⁶ The subsidiary would be the nominal purchaser of the digital goods/services and could redistribute them electronically to the rest of the enterprise. Under the Act’s sourcing rules, it is highly unlikely that any jurisdiction other than the one in which the nominal purchaser is located would have the legal authority to tax a portion of the purchase price.

If the federal government is going to impose on states uniform sourcing rules governing digital goods and services that *can* be used at multiple locations of a business, then those rules should establish how the purchase price is to be divided among all jurisdictions for tax purposes. At the very least, those rules must preserve the authority of jurisdictions to collect a tax directly from the purchaser on an apportioned share of the purchase price.

Development of a uniform sourcing rule for business purchases of digital goods and services used at multiple business locations of the purchaser will be difficult. The Streamlined Sales and Use Tax Project has been unable to reach a permanent agreement on this issue either among the participating states or between states and businesses; after it adopted a “multiple points of use” provision, it repealed it. Nonetheless, the current language in DGSTFA is too ambiguous and too easy to manipulate. The sponsors should encourage state and business representatives to go back to the drawing board and allow the development work to continue in order to develop a solution that is not so easy to manipulate.

“Unbundling” Provision Threatens to Reduce Sales Tax Revenues from the Sale of Physical Goods by Internet “Intermediaries”

The interaction of several provisions of DGSTFA could actually interfere with sales taxation of *physical* goods. Subsection (e) of Section 4 of the Act provides that “if charges for digital goods or digital services are aggregated with and not separately stated from, charges for other goods and services, then the charges for digital goods or digital services may be taxed at the same rate and on the same basis as charges for other goods or services, unless the seller can reasonably identify the charges for the digital goods or digital services from its books and records kept in the regular course of business.” The Act defines “digital service” as “any service that is provided electronically.” Another provision of the measure states that no digital service may be taxed as a result of an interpretation that a “tax on or with respect to any sale of tangible personal property” applies to such a service. In other words, any tax on a digital service must be imposed by explicit statutory language.

This last provision is something of a problem by itself, because it would hinder the ability of state tax administrators to interpret state tax statutes to keep tax rules consistent with changing technology.⁷ A much more severe problem is that, in combination, these three provisions threaten to disrupt and perhaps even permanently reduce tax revenues from the sale of physical goods when such sales are facilitated by online intermediaries. There is serious risk that such sales would only be taxable at the “wholesale” price received by the supplier of the good or service — not the higher “retail” rate charged by the intermediary.

Consider one well-known online intermediary, Amazon.com. In addition to selling its own inventory, Amazon allows other retailers to list and sell their merchandise on its website.⁸ Amazon bills the purchaser, collects the money through a credit card or other online payment method, and retains part of the consumer’s payment as a sales commission, remitting the balance to the seller.⁹

There is little question that the product listing, order forwarding, and billing services that Amazon provides to third-party sellers on its website constitute “digital services” under DGSTFA since they are services that are “provided electronically.” The “unbundling language” would allow retailers selling on Amazon (and other intermediaries with a similar business model) to treat the charge for these services as separate from the charge for the merchandise itself if they can “reasonably” separate the two. They can, in fact, clearly separate the two, because they know the selling price of the item to the ultimate purchaser and the amount of the commission they paid to the intermediary. Most states’ sales tax laws provide that a broker’s or auctioneer’s commission or fee is part of the taxable sales price of a physical product — “tangible personal property” in technical terminology. But DGSTFA provides that the sales tax on tangible personal property cannot be extended to tax a

“digital service,” a term that encompasses Amazon’s online brokerage services. Thus, there is a significant risk that until states enact explicit statutory language that online brokerage or intermediary services provided by companies like Amazon are subject to sales taxation, the taxable value of third-party-owned merchandise sold on their websites will be the seller’s “wholesale” price — not the higher “retail” price that includes the intermediaries’ commissions.¹⁰ Yet, if the sale were facilitated by a *non*-Internet-based intermediary, like an auction house or a consignment shop, the tax would be calculated on the retail price.

Such revenue losses could persist for a significant period of time or indefinitely. Legislators in many states are likely to be reluctant to amend their laws to include the commissions and service fees of online intermediaries in the sales tax base, knowing that they will be accused of increasing taxes. The political obstacles would be even greater in the many states that tax few, if any, services, have supermajority requirements for tax changes that raise revenue, and/or require voter approval for tax increases.

There is no justification for interfering with the authority of states and localities to impose their sales taxes on the total charge of a physical good when the purchase price effectively or explicitly includes the commission of an online intermediary. If it is to be enacted, the DGSTFA must be amended to prevent such interference. For example, the legislation could include an across-the-board carve-out for sales of tangible personal property.

DGSTFA’s Definition of “Seller” Explicitly Bars State and Local Taxation of Services Provided by Online Intermediaries When the Product Sold Is a *Digital* Good or Service

The previous section described how DGSTFA could at least temporarily prevent the taxation of services provided by online intermediaries like Amazon when “tangible personal property” — i.e., a *physical* good, is being sold. The bill creates a similar problem when the underlying product is a *digital* good or service — but in this case the new tax exemption would be permanent and not reversible by state action.

DGSTFA states: “Taxes on or with respect to the sale of digital goods or services may only be imposed on and collected only from a customer or seller.” It defines seller as “a person making sales of tangible personal property, digital goods, digital services, or other services.”¹¹ It also says that a seller does *not* include a person that, “with respect to the sale of a digital good or a digital service” “provides, on behalf of another person, order taking, order fulfillment, billing, or electronic delivery or transfer service. . .” Given this exclusion, no sales tax could *ever* be imposed on an online intermediary providing any of these services, despite the fact that the services are essential to actually selling and conveying the underlying digital good or service to a consumer.

