NCSL SALT Task Force Meeting

The Sales Taxation of Digital Business Inputs

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Agenda

- The Problem with Taxing Business Inputs
- Overview of Sales Taxation of Business Inputs (B2B)
- Different Approaches to the Sales Taxation of Digital Products
- Sales Taxation of Digital Business Inputs in Six Software and Digital Product Categories
- Statutory Exemptions for Business Purchases of Digital Products
- Taxing Digital Business Inputs Exacerbates the Design Flaw in State Sales Tax Systems
- Conclusion

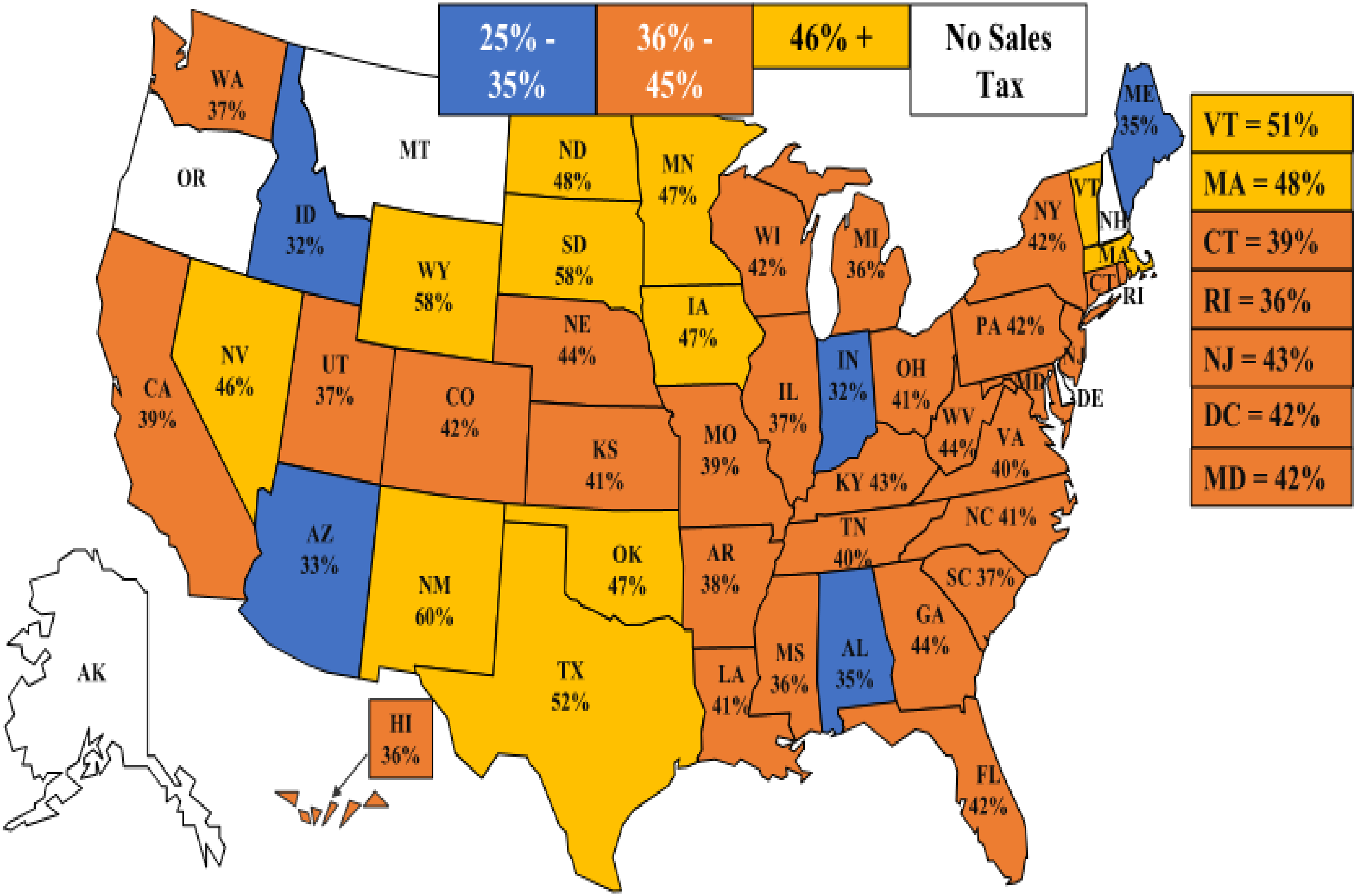
The Problem with Taxing Business Inputs

The Sales Taxation of Business Inputs

- The sales taxation of business inputs is not unique to digital commerce – but as states look to expand their tax bases to more digital products and services – the negative consequences of taxing digital business inputs need to be better understood.
- For the last four decades, the sales tax on business inputs contributed slightly over 40 percent of all state and local sales tax revenue.
- In fiscal 2020, the sales taxation of business inputs accounted for 42 percent of all sales tax revenue and over one-fifth of *all* state and local taxes paid by businesses.
- The business inputs share of sales tax revenue ranged from a low of 32 percent (Idaho and Indiana) to a high of 58 to 60 percent (South Dakota, Wyoming, and New Mexico).

Business Inputs Make Up 42% of All State and Local Sales Taxes

Business Inputs Share of Total Sales Tax Collected



The Impact of Imposing Sales Taxes on Business Inputs, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (May 2019)

The Problem with Taxing Business Inputs:

- This structural flaw of state sales tax systems — the widespread taxation of business purchases (excluding resale) — is of long-standing origin.
- The shortcomings of this deviation from the norms of a well-designed consumption tax are well documented.
- The pyramiding of sales tax at multiple stages of the supply chain creates a number of distortions because it affects business choices of input purchases, location of jobs and investments, and organization of business structures.
- A well-designed broad-based consumption tax on household goods and services can provide an efficient way to raise revenue for government with a minimal impact on economic growth.
- However, the cascading of taxes on business inputs can undermine this advantage and penalize both domestic business investment and the competitiveness of U.S. exports.

The Expert's Perspective: Historical Condemnation of the Sales Taxation of Business Inputs

- "In the establishment of the structure of a sales tax, it is highly desirable to confine the tax so far as possible to the sale of consumption goods, since the taxation of producers' goods is not only contrary to the intent and philosophy of the tax, but gives rise to undesirable effects, especially in countries in which maintenance of a high level of investment is important." John F. Due, *Sales Taxation* (1957)
- "A sensible sales tax would… exempt all sales to business." Charles E. McLure, Hoover Institution, Stanford University, "Understanding the Nuttiness of State Tax Policy," *National Tax Journal (September 2005).*
- An ideal retail sales tax "…should apply only to consumption expenditures, and thus not to savings or to purchases for use in production." John L. Mikesell, "Reversing 85 Years of Bad State Retail Sales Tax Policy," *State Tax Notes*, (Feb. 4, 2019).

Overview of Sales Taxation of Business Inputs (B2B)

The Sales Taxation of Digital Commerce

- Over the last quarter century, the sales taxation of digital commerce has emerged as one of the most prominent and contentious issues in state taxation.

- **Four significant issues have dominated the public dialogue:**
  - Whether states have jurisdictional nexus over remote sellers
  - Which digital goods and services should be included in (or excluded from) the sales tax base
  - How to define and categorize digital products for sales tax purposes.
  - How to source sales of digital products

- One central problem, however, regarding the sales taxation of digital commerce has been generally ignored or underreported – **the extent to which the sales tax base includes not only business-to-consumer (B2C) transactions but also business-to-business (B2B) transactions**

The Sales Taxation of Digital Business Inputs

- For its forthcoming 2022 Sales Tax Scorecard (2nd edition), COST researched the sales taxation of both consumer and business purchases of software and digital products in six categories:

  - 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 addition to conducting its own state-by-state research, COST reached out to State Departments of Revenue and tax practitioners in each state.

