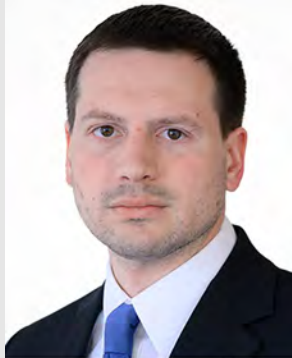


The Perils of the MTC's Digital Products Tax Push

by Jared Walczak



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In this installment of *Via Salaria*, Walczak cautions that state lawmakers should carefully weigh the Multistate Tax Commission's recommendations on the taxation of digital products, arguing that they could lead to an expansion of the sales tax base to many transactions not intended for that treatment.

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The Multistate Tax Commission has taken up an ambitious project of defining digital products to facilitate taxability determinations. On paper (or is that too last century?), the task does not appear unusually difficult: Most of us intuitively understand when a good or service is digital and can instinctively grasp how — in the context of digital products — a digital watch is not, but an e-book is. Of course, the digital world is full of edge cases, and simple definitions can yield outcomes we intuitively know are “wrong.” But the fundamental flaw in the MTC's project is not that the question it seeks to answer is difficult, but that it's the wrong question altogether.

Asking the Wrong Question

The MTC cautions that its goal is not to advocate for the taxability of all digital products, but a self-described uniformity project arising from an entity called the Multistate *Tax* Commission with a stated mission of

“promot[ing] uniform and consistent tax policy and administration among the states” cannot help but be viewed through that lens. Indeed, even in the cautious statements of MTC presenters at the now-monthly meetings on Sales Tax on Digital Products¹ — from the name, you might well conclude that the purpose of defining these products is that they might be subject to sales tax — routinely slip into language about how to tax these products.

This is not to suggest any disingenuousness on the part of the MTC's Uniformity Committee or its new standing subcommittee on digital products. It is simply an unavoidable reality: If you bring state tax administrators together to propose a definition of digital products, the obvious use of the new definition is to include it in state tax codes to expand taxability.

And therein lies the basic error of the entire undertaking: Whether a good or service constitutes a digital product tells us almost nothing about whether it belongs in state sales tax bases.

A draft outline of a forthcoming white paper from the MTC's Digital Work Group notes — as one of many existing resources to consult in developing a broader definition of digital products — the limited existing definition of specified digital products used by the streamlined states, which used uniform definitions under the multistate Streamlined Sales and Use Tax Agreement.² Yet the definition of specified digital products in these states is not limited because drafters lacked the wherewithal to define digital products more comprehensively, nor is the list less exhaustive because the Streamlined members

¹ Multistate Tax Commission Uniformity Committee, “Sales Tax on Digital Products.”

² MTC, “Discussion Draft of Detailed Outline of a White Paper on Sales Taxation of Digital Products” (Mar. 2, 2023).

struggled to enumerate potential digital products. Rather, the approach recognizes that the taxability question is ultimately a *policy choice*, not merely a definitional question. There is no reason that a transaction's classification as involving a digital product should create any presumption of taxability. Indeed, if anything, it should counsel extreme caution.

Another Digital Divide

Our world has changed. A while back, I tallied up the 100-odd books I "read" last year and was moderately surprised to find it entirely a mix of e-books and audiobooks. I evidently failed to provide even the slightest patronage to the bookbinding industry last year. The same can be said for my consumption of other media — and probably yours as well. For the first time since 1987, vinyl sales beat CDs in the United States,³ and it's not because most of us have dusted off our turntables. Streaming services have pummeled CDs, and as video goes, we're famously down to one last Blockbuster. For better or worse (and probably both), we're all digital natives now, and it makes sense that retail sales taxes should reflect this reality. As consumers find digital substitutes for the tangible products they used to purchase, sales tax bases can and should adjust to these new modes of consumption.

But let's be transparent about this: The real money isn't in your Spotify account, your Netflix subscription, or that next Kindle book. It's in digital controls, cloud computing, inventory management, automated production lines, digital payments, machine learning, software (and platform and infrastructure) as a service, digital advertising, and data processing.