In other words, states and localities would only be able to tax the “wholesale” price of the digital good or service — not the wholesale-to-retail mark-up received by the intermediary for its services. To reduce the taxes on the sale of digital goods and services, companies selling (for example) music and software developed by other firms could, instead of licensing the digital goods and re-licensing them to consumers, charge consumers a separate service fee for facilitating the transaction. For example, instead of charging consumers \$1.99 for a smartphone “app,” Apple or Verizon could charge them \$1.79 for the program and a \$.20 service fee for the storage, delivery, and billing service provided by Apple or Verizon to the app’s developer. DGSTFA prohibits taxation of the service

fee. Consequently, states with a five percent sales tax lose one cent of revenue per download. Consumers purchase billions of dollars of digital goods and services annually, and sales are expected to grow rapidly in the future.¹² The combination of actual revenue losses from restructuring taxable transactions and future revenue losses from restricting the potential taxable value of sales to the wholesale price could be significant. There is no justification for such a restriction in a bill that purports to set a framework for the taxation of digital goods and services — not limit their taxability.

Internet-Based Retailers Could Restructure Their Businesses to Reduce Taxes on the Sales of Their Own Goods and Services

The previous two sections described how various provisions of the DGSTFA could interact to reduce taxes on sales of both physical goods and digital goods/services when Internet-based retailers like Amazon and Apple sell such items on behalf of independent third parties who produce them. However, Internet retailers could also restructure their businesses to exploit the same provisions of the bill with respect to sales of their *own* merchandise, further increasing state and local revenue losses.

The bill applies to natural persons and to discrete legal entities engaged in buying or selling digital goods and services — including separately-incorporated members of a multi-corporate group. Accordingly, a company like Dell Computer that sells inventory it owns could easily form two separate subsidiaries, Subsidiary A, the “seller of record” of its merchandise, and Subsidiary B, which “sells” the right to list Subsidiary A’s wares on its website. Subsidiary B also processes orders from consumers on behalf of Subsidiary A, forwards them to Subsidiary A’s warehouses for fulfillment, bills the consumers, collects the money from them, and deposits the funds in Subsidiary A’s bank account. If Subsidiary B did not exist, Subsidiary A would have to do all of these things itself, and would incorporate into the sales price of its merchandise an amount sufficient to recover these costs. That amount would be subject to sales tax. But if Subsidiary B “sells” these services to Subsidiary A, Subsidiary A is free to unbundle the service charge and only charge tax on the merchandise itself until such time as the state closes the loophole with new statutory language that subjects Subsidiary B’s service charge to sales tax. The same is true for any seller of digital goods and services exploiting the “seller” loophole, such as a book publisher selling an electronic version of one of its titles.

The possibility that *any* Internet retailer of physical *or* digital goods/services could revamp its corporate structure into a nominal “retailer” and a nominal online “intermediary” to reduce the sales tax it would have to charge its customers makes it all the more urgent that this loophole be closed prior to the enactment of DGSTFA.¹³

DGSTFA Would Provide Online Travel Companies with Additional Grounds to Challenge State and Local Hotel Taxes

As discussed at length in two other Center reports, online travel companies (OTCs) like Expedia and Travelocity have waged a decade-long war against state and local taxation of hotel rooms that they book.¹⁴ They have taken the position that because they are mere “intermediaries” between hotels and room renters (rather than leasing and then subletting the rooms), the mark-up over the “wholesale” room rate that they retain for their services is never subject to state or local hotel taxes.

They have aggressively defended this position in scores of court cases that state and local governments have brought, seeking payment of tax on their wholesale-to-retail markups. They also are seeking federal legislation to ratify their position.

If enacted, the DGSTFA would represent a powerful new weapon in the OTCs' battles with state and local taxing authorities. The Act's definition of a "digital service" likely encompasses all of the OTCs' activities (except when people book their rooms using the OTCs' 1-800 phone numbers rather than online). Its "unbundling" provision would allow the OTCs to treat their mark-ups as a separate charge for that service. The bill's definition of a discriminatory tax on a digital service includes one levied "at a higher rate than is generally imposed on . . . similar services that are not provided electronically." The Act goes on to state: "A tax shall not be considered 'generally imposed' if it is imposed only on specific services . . ."

Some states impose hotel taxes at higher rates than their general sales taxes. Many local governments are authorized to impose hotel taxes but not general sales taxes. In such states and localities, taxes on the OTCs' wholesale-to-retail mark-ups would arguably be void as discriminatory taxes under DGSTFA because they are imposed "only on specific services." Yet a hotel room booked by a conventional travel agent would be taxable at the total charge with no deduction for the commission paid to the travel agent by the hotel. In short, DGSTFA would likely ratify tax discrimination *in favor* of OTCs and it would cost state and local governments tens of millions of dollars in forgone revenue.

The "Unbundling" Provision of the Act Could Have Other Adverse Consequences for State and Local Revenues

The "unbundling" provision of the Act could have a negative impact on state and local sales tax revenues in another way. In most states, a tax-exempt item becomes taxable if it is sold with a taxable item for a single price. States impose this requirement to avoid constant disputes with sellers of bundled taxable and tax-exempt items over how much of the bundled charge is attributable to each. If sellers choose to charge one price, they have to charge tax on that price.

DGSTFA overrides such laws and allows a seller of digital goods and services that are tax-exempt to not charge tax on them if the seller can "reasonably identify the charges for the digital goods or digital services from its books and records kept in the regular course of business." This will likely lead to a loss of revenue in many states and localities, since some sellers of tax-exempt digital goods and services are bundling them with taxable items and charging sales tax on the total amount. Companies engaged in such bundling will have an incentive to maximize the amount of the combined charge they attribute to the tax-exempt portion of the bundle. It is foreseeable that there will be disputes between companies selling bundled services and the states over what a "reasonable" split is.¹⁵

Once again, there is no justification for singling-out digital goods and services for favorable treatment when the longstanding and widespread practice of states is to tax bundles on the total charge — especially when the seller can avoid what it views as unfavorable treatment by charging separately for the items. If this provision is not eliminated entirely, at the very least it should be amended so that it only applies when the non-digital goods and services in the bundle are taxed at a higher rate than the generally-applicable sales tax rate in the jurisdiction.¹⁶

Permanent Prohibition on Imposing Tax Collection Responsibility on Third-Party Billing Services Would Lead to Widespread Tax Avoidance

As discussed above, the bill provides that a tax on digital goods and services can only be imposed on the purchaser or seller of such products. It explicitly excludes from the definition of “seller” a third party that bills purchasers on behalf of the seller. If enacted, this provision would lead to widespread avoidance or evasion of the sales taxes due on digital goods and services. It must be removed.