The Sales Taxation of Digital Business Inputs

- **Key finding**: 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.
- 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.
- In each category, no more than two states provide an exemption for digital products purchased by business.
- Currently **only one state (Iowa) has a broad exemption for business purchases of software and digital products**, three states have narrow exemptions (Maryland, New Jersey and Washington), and one state has a reduced rate for business purchases (Connecticut).

0 select products

1 select product

2 select products

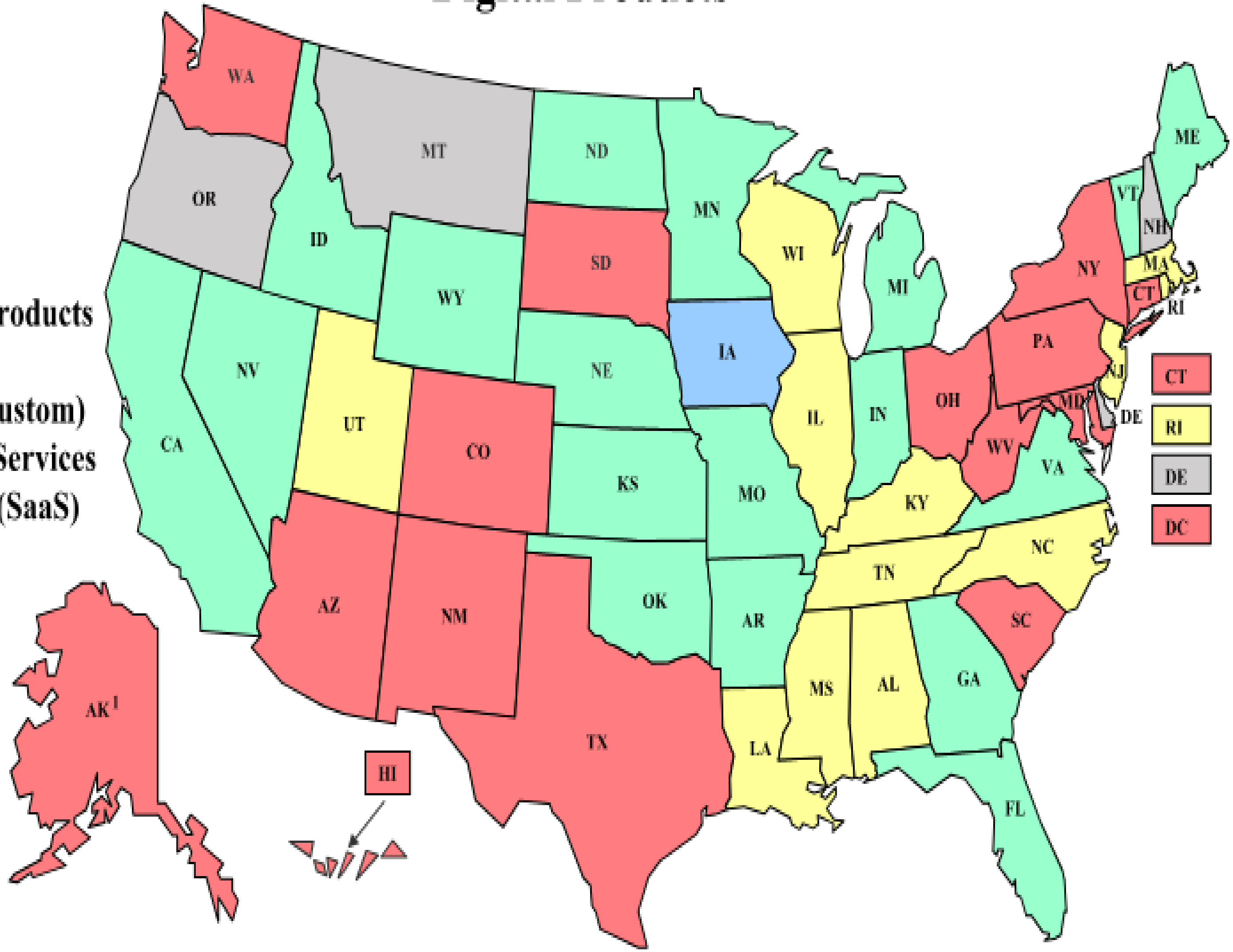
All 3 select products

No sales tax

States that Impose Tax on Business Purchases of Select Software and Digital Products

Three Software/Digital Products Tax Types

- **Software (canned or custom)**
- **Data Processing/Info Services**
- **Software as a Service (SaaS)**



Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Source: Council On State Taxation (COST)

[1] Data is based on local municipalities since Alaska does not have a state-wide sales tax

An International Perspective

- The U.S. approach to imposing a sales tax on digital products, without a broad exemption for business inputs, is unique among the major consumption taxes in the world.
- Virtually all other advanced nations use a value-added tax (VAT) that avoids tax pyramiding through a credit provision.
- Under a VAT, digital products are included in the tax base for business and consumer purchases.
- However, the VAT has a built-in mechanism that gives a business a credit for any VAT paid on digital products, at least to the extent the business charges VAT on its sales to consumers or is not required to charge VAT (for example, exports).
- Thus, the VAT effectively exempts most digital products purchased by businesses, including by manufacturers, wholesalers, and retailers that make taxable sales to end-use consumers.

Different Approaches to the Sales Taxation of Digital Products

Different Approaches to the Sales Taxation of Digital Products

- Historically, states have had very different approaches to taxing digital products.
  - Some states have long-standing sales tax statutes that broadly apply to both tangible personal property and services – a gross receipts tax concept.
  - Some states enact more modern statutes that encompass a broad range of digital products.
  - Some states approach the sales taxation of digital products on a piecemeal basis, adding specific taxable categories such as digital information services or SaaS.
  - Some states utilize long-standing statutes that include only tangible personal property in the sales tax base and extend these statutes by regulation or administrative action to certain categories of digital products.
  - Some states tax no digital products unless they are sold in conjunction with tangible property (disk or other similar media).
- However, under **all** of these different approaches, the sales taxation of business purchases of digital products (digital business inputs) is widespread.

Broad Inclusion of Digital Products Under Long-standing Statutes that Tax Most Goods and Services

- South Dakota
  - § 10-45-1.14. **Gross Receipts Defined.**
    - For the purposes of this chapter, the term, gross receipts, means the total amount or consideration, including cash, credit, property, and services, for which tangible personal property, any product transferred electronically, or services are sold, leased, or rented, valued in money, whether received in money or otherwise, without any deduction for the following:
    - (1) The retailer's cost of the property or service sold; (2) The cost of materials used, labor or service cost, interest, losses, all costs of transportation to the retailer, all taxes imposed on the retailer, and any other expense of the retailer; and (3) Except as provided in chapter 10-46A or 10-46B, charges by the retailer for any services necessary to complete the sale whether or not separately stated, including delivery charges.
  - Effective November 1, 2018, remote sellers who meet certain thresholds must obtain a South Dakota sales tax license and pay applicable sales tax. (Per SDCL 10-64)
- Hawaii
  - **HRS § 237-13. Tax Imposition**
  - Tax on other business. Upon every person engaging or continuing within the State in any business, trade, activity, occupation, or calling not included in the preceding paragraphs or any other provisions of this chapter, there is likewise hereby levied and shall be assessed and collected, a tax equal to four per cent of the gross income thereof. In addition, the rate prescribed by this paragraph shall apply to a business taxable under one or more of the preceding paragraphs or other provisions of this chapter, as to any gross income thereof not taxed thereunder as gross income or gross proceeds of sales or by taxing an equivalent value of products, unless specifically exempted.
- New Mexico
  - **NMSA § 7-9-3.5 Gross Receipts Defined**
  - "gross receipts" means the total amount of money or the value of other consideration received from selling property in New Mexico, from leasing or licensing property employed in New Mexico, from granting a right to use a franchise employed in New Mexico, from selling services performed outside New Mexico, the product of which is initially used in New Mexico, or from performing services in New Mexico. In an exchange in which the money or other consideration received does not represent the value of the property or service exchanged, "gross receipts" means the reasonable value of the property or service exchanged;

