State and Local Tax ADVISORY

Digital Goods: Simplifying Lives, Complicating Taxes

by Mary T. Benton and Jeffrey C. Glickman

For most of us, the digital age has simplified our lives. Today, we have the ability to carry thousands of our favorite songs on a device no bigger than the palm of our hand, to own one gadget about the size of a small paperback book holding hundreds of our favorite books and magazines, and to watch instantly our favorite television shows and movies while flying from New York to Los Angeles. Gone are trips to the library, bookstore and movie rental locations; gone are the days of having to buy a CD just to be able to listen to the two or three songs that you actually like; gone are the days of waiting for missed movies and television shows to come out on disk. In addition, we no longer have to find a place to store our books, CDs and DVDs, many of which we may go years without touching.

For taxpayers, however, the sales tax rules involving digital goods have complicated an already confusing tax system. As with every new form of consumer retail transaction, businesses and their tax advisors must determine whether, and where, such transactions involving digital goods are subject to sales tax.

States' Search for Revenue Drives Digital Tax Policymaking

At the time digital goods first entered the marketplace, the existing statutes and regulations imposing sales tax focused on taxing the sale of tangible personal property and specifically enumerated services. In the absence of statutory provisions imposing tax on digital goods or administrative guidance addressing the taxation of digital goods, sales of digital goods were generally not viewed as taxable because the consumer did not receive any tangible personal property.

Over the last several years, as states have looked for ways to expand their sales tax bases in order to increase revenues, new statues, regulations and rules have surfaced to address the taxability of digital goods. In addition, the Streamlined Sales and Use Tax Agreement (SSUTA) includes a specific section dedicated to the taxability of digital goods.[1]

Finally, Congress recently introduced The Digital Goods and Services Tax Fairness Act of 2011, evidencing an attempt by the federal government to regulate the states' taxation of digital goods.[2]

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1 *See* SSUTA § 332. For a copy of the SSUTA, *see* www.streamlinedsalestax.org.

2 S. 971/H.R. 1860.

The result of all of this is a very inconsistent and complicated set of rules for determining the taxability of digital goods. This article provides a brief summary of the trends we see in states' adoption of statutes and rules to tax or exempt from taxation the sale of digital goods. Further, this article seeks to highlight the inconsistencies, and thus complexities, related to the taxation of digital goods within the multi-state sales tax system. [3]

Several Digital Tax Trends

States generally follow one of several trends with regard to the taxability of digital goods.

No-Tax States, and Related Outliers

First, there are states that have not addressed the taxability of digital goods in their statutes or regulations, and thus, presumably, do not subject those goods to tax since they do not constitute tangible personal property.

For example, Florida imposes its sales tax on the sale at retail of tangible personal property, and it defines "tangible personal property" as "personal property which may be seen, weighed, measured, or touched or is in any manner perceptible to the senses." Since there are no statutory provisions in Florida that otherwise tax digital goods or that otherwise expand the definition of tangible personal property to include digital goods where no tangible medium is received by the purchaser, Florida does not subject digital goods to sales tax.[4]

Massachusetts is another example of a state with no express statutory provisions addressing the taxability of digital goods, thus basing taxability on whether or not the consumer actually receives its purchase in a tangible medium.[5] Recently, the Massachusetts Department of Revenue issued a directive stating that the receipt of professional photographs via digital download from the photographer's File Transfer Protocol site was not subject to Massachusetts sales tax because there was no transfer of tangible personal property.[6] Of course, a sale of the printed photographs would be subject to tax.

Interestingly, outliers to this trend include states that interpret their definition of tangible personal property to include digital items despite no express statutory or regulatory provisions regarding the taxability of digital products. For example, while Alabama does not expressly define "tangible

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[3] For purposes of this article, "digital goods"includes digital audio files (e.g., music, ringtones), digital video files (e.g., television shows or movies), digital images (e.g., photographs), and digital books. This article does not address the taxation of computer software or on-line services. In addition, this article does not address the issue of whether a transfer of digital goods represents a nontaxable service under the true object test.