If the purchase of a digital good/service is taxable, if the seller is legally obligated to charge the tax (because it is physically present in the purchaser’s state), and if a third party bills the purchaser on behalf of the seller, then the only practical way to ensure that the tax is charged is to require the party doing the billing to include the tax. State and local governments must retain the authority to impose responsibility for assessing the tax on the billing agent. It is not enough to retain the nominal right to impose the tax on the actual seller and hope that the seller’s contract with the billing agent will require the agent to charge the tax.

The states’ failure to close this loophole is already costing them revenue. Amazon.com, for example, does not charge sales tax on behalf of smaller third-parties who sell on its website via its “Marketplace” program and on whose behalf it bills purchasers.¹⁷ Most of those sellers are undoubtedly making some sales of taxable items to customers in their home states via Amazon’s website. Therefore they are legally obligated to charge sales tax and show the amount of that tax on the bill. Yet they simply have not had enough economic clout to compel Amazon to calculate the tax, place it on the bill, and remit it to the seller so that the seller can comply with the sales tax law in its home state. There is no easy way for states to identify which Marketplace sellers are located within their borders. It is likely that many of these sellers are simply not complying with their obligation to remit the tax on many such sales since Amazon does not charge the sales tax. (Even if they are remitting tax, they are violating widespread state laws requiring the tax to be disclosed to the purchaser at the time of sale.)

States need to close this loophole, and Congress must not interfere with their ability to do so. If this provision of the bill is enacted, it is almost inevitable that companies like Amazon will seek comparable provisions to cover its sale of *physical* goods on behalf of third parties. The sales tax could not survive as a major revenue source if a retailer’s duty to collect the tax could be nullified simply by contracting with an online agent to bill the purchaser.

Sale-for-Resale Provision Could Clog the Federal Courts

The bill provides that a digital good or service can only be taxed when it is sold to a business or individual deemed to be the final consumer — not when it is a “purchase for resale.” It also states: “A digital good or digital service is purchased for the purpose of resale if such good or service is purchased for reselling it or for using it as a component part of or integration into another digital good or service that is to be sold to another person. . .” As is readily apparent, the first part of that definition is tautological. The utility of the second part depends on the meaning of “component part” and “integration,” neither of which is further defined.

All state sales tax laws have sale-for-resale exemptions. Many states have had to struggle somewhat with determining when something purchased by a business is deemed to be consumed by that business and therefore taxable, and when it is “incorporated” into a product and therefore tax-exempt as a sale for resale. Such clarification has sometimes required litigation, the publication of industry-specific guidance, and/or private letter rulings for specific taxpayers. To prevent abuse of this exemption, states universally require business purchasers to file specific forms attesting to the fact that they are purchasing particular items for resale. States can and do assess civil and even criminal penalties for inaccurate filings or fraudulent sale-for-resale claims.

In light of the difficulty states already have in administering this exemption, and given the very wide, yet uncertain, scope of what constitutes a digital good or service under DGSTFA, it would be an enormous mistake to give businesses selling such items a federal court forum in which to litigate sale-for-resale disputes. This would require the creation of an entirely new body of law by the federal courts, which have no experience in administering sales taxes. Inevitably, they would establish criteria for making sale-for-resale determinations that are inconsistent with what many individual states have developed. There is simply not enough evidence of bad faith by state and local policymakers to warrant such heavy-handed intervention.

Unquestionably, states are not as liberal in granting sale-for-resale exemptions as businesses think they should be. There is no evidence, however, that the “pyramiding” of sales taxes that already results from the taxation of some business inputs is having a major adverse impact on the national economy. Nor is there evidence that purchasers of digital goods/services are more burdened by such pyramiding than businesses generally. DGSTFA’s definition of “purchase for resale” goes on to explicitly include “the purchase of a digital good or digital service for commercial broadcast, rebroadcast, streaming, restreaming,” etc. Perhaps a narrower definition of a mandatory sale-for-resale exemption can be crafted to ensure, for example, that when Netflix pays, say, \$1 million to a movie studio for the right to stream a particular movie and receives \$1.1 million from doing so, the initial \$1 million may not be taxed. But granting taxpayers a federal court forum in which to pursue sale-for-resale disputes would be unwise when the purchased items represent a minor cost for the business.

Sale-for-Resale Provision Would Have Particularly Adverse Impact on General Business Taxes of Ohio, Texas, and Washington

Forty-four states plus the District of Columbia levy a tax on corporate profits, at rates ranging between 4 percent and 12 percent. Corporations are allowed to deduct (subtract) all of their legitimate business expenses from their gross receipts in calculating the base of such a tax.

Ohio, Texas, and Washington, however, have chosen a different type of general business tax. Ohio and Washington do not allow expense deductions, but, in exchange, they tax corporate gross receipts at much lower rates than apply under corporate income taxes: 0.26 percent in Ohio and, depending upon the type of receipt, 0.471 percent to 1.5 percent in Washington. Texas’s tax allows some limited expense deductions, and it has slightly higher rates of 0.5 percent for wholesalers/retailers and 1.0 percent for all other businesses. The Ohio and Washington taxes are known as “gross receipts taxes,” and the Texas tax would be considered a modified gross receipts tax.

Due to the complete or substantial absence of expense deductions, these three states' corporate taxes inherently tax many business purchases, including purchases of items that will qualify as "digital goods" and "digital services" under DGSTFA. Because there are no general "sale for resale" exemptions under such taxes, they will run afoul of the Act even though business purchases of digital goods and services will be treated no differently than business purchases of other items. There is no justification for giving favorable treatment to digital goods and services in these three states; if DGSTFA is to be enacted with the sale-for-resale provision retained, all general business taxes should be explicitly carved out of its application — just as state corporate income taxes already have been.

A Federal Court Forum and Federal Injunctions for Challenging State and Local Taxes under DGSTFA Are Unwarranted

The Tax Injunction Act, a federal law enacted in 1948, provides that federal courts "shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State." In practical terms, this means that challenges to state tax laws must be brought in state courts (with the ultimate right of appeal to the U.S. Supreme Court), even if they are based on claims that the law violates the U.S. Constitution or a federal statute.

