

# Tax Treatment of Digital Goods and Services: Overview and Cross-State Comparison

Arizona State Legislature

Ad Hoc Joint Committee on the Tax Treatment of Digital  
Goods and Services

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# Taxation in the Digital Marketplace

- Digital economy poses challenges for taxpayers and tax professionals alike.
- Many state laws/regulations vague or silent on tax treatment of digital goods and services.
- Which tax laws/rules apply and which should be updated?
  - Legal clarification needed.

# The Digital Economy: A Quick Overview

- Digital economy in development since advent of modern electronics.
- Rapid growth in Internet use (esp. e-commerce) helped accelerate development.
- Digital economy now integral part of people's daily lives (e.g., Uber, Amazon, etc.).

# Digital Goods vs. Digital Services

## Digital Goods

- Stored, delivered and used in electronic format.
- Shipped to consumer via e-mail/Internet download.
  - Examples: E-books, music files and software.

## Digital Services

- Generally delivered via Internet or electronic network.
- Automated supply with minimal human intervention.
  - Examples: Online gaming, website hosting and subscriptions.

# State Tax Considerations

- More goods and services go digital. → Possible erosion in physical market sales. → State tax base impacted. → States broaden tax base to mitigate revenue loss (if they choose).
  - Example: In 2009, Wisconsin amended sales tax law to apply to sale, use and storage of certain digital goods.
- Broad tax treatment vs. selective tax treatment
  - Example: Under Wisconsin law, purchase of blank electronic legal forms is sales tax exempt while purchase of digital books is not.
- Digital goods and services – a growing segment of economy.
  - To tax or not to tax?
  - Question of public policy.

# Quill Corp. v North Dakota (1992)

- **Quill Corporation (Quill)**

- ❑ Illinois-based office supply and mail-order company.
- ❑ Business solicited through catalogs, flyers, advertisements and telemarketing.
- ❑ No physical presence in North Dakota.
- ❑ Products delivered to North Dakota customers by mail or common carrier from out-of-state locations.

- **U.S. Supreme Court**

- ❑ North Dakota cannot constitutionally require Quill to collect use taxes on sales made to in-state residents based on economic, versus physical, presence in the state.
- ❑ Requiring Quill to collect use taxes, without physical presence, places unconstitutional burden on interstate commerce, violating Commerce Clause.



# Legal Considerations

- *Quill Corp. v North Dakota (1992)*
  - ❑ Limits state ability to collect sales/use tax on e-commerce sales by remote vendors.
- Substantial nexus (i.e., physical presence) within state required for remote vendor to collect sales/use tax.
  - ❑ Absent nexus, state ability to realize revenues from e-commerce sales growth restricted.
  - ❑ State must either convince remote vendor to collect tax voluntarily or establish way for vendor to have physical presence.
  - ❑ Continuing issue – amount and degree of physical presence needed for nexus.
- Attempts by some states to extend sales tax nexus through alternative means (e.g., click-through or affiliate nexus laws).
  - ❑ Example: New York (2008)
  - ❑ Affiliation of individuals/organizations in New York with a remote vendor constitutes requisite physical presence in the state, subjecting vendor to tax collection requirement.
  - ❑ Law initially challenged by some vendors (e.g., Amazon.com and Overstock.com).
  - ❑ Vendors lost on appeal - *Overstock.com, Inc./Amazon.com, LLC v New York State Dept. of Taxation and Finance (2013)*

# Rationale for Affiliate Nexus Laws

- **Presumption:** Relationship between vendor and resident, established through solicitation of sales, sufficient to create substantial nexus.
- **One aim of affiliate nexus:** Improve state sales/use tax collection.
  - ❑ NCSL estimated \$23.3 billion in lost state revenue for 2012 (inability to tax online/catalog purchases).
- **Nexus standard established by *Quill* requires physical presence.**
  - ❑ Remote vendor not required to collect sales tax.
  - ❑ However, state residents purchasing from remote vendor may owe use tax on purchases.
- **Self-assessment/reporting of use tax by purchasers problematic.**
  - ❑ Purchaser may not be aware of tax liability or choose not to report.
  - ❑ States prefer collecting tax from vendors, versus purchasers – easier to track.