[4] *See* Fla. Stat. §§ 212.05, 212.02(19). *See also* Florida Technical Assistance Advisement 11A-002, 1/31/2011 (Video production and editing is not subject to sales tax if the product is transferred digitally because such sales are not sales of tangible personal property; however, files transferred via a hard drive, CD, flash drive, DVD, etc., are subject to sales and use tax because the items transferred are tangible personal property.).

[5] *See* Mass. Gen. L. Ch. 64H §§ 1, 2.

[6] Massachusetts DOR Directive No. 11-4, 8/9/11.

personal property" in its sales and use tax statutes, it does define the term for lease tax purposes, and that definition is substantially similar to Florida's (discussed above): "Personal property which may be seen, weighed, measured, felt, or touched, or is in any manner perceptible to the senses."[7]

Relying on that definition and prior case law interpreting that definition to hold that electricity constituted tangible personal property, Chief Administrative Law Judge Bill Thompson ruled that a photographer's sale of digital images transmitted electronically was subject to sales tax because the digital images constituted tangible personal property.[8]

Judge Thompson wrote:[9]

> But the form in which tangible property is delivered by the seller to the purchaser should be of no consequence…. Whether sales tax applies to the sale of digital goods delivered electronically is an emerging issue in state taxation. Admittedly, treating the sale of digitized photographs delivered electronically as a taxable sale of tangible personal property pushes the bounds of what has traditionally been viewed as the sale of tangible goods. But Alabama's broad definition of tangible personal property, which the Alabama Supreme Court has construed to include electricity, is sufficiently broad to include digital goods transmitted by electrical impulses. I also see no principled reason why the retail sale of goods that can now be delivered electronically due to advances in technology, i.e., photographs, music, movies, books, etc., should be taxed any differently than the sale of those goods delivered by traditional means.

Digital Goods as Tangible Property

A second trend encompasses states that expressly provide that digital goods are taxable because such goods are included in the definition of tangible personal property.

For example, Louisiana defines "tangible personal property" as "personal property that can be seen, weighed, measured, felt, touched, or is perceptible to the senses."[10] Note that this definition of tangible personal property is almost identical to the definition in states that are included within the first trend discussed above; however, by regulation, Louisiana provides examples of tangible personal property, including "digital or electronic products such as 'canned' computer software, electronic files, and 'on demand' audio and video downloads."[11]

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7 Ala. Code §40-12-220(8).

8 *Robert Smith d/b/a FlipFlopFoto v. Dep't of Revenue*, S. 05-1240, Alabama Administrative Law Division, 11/17/2006 (Final Order entered 4/30/2007).

9 *Id.* It is worth noting that (i) Ala. Admin Code 810-6-1-.119 ("Photographs, Photostats, Blueprints, etc.") was amended in 2008 to reflect the *FlipFlopFoto* ruling and (ii) Florida, like Alabama, treats electric power as tangible personal property, but unlike Alabama, does not extend that definition to digital goods. *See supra* footnote 2.

10 La. R.S. § 47:301(16)(a).

11 La. Admin. Code 61:I.4301.

Texas imposes its sales tax on each sale of a taxable item, and it defines "taxable item" as "tangible personal property and taxable services" and provides that "the sale or use of a taxable item in electronic form instead of on physical media does not alter the item's tax status."[12]

Stand-alone Definition of Digital Goods

The third trend, and the one with the largest following, consists of states that have enacted a standalone definition of digital goods in order to impose sales tax on such digital goods as defined. The vast majority of these states includes members of the Streamlined Sales Tax Project (SSTP), states who have drafted their sales and use tax statutes to be in substantial compliance with the provisions of the SSUTA.[13]

On September 20, 2007, the SSTP governing board adopted Section 332 of the SSUTA (and its related definitions), effective January 1, 2008. Section 332(A) provides that a member state may not include "specified digital products" within its definition of "ancillary services," "computer software," "telecommunication services" or "tangible personal property."[14]

In other words, a member state may choose to tax "specified digital products" but it can't do so by including those products within one of the other categories specified above.