Congress has enacted a number of laws that, like the proposed DGSTFA, regulate states' and localities' taxation of businesses and/or individuals. (One such law, the Internet Tax Freedom Act, already has been cited.) Among all those laws, only one, the so-called "4-R Act" governing state and local taxation of railroads, creates an exception to the Tax Injunction Act. It allows legal challenges, based upon its substantive provisions, to be brought in federal courts.

The 4-R Act was enacted after the railroad industry was able to document that states and localities were (arguably unintentionally), discriminating in their taxation of railroad property. As discussed in the companion report to this one, there has been no such showing of widespread state and local discrimination against sales of digital goods and services. Indeed, such discrimination already is barred by ITFA. Accordingly, there is no justification for including a nearly unprecedented exception to the Tax Injunction Act in DGSTFA.

By pursuing their remedies in federal court, taxpayers may obtain an injunction against the payment of the challenged tax while litigation is underway.¹⁸ Because states and localities must balance their budgets every year, the collection of currently-imposed taxes is critical — especially after a budget has been adopted and a fiscal year/biennium is underway. Allowing taxpayers to obtain injunctions against payment of a tax radically shifts the balance of power in the dispute toward the taxpayer, and puts great pressure on the state or locality to settle the case for partial payment of the tax rather than engage in lengthy litigation.

The Tax Injunction Act was enacted as an explicit acknowledgment that the federal government should not put states at such a disadvantage. But the DGSTFA reverses that approach. It also potentially clogs the federal courts with technical disputes over matters about which they have little expertise. Historically, taxpayers have been required to bring challenges to state and local taxes in state courts even when they are claiming that the tax infringes on fundamental rights granted by the

U.S. Constitution. They surely can be required to do the same when the challenge is based on the DGSTFA.

Inconsistencies with the Streamlined Sales and Use Tax Agreement Will Upend the Sales Tax Laws of Half the States

Slightly more than half the states that impose sales taxes have incorporated the provisions of the Streamlined Sales and Use Tax Agreement into their sales tax laws. The Agreement is the product of a decade-old cooperative business-state effort to harmonize many definitions and provisions of state sales tax laws in order to simplify tax compliance for retailers that must collect sales taxes in multiple states.¹⁹

The Streamlined Project has devoted a substantial amount of work to several aspects of state sales taxation covered by the Act — in particular, definitions and tax treatment of “digital goods,” and sourcing rules for “digital goods” and services generally. A number of corporations that are members of the “Download Fairness Coalition” organized to lobby for DGSTFA have been deeply involved in the Streamlined Project from its inception. But unfortunately, they are circumventing the Project as a forum in which to develop uniform state sales tax rules and supporting federal legislation that is inconsistent with the Streamlined Agreement in key ways. Most significantly, the Streamlined Agreement specifically excluded downloaded “canned” (pre-written) software from the definition of a “digital good” in order to allow states to continue treating it as “tangible personal property” — as many of them already do.²⁰ There are also significant differences between the Streamlined Agreement sourcing rules that determine which state has the right to tax electronically-delivered goods and services and the sourcing rules contained in the Act.²¹ The Agreement is also far more detailed in many areas affecting the taxation of digital goods and services than is the Act, such as in distinguishing between digital goods and video/audio streaming services.²²

As will be discussed in the next section of this report, the Act is filled with numerous undefined and ambiguous terms that will cause major headaches for taxpayers and tax administrators alike if it is enacted into law in its current form. Most of those problems would have been avoided if the businesses involved in the Coalition had brought their issues to the Streamlined Project for the same careful, good-faith discussion, negotiation, and development that the other provisions of the Agreement have received. If DGSTFA is enacted, the inconsistencies between its provisions and the Streamlined Agreement will substantially undo the progress in addressing the taxation of digital goods and services and compel every member of the Agreement to amend its laws once again to bring them into compliance with the Act.

Absence of a “Sunset” Date in the Act Is Problematic

The absence of a “sunset” date in DGSTFA is a major shortcoming. A sunset date, such as is contained in the Internet Tax Freedom Act, compels Congress to revisit the law regularly to determine if there is a continuing need for it and whether changes are warranted. Changes in federal laws regulating state and local taxing powers can be warranted because new issues arise as business and industry operations change, because unforeseen questions arise in how the law should be applied, because such laws can create inequities among different types of businesses, and because court decisions interpreting the law can preempt state and local tax practices in ways that the sponsors arguably did not intend. A relatively short sunset date — say, 3 to 4 years — is particularly

needed in this legislation because new digital goods and services are coming into the marketplace on what seems like an almost daily basis, and a one-size-fits-all approach may not be tenable over time.

A sunset date has a related, salutary effect on the application of such a law. As the previous discussion of the online hotel tax controversy makes clear, laws like DGSTFA constitute new weapons for businesses that object to states' and localities' taxes. Taxpayers will not hesitate to use them in these fights if there is the slightest bit of wording in the law that can bolster their case. As the history of litigation using the "4-R Act" makes clear, such aggressive litigation can result in court interpretations of these laws that are clearly inconsistent with their legislative history and the expressed intention of their sponsors.²³ A sunset date (which unfortunately was *not* included in the 4-R Act) helps to temper aggressive litigation. Businesses know that state and local representatives will have a guaranteed opportunity to come before Congress when the law comes up for renewal and make the case that the law is being applied in ways that the original sponsors did not intend. In sum, if DGSTFA is to be enacted, it should include a relatively short sunset date, such as the three years that was contained in the original version of the Internet Tax Freedom Act.

DGSTFA Could Prevent States and Localities from Taxing Phone Calls Made over the Internet

The Act says that "digital services" does not include "telecommunications," but it does not define the term. As a result, there is no way to know whether phone calls using "voice over Internet Protocol" (VOIP) technology are subject to the Act. The uncertainty is especially great with respect to VOIP services provided by companies like Skype or Vonage that provide software that allows a user to place calls over the public Internet but that own no physical telecommunications networks of their own. Those companies would have an especially strong claim that they are providing "digital services," not "telecommunications," because under federal telecommunications law their services are considered "information services" rather than "telecommunications services."

