



# The Taxation of Digital Products: An MTC Uniformity Project



NCSL Fiscal Institute Symposium  
Miami Beach, FL  
November 16, 2023



# Background on the MTC

- Interstate Governmental Agency:
  - “*mtc.gov*” – we do our work in public & have a public participation policy
  - Members are the heads of the state departments of revenue
  - 7-Member Executive Committee
- Created in 1967 when enough states adopted the Multistate Tax Compact
- Focus on Income/Franchise and Sales/Use Taxes
- MTC Programs:
  - Uniformity - model statutes & regulations; whitepapers & other guidance
  - National Nexus Program – voluntary disclosures
  - Multistate Joint Audit Program – MTC staff audits for multiple states
  - Legal Support – training, litigation support, amicus briefs



# The MTC Mission Statement

*An intergovernmental state tax agency whose mission is to **promote** uniform and consistent tax policy and administration among the states, **assist** taxpayers in achieving compliance with existing tax laws, and **advocate** for state and local sovereignty in the development of tax policy.*



# MTC Digital Products Project Scope

The MTC Uniformity Committee Requested a Whitepaper with this Information:

1. A general survey and description of the kinds of digital products currently offered in the marketplace and the nature of the transactions through which those digital products may be provided to customers;
2. A general survey of academic research or other analysis on policy reasons for including digital products in (or excluding them from) the sales tax base;
3. A review and summary of general information on the specific types of digital products that states currently tax (which information is available from different sources, including Streamlined);
4. Analysis of the extent to which mixed or bundled products (including nondigital services and intangibles) may create issues for taxing digital products;
5. A summary of sourcing issues and common approaches to sourcing digital products, including multiple points of use; and
6. Analysis of the ways that digital products might be defined, categorized, exempted, and sourced.





# Working with Streamlined States & FTA

- SST staff serve as *ex officio* members of the MTC work group.
- MTC and SST staff attend each other's meetings and regularly consult.
- MTC staff monitor the related SST projects:
  - Sourcing of sales without need for physical addresses.
  - Updating the SST Agreement relating to digital codes.
- SST and MTC adopted a joint resolution titled: [Joint Resolution Supporting State Efforts to Promote Uniformity in the Taxation of Digital Products](#).
- Federation of Tax Administrators adopted related Resolution [2023-1: Supporting State Efforts to Promote Transparency, Certainty, and Clarity of State Tax Policies](#).



# MTC Webpage Resources

- Visit <https://www.mtc.gov/Uniformity/Project-Teams/Sales-Tax-on-Digital-Products> for the following:
  1. information about upcoming meetings
  2. prior meeting agendas, materials, and notes
  3. whitepaper outline drafts
  4. research and analysis
  5. resolutions
  6. legislative reports
  7. background and other information on the Streamlined Sales and Use Tax Agreement
  8. selected information from state tax agencies on taxation of digital products
  9. written comments and feedback
  10. related federal information



# How we do our Work

- Virtual, public work group meetings the first Thursday of every month (unless otherwise noticed) at 11:00 a.m. Eastern. All are welcome.
- In-person Uniformity Committee meetings three times a year.
- Gil Brewer from Washington State is chair of the work group, which consists of 24 tax agency staff from 17 states, plus two Streamlined staff as ex officio members.
- April 2021: project approved by the MTC Uniformity Committee.
- July 2021: MTC staff began over 40 stakeholder meetings to compile information to guide the project.
- September 2022: Monthly work group meetings begin.



# What We Have Studied So Far - 1

1. Definitions for digital products.
2. Identification of what items exist in the marketplace, including a presentation by SST certified service provider Avalara representatives.
3. Presentation by Streamlined representatives ([watch via the MTC project page](#)).
4. Survey of state treatment of digital products ([website](#) has spreadsheet and details)
  - Jurisdictions have a variety of digital product tax bases – broad to narrow and in-between.
  - At a macro-level, no clear patterns in taxation approaches across the states.
  - Cloud product characterizations vary wildly; same item can be TPP or service depending on the jurisdiction's definition and things like prior case interpretations.
  - Characterizations impact sourcing, exemptions, ITFA analysis, and other outcomes.





## What We Have Studied So Far - 2

5. Panel discussion on digital products and business inputs at July 2023 Uniformity Committee meeting ([watch via the MTC project page](#)). Staff is working on a summary of information presented and otherwise compiled about state experiences with different approaches and policy considerations relating to taxing / exempting business inputs.
6. Developing [a matrix with “three approaches” to taxing digital products](#) used by the states today and possible guiding principles for policy makers.
7. Internet Tax Freedom Act – presentation on what states and taxpayers need to know about definitions and the anti-discrimination provision at the Nov. 14, 2023 Uniformity Committee (taped and will be posted to the website).