Broad Inclusion of Digital Products Under New Statutes that Tax Most Goods and Services

- Washington
  - In 2009 Washington's Legislature expanded the State's Sales Tax Base to Include:
    - **Digital Goods** – Washington previously taxed specified digital products as tangible personal property. However, to comply with changes to the SSUTA, Washington changed its law and broadly taxed digital goods, including digital codes and other products transferred electronically, that are sold to end users
      - There is a business exemption for digital goods
    - **Digital Automated Services** – Services transferred electronically that use one or more software application (*e.g.*, online gaming subscriptions, online digital photo editing services, etc.)
    - **Software as a Services (SaaS)** – The SSUTA restricts states taxing computer software transferred electronically as a specified digital product – Washington imposed a specific tax on SaaS to comply with the SSUTA

Inclusion of Digital Products Under Statutes that Tax Data Processing and Information Services

- **Ohio**
  - In 1983 Ohio began taxing business purchases of data processing services; subsequent law changes impose the tax on business purchases of automated data processing services (ADP) and electronic information services (EIS) – ORC 5739.01(B)(3)
    - Limited exclusions if purchase was for a professional service (*e.g.*, accounting) or the purchase is from an affiliated (related) entity (more than 50% control)
    - SaaS picked up only for business purchases via the State's tax on ADP and EIS
- **Texas**
  - In 1987 Texas expanded its sales tax base to include data processing services and information services – Texas Tax Code 2-151
    - Tax on data processing and information services only imposed at 80% (20% reduction) – Texas Code 2-151.351

Inclusion of Digital Products as Taxable Tangible Property

Some states are still asserting their sales tax applies to certain digital products based on the state's definition of tangible personal property

- **Arizona**
  - Arizona Dept. of Revenue asserts the purchase of some digital products constitutes the lease or rental of tangible personal property
  - This issue is currently subject to litigation – does a purchaser have the requisite "possession and/or control" over the product when it does not physically have access to a digital product
  - There are also sourcing issues
- **Colorado**
  - In 2020 the Colorado Dept. of Revenue also took a similar position to that of the Arizona DOR and amended a rule to pick up "streaming" and other digital products as tangible personal property
  - Colorado's Legislature "clarified" its law by enacting H.B. 1312 in 2021 to pick up "digital goods," which is defined as any item of tangible personal property that is delivered or stored by digital means, including video, music or electronic books.

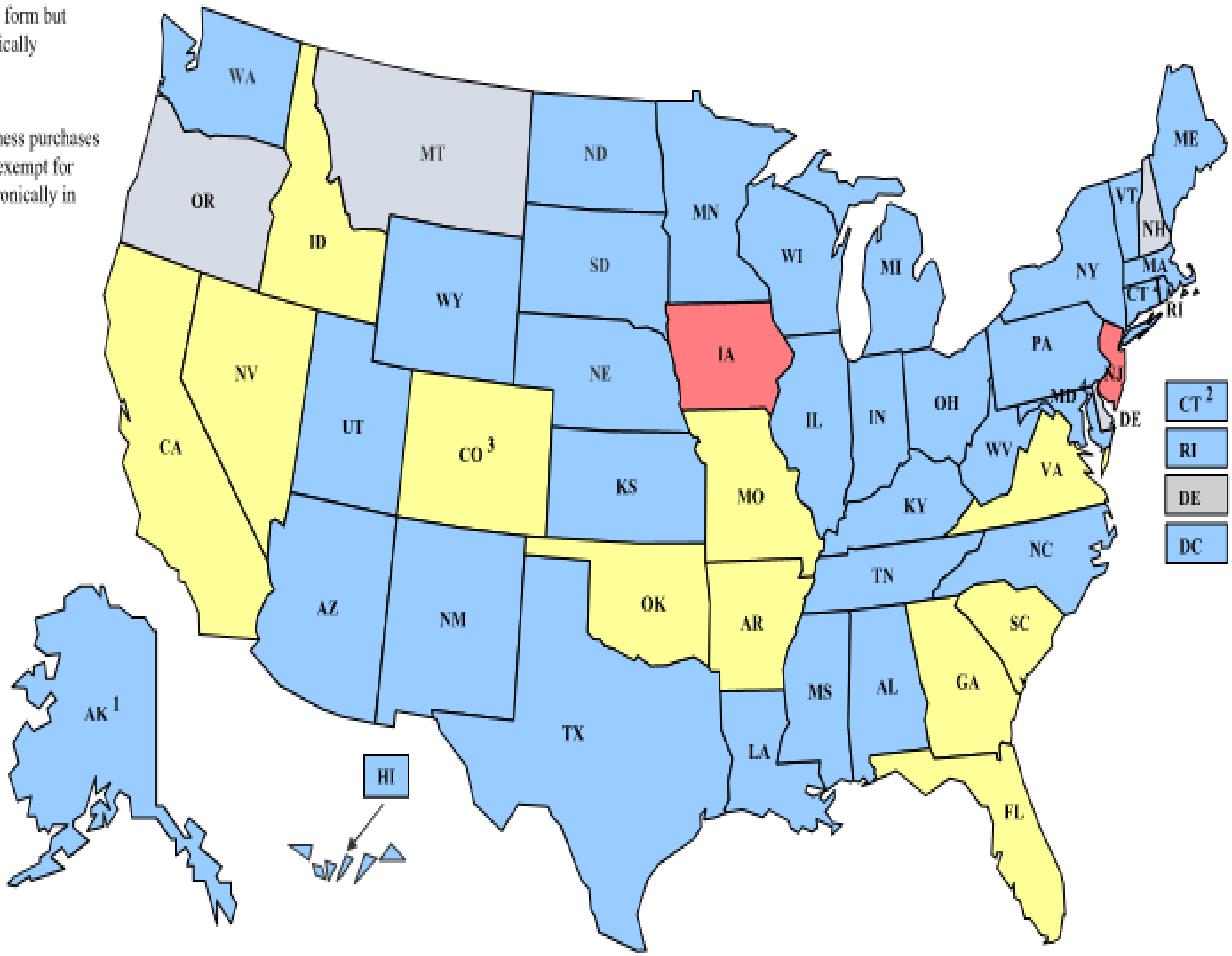
Exclusion of Digital Products from the Sales Tax Base

- Some states have not expanded their sales tax to digital products. The tax only applies if the software is sold via tangible media. The tax does not apply to software "delivered electronically"
- **California**
  - For the privilege of selling tangible personal property at retail in California, the state imposes sales tax upon all retailers based upon their gross receipts from the retail sales of tangible personal property within the state.
  - Cal. Rev. & Tax. Code § 6051.
- **Georgia**
  - Georgia imposes sales tax on the sales price of tangible personal property and of certain services. Ga. Code Ann. § 48-8-30(a). (The sale, lease, rental, license, or use of prewritten computer software is only subject to sales and use tax when sold in a tangible medium.)
  - While Georgia has not enacted a tax on digital products to date, legislation has been introduced (but not enacted).

