



What's News in Tax

Sales and Use Taxation of Digital Products

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In response to technological developments, states have begun to consider legislation explicitly addressing the taxability of products delivered electronically to purchasers. The Streamlined Sales and Use Tax Agreement has adopted standards member states must meet if they impose tax on those digital products. This article discusses the agreement's requirements and their effect on sales tax laws in both member and non-member states.

The digital revolution is coming slowly but steadily to sales and use taxation. As is customary, state tax law is following technological developments. The iPod and other digital music players have been around for nearly a decade, and electronic book readers such as the Kindle are in their second generation. Yet generally, it is only within the last two years that states have begun to consider legislation explicitly addressing the taxability of various products that are delivered electronically to purchasers, rather than through some tangible storage medium. The focus in recent years has been spurred to a considerable degree by requirements of the Streamlined Sales and Use Tax Agreement ("SSUTA") that will become fully effective January 1, 2010. While some states, including both SSUTA members and non-members, have enacted or are considering legislation specifically addressing taxation of digital products, other states have not. For those states that have considered the issue, some of the driving factors for taxation appear to be preserving or expanding the tax base and creating parity between digital products and equivalent goods that are delivered in tangible form. Whatever the reason, most taxpayers would agree that transparency is long overdue.

SSUTA Rules

Although state tax laws (at least until recently) generally did not explicitly address the taxation of digital products, a number of states took the position that certain digital products were taxable pursuant to their general sales and use tax imposition statute applicable to tangible personal property or to specifically enumerated

taxable services (*e.g.*, computer or information services) or under some other legal or administrative interpretation of the state's tax law.¹ Certain taxpayers, however, were not aware of the state position regarding the taxability of these products, which resulted in unanticipated tax exposure. To reduce this uncertainty and bring greater clarity to the area, various affected interests worked to incorporate standards into the SSUTA that member states must meet if they impose tax on electronically delivered products.

As amended, the SSUTA provides that effective January 1, 2008, a member state may not tax "specified digital products" pursuant to its imposition statute applicable to tangible personal property, "computer software," "telecommunications," or "ancillary services" (a category of telecommunications services).² "Specified digital products" is defined to include "digital audio-visual works," "digital audio works," and "digital books."³ To tax these defined digital products, an SSUTA member state must enact specific imposition language subjecting these products to taxation and must adopt the SSUTA definition of these terms.⁴ Furthermore, effective January 1, 2010, the above taxability restriction will also be applicable to all other products "transferred electronically," not just the three digital products defined above.⁵ A product is "transferred electronically" if it is provided to the purchaser in means other than on a tangible storage media.⁶ Accordingly, effective January 1, 2010, member states generally will no longer be able to tax products delivered via other-than-tangible media

¹ An accurate and consistent listing of states taking the position that electronically delivered digital products are taxable is difficult to obtain. According to a survey conducted by the Federation of Tax Administrators in 2007, 16 states imposed a sales tax on various downloaded products. See Federation of Tax Administrators, *Sales Taxation of Services – 2007 Update*, available at <http://www.taxadmin.org/fta/pub/services/services.html>. Another review found that in 2006, 15 states and the District of Columbia taxed such transactions. This list differed slightly from the Federation of Tax Administrators list. Stephanie Condon, *States May Tax iTunes, Other Digital Downloads*, CNET News, Aug. 12, 2008. Another review claimed that in late 2008, 20 states took a position that certain digital goods were taxable, including nine of whom reportedly did not have legislative authority for the position. *Don't Tax You, Don't Tax Me, Tax Anything Delivered Electronically*, Sutherland Legal Alert, Dec. 19, 2008.

² Streamlined Sales and Use Tax Agreement as amended through February 26, 2009 ("SSUTA") §§ 332, 333. The amendments were adopted on September 20, 2007, with some of the amendments effective January 1, 2008.

³ This requirement is contained in SSUTA section 332. The definitions of "digital audio-visual works," "digital audio works," and "digital books" are contained in Appendix C, Part II of the SSUTA Library of Definitions, Product Definitions.

⁴ SSUTA § 332.

⁵ SSUTA § 332A.

⁶ SSUTA § 332I.

unless the state has enacted specific laws taxing electronically delivered or enumerated digital products.