If any VOIP services are "digital services" under the bill, then states and localities could lose significant revenues from taxes levied on such services. For example, it would appear that taxing them at a higher rate than the general sales tax rate in the jurisdiction would be invalid under the definition of a discriminatory tax in the Act, even where conventional long distance phone calls are taxed at that higher rate (as they frequently are). In addition, any taxes imposed on such services as a result of administrative determinations that existing taxes on telecommunications apply to VOIP would be invalidated until the affected states/localities enact legislation subjecting them to taxation.

The Act Threatens Revenues from Sales of Tickets to Entertainment and Sporting Events

The Act defines a digital good as "any good or product that is delivered or transferred electronically. . ." This definition is so broad that it arguably encompasses an electronic ticket providing admission to a sporting or entertainment event or, more commonly, the ".pdf" version of such a ticket purchased online and then downloaded. If so, all provisions of the Act would govern such sales, even though the purchase is for admission to a physical place in the real world — not a digital good or service.

This could interfere with revenue from event admissions in a number of ways. In particular, the Act says that the sale of a digital good generally can only be taxed by the state and locality in which

the purchaser resides, but the tax for an admission ticket would normally be imposed by the jurisdiction in which the event is held. Thus, the bill's application to downloaded tickets could result in a substantial revenue loss for cities. States like New York, where a major city is near its border, also stand to lose revenue even as suburban jurisdictions could realize a corresponding gain. Because of the potential for substantial, and presumably unintended, revenue shifts among jurisdictions taxing event admissions, DGSTFA should be amended to make clear that it does not apply to such purchases.

Many Other Vague DGSTFA Provisions Are Likely to Lead to Substantial Litigation and Additional State and Local Government Revenue Losses

The preceding section described a number of key ways in which enactment of DGSTFA would be very likely to lead to significant revenue losses for state and local governments or cause significant disruption of sales tax administration. The issues discussed there, however, are by no means the only problematic features of the Act. It contains a number of key undefined terms and leaves many questions unanswered. These include — but are not limited to — the following:

- **Do all administrative interpretations of state tax law have to be upheld by courts to be valid under DGSTFA?** As discussed above, the bill includes a provision voiding taxes on digital goods and services that allegedly were imposed when tax administrators “construed” taxes on tangible personal property, telecommunications, internet access, and audio/video programming to include such goods and services. This section of the Act includes an exception to this provision for “any construction of a statute that was approved by a judicial interpretation...” But what if the tax administrators’ “construction” involves a simple interpretation of the plain wording of the state or local statute? Does such an interpretation have to be upheld by a court to be valid? Texas, for example, defines a “taxable item” as “tangible personal property and taxable services.” The very next sentence of the definition says that “[T]he sale or use of a taxable item in electronic form instead of on physical media does not alter the item’s tax status.” This definition is so crystal-clear that no one has ever challenged the taxability of a digital good in Texas. But because of the immediately-preceding reference to “tangible personal property,” it could be challenged as invalid unless a court upholds it. Is Texas’s taxation of digital goods voided by the Act or not? The fact that the Download Fairness Coalition, in lobbying for the bill, explicitly cites Texas as a state in which the taxation of digital goods results from administrative interpretation²⁴ suggests that the answer is yes.
- **Online intermediaries have two “customers,” not one.** As discussed above, the Act contains a set of “sourcing rules” that aim to attribute sales of digital goods and services for tax purposes to the location of the “customer’s tax address.” But in the case of online intermediaries or brokers like eBay or Amazon (with respect to independent retailers who sell on Amazon’s website), there are two “customers” — the seller of the merchandise and the buyer. Assuming the intermediary’s services are taxable (even if new legislation may be needed to ensure that), are they taxable at the seller’s location or the buyer’s location? The Act doesn’t say.

- **Do any taxes satisfy the “generally imposed” standard?** The Act says that a tax on a digital good/service will not be considered discriminatory if it is imposed at the same rate as another tax that is “generally imposed on or with respect to the sale of or use of tangible personal property or of similar services that are not provided electronically.” This appears intended to protect a tax on a digital/good service that is levied at the general sales tax rate in the jurisdiction. However, the Act goes on to say: “A tax shall not be considered ‘generally imposed’ if it is imposed only on specific services, specific industries or business segments, or specific types of property.” Every state and local general sales tax includes numerous exempt items, which means that all of them are imposed only on “specific services” and “specific types of property.” Thus, even general sales taxes may not qualify as “generally imposed.” All taxes on digital goods/services may therefore be discriminatory. Unless this language is narrowed substantially, any seller of a digital good or service that wants to avoid charging taxes would have a strong basis for that position by claiming the tax is discriminatory.
- **Why does a bill with detailed sourcing rules need a “multiple tax” prohibition?** The measure limits the taxation of digital goods/services to the state and locality in which the “customer’s tax address” is located and sets forth “sourcing” rules for determining that address. These are intended to ensure that only one state and local jurisdiction has the authority to tax the transaction. Why, then, is there a need for a separate prohibition on “multiple” taxes in the Act?
- **Is every service whose final product is delivered electronically a digital service?** Numerous services are embodied in documents that can be transferred electronically. Wedding photographers produce proofs, architects produce blueprints, lawyers draft contracts and wills, financial planners draft investment plans, and recording studios produce final mix “tapes.” Do all of these services become digital goods or services whose taxability is governed by DGSTFA if their final product is transferred electronically? Under the current wording of the bill, they arguably do. What is the need or justification for that?
- **When is Internet radio a digital service?** The Act says that digital goods and services do not include audio programming, defined as “programming . . . generally considered comparable to programming provided by, a radio . . . broadcast station.” The Rhapsody music streaming service allows subscribers to create playlists of music they wish to have streamed to them and to listen to music streams selected by the service, comparable to an Internet radio station.²⁵ So is Rhapsody a digital service or not? Or is it both, which means that the company can take advantage of the “unbundling” provision of ITFA and charge tax on only a portion of the monthly fee?
- **Is video/audio streaming a digital good or a digital service?** Are music and video streaming services like Rhapsody and Hulu Plus digital goods or digital services? DGSTFA proponents seem unable to answer the question. The website of the Download Fairness Coalition, which is lobbying for the bill, lists them as both.²⁶ Yet they are intended to be mutually exclusive categories. (The Act specifically provides that it is illegal for a state to administratively interpret a digital service to be taxable because a similar digital good is taxable.) The bill states that a sales “transaction involving a digital good shall be characterized solely as a transaction involving the provision of a digital service unless the transaction results in the transfer or delivery of a complete copy, with the right to use permanently or for a specified period, of the digital good that is the subject of the transaction.” One-time use and a weekly or