Sales Taxation of Digital Business Inputs in Six Software and Digital Product Categories

Prewritten Software (Including Electronic Delivery)

- Tax imposed both in tangible form and when delivered electronically
- Tax imposed in tangible form but not if delivered electronically
- No sales tax
- Tax is imposed but business purchases are exempt in Iowa and exempt for software delivered electronically in New Jersey



Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Source: Council On State Taxation (COST)

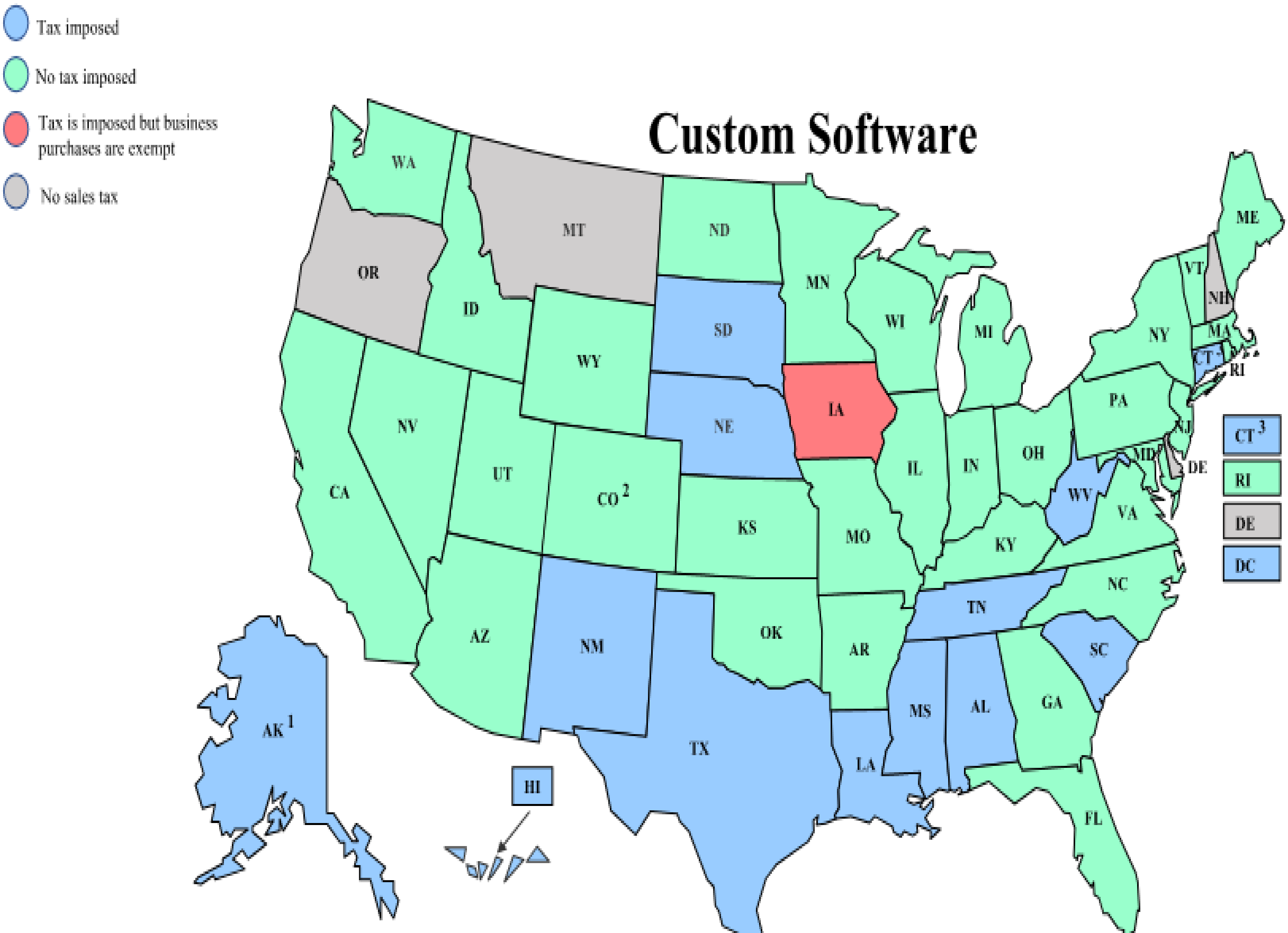
[1] Data is based on local municipalities since Alaska does not have a state-wide sales tax

[2] Software delivered electronically is taxed at a 1% rate for businesses

[3] Tax may be imposed by some localities on electronic delivery

[4] Maryland has a limited exemption for enterprise software

Custom Software



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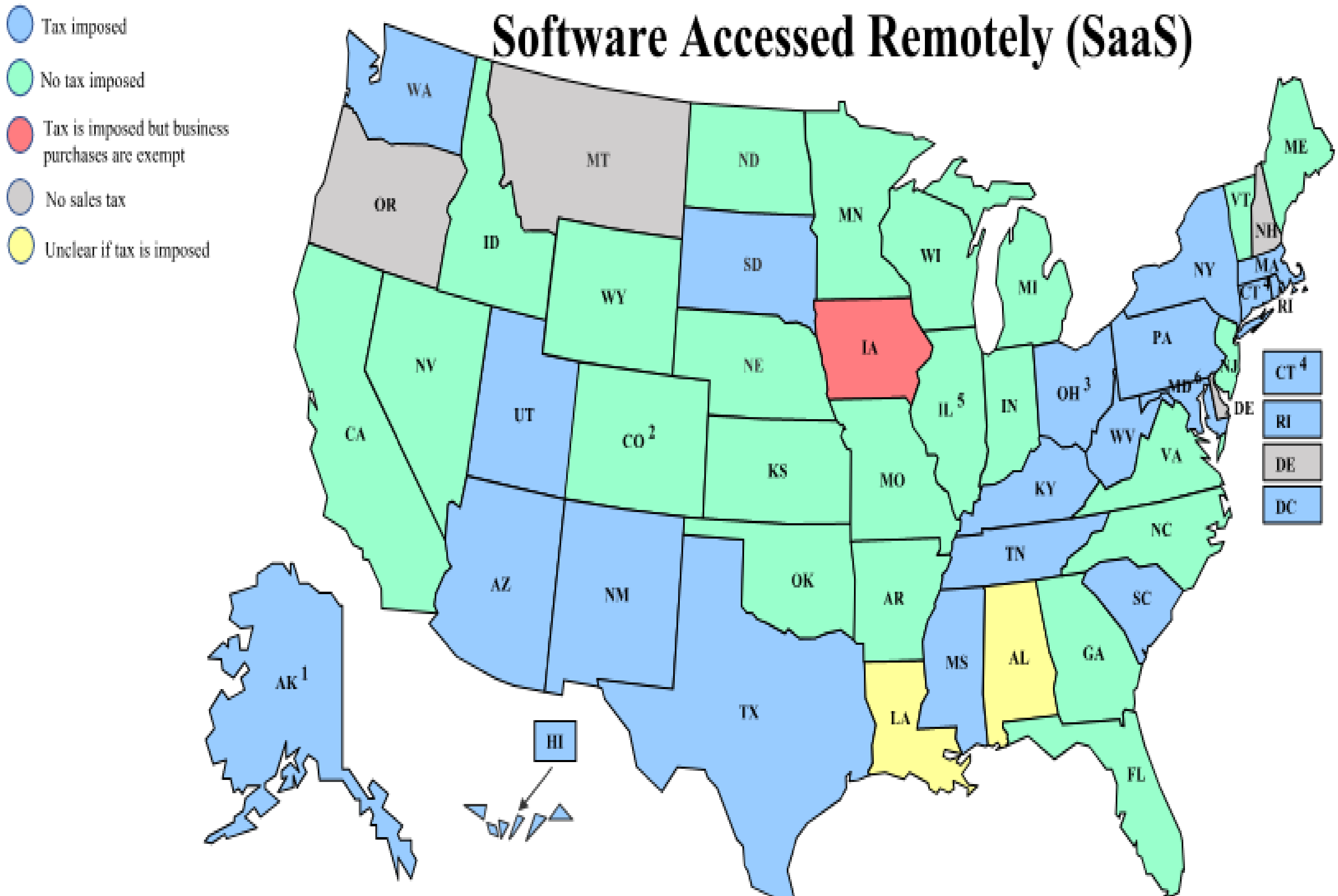
Source: Council On State Taxation (COST)

[1] Data is based on local municipalities since Alaska does not have a state-wide sales tax

[2] Localities may impose tax

[3] Taxed is imposed at a reduced rate of 1%.