To further enhance transparency, the SSUTA also provides that unless a state statute specifically provides otherwise, imposition of its tax on digital products is presumed to apply only to sales involving an end user, the transfer of a right of permanent use, and a transaction for which no further payment is required.⁷ A state may overcome this presumption and tax intermediate transactions, less-than-permanent use, and subscriptions to digital products; to do so, the state's statute must specifically address the taxability of these transactions.⁸ Additionally, the sale of a "digital code" allowing a purchaser to obtain a digital product will be treated the same as the purchase of the digital product itself.⁹ A "digital code" includes a "song code," "video code," or "book code" that allows the purchaser to obtain the product.¹⁰

SSUTA Impact

As a result of the amendments adopted in 2007, several SSUTA member states have enacted legislation specifically imposing tax on certain digital products. Member states that adopted legislation in 2008 include Indiana,¹¹ Nebraska,¹² and South Dakota,¹³ along with SSUTA associate members¹⁴ Tennessee¹⁵ and Utah.¹⁶ They were joined by Kentucky,¹⁷ Vermont¹⁸ and Washington State¹⁹ in 2009. With the exception of Vermont, each of these states took the position that it had previously imposed tax on some digital products and the enactments were necessary to meet the separate imposition requirement of the SSUTA and to clarify the taxability of digital products in the state. Imposition of the tax on digital goods resulted in an expansion of the tax base in Vermont. Also this year, as part of its overall legislation to conform its sales tax to the SSUTA, Wisconsin adopted

⁷ SSUTA § 332D.

⁸ *Id.*

⁹ SSUTA § 332G.

¹⁰ *Id.*

¹¹ S.B. 233, 116th Gen. Assem., 1st Reg. Sess. (Ind. 2008).

¹² L.B. 916, 100th Leg., 2d Sess. (Neb. 2008).

¹³ H.B. 1010, 83rd Legis. Assem., Reg. Sess (S.D. 2008).

¹⁴ An associate member is one that has adopted the various provisions of the SSUTA, but some of the provisions are not yet effective, or one that has adopted most of the provisions and is expected to adopt the remainder by a date certain.

¹⁵ S.B. 4173, 105th Gen. Assem., 2d Sess. (Tenn. 2008).

¹⁶ H.B. 206, 58th Leg., Gen. Sess. (Utah 2008).

¹⁷ H.B. 347, 2009 Leg., 2009 Reg. Sess. (Ky. 2009).

¹⁸ H.B. 441, 70th Biennial Sess., 2009 Special Sess. (Vt. 2009).

¹⁹ H.B. 2075, 61st Leg., 2009 Reg. Sess. (Wash. 2009).

legislation imposing its sales tax on certain digital products²⁰ and thus expanding its sales and use tax base.

In addition to these states, SSUTA members Minnesota²¹ and North Carolina²² considered legislation this year that would impose tax on certain digital products and that, as in Wisconsin, would mean an expansion of the current tax base in each state. Another SSUTA member, North Dakota, took a different approach: It adopted the digital product definitions and then passed a law to specifically exempt those products from taxation.²³

The actions of the SSUTA Governing Board to improve clarity around the states' taxation of digital products have had an impact beyond the contours of the member (and associate member) states. Mississippi,²⁴ a non-member state, adopted legislation this year imposing tax on the three specified digital products using the SSUTA definitions. In addition, legislation based in part on the SSUTA definitions has been considered in New York and California in the last two years.²⁵

Definitional Uniformity May Not Equal Taxability Uniformity

The SSUTA project has gone a long way to provide needed transparency regarding the taxability of digital products in member and other states. However, taxpayers should remember that the SSUTA is not intended to dictate the taxability of a specific product or service but rather to require member states to adhere to certain definitional provisions.²⁶ As such, there is still significant variance, even among member states, as to whether and to what extent digital products are taxable in a particular state.

For example, several states—Indiana, Mississippi, Nebraska, and Tennessee—have chosen to tax only the three defined types of digital products.²⁷ Wisconsin

²⁰ S.B. 62, 99th Legis. Sess., 2009-2010 Reg. Sess. (Wis. 2009). Wisconsin's petition for SSUTA membership was accepted in May 2009, and the state will become an associate member on July 1, 2009, and a full member effective October 1, 2009.

²¹ H.F. 2323, 86th Leg., 2009-2010 Reg. Sess (Minn. 2009).

²² H.B. 558, 2009 Gen. Assem., Reg. Sess. (N.C. 2009).

²³ S.B. 2347, 61st Gen. Assem., Reg. Sess. (N.D. 2009).

²⁴ H.B. 1461, 2009 Miss. Leg., 2009 Reg. Sess. (Miss. 2009).

²⁵ See 2009-2010 New York State Executive Budget, Revenue Article VII Legislation, Part CC. See *also* A.B. 1956, 2008 Gen. Assem., 2007-08 Reg. Sess. (Cal. 2008).

²⁶ SSUTA § 103.