# Where do we go from here?

1. “Three Approaches” matrix development continues
2. ITFA research and discussion continues
3. Whitepaper development continues
4. Multiple points of use
5. Bundled transactions
6. Sourcing (waiting on SST project results)
7. May circle back to definitions
8. Guiding principles for policymakers



## Preliminary Summary of Business Inputs Research

1. Some advocate that pyramiding should always be avoided, while others advocate that there are multiple policy considerations that affect the extent to which pyramiding exists in a sales and use tax base.
2. The severity of pyramiding depends on the facts and circumstances, including whether the eventual retail sale will be exempt from tax and the incidence of the tax.
3. Taxing digital business inputs can impose tax on industries, such as agriculture, that have historically been tax favored.
4. Exempting digital business inputs will be costly if done after the tax base is expanded to include digital business inputs.
5. Exempting business inputs should be considered in tandem with any proposed expansion of the tax base to include digital products.
6. Exempting business inputs can be complicated or simple. A simple version would rely on the identity of the purchaser as a commercial entity, such as the current Iowa statute.
7. Exempting business inputs, or any other anti-pyramiding effort, should be weighed against tax administration pros and cons, including the ability for exemptions to keep pace with the tax base.



We welcome questions, comments, and  
input from all stakeholders.

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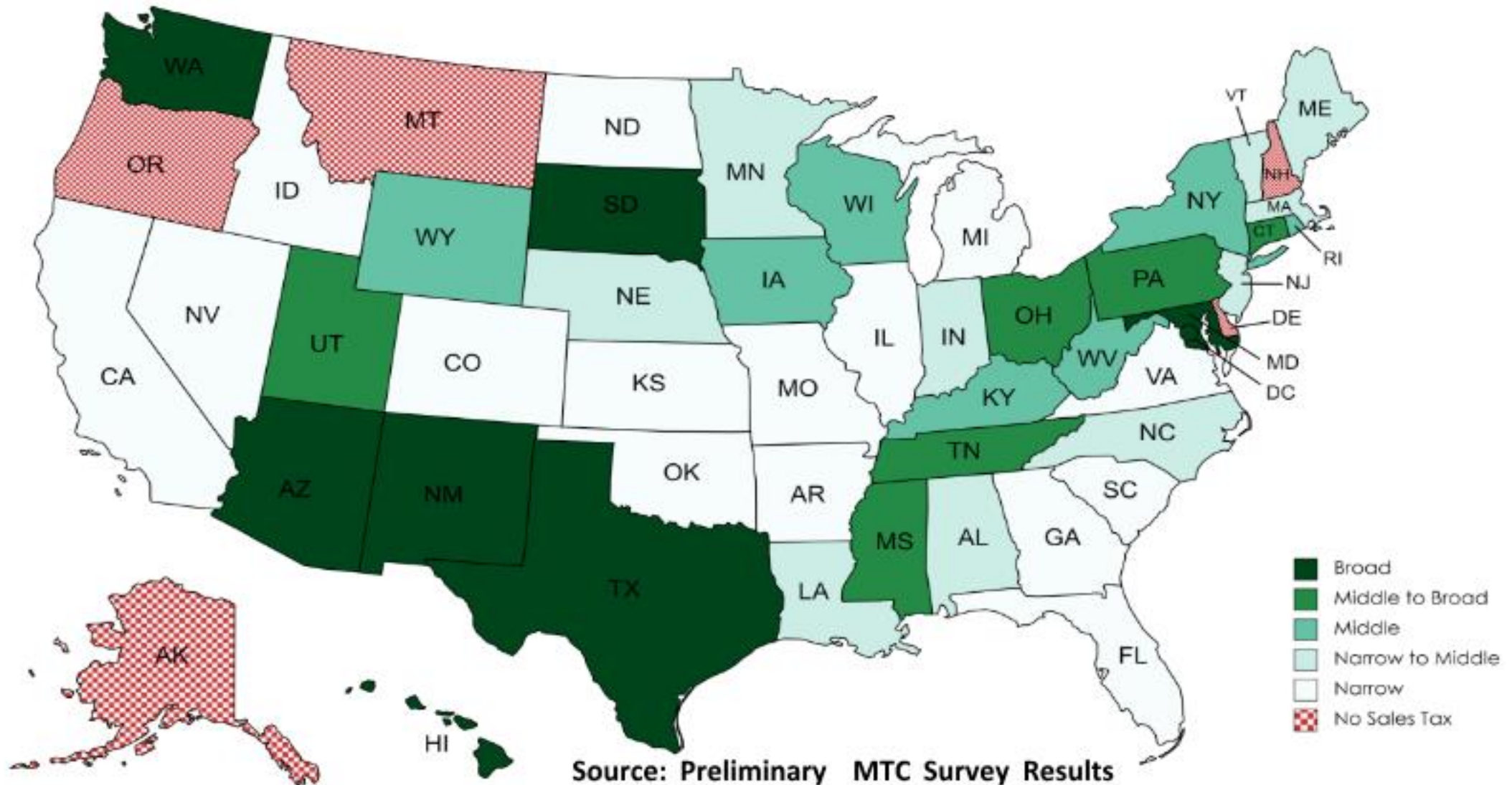
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# The Sales Taxation of Digital Business Inputs