monthly subscription fee both seem to satisfy the “specified period” criterion. So whether a video/audio stream is a digital good or a digital service seems to hinge on whether a “complete copy” has been transferred. Streaming generally does not result in the transfer of a complete copy of the movie or song; they are transmitted in real time. But what if, like Rhapsody, the service caches frequently listened-to songs on the user’s hard-drive, but the listener must be connected to the company’s Internet site to access the songs? Or what if, for an extra monthly fee, the listener can both stream music to her computer and download complete copies to an MP3 player — as Rhapsody also allows? Is Rhapsody both a digital good and a digital service?

- **What’s the difference between a digital service and “providing” a digital service?** The Act states that “If the charge for a . . . digital service is aggregated with, and not separately stated from, a charge for . . . providing the digital service, to the customer,” then the seller may treat the two as a single transaction or two separate transactions. Upon what basis can a tax administrator make a distinction between a “digital service” and “providing a digital service to the customer”?
- **Are “unbundled” digital goods and services tax-exempt?** As discussed above, DGSTFA provides that “if charges for digital goods or digital services are aggregated with, and not separately stated from, charges for other goods or services, then the charges for digital goods or digital services may be taxed for purposes of this Act at the same rate and on the same basis as charges for other goods or services unless the seller can reasonably identify the charges for the digital goods or digital services from its books and records kept in the regular course of business.” The Act is silent about the tax treatment of digital goods and services if the seller does elect to unbundle them. Does unbundling render them tax-exempt? Sellers can make this case based on the standard rule that no provision of a statute may be assumed to be repetitive of other provisions.
- **Does the Act preempt all state rules associated with sale-for-resale exemptions?** As discussed above, the Act requires that states grant a broad sale-for-resale exemption for purchases of digital goods and services by a business that sells digital goods and services. Does this provision preempt all state laws establishing conditions for claiming such exemptions, such as the requirement that a purchaser file a signed certificate attesting to its eligibility for the exemption? Even if the certificate requirement were not preempted, if a dispute arose over whether it had been properly complied with, would DGSTFA allow the taxpayer to pursue it in federal court rather than state court?
- **Does the “good faith reliance” provision of the Act apply to all sales and sellers of *non-digital* goods and services as well?** The Act defines a “seller” as a “person making sales of tangible personal property, digital goods, digital services, or other services,” i.e., *anyone* who sells *anything*. Since the legislation is supposed to govern the sales of digital goods and digital services only, it is worrisome that the definition of “seller” includes sellers of “tangible personal property” and “other services,” i.e., *non-digital* services. The bill further states that a “seller that relies in good faith on information provided by a customer to determine the customer’s tax address or addresses shall not be held liable for any additional tax based on a different determination of the customer’s tax address.” Again, nothing in the second statement restricts its application to sellers of digital goods/services. (The definition of “customer’s tax address” only describes how a customer’s tax address is to be determined when the item being sold is a digital good or digital service, but it does not say that the term is only applicable to such sales.)

Read literally, therefore, the second restriction applies to all sales in the U.S. economy by any seller of anything; furthermore, because of the Act's exception to the Tax Injunction Act, disputes over its application can be brought in federal court. If proponents of the Act intend for this provision to apply across the board and not be limited to digital goods/services, they should say so forthrightly and not try to slip one past state and local government representatives. If not, they should have no objections to dropping references to "tangible personal property" and "other services" from the Act's definition of "seller."

- **Which online intermediaries are excluded from the Act's definition of a "seller"?** The bill excludes from the definition of a "seller" every "person that provides, on behalf of another person, order taking, order fulfillment, billing, or electronic delivery or transfer service with respect to the sale of a digital good or digital service." It is ambiguous whether the modifier "with respect to the sale of a digital good or digital service" applies only to the last function in the list, i.e., a "transfer service," or to all of the other listed activities. If it is intended to apply to all of them, the sentence needs to be reworded to say that the term "seller does not include a person that provides, on behalf of another person and with respect to the sale of a digital good or a digital service, order taking, order fulfillment, billing, or electronic delivery or transfer service."

These are just some of the critical questions left unanswered by the current wording of the bill. The Federation of [state] Tax Administrators has identified many more.²⁷ The fact that so many potential problems can be identified is compelling evidence that considerably more work needs to be done on the legislation. A good forum for such work would be the Streamlined Sales Tax Project, which represents the major state and business stakeholders in sales tax policy and which has years of experience in working through many of these issues.

Conclusion

The principal objectives of the Digital Goods and Services Tax Fairness Act appear to be to prevent discriminatory and multiple taxation of digital goods and services, to roll back taxes on these products that allegedly have been imposed by tax administrators without legislative authority, and to ensure that sellers of these products are able to claim liberal sale-for-resale exemptions. In addition, industry representatives have privately expressed concern that they could face class-action lawsuits. To avoid such litigation, they seek a clear federal law specifying which state and locality has the right to tax purchases of these products as well as mandating explicit state legislation imposing the tax.

The sponsors and other proponents of the Act have yet to present any significant evidence that federal legislation is needed. As noted above, the Internet Tax Freedom Act has barred multiple and discriminatory taxes on digital goods and services since 1998. The single largest seller of digital goods, Apple Computer, for several years, has been charging sales tax on iTunes music and "apps" for its iPhone in numerous states, based on the billing address of the buyer.²⁸ No one has presented evidence that it — or any other company — has been sued for improperly collecting these taxes. Industry representatives have not presented evidence that sale-for-resale exemptions are being denied for purchases of digital goods and services used in the subsequent production of other digital goods and services. A few state courts have ruled in cases challenging administrative determinations that certain digital goods/services are subject to sales taxes. But where is the evidence that these

decisions were so ill-considered that federal legislation is warranted to retroactively strike down every administrative ruling on taxation of digital goods and services? There is none.