Software Accessed Remotely (SaaS)



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Source: Council On State Taxation (COST)

[1] Data is based on local municipalities since Alaska does not have a state-wide sales tax

[2] Tax may be imposed by some localities

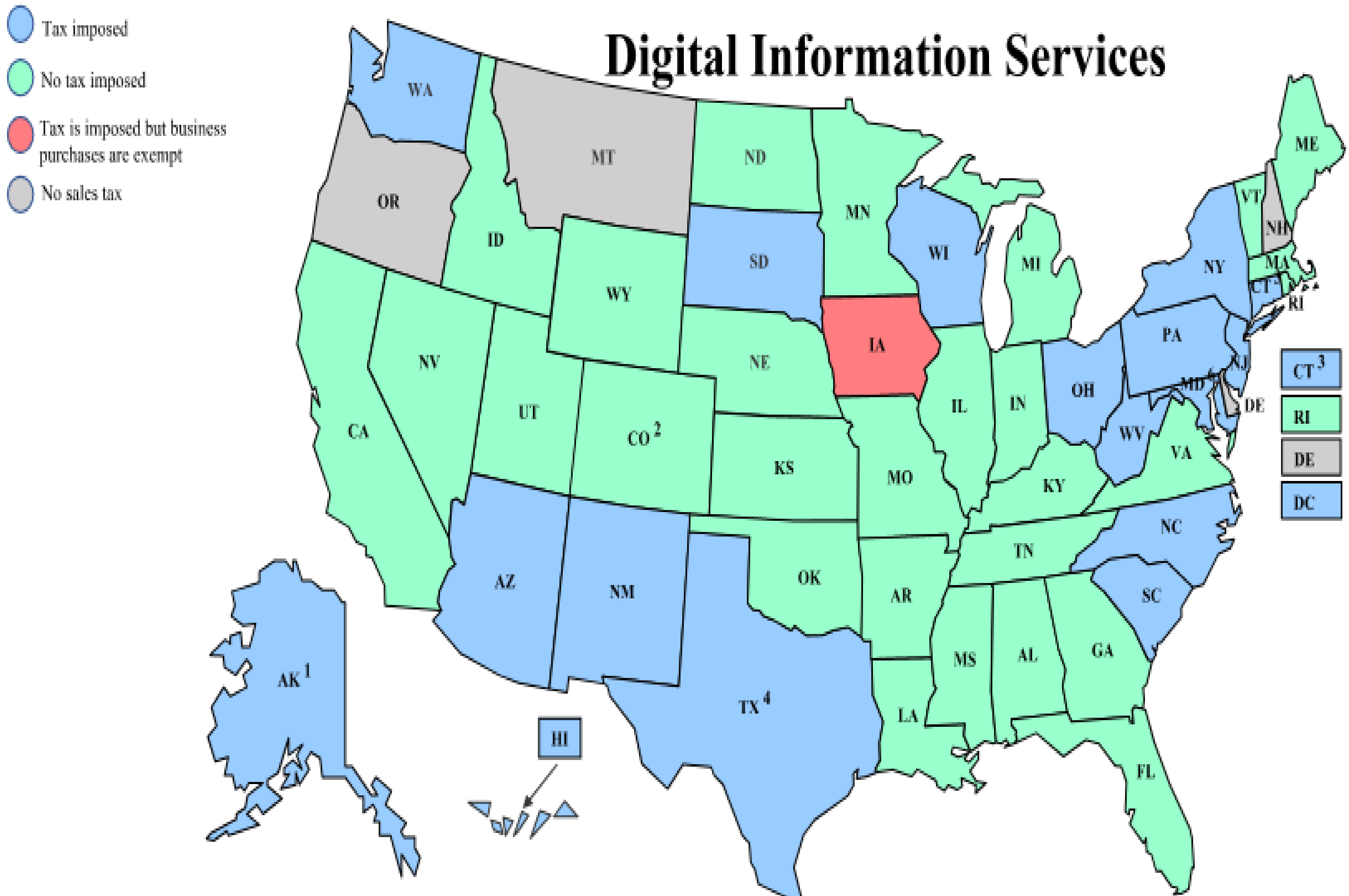
[3] Tax only applies to businesses

[4] Electronically accessed software is taxed at a 1% rate for businesses

[5] Taxed in Chicago

[6] Maryland has a limited exemption for enterprise software

Digital Information Services



Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Source: Council On State Taxation (COST)

[1] Data is based on local municipalities since Alaska does not have a state-wide sales tax

[2] Localities may impose tax

[3] Taxed at a reduced rate of 1%

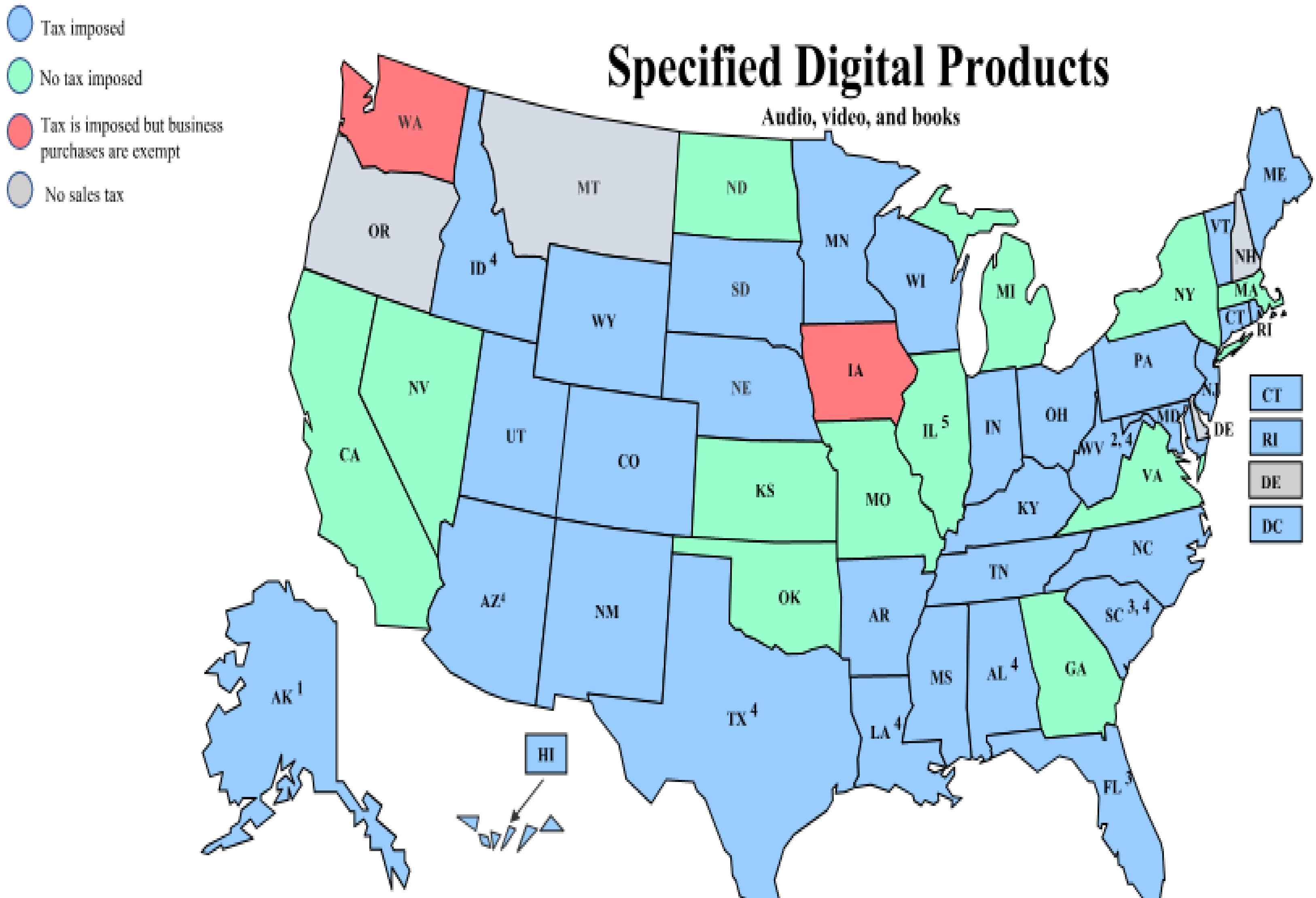
[4] Tax imposed at 80% the standard rate