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# State Sales Tax Systems: Narrow, Middle and Broad Sales Tax Bases on Digital Products



Source: Preliminary MTC Survey Results (2023)



# The Sales Taxation of Digital Business Inputs

- **Key finding of 2022 COST study:** the sales taxation of business purchases of digital products (*e.g.* digital business inputs) is not just commonplace, but the overwhelming norm among states that tax software and digital products. The COST study researched six categories of software and digital products.
  - Canned software (including electronic delivery)
  - Custom software
  - Digital software accessed remotely (SaaS)
  - Digital information services
  - Data processing services
  - Specified digital products (video, audio, books)
- **In each of the six categories of software and digital products, over 90% of the taxing states include both business and consumer purchases in the sales tax base.**
- **Currently only one state (Iowa) has a broad exemption for business purchases of software and digital products,** and several other states have narrow exemptions or rate reductions.





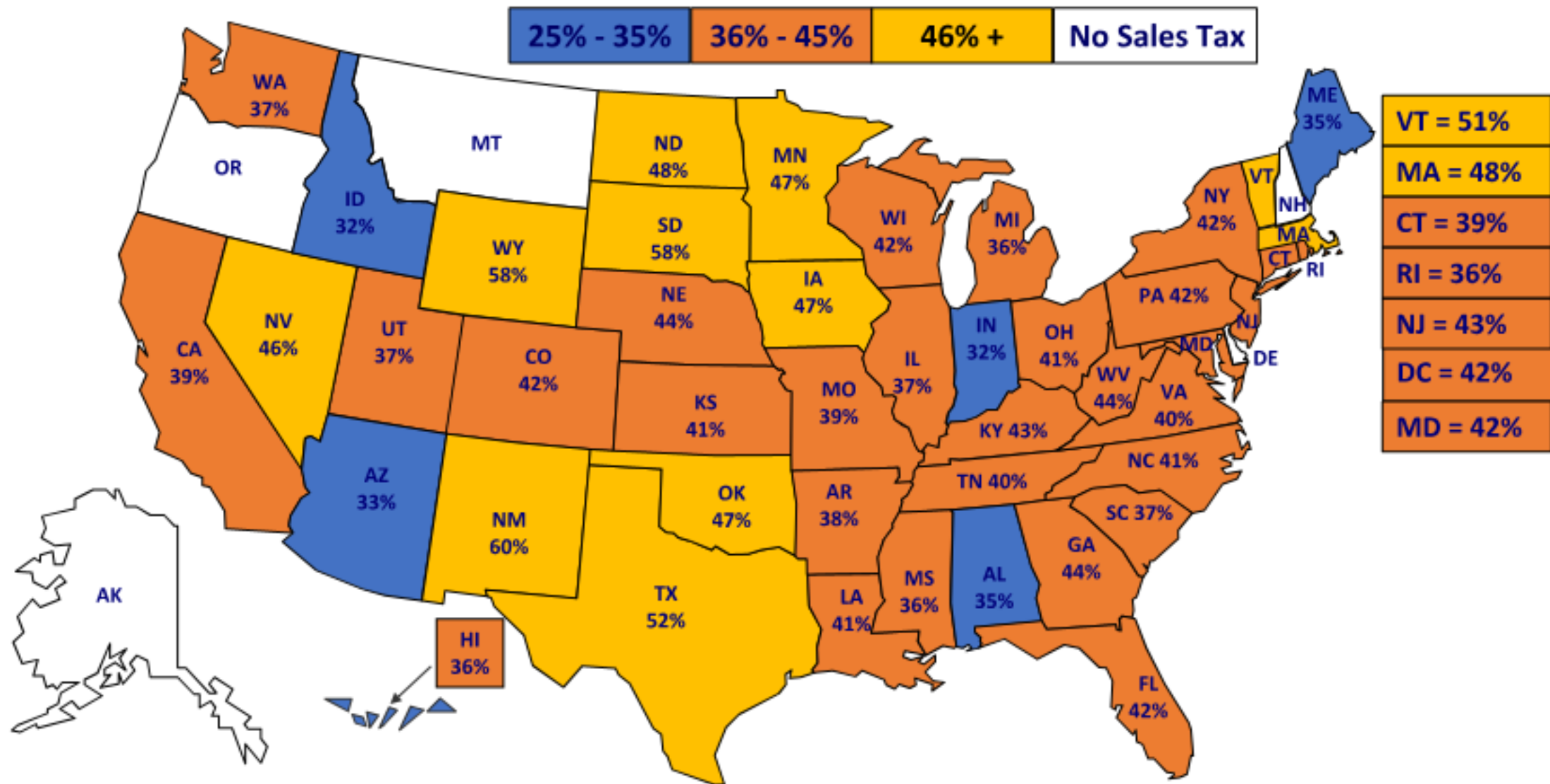
# Single Stage Sales Taxes and the Anti-Pyramiding Principle