# Equity in Tax Treatment

- Additional aim of affiliate nexus: Ensure equity in tax collection among vendors selling to state residents.
- Brick-and-mortar vendors allege competitive disadvantage due to state sales tax collection requirement.
  - ❑ Many remote vendors exempt from requirement.
- New York State Court of Appeals (2013 *Overtsock.com* court opinion): “[I]f a vendor is paying New York residents to actively solicit business in [the] state, there is no reason why that vendor should not shoulder the appropriate tax burden.”
- Affiliate nexus law application limited to remote vendors with in-state affiliate relationships.
  - ❑ May not apply to other remote vendors.

# Revisiting *Quill*

- Given changes in technology, some suggest *Quill* physical presence requirement no longer practical.
- “The world has changed dramatically in the last two decades, and it may be that the physical presence test is outdated. An entity may now have a profound impact upon a foreign jurisdiction solely through its virtual projection via the Internet.” (Chief Judge Jonathan Lippman, New York State Court of Appeals, 2013)
- “Today buyers have almost instant access to most retailers via cell phones, tablets, and laptops. As a result, a business may be present in a state in a meaningful way without that presence being physical in the traditional sense of the term. Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court’s holding in *Quill*.” (Justice Anthony Kennedy, U.S. Supreme Court, 2015).

# Federal Action

- **Current Law - Internet Tax Freedom Act (IFTA) (1998)**
  - ❑ Bars imposition of new taxes on online services or internet access.
  - ❑ Does not restrict imposition of sales/use tax on electronic commerce.
- **The Streamlined Sales and Use Tax Act (SSUTA) (2003)**
  - ❑ Requires remote sellers to collect and remit sales and use tax of state and local jurisdictions.
  - ❑ Aims to provide state uniformity in sales and use tax law.
  - ❑ Applies only to member states.
    - ❑ The SSUTA did not pass Congress, but was later adopted as an Agreement between a number of states.

# Federal Action (cont.)

## *Proposed Legislation*

- **Marketplace Fairness Act / Remote Transactions Parity Act**
  - ❑ Seek to establish destination based system for collecting taxes for sales made in other SSUTA member states.
  - ❑ Differ in some ways including small business exemptions, and audits on remote sellers.
- **Digital Goods and Services Tax Fairness Act (Proposed in 2015, awaiting reintroduction)**
  - ❑ Restricts taxation of digital goods to an encompassing state or local jurisdiction of a customer's tax address.
  - ❑ Prohibits multiple and discriminatory taxation of digital goods.