In short, the basic project of defining digital products for tax purposes is to create a massive inventory of business inputs, many either untaxed or only partially taxable at present (whether in tangible or digital form), and to slip them into sales taxes that are supposed to be imposed on retail transactions.

Policymakers rightly speak of a digital divide involving unequal access to digital technology.

But there is a digital divide for tax purposes as well — between digital products that are appropriate for sales taxation and those that are definitionally not a final consumer product and should be excluded from a well-designed sales tax base. The two sides of the divide are unbalanced, with most digital product transactions — especially when measured by cost — falling on the business side.

Sales tax codes already include far too many business-to-business transactions, yielding tax pyramiding. The goal of reformers for decades has been to reduce the number of intermediate transactions captured by sales tax bases.⁴ The upshot of broad digital products taxation would be to give up the whole game, and — as our economy becomes increasingly digital — to transform state sales taxes into something more akin to high-rate gross receipts taxes.

Even parity should not be the goal if it services bad tax policy. In practice, a sweeping approach to the taxation of digital products would tax the digital equivalents of many goods and services that are untaxed in an analog setting. Beyond that, the existence of taxes on certain tangible business inputs is an argument for reforming the existing system, not for extending the tax to additional business inputs that are in some way analogous to them.

Again, it is important to acknowledge the MTC's disclaimers — that this project on the sales taxation of digital products is not intended to be prescriptive and that the result will not be a recommendation that states tax all digital products. (Some participants, however, clearly have this in mind, and concerns about the current nontaxability of many of these transactions permeate the deliberations.) But it is equally important to ask what other real-world purpose the project might serve. Imagine that, miraculously, the working group lands upon a perfect definition of digital products — what then? What use will this be to lawmakers or state tax administrators, if not to incorporate into their tax codes in some way?

³ Brandon Drenon, "Vinyl Records Outsell CDs for First Time in Decades," BBC News, Mar. 13, 2023.

⁴ See, e.g., Charles E. McLure Jr., "Rethinking State and Local Reliance on the Retail Sales Tax: Should We Fix the Sales Tax or Discard It?" 2000(1) *BYU L. Rev.* 77 (Mar. 2000).

The MTC's draft outline offers extensive digital product exemplars within a variety of industries. Agriculture, manufacturing, healthcare, construction, education, energy, food, retail, office products, telecom and information technology, and travel all make the list. Examples of digital products in the agricultural industry include — to cite a few examples — digital pasture management, digital seed technology, drones, farm management software, GPS guidance systems, machine learning (used to improve crops and identify pests), monitoring technology, robotic harvesting, sensors, smart irrigation, and data and artificial intelligence for assessing things like soil quality and plant yield.

Sometimes it can be difficult to categorize a particular good or service as a business input or consumer transaction without knowing the purchaser's identity, because businesses and individuals alike purchase some of the same products. It is not, however, terribly difficult to recognize that digital seed technology has limited consumer applicability, and that hobbyist gardeners aren't using robotic harvesting or operating combines with GPS guidance systems.

Moreover, agriculture has generally been treated fairly well by state sales taxes, with exemption certificates often eliminating the taxability of many intermediate transactions that are not definitionally excluded from the base. Under a broad taxability of digital products, that would change overnight.

For manufacturing, digital goods could include modeling, simulations, automated production lines, data storage and processing, digital controls and machines, digital machines, robots, software as a service, and digital advertising — along with categories also applicable to agriculture like machine learning. The healthcare industry's digital products are ample, too, and might include storage of medical records, wearable devices, artificial intelligence and augmented reality used in medicine, cloud computing, robot-assisted surgery, virtual biopsies, and much more.

The MTC discussions are still proceeding, and no controlling definition has yet been promulgated. For now, the draft outline acknowledges many potential definitions as fodder for further deliberation, including —

amusingly — one provided by a prompt to ChatGPT. The definition it yielded is inaccurate in almost all particulars,⁵ but perhaps the further confusion it introduced to the discussion is the first glimmer of AI sentience; it must have intuited that the MTC draft outline would include ChatGPT itself on its inexhaustive list of digital products.