On the other hand, this report *has* presented compelling evidence that DGSTFA could adversely affect the collection of state and local taxes on both digital and non-digital goods and services, force states that have implemented the Streamlined Sales Tax Agreement to revamp their laws, and clog the federal court system with litigation involving issues that it is ill-equipped to adjudicate. It would also create great uncertainty because of its many undefined or ambiguously-defined terms, which could lead to additional litigation — potentially including class-action lawsuits against companies selling digital goods and services!²⁹

In light of the lack of evidence of serious problems caused by the absence of federal legislation in this area and the potential harms that this report has identified, the Act should not be rushed into law in its current form. Most state legislatures have finished their work for the year, and most state bills proposing to extend sales taxes to digital goods and services in recent years have not been enacted. There is time to get the substance right.

There is also time to get the process right. The Streamlined Sales Tax Project has developed considerable expertise in wrestling with very complex definitional, sourcing, and administrative issues arising from the birth of new industries and businesses. It also has the know-how to reconcile divergent state sales tax rules. It is *the* principal mechanism by which business and states work together to achieve greater interstate uniformity in sales tax policy. For now, at least, Congress should tell businesses supporting DGSTFA that the Streamlined Project is the appropriate forum in which to do the lion's share of any work on refining the Agreement's sourcing rules for digital goods and services, debating the need for new rules (for example, governing the tax obligations — or lack thereof — of online intermediaries), and developing any necessary new definitions. If, following this process, industry is dissatisfied with state *implementation* of the changes, then it is free to seek federal legislation to improve the process.

Notes

¹ See: 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>.

² More than one locality taxing digital goods/services — such as a city and a county — could conceivably encompass a given customer tax address. For the sake of readability, this report will refer to a single locality.

³ For example, Texas Administrative Code, Subchapter O, Rule 3.330, “Data processing services,” provides: “(1) To the extent a data processing service is used to support a separate, identifiable segment of a customer’s business (other than general administration or operation of the business) the service is presumed to be used at the location where that part of the business is conducted. (2) If that part of the business is conducted at locations both within and outside the state, the service is not taxable to the extent it is used outside Texas. A multi-state customer may use any reasonable method for allocation which is supported by business records. (3) A multi-state customer purchasing data processing services for the benefit of both in-state and out-of-state locations is responsible for issuing to the data processing service provider an exemption certificate asserting a multi-state benefit, and for reporting and paying the tax on that portion of the data processing charge which will benefit the Texas location.” Section 8202 of the Revised Code of Washington [State] provides for similar treatment of digital goods, “digital automated services,” computer software, and other services purchased by businesses for “multiple points of use.”

⁴ This is the primary sourcing rule for most business purchases of digital goods and services. It is superseded by a slightly different rule covering digital goods and services sold and delivered by mobile phone providers. It is also nominally superseded by a rule covering sales of digital goods and services received by the purchaser at the premises of the seller. It is hard to conceive of realistic circumstances in which that would occur, however, since, by definition, digital goods and services are transferred electronically and *not* on physical media like DVDs.

⁵ If the seller of a digital good/service is in a different state than the purchaser, but has some physical presence (property and/or employees) in the state of the purchaser, then the tax it will be charging the customer technically is a use tax rather than a sales tax. However, there is nothing different about the seller’s role in charging one tax versus the other. If the seller does not charge the use tax because it does not have a physical presence in the state of the purchaser, then the purchaser is still legally obligated to self-remit the use tax (if one is imposed).

The Act says that “Taxes on or with respect to the sale of digital goods or digital services may be imposed only by the State and local jurisdictions whose territorial limits encompass the customer’s tax address.” Because that sentence makes no reference to “use” of a digital good or service, proponents of DGSTFA might argue that the sourcing rules only apply to sales taxes and not use taxes, and therefore don’t preclude *any* state in which a digital good or service is used from trying to collect use taxes directly from the purchaser. But that would mean conceding that the sourcing rules do not apply to use taxes that sellers are required to collect, either — a proposition that proponents of the legislation undoubtedly do not intend. Accordingly, taxes, “with respect to the sale of digital goods or digital services,” are undoubtedly intended to encompass use taxes, meaning that the entire sourcing provision applies to such taxes. Accordingly (and as explained in the body of the report), if a purchaser tells a seller that it is using a digital good or service in one state where it clearly has a business location, the Act effectively precludes other states in which the product is also being used from imposing a use tax on even a portion of the purchase price.

⁶ There are no state or local sales taxes in Delaware, Montana, New Hampshire, or Oregon. There is no state sales tax in Alaska, although some local governments there do levy sales taxes.

⁷ See pp. 3-5 of the source cited in Note 1.

⁸ Amazon CEO Jeff Bezos recently disclosed that 30 percent of the items sold on Amazon’s site are third-party sales. See: Laura Hazard Owen, “Amazon’s Bezos: Mobile Shopping Has Great Room for Improvement,” June 7, 2011, <http://paidcontent.org/article/419-amazons-bezos-mobile-shopping-has-great-room-for-improvement-/>.

⁹ See: www.amazonservices.com/content/sell-on-amazon.htm.

¹⁰ There is considerable circumstantial evidence that sales tax compliance by many of the smaller third-party sellers on Amazon and eBay is poor, even when they are selling taxable items to residents of their home states and are therefore

clearly legally obligated to charge the tax. Nonetheless, there is some amount of compliance taking place, if for no other reason than Amazon does charge tax on behalf of some of its third party sellers. Accordingly, some revenue will be lost if the enactment of DGSTFA effectively allows sellers to start collecting and paying tax on the wholesale price rather than the retail price of their merchandise.

¹¹ According to its proponents, the Act is only intended to regulate the taxation of digital goods and services. Thus, there is absolutely no justification for the inclusion in the definition of “seller” the terms “tangible personal property” and “other services.” The inclusion of those terms is worrisome and could result in much wider unintended consequences from the enactment of DGSTFA than those being discussed in this report. If proponents believe those terms are needed here, then they need to explain in detail what problems they foresee if they are removed.