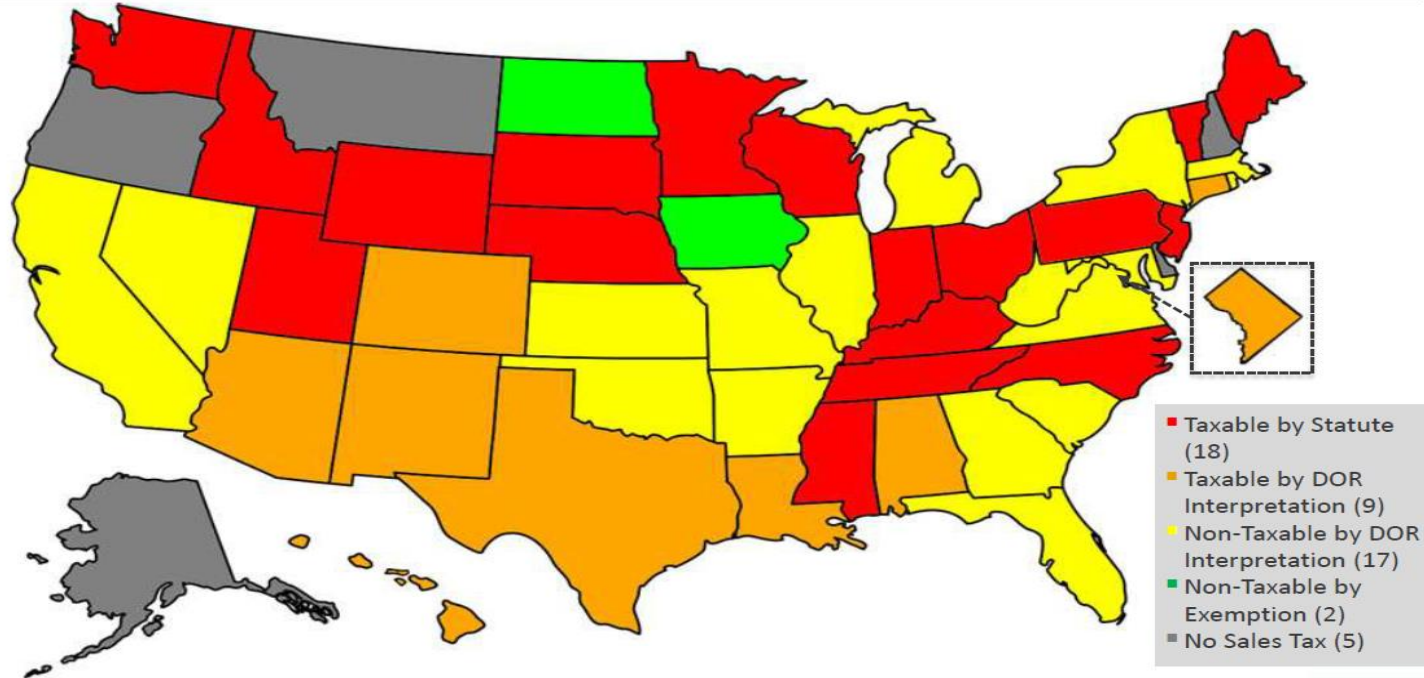
# State Sales and Use Taxes

- Generally, digital goods and services taxed as follows:
  - ❑ State sales tax on in-state purchases.
  - ❑ State use tax on out-of-state purchases.
- 45 states + D.C. levy sales/use tax on various products and services
- New Hampshire, Oregon, Montana, Alaska and Delaware
  - ❑ No sales/use tax at state level.



# State Tax Treatment of Digital Products

## Taxability of Digital Products



# Taxable By Statute – 18 States

- Example- Washington
  - Levies state sales tax on *digital goods, digital codes* and *digital automated services*.
  - Sales tax also applies to television and radio subscription services.
  - Definitions specifically exempt internet access, computer software, payment processing services, telecommunications and others.



# Non-Taxable By Statute – 2 States

- Example – North Dakota
- Statute includes a specific sales tax exemption for digital products.
- *“57-39.2-04. Exemptions. There are specifically exempted from the provisions of this chapter and from computation of the amount of tax imposed by it the following: ...54. Gross receipts from the sale of items delivered electronically, including specified digital products.”*
- Statute also provides a definition for “specified digital products,” which includes “digital audio-visual works, digital audio works and digital books.”





# Taxable By Department of Revenue Interpretation – 9 States

- Example – New Mexico
- New Mexico does not provide definitions for any digital goods or services.
- The New Mexico Taxation and Revenue Department interprets the statutes to include digital goods and services under the state gross receipts tax.