For those states that impose a tax on any of the "specified digital products," Section 332(D) of the SSUTA provides that, *unless the statute specifically states otherwise*, a tax on such products shall be construed as being imposed on a sale (i) to a purchaser that is an "end user,"[15] (ii) when the seller grants the right of "permanent use,"[16] and (iii) that is not conditioned upon continued payment to the seller by the purchaser.[17]

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[12] Tex. Tax Code Ann. §§ 151.051(a), 151.010.

[13] *See* www.streamlinedsalestax.org for more information about the SSTP. As of August 2011, there are 24 states that are either full or associate members.

[14] "Specified digital products"means electronically transferred (i) "Digital Audio-Visual Works," which means a series of related images that, when shown in succession, impart an impression of motion, together with accompanying sounds, if any; (ii) "Digital Audio Works," which means works that result from the fixation of a series of musical, spoken, or other sounds, including ringtones; and (iii) "Digital Books," which means works that are generally recognized in the ordinary and usual sense of "books." *See* SSUTA Library of Definitions.

[15] The definition of "end user" is "any person other than a person who receives by contract a product 'transferred electronically' for further commercial broadcast, rebroadcast, transmission, retransmission, licensing, relicensing, distribution, redistribution or exhibition of the product, in whole or in part, to another person or persons." SSUTA Section 332(D)(1).

[16] "Permanent" means "perpetual or for an indefinite or unspecified length of time." SSUTA Section 332(D)(2). The Agreement provides that "[a] right of permanent use shall be presumed to have been granted unless the agreement between the seller and the purchaser specifies or the circumstances surrounding the transaction suggest or indicate that the right to use terminates on the occurrence of a condition subsequent." *Id*.

[17] SSUTA Section 332(D)(3).

SSUTA States Not Entirely Consistent

Given the uniform definition and general directive outlined in the SSUTA, it would be fair to assume that the member states' tax imposition statutes on digital products are consistent.[18]

Well, you know what happens when one makes assumptions. Indeed, many of the member states have drafted their statutes to deviate from the terms construing the tax on specified digital products in the SSUTA in one or more ways. [19] Accordingly, even among the member states—where one might expect some consistency—a taxpayer must study each statute individually and cannot make a determination regarding the taxability of digital goods in one state based upon its knowledge of the taxability of digital goods in another.

For example, if the right to use a digital good is not permanent, the sale of such digital good would be taxable in Kentucky, Mississippi, Tennessee and several other states, but would not be taxable in Indiana or Vermont.[20]

Similarly, if the purchaser is obligated to make continuous payments, the digital good would be taxable in Nebraska, North Carolina, Utah and several other states, but would not be taxable in Indiana, Mississippi or Wisconsin.[21]

Further Complication: Sourcing Issues

Regardless of which trend a state has decided to follow, the taxation of digital goods is further complicated by sourcing issues—i.e., which state has the right to tax the sale of the digital goods.

The complexity of sourcing is rooted in the very nature of digital goods, as they are intended to be purchased from and used on mobile devices and can sometimes be made available to multiple users. In other words, digital goods are not necessarily constrained to a single taxing jurisdiction. Because most states have not addressed sourcing with respect to digital goods, taxpayers currently face uncertainty in this area.

As an example, which state should have the right to tax the sale of a song purchased from the iTunes server in Washington by a user with a Kentucky billing address who is visiting a friend in North Carolina? Perhaps it should be the state where the good was available for transmission by the seller, or where it was delivered to the purchaser, or where it was first used by the purchaser,

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[18] Indiana is one of the only states that has followed the construction outlined in the SSUTA, as the tax is imposed on all categories of "specified digital products," when they are electronically transferred to an end user, the seller grants the right of permanent use and the use is not conditioned upon the continued payment by the purchaser. Ind. Code §§ 6-2.5-4- 16.4, 6-2.5-1-26.5.

[19] For example, Utah's tax is imposed whether or not sold to the end user. *See* Utah SST Taxability Matrix.

[20] *See,* e.g., Ky. Rev. Stat. Ann. §§ 139.010, 139.200; Miss. Code Ann. § 27-65-26; Tenn. Code Ann. § 67-6-702(g); Ind. Code §§ 6-2.5-4-16.4, 6-2.5-1-26.5; Vt. Stat. Ann. 32 §§ 9771 (8) and 9773 (4).