Unavoidable Implications

The MTC's Uniformity Committee, in establishing the working group, suggested as a goal "determin[ing] the best approach to making existing state sales taxes adaptable and responsive to changes in the digital economy as opposed to creating a new tax or looking at gross receipts taxes." In one respect, this is commendable: The MTC is right to acknowledge that the appropriate response to the emergence of new categories of economic transactions is to modify sales tax bases, not to create new targeted excise taxes or to return to the bad old days of gross receipts taxes. An important qualification should be added, however: This exercise makes sense *only insofar as the new economic activity is rightly subject to consumption taxes*.

This goal, the first listed by the Uniformity Committee, makes even more precarious the MTC's already strained insistence that the project is not prescriptive about taxability. But while the instinct for avoiding punitive, targeted excise taxes (or worse, gross receipts taxes) on specific industries and activities rather than modifying the closest thing we have to a broad-based consumption tax is correct, the implicit assumption that digital products should be broadly taxable is fundamentally flawed. The question is not, primarily, the mode of taxation but rather the justification for including non-consumption under any kind of consumption tax.

An accurate botanical definition of berries may help us discover that bananas, watermelons,

⁵ According to a ChatGPT output generated by a prompt from MTC staff, the necessary preconditions of a digital product include that the product (1) can be accessed from any device (wrong), (2) is easily copied and shared (wrong), (3) is easily updated and improved (wrong), (4) is delivered electronically (wrong), and (5) is not physical (correct).

and pumpkins are surprisingly on the list while strawberries are not⁶ — but this knowledge will not serve us very well if we're trying to inventory livestock. Likewise, even solving all the definitional complexity around digital products is of little utility if our ostensible purpose is to improve the definition of taxable consumption.

Inherent Complexity

Sourcing services is more complex than sourcing goods, and adding a digital element only compounds the difficulty. Most states use destination sourcing for sales of tangible property, but much greater variation exists with the sale of services. Some states have distinct rules for different classes of services, and many have a flow chart of sourcing rules, while other tax codes are silent on the question.

Sourcing can be to the point of delivery, the market where a service's benefit is received, the purchaser's address, or the location where the service was provided, among other options. Some states account for multiple points of use — with purchasers required to reasonably apportion the tax among jurisdictions where the benefit of a service was received.⁷ There is a clear potential for double taxation because of the interaction of competing rules, and while credits for taxes paid to other jurisdictions can ameliorate some of that excess liability, they are not always sufficient and generate significant compliance costs.

Additional complexity arises from the potential for bundled transactions consisting of both taxed and untaxed constituent parts, and by proposed definitions that could categorize something as a digital product any time a digital process "touches" a transaction — in the extreme, potentially inclusive of purchasing tangible goods via a website or using a digital point-of-sale terminal for checkout at a brick-and-mortar retailer.

The MTC could help promote uniform rules for sourcing of services under sales taxes, which would be a beneficial outcome, but a multiplication of sales taxes on digital services is

likely to greatly exacerbate the existing clash of state sales tax codes and to make compliance considerably more costly. And while sourcing matters for consumer services — including digital services — and consumers would benefit from greater uniformity, the issue is overwhelmingly associated with business-to-business transactions. These additional headaches could be avoided by not expanding the base to include them.

It is widely recognized that taxing business inputs leads to tax pyramiding. Less commonly understood is how it transforms the sales tax from a tax on consumption to — at least in part — a tax on capital. In the process, it takes a tax that is neutral regarding in-state investment and turns it into a discriminatory tax on a state's own businesses.

It is, of course, perfectly constitutional for states to impose outside tax burdens on their own businesses. It is also remarkably short-sighted.

