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Digital Downloads Should Be Protected from Discriminatory and Duplicate Taxes

by

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Explosive growth in the purchase and delivery of digital goods and services through the Internet cloud is a sure source of economic vitality and optimism for our nation. With the deployment of next-generation broadband and wireless broadband networks, businesses and consumers increasingly are taking to digitally-downloadable products. For instance, Apple's App Store surpassed 100 million digital app downloads in 2011 alone, with a running total of over 18 billion downloaded apps. And on May 17 Amazon announced that its sales of downloaded e-books surpassed sales of print books.

As the economy grows progressively more digital it becomes all the more important that federal and state tax policies align with the new realities of Internet e-commerce. The market for digital goods and services must be allowed to advance without being stifled by uncertain tax laws or subjected to multiplying tax burdens.

Legislation now pending in Congress would create a sensible framework for state taxation of interstate sales of digital goods and services. And it would do so without itself imposing any new taxes or mandating tax or no-tax decisions by individual states.

S. 971 and H.R. 1860 – the "Digital Goods and Services Tax Fairness Act" – would set sourcing rules for determining when states have jurisdiction to tax retailers or taxpaying

consumers. This would prohibit states from imposing multiple taxes on the same transaction. The legislation would also require states that decide to tax such transactions to clearly make that determination through state legislation. And finally, the legislation would prohibit states from imposing discriminatory taxes on the sale or use of digital goods or services – that is, it would prohibit the sale or use of digital goods or services from being specially taxed or taxed at a rate higher than similar goods or services that are not provided electronically.

With increasing frequency, e-commerce transactions transcend state geographical boundaries. Buyers of digital goods and services may be located in one state, sellers based in a different state, and servers for delivering or providing the platform for goods and services located in yet another state. But as described in a December 2011 article in *Weekly State Tax Report*, no uniform set of sourcing rules currently exist for determining which state or states should have jurisdiction to tax such interstate digital goods and services transactions. So nothing in current law prohibits multiple states from taxing the same online interstate transaction for digital goods and services.

As the article explains, state legislatures have generally declined to address whether or how to tax digital goods and services. Such decisions are often left to state tax departments. State tax officials typically determine such issues through administrative regulations, letter rulings, or individual audits.

Uncertainty in tax laws and enforcement can pose serious dilemmas for businesses, and have a chilling effect on commercial enterprise. When state tax departments decide that businesses failed to collect taxes on transactions, claims for back taxes and penalties quickly follow. And when businesses facing uncertainty decide to collect taxes from consumers that state tax officials later determine to be unnecessary, consumer class-action lawsuits with double or treble damage awards and attorney fees can result.

Large e-commerce businesses might have in-house tax departments or hire expert tax attorneys to address uncertainties over the taxability of digital goods or services they provide in this state or that. But as a result, the time and money of innovative enterprises are diverted to navigating state tax administrative minefields. Clear sourcing rules could help e-commerce businesses comply with the law without unnecessary hassles so they can devote more attention to innovating and competing in the market. And what about smaller business and emerging entrepreneurs creating digital goods and offering new service solutions via the Internet? Typically, they cannot so easily cope with the costs of ambiguous state tax laws and bureaucratic enforcement processes.

State tax agencies, for their part, may be faced with tax jurisdictional and classification questions regarding digital goods and services without any guidance from their legislatures. In such circumstances, it would hardly be unexpected for state tax officials to seek guidance from existing state tax laws designed for the pre-digital world. But reliance on last-century taxing schemes for devising tax policy for digital goods and services can lead to dubious administrative determinations.

With federal and state tax policy toward digital goods and services so fragmented and uncertain, it is difficult to ascertain the administrative and economic dislocation costs created. But as Internet cloud e-commerce grows, with more consumers and businesses increasingly purchasing Software as a Service (SaaS) or Software as a Platform (SaaP) options and downloading apps from businesses and servers located elsewhere in the country, the uncertainties and costs are likely to grow. This growth will also invite outright clashes between state taxing jurisdictions, with no sourcing rules in place to set clear boundaries.