[5] Taxed in Chicago

[6] Maryland exempts some types of digital information services

Specified Digital Products

Audio, video, and books



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Source: Council On State Taxation (COST)

[1] Data is based on local municipalities since Alaska does not have a state-wide sales tax

[2] Some products may be picked up by the tax on general services

[3] Taxed under communications services tax

[4] Tax not based on clear statutory authority

[5] Taxed in Chicago

Statutory Exemptions for Business Purchases of Digital Products

Modest Exemption: Washington's Exemption for Business Purchases of Digital Goods

- In 2009 Washington enacted a comprehensive and detailed statute for the sales taxation of digital commerce.
- Washington taxes three broad digital commerce categories: digital goods, digital automated services, and SaaS.
- The state allows an exemption only for business purchases in one of the three categories — digital goods – a category that primarily consists of B-to-C sales.
- Washington provides that sales tax does not apply to the sale of digital goods to a business (and services rendered for those products), if purchased solely for a business purpose.
- "Business purpose" is defined as "any purpose relevant to the business needs of the taxpayer claiming an exemption" but does not include any personal, family, or household purpose or any activity conducted by a government entity.

Broad Exemption: Iowa's Exemption for Business Purchases of Software and Digital Products

- Iowa provides the broadest exemption for business purchases of digital commerce.
- Iowa provides a statutory exemption that covers specified digital products, prewritten computer software, and some enumerated services **furnished to a commercial enterprise** for use exclusively by the enterprise.
  - Included in the "enumerated services" are information services, custom software, and SaaS.
- "Commercial enterprise" is broadly defined to include: (1) businesses and manufacturers operating for profit; (2) insurance companies (for-profit and nonprofit); (3) financial institutions (for-profit and nonprofit); (4) professions and occupations; and (5) public utilities.
- As summarized by the Iowa Department of Revenue in a guidance document, specified digital products, prewritten computer software, information services, and SaaS are exempt "when purchased by a commercial enterprise and used exclusively by or furnished to that commercial enterprise."
  - Furthermore, to qualify for "use exclusively by the commercial enterprise," the use for noncommercial purposes must not be more than de *minimis.*

Tax Rate Reduction: Connecticut's Approach

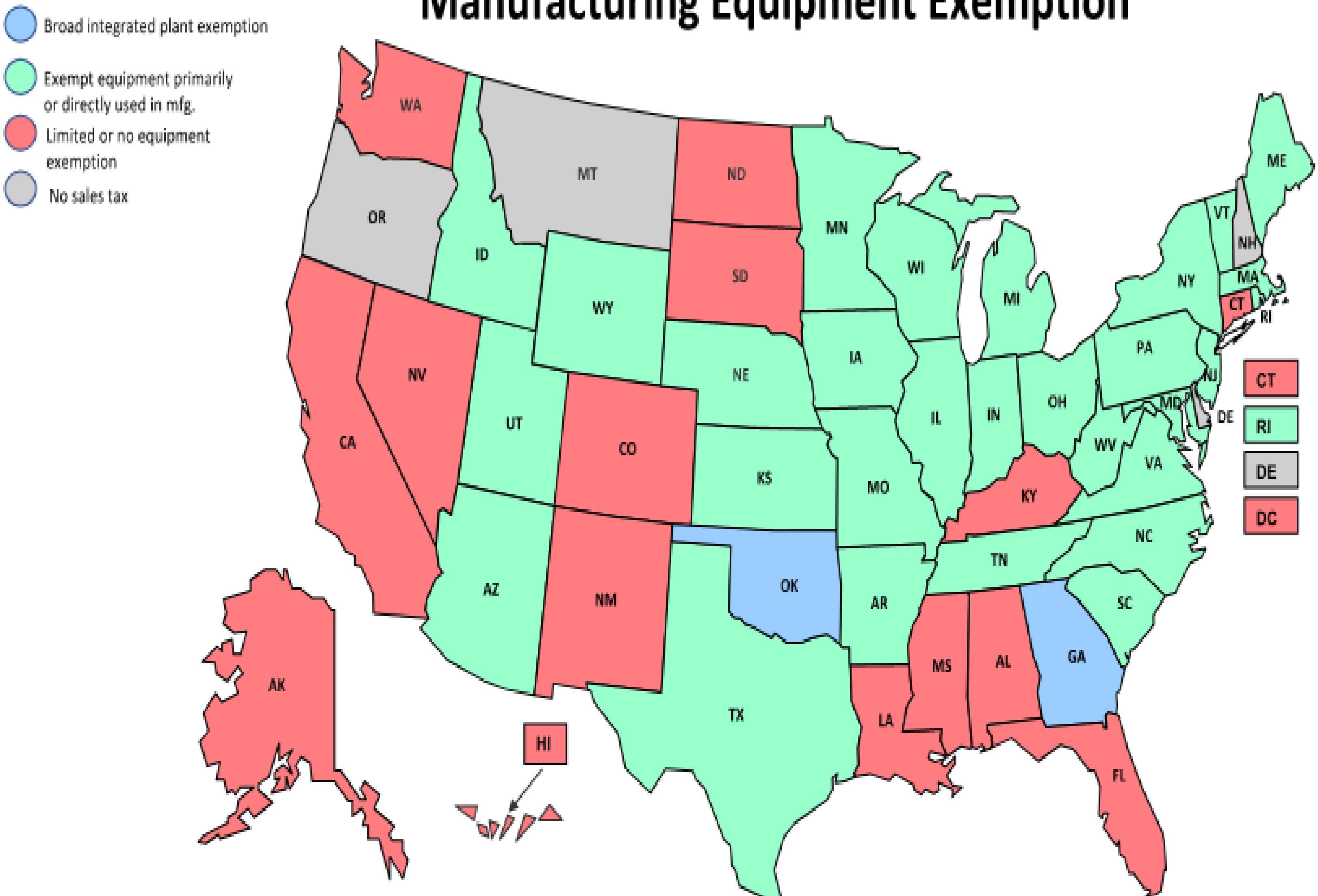
- Connecticut provides relief for some business purchases of digital commerce.
- The state provides for a reduced 1 percent rate for computer and data processing services, including electronically accessed or transferred canned software that is "sold to a business for use by the business."
- The reduced rate is lost, however, if the "software is provided with any tangible personal property (such as a box, plastic container, or CD), even if such tangible personal property only authorizes the electronic access or transfer of the software.

Taxing Digital Business Inputs Exacerbates the Design Flaw in State Sales Tax Systems

The Sales Taxation of Business Inputs in other Industries

- By comparison, if we look at several other industries where business inputs are frequently taxed, the track records of the states are mixed, but not as abysmal as with digital products.
- **Manufacturing** –
  - Manufacturers have one of the broadest business input exemptions. Thirty-one states have an exemption, generally covering equipment primarily or directly used in manufacturing.
- **Services –**
  - Most states tax both equipment used in providing wired and wireless telecommunications (business inputs) and the telecommunications services sold to consumers.
    - However, even in this service sector where the cascading of tax is widespread, 12 states exempt business purchases of telecommunications equipment, and two other states tax the equipment but exempt some or all of the sales to consumers.
  - Similarly, most states tax both equipment used in providing electric and gas service and the electricity and gas sold to consumers.
    - Nonetheless, 13 states still exempt business purchases of equipment used in electric and gas service, and six other states tax the equipment but exempt some or all of the sales to consumers.