# Non-Taxable By Department of Revenue Interpretation – 17 States

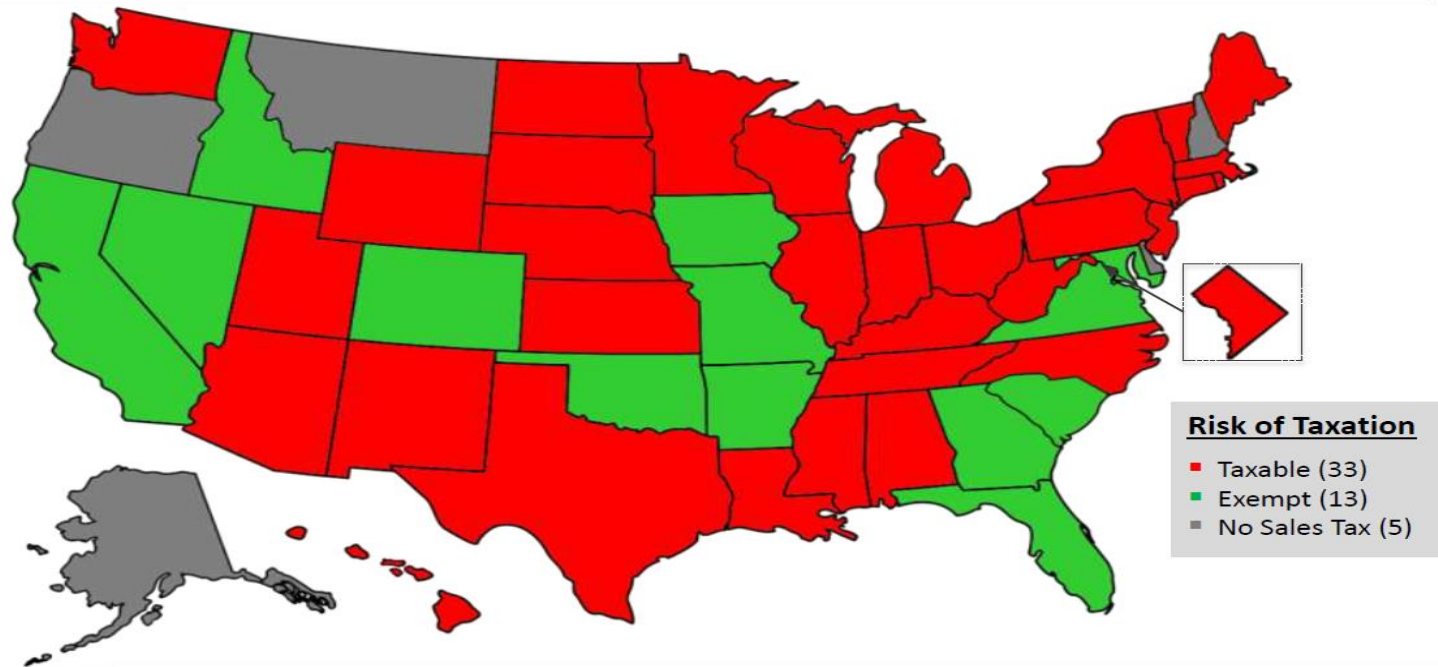
- Example – California
- Taxation of digital goods and services are not addressed in statute.
- The Board of Equalization does not view digital goods or services as tangible property and therefore does not tax them.
- If a physical form of an electronic device or storage medium is sold, then sales tax does apply.