- Retail sales taxes were first enacted in the United States at the state level in the 1930s.
- From the beginning, most state sales taxes were generally **designed to apply to one stage - the retail sales stage – so as to avoid the pyramiding of sales tax at the production, distribution and retail stages.**
- At the time, the U.S. states were among the world leaders in avoiding sales tax pyramiding, particularly in the manufacturing sector.
  - All states enacted sale for resale exemptions and ingredient and component part exemptions.
  - And most states eventually adopted exemptions for materials consumed and machinery used in the manufacturing sector.
- Unfortunately, over time, there was no similar history of “suspending” sales tax for B-to-B purchases by service providers, wholesalers, retailers, and eventually digital businesses.



# State and Local Sales Taxes Imposed on Business Inputs

## Business Inputs Share of Total Sales Tax Collected





# Lessons from the Adoption of Business Input Exemptions in the Manufacturing Sector that Are Applicable to the Digital Industry

- Many parallels: The digital sector is widely perceived as the driving force of the 21<sup>st</sup> century market economy much as the manufacturing sector was considered the foundation of the 20<sup>th</sup> century industrial economy.
- As with manufacturing, states vie to attract high technology and data-intensive businesses to provide a boost to their local economies.
- The keys to state adoption of business input exemptions in manufacturing were:
  - Broad adherence to the fairness and efficiency of a single stage sales tax.
  - State experimentation with business input exemptions.
    - One size does not fit all.
    - In a retail sales tax, business input exemptions are used to avoid tax pyramiding since there is no default mechanism (as in the VAT) for identifying whether future transactions are subject to tax.
  - Managing competing tradeoffs: optimal sales tax design vs. sales tax revenue generation.



# The Broad Iowa Digital Business Inputs Exemption

- **The Iowa B to B exemption solution is quite straightforward.**
  - The state uses the same exemption form for digital business inputs as it uses for other business inputs.
    - There is one box to check for “purchaser is doing business as a commercial enterprise”.
    - There is a second box to check in the list of exemptions for “qualifying computer software, specified digital products and digital services.”
    - Moreover, the Iowa statute dictates for eligibility for the exemption, non-commercial use must not be more than de minimis
    - **That’s it: that’s all it takes to exempt digital business inputs.**



# Other State Digital Business Input Exemptions

- Several states have business input **exemptions limited to a single category of digital business inputs.**
  - Exempts SaaS for use in an enterprise computer system (Maryland)
  - Exempts prewritten software delivered electronically to businesses (New Jersey)
- Other states have business input **exemptions that more closely resemble versions of manufacturing exemptions**
  - Exempts digital goods used as a component part of a digital good or service (Connecticut)
  - Exempts tangible property or digital codes/products used as part of a digital production activity (Maryland)





# Other State Digital Business Input Exemptions

- Other states have a **provision that prohibits discrimination** between digital products and tangible personal property
  - Exempts any category of digital products if the sale of such goods sold in tangible form is exempt (Wisconsin)
- Narrower or broader digital business input exemptions may be appropriate in conjunction with:
  - An incremental expansion of a state's digital sales tax base (matching B-to-B exemptions with B-to-C base inclusion)
  - A design that complements a state's existing business input exemptions



# The Business Perspective on Digital Business Input Exemptions

- If states expand their sales tax bases to include more B-to-C purchases of digital products, they should exempt B-to-B purchases (digital business inputs) to avoid additional pyramiding of sales taxes.
- States should also not discriminate against digital products by providing manufacturing exemptions for tangible property production but not for similarly situated digital goods production.
- It is easier to enact digital business input exemptions before state sales tax bases already include revenue from digital B-to-B purchases.
  - The good news here is that two-thirds of the states still have a narrow to medium digital sales tax base.
- For more information, see: Karl A. Frieden, Fredrick J. Nicely, and Priya D. Nair, “Down the Rabbit Hole: Sales Taxation of Digital Business Inputs,” *Tax Notes States*, July 18, 2022.  
<https://www.cost.org/state-tax-resources/cost-studies-articles-and-reports/>