²⁷ S.B. 233, 116th Gen. Assem., 1st Reg. Sess. (Ind. 2008); H.B. 1461, 2009 Miss. Leg., 2009 Reg. Sess. (Miss. 2009); L.B. 916, 100th Leg., 2d Sess. (Neb. 2008); S.B. 4173, 105th Gen. Assem., 2d Sess. (Tenn. 2008).

taxes not only these products, but also other enumerated digital products, including electronically transferred greeting cards, finished artwork, periodicals, and video or electronic games, unless the state already exempts the same product(s) sold in tangible form.²⁸ Like Wisconsin, Kentucky has chosen to tax specific digital items (*i.e.*, finished artwork, digital photographs, periodicals, newspapers, “digital audio works,” and “digital books”) but not “digital audio-visual works.”²⁹ Vermont has chosen to tax the three defined types of digital products plus ringtones.³⁰

In Washington State, “digital goods,” a term broadly defined to include the three specifically defined digital products in the SSUTA as well as other “sounds, images, data, facts, or information ... transferred electronically,” are subject to tax.³¹ However, certain products and services, including personal or professional services when the results of the work are delivered electronically, various digital goods purchased solely for business purposes, electronic public records, and certain newspapers delivered electronically, are specifically exempt.³²

Interestingly, Washington State also imposes its sales and use tax on “digital automated services,” defined as “service that is transferred electronically that uses one or more software applications.”³³ Examples of such services include photo sharing services, car history report services, information services, and search engines for which there is a charge. However, certain services, such as lending or transferring money, dispensing cash or physical products from a machine, payment processing, pari-mutuel wagering, online educational programs by accredited education institutions, online classified advertising services, Internet access, and travel agent services are explicitly excluded from the definition of digital automated service.³⁴ The Washington legislation also explicitly taxes “remote access software,” which is prewritten software provided remotely when the buyer pays the seller for the right to access and use the software, which resides on the seller’s server or the server of a third party.

South Dakota appears, for the time being, to have taken the broadest approach to taxing digital products. The state's imposition statute provides that “all sales, leases and rentals of any product transferred electronically”³⁵ are subject to tax.

²⁸ S.B. 62, 99th Legis. Sess., 2009-2010 Reg. Sess. (Wis. 2009).

²⁹ H.B. 347, 2009 Leg., 2009 Reg. Sess. (Ky. 2009).

³⁰ H.B. 441, 70th Biennial Sess., 2009 Special Sess. (Vt. 2009).

³¹ H.B. 2075, 61st Leg., 2009 Reg. Sess. (Wash. 2009).

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ H.B. 1010, 83rd Legis. Assem., Reg. Sess (S.D. 2008).

Utah, apparently to create parity between tangible and digital property, imposes its sales tax on all products that are “transferred electronically” only if those products would be subject to tax if “transferred in a manner other than electronically.”³⁶

More Work to Be Done

Although not perfect, the SSUTA amendments have already provided needed transparency around the taxation of digital products with additional clarity forthcoming when the other amendments discussed above are fully implemented in January 2010. However, adoption of the SSUTA requirements is mandatory only for member states. There are at least 11 other non-member states that have been identified in at least one source³⁷ as imposing tax on certain digital products. They include Alabama, Arizona, Colorado, Connecticut, the District of Columbia, Hawaii, Idaho, Louisiana, Maine, New Mexico, and Texas. It appears that these states may be identified as taxing digital products because their tax regimes fall into one of the following categories: (1) a tax imposed on all goods and services unless specifically exempted (Hawaii and New Mexico); (2) a tax imposed on various computer, information, or data processing services (Connecticut and Texas); or (3) a tax subject to case law indicating that certain digital products are taxable (Alabama).³⁸ For other states, statutory support for the taxability of digital products is not always clear.

Conclusion

State tax law changes generally lag technological developments, which can mean potential uncertainty and risk for purchasers and sellers, a diminution of state tax bases, and dissimilar tax treatment for similar transactions and products. The recent interest of states in considering legislation dealing with the taxation of certain digital products holds potential for improving the transparency and certainty in this area of sales and use taxation. However, to achieve greater transparency, enactment of the SSUTA definitions and other criteria will have to move beyond members of the SSUTA.

³⁶ H.B. 206, 58th Leg., Gen. Sess. (Utah 2008).

³⁷ See Federation of Tax Administrators, *supra* note 1; Condon, *supra* note 1. See also Apple Web site, <http://www.apple.com/support/itunes/store/buy/>, providing information to purchasers of downloaded music from a leading site.

³⁸ *Robert Smith d/b/a FlipFlopFoto v. Ala. Dep't of Revenue*, No. S. 05-1240, 2006 WL 3587184 (Ala. Admin. Law Div. Nov. 17, 2006).

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