When a sales tax is destination-sourced and the base is limited to final consumer transactions, the rate in a particular jurisdiction can induce cross-border shopping, which may be detrimental to brick-and-mortar retailers but does not otherwise impede a business's ability to compete with out-of-state competitors, since customers are taxed at their own local rates, not at the rate in the business's jurisdiction. As soon as taxes are imposed on a business's own purchases, businesses in that jurisdiction are placed at a disadvantage against competitors not subject to those taxes. If a state elects to tax the digital products purchased by a business as part of its production process, it is imposing a tax on that business's activity that is not faced by businesses elsewhere, and that can only be avoided by moving the production process out of state.

Digital advertising offers an interesting example of how sourcing digital services can go awry. In advertising, the benefit is to the company placing the ads (which hopes to generate sales or leads), not the consumers to whom the ad is served. If digital advertising is included in sales tax bases — and the MTC draft lists digital advertising as an example of a digital product — then where the advertising network is based or where the ads are served is immaterial; the benefit is received where the company purchasing the advertisement is located. A state that adopted

⁶ Colorado State University, "Everything You Need to Know: Is That a Berry?" Little Shop of Physics, Apr. 29, 2020.

⁷ Brian Hamer, "Report: Sourcing Digital Goods and Services," MTC, Uniformity Committee Meeting (Apr. 25, 2019).

such a provision would potentially tax their own companies based on all their digital advertising anywhere, while exempting other businesses from taxes on advertising served to their own residents.

Fundamentally, sales taxes were not intended for this kind of transaction — and there is no justification for imposing excise or gross receipts tax on advertising, either. When a company purchases advertising, it does not do so because its executives enjoy “consuming” advertising; it does so because they want to sell a product, which itself will be (or at least usually should be) subject to sales tax, and to generate profits, which are subject to income taxes. Sales tax sourcing rules do not work nearly as well when the tax is extended to intermediate transactions, because that’s not what sales taxes are for.

Wrong Venue

Unlike the Streamlined Sales Tax Governing Board and similar bodies, the MTC is composed not of legislative representatives — but of state tax administrators. They are experts in tax administration and offer excellent insights into technical questions involving tax uniformity, but they are not a policymaking community, nor were they intended to be.

In other intergovernmental bodies, a participant speaks for the state, or at least some element of it. Under the MTC approach, each participant speaks only for themselves, and not in their formal capacity as officials within their respective state governments, but the resulting work product tends to be seen as a consensus of the state policy community.

On mere technical questions, this may not be of much importance, and their contributions can be of utmost value — drawing on their expertise as tax administrators. But while the definition and taxability of digital products *involves* many technical details, these are ultimately policy questions of the greatest import. The answers to these questions could fundamentally remake state sales tax codes. That is a matter for policymakers — not one that can be easily outsourced to an intergovernmental state tax agency in which no elected officials participate.

The working group is filled with smart, public-spirited people doing their best on a

difficult issue. But whatever expertise the group may bring to these questions, promulgating a uniform approach to the sales taxability of digital products is not something that should be left to agency officials on conference calls — particularly if that approach would lead to substantial business tax increases across the country.

Conclusion

The MTC’s working group on the sales tax on digital products draws upon the efforts and insights of talented and public-minded people. It may yield some useful products, like better matrices of the state tax treatment of digital goods and services. It may also generate intelligent responses to avoidable problems, like better sourcing rules for services that, ideally, would not be taxed at all. At heart, however, this is an exercise in tax expansion — particularly the dramatic expansion of the sales tax base to include a host of transactions not intended for such treatment.

State lawmakers should therefore weigh any resulting recommendations carefully, with a full appreciation of why fiscal policy experts across the spectrum broadly reject consumption taxes on intermediate transactions. They should also recognize that any MTC analyses or recommendations, while the work of very qualified tax administrators, does not necessarily reflect the policy goals of legislators in state capitals across the country.

Policymakers should be open to sales tax base broadening when it is designed to arrest the erosion of the personal consumption base as consumers shift from goods to services, or from tangible to digital goods. Broad, indiscriminate expansion to digital products, however, is another matter altogether. ■