[21] *See,* e.g., Neb. Rev. Stat. §77-2701.16(9); N.C. Gen. Stat. §105-164.4; Utah Code Ann. §59-12-103(1)(m) and Utah SST Taxability Matrix; Ind. Code §§ 6-2.5-4-16.4, 6-2.5-1-26.5; Miss. Code Ann. § 27-65-26; Wis. Stat. §§77.51 and 77.52.

or perhaps the state of the purchaser's address (and what if a purchaser has separate physical and billing addresses)? To answer this question, states will typically follow the sourcing provisions applicable to other tangible goods.

Under SSUTA, there is a sourcing hierarchy that would also apply to the sale of digital goods, but making the determination about which to apply can itself be a complicated task.[22]

Proactive Approach in Washington

One state that has taken a more proactive approach by attempting to flesh out the application of the sourcing hierarchy to digital goods is Washington.[23] In a draft rule, the state has set forth the sourcing provisions with examples as to when each provision would apply.[24]

The first sourcing rule is the business location of the seller. As an example, the draft rule describes a scenario when someone downloads a music file to his digital music player from a kiosk in a retail store. [25] Under such circumstances, the sale would be sourced to that business location.

If the first rule does not apply, the sale would be sourced to the place of receipt. The draft rule defines receipt as "taking possession or making first use of digital goods or digital codes, whichever comes first."[26] If the seller cannot determine where the purchaser takes possession or makes a first use of the digital good, then the third rule is the address in the records of the seller. The Washington rule explains the address must be available from the seller's business records, should estimate the receipt location of the digital goods and reliance upon such address must be in good faith.[27] Thus, Washington attempts to bring some clarity to otherwise amorphous sourcing provisions.[28]

Federal Lawmakers Enter the Ring

Concerned primarily with the complexities and uncertainty related to the taxation of digital goods, the federal legislature has thrown its hat into the ring under the authority conveyed by the Commerce Clause of the U.S. Constitution.

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[22] *See* SSUTA Section 310.

[23] Washington has enacted a broad-based tax on digital goods, which incorporates "digital products," digital code, and "digital automated services." Wash. Rev. Code §§ 82.04.050(8), 82.04.192.

[24] Washington Draft Digital Products Rule 15503.

[25] *Id.* at Section IV (1)(Example 21).

[26] Id. at Section IV (2).

[27] Id. at Section IV (3).

[28] The final two sourcing rules are an address obtained during the sale and then finally the place of origin. *See id.*, at Sections IV(4) and (5).

The Digital Goods and Services Tax Fairness Act of 2011 addresses not only digital goods, but also online services and certain sales of software with the stated purpose of preventing "multiple and discriminatory taxation"of digital goods and services. [29] The legislation attempts to address certain of the issues discussed in this paper, including the thorny topic of sourcing. In relevant part, it restricts the tax imposition to the sale of the digital good to the customer, or end user, and sources the sale to the customer's "tax address." [30]

The bill does not provide for apportionment for sales of digital goods or services intended for multiple users, rather the seller may rely upon one address provided by the purchaser.[31] Interestingly, there are a number of critics who oppose the bill, at least as currently drafted, including the SST Governing Board, which believes that it would actually complicate the administration of the tax on digital goods and force SST members to change their laws.[32]

Generalize Among States at Your Peril

As one can see, the taxation of digital goods is not straightforward and taxpayers will find that they will generalize among the states at their peril.

Rather, it is necessary to carefully review the statutes, regulations, rulings and even policy statements of each state where business is conducted in order to determine whether the state imposes a tax on digital goods, under what circumstances and where the sale should be sourced. While advances in technology have simplified life for many, taxpayers and their tax advisors cannot take it easy and must continue to grapple with the many complexities related to the sale of digital goods.

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[29] S. 971, Section 2.

[30] *Id*. at Section 4.

[31] *Id*. at Section 4(c)(2).

[32] A resolution sponsored by Washington, Indiana, North Dakota, South Dakota and Utah opposing federal preemption of state authority over how to exempt or tax digital goods and services, passed August 31, 2011, posted on the SST website, www.streamlinedsalestax.org.

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