Under Article I, Section 8 of the U.S. Constitution, Congress is responsible for regulating interstate commerce. Also, under Section 5 of the 14th Amendment, Congress is empowered to prohibit state action that violates equal protection, including discriminatory or arbitrary state taxes. The Constitution therefore entrusts Congress with a critical role in refereeing the tax boundaries of states. States may not be desirous of seeing the outer reaches of their taxing authority limited. But states should want to avoid having their respective taxing authority and economies unduly interfered with by other states exercising tax authority in an extra-territorial manner. Targeted congressional action can actually protect states and their citizens from being subjected to out-of-state taxation or multiple taxation.

One important way that Congress carries out its constitutional duties regarding interstate commerce is through the establishment of sourcing rules for determining when states have tax jurisdiction when goods and services are sold across state lines. State tax jurisdiction over wireless voice services, for instance, are already governed by a framework that Congress created in the Mobile Telephone Sourcing Act (2000). A similar approach by Congress to state taxation of digital goods and services is now called for.

The Digital Goods and Services Tax Fairness Act would establish a reasonable and responsible tax policy toward interstate e-commerce in digital goods and services. Its sourcing provisions would clarify which state has the right to tax, helping prevent repeated taxation of the same digital goods or services transactions. Jurisdiction would generally belong to states where the consumer resides. And by limiting tax imposition and collection obligations to retail buyers and sellers, the legislation prohibits "pyramiding" – the repeated taxation of inputs that ultimately reach the consumer as a digital good or service output.

The legislation would also prevent discriminatory state taxing of digital goods and services. For instance, states would be prohibited from singling out digital goods and services or business segments offering such goods or services for specially imposed tax burdens. States would likewise be prohibited from subjecting digital goods and services to higher telecom or utility tax rates when the non-digital equivalent to such goods and services are taxed at a lower state sales tax rate.

In this respect, S. 971 and H.R. 1860 track non-discriminatory provisions contained in other congressional statutes. The Railroad Revitalization and Regulatory Reform Act prohibits discriminatory state taxation in shipping. Decisions by Supreme Court have taken that Act's non-discriminatory provisions seriously in decisions that could provide guidance for future court cases involving discriminatory taxes on digital goods and services. Likewise, the Internet Tax Freedom Act includes both a general moratorium on Internet access taxes and a prohibition against multiple or discriminatory taxes on e-commerce.

The Digital Goods and Services Tax Fairness Act would prohibit state tax agency regulations or rulings from construing tangible personal property, telecom service or other such taxes as applying to digital goods or services. It would similarly prohibit state tax departments from construing taxes imposed on digital goods from applying to digital services through tax agency regulations or rulings. This means that state legislatures must make any basic tax classification decisions regarding digital goods and services. And it would result in state laws providing greater clarity about whether or what tax obligations attach to digital goods and services.

It bears repeating that the Digital Goods and Services Tax Fairness Act is *not* a taxability bill. The legislation does not impose new taxes. Nor does it create new tax authority in the states. Under S. 971 and H.R. 1860, states would retain decision-making authority as to whether or not to tax digital goods and services or what particular type of taxing scheme it should establish if it chooses to tax digital goods and services. But states would be required to declare their tax policy clearly in legislation and be prevented from adopting discriminatory measures.

Good tax policy should be a boon for the digital economy, not for tax lawyers. Federal and state tax policy should promote, not hinder, the promise of online e-commerce for furthering our future prosperity. S. 971 and H.R. 1860's sourcing rules, non-discriminatory provision, and requirement for clear statements of tax policy by state legislatures would create the kind of framework in which states can equitably collect revenues without burying digital goods and services beneath multiple state taxes.

Congress would do well to give the Digital Goods and Services Tax Fairness Act a fair hearing – and then pass the bill.

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Further Readings

Seth L. Cooper, "Saying NO to Maryland's New Tech Tax," *FSF Blog* (February 2, 2012).

Seth L. Cooper, "Taxing Ad Affiliate Internet Sales Would Be Maryland's Mistake," *Perspectives from FSF Scholars*, Vol. 6, No. 29 (November 18, 2011).

Seth L. Cooper, "Calling for a Moratorium on New Discriminatory Wireless Taxes," *FSF Blog* (August 8, 2011).

Seth L. Cooper, "High Taxes and Surging Surcharges Weigh Down Wireless Subscribers," *FSF Blog* (February 23, 2011).

Randolph J. May, "A Tax Worthy of a Tea Party," *FSF Blog* (February 10, 2011).