Manufacturing Equipment Exemption



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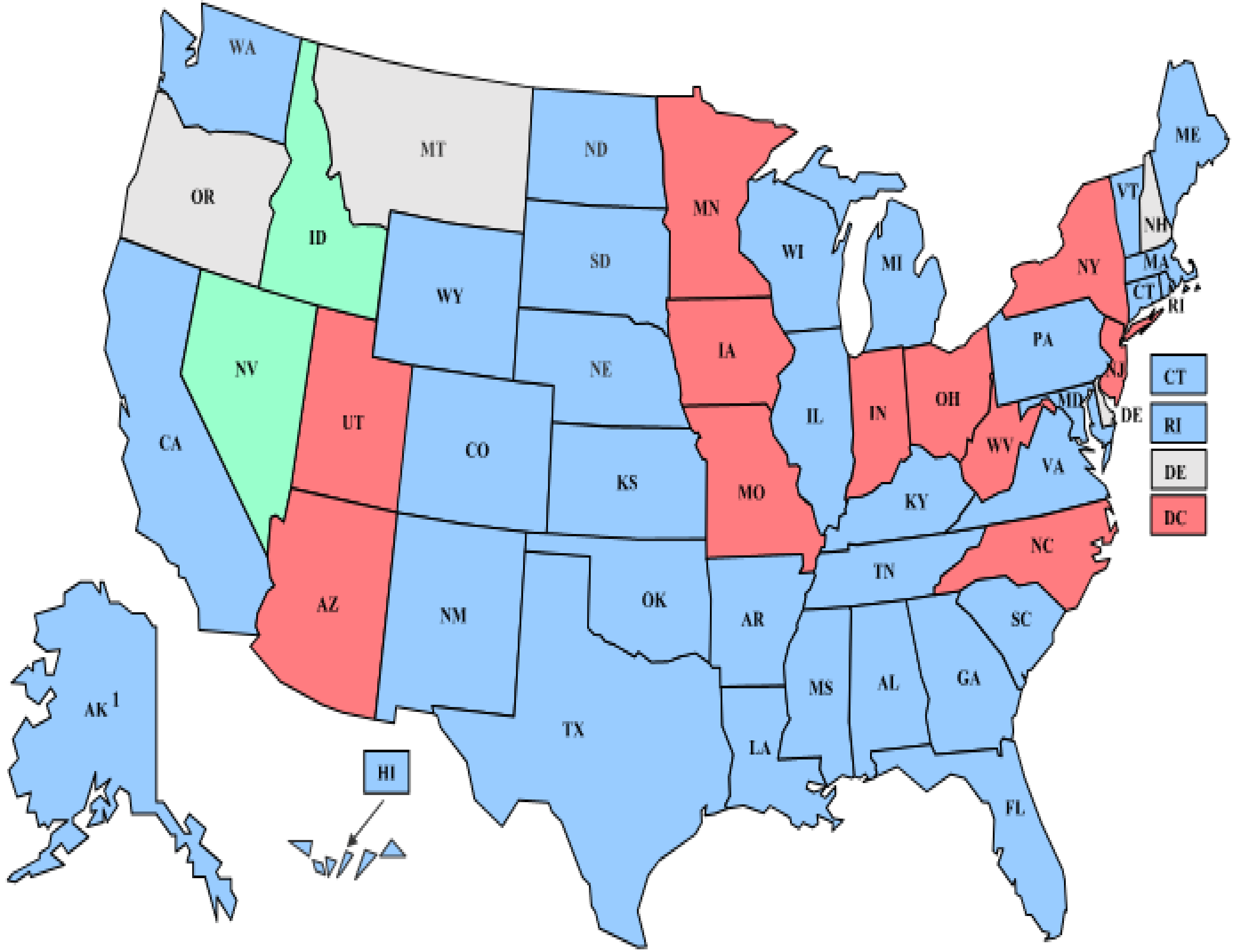
Source: Council On State Taxation (COST)

- All or some substantial portion of equipment is subject to sales tax
- Equipment is taxable but some or all consumption is exempt
- Equipment is not subject to sales tax or similar tax
- No sales tax or similar tax

Wired and Wireless Telecommunications Service Providers Equipment Exemption



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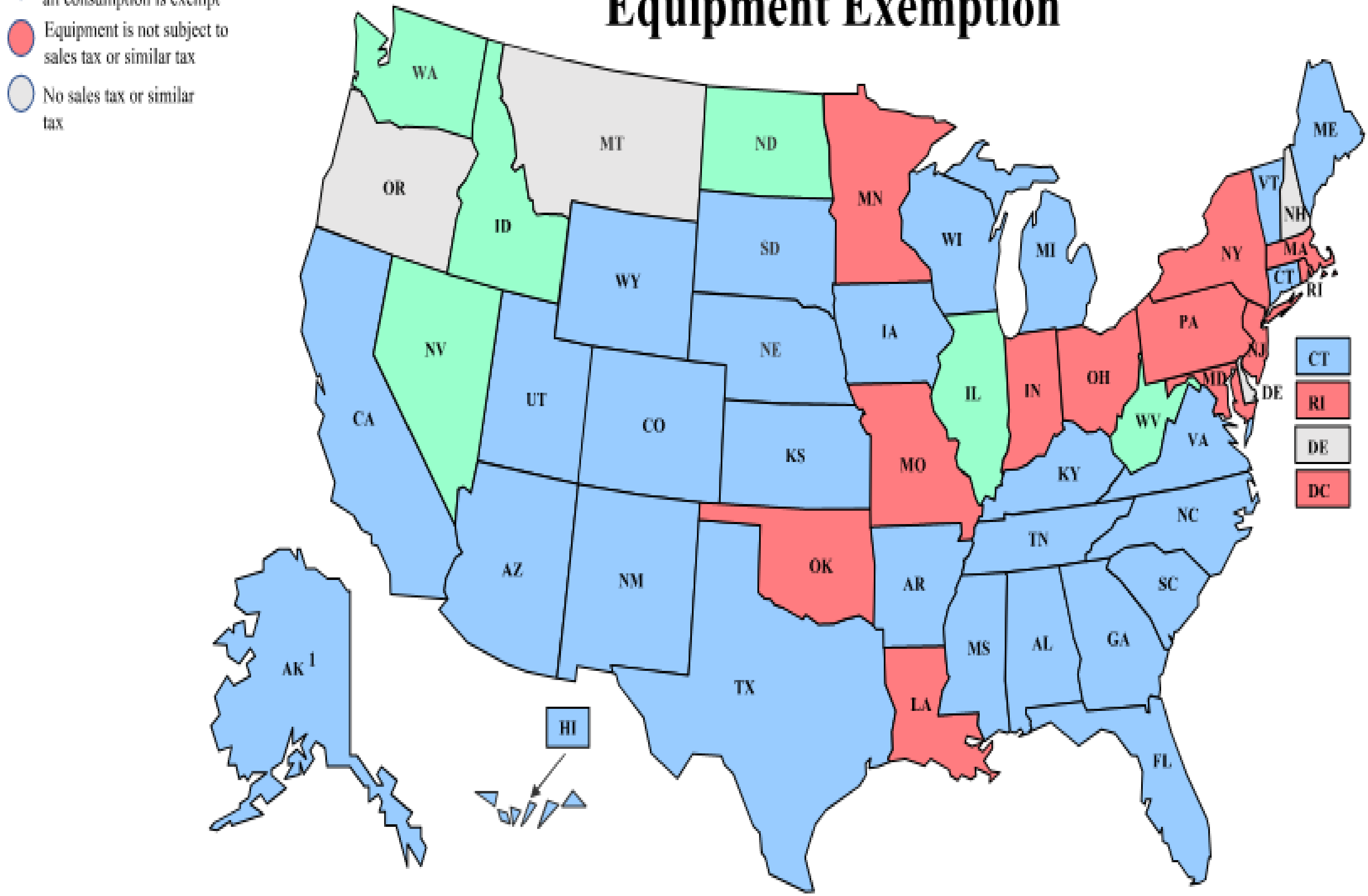
Electric and Gas Service Providers Equipment Exemption