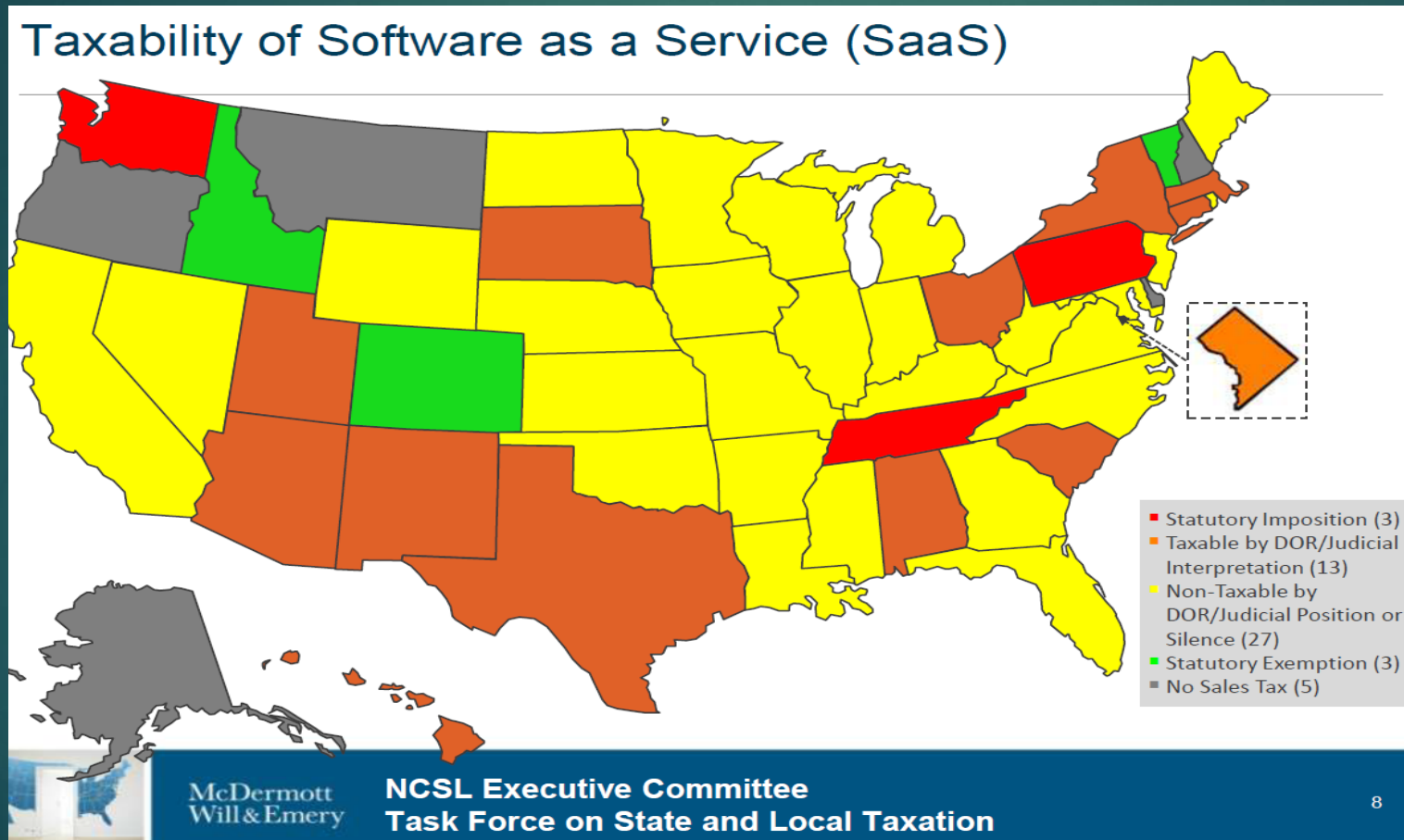


# State Tax Treatment of Prewritten Software Delivered Electronically

## Taxability of Prewritten Software Delivered Electronically



# State Tax Treatment of Software Delivered as a Service



# Issues at the Local Level

- **Chicago – Levies 9% amusement tax**
  - ❑ 2015: Amusement Tax Ruling #5 expanded tax assessment to include online amusements.
  - ❑ Decision has been brought before Cook County Circuit Court on grounds that it violates the IFTA.
- **California – Cities have sought to expand Utility Users Tax (UUT) to apply to Over-the-Top (OTT) services.**
  - ❑ Temporary ban on local impositions on OTT services introduced in Legislature; held in committee.
  - ❑ Interim study committee is forthcoming.

# Arizona's Tax Treatment of Digital Goods and Services

- No explicit statutory definition of digital goods or services for transaction privilege tax (TPT) and use tax purposes.
  - Regulatory guidance with respect to vendor tax liability and nexus provided by Arizona Department of Revenue (DOR).
- Digital goods and services treated as tangible personal property, defined as personal property which may be seen, weighed, measured, felt or touched or is in any other manner perceptible to the senses (A.R.S. § 42-5001(17)).
  - All sales of tangible personal property subject to TPT under the retail classification, unless specifically exempted or excluded by statute.
- DOR Transaction Privilege Tax Ruling (TPR 16-3):
  - Business operating online marketplace and making online sales on behalf of third-party merchants considered retailer conducting taxable sales.
  - Gross receipts derived from sales of tangible personal property to Arizona purchasers by marketplace business subject to retail TPT, provided business has nexus.

# Questions?