¹² In testimony in support of DGSTFA, Robert D. Atkinson of the Information Technology and Innovation Foundation stated that digital music tracks worth \$1.5 billion had been sold in 2010, that mobile device “apps” worth \$1.6 billion had been sold in the same year, and that sales of digital books surpassed \$1.0 billion and are expected to triple by 2015. His testimony is available at judiciary.house.gov/hearings/pdf/Atkinson05232011.pdf.

¹³ The scenario being described in this section is not far-fetched. Indeed, Amazon has done something very similar to avoid charging sales tax in jurisdictions in which it has located its warehouses. It has formed a separate subsidiary to own those warehouses and claimed that it does not have to charge sales tax in the states in which the warehouses are located because the nominal seller of its merchandise is a different subsidiary that does not have a physical presence in those states. See: Michael Mazerov, “Amazon’s Arguments Against Collecting Sales Taxes Do Not Withstand Scrutiny,” Center on Budget and Policy Priorities, Revised November 29, 2010, pp. 6-7; www.cbpp.org/11-16-09sfp.pdf.

¹⁴ See: Michael Mazerov, “Banning Taxation of Online Hotel Reservations is Unwarranted and Could Cost States and Localities Billions of Dollars,” Center on Budget and Policy Priorities, Revised September 18, 2009; www.cbpp.org/9-2-09sfp.pdf. See also: Michael Mazerov, “State and Local Governments Should Close Online Hotel Tax Loophole and Collect Taxes Owed,” Center on Budget and Policy Priorities, April 11, 2011; www.cbpp.org/files/4-12-11sfp.pdf.

¹⁵ Such disputes are all the more likely because the language refers to “charges” rather than “costs.” There are no separate “charges” for a bundled digital good or service by definition; the “charge” is whatever the seller says it would hypothetically charge if it were separately charging for the item. The company’s cost of providing the digital good or service, in contrast, could be determined with reasonable objectivity, although there would still be disputes about the appropriate profit margin to apply to these costs.

¹⁶ Several leading proponents of DGSTFA are mobile telephone companies that have been involved for years in an effort to roll back what they view as excessive and discriminatory tax rates that apply to their services. Some of these companies may be selling, or may be contemplating selling, digital goods and services in a bundle with basic phone service. (For example, they may be selling a package that allows cell phone service subscribers to download a certain number of smartphone apps per month or to include a video streaming service.) Given their position that the tax rate on cell phone service is discriminatory in many jurisdictions, it is understandable that they would want to carve out some amount of the total charge attributable to the bundled digital goods and services that would not be subject to such a “discriminatory” rate. That would especially be true in jurisdictions where the digital goods and services would be completely exempt if sold separately. Nonetheless, if otherwise tax-exempt non-digital goods and services are taxable at the general sales tax rate in the jurisdiction when sold in a bundle with taxable goods, otherwise tax-exempt digital goods and services should be taxable as well when bundled with taxable items.

¹⁷ Amazon’s “Participation Agreement” for its “Marketplace” sellers states: “You agree that it is the Seller’s responsibility to determine whether Seller Taxes apply to the transactions and to collect, report, and remit the correct seller taxes to the appropriate tax authority. You also agree that Amazon is not obligated to determine whether Seller Taxes apply and is not responsible to collect, report, or remit any sales, use, or similar taxes arising from any transaction.” Available at <http://www.amazon.com/gp/help/customer/display.html?nodeId=1161302>.

¹⁸ In response to objections about DGSTFA’s exception to the Tax Injunction Act, proponents have argued that the Act does not require that challenges based upon it be brought in federal court but merely authorizes concurrent federal court jurisdiction. This is a disingenuous argument. Leaving aside the fact that corporations routinely complain that their tax challenges do not get a fair hearing in state courts whose personnel are paid with state tax revenues, most states require

the payment of challenged taxes while litigation is proceeding. An injunction against payment is usually only available when the case is brought in federal court, which is why DGSTFA challenges will inevitably be brought there if the Act is enacted in its current form.

¹⁹ The Streamlined Sales and Use Tax Agreement is available at <http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA%20As%20Amended%2005-19-11.pdf>

²⁰ See Section 332A of the Agreement and its definition of “tangible personal property.”

²¹ See, for example, Section 310.A.5. and Section 311.C. of the Agreement.

²² See Section 332D of the Agreement.

²³ See: Michael Mazerov, “The ‘4-R’ Act: A Cautionary Tale for the Proposed ‘Internet Tax Freedom Act,’” Center on Budget and Policy Priorities, April 24, 1998. Available from the author.

²⁴ See the map on the Coalition’s homepage at www.downloadfairness.com.

²⁵ The author of this report is a long-time Rhapsody subscriber, which is why it is used as an example several times.

²⁶ See the answer to the first question on the “Tax Facts” document on the Download Fairness Coalition’s website at www.downloadfairness.com/tax-facts/. “Streaming of a movie or video game” is provided as an example of both a digital good and a digital service.

²⁷ Letter from Martin Morris, Federation of Tax Administrators, to Representative Howard Coble, dated May 31, 2011. Copy available from the author of this report.

²⁸ The “Terms and Conditions” document for Apple’s iTunes Store states “Your total price will include the price of the product plus any applicable sales tax; such sales tax is based on the bill-to address and the sales tax rate in effect at the time you download the product. We will charge tax only in states where digital goods are taxable.” See: www.apple.com/legal/itunes/us/terms.html.

²⁹ For example, as discussed above, the Act authorizes businesses that sell, for one price, a package of taxable goods/services and tax-exempt digital goods/services to “unbundle” them if they can “reasonably” separate the two charges and charge tax only on the taxable item. This provision could conceivably open the door to consumer class action lawsuits against a company on the grounds that it assigned too little of the combined charge to the tax-exempt items and therefore overcharged tax. This is not a hypothetical. AT&T was just forced to pay almost \$1 billion to its customers to settle a class-action suit alleging that it had improperly charged tax on data services that were tax exempt under the Internet Tax Freedom Act. AT&T was a major supporter of the enactment of ITFA. Had the law never been enacted, the company would not have had to pay this money out of its own pocket while trying to collect refunds from state and local governments.