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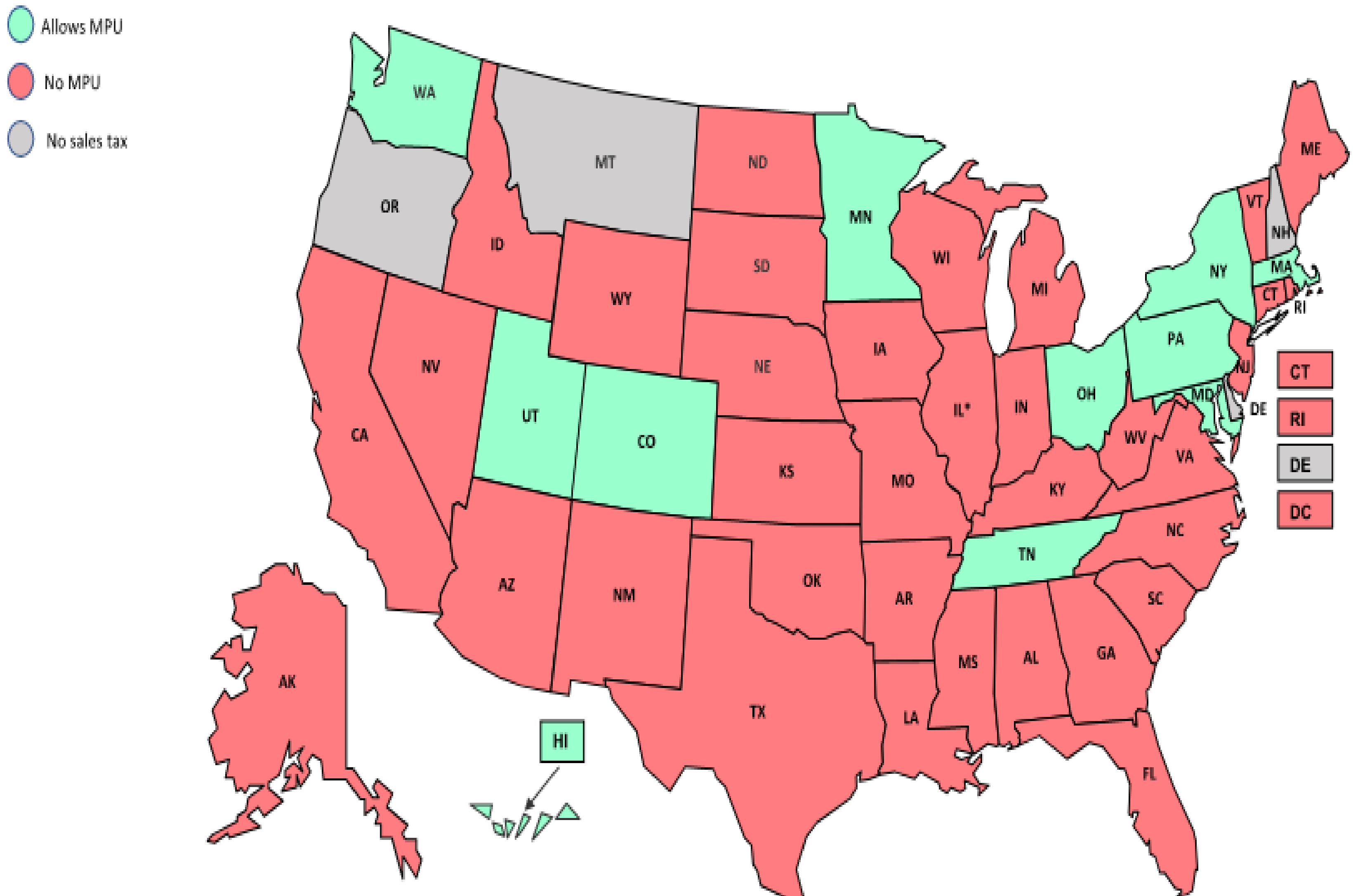
The Growing Importance of Digital Commerce

- The escalation of the sales taxation of digital business inputs is particularly worrisome given the scale and rapid growth of the digital economy.
- For instance, in 2021 the U.S. business software and services market, virtually all of which is digitally based, totaled $77.8 billion. Moreover, the market is growing at a compound annual rate of 10.6 percent and is projected to total about $200 billion by 2030.
- The primary business use of software and related services are for the finance, sales and marketing, manufacturing, research and development, human resources, and supply chain functions (logistics).

Administrative Issues with Digital B-to-B Purchases: States that Allow Multiple Points of Use (MPU) Apportionmen



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Source: Council On State Taxation (COST)

* MPU allowed in Chicago

Conclusion

The Future of Sales Taxation of Digital Commerce

- There is a clear trend toward states broadening their sales tax bases to include additional categories of digital products.
- The expansion of the digital sales tax base is largely a response to both the acceleration of digital commerce economy and the realization that many of the new categories of digital products were previously included (and taxable) in the tangible sales tax base (for example, software, books, videos, or music albums).
- Our primary concern is not so much the expansion of the sales tax base to digital products for end-user consumer purchases, but the near-total failure of state laws to provide business use exemptions for digital products.
- This development makes a long-standing systemic flaw of state sales tax systems worse – the pyramiding/cascading of states' consumption taxes on business inputs.

The Future of Sales Taxation of Digital Commerce

- As states continue to evaluate the appropriate level of inclusion of digital products in their sales tax bases, it is important that they take steps to avoid taxing both business inputs and consumer purchases.
- As the COST study documents, current precedents for excluding business purchases of digital products are generally limited in scope and applied by few states.
- **COST Recommendation:** Every state that taxes some or all digital products should adopt a broad statutory exemption for business purchases. Otherwise, states risk making the sales tax even more inefficient than it already is, diverging further from the norms of an optimal consumption tax.

For more information see: Karl A. Frieden, Fredrick J. Nicely, and Priya D. Nair, Tax Notes State, "Down the Rabbit Hole: Sales Taxation of Digital Business Inputs", July 18, 2022

Down the Rabbit Hole: Sales Taxation of Digital Business Inputs

by Karl A. Frieden, Fredrick J. Nicely, and Priya D. Nair

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In this article, the authors examine key issues regarding state sales taxation of digital commerce, focusing on the absence of sales tax exemptions in most states for purchases of software and digital products by businesses.

The authors thank Megan Wilson, a 2021-2022 COST fellow, for her assistance in researching state sales taxation of digital products.

Introduction

Most state sales taxes had their beginnings in the 1930s and 1940s and were drafted broadly to include all sales of tangible property in their tax bases, absent specific exemptions.[1] Most states did not initially impose sales taxes on services because consumer services were a small part of the economy. Moreover, because the enactment of sales tax statutes predated the widespread use of computers and the creation of the Internet, early state statutes did not (and could not) address the taxation of digital goods and services.[2]

Over the last 25 years, however, the sales taxation of digital commerce has emerged as one of the most prominent and contentious issues in state taxation. This is a function of both the rapid growth of digital commerce and of the unique challenges of imposing transaction taxes on sales of non-tangible goods or services.

In analyzing digital goods and services (collectively referred to as digital products), this article focuses on products delivered to or accessed by a consumer electronically over the Internet. These digital products include both goods previously sold to a purchaser in tangible form (for example, books, films, record albums, and software on a disk) and goods and services with no clear tangible equivalent (for example, computer applications, software as a service

[1] See SalesTaxHandbook.com, "History of Sales Taxes in the United States," which notes that 24 states began imposing sales taxes during the Depression. References to state sales taxes throughout this article encompass state and local sales and use taxes.

[2] Karl A. Frieden and Douglas L. Lindholm, "A Global Perspective on U.S. State Sales Tax Systems as a Revenue Source: Inefficient, Ineffective, and Obsolete," State Tax Research Institute, at 89-91 (Nov. 2021).

Questions?

Thanks!

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